Fair Value Option
Comment Letter Analysis

PURPOSE

1. This paper presents the staff’s summary of the comment letters received in response to the FASB Exposure Draft, The Fair Value Option for Financial Assets and Financial Liabilities.

GENERAL

2. As of 12 days after the April 10 close of the comment period, 73 comment letters had been received. Comment letters received subsequently have not been included in this analysis, but have been distributed to Board members and are available on the FASB website.

3. This analysis provides a summary of the respondents’ positions on various issues and their recommendations to address certain issues. The analysis includes issues raised in the notice for recipients, as well as other issues that were not specifically addressed in the notice.

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PROFILE OF RESPONDENTS

4. This paper includes an analysis of the comment letters submitted by 73 organizations and individuals. The table below summarizes the types of entities included in this analysis of responses to the fair value option (FVO) Exposure Draft.

<table>
<thead>
<tr>
<th>Type of Respondent</th>
<th>Number</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banking &amp; non-bank financial</td>
<td>26</td>
<td>36%</td>
</tr>
<tr>
<td>Insurance-related</td>
<td>12</td>
<td>16%</td>
</tr>
<tr>
<td>Industry</td>
<td>10</td>
<td>14%</td>
</tr>
<tr>
<td>Public accounting</td>
<td>10</td>
<td>14%</td>
</tr>
<tr>
<td>Securities analyst &amp; other users</td>
<td>6</td>
<td>8%</td>
</tr>
<tr>
<td>Academe</td>
<td>2</td>
<td>3%</td>
</tr>
<tr>
<td>Regulator</td>
<td>2</td>
<td>3%</td>
</tr>
<tr>
<td>Other</td>
<td>5</td>
<td>6%</td>
</tr>
<tr>
<td><strong>Total respondents</strong></td>
<td><strong>73</strong></td>
<td><strong>100%</strong></td>
</tr>
</tbody>
</table>

OVERALL POSITION

5. Overall, the Exposure Draft received a significant level of support from the constituents that submitted comment letters. About one-third of

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1Respondent categories include representative organizations.
respondents expressed general support for the proposed Statement. In addition, a little over another third of the respondents support the proposal but requested more-than-trivial modifications in one or more areas. Slightly less than a quarter of the respondents opposed the proposal.

6. Supporters and opponents alike acknowledged that the FVO will create some comparability issues, but the supporters viewed the advantages of the FVO and the proposed disclosures as overcoming that drawback. Supporters emphasized that the FVO enables entities to achieve an offset accounting effect for the fair value changes of related financial assets and financial liabilities without having to endure the significant efforts involved in qualifying for hedge accounting. A number of opponents urged the Board to relax the requirements for hedge accounting in lieu of creating the FVO.

7. The following table shows a general summary of frequent comments made by all respondents categorized as either generally positive comments or generally negative comments.

<table>
<thead>
<tr>
<th>Generally Positive Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Accounting under the Exposure Draft:</strong></td>
</tr>
<tr>
<td>Achieves an offsetting effect without having to meet hedging requirements of Statement 133</td>
</tr>
<tr>
<td>Reduces the need for exception-based accounting to counteract differences caused by a mixed attribute model; minimizes the challenges and difficulties caused by that model</td>
</tr>
<tr>
<td>Better aligns financial reporting with how most entities manage risk</td>
</tr>
<tr>
<td>Promotes the use of fair value, which is the most relevant measure for financial instruments</td>
</tr>
<tr>
<td>Will decrease volatility in earnings</td>
</tr>
<tr>
<td>Furthers convergence with the IASB</td>
</tr>
<tr>
<td>Creates advantages by recording financial instruments at fair value that significantly outweigh the potential reduction in comparability</td>
</tr>
<tr>
<td>Provides a reasonable transition to requiring fair value</td>
</tr>
</tbody>
</table>
Generally Negative Comments

**Accounting under the Exposure Draft:**
- Will impair comparability, enabling economically similar transactions to be accounted for differently
- Does not provide a reliability threshold, such as limiting to reliably measurable fair values or verifiable fair values, to curb abuse
- Pertaining to financial liabilities might result in the entity recognizing gains or losses in earnings for changes in its own creditworthiness
- Should not be issued until the proposed FASB Statement on fair value measurement is finalized
- Will increase volatility in earnings
- Would be better reported as a disclosure item rather than on the face of the financial statements
- Will be costly to implement
- Will create transition issues, such as an opportunity to “bury” previously unrecognized losses in a cumulative catch-up adjustment
- Indicates that the Board is placing undue weight on convergence with international standards
- Should be required, not be an option, thus avoiding comparability problems
- Should not be issued until the conceptual framework project reconsiders whether cost basis or fair value is more relevant
- Will require burdensome recordkeeping, tracking, etc.

