Deloitte.

Deloitte & Touche LLP Ten Westport Road PO Box 820 Wilton, CT 06897-0820

Tel: +1 203 761 3000 Fax: +1 203 834 2200 www.deloitte.com

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Mr. Lawrence W. Smith
Director, TA&I – FSP
Financial Accounting Standards Board
401 Merritt 7
P. O. Box 5116
Norwalk, CT 06856-5116

Letter of Comment No: 1923 File Reference: EITF03-1A

File Reference No. EITF Issue 03-1-a

Re: Proposed FASB Staff Position EITF Issue 03-1-a

Dear Mr. Smith:

We are pleased to comment on the proposed FASB Staff Position EITF Issue 03-1-a, "Implementation Guidance for the Application of Paragraph 16 of EITF Issue No. 03-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments" (the "proposed FSP").

The Recognition Provisions of Issue 03-1 Are Flawed

The Board should rescind its ratification of the recognition provisions of Issue 03-1 rather than trying to patch the consensus via implementation guidance. The FASB should develop an approach that preparers and auditors can consistently apply and that reduces the possibility of good faith judgments being second-guessed in later periods. Issue 03-1 fails to achieve either of these objectives.

In Appendix A, we recommend a model to replace step 2 of Issue 03-1. Broadly summarized, it focuses on intent to sell, rather than the absence of an intent to hold, and it contains outside boundaries (quantitative and time-related) that determine the recognition of an other-than-temporary impairment. While developing the model, we attempted to avoid the fundamental flaws in Issue 03-1 and to meet the objectives described in the previous paragraph. As we see it, the flaws in Issue 03-1 our model attempts to avoid are described below.

Over-reliance on Intent – Issue 03-1 requires an investor to assert its intent to hold an impaired security until a forecasted recovery of cost. SEC Staff Accounting Bulletin Topic 5.M, "Other Than Temporary Impairment Of Certain Investments In Debt and Equity Securities" lists intent to hold as one consideration, among several others, in determining when an investment is other-than-temporarily impaired. Raising the criterion from a consideration to a requirement creates problems with investment classification under FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities. Our comment letter on proposed FSP EITF Issue 03-1-b, "Effective Date of Paragraph 16 of EITF Issue No. 03-1, The Meaning of Other-Than-

¹ Appendix B contains comments regarding impairment accounting that are outside of the scope of the Proposed FASB Staff Position.

Temporary Impairment and Its Application to Certain Investments" further discusses these classification issues.

The impairment model in Issue 03-1 further complicates one of the problems that Statement 115 identified; intent-based accounting impairs comparability². Management's assertion of an intent to hold cannot be objectively verified. A simple example highlights the difficulty with intent-based accounting. Consider a situation in which an impaired security is sold prior to forecasted recovery (see below for further discussion of forecasted recovery). Management could argue that the sale was the result of a change in forecasted recovery (i.e., just prior to the sale, management recognized an other-than-temporary impairment attributed to a change in management's expectation of recovery), rather than a change in intent. In that case, would management's intent not be called into question for other underwater securities held in the portfolio?

Evidence to Support Market Recoveries — In most situations, Issue 03-1 requires that the investor assemble evidence to support a judgment that an impairment is temporary. We are skeptical that evidence, in any meaningful sense, exists that outweighs the current market's assessment of the value of the investment (with the exception of creditworthy debt instruments described in paragraph 16). Example 2 illustrates the use of evidence to support a conclusion that an impairment is temporary. One could read the fact pattern and reach the opposite conclusion; in spite of the positive announcement, the stock failed to rally to a price that exceeded the investor's cost. Further, the footnote disclosure example fails to provide any insight into the nature of the evidence that satisfied or failed to satisfy the investor with respect to impairments of equity securities. In short, Issue 03-1 lacks helpful guidance that would result in reasonable investors making comparable impairment decisions given similar sets of facts.

Forecasted Recovery Period – Issue 03-1 introduces a forecasted recovery period as an element of recognizing an impairment. The implications of the phrase are unexplained. It is unclear (1) whether an investor must document the dates covered by the forecasted period if it concludes that an impairment is unnecessary, (2) whether the forecasted recovery period can be extended without accounting consequences, or (3) what the accounting consequences are for current forecasts if the investor has a poor historical track record of making reliable forecasts.

Unwarranted Loss Recognition for Certain Debt Securities – Consider an underwater debt security of the type described in paragraph 16 that remains creditworthy despite its decline in value. Because the instrument itself is inherently only temporarily impaired (at maturity, its fair value will equal cost), it is the investor's decision to <u>sell</u> the security that makes the loss other-than-temporary. The model in Issue 03-1 makes it is possible that losses, which neither may be realized nor may be probable of being realized, will be recognized in earnings.

Comments on the Proposed FSP

If the FASB does not agree with our recommendation to substantially revise Step 2 of Issue 03-1, we have several suggestions that will improve the application of the proposed FSP described below.

