April 10, 2006

Ms. Suzanne Bielstein
Director – Major Projects and Technical Activities
Financial Accounting and Standards Board
401 Merrit 7
P.O. Box 5116
Norwalk, CT 06856-5116


Dear Ms. Bielstein:


We believe that fair value is the most relevant measurement attribute for financial assets and financial liabilities and support the Board’s effort to broaden the use of fair value as a measurement attribute. This project, however, raises certain questions (e.g., what is the appropriate unit of account and should there be a reliability threshold?) that also surface in other fair value projects. Instead of addressing those questions in this proposed Statement, the Board is encouraged to address these issues in its Fair Value Measurements project and assign that project a priority that is at least equal to the Fair Value Option project. The Board also should be mindful of any potential mismatch in the effective dates of the Fair Value Measurement and the Fair Value Option projects (including opportunities for early adoption of the Fair Value Option Statement), since financial statement users may view the disclosures required by the Fair Value Measurements Statement as being critical for understanding the impact of an entity’s application of the fair value option.

When issued, the proposed Statement will establish disclosure requirements that are not entirely consistent with other existing and proposed Statements that permit or require measurement of financial assets and financial liabilities at fair value with changes in fair value reported in earnings (e.g., the proposed Fair Value Measurements Statement, Statement 133, and Statement 115). Although in some cases these different requirements are warranted, we believe the Board could further improve financial reporting by establishing (either in the Fair Value Measurements Statement or a separate project) a disclosure framework that could be applied to all financial assets and financial liabilities measured at fair value. This framework would help promote consistent fair value disclosure, yet still allow for individual statements to require special supplemental disclosure when necessary.
Equally important to finalizing the Fair Value Measurements project is the resolution of proposed FSP No. FAS 133-a, “Accounting for Unrealized Gains (Losses) Relating to Derivative Instruments Measured at Fair Value Under Statement 133,” since the day-one gain issue may manifest itself in the measurement of other assets and liabilities measured at fair value. Until the issues in proposed FSP FAS 133-a are resolved, a conceptual inconsistency might exist in GAAP, since a minimum reliability threshold would be required for recognition of day-one gains that pertain only to a single class of instruments.

Additionally, the Board should seek input from financial statement users regarding whether the lack of comparability that could result from unrestricted application of the fair value option on a contract-by-contract basis in certain situations is of sufficient concern to warrant placing certain constrains on the ability of companies to apply the fair value option contract-by-contract. For example, it is unclear whether allowing companies to apply the fair value option to only a subset of a homogeneous population such as a small proportion of a larger bond issue (e.g., to 500 individual bonds having a par value of $500,000 out of a total issue of 10,000 bonds having a par value of $10 million) or to individual lots of an equity security purchase (e.g., to 20 percent of an equity method investment that is owned 40 percent in the aggregate) improves financial reporting.

Finally, we believe that fair value is a useful measurement attribute for nonfinancial assets and liabilities, and that financial statement users may find fair value information about nonfinancial assets and liabilities to be relevant for their analysis and decision making. Application of the fair value option to certain nonfinancial assets and liabilities, however, will raise issues associated with revenue recognition and performance reporting. Those issues are discussed in more detail in our response to Issue 5. Ultimately, when the Board begins deliberating Phase 2 of the Fair Value Option project, we believe it will need to have largely addressed the related revenue recognition and performance reporting issues.

Our comments on the issues identified in the Notice for Recipients are submitted below in Appendix A. Additional comments and suggestions intended to improve the clarity and usefulness of the proposed Statement are provided in Appendix B.

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Deloitte & Touche LLP appreciates the opportunity to comment on the proposed Statement. If you have any questions concerning our comments, please contact Jim Johnson at (203) 761-3709.

