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September 1, 2010

Mr. Robert Herz Financial Accounting Standards Board 401 Merritt 7 PO Box 5116 Norwalk, CT 06856-5116

Re: File Reference No. 1810-100 – Proposed Accounting Standards Update: Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities, Financial Instruments (Topic 825) and Derivatives and Hedging (Topic 815)

Dear Mr. Herz:

Thank you for the opportunity to comment on the Financial Accounting Standards Board exposure draft on Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities, Financial Instruments (Topic 825) and Derivatives and Hedging (Topic 815). The American Council of Life Insurers (ACLI) represents more than 300 legal reserve life insurer and fraternal benefit society member companies operating in the United States. These member companies represent over 90 percent of the assets and premiums of the U.S life insurance and annuity industry. We submit this letter by September 1, 2010, in order to participate in the Board's public roundtables in October, 2010.

## **GENERAL COMMENTS**

We support the general objectives of simplifying and improving reporting for financial instruments for clarity and transparency. However, we have serious concerns about the approach proposed by the FASB and do not believe this proposal accomplishes the stated objectives.

The companies represented by the ACLI, which is a member of Financial Instruments Reporting and Convergence Alliance (FIRCA), agree and support the simplification of financial instrument classification to three categories: fair value through net income, fair value through comprehensive income, and amortized cost. As such, we believe an insurance company is best enabled to communicate its business condition and performance when management is allowed to designate the classification and measurement of its liabilities, consistent with its business strategy and its business model. The assets are then designated to follow the measurement of the liabilities they support. The mixed attribute model most clearly communicates decision-useful information to our stakeholders that is relevant to their needs and our business strategy.

We believe this exposure draft (ED) is narrowly focused on forcing fair value accounting on all companies and financial instruments, and represents a drastic and unnecessary change from current accounting practice. It is our opinion that the ED increases complexity in many of its provisions. Furthermore, it does not simplify or clarify communication of decision-useful data, but buries it in a preconceived structure requiring more effort and adjustment to gain a clear picture of an entity's individual financial position and performance.

It is also critical to align the Financial Instruments guidance with other guidance being proposed. We would emphasize the alignment of the measurement approaches with the Insurance Contracts Project

and a reconsideration of the Financial Statement Presentation Project. We also believe that convergence with International Financial Reporting Standards is of critical importance.

### **GENERAL COMMENTS ON EXPOSURE DRAFT SECTIONS:**

### Objective

We note the FASB's objectives for this ED are expressed as (noted in BC6, BC8, BC11, BC13, and BC17):

- o Improving and simplifying the reporting for financial instruments
- Providing information that an entity and its advisors and investors need to effectively assess risk
- Avoiding too heavy a reliance on subjective classification of financial instruments
- o Achieving convergence
- o Allowing sufficient due process
- Providing greater transparency
- Reducing complexity
- o Providing consistency a method that can be applied to all industries and companies
- o Providing decision-usefulness to users.

We agree with these objectives, in general, but we do not believe this ED achieves these objectives. In addition, we do not believe this ED reflects the proper prioritization of these objectives. We believe, in particular:

- The objective of transparency has not been achieved by requiring fair value in most cases, because fair value does not communicate appropriately the condition or expected results of the business in all cases.
- Reducing complexity is eluded by requiring more, rather than fewer, classification categories (Fair Value through Net Income (FVTNI), Fair Value through Other Comprehensive Income (FVTOCI), Amortized Cost for liabilities, Redemption Value, Net income re-measurement and OCI re-measurement.)
- The greater disclosures and explanations that would be required to achieve transparency and clarity of communication for an insurance company under this ED would undoubtedly not reduce complexity, nor would they be conducive to producing the optimal amount of information. Given the complexity of the financial statement users' analytical process, the resulting disclosure clutter unavoidably impairs users' ability to understand and the entity's ability to effectively communicate. If users do not understand all of the accounting concepts underlying current financial reporting, the added mental gymnastics required for the concepts in this ED will not be understood. An extensive educational foundation would be required (see effective date and transition section.)

### Convergence

For many of our companies, whether global or US based, convergence with international standards is an important objective. However, we note that the objective of the ED set forth in paragraph 2 is very different from the objective stated in IFRS 9, 1.1.<sup>(4)</sup> While both Boards agreed to core principles that are to govern all projects (Joint statement confirming Memorandum Of Understanding, November 5, 2009, Appendix A) to enable a converged solution, the application of the core principles have led the Boards to very different conclusions. We find the divergence at this point concerning. However, we believe it reflects the two ends of the spectrum with regard to a) an understanding of a principle vs. a rule, and b) the fundamental differences in the debate over financial reporting. We recommend and request that the Boards begin re-deliberations with a thorough discussion of the fundamental philosophical issues upon which the guidance will rest. Without agreement here, we fear that convergence will not be possible.

Recent media quotes from the Boards have indicted a possible move away from convergence toward comparability. Comparability, as a compromise, would send us back to pre-2006 SEC filings requiring reconciliation between two bases and changes in the two bases of accounting that would not move in sync with one another. We continue to believe that convergence with IFRS is critical.

### Importance of Communicating the Business

- The business of an insurance company is to make long-term promises (obligations) and, through an investment strategy, provide sufficient ultimate cash flows to fulfill those promises. Taking asset risk is an inherent part of the business. This strategy of taking asset risk pays off over time, but will fluctuate in the interim. The volatility in the interim is mitigated by management's investment decisions, but is not immediately relevant as an indication of the results of the business. For stakeholders of an insurance company, fair value is neither the most decision-useful information nor is it reflective of the expected results. We believe the financial statements should, as a primary goal, reflect an entity's risk management strategies, including asset/liability management (i.e., management of resources and uses of those resources).
- For insurance companies, the appropriate measurement methodology should be determined based on how the insurance liabilities are treated (discussed further herein). We believe that amortized cost is generally more appropriate for certain instruments for which the business' strategy is primarily to hold for the collection of cash flows to back liabilities and not for resale. We believe that reporting loans, for example, at fair value does not improve the clarity or quality of information. Amortized cost, as provided in IFRS 9 is a more appropriate treatment in this example. We support the IASB model which reduces the number of classification categories and provides a clearer rationale for measuring financial assets (IFRS 9, BC8(a)). We believe it better communicates the use and expectations of insurance assets and aligns the measurement attribute to the way the entity manages its financial assets, providing relevant and useful information to users (IFRS 9, BC8(c)).
- We recognize that the users of an entity's financial statements include a wide range of constituents with varying purposes. One set of financial statements cannot achieve simplicity and transparency to the greatest extent when trying to communicate to such a wide range of users. US GAAP financial statements are directed to shareholders, customers, and other stakeholders, whose interest is not to determine the sale value of the business at the reporting date. Our comments, therefore, are informed by the needs of our most important users first, our shareholders. Analysts, customers, regulators, and other users have other sources of information and more time and skills with which to derive it, making the financial statements only one of the resources they use. More information especially if the information departs from the entity's business strategy for managing the financial instruments, will neither reflect the results of management's stewardship nor satisfy the objective of decision usefulness (cf. BC2).
- The purpose of financial reporting is to communicate an entity's current financial position and performance to date with sufficient clarity in order to be understood by users.

We, further, do not agree with the ED's contention that "risks and market forces have blurred the distinction between industries" (BC18). Attempting to require a single reporting methodology makes communication to our shareholders and other stakeholders more difficult as it blurs the connection between management business decisions and the business performance.

Financial statements are a tool of communication used by a company's management regarding the business condition and period performance to its stakeholders. As defined by FASB Concept Statement 1, financial statements should provide information that is useful in decision-making. The primary users of our US GAAP financial statements are our stockholders who are not

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investing for immediate liquidation. (This point does not consider day traders as stakeholders who rely on financial statement information. Rather, they focus on daily patterns of market pricing).

