Issue Analysis 02-1

Recognition of Other-than-Temporary Decline in Investments for Not-for-Profit Organizations

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I. INTRODUCTION

This is the fourth Issue Analysis of the Healthcare Financial Management Association’s Principles and Practices (P&P) Board. The P&P Board writes issue analyses to provide short-term, practical assistance on emerging issues in healthcare financial management. To expedite information to the industry, issue analyses are not sent out for public comment. Therefore, they are factual, but not authoritative. The purpose of IA 02-1, Recognition of Other-than-Temporary Decline in Investments for Not-for-Profit Organizations, is to provide some clarity to the healthcare industry on other-than-temporary impairment.

II. SUMMARY

In the 1990s, the overall trend in equities was a stable and increasing market, although there was some fluctuation and selected individual equities experienced significant losses. The experience from 2000 to 2002, however, has been anything but stable. Recent events suggest that the significant declines in the overall market may take several years, if ever, to recover. This raises questions about when the losses should be recognized as part of operations.

Many not-for-profit healthcare organizations hold significant amounts of equity investments (in the stocks of individual companies as well as mutual funds and
indexed mutual funds) for which unrealized losses must be recognized due to declines in the fair market value of those investments. Some declines may be other-than-temporary declines in fair value (OTT), as discussed in accounting literature. Since these investments are carried at market value, there is no confusion over the amounts that should be reflected on the balance sheet.

There is a diversity of practice, however, over what constitutes an other-than-temporary impairment and how such impairment should be recognized in the statement of operations. Specifically, bright-line guidance is lacking on which amounts should be included within the performance indicator and which amounts should be presented as other changes in net assets outside the performance indicator. The P&P Board maintains that guidance on these matters should be consistent with the guidance that has been established for for-profit entities.

When an other-than-temporary decline occurs, losses are to be recognized through the income statement and belong in the performance indicator. Temporary unrealized losses on investments that are not considered trading securities are recognized as other changes in net assets and belong outside the performance indicator.

**III. CURRENT TECHNICAL GUIDANCE**

Guidance on other-than-temporary impairment has existed under generally accepted accounting principles (GAAP) for several years. Companies should use guidance in the following publications when determining whether an other-than-temporary impairment exists:

Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 115, Accounting for Certain Investments in Debt and Equity Securities (FAS No. 115). The FASB states in paragraph 16 of this statement that for individual securities classified as either available-for-sale or held-to-maturity, an enterprise must determine whether a decline in fair value below the amortized cost basis is other than temporary. If the decline in fair value is judged to be other than temporary, the cost basis of the individual security should be written down to fair value as a new cost basis and the amount of the write-down shall be included in earnings (that is, accounted for as a realized loss). The new cost basis should not be changed for subsequent recoveries in fair value.

FASB Statement of Financial Accounting Standards No. 124, Accounting for Certain Investments Held by Not-for-Profit Organizations (FAS No. 124). Although FAS No. 124 does not specifically address other-than-temporary declines, it provides useful guidance on investment reporting. All not-for-profit healthcare organizations should report their investments in marketable equity and debt securities at fair value, with gains and losses reported in the statement of activities or operations.

**The American Institute of Certified Public Accountants (AICPA) Audit and Accounting Guide, Health Care Organizations.** The guide requires the use of a performance indicator in the statement of operations. It states that unrealized gains and losses on securities classified as trading are reported in the performance indicator, while unrealized gains and losses on securities not classified as trading that are deemed to be temporary are reported below the performance indicator. Unless specifically restricted by donors or by law, all investment income, realized gains and losses, and other-than-temporary impairment losses on all securities should be reported in the performance indicator.

AICPA Statement on Auditing Standards No. 92, Auditing Derivative Instruments, Hedging Activities, and Investments in Securities (SAS No. 92). SAS No. 92 provides additional guidance on the types of indicators that would generally require an evaluation of whether or not a decline in fair value is other-than-temporary.