Yours truly,

Deloitte & Touche LLP

cc: Carrie Bloomer
Jim Kroeker
Mark Bolton
APPENDIX A
DELOITTE & TOUCHE LLP COMMENTS
Responses to Notice for Recipients
File Reference No. 1250-001

Scope

Issue 1: The scope of this proposed Statement includes the following financial assets and financial liabilities that some may not have considered as being included:

a. An investment being accounted for under the equity method
b. Investments in equity securities that do not have readily determinable fair values, as described in paragraph 3 of FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities
c. Insurance and reinsurance contracts that are financial instruments, as discussed in FASB Statements No. 60, Accounting and Reporting by Insurance Enterprises, No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments, and No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts
d. Warranty obligations that are financial liabilities and warranty rights that are financial assets
e. Unconditional purchase obligations that are recorded as financial liabilities on the purchaser’s statement of financial position as discussed in paragraph 10 of FASB Statement No. 47, Disclosure of Long-Term Obligations.

Should an entity not be permitted the option to initially and subsequently measure those financial assets and financial liabilities or any others at fair value? If so, why should those financial assets and financial liabilities be excluded from the scope of this proposed Statement?

We support permitting the option for these items to the extent they meet the definition of a financial asset or financial liability. However, as discussed below, we believe that the Board will need to provide additional clarification or implementation guidance for several of these assets or liabilities.

a. Equity Method Investments

The Board should clarify what constitutes the appropriate unit of account for equity method investments. The proposed Statement permits contract-by-contract election, and might be interpreted as allowing an entity to apply the fair value option to some individual ownership interests or shares in the equity method investment but not to others. We believe that the appropriate unit of account for purposes of making the fair value option election for equity method investments is the entire ownership interest.
Additionally, we believe that any subsequent incremental investment in an equity method investment must be carried on the same basis as the original investment. Permitting some portion of the equity method investment to be carried at fair value while the other portion is accounted for under the equity method (1) seems to exacerbate the mixed attribute measurement issues that the Board is attempting to mitigate, (2) may not be useful to users of financial statements, and (3) would require further clarification by the Board as to how to account for the portion not carried at fair value (for example, if an entity has a 40 percent equity method investment and accounts for 30 percent at fair value, how should it account for the remaining 10 percent?).

b. Investments in Equity Securities That Do Not Have Readily Determinable Fair Values

Our comments with respect to unit of account for equity method investments also would apply to investments in equity securities that do not have readily determinable fair values (i.e., cost method investments). While carrying a portion of a cost method investment at fair value does not present the same challenge as exists with an equity method investment with respect to how to account for the portion not being carried at fair value, cost method investments could later become equity method investments and we don’t believe there is a compelling reason to permit an entity to carry only a portion of such investments at fair value.

c. Insurance and Reinsurance Contracts

Definition

It may be difficult to determine whether some insurance contracts meet the definition of a financial asset or financial liability as illustrated by four sample contracts in which the insured’s claim is settled as follows:

1. The insurer makes a cash payment to the insured.
2. The insurer reimburses the insured in cash for out-of-pocket expenditures covered by the insurance contract.
3. The insurer pays a third party to perform services to settle the insured’s claim.
4. The insurer provides noncash services to the insured.

Although all four contracts result in a similar economic outcome, it is likely that only the first two contracts meet the proposed definition of a financial liability for the insurer. The analysis may be more complex if the contact provides one of the parties with the option of choosing a settlement method.

Since there has been no previous accounting requirement or option to measure insurance contracts that qualify as financial assets or liabilities at fair value through earnings, we encourage the Board to provide examples in the final Statement to illustrate how to determine whether an insurance contact meets the definition of a financial asset or liability. One could interpret the Board’s conclusion in paragraph A6(c) as limiting the scope of the Statement to only “pure” financial assets or liabilities (i.e., no nonfinancial components).
Additionally, consideration should be given to the fact that many insurance contracts whose predominant feature is that of a financial asset or liability also contain certain minor nonfinancial components. For example, the underwriter of an insurance contract also may provide claims processing or administration. The Board should consider providing guidance for how these arrangements impact the analysis of whether the contract is a financial asset or liability.

**Deferred Acquisition Costs and Unearned Premiums**

The proposed Fair Value Measurements Statement indicates that “transaction costs” should not be included in an estimate of fair value, but it does not specify how to account for transaction costs (indicating that other existing GAAP should be followed). The Board should clarify how electing the fair value option impacts the accounting for certain deferred items such as deferred acquisition costs and unearned premiums.

**Demand Deposits Definition**

If the Board ultimately concludes that demand deposits should not be included in the scope of the proposed Statement, it should clarify whether other financial instruments that have characteristics similar to a demand deposit account (e.g., certain insurance contracts) also should be excluded.

