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**Proposed FASB Staff Position, Proposed FSP EITF 03-1a, Implementation Guidance for the Application of Paragraph 16 of EITF 03-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments"**

We appreciate the opportunity to comment on the referenced proposed FSP. We are concerned that many preparers will consider the Consensus of EITF 03-1 (the "Consensus") to represent a significant change from how they previously evaluated available for sale securities ("AFS") for other than temporary impairment. We do not support the issuance of the proposed FSP because we now believe, based on the Basis for Conclusions of SFAS 115, the Consensus and FSP would deviate from the original intent of the FASB when the available for sale classification was developed. As such, we believe the guidance provided by both the Consensus and related FSP represents an amendment of SFAS 115 that would not be appropriate through either the EITF process or issuance of an FSP. We believe the FASB should delay the effective date of the Consensus indefinitely until it can accelerate consideration of reporting financial assets and liabilities at fair value or more comprehensively reconsider SFAS 115.

However, should the FASB decide to move forward with the guidance under EITF 03-1 and the related FSP, we recommend certain changes that we also discuss.

**EITF 03-1 Is Inconsistent with the Intent of the AFS Category Under SFAS 115**

We understand that the FASB and certain others believe the Consensus of EITF 03-1 is simply a clarification of SFAS 115 and its related guidance. However, as noted in the comment letters received to date from a wide variety of preparers, general practice has been markedly different than the Consensus model and diverse among preparers with respect to how the concept of other than temporary impairments has been applied to available-for-sale securities. This diversity has been largely enabled by the limited guidance available under SFAS 115 that has been broadly interpreted that, for fixed term debt securities, the OTT consideration focused on securities for which it was probable that the investor would be unable to collect all amounts due according to

the contractual terms of the security (i.e., securities impaired due to credit issues) or for which a positive decision to sell at a loss had been made.

Many preparers have not historically considered high quality securities that were impaired solely due to interest rate changes as other than temporarily impaired because interest rates are in a constant state of movement and the value of these securities would recover, at least at their maturity. This view is not unfounded as it is also applied in IAS 39 as noted in the following excerpt from paragraph 60:

*...A decline in the fair value of a financial asset below its cost or amortised cost is not necessarily evidence of impairment (for example, a decline in the fair value of an investment in a debt instrument that results from an increase in the risk-free interest rate).*

This view also developed from the guidance in SFAS 115 on what constitutes an other than temporary impairment. Many preparers, particularly those in the banking and insurance industries, and their regulators, believe that SFAS 115 acknowledged traditional asset-liability management practices, which are generally considered to represent prudent and economically sound risk management and do not contemplate a positive intent to hold impaired securities until their eventual recovery in value. SFAS 115 clearly acknowledges the need for flexibility to sell investments to meet liquidity needs in discussing the available for sale classification in the basis for conclusions of SFAS 115.

For example, paragraph 82 of SFAS 115 indicates:

*... Additionally, the available-for-sale category will include debt securities that are being held for an unspecified period of time, such as those that the enterprise would consider selling to meet liquidity needs or as part of an enterprise's risk management program.*

Paragraphs 93 and 94 further acknowledge common asset-liability management practices, without suggesting an interaction with the OTT guidance when they state:

*However, some enterprises, particularly financial institutions, that consider both their investments in securities and their liabilities in managing interest rate risk contend that reporting unrealized holding gains and losses on only the investments, and not related liabilities, in earnings has the potential for significant volatility that is unrepresentative of both the way they manage their business and the impact of economic events on the overall enterprise.*

Mr. Lawrence W. Smith

October 29, 2004

Page 3

*Based principally on those concerns, the Board decided that unrealized holding gains and losses on debt and equity securities that are available for sale but that are not actively managed in a trading account should be reported outside earnings—a method of reporting currently used for some securities under Statement 12. That reporting would alleviate the potential for volatility in reported earnings resulting from a requirement to value some assets at fair value without at least permitting fair-value-based accounting for related liabilities. It also would mitigate concerns about reporting the fluctuation in fair value of long-term investments in earnings. However, the Board recognizes that volatility in earnings can still result from the sale of securities...*

Paragraphs 16, as well as 83-114 of SFAS 115 include additional discussions that form the basis for the currently existing view of focusing primarily on a probable default when considering the impairment of fixed income securities. Further, EITF Topic D-44 also supports the view that where collection in accordance with contractual terms was probable, an other than temporary impairment was not present until an affirmative decision was made to sell the security.

