

Accounting for Eurozone Sovereign Debt Holdings

Financial Reporting Alert 12-1

January 9, 2012

This alert applies to all entities with holdings of eurozone sovereign debt and outlines accounting and disclosure considerations for affected entities. We recommend that you consult with a professional adviser if you have any questions about the issues addressed in this alert.

Background

In the second quarter of 2011, a decline in the creditworthiness of some eurozone countries became increasingly evident, in particular that of Greece. On July 29, 2011, Deloitte issued a Financial Reporting Alert that concluded that for entities reporting under IFRSs, (1) holdings in Greek government bonds (GGBs) and other loans issued by the Greek state maturing in 2020 or earlier were impaired as of June 30, 2011, and (2) it could not be assumed that post-2020 GGBs were not impaired as of June 30, 2011. Entities holding post-2020 GGBs would have to consider all relevant facts and circumstances. For entities applying U.S. GAAP, the alert indicated that loans issued by the Greek state were impaired (other-than-temporarily impaired in the case of GGBs) as of June 30, 2011, irrespective of the maturity date. The alert also concluded that holdings of debt issued by other eurozone states were not impaired as of June 30, 2011, although it encouraged robust disclosures regarding holdings of both Greek and other eurozone sovereign debt holdings.

Since then, Greece's economic situation has worsened and uncertainty about the creditworthiness of certain other eurozone states, such as Portugal, Ireland, Spain, and Italy, has persisted. In the face of Greece's continuing economic distress, the European Union is again looking at restructuring Greece's debt. In an October 26, 2011, Euro Summit Statement, member states proposed "a voluntary bond exchange with a nominal discount of 50% on notional Greek debt held by private investors."

Impairment Assessment — Holdings of Greek Debt

U.S. GAAP

Our assessment of the application of U.S. GAAP impairment indicators¹ is **that GGBs and other loans that are issued by the Greek state and held by entities applying U.S. GAAP are impaired (other-than-temporarily impaired in the case of GGBs) as of December 31, 2011.**

The measurement of the impairment loss depends on the type of investment:

- *Available-for-sale (AFS) and held-to-maturity debt securities* — ASC 320-10-35-34C and 35-34D state:

If an entity does not intend to sell the security and it is not more likely than not that the entity will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss,^[2] the other-than-temporary impairment shall be separated into both of the following:

- a. The amount representing the credit loss^[3]

- b. The amount related to all other factors.

The amount of the total other-than-temporary impairment related to the credit loss shall be recognized in earnings. The amount of the total other-than-temporary impairment related to other factors shall be recognized in other comprehensive income, net of applicable taxes.

- *Loans* — ASC 310-10-35-22 states, in part, that “a creditor shall measure impairment based on the present value of expected future cash flows discounted at the loan's effective interest rate, except that as a practical expedient, a creditor may measure impairment based on a loan's observable market price, or the fair value of the collateral if the loan is a collateral-dependent loan.”

IFRSs

Our assessment is that **GGBs and other loans issued by the Greek state and held by IFRS-applying entities are impaired as of December 31, 2011**. Paragraph 59 of IAS 39⁴ includes indicators of impairment of which at least three are relevant in this instance (significant financial difficulty of the obligor, the lender's granting a concession to the borrower, and the disappearance of an active market for the asset because of financial difficulties). If there is evidence of impairment, an entity must recognize an impairment loss in profit or loss in accordance with IAS 39. The measurement will depend on how the impaired asset is classified:

- *AFS investments* — The cumulative fair value loss at period-end is recognized in earnings. This applies to assets currently classified as AFS as well as to assets reclassified from AFS in previous periods in which an amount continues to be recognized in other comprehensive income.
- *Loans and receivables and held-to-maturity investments* — The difference between the carrying value and the sum of the best estimate of the recoverable cash flows discounted by the effective interest rate will be recognized in earnings as an impairment loss.

Impairment Assessment — Holdings of Other Eurozone Debt

Generally, loans to other eurozone member states are not considered impaired as of December 31, 2011, under both U.S. GAAP and IFRSs. Under U.S. GAAP (but not IFRSs), holdings of sovereign debt securities issued by such member states are impaired if their fair value is less than their amortized cost basis. In determining whether such impairment should be recognized as an other-than-temporary impairment loss, an entity would assess whether it (1) has the intent to sell the debt security or (2) more likely than not will be required to sell the debt security before its anticipated recovery. If an entity determines that it does not intend to sell an impaired debt security and that it is not more likely than not that it will be required to sell such a security before recovery of the security's amortized cost basis, the entity must assess whether it expects to recover the entire amortized cost basis of the security (i.e., whether a “credit” loss exists as described in ASC 320-10-35-33D).

Sales of Eurozone Sovereign Debt Classified as Held to Maturity

In light of the uncertainty about the creditworthiness of eurozone countries, some entities may contemplate selling eurozone sovereign debt securities that are classified as held to maturity. U.S. GAAP and IFRSs have strict rules for reclassifying securities that remain in the held-to-maturity category (i.e., are not sold).

Under U.S. GAAP, sales of held-to-maturity securities or transfers out of this category that materially contradict management's assertions that it intended to hold those securities to maturity call into question (or “taint”) management's assertions about debt securities remaining in the held-to-maturity category. After such sales or transfers, therefore, an entity may be required to reclassify all remaining securities from the held-to-maturity category to the AFS category. Only sales or transfers in response to certain changing conditions would not call

into question (or materially contradict) management's intent to hold remaining debt securities to maturity, specifically the changes in circumstances outlined in ASC 320-10-25-6 through 25-9 and ASC 320-10-25-14. Notably, sales of a particular issuer's bonds (e.g., GGBs) in response to a significant deterioration in the issuer's creditworthiness would not call into question management's intent to hold bonds issued by other counterparties (e.g., other eurozone or noneurozone issuers).