**d. Warranty Rights and Obligations**

Warranties can also possess financial and non-financial aspects. Please see the discussion regarding insurance contracts and the definition of a financial asset or liability.

**Other Scope Comments**

It is unclear whether the fair value option could be applied to certain deferred revenues or similar items recorded as liabilities as a result of sales of future revenue under Issue 88-18, failed real estate sales under Statement 66, failed sale leaseback transactions under Statement 98, or deferred credits in a multiple element arrangement under Issue 00-21. Some may argue that these liabilities possess characteristics of financial liabilities.

For example, assume there is a multiple element arrangement in which the first unit of accounting is delivered and paid for, but the amount paid is refundable if the second unit of accounting is not delivered. Paragraph 14 of Issue 00-21 requires the revenue on the first unit to be deferred. That deferred revenue could be viewed as a financial liability (a deposit or amount due to the customer) until the second unit is delivered; alternatively, since the liability can be settled by delivering a nonfinancial good or service the deferred revenue might not be considered a “pure” financial liability.

We encourage the Board to add additional implementation guidance or illustrative examples to the proposed Statement that would clarify how to determine whether arrangements such as these met the definition of a financial liability that would be eligible for the fair value option.
Issue 2: This proposed Statement permits an entity to elect the fair value option at inception for a firm commitment that would otherwise not be recognized at inception under existing generally accepted accounting principles (GAAP) and involves only financial instruments. Should an entity be permitted the option to recognize those firm commitments at fair value at inception of the contract? If so, why is the availability of the fair value option election important for those contracts and what types of entities would likely avail themselves of that fair value option election? Should the scope be limited to forward contracts that meet the definition of firm commitments under FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities (that is, requiring that the terms of the forward contract include a disincentive for nonperformance that is sufficiently large to make performance probable)? If not, why not?

We believe that firm commitments as defined in the proposed Statement meet the definition of assets and liabilities included in the FASB Concepts Statements; accordingly, we do not object to including firm commitments in the scope of the proposed Statement.

Issue 3: The scope of this proposed Statement would exclude both (a) written loan commitments that are not accounted for as derivative instruments under Statement 133 and (b) financial liabilities for demand deposit accounts. The Board decided to specifically exclude those financial instruments, since the determination of their fair values involves consideration of nonfinancial components. Should an entity be permitted the fair value option election for those financial instruments? If so, why? What would be the appropriate unit of account for determining the fair value of demand deposit liabilities? What other financial assets and financial liabilities for which their fair values involve consideration of nonfinancial components should be excluded from the scope of this proposed Statement?

We believe that demand deposits and written loan commitments should be within the scope of the proposed Statement. The stated reason for excluding these items is that nonfinancial components factor into the determination of their fair values. Although the existence of nonfinancial components could raise unit of account issues, other contracts whose valuation also considers nonfinancial components are included in the scope of the proposed Statement. Examples include certain insurance contracts (whose fair value may be based on factors such as mortality statistics) and credit card instruments and mortgage securities (whose fair values may consider the value of customer relationships). Also, although the fair value of written loan commitments may contain a nonfinancial component, an established market exists for certain of these commitments (i.e., a market exists such that prices are often observable), and their valuation may be more reliable than other instruments currently included in the scope of the proposed Statement.

If demand deposits are going to be excluded from the scope of the proposed Statement (or limited in some other manner), the characteristics of a demand deposit that warrant exclusion should be the basis for the exclusion rather than legal form of the instrument.
Issue 4: The scope of this proposed Statement would also exclude:

a. An investment that would otherwise be consolidated
b. Employers' and plans' financial obligations for pension benefits, other postretirement benefits (including health care and life insurance benefits), postemployment benefits, employee stock option and stock purchase plans, and other forms of deferred compensation arrangements as defined in FASB Statements No. 35, Accounting and Reporting by Defined Benefit Pension Plans, No. 87, Employers' Accounting for Pensions, No. 106, Employers' Accounting for Postretirement Benefits Other Than Pensions, No. 112, Employers' Accounting for Postemployment Benefits, No. 123 (revised December 2004), Share-Based Payment, No. 43, Accounting for Compensated Absences, and No. 146, Accounting for Costs Associated with Exit or Disposal Activities, and APB Opinion No. 12, Omnibus Opinion—1967

c. Financial liabilities recognized under lease contracts as defined in FASB Statement No. 13, Accounting for Leases. (This exclusion does not include a contingent obligation arising out of a cancelled lease or a guarantee of a third-party lease obligation.)

