

FASB Amends Impairment Guidance for Certain Beneficial Interests

by Randall D. McClanahan

In response to concerns expressed by constituents due to impairment issues arising from the current financial crisis, the FASB recently issued FASB Staff Position EITF 99-20-1, *Amendments to the Impairment Guidance of EITF Issue No. 99-20* (the “FSP”). Prior to the FSP, there were two tests for determining whether the impairment of a debt security was other than temporary, depending on the type of instrument. The FSP basically achieves uniformity by retaining guidance provided in FAS 115, *Accounting for Certain Investments in Debt and Equity Securities*, for (i) the analysis of an “other than temporary impairment” and (ii) the related disclosure requirements.

The classification of an investment as other than temporarily impaired is significant, as the amount of the other than temporary impairment is recognized directly as a reduction in earnings. Temporary impairments in the value of debt securities that are classified as “available for sale” are reported as an unrealized loss in the “other comprehensive income (loss)” area of the income statement, and thus do not result in a reduction of net income. Consequently, there is an incentive for holders of debt securities to classify an investment as temporarily impaired to avoid a reduction in net income.

EITF 99-20, *Recognition of Interest Income and Impairment on Purchased Beneficial Interests and Beneficial Interests that Continue to Be Held by a Transferor in Securitized Financial Assets* (“Issue 99-20”), provides guidance for determining whether beneficial interests in securitized financial assets with contractual cash flows are other than temporarily impaired. Issue 99-20 does not apply to interests in securitized financial assets that are of high credit quality (“AA” rated or higher) and that may not be prepaid or settled in a manner such that the holder receives less than all of its investment. Per Issue 99-20, an impairment is deemed to be other than temporary if there is a decline from one period to another in the best estimate of cash flows from the debt security that a market participant would use in estimating its fair market value.

FAS 115 basically applies to all debt securities other than those covered by Issue 99-20. If a debt security is not covered by Issue 99-20, and is instead covered by FAS 115, an impairment is other than temporary if the holder would probably not be able to collect all amounts contractually due (considering all information, including, but not limited to, market participant assumptions). As a result, there were two potentially different tests for determining whether impairment was other than temporary for holders of debt securities, depending on the type of instrument.

Consequently, the FASB received concerns that in a “dislocated market,” Issue 99-20 would usually result in an other than temporary impairment conclusion, since only market participant assumptions can be used, and since such a market would lead to a conclusion that the security was other than temporarily impaired. In response to the concerns that (i) this “automatic” classification as an impaired security is not desirable,

and (ii) that the impairment tests should be more uniform, the FASB issued the FSP to amend Issue 99-20.

The FSP provides that for beneficial interests in securitized financial assets, the holder must consider all information relevant to the collectability of the security in estimating future cash flows, such as information surrounding past events, current conditions, and reasonable and supportable forecasts. In making these projections of future cash flows, the following are among the aspects that should be considered:

- Remaining payment terms of the security
- Speed of prepayments
- Financial condition of the issuer
- Expected defaults
- Value of any underlying collateral

In making the above analysis, the holder should consider data such as the following:

- Industry analysis reports and forecasts
- Sector credit ratings
- Any other market data applicable to the collectability of future cash flows
- How credit enhancements affect the expected performance of the security
- Whether a security backed by currently performing loans will continue to perform when the required payments increase in the future (for example, a balloon payment)
- How the value of any collateral would affect the expected performance of the security

The FSP cautions against automatically determining that a beneficial interest is temporarily impaired merely because all of the scheduled payments to date have been received. Additionally, the FSP equally cautions against determining that a beneficial interest is other than temporarily impaired because of a decline in fair value. The larger and more severe the decline in fair value, the greater the probability that the holder will not recover all contractually due future cash flows. In summary, the FSP stresses that all factors must be considered.

The FSP is not without controversy. As a result of the FSP, certain beneficial interests that would have been classified as other than temporarily impaired likely will be classified as temporarily impaired, based on management's assumptions as to the collectability of future cash flows. If management is overly optimistic, investors in entities that own such securitized financial assets may not be receiving sufficient or accurate information. Time will tell whether the FSP is more harmful than beneficial to investors.

This FASB will be effective for interim and annual reporting periods ending after December 15, 2008, and will be prospectively applied.

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