Similar requirements exist under IAS 39. Paragraph 52 of IAS 39 requires an entity to reclassify all held-to-maturity investments as AFS whenever more than an insignificant amount of such investments is sold or is no longer held with the intent and ability to hold the investments to maturity. However, paragraph AG22(a) of IAS 39 permits an exception to this general requirement when sales before maturity are made in response to "a significant deterioration in the issuer's creditworthiness" after initial recognition.

Disclosures

Transparent disclosures are critical in helping investors understand the financial position and performance of entities that have material exposures to eurozone sovereign debt. An entity should consider providing relevant disclosures regarding both direct and indirect exposures (e.g., guarantees and other financial instruments). On January 6, 2012, the SEC's Division of Corporation Finance issued **Disclosure Guidance: Topic No. 4, *European Sovereign Debt Exposures***, which notes that "[t]his guidance is not a rule, regulation or statement of the Securities and Exchange Commission." However, the release does provide more detailed information regarding the disclosures that the SEC generally expects registrants to provide. Specifically, the SEC states that "[i]n deciding what disclosure is relevant and appropriate for the particular facts of each registrant, [the SEC] encourage[s] registrants to consider the following:

I. Gross Funded Exposure

a. Countries

- i. The basis for the countries selected for disclosure.
- ii. The basis for determining the domicile of the exposure.

b. Type of Counterparty

- i. Separate categories of exposure to Sovereign and Non-Sovereign counterparties.
 1. Sovereign exposures consist of financial instruments entered into with sovereign and local governments.
 2. Non-Sovereign exposures comprise exposure to corporations and financial institutions. To the extent material, separate disclosure may be required between financial and non-financial institutions.

c. Categories of Financial Instruments

- i. Categories to be considered for disclosure include loans and leases, held-to-maturity securities, available-for-sale securities, trading securities, derivatives, and other financial exposures to arrive at a gross funded exposure.
 1. For loans and leases, the gross amount prior to the deduction of the impairment provision and the net amount after impairment provision.
 2. For held-to-maturity securities, the amortized cost basis and the fair value.
 3. For available-for-sale securities, the fair value, and if material, the amortized cost basis.

4. For trading securities, the fair value.
5. For derivative assets, the fair value, except that amount could be offset by the amount of cash collateral applied if separate footnote disclosure quantifying the amount of the offset is provided.
6. For credit default contracts sold, the fair value and notional value of protection sold, along with a description of the events that would trigger payout under the contracts.
7. For other financial exposures, to the extent carried at fair value, the fair value. To the extent carried at amortized cost, the gross amount prior to the deduction of impairment and the net amount after impairment.

II. Unfunded Exposure

- a. The amount of unfunded commitments by type of counterparty and by country.
- b. The key terms and any potential limitations of the counterparty being able to draw down on the facilities.

III. Total Gross Exposure (Funded and Unfunded)

- a. The effect of gross funded exposure and total unfunded exposure should be subtotaled to arrive at total gross exposure as of the balance sheet date, separated between type of counterparty and by country.
- b. Appropriate footnote disclosure may be provided highlighting additional key details, such as maturity information for the exposures.

IV. Effects of Credit Default Protection to Arrive at Net Exposure

- a. The effects of credit default protection purchased separately by counterparty and country.
- b. The fair value and notional value of the purchased credit protection.
- c. The nature of payout or trigger events under the purchased credit protection contracts.
- d. The types of counterparties that the credit protection was purchased from and an indication of the counterparty's credit quality.
- e. Whether credit protection purchased has a shorter maturity date than the bonds or other exposure against which the protection was purchased. If so, clarifying disclosure about this fact and the risks presented by the mismatch of maturity.

V. Other Risk Management Disclosures

- a. How management is monitoring and/or mitigating exposures to the selected countries, including any stress testing performed.
- b. How management is monitoring and/or mitigating the effects of indirect exposure in the analysis of risk. Disclosure should explain how the registrant identifies their indirect exposures, examples of the identified indirect exposures, along with the level of the indirect exposures.
- c. Current developments (rating downgrades, financial relief plans for impacted countries, widening credit spreads, etc) of the identified countries, and how those developments, or changes to them, could impact the registrant's financial condition, results of operations, liquidity or capital resources.

VI. Post-Reporting Date Events

- a. Significant developments since the reporting date and the effects of those events on the reported amounts."

-
- 1 ASC 310-10 and ASC 320-10 provide impairment indicators for loans and debt securities, respectively.
 - 2] ASC 320-10-35-34B states, in part, "If an entity intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss, the other-than-temporary impairment shall be recognized in earnings equal to the entire difference between the investment's amortized cost basis and its fair value at the balance sheet date."
 - 3] ASC 320-10-35-33D states that "[i]n determining whether a credit loss exists, an entity shall use its best estimate of the present value of cash flows expected to be collected from the debt security. One way of estimating that amount would be to consider the methodology described in Section 310-10-35 for measuring an impairment on the basis of the present value of expected future cash flows. Briefly, the entity would discount the expected cash flows at the effective interest rate implicit in the security at the date of acquisition."
 - 4 IAS 39, *Financial Instruments: Recognition and Measurement*.

[Deloitte.com](#) | [Security](#) | [Legal](#) | [Privacy](#)

1633 Broadway
New York, NY 10019-6754



Official Professional Services Sponsor

Professional Services means audit, tax, consulting and financial advisory services.
United States

Copyright © 2012 Deloitte Development LLC. All rights reserved.
36 USC 220506
Member of Deloitte Touche Tohmatsu Limited

To unsubscribe, reply to this message and add "Unsubscribe" in the subject line.

 [Deloitte RSS feeds](#)