The Board decided to specifically exclude those financial assets and financial liabilities from the scope of this proposed Statement, as the Board believes that any modifications to the accounting for such financial assets and financial liabilities should be part of a reconsideration of those areas and should not be affected by the fair value option. Should an entity be permitted the fair value option election for those financial instruments? If so, why?

We agree with the Board’s decisions to exclude these financial assets and liabilities. We also believe it would be helpful if the body of the Statement made it clear that assets recognized under Statement 13 as part of sales-type, direct financing, and leveraged leases are specifically excluded from the scope of the Statement, as some might conclude that such assets are financial assets if they did not read the discussion in the Basis for Conclusions of the proposed Statement (i.e., paragraph A6). Additionally, in the Basis for Conclusions the Board may want to clarify why it believes such instruments are not pure financial instruments, since paragraph 89 of Statement 140 indicates that some of these contracts may be financial instruments. Explaining the rationale for why these contracts are not pure may help clarify why other contracts may or may not be financial instruments (e.g., insurance and warranty contracts).
Issue 5: As noted above, this proposed Statement represents Phase 1 of the fair value option project. Phase 2 will consider permitting the fair value option for selected nonfinancial assets and liabilities. The Board is seeking input on what nonfinancial instruments should be included in the scope of Phase 2. Please provide details of those nonfinancial instruments and why they should be eligible for the fair value option. How would applying the fair value option to those nonfinancial instruments (a) improve financial reporting, (b) mitigate problems for reported earnings caused by the mixed-attribute model, and (c) enable an entity to simplify its accounting methods? Is fair value information readily available for those nonfinancial instruments?

We don’t believe there is a one-size-fits-all approach for determining which nonfinancial assets and liabilities should be eligible for the fair value option. A combination of factors should be considered, including (1) how the reporting enterprise uses the asset or liability in the normal course of business and (2) the reliability of the fair value measurement. For example, if an entity actively trades a given commodity in an established market as part of its business model, providing that entity with the option to carry that commodity at fair value would improve financial reporting, since carrying that commodity at a readily determinable fair value in the entity’s financial statement allows financial statement users to gauge how effectively the entity executed its business model.

It is less certain whether financial reporting would be improved in a situation in which a manufacturer purchases the same commodity as raw material to use in its manufacturing process. In this circumstance, application of the fair value option raises conceptual issues about whether or when the manufacturer should cease marking the commodity to market as it is transformed into work in process or finished goods inventory. Before permitting use of the fair value in this situation, the Board would need to determine if recognizing revenue for fair value adjustments to the cost basis of the commodity in advance of the ultimate sale of the finished goods inventory to a third party would provide financial statement users with information that is useful for their decision making and analysis of the manufacturer’s operations. This determination is inherently interrelated with the Board’s ultimate conclusions on revenue recognition and what performance measures are most useful for financial statement users (i.e. the financial performance reporting by business enterprises project).
Extending the fair value option to nonfinancial assets and liabilities also raises issues as to whether existing consolidation guidance should be modified. Some entities may argue that allowing them to opt to account for certain investments in operating entities at fair value provides information to their investors that is more useful than information produced by the current accounting model. For example, assume an entity makes a venture capital or merchant banking investment in an operating property (e.g., a hotel) for the purpose of income and capital appreciation with an intent (and perhaps a past history) of selling the property for profit. Since the entity views the operating property as an investment and not as an integral component of its operations, it may argue that carrying that property as an investment at fair value provides financial statement users with information that is more useful for decision making or analysis than the information that would be provided if the operating property were consolidated with the entity’s other assets and liabilities. Conversely, granting that same fair value option to a hotel chain whose primary business is operating hotels would not necessarily provide financial statement users with information that is more useful than that provided by the existing accounting model. Similar issues have been discussed by AcSEC in its deliberations of the scope of the AICPA Audit and Accounting Guide Investment Companies; however the Board’s efforts to broaden constituents’ use of fair value may warrant reconsideration of some of these issues.