Securities and Exchange Commission (SEC) Staff Accounting Bulletin No. 59, Accounting for Noncurrent Marketable Equity Securities (SAB No. 59). SAB No. 59 gives examples of factors that, individually or in combination, indicate that a decline is other-than-temporary and that a write-down of the carrying value is required. SAB No. 59 (Topic 5M) emphasizes that the phrase "other-than-temporary" should not be interpreted as meaning "permanent."

**SEC Accounting and Auditing Enforcement Releases (AAERs).** The SEC has taken action when other-than-temporary declines in value were not reported appropriately. In several AAER releases, the commission observed that a registrant’s assessment of the realizable value of a marketable security should begin with its contemporaneous market price, which reflects the market’s most recent evaluation of all available information. Objective evidence is required to support a realizable value in excess of a contemporaneous market price.

Additional guidance on other-than-temporary declines is listed in Appendix A.
IV. INDICATORS THAT A DECLINE IS OTHER-THAN-TEMPORARY

An assessment of whether investments have been impaired should be based on individual investments, not on an aggregated basis. Unrealized gains in some investments should not be netted against unrealized losses in others, thereby avoiding a possible impairment write-down.

A. Major Indicators

The following indicators should prompt an evaluation of whether or not a decline in fair value is other-than-temporary. These indicators are discussed in SAS No. 92, and also addressed in SAB No. 59 and SEC enforcement actions.

Fair value is below cost. The primary indicator is that the investment’s fair value is significantly below cost. There is a wide diversity of practice on what level constitutes a “significant” decline. An assessment of existing guidance and current practices suggests that 20 to 25 percent below cost is an appropriate range of decline. However, in some cases a smaller loss may need to be reported as other-than-temporary (for example, if sustained for an extended period of time).

An extended period of decline. Another important indicator is that the decline has existed for an extended period of time. As emphasized in SAB No. 59, other-than-temporary does not mean permanent. Again, there is a wide diversity of practice on the duration of the decline. An assessment of existing guidance and current practices suggests that a duration of six to nine months is an appropriate indicator that the impairment is other-than-temporary.

It’s important to note that a shorter period of decline in the value of a security is not a valid reason to reject a determination of an other-than-temporary impairment if other compelling factors are present. For example, a sudden drop of 40 to 50 percent in the price of a security could indicate an other-than-temporary impairment, even though the duration is far less than six months.

Lack of intent or ability to hold the security. Additionally, if management has neither the intent nor the ability to hold the security until an anticipated recovery in fair value, the decline in fair value is deemed to be other-than-temporary. The P&P Board believes that when investment managers have been granted discretionary authority over an entity’s holdings, management lacks the ability to hold the security until it recovers. Also, securities that are classified as current are presumed to reflect management’s intention not to hold for an extended period of time.

FAS No. 115 states that in evaluating an available-for-sale security’s decline in fair value below amortized cost, a company should consider management’s intent and ability to retain an investment long enough for the security to recover its fair value. In addition to obtaining the appropriate representations in management’s representation letter, the company should consider whether the company’s cash or working-capital requirements and contractual or regulatory obligations indicate that the security needs to be sold before the projected recovery in fair value.

The company should also consider whether the time frame that management has projected for the recovery of the security’s fair value is reasonable. (In its enforcement releases, the SEC has indicated that practical limitations may restrict management’s ability to make forecasts about periods that lie beyond a reasonable time frame. As the forecasted recovery period lengthens, the uncertainties inherent in the assumptions underlying the projected recovery will lengthen as well.)

B. Additional Indicators

- The decline is attributable to adverse conditions specifically related to the security or to specific conditions in an industry or in a geographic area;
- The security has been downgraded by a rating agency;
- The financial condition of the issuer has deteriorated;
- Dividends have been reduced or eliminated, or scheduled interest payments have not been made;
- The entity recorded losses from the security following the end of the reporting period.

