



## DO YOU HAVE UNREALIZED LOSSES ON INVESTMENTS?

*Accounting for investment activities during these tumultuous times is a daunting task – are you ready to apply the complex reporting requirements?*

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*March 5, 2009*

# Other Than Temporary Impairments of Investments

## Today's Objectives

- *Factors Highlighting Importance - How We Got Here*
- *Evaluation and Application Guidance*
- *Disclosure Requirements*
- *Summarize Important Elements*

# A Look Back

- **Accounting Requirements for Valuing Investments:**
  - ✓ For-Profit Entities – January 1, 1994
  - ✓ Not-For-Profit Entities – January 1, 1996
  - ✓ SFAS No. 115 and SFAS No. 124
  
- **Investments Recorded at Fair Value**
  - ✓ Exception – debt securities for which a For-Profit Entity has the positive intent and ability to hold to maturity

# Typical Investment Portfolios

➤ **For Profit:**

- ✓ Cash & cash equivalents, equity securities, corporate bonds, alternative investments

➤ **Not-for-Profit Healthcare:**

- ✓ Mutual funds, municipal bonds, equity securities, corporate bonds

➤ **Not-for-Profit:**

- ✓ Principally cash equivalents, some equity securities and bonds (municipal and corporate)

# How Did We Get Here?

- **Unprecedented Declines in Fair Values**
  - ✓ Unrealized Losses Incurred in Typical Investment Portfolios
  
- **Market Environment**
  - ✓ US
  
  - ✓ Global
  
  - ✓ Volatility of the financial markets

# Dow Jones Industrial Average



# NASDAQ



# S&P 500 Index



# NIKKEI 225



## Not Concerned About Accounting?

- **Prior unrealized losses**
  - ✓ Generally short-term and recoverable (used as a default)
  - ✓ Ordinarily reported outside of “earnings”
    - *Major exception – investments bought for the purpose of selling (trading securities)*
- **Now - evaluating the character of the unrealized loss is critical**
  - ✓ Report unrealized losses within “earnings” (same manner as a realized loss) depending on the character

# What is “Earnings”

- **Not-For-Profit Healthcare Entities – Statement of Activities:**
  - ✓ Income (loss) from operations
  - ✓ Operating income (loss)
- **For-Profit Entities – Statement of Income(Loss)**
  - Net income
- **Not-For-Profit Entities Other Than Healthcare Entities**
  - Do not present a separate financial performance measure of “earnings”



# Not-for-Profit Healthcare Entity

Changes in unrestricted net assets:				
Revenue and gains:				
	Net patient service revenue			\$ 10,000,000
	Contributions			2,000,000
	Investment income			300,000
	Total unrestricted revenue and gains			12,300,000
	Expenses			10,300,000
	Operating Income ("Earnings - Operating Indicator")			2,000,000
	Other unrestricted income, contributions designated for endowment			500,000
	Excess of unrestricted revenue, gains and other support over expense			2,500,000
	Other changes in unrestricted net assets, unrealized loss on investment securities			(100,000)
	Increase in unrestricted net assets			\$ 2,400,000

# For Profit Entity

Revenues			\$ 15,000,000
Cost of sales			10,000,000
Gross profit			5,000,000
Selling, general and administrative			3,000,000
Operating income			2,000,000
Other income (charges):			
Interest expense			600,000
Rental income			(200,000)
Other income			(100,000)
			300,000
Net income ("Earnings")			\$ 1,700,000
Changes in Other Comprehensive Income:			
Balance, beginning			\$ 500,000
Unrealized losses on investments			(200,000)
Balance, ending			\$ 300,000

# Character of Unrealized Losses

- **Temporary**
- **Other-Than Temporary**
  - ✓ Does not mean permanent
  - ✓ When you decide to sell an investment for which its fair value is less than cost and you do not expect the fair value to fully recover before the expected sales date
- **Qualitative criteria must be evaluated to determine the character**