Limiting the Notion of Minor Impairment – The proposed FSP limits the notion of minor impairment to paragraph 16 securities that are impaired due to interest rate and/or sector spread increases. At a minimum, the notion of minor impairment should be expanded to include all

² Statement 115, Appendix A, paragraph 27 (e)

paragraph 16 debt securities, except when it is probable that the investor will be unable to collect all amounts due according to the contractual terms of the debt security. For example, a AAA security is downgraded to AA; however, all contractual cash flows are expected to be collected. Why should this example be excluded from the scope of minor impairment?

Additionally, we propose expanding the notion of minor impairment to paragraph 10 securities. Impairment analysis under Issue 03-1 requires a significant level of effort on behalf of preparers, especially entities with large portfolios. The requirement to assert intent and ability to hold impaired investments, on a security-by-security basis, is time consuming and costly. Expanding the notion of minor impairment to all securities allows for normal market volatility that may eliminate an impairment in a subsequent period. Thus, the need to document management's intent and forecasted recovery of fair value for these securities is also eliminated.

Defining Minor Impairment – Although the use of "bright-lines" (we prefer the term "boundaries") departs from principles-based standard setting, the resulting consistency benefits financial statement users in certain situations. Recognition of impairments may be one such situation. Certainly bright lines should be avoided when their use detracts from the representational faithfulness of the reported accounting. However, we do not believe the use of boundaries would significantly decrease the quality of the accounting in this area for the following reasons³:

- For securities, the distinction between reporting unrealized gains and losses in earnings (e.g., trading) versus reporting them in other comprehensive income (e.g., available-for-sale) is largely arbitrary. In addition, a decline in fair value is transparent to users of financial statements.
- In our experience, entities rarely take impairments too soon; rather, questions or challenges arise when entities delay impairment recognition. Guidance that contains appropriate boundaries prevents investors from recording other-than-temporary impairments too late.
- Boundaries reduce the likelihood of two different investors, facing similar circumstances, from reaching non-comparable conclusions.

Our view is that the definition of minor impairment should consist of a 10% severity component and a one-year threshold to address the duration of the impairment (i.e., impairment would not be considered minor if it is greater than 10% of the security's cost or has lasted more than one year). The basis for our view is discussed in the following paragraphs.

Without specific guidelines regarding minor impairment, different investors will reach different conclusions without any conceptual reason to explain the difference. The precedent for using a 5% boundary has been established in the Board's discussion on the proposed FSP, while 10% boundaries are commonly used in other sources of GAAP. Either position could be fully supported; however, the disparity in practice would weaken comparability and consistency in financial statement reporting. The 10% boundary is more appropriate in this situation. Many 'normal' market fluctuations exceed 5%. These 'normal' fluctuations should not trigger other-than-temporary impairment analysis.

³ These reasons would also support the use of boundaries in the model proposed in Appendix A.

As suggested by the term "other-than-<u>temporary</u>," the amount of time that an investment is impaired should be considered when assessing whether a minor impairment exists. In requesting comments on the proposed FSP, the staff has focused on defining minor impairment based solely on the severity of the impairment. There is no direct relationship between a small amount (i.e., 5% or less) and the duration of an impairment. We propose that from the date that an entity first determines an investment is impaired, a period of one year should be allowed for a recovery of fair value.

Additional comments -

- Paragraph 7 of the proposed FSP lists several circumstances that do not call into question
 the investor's intent or ability to hold securities to recovery. The FSP would benefit from
 a few examples illustrating these points. Our other comments or questions follow the
 paraphrase of the circumstance below.
 - o Unexpected and significant changes in liquidity needs
 - Would investors need to document what constitutes an expected change in order to identify an unexpected change?
 - Could this represent a very difficult assessment for some investors (e.g., property and casualty insurers)? For example, an entity faces unusually heavy liquidity requirements periodically, say every five or eight years. The entity does not routinely face heavy liquidity needs. In fact if it did, it would then have to use a different business model/price structure to survive if such liquidity needs were annual. Can the investor assert that the periodic and unusually high liquidity needs are unexpected and significant?
 - o Unexpected and significant increases in interest rates and/or sector spreads...
 - Would investors need to document what constitutes an expected change in order to identify an unexpected change?
 - Should the investor's expectation of increases in interest rates and/or sector spreads be based on their own views or incorporate market expectations?
 - Should the word "changes" replace "increases"? This would permit sales in response to unexpected shifts in the shape of the yield curve or nonparallel shifts in the yield curve.
 - o A de minimis volume of sales of securities
 - How is this to be measured (e.g., cumulative over time, period by period, relative to size of portfolio, underwater sales relative to total sales)?
- Adopting the current provisions of Issue 03-1 will have a significant impact on the way
 that many companies manage their investment portfolio. For those investments that
 management would be unwilling to assert an intent to hold, the FSP should permit
 companies, a one-time election to reclass investments from the available-for-sale
 category to the trading category. Unrealized gains and losses associated with the
 reclassified investments would be recognized in earnings in the period in which the
 election is made.
- The Board should carefully consider preparers' concerns when determining the effective date of finalized guidance. Investors with large portfolios may need to significantly enhance systems to better track specific intent, capture reasons for sales, etc.