V. EVIDENCE TO SUPPORT AN OTHER-THAN-TEMPORARY DETERMINATION

The duration and extent to which the market value has declined below cost is, on its own, compelling evidence for a write-down. SAB No. 59 states that, “Unless evidence exists to support a realizable value equal to or greater than the carrying value of the investment, a write-down accounted for as a realized loss should be recorded.” To determine whether such evidence exists, management should evaluate the available facts and circumstances, including its investment intent. This evaluation requires the application of significant judgment, although the evidence supporting the realizable value should be objective. Such evidence need
not be literal proof (such as an upgrading of the security’s investment rating by rating companies, or a recovery in market value subsequent to the balance sheet date) but rather could consist of an accumulation of factors about the issuer, the issuer’s industry, or the specific security under consideration. The following paragraphs discuss the types of evidence available.

A. Positive Evidence
If an investment’s fair value declines below cost, the investor must determine whether there is adequate evidence to overcome the presumption that the decline is other-than-temporary. A recovery in fair value after the balance sheet date is the most compelling evidence to support that determination. Additional supporting evidence can come from the issuer’s financial performance and near-term prospects, as indicated by factors such as earnings trends, dividend payments, analysts’ forecasts, asset quality, and specific events. The financial condition and prospects for the issuer’s geographic region and industry can also be included as supplemental positive evidence.

B. Specific Adverse Conditions and General Market Declines
Management is required to consider all relevant information when determining whether a security has underlying factors that may indicate impairment (such as the factors discussed above). The P&P Board believes that the positive evidence required to overcome the need to write down a security’s carrying amount must be verifiable and objective. If an entity believes that the decline in the value of its securities is temporary, it should consider reviewing issuers’ press releases and websites, industry periodicals, and analyst reports. Also useful is a duration analysis, similar to what is used in option-pricing models for evaluations of equity-investment holdings. There may be industries or issuers for which the decline should be considered other-than-temporary, even if the decline has existed for less than six months.

C. Negative Evidence
The positive factors must be weighed against any negative evidence that is gathered about the security. The SEC has noted in SAB No. 59 and various enforcement releases a number of factors and circumstances that, individually or in combination, may indicate that a company needs to write down a security’s carrying amount by way of a charge to income. The indicators discussed in Section IV.A are in themselves negative evidence. Additional factors and circumstances are:

- The issuer’s financial condition and quality of assets is deteriorating, without positive near-term prospects;
- The issuer’s level of earnings or the quality of its assets is below that of its peers;
- The issuer has sustained severe losses in the current year or in both current and prior years;
- Dividend payments have decreased;
- The regulatory, economic, or technological environment has changed in a way that is expected to adversely affect the issuer’s profitability;
- Trading in the security has been suspended;
- A qualification is included in the accountant’s report on the issuer because of the issuer’s liquidity or because of problems that jeopardize the issuer’s ability to continue as a going concern;
- The issuer has announced adverse changes or events, such as changes in senior management, salary reductions or freezes, elimination of positions, sale of assets, or problems with equity investments;
- The issuer’s debt rating has been downgraded;
- The general market condition of either the geographic area or industry in which the issuer operates has weakened, with no immediate prospect of recovery;
- Factors, such as an order or action by a regulator, require an issuer to scale back operations, dispose of significant assets, or otherwise impair its ability to recover the carrying amount of assets;
- The issuer reports unusual changes in reserves (such as loan losses, product liability, or litigation reserves) or inventory write-downs due to changes in market conditions for products;
- The issuer loses a principal customer or supplier; and
- Other factors that raise doubt about the issuer’s ability to continue as a going concern, such as negative cash flows from operations, working-capital deficiencies, investment advisors’ recommendations, or non-compliance with statutory capital requirements.
VI. DOCUMENTATION

Whether a company determines that a decline in fair value of a security below cost is temporary or other-than-temporary, it must contemporaneously document its decision process to support that conclusion. Appropriate documentation would address the positive and negative evidence discussed in Section V. The company should also document its expectations about the security’s performance, based on the information available and its intentions and ability to hold the security or to sell the security within a planned time frame. The documentation should also include the timing of the review and the principal reasons for the decision.