## Evaluating Character and Accounting A Three-Step Process

- **Step 1 – Determine Whether an Investment is Impaired**
- **Step 2 – Evaluate Whether the Impairment is “Other Than Temporary”**
- **Step 3 – If the Impairment is “Other Than Temporary”, Recognize Loss (Difference Between the Cost Fair Value of the Investment) Within “Earnings”**



# Application

*[continued]*

- **Step 1 – Determine Whether an Investment is Impaired**
  - Assessed at the individual security level
    - ✓ *"CUSIP" number*
    - ✓ *Mutual fund, not underlying investment level*
    - ✓ *Debt security – by series issuance and maturity date*
    - ✓ *If impaired, proceed to Step 2*
  - Considered impaired if the fair value of the investment is less than the cost

# Application Step #1 - Example

- General Motors:

Security Name	11/2005 Cost Basis (per Share)	12/31/2008 Fair Value (per Share)
General Motors	22.00	3.20

# Application Step #1 - Example

- General Motors:



# Application

*[continued]*

- **Step 1 – Determine Whether an Investment is Impaired**
  - Assessment occurs in each reporting period:
    - ✓ *External financial statements:*
      - Annual
      - Quarterly or other interim
    - ✓ *Internal financial statement reporting periods, if prepared in accordance with GAAP*

# Application

*[continued]*

- **Step 2 – Evaluate Whether an Impairment is Other Than Temporary**
  - Factors to consider in determining whether an investment is other than temporarily impaired
    - ✓ *Length of time and extent to which the fair value has been less than cost*
    - ✓ *Financial condition and near-term prospects of the issuer*
    - ✓ *Intent and ability of the holder to retain its investment for a period of time sufficient to allow for any anticipated recovery in market value*
    - ✓ *Recognized losses on security after the reporting period.*

# Application

*[continued]*

- **Step 2 – Evaluate Whether an Impairment is Other Than Temporary**
  - Evaluative Process
    - ✓ *Size of investment portfolio*
    - ✓ *Thresholds may be established*
      - Dialogue with investment committee /board of directors
      - Dialogue with external auditors
    - ✓ *Time consuming*

# Application

*[continued]*

- **Step 2 – Evaluate Whether an Impairment is Other Than Temporary**
  - Evaluating:
    - ✓ *Length of time for which the fair value has been less than cost*
    - ✓ *Extent to which the fair value has been less than cost*
    - ✓ *Financial condition and near-term prospects of the issuer:*
      - One year target price
      - Suspension of dividends
      - Default on debt obligations
      - Moody's and S&P ratings
      - Industry factors

# Application Step #2 – Example #1

- General Motors:



# Application Step #2 – Example #1

- General Motors: ([finance.yahoo.com](http://finance.yahoo.com))

<b>GEN MOTORS</b> (NYSE: GM)			
After Hours: <b>2.25 0.00 (0.00%)</b> 7:56PM ET			
Last Trade:	<b>2.25</b>	Day's Range:	<b>2.10 - 2.44</b>
Trade Time:	<b>Feb 27</b>	52wk Range:	<b>1.52 - 24.27</b>
Change:	<b>↓ 0.13 (5.46%)</b>	Volume:	<b>12,682,117</b>
Prev Close:	<b>2.38</b>	Avg Vol (3m):	<b>23,094,000</b>
Open:	<b>2.25</b>	Market Cap:	<b>1.37B</b>
Bid:	<b>N/A</b>	P/E (ttm):	<b>N/A</b>
Ask:	<b>N/A</b>	EPS (ttm):	<b>-38.74</b>
1y Target Est:	<b>0.95</b>	Div & Yield:	<b>N/A (N/A)</b>

# Application

*[continued]*

- **Step 2 – Evaluate Whether an Impairment is Other Than Temporary**
  - Application to Debt Securities
    - ✓ *More difficult to evaluate*
      - Fair value information not as readily available
      - Important considerations:
        - *Financial stability of issuer*
        - *Near-term prospects of issuer*
        - *Default on interest payments*
        - *Length of time between evaluation date and maturity date*
        - *Ability of issuer to repay the obligation at maturity*

