

**Accounting for Impairment of Assets**

Mike Foley, Partner, Department of Professional Practice

November 2007, Washington DC

AUDIT

AUDIT • TAX • ADVISORY

## About this session

- ◆ **Address current accounting and auditing developments and practice issues encountered in connection with assessing potential impairment of assets.**

## Agenda

Topic	Page
◆ Other-Than-Temporary Impairment of Debt and Equity Securities (FAS 115)	5
◆ Securities within the scope of EITF 99-20	10
◆ LOCOM Assets	14
◆ Commitments	20
◆ Goodwill and Other Acquired Intangibles (FAS 141 and FAS 142)	25
◆ Other Real Estate Owned (FAS 144)	30



© 2007 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved. KPMG and the KPMG logo are registered trademarks of KPMG International.

3

## Agenda (2)

Topic	Page
◆ Deferred Tax Assets	35
◆ Accounting Considerations Related to Illiquid Credit Market Conditions	38



© 2007 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved. KPMG and the KPMG logo are registered trademarks of KPMG International.

4



## Other-Than-Temporary Impairment of Debt and Equity Securities (FAS 115)

### Three-Step Process

- 1) **Is the investment impaired? – An investment is impaired if the fair value of the investment is less than its cost<sup>1</sup>.**
- 2) **If there is an impairment, is it other-than-temporary?**
- 3) **If it is other-than-temporary, recognize impairment loss in the *income statement*<sup>1</sup>.**

<sup>1</sup>Cost will not necessarily be the amount at which a security is currently recorded on the balance sheet. Losses and gains taken on available-for-sale (AFS) investments that are deferred in Accumulated Other Comprehensive Income (AOCI) do not impact adjusted cost. So writing down an AFS security to its fair value with the loss reported in AOCI does not constitute recognition of impairment.



## Other-Than-Temporary Impairment

- ❑ An entity must have both the intent and ability to hold an impaired security until recovery to conclude the impairment is not other-than-temporary.
- ❑ Sales of securities prior to recovery may raise questions concerning the intent to hold other securities until recovery.
- ❑ Other-than-temporary impairments may result from general market conditions, such as an increase in market interest rates.



© 2007 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved. KPMG and the KPMG logo are registered trademarks of KPMG International.

7

## Indicators of Possible (Other-Than-Temporary) Impairment

**The following examples of factors may indicate that a decline is other-than-temporary:**

- ◆ The length of time and the extent to which the market value has been less than cost.
- ◆ The financial condition and near-term prospects of the issuer.
- ◆ Realization of a loss on subsequent disposition of the investment.
- ◆ Whether the issuer has defaulted on scheduled interest and principal payments
- ◆ Downgrade in ratings by rating agencies.



© 2007 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved. KPMG and the KPMG logo are registered trademarks of KPMG International.

8

## Extensive Disclosures

- ◆ **If an impairment is considered temporary, the following should be disclosed for impaired investments (FSP FAS 115-1/124-1):**
  - A table breaking down underwater investments by category presenting each category's fair value and unrealized losses.
  - Information must be further broken down between investments that have been in a loss position for less than one year, and those in a continuous unrealized loss position for 12 or more months.
  - Qualitative disclosures sufficient to allow financial-statement users to understand both the aggregated, tabular information and the positive and negative information the reporting entity considered in reaching conclusion that impairments were temporary.



© 2007 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved. KPMG and the KPMG logo are registered trademarks of KPMG International.

9



## Securities within the Scope of EITF 99-20

## Scope of EITF 99-20

**Beneficial interests that continue to be held by a transferor in securitization transactions that are accounted for as sales under FAS 140 and purchased beneficial interests in securitized financial assets. The scope includes beneficial interests that:**

- Are either debt securities under Statement 115 or required to be accounted for like debt securities under FAS 115 pursuant to paragraph 14 of Statement 140 (*Financial Assets Subject to Prepayment* such as interest-only strips).
- Involve securitized financial assets that have contractual cash flows.
- Do not result in consolidation of the entity issuing the beneficial interest by the holder of the beneficial interests.
- Are not beneficial interest in securitized financial assets that (1) are of high credit quality and (2) cannot contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment.



© 2007 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved. KPMG and the KPMG logo are registered trademarks of KPMG International.