Principles of good communication should govern financial statement presentation <sup>(3)</sup>. These include succinctness, clarity (cf. IG171), and integrity of the message to the purpose. Concept Statement 1 refers to decision-useful information including enterprise resources, claims to those resources, and changes in them. In times of market uncertainty and volatility as has been increasingly experienced, fair value does not provide an accurate assessment of resources that will be available to meet future claims. Fair value tends to overstate the good in the good times and the bad in the bad times and, consequently, fails the test of good communication.

#### **Basis of Conclusions**

- The FASB dismisses the value of a mixed-attribute measurement model. We do not agree that a mixed-attribute measurement model, in and of itself, provides inadequate information for assessing risk (BC8). More information does not require a complete change in methodology. Various users of financial reporting information have differing information needs. Elevating fair values as the dominant measurement objective puts the interest of investors and creditors at risk by not providing adequate information for their assessment of the amount, timing, and uncertainty of the entity's future cash flow. Thus, IFRS 9's mixed-attribute measurement model that aligns measurement attributes of financial instruments with an entity's business model (a matter of fact that does not relate to choice) is a better basis for classification and measurement decisions.
- This section of the ED also states that the FASB's present model relies too heavily on subjective classification of financial instruments. The change in classification requirements does nothing to remove the subjectivity by assuming all transactions should be classified and measured based on the market's estimate. In addition, the current GAAP requirement to disclose the methodologies used for determining fair value does not remove subjectivity (unobservable inputs), but merely puts users on notice regarding that subjectivity. We do not believe that removing subjectivity is the remedy. We agree that subjectivity that introduces idiosyncratic errors undermines the decision-usefulness of financial reporting information, but so does subjectivity that is systematically biased and strategically presented to achieve a predetermined outcome. Use of fair value (especially level 2 and 3 valuation methodologies) does not remove subjectivity. Risk assessments, even when calculated mathematically, incorporate subjective elements and estimates. The antidote for subjectivity is transparency, clear disclosure of assumptions and methodologies, to allow users to adjust their own analyses.

## Simplicity and Clarity

- Much of the guidance in this ED, which attempts to provide more detailed information in the financial statements, results in a transaction-level-focus not only for accounting, but for reporting. The greater detail requires similar transactions be analyzed for differences, even when none are anticipated (e.g., difference between transaction price and fair value) or significant to the message of the financial statements (i.e., decision-worthy). This focus creates significantly more complexity and operational burden for preparers.
- The ED Summary, page 1, notes that current US GAAP permits different accounting treatments for similar financial assets. The ED goes on to explain that it simplifies and improves financial reporting by developing a consistent and comprehensive framework...the result of which should be more consistent and transparent reporting. We strongly disagree with these assumptions and conclusions. Although reducing the alternatives may appear to increase simplicity or transparency, if the requirements foisted on transaction reporting do not communicate clearly the most relevant and representationally faithful financial position and performance of the entity, then the objective of simplicity and clarity has not been achieved.

### Scope

- We observe that certain assets are included in this ED that were previously not considered together with securities (under FAS 115 or Topic 820). These include loans and receivables of various types. While we do not oppose their inclusion in a comprehensive set of guidance for financial instruments, we do not agree with their default-inclusion in fair value measurement (discussed under the next section).
- There remains a lack of clarity around whether some types of assets would be included, for example policy loans in an insurance company. It is unclear whether these will be addressed as part of the insurance contracts project or if they are intended to be viewed as financial instruments. We believe that policy loans should be either clearly included in the insurance contracts guidance for reasons of their distinctiveness from other types of lending and their basis in the insurance contract terms, or carried as loans and evaluated for appropriate measurement under a mixed-attribute model that is better aligned to the insurance company's purpose for those policy loans.
- There remains a lack of clarity in the ED around the treatment of investment contracts, which is a broad category of instruments with a range of insurance and investment elements. It appears that, apart from further guidance under the insurance contracts project, the contracts that contain insignificant insurance risk would be included in the scope of this ED and may be treated as hybrid financial instruments (fair value through net income). Again, investment contracts do not have a market, are not traded, and their fair value is determined based on derived information and assumptions. Although they are currently included in Topic 825 (formerly FAS 107) disclosures with a "fair value", we believe this represents a true opportunity for improving and simplifying the guidance by classifying these contracts separately from fair value financial instruments and more in line with their characteristics and use. (See our response to question 3).

### Classification and Initial Measurement; Fair Value Default

- Classification and measurement of financial instruments should reflect management's risk strategies, including for example, asset/liability management which is the crux of the business for insurance companies. Requiring all transactions to be valued at fair value, whether through net income or comprehensive income, overshadows actual company performance by reporting income, expenses, gains, and losses that may never be realized.
- This ED does not recognize the large disconnect between a market value (fair value) and the intrinsic value of a significantly large percentage of financial instruments. The lesson of Lehmann is that for illiquid or hard to value assets, fair value is not necessarily objective or agreed upon. Our investment analysts confirm that the illiquidity premium is a conjecture as there is no way to objectively observe exactly how much of a fair value or a change in value is related to illiquidity. These issues are exacerbated for assets for which there is no market, e.g., an insurance company's policyholder liabilities, nor is there intended to be one.
- Whether fair value is the most appropriate measurement basis for all instruments depends on whether the user is looking for a current liquidity value or a going-concern value. Our discussions with internal and external financial statement users indicate that the majority are not, in fact, looking for a current liquidity value as the primary measurement methodology, although they may use it as a data point and footnote disclosure would be sufficient. Consequently, forcing fair value as the measurement default further complicates their efforts in gleaning the information they need for evaluating the going-concern of the entity.
- Another reason that we do not believe that fair value (immediate-only view of value) should be the default reported value for all assets is that fair value does not represent what will be

available for business needs in the future or management's strategy to achieve its objectives. The disconnect between fair value today and the ultimate business outcome is greater in times of great market fluctuation and economic uncertainty. Fair value for all assets is not consistent with our business strategy which is to assure, over the long-term, assets and returns adequate to meet future claims. Reporting everything at fair value is inconsistent with the going-concern concept underlying financial reporting. (Contrast that with investment company entities that fair value everything since their objective is to pay out the full amount of the net asset value of their assets to the owners upon demand).

- There has been some debate about the existence and impact of fair value information on procyclical behavior (cf. BC8). By far, most market participants believe that fair value causes greater volatility because market value incorporates speculation and emotional response to reported (true or not) conditions. We believe that this issue warrants careful consideration. The pro-cyclical impact of information is evident in daily reported analysis of market movements. (2)
- The attempt to so narrowly parse the definition of fair value so as to create distinctions between initial transaction price and fair value, and in the treatment of those, introduces a level of complexity, both analytically and operationally, that is unwarranted. We cannot even estimate the appropriate level of resources, processes, documentation, and explanation that would be required. The gyrations required for one reporting period (initial measurement) are not at all in line with any possible benefit to a few users. We believe the guidance should state that unless there is significant evidence to the contrary, the transaction price is deemed to be fair value.
- Reclassifications, with required disclosure, should be allowed if a business model or accounting guidance change creates asymmetrical accounting. We would expect reclassifications, which would be based on business purpose, to be atypical in normal business circumstances. One example of an appropriate reclassification would include a transfer of an asset from one subsidiary to another subsidiary, where the business model (use of that asset) is different from one to the other (e.g., intercompany sales).