Changes in Creditworthiness

Issue 6: This proposed Statement would permit an entity to elect the fair value option for certain financial liabilities, including debt liabilities. Under this proposed Statement, an issuer who has elected the fair value option for its debt liabilities would report changes in fair value of those liabilities, including changes resulting from changes in that issuer’s own creditworthiness, as gains and losses in earnings. If significant changes in fair value of those liabilities occur during a period, qualitative disclosures about the nature of those changes would be required. The Board discussed several possible approaches for curtailing the debtor’s recognition of the portion of a liability’s changes in fair value that is attributable to changes in its own creditworthiness and determined not to provide any curtailment; instead, the Board decided that liabilities should be recorded at fair value when the fair value option has been elected with all changes in fair value recorded in earnings. Do you agree with the Board’s decision? If not, why not? What alternative approaches or additional disclosure requirements should the Board consider?

As we noted in our comments on the Fair Value Measurements Exposure Draft, we understand the Board’s rationale in requiring an entity to consider its credit standing when estimating the fair value of a liability, and agree that it has substantial conceptual merit; however, we continue to wonder whether a wide range of financial statement users will find this measurement and its potential income statement effect useful. The proposed Fair Value Option Statement requires qualitative disclosure about the reasons for any significant changes in the fair value of liabilities measured at fair value; but we question whether qualitative information alone will be sufficient for users of financial statements to understand the impact of changes in an entity’s creditworthiness on its financial statements. To make this impact more transparent, the Board should require additional disclosure of the quantitative impact on earnings of changes in an entity’s own credit standing during the reporting period. We also believe that entities that carry liabilities at fair value should be required to provide parenthetical disclosure, on the face of the balance sheet, of amounts that would be contractually due if the debt were to be extinguished at the balance sheet date.
Presentation and Disclosure Requirements

Issue 7: The Board discussed several possible approaches for separately reporting changes in the fair values of financial assets and financial liabilities measured at fair value pursuant to the election of the fair value option in the income statement or in the notes to the financial statements. The Board decided that an entity should provide information that would allow users to understand the effect of changes in the fair values of assets and liabilities subsequently measured at fair value as a result of a fair value election, but it did not prescribe detailed guidance on where and how that information should be reported. How should changes in the fair values of assets and liabilities subsequently measured at fair value as a result of a fair value election be reported? Should those changes be aggregated with the effect on earnings derived from other similar financial assets and financial liabilities in the income statement, or should separate display of those changes in the income statement be required? What level of aggregation should be permitted? What additional disclosure requirements should the Board consider?

As noted in our cover letter, we encourage the Board to develop one disclosure framework that would apply to all assets and liabilities carried at fair value, with changes in fair value reported in earnings. To the extent possible, those requirements should be incorporated into the final Fair Value Measurement Statement.

Disclosure Requirements

If the Board concludes that the Fair Value Option Statement should require a separate set of disclosures, the disclosures outlined in paragraphs 12 and 13 (when combined with those of the proposed Fair Value Measurements Statement) generally appear sufficient to allow users of financial statements to understand the impact of using the fair value option. We also believe, however, that the following suggestions would provide additional value to financial statement users:

Paragraph 12

The disclosure requirement in paragraph 12(a) is unclear (e.g., how would this requirement be applied to zero coupon debt?) and may not provide the most relevant information to users of financial statements. We believe it would be clearer if the Board rephrased the existing requirement that states in part, “[disclose the difference between fair value] ... and the aggregate principal amount the entity would be contractually required to pay to holders of the obligations at maturity (or through the maturity date for any debts whose principal amounts are payable in installments),” so that it instead expressed a requirement to disclose the amount that would be contractually due if the liability were to be extinguished as of the balance sheet date. Alternatively, perhaps there should be two requirements (1) to disclose the amount due if the liability were to be extinguished as of the balance sheet date and (2) to disclose the amount due at maturity (or through the maturity date).