11

## Special Rules for Beneficial Interests in Securitized Financial Assets

- ◆ **EITF Issue No.99-20 governs how other-than-temporary impairments are to be determined for beneficial interests in securitizations that were accounted for as sales under FAS 140.**
- ◆ **The EITF has a built-in two-step test for other-than-temporary impairments of beneficial interests:**
  - Step 1 – Is the beneficial interest's fair value below its adjusted carrying amount? If yes, proceed to step 2.
  - Step 2 – Is there an *adverse change in estimated cash flows*? If no, no impairment needs to be recognized. If yes, recognize an other-than-temporary impairment.



© 2007 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved. KPMG and the KPMG logo are registered trademarks of KPMG International.

12

## Special Rules for Beneficial Interests in Securitized Financial Assets (Continued)

- ◆ **An *adverse change in estimated cash flows* occurs when the present value of the previously estimated cash flows exceeds the present value of the currently estimated cash flows.**
- ◆ **The present values are calculated using the effective yield currently used to accrete interest income.**



© 2007 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.  
KPMG and the KPMG logo are registered trademarks of KPMG International.

13



## Lower of Cost or Fair Value (LOCOM) Assets

## LOCOM Assets

- Mortgage loans held for sale (FAS 65)
- Nonmortgage loans held for sale (SOP 01-6)
- Long-Lived assets to be disposed of by sale (FAS 144)



© 2007 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved. KPMG and the KPMG logo are registered trademarks of KPMG International.

15

## LOCOM Considerations for Mortgage Loans Held for Resale

- ◆ Any declines in value, including those attributable to changes in credit quality, and recoveries of such declines in value should be accounted as a valuation allowance for held for sale loans, not adjustments to the allowance for loan losses.
- ◆ Purchase discounts on mortgage loans should not be amortized as interest revenue during the period the loans are held for sale.
- ◆ Loan origination fees and the direct loan origination costs as specified in FAS 91 shall be deferred until the related loan is sold.



© 2007 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved. KPMG and the KPMG logo are registered trademarks of KPMG International.

16

## LOCOM Considerations for Mortgage Loans Held for Resale (Continued)

- ◆ **A mortgage loan transferred to a long-term investment classification should be transferred at the lower of cost or fair value on the transfer date.**
- ◆ **A mortgage loan should not be classified as a long-term investment unless the mortgage banking enterprise has both the ability and the intent to hold the loan for the foreseeable future or until maturity.**



© 2007 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved. KPMG and the KPMG logo are registered trademarks of KPMG International.

17

## Fair Value Determination

- ◆ **Fair value of mortgage loans held for sale should be determined by type of loan.**
- ◆ **Either aggregate or individual loan basis maybe used in determining LOCOM for each type of loan.**
- ◆ **Separate determination for committed loans and uncommitted loans.**



© 2007 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved. KPMG and the KPMG logo are registered trademarks of KPMG International.

18

## Disclosures

- ◆ **The method used in determining the lower of cost or fair value of mortgage loans (that is, aggregate or individual loan basis) shall be disclosed.**



© 2007 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved. KPMG and the KPMG logo are registered trademarks of KPMG International.

19



## Commitments

## Commitments to Underwrite Securities

**Forward contracts to purchase securities will be accounted for under FAS 115. At inception, they are designated as held-to-maturity, available-for-sale, or trading.**

### Held-to-Maturity

Changes in fair value would not be recognized unless a decline in the fair value is other-than-temporary

### Available-for-Sale

Changes in fair value would be recognized in other comprehensive income. However, if a decline in fair value is considered other-than-temporary, it would be recognized as impairment charges in earnings.

### Trading

Changes in fair value would be recognized in earnings as they occur.

**Derivatives** – Forward contracts that are derivatives subject to FAS 133 should be recorded as assets or liabilities and measured at fair value.



© 2007 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved. KPMG and the KPMG logo are registered trademarks of KPMG International.

21

## Commitments to Fund Loans that Are Not Debt Securities

- ◆ **Companies must assess their loan commitments to fund loans that are not debt securities based on whether,**
  - 1) the commitment would be considered a derivative under FAS 133 and SAB 105,
  - 2) the company has early adopted FAS 159 and elected to account for loan commitments at fair value,
  - 3) the company applies industry-specific accounting guidance that requires financial instruments to be accounted for at fair value,
  - 4) the company intends to sell the loan upon funding the commitment, or
  - 5) the company has the intent and ability to hold the loan, when funded, for investment in its loan portfolio.



