Other-Than-Temporary Impairment
A brief analysis of current regulatory and market trends and the related accounting and auditing implications

Background
Although the circumstances surrounding the Dot-com bubble in 2000 may be fading from recent memory, the effects of the Great Recession of 2007/2008 are still being felt from Wall Street to Main Street. These two financial events caused chaos and decreased liquidity in the financial markets. As a result of these two events, the assessment of other-than-temporary impairments (“OTTI”) became a hot button issue that led to significant losses and accounting issues for financial services companies and virtually all companies that held marketable security investments.

The issues caused by OTTI were so severe that they prompted a plethora of enhanced guidance issued by accounting standard setting bodies such as the FASB, IASB, and the NAIC. Both U.S. GAAP and NAIC statutory accounting principles (“SAP”) have issued guidance associated with the determination of OTTI in recent years. At the center of the GAAP and SAP guidance is the determination of management’s intent and ability to hold a particular security until a recovery in cost basis is expected to occur, or in the case of fixed maturity securities whether it is more likely-than-not that a company will be required to sell the security before a recovery in amortized cost.

Despite the enhanced guidance, regulators continue to question the robustness of management’s process in evaluating OTTI as well as the auditors’ approach to challenging such processes, especially qualitative aspects of the related analyses.

Current Market Environment
In recent years, the financial markets have enjoyed generally steady increases in company earnings and falling interest rates which as a whole have boosted both equity and fixed maturity markets. As such, OTTI has not been top of mind during this market environment. However, given that interest rates have been held to historic lows during the last few years by accommodative monetary policy by the Federal Reserve, and equity markets in the United States have been on a five year climb¹, many economists are uneasy about the potential rise in rates with a more hawkish Federal Reserve in the next few years.

¹ http://research.stlouisfed.org/fred2/series/DJIA/downloaddata
There is a growing expectation that increased bond and stock market volatility will occur in the near term while the Federal Reserve begins to undertake the process of unwinding the recent monetary policy (Quantitative Easing or QE) of the last few years. This is likely to bring OTTI back to the forefront of financial reporting for financial services companies as well as companies that hold significant portfolios of marketable securities.

In a recent interview, St Louis Federal Reserve President, James Bullard, said that he believes the “U.S. is no longer in a low-inflation environment and that inflation will continue to tick higher and rise above 2 percent next year.” Bullard reiterated his belief that raising rates by the end of the first quarter in 2015 will be appropriate based on his forecast that U.S. growth will register 3 percent for the next 4 quarters.”

Further, Dean Maki, the chief U.S. economist at Barclays Capital, agrees with Bullard that inflation will likely make a “steady move higher” and surpass the 2 percent target inflation rate set by the Federal Reserve by year end (2014). In turn, Maki believes the Federal Reserve will likely raise interest rates by mid-2015 as he stated that the “markets have not yet priced in an interest rate hike, so the fixed income market could sell off as expectations shift.”

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2 http://www.cnbc.com/id/101781858
3 http://www.cnbc.com/id/101781858
4 http://www.cnbc.com/id/101792845
5 http://www.cnbc.com/id/101792845
Upon closer inspection of the current versus historical interest rate and inflationary environment, it is clear that the market rates are at historical lows and that even a reversion to the mean over the past 34 years would yield a 3.7% increase in the 10 year Treasury bill rate to 6.6% from the current rate of 2.9%. This fact should give pause for concern for all financial services companies and those companies which currently hold significant portfolios of fixed maturity securities. As such, the need for increased focus on the assessment of OTTI as well as the adequate documentation of management’s intent is all the more relevant today in order to avoid costly, untimely write-downs and meet the increased documentation standards expected by regulatory bodies.

**Business Considerations**

With respect to OTTI, one of the areas that may be very sensitive to large and small companies as well as auditors is the documentation supporting the intent and ability to hold (or intent not to sell). Some companies rely on investment reporting vendors to assess OTTI. The investment reporting vendor will typically make an OTTI determination based on certain benchmarks such as the duration a particular holding has been in an unrealized loss position, which according to both GAAP and SAP guidance, is not sufficient in and of itself. Often absent from this determination is the assessment of the financial condition of the investor and whether the investor can reasonably assert its intent and ability to hold to recovery (or intent not to sell).

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6 [http://www.multpl.com/interest-rate/table](http://www.multpl.com/interest-rate/table)

The Company’s evaluation of intent and ability to hold (or intent not to sell) should include a statement as well as corroborating evidence and analysis. Below are some considerations to consider when evaluating the ability and intent to hold:

- **Working Capital** - Does the Company have working capital, regulatory restraints, or debt covenants that could compromise the intent or ability to hold or intent not to sell?

- **Investment Strategies** - Does the Company’s management employ investment strategies or have any financial needs that may undermine management’s ability to assert its intention to hold such as a history of selling investments at a loss; a tax strategy of selling underwater investments to offset capital gains; planned future investments that would require other untimely dispositions of holdings in a loss position; or a management agreement with external portfolio managers that allow the sale of impaired securities without management’s pre-approval?

- **Duration Risk** - Does the duration of the fixed maturity security portfolio correspond and align with normal business operations? For instance, does the portfolio’s scheduled maturities allow for appropriate cash flow given management’s expected frequency and severity of losses?

- **Materiality of Unrealized Losses** - Do the holdings in an unrealized loss position either individually or in aggregate represent a material amount to the financial statements? The more significant the unrealized losses, the more robust management’s documentation should be.

**Audit Considerations**

To avoid surprises, management should have specific and open conversations concerning OTTI with their auditors during the initial planning stages of the audit. During these conversations, management should discuss their OTTI assessment process with focus on the considerations mentioned above.

Companies should expect their auditors to challenge management’s analyses when assessing the reasonableness of certain assumptions, including intent and ability to hold (or intent not to sell). Auditors will likely utilize relevant market information as well other knowledge of a company’s operations in performing their assessment of the appropriateness of such assumptions and assertions.

**Summary**

With the expected increase in interest rates and further market volatility, OTTI will likely be an area of focus for management and auditors alike in coming years. However with careful consideration of current market trends, portfolio exposure, and supportable analyses, both management and auditors can help mitigate costly or untimely future write downs, audit adjustments, and regulatory inspection comments.
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