VII. MEASUREMENT OF IMPAIRMENT

FAS No. 115 states that once a company determines that an other-than-temporary impairment exists, the company must write down the investment to fair value on the date that the impairment was determined, regardless of subsequent changes in value that may take place before the company issues its financial statements. Fair value is generally based on market value (the quoted price of a single unit in the most active market), and the impairment is measured only on the balance sheet reporting dates. If there is not an actual traded market, then the security will generally not be accounted for under FAS No. 115 (unless owned by an insurance company). However, a test of other-than-temporary impairment should still be performed.

The write-down to fair value establishes a new cost basis, and the amount of the write-down should be included as a realized loss, a component of investment income (which is included in the performance indicator). Subsequent increases in the fair value of other-than-trading securities should be included in other changes in net assets (or below the performance indicator). Subsequent decreases in fair value, if not an other-than-temporary impairment, also should be included in other changes in net assets (or below the performance indicator).

Providing a general allowance for unidentified impairment in a portfolio of securities is not appropriate (see FAS No. 115 Q&A.48).

After an other-than-temporary impairment has been recognized on a security, the new cost basis shall not be changed for subsequent recoveries in fair value (see FAS No. 115). Subsequently, an unrealized holding gain or loss is determined by comparing an other-than-trading security’s fair value with its new cost basis; increases and decreases in fair value are accounted for in other changes in net assets unless another other-than-temporary impairment occurs. A recovery

in fair value should not be recorded in earnings until the security is sold (see FAS No. 115 Q&A.49).

A. Example

Entity X is held as an investment common stock of Company Y, which is publicly traded on the New York Stock Exchange (NYSE). The investment had an original cost basis of $100, which had fallen to $70 on the NYSE as of the balance sheet date. Entity X determined that the investment was impaired. If Company Y stock were to recover to $75 on the NYSE after the balance sheet date but before the issuance of the financial statements, the other-than-temporary impairment would still be $30 (the original cost basis of $100 less the $70 as of the balance sheet date on which Entity X determined that the investment was impaired).

The information contained in this issue analysis is believed to be current as of the date issued. Validity of the information may decrease in proportion to the time lapse from the issue date.
VIII. APPENDIX A—BIBLIOGRAPHY

Accounting Principles Board (APB)
Opinion No. 18, *The Equity Method of Accounting for Investments*

American Institute of Certified Public Accountants (AICPA)
*AICPA Audit and Accounting Guide, Health Care Organizations*

Financial Accounting Standards Board (FASB)
FASB Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies* (FAS No. 5)
FASB Statement of Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (FAS No. 115)
FASB Statement of Financial Accounting Standards No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations* (FAS No. 124)
Emerging Issues Task Force Issue No. 99–20, *Recognition of Interest Income and Impairment on Certain Investments*

Securities and Exchange Commission (SEC)
SEC Staff Accounting Bulletin No. 59, *Accounting for Noncurrent Marketable Equity Securities* (SAB No. 59)
SEC Accounting and Auditing Enforcement Releases (AAERs)
- In the Matter of Fleet/Norstar (AAER No. 29557);
- In the Matter of Excel Bancorp, Inc. (AAER No. 29675);
- In the Matter of Abington Bancorp, Inc. (AAER No. 30614); and
- In the Matter of Presidential Life Corporation (AAER No. 31934).

IX. APPENDIX B—USEFUL WEB SITES

American Institute of Certified Public Accountants
http://www.aicpa.org/index.htm

Financial Accounting Standards Board (FASB)
http://accounting.rutgers.edu/raw/fasb/

Securities and Exchange Commission (SEC)
http://www.sec.gov

HFMA P&P Board Statements
http://www.hfma.org/resource/P_and_P_board/P_and_P_board_statements.htm

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