# Application

*[continued]*

- **Step 2 – Evaluate Whether an Impairment is Other Than Temporary**
  - Evaluating:
    - ✓ *Intent and ability of the holder to retain its investment for a period of time sufficient to allow for any anticipated recovery in fair value:*
      - Use of outside investment manager with discretionary authority

# Application

*[continued]*

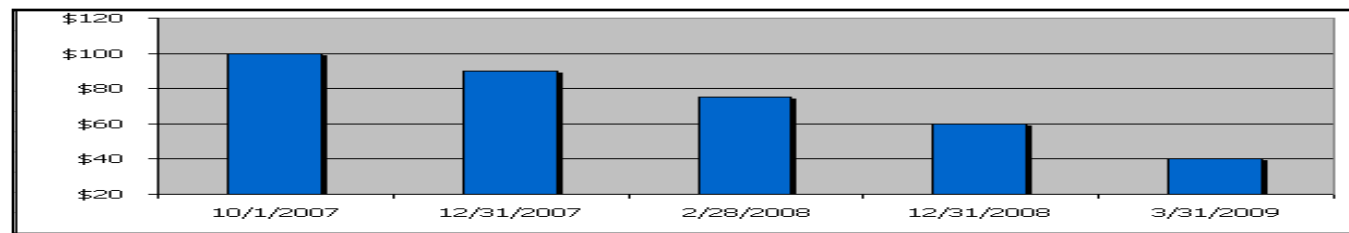
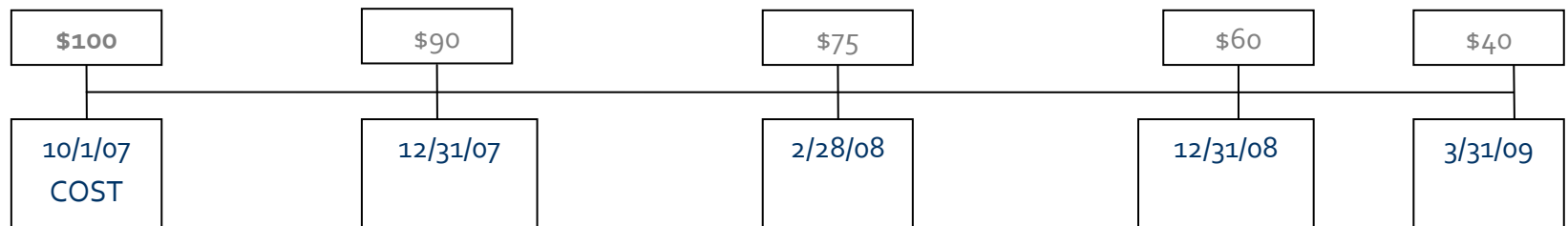
- **Retaining intent and ability when using an outside investment manager with discretionary authority:**
  - ✓ *Review investment policies for existing substantive restrictions*
  - ✓ *Require entity advanced approval for sale of investments with unrealized losses*