The current economic environment has created an increase in the level of impairments within high quality portfolios for many companies. We have experienced a sustained period of falling interest rates that resulted in few prolonged impairments of fixed income investments due to interest rate changes. However, as the level of economic activity increases with the resultant expected increases in interest rate levels, a refocus on what should constitute an other than temporary impairment and how to apply the guidance issued has emerged.

The difference between practice based on SFAS 115 about how to determine OTT impairments and the views of the EITF and FASB staff became apparent when preparers began to fully understand and deal with implementation of the Consensus.

Further, we do not believe that the implementation guidance and the Consensus can be consistently applied. There will be a significant lack of consistency among preparers as a result of the judgmental nature of the guidance, including the determination of when a subsequent sale of an impaired security taints all or portions of the remaining impaired securities, the nature of evidence that should be considered when evaluating an impairment and other factors. For example, the range of views regarding tainting is wide, with some believing a single sale could taint the portfolio and many others believing such tainting has no basis within SFAS 115 unless the security was within a held-to-maturity portfolio. The implementation guidance does not clarify this issue.

Given the significant systems issues that will need to be addressed, as pointed out by several preparers, and the upcoming SOX 404 reporting requirements, we also believe the FASB should

Mr. Lawrence W. Smith

October 29, 2004

Page 4

in any event reconsider its position that it will issue final guidance in this area effective before January 1, 2005

Given this likely lack of comparability among preparers, if the Consensus becomes fully effective, we believe the Board should more diligently reconsider whether an intent-based model for determining other than temporary impairments is operable for SFAS 115 available for sale securities. We believe the Board could help resolve this issue by considering the action below.

We believe in the long run, the Board should accelerate its efforts to consider a more consistent use of fair values for all financial assets and liabilities. This would provide an opportunity to address the symmetry of changes in the fair value of financial assets and liabilities, which represent match funding for many companies. The Board's consideration of this issue should allow a proper comment period and full consideration of the issues involved, including potential volatility in earnings, the impact a resulting model might have on traditional asset-liability management, potential market implications and regulatory concerns. For example, in a recently released report by one of the major rating agencies, it was noted that to the extent match funding is present, they do not consider security impairments recognized due to interest rate changes as having an impact on the financial strength of the company. As such, ratings assigned are not impacted by such changes whether the changes are reflected in earnings or not.

In the meantime, to minimize confusion among preparers and improve consistency until a broader model is considered, we believe a simplified other than temporary impairment approach is more appropriate.

We suggest that guidance under existing literature clarify that OTT impairments occur when:

- a) it is probable that the investor will be unable to collect all amounts due according to the contractual terms of the debt security, (EITF 99-20 would still be applied to securities within its scope);
- b) for equity securities (including those accounted for under the cost method), the decline is sustained or is believed will represent a sustained decline (typically defined as a period of six months or less) absent persuasive evidence that outweighs other evidence to the contrary; or
- c) it is probable that the impaired security will be sold in the near term (defined as typically within one year).

This approach would clarify and bring consistency to existing practice. Additionally, the interim approach above would alleviate many of the systems issues concerning "recycling of income" preparers are facing. Such recycling occurs when an impairment charge is taken on a debt security, lowering the investor's basis, and then the difference between the basis and the

Mr. Lawrence W. Smith

October 29, 2004

Page 5

contractual amounts due and expected to be received is accreted into income under the effective interest method. This recycling would be most prevalent when the impairment was predominantly due to interest rate increases but the cash flows expected to be received remain unchanged.

Should the FASB push forward with the present Consensus and related guidance we have several suggestions, as requested, that we believe will improve the clarity and operability of the Consensus and FSP as provided below.

#### **Comments on Question 1**

We concur with the FASB staff's proposed guidance.

