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The IMA's Financial Reporting Committee (FRC) appreciates the opportunity to share its views on the FASB's proposed Accounting Standards Update Financial Instruments (Topic 825) and Derivatives and Hedging (Topic 815), Accounting for Financial Instruments and Revisions to the Accounting for Derivatives and Hedging Activities, (the "proposed ASU").

The FRC is the financial reporting technical committee of the IMA. The committee includes preparers of financial statements for some of the largest companies in the world, representatives from the world's largest accounting firms, valuation experts, accounting consultants, academics and analysts. The FRC reviews and responds to research studies, statements, pronouncements, pending legislation, proposals and other documents issued by domestic and international agencies and organizations.

The FRC supports the broad objectives of the project to improve the accounting for financial instruments and to simplify the accounting for derivatives. We have considered the Board's proposal on its own and in comparison with the proposals currently under deliberation by the IASB. While we do not support the fair value recognition and measurement model in the proposed ASU, we would support a blending of elements of the FASB and IASB approaches to form a converged global standard. We believe that it is imperative that the Boards reach agreement on a single set of requirements in this area as differences can, and likely will, create comparability problems and competitive advantages and disadvantages for multinational companies if they are allowed to persist. This reality is underscored by the actions each Board has had to take in the wake of the financial crisis. We emphatically disagree with those who believe that having FASB and IFRS standards that are reconcilable to one another is an acceptable compromise.

We believe that the optimal financial reporting for financial instruments would reflect the business model of the reporting entity and how those instruments affect its future cash flows. We see some recognition of this view in the conclusions reached by both the FASB and IASB. However, we believe that the decision to use fair value as the dominant measurement attribute is not helpful to users of financial statements because:

 Amortized cost is the more relevant measure for predicting future cash flows on financial assets and liabilities held for the collection or payment of contractual principal and interest.

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- For financial assets and liabilities held for cash flows, fair value measurement is inconsistent with how management manages the business. Users often wish to view the business through the eyes of management and the business model.
- Fair value measures often introduce unnecessary volatility and reliability issues into financial reporting. Differences in judgments about measurement decisions undermine users' ability to compare companies.
- Fair value measures of assets held for cash flows can send misleading signals of a company's economic performance.
- Fair value measures of liabilities held for cash flows produce nonsensical and counter-intuitive results.

Most of the surveys of users we have seen suggest users prefer amortized cost measures for financial assets and liabilities held for cash flows. Our reading is that while users are interested in fair values, they prefer to consume the information through footnote disclosure rather than as the dominant measurement attribute affecting the primary financial statements.¹

Besides being of questionable usefulness, the Board's proposal would be enormously costly for companies to implement:

- Companies will need to implement the accounting, fair value measurement, and related controls at the individual instrument level (e.g., individual loans). In contrast, preparing disclosures of fair value information can be accomplished at the portfolio level, which is far less expensive.
- Since the new accounting is inconsistent with the way the business is managed, companies will need to maintain two parallel systems for financial instruments
- Communicating with investors will likely require additional non-GAAP measures to present the business consistent with the business model.

As the Board's due process begins the redeliberation phase, the FRC believes that it is critically important that the Board examine and reach a high level of confidence that the resulting revised principles are operational to apply and can be implemented in a cost-efficient manner. This objective will be facilitated by requiring or permitting the use of information already used by management in running the business. We also think that the Board should make use of practical expedients where appropriate and consistent with the overall objective of the standard. Depending on the direction of the changes made, the Board should carefully consider the need for re-exposure and field-testing of new approaches.

Our comments are organized into three sections that related to the major project segments covered in the proposed ASU: recognition and measurement, impairment, and derivatives and hedging. We have some comments on additional topics toward the end of this letter.

¹ PricewaterhouseCoopers Survey: What Investment Professionals Say About Financial Instrument Reporting, June 2010, and Barclays Capital Survey: Bank Brief Newsletter Survey, June 2010.