### Subsequent Measurement

- Classification and subsequent measurement should continue to be recorded based on the value relative to its use in the business. Fair value through net income makes sense for assets used for a short term, reflecting the potential (probable) sale before the next reporting period. Assets and liabilities used over a long term should be valued at either amortized cost or fair value through OCI based on which best aligns with the business model. Current market value includes any changes in an entity, including its credit standing, that call into question or would militate against the expectations that management can accomplish its strategy. As provided in current GAAP, a recycling of the gains/losses out of OCI to the P&L is appropriate when they have occurred.
- The income statement should not be impacted by short-term fluctuations in fair value. Liquidation value of an entity (other than an investment company whose purpose is to provide current liquidity to its shareholders) is irrelevant and point-in-time market prices should not be determinative in relation to income recognition.
- As we've indicated, we disagree with the fundamental assumption of this ED, that financial instruments should be measured at fair value through net income unless certain narrow exceptions are met. Under the proposed guidance in this ED, in order to properly analyze those instruments that would meet the exceptions to the default category of fair value through net income, further clarity is needed around the appropriate and/or allowable levels or segments at which business strategy can/should be determined. In addition clarity is needed to determine if there can be any reason for deviation from the strategy versus what constitutes a change in strategy. We especially refer to paragraph 21 and 22 which refers to an entity's business

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strategy for an instrument versus its intent for the instrument. As written, we do not find this guidance operational and prefer the IASB's criteria.

- In addition, the exceptions to the default fair value method for both assets and liabilities confirm our contention that fair value is not the most appropriate measurement. We believe it contradicts the Board's underlying assumptions in BC18.
- Application of this guidance requires parsing the fair value for each instrument down to its identifiable and unidentifiable components and treating those components of fair value differently. We do not agree that doing so in the ledger accounts that are summarized on the face of the financial statements provide clearer or more reliable information. In fact, we believe this information, if required, is more appropriate in the footnotes where adequate explanations of methodology and assumptions can be addressed.
- The subsequent measurement requirements for liabilities in this ED are driven by a focus on the determination made for invested assets. This is contrary to the principle of insurance company business management which focuses first on the appropriate measurement and reporting of the liabilities (future obligations to policyholders), the fair value of which is irrelevant since the liabilities will be settled according to the contract and not sold in an interim period. Proper reporting of the subsequent measurement of the assets supporting these liabilities should be based on, matched with, the reporting of the liabilities and not vice versa.

### **Equity Method Accounting**

- We believe the Equity Method guidance proposed in the ED would primarily relate to limited partnerships in which our companies invest. Limited Partnerships are usually set up to invest in and manage other types of investments that are less liquid than investment entities that are subject to daily asset valuation (e.g., mutual funds) and to diversify the investment portfolio. The ED adds the requirement to evaluate the business similarity of the limited partnership to the reporting entity business (insurance company). While both engage in financial services, their purpose and methodology are different. There is no consensus among our companies regarding how this guidance should be applied. However, we do note that this requirement is not consistent with the consolidations project which contains no similar requirement for determination of consolidation. Consequently, we believe this adds to the complexity and lack of transparency of financial information, requiring more detailed explanation closer to the individual transaction level in order to communicate clearly with our stakeholders. Additionally, we note that criteria similar to what the FASB includes in the proposed guidance is not included in existing guidance under IFRS (nor any proposals) and incorporating this proposed criteria would create divergence in the FASB and IASB accounting guidance related to investments accounted for under the equity method of accounting.
- Another reason that we do not favor the narrowing of equity method is that these investments typically provide their financial information significantly later (three nine months after the reporting date) than other investment entities. This ED refers to Subtopic 323-10 (Equity Method Investments and Joint Ventures) and paragraph 35-6 which allows for a consistent lag in reporting. Should certain limited partnerships not pass the "similarity test", they would be required to be fair valued through net income. The lag of information that is the basis for valuation, including the lack of an active market providing objective inputs, defeats the definition of fair value at the investing entity's reporting date.
- A significant and unresolved question remains with regard to the definition of similarity of operations. We believe that investment companies are similar to our companies' operation in financial services. However, if the requirement is to compare an investment company to an insurance company, it would seem to fail the test for use of the equity method. We do not see

the relevance or benefit to distinguishing between the operations or business in requiring fair value through net income over the equity method.

We believe the equity method guidance contained in current US GAAP (Topic 323) is sufficient and does not warrant change or impact by this ED. We believe retention of the ED guidance would require inclusion of our alternative investments (e.g., tax credits, private equity, real estate partnerships) in the equity method, which is not appropriate.

### **Impairment**

- We believe that management's estimate of expected cash flows over the life of the asset which should consider all relevant information, provides the best basis for assessment of impairment.
- Under the ED we understand we cannot forecast future events. However, an appealing differentiation has been made by some between future variables (exists today, but is likely to change in a reasonably predictable way) and future events (does not exist today, but could occur in the future and is unpredictable with any degree of accuracy)<sup>(5)</sup>. We recommend this distinction be made in the guidance as a part of clarifying what is acceptable in consideration of an impairment. Fair value estimates should include consideration of future variables.
- A general allowance for all assets OR an individual assessment based on clear criteria (as under current GAAP) is appropriate. But not both. We believe that an entity should determine the most appropriate method for loss assessment. We disagree that an individual asset, once determined to not have an impairment, should be included in a pool for allowance determination. If an entity individually assesses an asset for impairment and determines that none is warranted, that should not lead to an allowance for that asset as part of a pool.
- When contemplating paragraph 24 of the ED, we do not understand the rationale for proposing a general allowance at purchase that would then require an immediate offset (plug) to get back to the fair value/transaction price. Our investment analysts confirm that while the price and return is a function of what you expect plus unexpected volatility risk, these components are not quantifiable or objective. Analysts further acknowledge that during a crisis, prices do not equal expected outcomes. Fair value may not have a direct relationship to economic value due to illiquidity, fear, or other factors usually lumped into the term "market sentiment". Consequently, to attempt to quantify and then reconcile out these amounts on the face of the balance sheet gives an overweight to their significance and creates noise that does not provide any benefit.
- We would encourage the FASB to further investigate the concepts underlying the National Association of Insurance Commissioners (NAIC) statutory insurance guidelines for impairment, which is an intrinsic value approach building from the bottom up. It also has the advantage of clarity in its use of clear triggers for determining impairment that are consistent across insurance companies.
- We support the current treatment of deferred tax assets associated with debt securities. "Intent to hold" is an appropriate tax planning strategy, as discussed in our previous letter to IFRIC (attached for your reference in Appendix A). However, we do not believe that the financial instruments guidance is the appropriate place to address deferred tax assets and tax strategies. We recommend this guidance be addressed separately.

### Income Recognition

- Interest income should generally be recognized using the effective interest rate of the instrument. Decreases in expected cash flows should continue, as under current guidance, to result in an impairment being recorded. Interest income should continue to be recognized on the net carrying value using the original effective interest rate.
- The proposed guidance related to non-accrual of interest is not necessary. The reduction in carrying value that results from recognizing an impairment would result in lower interest income recognized. The key is, when establishing cash flows, one considers the expected timing of principal and interest payments in determining the present value.
- Presentation of income recognition components should be kept separate from credit losses in order to maintain clarity and transparency.

## **Derivatives and Hedging**

We support these changes in the exposure draft to the derivatives and hedging guidance, except:

- Hedging guidance should allow for voluntary de-designations if it can be shown that the use of the derivative has changed. The requirement to offset derivatives is arbitrary and unnecessarily restricts the business strategy.
- We believe that under the ED, as proposed, most reasons for attempting to meet hedging requirements for fair value hedges are eliminated. The guidance in ASC 815 (formerly FAS 133) for fair value hedges remains relevant only if there are instruments that are not otherwise fair valued through the P&L.
- We recommend and request that the Board also relax the requirements for portfolio hedging, consistent with International Financial Reporting Standards.

#### Presentation and Disclosure

- A comprehensive disclosure framework is needed to ensure the right disclosures are being provided in the clearest manner. We are concerned with an over-supply of data that will overwhelm the user and obscure the message, if not mislead and confuse.
- We believe that a comprehensive approach to presentation and disclosure should be developed that would be designed to condense and make succinct the necessary information. We do not believe that a highly complex business like a financial institution can explain its business and management's assumptions and decisions in a simple, short format. However, there is a strong reduction in benefit to the user by continuing to pile information on top of more information.
- While we strongly support clarity and transparency in financial statements, we also recognize and adhere to two important, foundational beliefs:
  - Financial statements are not the only source of information used by investors and analysts to understand and evaluate a company.
  - The explanatory information provided in footnote disclosures is just as important, carries as much weight and is subjected to the same rigor as the numbers presented on the face of the financial statements.