# Application

*[continued]*

**Examples demonstrating  
the application of  
qualitative factors**

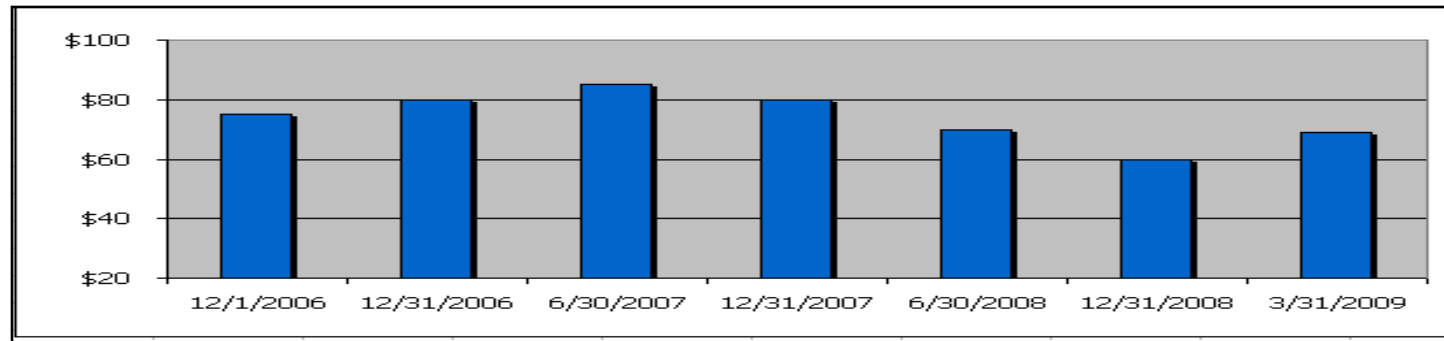
## Application Step #2 - Example #2



- Is the investment other than temporarily impaired?

## Application Step #2 - Example #3

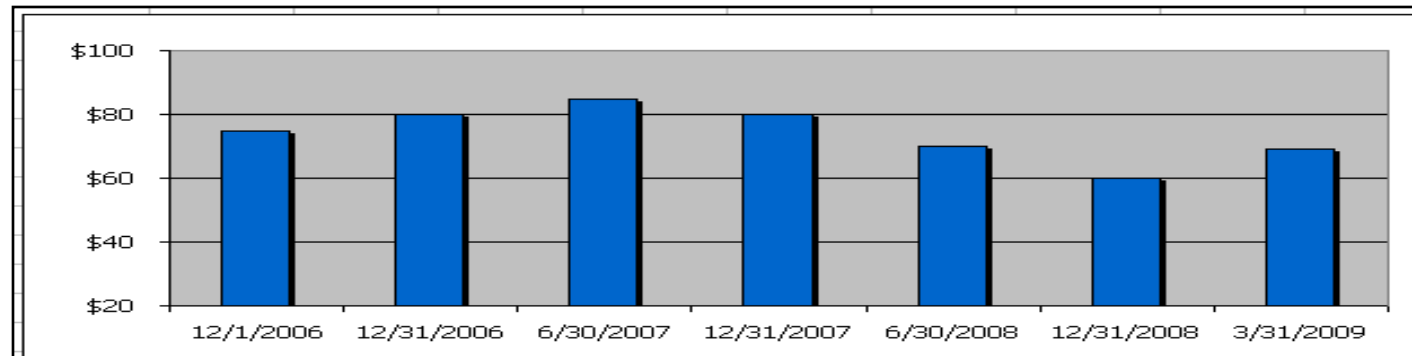
\$75	\$80	\$85	\$80	\$70	\$60	\$69
12/1/06 COST	12/31/06	6/30/07	12/31/07	6/30/08	12/31/08	3/31/09



- Is the investment other than temporarily impaired?