8. The remainder of this paper addresses the various issues identified in the notice for recipients as well as other aspects of the proposed Statement.

**SCOPE**

9. Issues 1–4 of the notice for recipients in the Exposure Draft address scope issues for Phase 1 of the FVO project.
Investments Being Accounted for under the Equity Method [NFR Issue 1a]

10. About one-third of all respondents commented on whether investments accounted for under the equity method should be within the scope of the FVO document. Those respondents were nearly evenly split in their support or opposition to the proposal.

11. A majority of the respondents who disagree argued that fair value should not be used unless the investment’s fair value was either readily determinable or observable in the market.

12. One respondent PricewaterhouseCoopers (PwC) (Letter #43, page 4), suggested that the FVO should not be available for equity method investments (a) that are made for strategic operating purposes and (b) that do not have a readily determinable fair value. PwC mentioned in its letter that it considers only Levels 1 and 2 within the fair value measurement project hierarchy to be readily determinable. PwC also mentioned that it would like the Board to undertake a comprehensive reconsideration of APB 18. Air Products and Chemicals Inc. (Letter #6, page 3) suggested that fair valuing investments that are accounted for under the equity method is not meaningful unless an entity is going to sell its investment. Air Products and Chemicals’ letter suggested that the amount of investment the company has made and the current earnings from those affiliates as currently reflected in income is more important.

13. While PwC (Letter #43, page 4 of Attachment A) would only allow fair value for equity-method investments when those investments are made for the purpose of current income or capital appreciation or both. Ernst & Young (Letter #67, page 1 of Attachment A) suggested that equity investments may have nonfinancial components in them and therefore it may be more appropriate to exclude these instruments from the scope of
Phase 1 and address them in Phase 2. It appears that most respondents that disagree with applying the FVO are more concerned with lack of reliability than lack of comparability.

14. The AICPA (Letter #65, page 4) supports an inclusion of equity method investments within the scope of the FVO and noted that the final Statement needs to “clarify explicitly that once fair value measurement has been elected, the investment is not an equity method investment and any accounting guidance that applies to equity method investments (e.g., intercompany profit elimination in accordance with APB No. 18 and SOP-18-9) is no longer applicable.”

**Investments in Equity Securities That Do Not Have Readily Determinable Fair Values [NFR Issue 1b]**

15. About one third of all respondents commented on whether investments in equity securities that do not have readily determinable fair values should be within the scope of the FVO document. Slightly over half of those that commented support the proposed inclusion of such investments.

16. Most of the few who disagree suggested that if there were no observable markets or the markets were thinly traded, the fair value that could be derived would not represent the true fair value and therefore was inappropriate. The letter from the five federal financial institution regulatory agencies—Federal Reserve, FDIC, OCC, OTS, and NCUA—(Letter #69, page 3) suggested that the guidance take into account the IASB’s criteria for reliable measurement as specified in IAS 39.

**Insurance and Reinsurance Contracts [NFR Issue 1c]**

17. About a third of all respondents commented on whether insurance and reinsurance contracts should be within the scope of the FVO document.
More than half of those that commented support the inclusion of those contracts.

18. Several respondents who disagree with including insurance contracts within the scope of the FVO document suggested that including insurance contracts in this document would be inconsistent with the movement to international convergence and that the Board should exclude insurance and reinsurance contracts from Phase 1, pending completion of the modified joint insurance project.

19. A number of respondents argued that there are no observable markets and, in some cases, no active secondary markets. Those respondents believe that there is insufficient guidance for determining fair value measurements for such contracts, and application without more guidance is likely to lead to restatements and inconsistent fair value measurements. They suggested that many of the assumptions used in fair valuing contracts, in particular: the use of risk margins, changes in creditworthiness, the selection of discount rates, the use of deposit floors, and unbundling are subjective and complex.

20. Some cited that inclusion of insurance contracts in the scope was inconsistent with the exclusion of insurance contracts in FASB Statement No. 107, Disclosures about Fair Value of Financial Instruments. A number of respondents also suggested that including insurance contracts was inconsistent with the exclusion of leases, pensions, and other post-employment benefits (which were also scoped out of Statement 107).