© 2007 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved. KPMG and the KPMG logo are registered trademarks of KPMG International.

22

## Commitments to Fund Loans that Are Not Debt Securities (Continued)

- ◆ **Intention to sell the loan upon funding the commitment**  
There are two acceptable accounting policy alternatives for loan commitments that are (1) not accounted for at fair value under FAS 133, FAS 159, or industry-specific accounting guidance and (2) relate to loans that the company intends to hold for sale:
  - **Alt A** – Lower of cost or fair value model (“LOCOM”)
  - **Alt B** – Under FAS 5

The premise under both alternatives is that it is inappropriate to delay recognition of a loss related to declines in the fair value of a loan commitment until the date a loan is funded and classified as held-for-sale.



© 2007 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved. KPMG and the KPMG logo are registered trademarks of KPMG International.

23

## Commitments to Fund Loans that Are Not Debt Securities (Continued)

- ◆ **Loan to be held for investment** – Loan commitments that (1) are not accounted for at fair value under FAS 133, FAS 159, or industry-specific guidance and (2) relate to loans that a company intends to hold for investment (i.e., for the foreseeable future) should be evaluated for possible credit impairment in accordance with FAS 5 and other relevant guidance.  
**Changes in Intent** – If the company subsequently changes its intent to hold a loan for investment, it should apply its accounting under Alternative A or B (pursuant to a consistently followed accounting policy) through the date that its intent changed, including recording any loss that would be required under Alternative A or B immediately prior to the change in intent.



© 2007 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved. KPMG and the KPMG logo are registered trademarks of KPMG International.

24



## Goodwill and Other Intangibles (FAS 141 and FAS 142)

### Goodwill

- ◆ **Tested for impairment at a level of reporting referred to as a *reporting unit*. Paragraphs 30 to 36 of FAS 142 provide guidance on determining reporting units.**
- ◆ **Impairment is the condition that exists when the carrying amount of goodwill exceeds its implied fair value.**
  - The first step of the goodwill impairment test, used to identify potential impairment, compares the fair value of a reporting unit with its carrying amount including goodwill.
  - The second step of the goodwill impairment test used to measure the amount of impairment loss, compares the implied fair value of reporting unit goodwill with the carrying amount of that goodwill.



## Goodwill (Continued)

- ◆ **The loss recognized cannot exceed the carrying amount of goodwill.**
- ◆ **Goodwill of a reporting unit should be tested for impairment on an annual basis and between annual tests in certain circumstances as described in paragraph 28 of FAS 142.**
- ◆ **After a goodwill impairment loss is recognized, the adjusted carrying amount of goodwill will be its new accounting basis.**
- ◆ **Subsequent reversal of previously recognized goodwill impairment loss is prohibited once the measurement of that loss is completed.**



© 2007 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved. KPMG and the KPMG logo are registered trademarks of KPMG International.

27

## Intangible Assets

- ◆ **An intangible asset subject to amortization should be reviewed for impairment in accordance with FAS 144 by applying the recognition and measurement provisions of that statement.**
- ◆ **An impairment loss is recognized if the carrying amount of an intangible asset is not recoverable and its carrying amount exceeds its fair value.**
- ◆ **An intangible asset that is not subject to amortization should be tested for impairment annually, or more frequently if events or changes in circumstances indicate that the asset might be impaired. The impairment test consists of a comparison of the fair value with carrying amount.**



© 2007 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved. KPMG and the KPMG logo are registered trademarks of KPMG International.

28

## Intangible Assets (Continued)

- ◆ **If the carrying amount exceeds fair value, an impairment loss is recognized in an amount equal to that excess.**
- ◆ **Reversal of previously recognized impairment loss is prohibited.**



© 2007 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.  
KPMG and the KPMG logo are registered trademarks of KPMG International.

29



## Other Real Estate Owned (OREO)

## Other Real Estate Owned

- ◆ **Foreclosed assets**
- ◆ **Real estate investments**
- ◆ **Real estate loans that qualify as investments in real estate**
- ◆ **Premises that are no longer used in operations**



© 2007 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved. KPMG and the KPMG logo are registered trademarks of KPMG International.