Paragraph 12(a) indicates that the disclosure requirement is limited to financial liabilities. Financial statement users would be similarly interested in financial assets carried under the fair value option whose fair values differ from their contractually obligated amounts. The Board should consider requiring the same disclosure for financial assets.
Paragraph 15 of the proposed Statement provides transition guidance for when the fair value option is applied to securities previously classified as available for sale or held to maturity under Statement 115. That guidance states that application of the fair value option effectively reclassifies those securities as trading securities, implying that even after application of the fair value option, such securities still are subject to the requirements of Statement 115. The Board should indicate if this interpretation is correct, since the disclosure requirements for Statement 115 trading securities differ from those required by the proposed Statement (i.e., Statement 115 paragraph 21(c) requires disclosure of unrealized gains and losses, while paragraph 12(c) of the proposed Statement does not appear to require such disclosure). It seems counter-intuitive that there would be a requirement to disclose unrealized gains and losses associated with securities that have readily determinable fair values (i.e., Statement 115 trading securities), but that no similar information would be provided about assets without readily determinable fair values that are carried at fair value pursuant to the fair value option (or Statement 133 derivatives).

As noted above, it is not clear whether the disclosure required by paragraph 12(c) of the proposed Statement encompasses all gains and losses, or only unrealized gains and losses. The Board should solicit feedback from financial statement users as to whether the distinction between realized and unrealized gains and losses is useful for decision making and analysis and then clarify the requirement.

**Paragraph 13**

Paragraph 13 of the proposed Standard requires entities to disclose qualitative information about significant changes in the fair values of liabilities carried at fair value. The Basis for Conclusions states that the purpose of this disclosure is to capture significant adjustments to the fair value of a financial liability (for which the fair value option has been elected) caused by changes in the entity’s own credit standing. The current wording in this paragraph appears to allow offsetting changes in fair value to reduce the usefulness of this disclosure. For example, the fair value of a liability carried at fair value could decrease significantly due to a change in interest rates and simultaneously increase significantly due to a change in the entity’s own credit standing. It appears that the Board’s concern is the latter; if so, the Board should consider changing the requirement to clarify that disclosure is required for significant changes resulting from changes in the entity’s own credit standing.

**Income Recognition**

Paragraph A15 of the proposed Statement indicates that the Board considered whether guidance should be provided about how reported interest should be determined for receivables and payables reported at fair value under the fair value option, and concluded that this issue is not new and should be resolved in a different project. We believe that the Board did not intend this paragraph to change existing guidance for calculating interest and dividends; however, some might interpret paragraph 12(d) as allowing a change as long as the methodology is disclosed. That is, paragraph 12(d) requires entities to describe how interest and dividends are measured and reported in the income statement (clearly implying that there are alternatives). We suggest the Board adopt an approach similar to that taken in Statement 115. Paragraph 14 of Statement 115 states in part:
Dividend and interest income, including amortization of the premium and discount arising at acquisition, for all three categories of investments in securities shall continue to be included in earnings. This Statement does not affect the methods used for recognizing and measuring the amount of dividend and interest income.

We believe a similar statement (i.e., that election of the fair value option does not change dividend and interest income or expense recognition) should be incorporated into the proposed Statement. Entities that elect the fair value option should continue to compute dividend and interest income and expense as before, and the required mark to fair value should be applied to the asset or liability cost basis that already reflects this income/expense recognition. This should help maintain the comparability of dividend and interest income and expense amounts reported by entities, and help ensure that any quantitative disclosure of the changes in the fair values of assets and liabilities that are reported in earnings are calculated on the same basis. Absent such a requirement, amounts disclosed to comply with paragraph 12(c)'s requirement that entities disclose by line item the impacts of items carried at fair value through earnings will likely be calculated using different computation methodologies, and therefore be less useful to financial statement users.
APPENDIX B
DELOITTE & TOUCHE LLP COMMENTS
Comments and Suggestions on the Proposed Statement
File Reference No. 1250-001

Objective

Paragraph 1 of the proposed Standard indicates in part that the Statement's objective is to improve financial reporting by providing entities a mechanism by which they can mitigate volatility in reported earnings that is caused by an accounting model that uses multiple measurement attributes. Paragraph A3(a) also includes the same reasoning, but adds the following sentence, "The effect on earnings from using mixed measurement attributes under U.S. GAAP may not be representative of the economics of the reporting entity's activities." We encourage the Board to consider refining the language in paragraph 1 to reflect the notion that the current mixed measurement system may not be representative of the economics of the reporting entity's activities.