21. St. Paul Travelers stated:

   We believe that it would be premature to include insurance contracts in the scope of the FVO given the lack of guidance on fair value measurement and the absence of developed practice
for such contracts. Until the IASB develops a relevant and reliable model for measuring insurance contracts at fair value, we believe that the same reasons that insurance contracts have been excluded from Statement 107 and other fair value standards continues to exist. [Letter #34, page 4]

22. Ernst & Young stated the following:

There are a number of significant and fundamental issues/questions that the Board needs to address before allowing entities to fair value insurance contracts. These issues include, but are not limited to, the following:

- Clarification as to which insurance contracts are deemed to be financial instruments.

- Additional guidance with respect to the unit of account for insurance contracts:
  
  - Clarification as to what exactly is to be measured at fair value; only the liability associated with the contract (e.g., in the case of property and casualty contracts this would represent incurred claims, claims incurred but not yet reported and the stand ready obligation associated with unexpired coverage for future claims) or the entire book of business, which would include intangible assets;

  - Clarification as to the appropriate level of aggregation when measuring insurance contracts at fair value (i.e., individual contract level vs. portfolio level).

- Additional guidance with respect to what represents an appropriate exit price for insurance contracts, considering the following alternatives:

  - Price in the reinsurance market for indemnity reinsurance—given that this reinsurance allows only for the transfer of risk, not the transfer of actual contractual obligations (i.e., the customer stills looks to the original insurer to settle its claim and the original insurer may maintain administration requirements), would this qualify as an exit market;

  - Amount required to be paid to a customer to have them terminate the contract;
o Cost to legally novate a contract (i.e., assumption reinsurance);

o Price to transfer the entire book of business in the context of selling the legal entity.

- Treatment of the non-financial component of an insurance contract (i.e., the stand ready obligation to defend the policyholder inherent in certain property and casualty contracts). [Letter #67, pages 3-4 of Attachment A]

23. Allstate Corporation (Letter 68, page 2) suggested that in the absence of (a) an orderly transaction to sell or otherwise dispose of an asset or to transfer a liability and (b) market inputs that reflect assumptions that participants would use in pricing the asset or liability, reporting entities should not be allowed to subjectively develop fair value proxies. It also recommends that any preliminary decision to allow a “mark to model” approach (Level 3) be tested to determine whether “allowing MTM accounting for insurance contracts can be accomplished in a manner that does not irreparably harm the consistency, comparability, reliability, and understandability of insurance company financial statements.”

24. Respondents requested additional guidance for determining whether an insurance contract is a financial liability and whether insurance contracts can be fair valued. St. Paul Travelers stated the following:

In our opinion, most property casualty insurance contracts would not be considered financial instruments (under the Board’s definition of financial instrument and the characterization of insurance contracts under paragraphs 138 and 139 of the Preliminary Views document). The only insurance contracts that would be considered financial instruments are those that are settled in cash, e.g., certain life insurance contracts, business interruption without property coverage and certain heath and long-term care policies. It is unclear what current reference FASB intends to be used for the determination of whether an insurance or reinsurance contract is a financial instrument in applying the FVO. [Letter #34, page 3]
Warranty Obligations and Rights  [NFR Issue 1d]

25. Nearly a third of all respondents commented on whether warranty obligations that are financial liabilities and warranty rights that are financial assets should be within the scope of the FVO document. Most of those that commented agree that warranties should be included within the scope of the FVO document. A couple respondents argued for inclusion in Phase 2. One of those respondents, Ernst & Young, noted that it would be more appropriate to include all warranty rights and obligations in Phase 2 of the FVO project and stated:

Most warranty rights and obligations, including those that meet the definition of a financial asset or liability, tend to serve as a functional component of a non-financial asset...allowing the fair value option to be elected only for those warranty rights and obligations that are deemed to be financial assets and liabilities would unnecessarily add complexity to the accounting for these contracts....If the Board decides to include financial warranty rights and obligations in the scope of Phase I, it should clarify that the guidance in FASB Technical Bulletin 90-1 is no longer applicable to these contracts. [Letter #67, pages 4 and 5 of Attachment A]

Unconditional Purchase Obligations  [NFR Issue 1e]

26. Less than one-fourth of all respondents commented on whether unconditional purchase obligations should be within the scope of the FVO document. Of those that commented, only a couple disagree with including unconditional purchase obligations in the scope of the FVO project. Ernst & Young (Letter #67, page 5), stated that unconditional purchase obligations are no different than leases, yet leases have been excluded from the scope. The firm suggested that this may be inconsistent.
Written Loan Commitments [NFR Issue 3a]

27. Nearly a third of all respondents commented on this issue. About two-thirds of those that commented disagree with excluding written loan commitments that are not accounted for under FASB Statement No. 133, Accounting for Derivatives and Hedging Activities.