31

## Foreclosed Assets

- ◆ **Classified as separate balance-sheet amount or included in other assets in the balance sheet, with separate disclosure in the notes.**
- ◆ **Reported at the lower of carrying amount or fair value less cost to sell in accordance with FAS 144.**



© 2007 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved. KPMG and the KPMG logo are registered trademarks of KPMG International.

32

## Long-Lived Assets to Be Disposed of by Sale

- ◆ **Measured at the lower of its carrying amount or fair value less cost to sell.**
- ◆ **Shall not be depreciated (amortized) while its is classified as held for sale.**
- ◆ **Interest and other expenses shall continue to be accrued.**



© 2007 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved. KPMG and the KPMG logo are registered trademarks of KPMG International.

33

## Long-Lived Assets to Be Held and Used

- ◆ **Tested for recoverability whenever events or changes in circumstances that indicate that the carrying amount may not be recoverable.**
  - Use of undiscounted cash flows to determine recoverability
  - Impairment is measured based on fair value
  - May be necessary to review depreciation estimates and methods when a long-lived asset is tested for recoverability.
  - If an impairment is recognized, the adjusted carrying amount becomes the new cost basis.
  - Impairment loss is included in income from continuing operations before income taxes. If a subtotal such as “income from operations” is presented, it should include the amount of that loss.



© 2007 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved. KPMG and the KPMG logo are registered trademarks of KPMG International.

34



## Deferred Tax Assets

### Deferred Tax Assets

- ◆ **Deferred tax assets are to be recognized for deductible temporary differences and for tax net operating loss (NOL) and credit carryovers.**
- ◆ **The determination of deferred taxes includes reduction of deferred tax assets by a valuation allowance. If based on the weight of available evidence, it is *more likely than not* (a likelihood of more than 50 percent) that some portion or all of the deferred tax assets will not be realized.**
- ◆ **Paragraph 26 of FAS 109 generally requires that a change in the amount of the valuation allowance be recognized in income from continuing operations in the period of change.**



## Deferred Tax Assets (Continued)

- ◆ **Forming conclusion that a valuation allowance is not needed is difficult when there is negative evidence such as cumulative losses in recent years. Other examples of negative evidence include (but are not limited to) the following:**
  - A history of operating loss or tax credit carryforwards expiring unused
  - Unsettled circumstances that, if unfavourably resolved, would adversely affect future operations and profit levels
  - A carryback, carryforward period that is so brief that it would limit realization of tax benefits.
- ◆ **Examples (not prerequisites) of positive evidence that might support a conclusion that a valuation allowance is not needed when there is negative evidence include (but not limited to) the following:**
  - Existing contracts or firm sales backlog that will produce more than enough taxable income
  - An excess of appreciated asset value over the tax basis
  - A strong earnings history exclusive of the loss that created the future deductible amount.



© 2007 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved. KPMG and the KPMG logo are registered trademarks of KPMG International.

37



## Accounting Considerations Related to Illiquid Credit Market Conditions

## Illiquid Markets

- ◆ Recent problems in fixed income markets have led to liquidity issues, which have had an impact on valuations.
- ◆ Further Complicating the Issue are Questions as to the proper measurement of fair value in less liquid markets.
- ◆ The Center of Audit Quality, an entity affiliated with the American Institute of Certified Public Accountants, has issued a series of white papers, including guidance on measuring fair value under the current market conditions.



© 2007 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved. KPMG and the KPMG logo are registered trademarks of KPMG International.

39

## Measurements of Fair Value in Illiquid (or Less Liquid) Markets

- ◆ GAAP defines fair value as the price that would be received to sell the asset or paid to transfer the liability at the measurement date (exit price).
- ◆ It is important to distinguish between an imbalance between supply and demand and a forced or distressed transaction – Market conditions, such as imbalances in supply and demand should be considered when determining the current value.
- ◆ Use of quoted prices in active markets whenever they are available – If market is not considered active due to transaction volume that is insufficient to produce reliable pricing information, observable transactions are still considered as Level 2 inputs.
- ◆ Unobservable (Level 3) inputs shall reflect the assumptions that market participants would use in pricing the asset in a current transactions



© 2007 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved. KPMG and the KPMG logo are registered trademarks of KPMG International.

40

## Q & A



© 2007 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.  
KPMG and the KPMG logo are registered trademarks of KPMG International.