Financial Instrument Recognition and Measurement

As a result of our significant concerns about the utility of a primary measurement model based on full fair value in communicating the meaningful information to investors and the consequential effects on the viability of the proposed ASU, we do not plan to provide detailed comments on that model. Overall, the FRC supports the development of a recognition and measurement model based on the framework in the recently issued IFRS 9 standard, with two important caveats:

- (1) We do not believe that gains and losses on equity instruments should be left in Other Comprehensive Income (OCI) without recycling. The fair value of equity instruments is the present value of expected future distributions, so the decision to include dividends in net earnings and capital gains and losses in OCI with no recycling appears to somewhat arbitrary. The ultimate realization of gains and losses on disposal represent real events that investors will expect to be included in earnings and earnings per share when realized. If this approach is retained in a converged standard we are concerned that it will inevitably lead to parsing of elements of OCI and pro-forma reclassifications of these items back into earnings by investors, analysts and the media. Net income is a crucial performance measure for which management is accountable and it should reflect the effects of these gains and losses.
- (2) We do not agree with recognizing the changes in the fair value of hybrid instruments in net income in their entirety. The definition of a derivative is so broad and inclusive that it has the undesirable effect of characterizing many ordinary features of financial instruments as embedded derivatives. Very often in practice, these features are minor and have an insignificant fair value. For example, a debt instrument issued at par may have provisions that permit the debt to be put back to the issuer at a substantial premium in the event of an initial public offering or a change in control. In many cases, the likelihood of those events would be remote and the fair value of the embedded derivative would be insignificant. To require the entire instrument to be marked to market as a result seems inconsistent with underlying economics and unhelpful to users. While we understand that the approach in the proposed ASU was developed because it was believed to be simpler, we observe that practice has developed reasonable and consistent approaches to bifurcate and separately account for such features when necessary, so we would prefer to continue with present requirements of Topic 815 in this area, which permit but do not require the entire instrument to be marked to market.

Impairment

The FRC believes that the goal of providing for more timely recognition of losses is appropriate and responsive to investor concerns regarding weaknesses in the accounting model revealed by the financial crisis. Current rules, by design can defer recognition of impairment and may not have served investors well. We observe that there are several ways to accomplish this objective. One way is to retain and enhance the notion of incurred loss, but lower or eliminate the probability threshold from the current model. Another way is to remove the notion of incurred loss and adopt some form of expected loss. Both approaches have potential and have different strengths and weaknesses.

We object to the models put forward by the FASB and the IASB because of concerns over operationality, cost and complexity. With regard to the Board's proposal, we have the following specific issues and concerns:

- (1) Use of best estimates to measure impairment losses The inability to assume changes in economic conditions in the future renders this measurement irrelevant for investors. In most every other area of accounting, estimates are based on assumptions about the future. Other than concerns about abuse, we can see no reason to restrict measurement to historical and current information.
- (2) Timing of loss recognition Reflecting losses on Day 1 (or in the quarter of loan origination) does not generally reflect the economics of lending and can result in the loans being recorded at less than fair value. As a general notion, we do not believe making a loan is a triggering event that justifies recording a Day 1 loss. However, spreading the losses generally presents conceptual issues and creates operationality concerns similar to those mentioned in item (3) below.
- (3) Recognition of interest income should not include the provision for credit losses The FRC disagrees with the Board's approach for three reasons. First, it comingles interest income and impairment notions together, yielding insights into neither, and obscuring information that we believe many investors wish to see. Specifically, we think investors want to see interest income that represents contractual interest on performing loans, in part, because it helps them gauge how the entity is being compensated for the risk assumed. Second, the administrative burden that the proposed approach imposes is significant. For example, in computing interest income, the proposal requires an arbitrary allocation of the loan loss allowance to individual or narrow groups of loans. Third, we see no reason to change current practice for measuring interest income. Current approaches, which report interest gross for loans that remain on accrual status, are well understood and are not a source of investor concern.