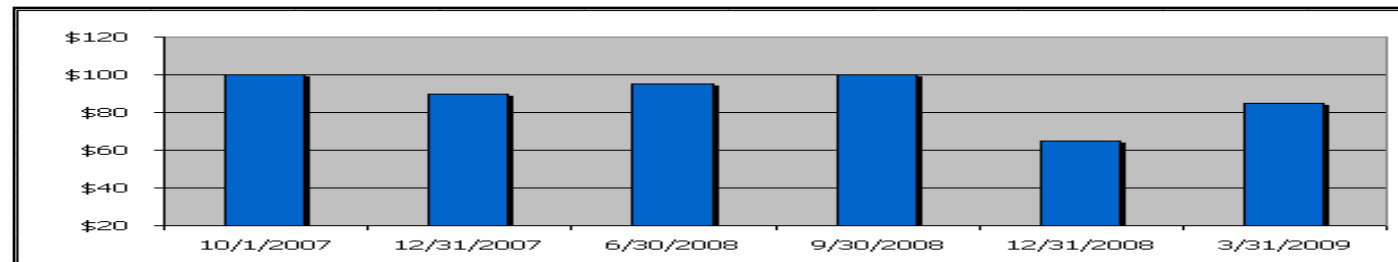
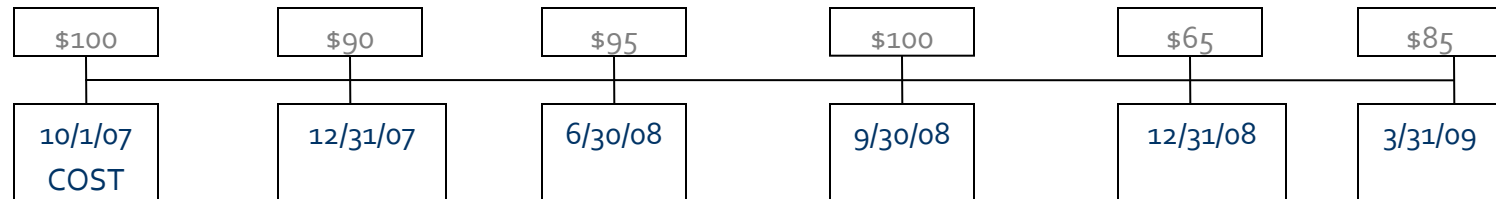
## Application Step #2 - Example #4

\$75	\$80	\$85	\$80	\$70	\$60	\$69
12/1/06 COST	12/31/06	6/30/07	12/31/07	6/30/08	12/31/08	3/31/09 SOLD



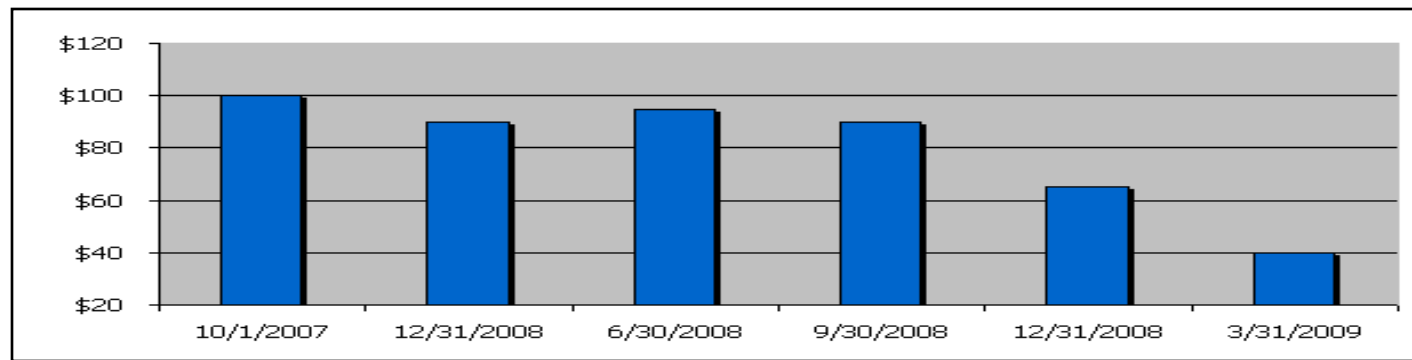
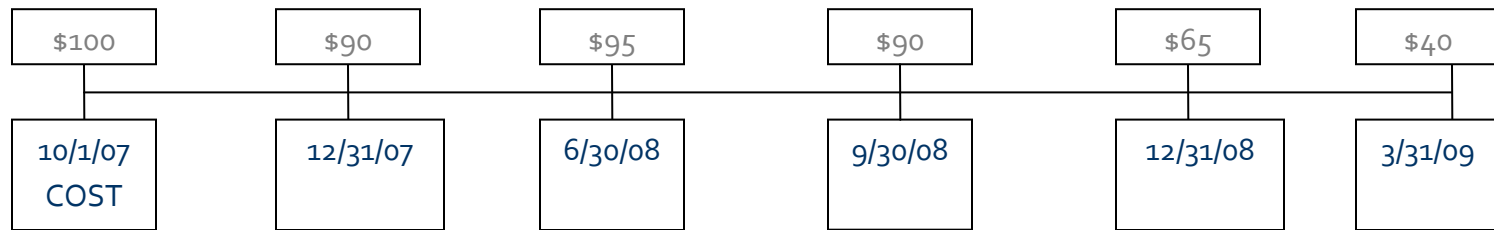
- Is the investment other than temporarily impaired?