We thank you for the opportunity to present our views and debate the important issues of the proposed guidance on financial instruments. Our response to the ED questions and an appendix follows. We submit our comments as of September 1 in order to participate in the Roundtable discussions in October.

Sincerely,

Michael Monahan

Director, Accounting Policy

### RESPONSE TO EXPOSURE DRAFT QUESTIONS:

Question 1: Do you agree with the scope of financial instruments included in this proposed Update? If not, which other financial instruments do you believe should be excluded or which financial instruments should be included that are proposed to be excluded? Why?

This ED incorporates more types of assets into the scope of financial instruments than current GAAP. Including loans and receivables in the scope increases the difficulty of achieving the FASB's stated objectives. These are not securities, are not traded and, therefore, the "fair value" is more subjective than if there were a quoted market. The IASB's standard allows for valuing these at amortized cost, which is more appropriate for reporting relevant financial position and performance.

Loans and receivables should be excluded unless amortized cost is retained as an option for transactions and contracts that are not traded. It is unclear whether policy loans on the books of an insurance company and some investment contracts with elements of insurance (see response to question 3) would or would not be included in the scope. We believe that policy loans should be either clearly included in the insurance contracts guidance for reasons of their distinctiveness from other types of lending and their basis in the insurance contract terms. If this is not suitable, they should be carried as loans at amortized cost.

Question 2: The proposed guidance would require loan commitments, other than loan commitments related to a revolving line of credit issued under a credit card arrangement, to be measured at fair value. Do you agree that loan commitments related to a revolving line of credit issued under a credit card arrangement should be excluded from the scope of this proposed Update? If not, why?

These loan commitments related to revolving line of credit issued under a credit card arrangement are not particularly relevant to insurance companies. However, we believe that commitments for other types of loans should not be required to measured at fair value. The operational challenges of fair valuing these commitments is not warranted given the short period of time commitments are outstanding and the insignificance of their balances relative to the overall balance sheet. As such we believe that current disclosures related to commitments is sufficient to convey their risk.

Question 3: The proposed guidance would require deposit-type and investment contracts of insurance and other entities to be measured at fair value. Do you agree that deposit-type and investment contracts should be included in the scope? If not, why?

We believe it is premature to address the treatment of investment contracts, which is interdependent with the project on insurance contracts, until the insurance contracts guidance is clarified. For insurance companies, contracts range from pure investment contracts (e.g., Guaranteed Investment Contracts) to pure insurance contracts (e.g., life insurance). Many contracts contain elements of both investment and insurance to varying degrees. Therefore, our comments regarding investment contracts and their treatment depend upon the definitions that would be applicable. We recognize the Boards are debating these issues under the insurance contracts project and that there remain differences between IFRS and US GAAP. We agree that pure investment contracts are appropriately scoped into financial instrument guidance. For those contracts that contain elements of both investment and insurance, we do not believe that the timeframe given for responding to this ED allows enough time for the resolution of the dueling definitions under current insurance/investment accounting guidance and provision of thoughtful comments.

Question 4: The proposed guidance would require an entity to not only determine if they have significant influence over the investee as described currently in Topic 323 on accounting for equity method investments and joint ventures but also to determine if the operations of the investee are related to the

entity's consolidated business to qualify for the equity method of accounting. Do you agree with this proposed change to the criteria for equity method of accounting? If not, why?

We do not believe use of the equity method needs changing nor do we see any significant benefit for doing so. The ED requirements increase complexity by requiring analysis of "similarity" of entity's operations -- something that would require extensive discussion and disclosure to achieve transparency to the investor and would not lend itself to consistency between companies. In addition, we find the theory behind this requirement inconsistent with the consolidations analysis currently required. Given that the IASB has already clearly rejected the use of a FV practical expedient, this requirement does not meet the objective of convergence (BC11), which we consider a critically high priority.

The Board, in its discussion of the proposed accounting for equity-method investments, observed that "...the only way to realize gains or losses from equity securities is to sell the equity securities as compared to debt securities, which can be held for collection of contractual cash flows" (FASB ED BC24). We believe that this observation is flawed, not only because it over-generalizes the cash flow characteristics of equity instruments which could include dividends in addition to realized gains or losses upon disposal, but also it suggests certain indiscrimination in the nuance between gain and revenue.

## [Questions 5 – 7 are directed to users of financial statements]

## Question 8: Do you agree with the initial measurement principles for financial instruments? If not, why?

No. The underlying principle that fair value through net income is the most appropriate classification and measurement for all assets is patently incorrect as discussed in the general section of our letter. We believe transaction price is the most appropriate initial measurement, and unless significant evidence exists to the contrary, should be deemed as fair value at purchase.

Question 9: For financial instruments for which qualifying changes in fair value are recognized in other comprehensive income, do you agree that a significant difference between the transaction price and the fair value on the transaction date should be recognized in net income if the significant difference relates to something other than fees or costs or because the market in which the transaction occurs is different from the market in which the reporting entity would transact? If not, why?

No, we do not agree with recording Day 1 profits or losses under any circumstances. Recording Day 1 profits or losses is as counter-intuitive as recognizing income for an entity's decline in the value of its own debt (which is being blasted in the market as an abomination $^{(1)}$ ) Day 1 profits and losses will require the same complex explanation, confusion and uncertainty and are irrelevant to the business financial position, strategy and performance.

Question 10: Do you believe that there should be a single initial measurement principle regardless of whether changes in fair value of a financial instrument are recognized in net income or other comprehensive income? If yes, should that principle require initial measurement at the transaction price or fair value? Why?

We do not disagree with a single measurement principle, if it sufficiently incorporates the concepts that a) not all assets are similar, b) not all assets are used similarly, and c) financial reporting should communicate clearly and simply to the reader the purpose and strategy of business; i.e., management's best estimate of the performance of the business to/at the reporting date. However, a single measurement rule that assumes that fair value always communicates these elements is mistaken. Reporting a transaction at amortized cost is the clearest and simplest way to communicate what has actually occurred. Disclosures, impairments and other information that complete the picture are discussed in other sections of this letter.

As stated in question 8, distinction between transaction price and fair value at initial measurement is unnecessary. In the rare situation that there is objective evidence that the transaction price is significantly different from the market value, this should be fully explained in a footnote disclosure.

Question 11: Do you agree that transaction fees and costs should be (1) expensed immediately for financial instruments measured at fair value with all changes in fair value recognized in net income and (2) deferred and amortized as an adjustment of the yield for financial instruments measured at fair value with qualifying changes in fair value recognized in other comprehensive income? If not, why?

Transaction costs for all financial assets and liabilities should be treated consistently in order to meet the objectives of simplicity and decision-usefulness. Transaction costs which are included in the valuation of an asset or liability should not be segregated. Because we believe that amortized cost is the generally more appropriate measurement of a loan, we also believe that significant incremental direct transaction costs should be treated consistently as an adjustment to the effective yield.

Question 12: For financial instruments initially measured at the transaction price, do you believe that the proposed guidance is operational to determine whether there is a significant difference between the transaction price and fair value? If not, why?

No. Evaluating the possibility of a difference between the transaction price and the fair value would require a crippling increase in processes, controls, documentation and human resources to a) survey the market for each transaction to consider and determine if there is a difference, b) document the rationale, and c) audit and report significant differences. In addition, like Day 1 profits and losses, extensive disclosure and explanation would be required to communicate the significance and reasons for the measurement basis chosen to shareholders and analysts. They have not asked for this information and, undoubtedly, would see little benefit from it. Discussions with our investment managers who use financial statements in their analysis confirm these facts. Other relevant points are contained in the general comments of our letter, above.