#### **Comments on Question 2**

Given the significance of the guidance under the Consensus, we believe the concept of a "minor impairment" should be deleted from FSP 03-1a. We question whether there is a need for such guidance and believe that the guidance as drafted is ambiguous and would create unwarranted inconsistency in application. To the extent an impairment was small on a security that had frequent and small changes in value, we believe the levels of support for an assertion that the security will recover and will be held until recovery would also not be great. Additionally, preparers are able to apply materiality arguments in complying with the Consensus just as with other guidance.

The notion of what constitutes a "minor impairment" would be very subjective and, as drafted, is focused on a balance sheet evaluation. We believe this focus is not appropriate, as the concern with respect to OTT impairments is the effect the impairment will have on an enterprise's income statement. For example, the declines in fair values for impaired securities may not represent a large percentage of the investments but may be material individually and/or in total to pretax earnings due to the size of the investments, limited pretax income in the period or other factors that are unique to the reporting entity. Additionally, the decision regarding whether securities are other than temporarily impaired may be material in connection with the impact of subsequent sales of impaired securities before recovery if such sales represent a pattern and taint the assertion to hold to recovery similar securities.

If the Board decides to include such a concept, additional clarity should be provided around what the Board means by a "minor impairment." We suggest alternative language such as insignificant, which is likely to be understood as a lower threshold than "minor." The consideration of qualitative factors, such as the historical volatility of the security's price, the components of the decline, including whether they are the result of overall market conditions or

are partially or fully issuer specific, and other relevant factors should be discussed. We do not believe the Board should provide an arbitrary "bright line" quantification such as 5% due to the materiality concerns expressed previously.

Lastly, if the Board decides to provide the notion of "minor impairments" or a similar concept, we do not believe the supporting argument to limit its application to certain impairments under paragraph 16a is persuasive. If the Board believes the notion has merit, we believe it should apply to impairments of all securities under the Consensus.

**Comments on Question 3(a):**

We believe the staff's response to this question is unclear, particularly the last two sentences, and we suggest that further clarification be provided. Companies acknowledge that impaired securities for which it is probable they will not recover all cash flows as contractually due are other than temporarily impaired. However, for all other impaired securities, EITF Topic D-44 and related guidance has been interpreted by many preparers to provide that as long as an explicit decision to sell an impaired security, which by necessity includes an identification of the securities which would be sold, had not been made, the impairment should continue to be considered temporary. For companies taking this position, even if it is probable that impaired securities will be sold in the near term, as long as they have not made an explicit decision to sell specific securities, they believe EITF Topic D-44 allows them to continue to consider the impairments to be temporary.

Based on the FASB discussion at the meeting on September 8, 2004, we believe the intent of the staff's language was to clarify that the model to be applied is one in which the intent to hold is the focus, not the intent to sell. For example, an investor may decide that while it has no current intent to sell impaired securities, it may desire to at some point in the future and no longer can positively assert it will hold until recovery. Under the Consensus, the investor is required to record the impairment as other than temporary at the point it can no longer positively assert it will hold the security to recovery. Any final guidance must clarify the position that changes in a positive intent to hold would, in many cases, occur prior to both an explicit decision to sell impaired securities as well as the identification of which impaired securities would be sold. Once the FSP is finalized, EITF Topic D-44 would no longer be needed and should be rescinded.

**Comments to Question 3(b):**

We believe this question should be applicable to all securities, not just those under paragraph 16. We also believe the debate surrounding when a portfolio becomes "tainted" best illustrates the practical difficulties and inconsistency of application that will be present under the intent-based model of the Consensus. The fact that securities are not typically bought and sold on an

Mr. Lawrence W. Smith

October 29, 2004

Page 7

incremental isolated security basis but that such decisions are considered by how they impact a portfolio as a whole causes further divergence between how investors make decisions and look at impairments and how the Consensus and FSP consider other than temporary impairments. The language in the first two criteria permitting a change in intent due to "Unexpected and Significant" changes in interest rates or liquidity needs is too ambiguous for a topic that will have such critical implications.