## Application Step #2 - Example #5



- Assume the market began to decline on 9/30/08.
- Is the investment other than temporarily impaired?

## Application Step #2 - Example #6



- Assume the market began to decline on 9/30/08.
- Is the investment other than temporarily impaired?

## Questions on Step 2?

# Application

[continued]

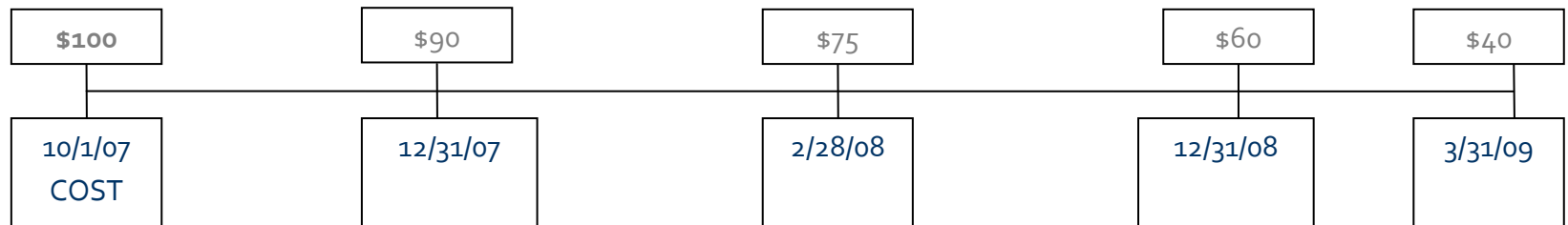
- **Step 3 – If the Impairment is Other Than Temporary, Recognize an Impairment Loss Equal to the Difference Between the Investment’s Cost and its Fair Value**
  - Impairment loss recognized is equal to the entire difference between the investment’s cost and its fair value at the reporting period
    - ✓ *This also includes recognizing as a realized loss previously recognized as an unrealized loss.*

# Application Step #3 – Example #1

- General Motors:

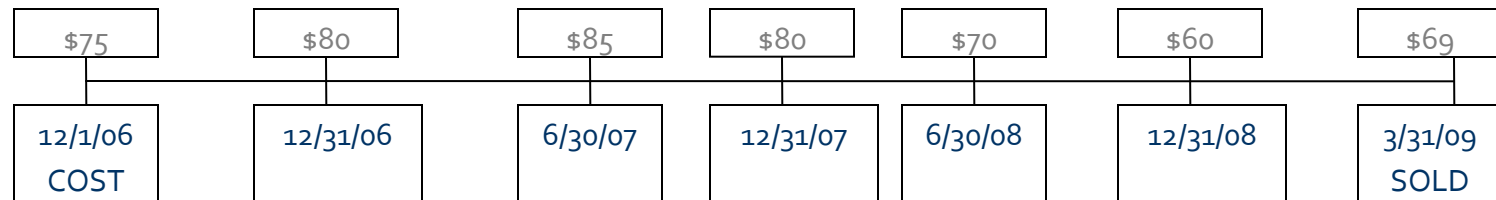
Security Name	11/2005 Cost Basis (per Share)	12/31/2008 Fair Value (per Share)	1 Year Target Price	Length of Time in Continuous Loss position (in Months thru 2/27/09)	Unrealized loss realized through sale after reporting date	OTTI LOSS (COST less FAIR VALUE at Reporting Date PER SHARE)
General Motors	22.00	3.20	0.95	14.00	NO	(18.80)

## Application Step #3 - Example #2



- What should be the OTTI loss recorded?

## Application Step #3 - Example #3



- What should be the OTTI loss recorded?