Question 13: The Board believes that both fair value information and amortized cost information should be provided for financial instruments an entity intends to hold for collection or payment(s) of contractual cash flows. Most Board members believe that this information should be provided in the totals on the face of the financial statements with changes in fair value recognized in reported stockholders' equity as a net increase (decrease) in net assets. Some Board members believe fair value should be presented parenthetically in the statement of financial position. The basis for conclusions and the alternative views describe the reasons for those views. Do you believe the default measurement attribute for financial instruments should be fair value? If not, why? Do you believe that certain financial instruments should be measured using a different measurement attribute? If so, why?

We are opposed to a default measurement. No one measurement properly and completely reports the status and use of financial assets. We agree with the IASB model that provides for both FV and Amortized cost as appropriate to the business and the characteristics of the asset. Additional information should be disclosed as appropriate to the users of the financial statements. For certain businesses, that might include amortized cost information for assets reported at fair value, or fair value information for assets reported at amortized cost.

Question 14: The proposed guidance would require that interest income or expense, credit impairments and reversals (for financial assets) and realized gains and losses be recognized in net income for financial instruments that meet the criteria for qualifying changes in fair value to be recognized in other comprehensive income. Do you believe that any other fair value changes should be recognized in net income for these financial instruments? If yes, which changes in fair value should be separately recognized in net income? Why?

No other fair value changes should be recognized in net income. These elements, interest income/expense, credit impairments/reversals, and realized gains/losses, should each be recognized separately in order to convey the clearest picture of period performance. Interest income/expense should be measured based on contractual terms, adjusted for amounts not received when due. Disclosures regarding changes in assumptions should remain in the notes to the financial statements in order to most clearly convey and distinguish what has occurred from managements' or market expectations. (See questions 48 - 51, below) Credit impairments/reversals are discussed in questions 37 - 47, below.

# Question 15: Do you believe that the subsequent measurement principles should be the same for financial assets and financial liabilities? If not, why?

A principle is an assumption that applies in all situations (e.g., drive safely); a rule applies the principle to a specific situation (e.g., drive 55 mph on this highway). Certainly, subsequent measurement principles should be the same for all financial statement items. There is more judgment associated with a principle than a rule which is definitive.

We agree that the principle for subsequent measurement of liabilities should be the same as we have stated for assets: to convey the clearest picture of period performance by providing relevant data appropriate to the companies business, strategy and expectations, consistent with the characteristics and management of the asset or liability. For this reason, we feel debt of an entity that is not held for trading purposes is more appropriately not measured at fair value through net income.

Question 16: The proposed guidance would require an entity to decide whether to measure a financial instrument at fair value with all changes in fair value recognized in net income, at fair value with qualifying changes in fair value recognized in other comprehensive income, or at amortized cost (for certain financial liabilities) at initial recognition. The proposed guidance would prohibit an entity from subsequently changing that decision. Do you agree that reclassifications should be prohibited? If not, in which circumstances do you believe that reclassifications should be permitted or required? Why?

Based on the principle to which we adhere, reclassifications should not be prohibited. However, they should be disclosed and explained within the concepts of the principle: characteristics of the asset/liability, the company's business and strategy with regard to the financial instruments.

Question 17: The proposed guidance would require an entity to measure its core deposit liabilities at the present value of the average core deposit amount discounted at the difference between the alternative funds rate and the all-in-cost-to-service rate over the implied maturity of the deposits. Do you believe that this remeasurement approach is appropriate? If not, why? Do you believe that the remeasurement amount should be disclosed in the notes to the financial statements rather than presented on the face of the financial statements? Why or why not?

The ACLI represents insurance companies that may or may not have affiliate entities for which this question applies. For purposes of the ACLI response, this aspect of the guidance does not impact the insurance companies. Therefore, we would direct you to individual companies' response letters on this matter.

Questions 18: Do you agree that a financial liability should be permitted to be measured at amortized cost if it meets the criteria for recognizing qualifying changes in fair value in other comprehensive income and if measuring the liability at fair value would create or exacerbate a measurement attribute mismatch? If not, why?

All measurement options for financial assets should also be available for financial liabilities in order to allow management to maintain asset/liability matching where it is appropriate to the business strategy.

The current FASB model further complicates financial reporting by creating rules and exceptions that are difficult to apply and explain.

Question 19: Do you believe that the correct financial instruments are captured by the criteria in the proposed guidance to qualify for measurement at the redemption amount for certain investments that can be redeemed only for a specified amount (such as an investment in the stock of the Federal Home Loan Bank or an investment in the Federal Reserve Bank)? If not, are there any financial instruments that should qualify but do not meet the criteria? Why?

We believe it is dangerous and short-sighted to specify specific measurement rules for specific assets. While this might be effective for certain financial statements, it has been clearly demonstrated that the creativity of the global financial market will always outpace the ability of rules to cover all situations and products. Consequently, we hold to the principle stated in questions 15 - 18, above.

Question 20: Do you agree that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to a debt instrument measured at fair value with qualifying changes in fair value recognized in other comprehensive income in combination with other deferred tax assets of the entity (rather than segregated and analyzed separately)? If not, why?

We support the current treatment of deferred tax assets associated with debt securities. "Intent to hold" is an appropriate tax planning strategy, as discussed in our previous letter to IFRIC (attached for your reference in Appendix A). However, we do not believe that the financial instruments guidance is the appropriate place to address deferred tax assets and tax strategies. We recommend this guidance be addressed separately.

Question 21: The Proposed Implementation Guidance section of this proposed Update provides an example to illustrate the application of the subsequent measurement guidance to convertible debt (Example 10). The Board currently has a project on its technical agenda on financial instruments with characteristics of equity. That project will determine the classification for convertible debt from the issuer's perspective and whether convertible debt should continue to be classified as a liability in its entirety or whether the Board should require bifurcation into a liability component and an equity component. However, based on existing US GAAP, the Board believes that convertible debt would not meet the criterion for a debt instrument under paragraph 21(a)(1) to qualify for changes in fair value to be recognized in other comprehensive income because the principal will not be returned to the creditor (investor) at maturity or other settlement. Do you agree with the Board's application of the proposed subsequent measurement guidance to convertible debt? If not, why?

We disagree with the application of paragraph 21(a)(1) as disqualifying convertible debt from FV-OCI. Whether the original amount is returned to the investor in the form of cash or equity securities, the original amount is returned to the investor by contractual agreement. Consequently, we do not believe that the form of repayment changes the character of the asset.

In addition, we believe, based on the principle we have stated, that any instrument should be accounted for based on its current characteristics and business use. It would be inconsistent with other provisions of the guidance (e.g., impairment) to consider future events in the classification of an instrument, but not in its subsequent measurement.

Reclassifications should be permitted, with disclosure. Disclosure with regard to management's intentions and expectations with respect to the conversion provisions would provide users with clearer information than guesses about the future baked into the financial report.

[Ouestions 22 – 27 are directed to users of financial statements]

## Question 28: Do you believe that the proposed criteria for recognizing qualifying changes in fair value in other comprehensive income are operational? If not, why?

There is currently inadequate readily-available market information, IT systems and processes to provide the proposed disclosures. The theoretical components of fair value attributed in the ED to any market price, whether quoted or modeled, are not calculated and reported as observable market inputs. Based on Topic 820 (formerly FAS 157) guidance and theory, this alone defeats the purpose of using fair value.

With regard to the criteria for fair value changes through OCI, we encourage further clarification in the guidance around how the Board views determination of a business strategy and at what level. We believe, consistent with SEC guidance on MD&A and consistent with our view of clearly communicating the business, that evaluation and determination of business strategy should be aligned with the entity's risk management.

