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# SEC Issues Letter Clarifying Other-Than-Temporary Impairment Guidance for Perpetual Preferred Securities

Financial Reporting Alert 08-16 (Revised)

Updated October 17, 2008 (Originally Released October 15, 2008)

**Editor's Note:** This Financial Reporting Alert was revised after informal discussions with the staff of the SEC's Office of the Chief Accountant. Please see the "Update for SEC Staff Discussions" section below.

## Summary

On October 14, 2008, Conrad Hewitt, chief accountant of the SEC's Office of the Chief Accountant (OCA), sent a [letter](#) to FASB Chairman Robert Herz clarifying the OCA's views on the application of the other-than-temporary impairment guidance in Statement 115<sup>1</sup> to certain perpetual preferred securities (PPSs). In his letter, Mr. Hewitt stated that the OCA (after discussion with and agreement by the FASB staff) will not object to registrants' applying an other-than-temporary impairment model to investments in PPSs that possess significant "debt-like" characteristics that is similar to the impairment model applied to debt securities. The OCA's views apply to financial statements issued after the date of the letter (e.g., third-quarter filings issued after October 14, 2008).

Mr. Hewitt stated that the views of the OCA are an intermediate step in addressing certain practice issues related to other-than-temporary impairment guidance and that the OCA has requested that the FASB "expeditiously address issues that have arisen in the application of the OTTI model in Statement 115."

## Background

Recently, questions have been raised regarding the application of the other-than-temporary impairment guidance in Statement 115 to certain PPSs that possess significant "debt-like" characteristics. By nature, the PPSs discussed in the letter do not contain a contractual maturity or other mechanism to allow the holder to put the security back to the issuer. Therefore, these securities are considered equity securities by the holder for purposes of classification in accordance with Statement 115.

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Statement 115 and FSP FAS 115-1/124-1<sup>2</sup> require an entity to recognize an impairment loss on a security if a decline in fair value below cost is considered other-than-temporary. Paragraph 16 of Statement 115 states that an investment in a debt security is considered other-than-temporarily impaired if “it is probable that the investor will be unable to collect all amounts due according to the contractual terms of [the] debt security.” SAB Topic 5.M<sup>3</sup> clarifies that an other-than-temporary impairment is required unless evidence exists to support that an entity will be able to realize an amount “equal to or greater than the carrying value of the investment.”

For declines in value in which there is no evidence of a deterioration in the credit quality of the issuer, whether a security is other-than-temporarily impaired often depends on the characteristics of the security. An investor in a **debt security** may avoid recognizing an other-than-temporary impairment if it has the intent and ability to hold the debt security for a sufficient period to allow for a forecasted recovery in market value<sup>4</sup> (including potentially to maturity). However, an investor in an **equity security** must analyze that security differently. Because an equity security does not have a final contractual cash flow that allows the investor to recover its investment without selling the security into the secondary market, an investor cannot rely solely on its intent and ability to continue holding the security indefinitely to avoid recognizing an other-than-temporary impairment.<sup>5</sup>

## Other-Than-Temporary Impairment Considerations for PPSs

Mr. Hewitt’s letter to Chairman Herz is in response to questions raised regarding whether PPSs are more akin to debt securities or equity securities in the analysis of an impairment. In his letter, Mr. Hewitt acknowledged that many PPSs are structured in equity form but possess significant “debt-like” characteristics, including (1) periodic dividends (e.g., recurring fixed dividend payments or dividend payments that are indexed to market interest rates), (2) call features (e.g., those that allow the issuer of the PPS to redeem the security at par), (3) credit ratings similar to those of debt securities, and (4) pricing similar to that of long-term callable bonds. Because certain PPSs possess characteristics similar to those of debt securities, Mr. Hewitt stated in his letter that the OCA will not object to registrants’ applying an other-than-temporary model to investments in PPSs that possess significant “debt-like” characteristics that is similar to the impairment model applied to debt securities.

Thus, an investor in a PPS with a fair value below cost that **is not** attributable to the credit deterioration of the issuer **may avoid** recognizing an other-than-temporary impairment by asserting that it has the intent and ability to continue holding the PPS for a sufficient period to allow for an anticipated recovery in market value. This assessment may include the intent and ability to hold the PPSs indefinitely.

## Update for SEC Staff Discussions

An entity is permitted to apply the views in Mr. Hewitt’s letter in its financial statements for the reporting period ending on or before the date of the letter (e.g., September 30, 2008) as long as the entity has not yet issued its financial statements (i.e., filed them with the SEC). An entity that issued an earnings release before the date the SEC released its letter, but that has not yet issued its financial statements, is permitted, but not required, to apply the views in Mr. Hewitt’s letter when it issues those financial

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statements.

The SEC staff confirmed that in the assessment of a PPS that does not have any credit deterioration, there is no limit on a forecasted recovery period provided that the entity has the intent and ability to hold the PPS indefinitely. In a manner consistent with paragraph 14 of FSP FAS 115-1/124-1, an investor that decides to sell an impaired PPS must immediately recognize an other-than-temporary impairment if it does not expect the fair value of that security to fully recover before the expected date of sale. In this case, the other-than-temporary impairment must be recognized in the period in which the investor decides to sell the PPS, regardless of when the sale actually occurs.

**Editor's Note:** Application of the views in Mr. Hewitt's letter does not constitute a change in accounting principle under Statement 154.<sup>6</sup> However, the SEC staff is encouraging registrants to disclose, in the notes to the financial statements, the model used to determine whether a security is considered other-than-temporarily impaired (e.g., Statement 115, Issue 99-20). In addition, Mr. Hewitt's letter encourages disclosure of the information considered in concluding that an impairment of a PPS is not other-than-temporary.

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- 1 FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*.
  - 2 FASB Staff Position No. FAS 115-1/124-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments."
  - 3 SEC Staff Accounting Bulletin Topic 5.M, "Other Than Temporary Impairment of Certain Investments in Debt and Equity Securities."
  - 4 If the investor does not have the intent and ability to hold the security for a sufficient period to allow for an anticipated recovery in market value, the security is automatically considered other-than-temporarily impaired.
  - 5 In Section II(H)(1) of the SEC's Current Accounting and Disclosure Issues in the Division of Corporation Finance (as updated November 30, 2006), the SEC staff stated, "Since the typical equity security does not have a contractual cash flow at maturity on which to rely, an investor's intent and ability to hold an equity security for a reasonable period of time should be analyzed differently than a typical debt security. The ability to hold an equity security indefinitely would not, by itself, allow an investor to avoid an other-than-temporary impairment."
  - 6 FASB Statement No. 154, *Accounting Changes and Error Corrections* — a replacement of APB Opinion No. 20 and FASB Statement No. 3.
  - 7 EITF Issue No. 99-20, "Recognition of Interest Income and Impairment on Purchased Beneficial Interests and Beneficial Interests That Continue to Be Held by a Transferor in Securitization Financial Assets."

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