The FRC encourages the Boards to engage with experts including, but not limited to, the Expert Advisory Panel (EAP) in an effort to develop an impairment model that meets the following criteria:

- a. Provides timely signaling of impairment and which can be implemented in a practical manner.
- b. Responds to concerns about Day 1 recognition of lifetime impairment losses, either by limiting the forecast horizon or through an operational and cost-effective approach to spreading.
- c. Does not commingle interest income and impairment losses.
- d. Uses information currently available on loans (i.e., does not precipitate massive system changes nor require collection of information that management does not use in managing its financial instruments).
- e. Does not ask management to do the impossible, such as estimate probabilityweighted cash flows for distant future periods.

We strongly believe the FASB and the IASB need to work together to develop a converged impairment model that is operational and cost-effective to apply. We further

recommend that the model be exposed for public comment for an appropriate period of time and field tested.

Derivatives and Hedging

Overall, FRC supports most of the changes proposed related to hedging. We believe that the proposed ASU simplifies the mechanics of hedging in significant and important ways. These revised principles are more operational to apply than existing standards. As a result, it is far more likely that under this model economically effective hedges will qualify for hedge accounting and can be sustained over time. That said, there are a number of issues we would believe need to be addressed:

Ability to dedesignate and redesignate – The FRC strongly disagrees with the proposed ASU's removal of the ability to voluntarily de-designate and re-designate hedge accounting relationships. The risk profile of any large financial institution changes on a daily basis in response to economic factors and market conditions. Accordingly, it is often necessary to enter new hedging relationships and exit, or de-designate, existing hedge relationships to properly manage new risk exposure profile. While we understand that an enterprise can decide to terminate or offset hedging relationships as a remedy, this would cause entities to incur significant incremental costs and, in the case of termination, endure unnecessary and potentially untimely cash consequences. It would be unfortunate if this prohibition causes entities to change from prudent risk management strategies solely as a result of the attendant costs imposed by this change.

Practical expedients for hedge relationships in which all of the critical terms match -- For many non-financial services companies, the requirement to compute ineffectiveness for hedging relationships that would have otherwise qualified for the short-cut method imposes an operational burden that needs to be addressed. The classic plain vanilla interest rate swap that perfectly matches the debt being hedged is a very commonly executed hedge that will require far more accounting and measurement support effort under the revised guidance. While we accept that such hedges may not be 100% effective in all cases, we understand that there are simpler and more operational means to giving accounting recognition to the ineffectiveness that does not require the entity to apply the classic long-haul calculations for what are likely to be insignificant amounts of ineffectiveness. We further understand that such methods are routinely applied in the application of the ineffectiveness requirements under IAS 39. We ask that the Board explicitly provide for the use of practical expedients to measurement in these cases.

Designation of hedged items after they are initially recognized in the financial statements -- It is not clear whether the proposed ASU would permit this common practice (sometimes referred to as late hedging). Companies need to be able to enter into a hedge after debt has been issued as it is not always possible or prudent to hedge a financial instrument simultaneously with its issuance. Prohibiting late hedging results in these being accounted for as speculative positions, which is inconsistent with the intent and the economics of the company's use of the instrument.

Bifurcation of embedded derivatives -- As discussed previously, we disagree with the FASB's proposal to initially and subsequently measure all hybrid financial assets and liabilities at fair value if they contain embedded derivatives that would otherwise require bifurcation under Topic 815. Such a requirement is not consistent with the risk management strategies employed for these instruments and accordingly, will exacerbate

accounting measurement mismatches. We do not believe the Board's proposed guidance for hybrid instruments represents an improvement in financial reporting and would trigger fair value measurement for hybrids that have insignificant embedded derivatives, which is not appropriate. Rather, we believe it would be more appropriate to account for the host contract in accordance with the business strategy for the entire hybrid instrument rather than defaulting to fair value through earnings. Such a model would promote consistency with other non-hybrid instruments with similar business strategies.

