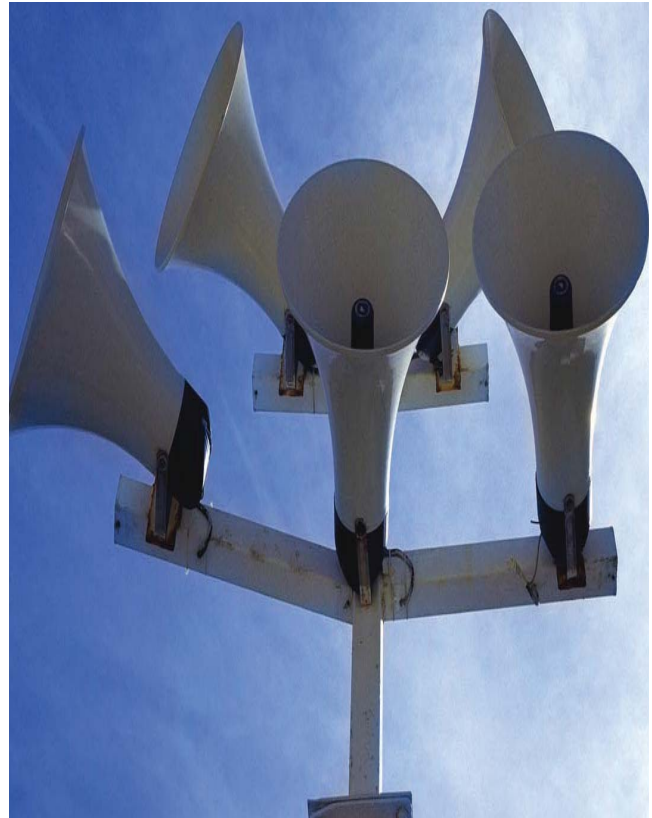


# defining issues<sup>®</sup>

SEPTEMBER 2004 No. 04-15



## ALERT

## FASB to Delay and Modify Guidance on Other-Than-Temporary Impairment

The FASB plans to defer the effective date of the requirement to record impairment losses caused by the effect of increases in interest rates or “sector spreads” on debt securities subject to paragraph 16 of EITF 03-1 and to exclude minor impairments from the requirement.<sup>1</sup> Two proposed FASB Staff Positions would bring the changes into being.<sup>2</sup>

One proposed Staff Position would defer the effective date of the paragraph 16 requirement until new implementation guidance can be issued. The other would provide the new guidance. If these steps are not taken, paragraph 16 will be effective for quarters ending September 30, 2004.

The proposed changes would have no effect on EITF 03-1’s other provisions or on the SEC staff’s guidance on other-than-temporary impairments of debt securities.<sup>3</sup>

- (1) A sector spread is the number of basis points a borrower pays in addition to the benchmark rate common to the borrower’s industry (e.g., the amount above the U.S. Treasury rate for, say, the automotive industry). The proposed Staff Position uses this language to refer to the two interest-rate components: “interest rate and/or sector spread increases.”
- (2) Proposed FASB Staff Position EITF 03-1-b, Effective Date of Paragraph 16 of EITF Issue No. 03-1, “The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments”; Proposed FASB Staff Position EITF 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.”
- (3) SEC Staff Accounting Bulletin No. 59, Accounting for Noncurrent Marketable Equity Securities, September 1985, SAB Topic 5.M, Other Than Temporary Impairment of Certain Investments in Debt and Equity Securities.

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According to EITF 03-1, a security is impaired when its fair value is less than its carrying value, and an impairment is other-than-temporary if the investor does not have the “ability and intent” to hold the investment until a forecasted recovery of its carrying amount. The forecasted recovery date of a debt security may extend to its scheduled maturity.

## EFFECTIVE DATE

Proposed Staff Position EITF 03-1-b would delay the effective date of the relevant paragraph 16 requirement from September 30 until new guidance is effective. At that time companies must assert their “ability and intent” to hold affected debt securities as the basis for not recognizing an impairment loss. Paragraph 16 applies to debt securities that cannot be prepaid and debt securities that cannot be otherwise settled in a way that the investor does not recover its cost.

Proposed Staff Position EITF 03-1-b has a 14-day comment period.

## IMPLEMENTATION—SEVERITY OF THE IMPAIRMENT

EITF 03-1 holds that the impairment of each security must be assessed using the ability-and-intent-to-hold criterion regardless of the severity or amount of the impairment. The criterion may not be applied at the portfolio level. Proposed Staff Position EITF 03-1-a would allow companies to forego that assessment and treat the impairment as temporary if a qualitative analysis determines that the impairment is minor. The FASB Staff asks constituents whether a quantitative threshold should be prescribed to determine the significance of an impairment. For example, an impairment of 5% or less of the cost of the debt security might be considered minor.

## CHANGE IN INTENT

Proposed Staff Position EITF 03-1-a also addresses the effect of a pattern of selling investments on the

investor’s ability and intent to hold other securities until a forecasted recovery of fair value. Under the proposed guidance, sales of interest-rate- or sector-spread-impaired debt securities would not necessarily call into question (“taint”) the investor’s ability and intent to hold other debt securities to a forecasted recovery under the following circumstances:

- Unexpected and significant changes in liquidity needs
- Unexpected and significant increases in interest rates or sector spreads that significantly extend the period that a security would need to be held by the investor
- A de minimis volume of securities sales

Unless the final Staff Position defines the key terms in these criteria clearly enough to facilitate their application, a considerable degree of judgment will have to be brought to bear.

## TRANSITION

Proposed Staff Position EITF 03-1-a is subject to a 44-day comment period and is expected to be issued in final form by December 31, 2004. Its guidance will be effective for other-than-temporary-impairment evaluations of interest-rate- or sector-spread-impaired debt securities for periods ending after it is final and posted. If so, a calendar-year company would have to make an assertion about its “ability and intent” to hold an impaired debt security subject to the provisions of EITF 03-1’s paragraph 16 at December 31, 2004, and the “tainting” provisions of the Staff Position would be effective in the first quarter of 2005.

Other investments within the scope of EITF 03-1 remain subject to its provisions for interim and annual periods beginning after June 15, 2004. The disclosure provisions remain in effect for annual periods ending after June 15, 2004.





## RELATED SEC STAFF BULLETIN

Unless the SEC staff takes new steps, public companies with investments in securities covered by the proposed deferral will have to continue to comply with the provisions of SAB 59 in assessing whether an impairment is other-than-temporary even if the FASB issues the proposals described above. Under SAB 59, public companies should continue to consider, based on the facts and circumstances, the length of time the security has been impaired, the severity of the impairment, and the financial condition and near-term prospects of the issuer of the security.

The descriptive and summary statements above are not intended to substitute for the texts of proposed FASB Staff Positions EITF 03-1-b and EITF 03-1-a and SAB 59 and are not necessarily applicable to any company's particular circumstances. Companies applying the final Staff Positions and SAB 59 should consult the texts of the documents and their accounting and legal advisors.

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