## Question 29: Do you believe that measuring financial liabilities at fair value is operational? If not, why?

The more critical question is whether measuring financial liabilities at fair value is appropriate, and if so, what is the best methodology for measuring a financial liability that is not traded and has no market. An insurance company typically holds few, if any, trading securities for the primary reason that the volatility in market value is not conducive to matching and management of assets against its liabilities. Since the characteristics and business strategy with respect to liabilities is the primary driver of the performance of the business, their long-term nature should dictate the measurement methodology of the assets and not vice versa. Furthermore, for the reasons outlined in Question 15, we feel debt of an entity that is not held for trading purposes is more appropriately not measured at fair value through net income.

# Question 30: Do you believe that the proposed criteria are operational to qualify for measuring a financial liability at amortized cost? If not, why?

We do not believe that the criteria for qualifying are appropriate. An insurance business that is based on investing cash inflows in a way that will provide for liabilities does not contractually link its assets and liabilities, but invests and manages the assets based on the characteristics of the assets that will meet the demands of its obligations. This is a completely different strategy and paradigm than a manufacturing company that invests to supplement its primary source of income or better utilize idle cash. Consequently, as indicated in questions 18 and 29, we believe these criteria should be eliminated and a more uniform and appropriate model for financial assets and liabilities be offered.

Question 31: The proposed guidance would require an entity to measure its core deposit liabilities at the present value of the average core deposit amount discounted at the difference between the alternative funds rate and the all-in-cost-to-service rate over the implied maturity of the deposits. Do you believe that this remeasurement approach is clearly defined? If not, what, if any additional guidance is needed?

The ACLI represents insurance companies that may or may not have affiliate entities for which this question applies. For purposes of the ACLI response, this aspect of the guidance does not impact the insurance companies. Therefore, we would direct you to individual companies' response letters on this matter.

Question 32: For financial liabilities measured at fair value with all changes in fair value recognized in net income, do you agree that separate presentation of changes in an entity's credit standing (excluding changes in the price of credit) is appropriate, or do you believe that it is more appropriate to recognize the changes in an entity's credit standing (with or without changes in the price of credit) in other comprehensive income, which would be consistent with the IASB's tentative decisions on financial liabilities measured at fair value under the fair value option? Why?

We disagree with the FASB's approach to FV of liabilities, as well as to the inclusion of an entity's own credit standing in the valuation of those liabilities. The difference in yields between ratings is true overall, but is not true every period. Ratings include a provision for defaults, but the rating agencies will tell you that this provision is not based directly or primarily on expected cash flows. Analysts are taking financial statement information and making adjustments to attempt to get at free cash flow. To include a tenuous number for changes in an entity's own credit rating only forces more unwinding to get to real information.

Attempting to quantify the effects of a change in credit rating in the entity's own financial statements, while recognizing an observable relationship, fails to recognize that that relationship is not direct or linear, nor is it quantifiable. This is part of the reason that credit ratings are in disarray. This concept, therefore, leads further down the path of the much-maligned mark-to-myth reputation of fair value accounting highlighted by the media.

In order to address questions and concerns about changes in an issuer's credit rating, we recommend explanatory disclosures in the footnotes or MD&A. Running nebulous numbers through the P&L makes sense to no one.

Question 33: Appendix B describes two possible methods for determining the change in fair value of a financial liability attributable to a change in the entity's credit standing (excluding the changes in the price of credit). What are the strengths and weaknesses of each method? Would it be appropriate to use either method as long as it was done consistently, or would it be better to use Method 2 for all entities given that some entities are not rated? Alternatively, are there better methods for determining the change in fair value attributable to a change in the entity's credit standing, excluding the price of credit? If so, please explain why those methods would better measure that change.

We strongly disagree with attempting to create an amount that is not quantifiable. As indicated in question 32, we recommend explanatory narrative through disclosure or management's discussion and analysis (MD&A).

Question 34: The methods described in Appendix B for determining the change in fair value of a financial liability attributable to a change in an entity's credit standing (excluding the changes in the price of credit) assume that the entity would look to the cost of debt of other entities in its industry to estimate the change in credit standing, excluding the change in the price of credit. Is it appropriate to look to other entities within an entity's industry, or should some other index, such as all entities in the market of a similar size or all entities in the industry of a similar size, be used? If so, please explain why another index would better measure the change in the price of credit.

As indicated by the guidance, these are estimates. We do not believe any index provides an accurate indication of the wide array of variables and estimates, both specific to the entity and a part of the general market, which could cause a change in an entity's credit rating.

[Questions 35 – 36 are directed to users of financial statements]

Question 37: Do you believe that the objective of the credit impairment model in this proposed Update is clear? If not, what objective would you propose and why?

The objective, as we understand it, is to report all credit losses immediately as impairments, and to adjust for changes in expected collectability of cash flows over the life of the asset. It is stated clearly enough, but we are concerned with the increase in subjectivity required in order to provide early warning even before loss events become probable.

Question 38: The proposed guidance would require an entity to recognize a credit impairment immediately in net income when the entity does not expect to collect all contractual amounts due for originated financial asset(s) and all amounts originally expected to be collected for purchased financial asset(s). The IASB Exposure Draft, Financial Instruments: Amortised Cost and Impairment (Exposure Draft on impairment), would require an entity to forecast credit losses upon acquisition and allocate a portion of the initially expected credit losses to each reporting period as a reduction in interest income by using the effective interest rate method. Thus, initially expected credit losses would be recorded over the life of the financial asset as a reduction in interest income. If an entity revises its estimate of cash flows, the entity would adjust the carrying amount (amortized cost) of the financial asset and immediately recognize the amount of the adjustment in net income as an impairment gain or loss. Do you believe that an entity should immediately recognize a credit impairment in net income when an entity does not expect to collect all contractual amounts due for originated financial asset(s) and all amounts originally expected to be collected for purchased financial asset(s) as proposed in this Update, or do you believe that an entity should recognize initially expected credit losses over the life of the financial instrument as a reduction in interest income, as proposed in the IASB Exposure Draft on impairment?

There is no consensus that either model is an improvement over current impairment analysis and reporting. We do not see the benefit to anyone of introducing additional complexity and subjectivity into the financial statements. We do not believe that clarity will be enhanced by co-mingling credit and interest components, either in the allowance or effective yield.

Question 39: Do you agree that a credit impairment should not result from a decline in cash flows expected to be collected due to changes in foreign exchange rates, changes in expected prepayments, or changes in a variable interest rate? If not, why?

We want to emphasize that the implied components of any valuation cannot be parsed easily or consistently. Objective measurement of all of the components of fair value do not exist. While the credit component of fair value is theoretically distinct from exchange rates, prepayments or contractual changes in interest, we believe the assumption underlying this proposal is faulty and its implementation is unclear.

Question 40: For a financial asset evaluated in a pool, the proposed guidance does not specify a particular methodology to be applied by individual entities for determining historical loss rates. Should a specific method be prescribed for determining historical loss rates? If yes, what specific method would you recommend and why?

We do not believe that historical loss rates are the best indication of actual losses for any class or pool of assets. Historical loss rates did not and would not have better predicted the losses of the last two to three years. Even if adjusted based on current expectations, the ability of any entity to accurately or closely forecast the impacts of current events is unlikely. We further believe that using historical loss rates to apply a general reserve is inconsistent with the concept of fair value, which already includes the markets expectations of cash flows and losses in current conditions.

Question 41: Do you agree that if an entity subsequently expects to collect more cash flows than originally expected to be collected for a purchased financial asset, the entity should recognize no immediate gain in net income but should adjust the effective interest rate so that the additional cash flows are recognized as an increase in interest income over the remaining life of the financial asset? If not, why?

We do not agree that it should be presumed that an increase in cash flow expectations is attributed to interest/yield expectations. We advocate an approach that is more consistent with the objective evidence of the reasons for the changes in cash flows and then appropriate treatment based on those characteristics.