Financial Statement Presentation

Cash Flow Reporting

We encourage the Board to indicate in the title to the proposed Statement that the proposed Statement includes an amendment of Statement 95. Also, we recommend that the Board add to paragraph 11 a reference to Appendix B, since the proposed Statement is itself amending Statement 95.

Paragraph 11 of the proposed Statement notes that cash receipts and cash payments associated with financial assets and financial liabilities carried at fair value due to election of the fair value option shall be classified pursuant to Statement 95, based on the nature and purpose for which the related financial assets and liabilities were acquired or incurred. We disagree that the classification of cash flows produced by assets and liabilities carried at fair value pursuant to the fair value option should be "locked in" on the acquisition or incurrence date. Instead, we encourage the Board to allow the cash flow classification to be dictated by management's intent for and use of the asset or liability at the reporting date. We believe this alternative will be easier for preparers to apply and will provide investors and analysts with information that is more useful for their decision making.

For example, a bank may elect to apply the fair value option to one of its loans held for sale at the origination date of the loan. Since it intends to sell the loan in the near future, it classifies the funding of the loan and subsequent principal collections as operating activities in its statement of cash flows. A year later, the bank may decide that it no longer wants to sell the loan, and instead intends to hold the loan for investment. Under the proposed Statement, principal collections on the loan and its ultimate sale must still be classified as operating activities. We believe, however, that when management changes its intent with respect to the loan, the cash flows produced by the loan should be classified as investing activities.
The benefits of this alternative are (1) it is easier for the bank to apply, since the classification of cash flows produced by the loan is based on management’s intent and actual use of the loan at the reporting date (i.e., there is no need for the bank to keep track of the nature and purpose for which the loan was originated) and (2) the cash flows reported to investors and analysts reflect the bank’s actual intentions for and use of the loan at the reporting date.

In addition, while the Basis for Conclusions explains why the Board did not require operating classification for all financial assets and liabilities subject to the fair value option, the final statement would benefit if the Board explained the rationale behind making the amendments included in the proposed Statement.

**IAS Differences**

We believe the following differences between IAS 39, *Financial Instruments*, or other relevant IAS literature and the proposed Statement should be highlighted in paragraph A22 of Appendix A of the proposed Statement:

- IAS 39 only allows the fair value option to be applied to equity instruments whose values can be reliably measured (IAS 39, paragraph 9).

- IAS does not permit equity method investments (except if held by certain venture capital organizations, mutual funds, unit trusts, or similar entities) where significant influence exists to be carried at fair value (IAS 39, paragraph 2(a) and IAS 28, *Investments in Associates*, paragraph 18).

- For hybrid instruments, the fair value option cannot be applied under IAS 39 (paragraph 11A) if (a) the embedded derivative(s) does not significantly modify the cash flows that otherwise would be required by the contract or (b) it is clear with little or no analysis when a similar hybrid (combined) instrument is first considered that separation of the embedded derivative(s) is prohibited, such as a prepayment option embedded in a loan that permits the holder to prepay the loan for approximately its amortized cost.

**Other Comments, Suggestions, and Editorial Items**

- The Board should consider clarifying that electing the fair value option as a preexisting policy (as described in paragraph 6) does not preclude an entity from permitting exceptions to that policy, as long as documentation prepared at the inception of the contract clearly specifies the accounting policy that will be applied to the contract. Paragraph A8 of the proposed Statement discusses the Board's intent to provide entities with greater flexibility in obtaining benefits from the fair value option; we believe that permitting occasional exceptions at the inception of the contract is consistent with the Board's intent.
• Statement 155 does not permit an item carried at fair value under that Statement's fair value option to be used as a hedging instrument in a Statement 133 hedge. The proposed Statement does not include a similar prohibition. Since Statement 133 allows entities to use a non-derivative contract as a hedging instrument in certain foreign currency hedges, the Board should consider prohibiting financial assets and liabilities carried at fair value under the fair value option from being used as hedging instruments in a hedging relationship under Statement 133.