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Impairment of Sovereign-Debt Investments

As governments throughout the world become less creditworthy, holders of sovereign-debt securities may need to reexamine their financial reporting.

National and local governments frequently borrow cash by issuing debt securities (e.g., U.S. Treasury bonds). Such *sovereign-debt* securities are widely held as investments by many kinds of entities, especially financial institutions and insurance companies. In this month's column, I'll discuss how recent declines in the creditworthiness of many countries have given rise to financial-reporting implications for investors in sovereign-debt securities.

Background

Although sovereign-debt securities typically are backed by the "full faith and credit" of the governments that issue them, entities that invest in such securities still bear some *credit risk*—that is, the risk that debtor governments won't pay principal and interest in full and on time. Naturally, the credit risk associated with a specific sovereign-debt security reflects the creditworthiness of the issuing government, which can change over time. Because an accurate, current assessment of sovereign credit risk is important to both debtor governments and investors, credit-rating agencies (CRAs) routinely assess the credit risk of sovereign-debt securities. The most active and influential CRAs are Standard & Poor's, Moody's, and Fitch.

Greece has emerged as the most prominent recent example of sovereign credit risk. Like most countries, Greece has issued sovereign-debt securities, which generally are referred to as Greek government bonds (GGBs). By mid-2011, CRAs had significantly downgraded GGBs well into "junk" territory as the risk of Greece's default on those obligations grew. Market prices of GGBs hit historical lows, and the cost of buying credit protection against GGB default (e.g., via credit-default swaps) hit historical highs. At that point, creditors weren't concerned with *whether* they would "take a haircut" on GGBs—it was *how much*.

But Greece isn't the only recent example of the increasing riskiness of holding sovereign-debt securities. On August 5, 2011, Standard & Poor's downgraded the credit rating of the United States's long-term sovereign debt from AAA (the highest rating) to AA+ (the next-highest rating). Interestingly, while market prices of most investment assets declined globally as investors perceived them to be more risky in absolute terms than they had previously thought, market prices of downgraded U.S. sovereign-debt instruments actually rose as investors shifted their asset allocations to investments that were relatively less risky. Investors still widely considered U.S. Treasury securities to be the least risky investment of any kind.

More recently, on January 13, 2012, Standard & Poor's downgraded the sovereign debt of nine eurozone countries. Most notably, France and Austria, which held AAA ratings, were downgraded to AA+ status. Italy and Spain, while significantly downgraded, maintained investment-grade ratings (BBB+ and A, respectively). Faring worst were Portugal and Cyprus, whose sovereign debt was downgraded to junk-grade status (BB and BB+, respectively). Yet market prices for sovereign-debt securities issued by many of the downgraded countries remained relatively stable. This phenomenon likely reflected circumstances in which investors already perceived an accurate level of credit risk before the formal downgrade.

Investors' Financial Reporting

Even though credit-rating downgrades and declines in market prices of sovereign-debt securities have occurred, these events may or may not affect financial reporting by entities that have invested in such securities. Whether an investor entity must alter its reported investment values and/or disclosures depends on which set of financial reporting standards it follows.

In particular, U.S. Generally Accepted Accounting Principles (GAAP) requires each investor entity to periodically assess whether debt securities held as assets, other than securities held for trading purposes, are impaired. Section 320-10-35 (*Investments—Debt and Equity Securities > Overall > Subsequent Measurement*) of the Financial Accounting Standards Board's (FASB) *Accounting Standards Codification*® (ASC) prescribes the specific method of impairment testing to be applied. If debt securities are found to be impaired, Section 320-10-35 also prescribes the method for measuring the amount of impairment. Some of the more distinctive (and controversial) provisions of Section 320-10-35 further specify the portion of the impairment loss that is to be recognized in Net Income vs. Other Comprehensive Income based on the portion of the total impairment that's considered other-than-temporary and the portion of other-than-temporary impairment that's attributable to credit losses vs. other factors.

Accounting for impairment of investments in debt securities under International Financial Reporting Standards (IFRS) is broadly similar, though not identical, to the accounting under U.S. GAAP. Under both sets of standards, regardless of whether or not impairment has been recognized, entities are required to make significant disclosures about the risks and uncertainties associated with sovereign-debt investments.

High-level Reactions

Recent world events related to sovereign debt haven't escaped the attention of standards setters and regulators, who have reacted to the events in various ways. On August 4, 2011, the International Accounting Standards Board (IASB) sent a letter to the European Securities and Markets Authority (ESMA), expressing concern that European reporting entities that are required to follow IFRS weren't doing so, especially with regard to recognizing and measuring impairment of GGBs. The ESMA responded on November 25, 2011, by issuing a public statement regarding sovereign debt in IFRS financial statements, in which the Authority identified specific financial-reporting elements that should have been and should be considered by regulated reporting entities.

More recently, on January 6, 2012, the Division of Corporation Finance of the U.S. Securities & Exchange Commission (SEC) published disclosure guidance regarding European sovereign-debt exposures. As stated in the guidance, the Division "determined that investors would benefit from our providing additional guidance to assist registrants in their assessment of what information about exposures to European countries they should consider disclosing and how they should disclose this information with the goal of greater clarity and comparability." Additionally, on January 17, 2012, the United Kingdom's Financial Reporting Council (FRC) issued "An Update for Directors of Listed Companies: Responding to increased country and currency risk in financial reports," which reinforced and enhanced the recognition, measurement, and disclosure issues raised in the November 2011 ESMA statement.

Key Implications for Reporting Entities

There are three key financial-reporting implications of recent events related to sovereign-debt securities. First, it's important to understand that, under both U.S. GAAP and IFRS, a CRA downgrade, by itself, isn't determinative that the downgraded security is impaired for financial-reporting purposes. At the same time, a decline in market price may, by itself, be determinative of impairment despite the absence of other risk factors, while a rise in market price may, by itself, preclude impairment despite the existence of other risk factors. As always, you must pay close attention to applying the pertinent impairment rules so the correct treatment will result.

Second, under U.S. GAAP, the entity's management may be biased toward treating all impairment of sovereign-debt securities as temporary, or to consider all other-than-temporary impairment as being due to factors other than credit loss, so that the impairment doesn't affect reported net income unfavorably. Preparers' staff and auditors should

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be alert for this bias.

Finally, regardless of whether impairment is or isn't recognized for sovereign-debt investments, full disclosure of the risks and uncertainties associated with such investments has become a high enforcement priority among U.S. and European regulators.

Looking Ahead

For many years, the FASB and the IASB have sought to improve and converge the provisions of U.S. GAAP and IFRS that pertain to financial instruments in general, including impairment. The Boards' joint efforts in this area have been further stimulated by the global financial crisis. At this time, though, despite years of substantive effort, the Boards haven't reached agreement on a better impairment model. But they do agree that a more-forward-looking model is needed in contrast to today's models, which have been heavily criticized for being strictly backward-looking. While a better, converged impairment model might not prevent future financial crises, it may help us blunt the impact of an emerging crisis by providing better information sooner to users of financial statements, especially statements issued by entities that are systemically important to the world's economic health. **SF**

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