# Application

[continued]

- **Step 3 – If the Impairment is Other Than Temporary, Recognize an Impairment Loss Equal to the Difference Between the Investment’s Cost and its Fair Value**
  - Such loss should be recognized in determination of earnings during the period in which it occurs
  - Value to which the security is written down becomes new cost basis of the investment
  - Shall not be adjusted for subsequent recoveries in fair value

## Application Step #3 - Example #4A For Profit Entity

**Cost basis: \$75,000**

**Fair value: \$50,000**

**Impairment Loss: \$25,000**

- How should the decrease in fair value be recorded?



## For Profit – Before and After OTTI

	Temporary	Other-Than-Temporary
Revenues	\$ 15,000,000	\$ 15,000,000
Cost of sales	10,000,000	10,000,000
Gross profit	5,000,000	5,000,000
Selling, general and administrative	3,000,000	3,000,000
Operating income	2,000,000	2,000,000
Other income (charges):		
Interest expense	600,000	600,000
Rental income	(200,000)	(200,000)
Other income	(100,000)	(100,000)
Loss on investment securities	300,000	25,000
	300,000	325,000
Net income ("Earnings")	<u>\$ 1,700,000</u>	<u>\$ 1,675,000</u>
Changes in Other Comprehensive Income:		
Balance, beginning	\$ 500,000	500,000
Unrealized losses on investments	(25,000)	-
Balance, ending	<u>\$ 475,000</u>	<u>\$ 500,000</u>
Equity:		
Retained Earnings	\$ 1,200,000	\$ 1,175,000
Other Comprehensive Income	475,000	500,000
Total	<u>\$ 1,675,000</u>	<u>\$ 1,675,000</u>

## Application Step #3 - Example #4B Not-for-Profit Healthcare Entity

**Cost basis: \$75,000**

**Fair value - 12/31/2007: \$76,000**

**Fair value – 12/31/2008: \$50,000**

**2008 Unrealized Loss: \$25,000**

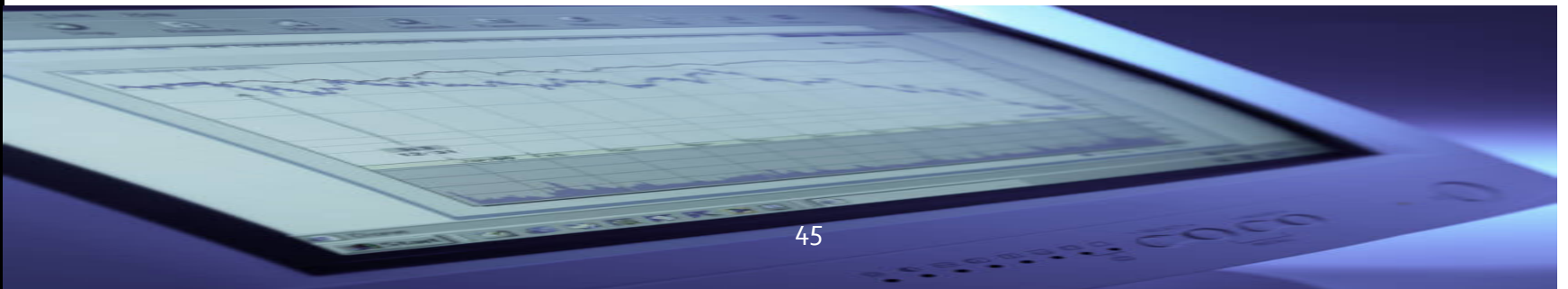
- How should the decrease in fair value be recorded?