Ability to hedge selected risks in non-financial instruments such as commodities -- Many companies have significant exposures to market risks hedged with derivatives in the ordinary course of business that are not able to apply hedge accounting because existing GAAP does not permit bifurcation by risk for nonfinancial hedged items. The inability to achieve hedge accounting for such exposures results in accounting that differs from the economics due to asymmetry in the accounting model. We urge the Board to amend the guidance in the ASU to extend bifurcation by risk to nonfinancial items such as commodities meeting specified conditions.

Retain measurement requirements for ineffectiveness – The FRC believes that measurement of ineffectiveness for cash flow hedges should only be recognized when an entity is overhedged and not when it is underhedged. The Board recognized the counterintuitive reporting that results from a symmetrical model. In par. 379 of FAS 133, the Board noted that symmetrical accounting would require an entity to "defer in other comprehensive income a nonexistent gain or loss on the derivative and to recognize in earnings an offsetting nonexistent loss or gain." We believe that the rationale for asymmetrical treatment of overhedged and underhedged arrangements continues to be relevant and appropriate as part of the revised model for accounting for financial instruments.

Retain existing accounting treatment for option premiums – We believe the Board developed a pragmatic and appropriate approach for accounting for option premiums in DIG Issue G-20. We do not believe that the revised approach improves the financial reporting for these hedging arrangements. Moreover, it will inevitably lead to the types of issues in practice (including operational complexity, significantly more accounting and measurement effort, lack of representational faithfulness) that precipitated the DIG addressing this matter in the first place.

Equity Method

We believe that the requirement to limit application of the equity method to those circumstances in which the investee's activities are related to those of the reporting entity is fraught with unintended consequences. There are common situations that would be routinely encountered in which carrying the investment at fair value through earnings misrepresents the substance and purpose of the investment (e.g., expanding into a new line of business through a joint venture), or where prohibiting mark to market accounting because the investment is deemed related also obscures the true impact of the investment (e.g., when an investment is made in an existing line of business but the intent is to sell after a short holding period for a profit). This results in financial reporting that is not representative of the business strategy of the entity. In addition, practice issues will arise about what is deemed to be *related*. We recommend that the Board

leave the existing US GAAP principles in place, including the availability of the fair value option.

Own Credit

We believe that the fair value adjustments of a non-derivative liability that relate to an entity's own credit risk should not be included in net income. As we have noted previously the accounting for issued debt at fair value produces non-sensical results: booking gains when a company's own credit is deteriorating and charges to earnings when it returns to financial health. We believe that this does not provide decision useful information and therefore that it should not be included in earnings.

Convertible Debt

Consistent with our prior comments on the need for the accounting model to reflect the business model and our objection to the proposed accounting for embedded derivatives, we do not see the value of recording convertible debt at fair value on a recurring basis. We expect that these earnings effects will be removed from the results of reporting entity by investors. Furthermore, we fundamentally disagree with the notion that changes in an issuer's stock price (which affects the fair value of the convertible instrument) should be recorded in earnings on a mark-to-market basis. We fully expect that there will be a resolution to the joint project on debt vs. equity that will have consequential effects for all forms of convertible debt. We believe that is the appropriate place to address these types of instruments. Until that time, we believe that convertible debt should generally be recorded by the issuer at amortized cost.

Disclosures

This project along with most of the new standards and interpretations issued in the last few years have added substantially to the supplemental information companies are required to include in their financial statements on an interim and annual basis. It is, at best, unclear as to whether investors have benefited from these expanded disclosures. Before adding still more, we would recommend that the Board defer adding to the disclosure checklist until such time as the Disclosure Framework project has been fully vetted and a rational basis has been established as to what this information allows investors to do.

Scope

We do not believe that fair value is the appropriate model for loan commitments and standby letters of credit. We are not aware of an existing investor concern with the accounting for these instruments and question the usefulness of recording these in the balance sheet at fair value on a recurring basis. Additionally, scoping them out would be convergent with IFRS.

We appreciate the Board's consideration of these comments. We are available to discuss these matters at your convenience.

Sincerely,

Allan Cohen

Chair, Financial Reporting Committee Institute of Management Accountants