We appreciate the opportunity to comment on the proposed FSP. If you have any questions concerning our comments, please contact James Johnson at (203) 761-3709 or Robert Uhl at (203) 761-3705.

Yours truly,

Deloitte & Touche LLP

APPENDIX A Suggested Replacement for Step 2 Proposed FASB Staff Position EITF Issue 03-1-a

To fully address the problems discussed in our cover letter, step 2 of the impairment model should be revised. Our proposal employs objective criteria to evaluate whether impairment is other-than-temporary, thus enhancing comparability and consistency in financial reporting.

- For all securities, an investor should recognize an impairment in earnings if either of the following conditions are met:
 - o Management has decided to sell an impaired security. Impairment should be recognized in the period in which the decision to sell is made.
 - The entity does not have the ability to hold an impaired security for the near term. Near term is defined as a period of time not to exceed one year.
- For equity securities (including cost method investments) and debt securities that can
 contractually be prepaid or otherwise settled in such a way that the investor would not
 recover substantially all of its cost, impairment should be recognized no later than when
 either of the following criteria are met:
 - A substantial decline in fair value (we propose a threshold of 30% below cost basis) has occurred, or
 - The cost basis of the investment exceeds its fair value for a prolonged period of time, which we propose to be defined as one year.
- For debt securities that contractually cannot be prepaid or otherwise settled in such a way that the investor would not recover substantially all of its cost, impairment should be recognized when it is probable that the investor will be unable to collect all of the contractual cash flows according to the contractual terms of the investment (unless it was probable, at acquisition, that the investor would be unable to collect all amounts due according to the contractual terms of the investment).

The proposed model addresses each of the flaws within Issue 03-1 that we identified in our cover letter. These points have been summarized below.

Over-reliance on Intent – This model eliminates the requirement of positive intent to hold, and focuses on whether a decision to sell has been made. This model is still intent-based to some extent, however, there is an action (the sale of an investment) to reveal the intent versus the absence of an action (not selling an investment) in the Issue 03-1 model.

Evidence to Support Market Recoveries and Forecasted Recovery Period – The proposed model eliminates the requirement to estimate forecasted recovery of impaired securities and to obtain the evidence supporting such recoveries. These requirements have been replaced with objective boundaries for measuring the severity and duration of impairment. Objective criteria prevent entities from unduly delaying loss recognition and promote consistency in financial reporting.

Unwarranted Loss Recognition for Certain Debt Securities – The risk of recognizing losses prematurely has been mitigated by shifting the focus away from a lack of intent to hold. Impairment for creditworthy securities under paragraph 16 should not be recognized unless management decides to sell an underwater security.

APPENDIX B DELOITTE & TOUCHE LLP COMMENTS Proposed FASB Staff Position EITF Issue 03-1-a

International Convergence

International Accounting Standard 39, Financial Instruments: Recognition and Measurement, (IAS 39) allows for the write-up of previously impaired available-for-sale debt instruments through the income statement in certain cases (see paragraph 70). This represents one of a few differences between international and U.S. accounting standards in the area of recognizing impairments on securities. We encourage the Board to consider the merits of the approach in IAS 39.

LOCOM model under Statement 115, paragraph 16

Paragraph 16 of Statement 115 states in part,

"...if it is probable that the investor will be unable to collect all amounts due according to the *contractual terms* (emphasis added) of a debt security not impaired at acquisition, an other-than-temporary impairment shall be considered to have occurred. (footnote omitted) If the decline in fair value is judged to be other-than-temporary, the cost basis of the individual security shall 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 guidance goes on to state that future increases in fair value shall not affect the new cost basis. Application of this guidance creates a lower-of-cost or market model. Paragraph 16 should advise readers to focus on the *revised cash flows* after taking an initial impairment, rather than the *contractual terms* of the investment.

Reconsider the impairment guidance in EITF Issue No. 99-20

In EITF Issue No. 99-20, Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets, the Task Force provided guidance for when to recognize, in earnings, an impairment of certain beneficial interest in securitized financial assets. This guidance was created in the context of other-than-temporary impairment guidance existing at that time. If the FASB agrees that overall guidance on other-than-temporary impairments should be significantly revised, the Board should also consider revising or rescinding the guidance in this EITF Issue.

Reconsider Statement 115 categories

The available-for-sale category under Statement 115 was intended to be an interim solution to problems that existed in the accounting and reporting practices for debt and equity securities. The Board should consider re-visiting the subject of investment classification under Statement 115 to determine whether the approach is providing decision-useful information to readers of financial statements. Possible alternatives include (i) eliminating the available-for-sale category, leaving just the trading and held-to-maturity categories, or (ii) adopting a full fair value model for all investments. Note that implicit in adopting a full fair value model for all investments would be the requirement to also value the associated liabilities at fair value.