We have already heard a wide variety of interpretation of these criteria. For example, some assert that recovery expectations for an impaired security whose decline is solely due to interest rate increases would be based on the forward curve as of the date the assertion to hold is made. Therefore, any future shift in the curve would have been unexpected at the date the assertion was made. Further, they suggest that any change in market conditions or liquidity needs that resulted in selling securities out of an investment portfolio beyond a de minimus level would by definition be significant. They supported this position by asking that we consider the significant time, resources and sophisticated decisions made during the process of analyzing the effect such market changes have on expected future portfolio performance and risk (which would involve duration and yield considerations among others), including asset-liability management policy implications, all resulting in the need to identify the proper mix of individual securities that would be best to sell (and in many cases which additional securities should be purchased).

Some also assert that they do not believe a remaining portfolio should ever be able to be tainted as a result of sales of previously held securities as they view the circumstances surrounding each sale as unique given the change in market and portfolio conditions over time. They correctly point out that a tainting concept is not mentioned in SFAS 115 or related guidance in connection with the AFS classification. However, without a tainting concept, they question what the ramifications would be of making an assertion to hold and then changing that decision. If the FASB moves forward with the Consensus impairment model, we believe the staff should develop examples of situations in which it believes the intent could appropriately change and the security could be sold as well as examples in which such changes and sales would result in tainting. We would be glad to work with the FASB staff to help develop applicable examples.

Lastly, we believe the third criteria concerning a "de minimus" level of sales should be reworded to avoid confusion between the level of sales the FASB believes is permissible and other guidance (for example, the PCAOB's use of de minimus). In keeping with the intent of the criteria as discussed at the Board meeting on September 8, 2004, the staff could revise this criterion to be sales that are both "infrequent and insignificant" or a similar concept.

In addition to the comments above on the questions solicited, please consider the following implementation comments, to the extent the FASB moves forward with the Consensus and FSP guidance:

**Definition of “Substantially All”**

In many cases how “substantially all” is defined will determine whether an impaired security should be evaluated under paragraph 10 or paragraph 16 of the Consensus. As you are aware, the evaluation under paragraph 10 is more restrictive than that under paragraph 16 such that the determination of which paragraph applies is significant.

There are currently divergent views as to whether “substantially all” should be interpreted as greater than 95% or greater than 90% of the investor’s cost must be recoverable. The language in paragraph 10 is consistent with that used in paragraph 14 of SFAS 140. We believe it is commonly understood that more than 90% of the investor’s cost should be recoverable in order for the investor to assert the security cannot be contractually prepaid such that substantially all of the investor’s cost would not be recovered under paragraph 14 of SFAS 140. It would be helpful if the Board also clarified this with respect to the Consensus.

**Forecasted Recoveries for Equity and Debt Securities Under Paragraph 10**

For securities that apply the paragraph 10 model under the Consensus, we believe the staff should consider clarifying what is meant by supporting evidence of a recovery that “outweighs evidence to the contrary”. For example, all known market information is theoretically considered in the price of a publicly traded equity or debt security. Pricing, therefore includes consideration of projected possible outcomes of improvement or deterioration in performance weighted according to probability and risk. As such, we believe the FASB should clarify whether and how an individual investor would be able to overcome the market expectation in order to successfully assert the security will recover in a reasonable period beyond current prices.

**Amnesty for Transfers between Classification Categories within SFAS 115**

Many preparers view the Consensus as a significant amendment of SFAS 115. They believe application of the Consensus will limit their flexibility and therefore the usefulness of the available for sale classification. It is inappropriate to burden preparers with classifications made in previous periods under these circumstances. As such, we believe the Board should consider granting an additional one-time amnesty allowing preparers to reconsider their classification of securities under SFAS 115 on a security-by-security basis.

**Disclosure of Recognized OTT Impairments and Incremental Accretion**

To the extent the FASB moves forward with its current approach, we believe analysts and investors will desire disclosure of impairments recorded in profit and loss from AFS securities,



Mr. Lawrence W. Smith

October 29, 2004

Page 9

particularly those primarily related to interest rate increases. We also believe separate disclosure of the subsequent accretion component in interest income (the "recycling effect") will be requested. All of this will put increasing pressure on preparers' that may conflict with their responsibilities regarding disclosure of Non-GAAP measures. We believe it would be helpful if the staff required such disclosures as part of the disclosure requirements of the Consensus.

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We would be pleased to discuss our comments with the Board members or the FASB staff at your convenience.

Sincerely,

*Ernst + Young LLP*