Question 42: If a financial asset that is evaluated for impairment on an individual basis has no indicators of being individually impaired, the proposed guidance would require an entity to determine whether assessing the financial asset together with other financial assets that have similar characteristics indicates that a credit impairment exists. The amount of the credit impairment, if any, would be measured by applying the historical loss rate (adjusted for existing economic factors and conditions) applicable to the group of similar financial assets to the individual financial asset. Do you agree with this requirement? If not, why?

We understand the basis in logic for a general provision on instruments that are held at amortized cost. Securities, however, that are reported at fair value, whether through net income or equity (other comprehensive income), include the market's estimate of expected future cash flows. Consequently, the fair value already includes expected future losses. An additional general provision, based on historical loss rates either double counts or requires an artificial offset to reconcile the reported numbers back to fair value (in line with paragraph 24).

## [Questions 43 - 45 are directed to users of financial statements]

Question 46: The proposed guidance would require that in determining whether a credit impairment exists, an entity consider all available information relating to past events and existing conditions and their implications for the collectability of the cash flows attributable to the financial asset(s) at the date of the financial statements. An entity would assume that the economic conditions existing at the end of the reporting period would remain unchanged for the remaining life of the financial asset(s) and would not forecast future events or economic conditions that did not exist at the reporting date. In contrast, the IASB Exposure Draft on Impairment proposes an expected loss approach and would require an entity to estimate credit losses on basis of probability-weighted possible outcomes. Do you agree that an entity should assume that economic conditions existing at the reporting date would remain unchanged in determining whether a credit impairment exists, or do you believe that an expected loss approach that would include forecasting future events or economic conditions that did not exist at the end of the reporting period would be more appropriate?

Absolutely not. It is ludicrous to attempt to project expected cash flows based on unchanging circumstances when the history of the world clearly indicates ongoing change. The CBOE Volatility Index® (VIX®) is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices. Since its introduction in 1993, VIX has been considered by many to be the world's premier barometer of investor sentiment and market volatility. A review of the data underlying this index back to 1986 indicates the irrelevance, if not madness, of assuming no change in current circumstances. In addition, this concept is counter to the fair value basis of valuation and inconsistent with the model the FASB is proposing.

### Are both methods operational? If not, why?

Were the Board to finalize rules based on the FASB's methods, we anticipate much greater operational challenges than would be required under the IASB's model. New and/or additional sources of information would be required to be developed, automated systems and flows of information redesigned, internal controls designed and added, which are among the many changes required to comply. Timelines for financial reporting would have to be revisited and adjusted to gather, analyze, verify and report information to meet compressed deadlines. Organizational structures and resources would need to be reassessed and realigned to meet the greater reporting needs. And maybe most importantly, a sizable and comprehensive education effort must undergird these changes, focusing on all preparers, auditors, and users. We believe the time and effort just to adequately execute the educational requirements to appropriately and adequately comply with the revolutionary new guidance

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would be a minimum of two years. Such radical changes in financial accounting and reporting should not take place until it is clear that both accounting professionals and investors have had the opportunity to absorb and understand the concepts and to adjust to the effects in the reports.

Question 47: The proposed guidance would require that an appropriate historical loss rate (adjusted for existing economic factors and conditions) be determined for each individual pool of similar financial assets. Historical loss rates would reflect cash flows that the entity does not expect to collect over the life of the financial assets in the pool. Would such an approach result in a significant change in practice (that is, do historical loss rates typically reflect cash flows that the entity does not expect to collect over the life of the financial assets in the pool or some shorter period)?

See our response to question 40.

Question 48: The proposed guidance would require interest income to be calculated for financial assets measured at fair value with qualifying changes in fair value recognized in other comprehensive income by applying the effective interest rate to the amortized cost balance net of any allowance for credit losses. Do you believe that the recognition of interest income should be affected by the recognition or reversal of credit impairments? If not, why?

No. The commingling of interest and credit components does not enhance clarity of information. We believe the income recognition guidance in this ED significantly overcomplicates a simple process. By applying the effective interest rate to the carrying value of the asset the appropriate level of interest income is recognized. As indicated in the general comment section above, the reduction in carrying value that results from recognizing an impairment would result in lower interest income recognized. The key is, when establishing cash flows, one considers the expected timing of principal and interest payments in determining the present value.

Question 49: Do you agree that the difference in the amount of interest contractually due that exceeds interest accrued on the basis of an entity's current estimate of cash flows expected to be collected for financial assets should be recognized as an increase to the allowance for credit losses? If not, why?

Unless the amounts contractually due are expected not to be collected, the validity of the contractual terms should supersede estimates based on assumptions, no matter how well founded. Once there is enough evidence to support the expectation that the amounts accrued will not be collected, an impairment or write-off of the uncollectable amounts would be appropriate. We do not agree that introducing estimates of remote or unlikely events is appropriate nor does it enhance the reliability of the reported information. This approach seems to assume that the entity's crystal ball, or that of the market, is better than the management efforts and ethics of the contracted parties. This has proved to be an erroneous assumption. We do not agree that the current impairment model requires improvement in the timing of the reporting of expected losses. We continue to advocate that management's best estimates should be recorded when they are determined and their basis should be the likelihood the amounts being realized.

Question 50: The proposed guidance would permit, but would not require, separate presentation of interest income on the statement of comprehensive income for financial assets measured at fair value with all changes in fair value recognized in net income. If an entity chooses to present separately interest income for those financial assets, the proposed guidance does not specify a particular method for determining the amount of interest income to be recognized on the face of the statement of comprehensive income. Do you believe that the interest income recognition guidance should be the same for all financial assets?

The most appropriate income recognition guidance should be a principle (see Conceptual Framework) that is applicable to all types of income and adaptable to the characteristics and use (business strategy) of the instrument producing the income. A principle would direct the recognition of when the income should be recognized (i.e., when the rights and/or obligations have accrued) with appropriate consideration for the probability that the contractual obligations will not be honored. Additional guidance regarding the reporting and explanation of these amounts should provide for an entity's ability to transparently and appropriately convey the entity's best understanding of its condition and performance.

Question 51: Do you believe that the implementation guidance and illustrative examples included in this proposed Update are sufficient to understand the proposed credit impairment and interest income models? If not, what additional guidance or examples are needed?

The process we have exercised in digesting and responding to this exposure draft clearly indicates that there are many questions left unanswered and opportunity for differences in understanding and interpretation still exists in the guidance. We have made an exhaustive analysis of the proposed guidance, the appendices, the implementation guidance and examples, as well as the basis for conclusions provided in the ED. The limitation of the implementation guidance and examples is based in the fact that these do not reflect the assumptions and sources of information required to develop a recordable entry. The implementation guidance and examples address the mechanics, but not the decision-making process and application based on real-world circumstances.

[Questions 52 – 55 are directed to users of financial statements]

Question 56: Do you believe that modifying the effectiveness threshold from *highly* effective to reasonably effective is appropriate? Why or why not?

The slight expansion does not significantly affect hedges that are effective or ineffective, as it is immaterial to the issues of our hedge strategies; this expansion is unlikely to maintain hedges that might fail effectiveness testing. If you have criteria you have to match (given the fact that duration is not provided for in hedge accounting guidance, which is the main reason for insurance companies entering into derivatives) our hedge strategies would be equally likely to fail under either threshold.

The problem is not the effectiveness testing, but the mathematical calculation that must be used to prove why it is effective. A greater benefit would be a relaxation of the rules around portfolio hedging, similar to IFRS guidance, which would enable an entity to follow the economics of the business strategy with hedge accounting.

Question 57: Should no effectiveness evaluation be required under any circumstances after inception of a hedging relationship if it was determined at inception that the hedging relationship was expected to be reasonably effective over the expected hedge term? Why or why not?

Yes. The things that cause a hedge that is effective at inception to fail are largely not economically related to the positions, but are things like the law of small numbers and market anomalies that militate against the business purpose for the hedge.

Question 58: Do you believe that requiring an effectiveness evaluation after inception only if circumstances suggest that the hedging relationship may no longer be reasonably effective would result in a reduction in the number of times hedging relationships would be discontinued? Why or why not?