## Not-for-Profit Healthcare – Before and After OTTI

	Temporary	Other-Than-Temporary
Changes in unrestricted net assets:		
Revenue and gains:		
Net patient service revenue	\$ 10,000,000	\$ 10,000,000
Contributions	2,000,000	2,000,000
Investment income	-	(25,000)
Total unrestricted revenue and gains	12,000,000	11,975,000
Expenses	10,300,000	10,300,000
Operating Income ("Earnings - Operating Indicator")	1,700,000	1,675,000
Other unrestricted income, contributions designated for endowment	500,000	500,000
Excess of unrestricted revenue, gains and other support over expense	2,200,000	2,175,000
Other changes in unrestricted net assets, unrealized loss on investment securities	(26,000)	(1,000)
Increase in unrestricted net assets	2,174,000	2,174,000
Net assets, beginning of year	3,000,000	3,000,000
Net assets, end of year	\$ 5,174,000	\$ 5,174,000

## Application for Debt Securities

**In periods subsequent to the recognition of an other than temporary impairment loss for debt securities, an investor shall account for the security as if the debt security had been purchased on the measurement date of the other than temporary impairment.**



## Application for Debt Securities - Example

- **Bond Maturity Value (12/31/2015) = \$100**
- **Bond Cost Basis (1/1/2006) = \$90**
- **Original Discount to Amortize = \$10**
  
- **At 12/31/2008 – recorded other than temporary impairment of Bond to \$65**
  
- **New basis for Bond at 12/31/2008 = \$65**
- **Need to amortize discount of \$35 through 1/1/2009 through 12/31/2015**

# Potential Effects of OTTI Accounting

- **Non-compliance with financial covenants in debt arrangements**
  - ✓ Minimum debt-service coverage ratio
  - ✓ Minimum EBITDA calculation
- **Non-compliance with requirement to provide GAAP financial statements if accounting requirements are not implemented**
- **Proactive steps:**
  - ✓ Discuss with lender
  - ✓ Obtain amendment to loan covenant calculations
  - ✓ Discuss with external auditors

# Questions on Step 3?

## Disclosure Requirements

- **For all investments in an unrealized loss position for which other than temporary impairments have not been recognized (realized in net income / operating indicator), an investor shall disclose:**
  - As of the date of the statement of financial position being presented, quantitative information, aggregated by category of investment:
    - ✓ *Aggregate FV of investments with unrealized losses*
    - ✓ *Aggregate amount of unrealized losses*
    - ✓ *Additional information providing sufficient information for reader to understand the quantitative disclosures and information (positive and negative) that was used to determine that the impairment was not other than temporary.*

# Disclosure Requirements

- Example disclosure:**

The following table shows the gross unrealized losses and fair value of the Company's investments with unrealized losses, and the length of time the investments have been in a continuous unrealized loss position as of December 31:

	2008				2007	
	Less than 12 months		More than 12 months		More than 12 months	
	Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses
Mutual funds	\$278,623	\$29,433				
Fixed income funds			\$388,709	\$15,727	\$444,525	\$11,588

The unrealized losses at December 31, 2008 and 2007 relate to five mutual funds investing in other equities and five investments in fixed bond income funds whose value has declined as a result of current market conditions and rising interest rates. Because the Company has the ability and intent to hold these assets until a recovery of fair value occurs, the Company does not consider them to be other-than-temporarily impaired at December 31, 2008 and 2007.

## Disclosure Requirements

- **Disclose significant declines in fair value subsequent to year end**
- **Example disclosure:**

“The fair value of the Company’s investments held at December 31, 2008 which are still held as of March 5, 2009 decreased from approximately \$3,500,000 to \$2,800,000.”

# Questions on Disclosure Requirements?

## Summary

- Unprecedented market conditions – accounting may be different from the past
- Qualitatively evaluate the character of unrealized losses
- Communicate with Investment Committee, Board, and external auditors
- Recognize “Other Than Temporary” losses within “Earnings”
- Be proactive, not reactionary, to potential effects on loan covenant compliance
- Disclose, Disclose, Disclose .....

# Suggested Reading

- **Other Than Temporary Impairment:**
  - Statement of Financial Accounting Standards (SFAS) No. 115 (SFAS No. 124 for NFP)
  - FASB Staff Position FAS 115-1 & FAS 124-1
  - Staff Accounting Bulletin 50





# Other Than Temporary Impairments of Investments

## *Questions?*

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