Yes where it would prevent the pitfalls noted above.

### [Questions 59 - 60 are directed to users of financial statements]

Question 61: Do you foresee any significant operational concerns or constraints in calculating ineffectiveness for cash flow hedging relationships? If yes, what constraints do you foresee and how would you alleviate them

No. Current processes could be utilized with small changes in decision-making parameters.

Question 62: Do you foresee any significant operational concerns or constraints in creating processes that will determine when changes in circumstances suggest that a hedging relationship may no longer be reasonably effective without requiring reassessment of the hedge effectiveness at each reporting period? If yes, what constraints do you foresee and how would you alleviate them?

Yes. It is clear that process changes would be required. However, it is not clear how an assessment of changes in market conditions that trigger ineffectiveness would be made. This seems to be a definitional problem and should not be entity specific. All entities are subject to the same market conditions. Therefore, the accounting guidance should include a clearly understood set of criteria against which all companies would evaluate their hedges. However, the downside would be that without very careful thought and testing, these criteria may subject entities to similar "gotcha"s, maybe with wider parameters. This would not provide improvement over current guidance.

Question 63: Do you foresee any significant operational concerns or constraints arising from the inability to discontinue fair value hedge accounting or cash flow hedge accounting by simply de-designating the hedging relationship? If yes, what constraints do you foresee and how would you alleviate them?

Elimination of de-designation provisions would be operationally more difficult, increase costs, and add very finite operational risk. This element of the guidance complicates hedge strategies and the management/monitoring of them. The biggest problems and risks will take place in non-agency CMO assets and similar asset classes because you are buying another derivative well into the life of the asset. In addition, elimination of de-designation would not allow re-designation to another instrument, thereby limiting business management and hedge strategy opportunities.

Question 64: Do you foresee any significant operational concerns or constraints arising from the required concurrent documentation of the effective termination of a hedging derivative attributable to the entity's entering into an offsetting derivative instrument? If yes, what constraints do you foresee and how would you alleviate them?

This requirement creates more operational burden and another opportunity to fail for reasons other than those relevant to the business strategy. As indicated in the previous question, we recommend that dedesignation continue to be allowed.

This ED narrows the use/benefit of derivative hedging strategies for accounting when the economics do not change. The greatest benefit to users and business entities would be a qualitative assessment of hedge effectiveness at the beginning of the relationship, a relaxation of requirements around portfolio hedging, the flexibility to adjust hedge relationships, and disclosures that enable the entity to provide users with an understanding of the hedge strategies and changes during the period.

Question 65: Do you agree with the proposed disclosure requirements? If not, which disclosure requirement do you believe should not be required and why?

We have a great concern about the amount and types of disclosures that are being added by various projects in a piece-meal fashion. We strongly urge the Board to segregate a review of financial

statement disclosures, taking a comprehensive approach in conjunction with the financial statement presentation project.

### [Questions 66 - 67 are directed to users of financial statements]

### Question 68: Do you agree with the transition provision in this proposed Update? If not, why?

We believe there remain significant adjustments needed to the proposed guidance in order to achieve the necessary objectives, such that transition provisions cannot yet be evaluated. Clearly, it would require a long-range transition period were changes as drastic as those proposed were actually to be required. The transition would have to consider the significance of the changes to the financial statements and how best to enable users to determine the components that would affect their analyses covering years before and after the change. We believe more debate is warranted on this topic once the converged, proposed guidance is determined.

We note that the SEC has released a request for comment to users of financial statements regarding their current familiarity and educational process for understanding IFRS. The SEC clearly recognizes, as stated in their request for comment, the need for education for users to better understand the financial statements of an entity under IFRS. We believe that the proposed guidance in this ED would require an educational endeavor no less robust than for US users to convert to IFRS. With this in mind, we again strongly urge the Boards to align their standards and include sufficient lead time for a pervasive reeducation plan.

## Question 69: Do you agree with the proposed delayed effective date for certain aspects of the proposed guidance for nonpublic entities with less than \$1 billion in total consolidated assets? If not, why?

We are aware that there is much debate in the market place around small and medium sized companies. There have been proposals for a separate GAAP for those entities. The feasibility of small and medium sized companies to implement the changes proposed in this ED is much less likely and, in many cases, even less useful. Consequently, we believe that this proposed delay is warranted only if the ill-advised, draconian provisions of the ED are mandated.

### Question 70: How much time do you believe is needed to implement the proposed guidance?

There are some provisions of the guidance, as we have noted herein, that we do not believe are implementable. Were the ED to be finalized as proposed, it would take several years a) for the market-place to adjust to the new concepts and terminology, b) develop methodologies for producing reliable components of fair value, c) developing and programming data warehouse and IT systems to process the information, d) adjust processes and internal controls to assure accurate reporting and compliance, and e) a parallel run and possible reconciliation for a period of time to support education and discussions with stakeholders.

## Question 71: Do you believe the proposed transition provision is operational? If not, why?

No. Not in the immediate future for all of the reasons indicated in this comment letter.

### **NOTES**

(1) Financial Times article: "Bank Profits Depend on Debt-Writedown 'Abomination' " by Bradley Keoun and David Henry, July 11, 2010; Oppenheimer & Co, NY, analyst Chris Kotowski says, "In practice, it's an accounting "abomination" because fluctuations in the value of the debt don't change the amount the

banks owe. Just because Morgan's credit spreads widened out this quarter doesn't mean that their ultimate interest and principal payments changed one iota. The market will back it out, both on the upside and the downside."

(2) Examples include articles such as the report in FierceFinance by Jim Kim <a href="http://www.fiercefinance.com/story/hedge-funds-aim-cash-apple/2010-07-14?utm\_medium=nl&utm\_source=internal">http://www.fiercefinance.com/story/hedge-funds-aim-cash-apple/2010-07-14?utm\_medium=nl&utm\_source=internal</a>

The following excerpts illustrate:

"Hedge funds apparently got giddy when *Consumer Reports* issued its report on the iPhone 4... Beyond this kind of hysteria, the truth is that under a worst case scenario Apple would recall the few million iPhone 4's that have been sold and the problem would be solved."

"Hedge funds aren't looking to short the stock. Rather, they are waiting for it to slingshot back...Apple's pristine balance sheet, exponential growth opportunity, and innovative future product pipeline give hedge fund's confidence that this stock will always bounce back after being beaten down." It's an interesting take."

Articles like this lead us to question the fairness of fair value. What is the fair value of Apple stock in a situation like this? It is only apparent in hindsight with time for research and analysis to determine what is true and what is speculation, or worse, manipulation.

What is the value of "fair value" information on a particular reporting date when the reporting entity has no intention of selling in the near term?

(3) Excerpted from Principles of Communication: http://www4.uwm.edu/cuts/bench/commun.htm

Communication is complex. When listening to or reading some else's message, we often filter what's being said through a screen of our own opinions. One of the major barriers to communication is our own ideas and opinions.

Understanding and good communication depends on clarity and simplicity. Clear writing is concise.

Too much reliance on written material as a communication method may obscure the true needs of potential users. (emphasis added)

### (4) FASB Financial Instruments ED, Paragraph 2: Objective

"The objective of the proposed guidance is to provide an improved and consistent financial reporting model for the recognition, measurement, and presentation of financial instruments in an entity's financial statements. The model increases the decision usefulness of the information provided in the financial statements to users by recognizing and measuring many financial instruments at fair value, without eliminating amortized cost information."

### IFRS 9 Financial Instruments, 1.1: Objective

The objective of this IFRS is to establish principles for the financial reporting of financial assets that will present relevant and useful information to users of financial statements for their assessment of the amounts, timing and uncertainty of the entity's future cash flows.

(5) An example of future variables would be the occupancy rates that fund the mortgage on a piece of commercial real estate. An example of future events might be the possibility of regulatory changes that could affect commercial real estate.