28. Most of the respondents who disagree with excluding loan commitments that are not accounted for under Statement 133 believe its exclusion is inconsistent with other items that are within the scope of the FVO documents that include nonfinancial components. One respondent, AcSEC of the AICPA summed up the views of at least nine other respondents and stated:

   The exclusion of written loan commitments...from the scope of Phase I because the fair value of these financial instruments involves the consideration of nonfinancial components seems to be inconsistent with the treatment of other financial instruments under the scope of the FVO. Nonfinancial components are considered in the determination of fair value for many financial instruments including insurance contracts (e.g., mortality rates), mortgage loans (e.g., prepayment drivers), and warranty obligations (as previously described). In our view, the consideration of these factors does not warrant exclusion from the scope of the FVO. We believe that any specific concerns the Board has with respect to the valuation of written loan commitments...can be addressed...without the wholesale exclusion of these financial instruments from the scope of Phase I. [Letter #65, page 5]

29. Mortgage Bankers Association and Allianz Group (Letters #64 and #72) reasoned that there are no substantial economic differences between loan commitments that are within the scope of Statement 133 and those that are not. Others—Citigroup, Canadian Bankers Association, and KPMG (Letters #3, #33, and #58)—suggested that convergence with both international and Canadian GAAP was another reason to include all loan
commitments within the scope of the FVO document. Goldman Sachs and Bank of America (Letters #59 and #70) suggested that commercial loan commitments do not have significant nonfinancial components.

30. Some of the respondents that support the inclusion of loan commitments in Phase 1 suggested that the value of loan commitments be determined in accordance with SEC Staff Accounting Bulletin No. 105, *Application of Accounting Principles to Loan Commitments*, which requires an entity to exclude expected future cash flows related to the associated servicing of the loan when determining the fair value of loan commitments. The limitations in SAB 105 could be viewed as inconsistent with the definition of *fair value* in the Board’s project on fair value measurement.

**Financial Liabilities for Demand Deposit Accounts  [NFR Issue 3b]**

31. About one-third of all respondents commented on this issue. Most of those that commented disagree with excluding financial liabilities for demand deposit accounts.

32. More than half of those respondents that disagree with excluding demand deposit accounts from the scope of the FVO document, argued that excluding demand deposit accounts because there were nonfinancial components involved was inconsistent with other items that were included in the scope (such as loans and insurance) that also contained nonfinancial components. At least two of the respondents, the American Bankers Association and McGuire Performance Solutions, Inc. (Letters #56 and #73), indicated that while valuation would not be easy, it could be done and must be done to alleviate marking to market only one side of a transaction. The AICPA and Mid-State Financial Credit Union (Letters #65 and #57) asked for additional guidance clarifying what demand deposits are and how to determine fair value.
Otherwise-Unrecognized Firm Commitments  [NFR Issue 2]

Fair Valuing Otherwise-Unrecognized Firm Commitments at Inception of the Contract

33. Less than a fourth of all respondents commented on whether an entity should be permitted the option to recognize those otherwise-unrecognized firm commitments at fair value at inception of the contract. Most of the respondents who commented on this issue agree that otherwise-unrecognized firm commitments should be permitted to be recognized at fair value at inception of the contract. A few respondents disagree for different reasons. One respondent—PwC (Letter #43, page 3)—indicated that it had concerns about the ability of firms to measure the value of those commitments, while another—Air Products (Letter #6, page 3)—implied that disclosure was more appropriate than recognition on the face of the financial statements. Only one respondent, Grant Thornton (Letter #49, page 2), recommended delaying addressing these instruments until Phase 2 and suggested that it is unclear as to why unrecognized firm commitments should be allowed to be reported at fair value while unrecognized written loan commitments, demand deposit liabilities, and financial assets and financial liabilities arising from lease contracts are not eligible. The firm also stated that it is unclear what forms of unrecognized firm commitments could be eligible for the option.

Using the Statement 133 Definition of a Firm Commitment

34. The question was also raised as to whether the definition of a firm commitment in Statement 133 should be used for the FVO and if not, what should be used and why. Less than one-fifth of all respondents commented on this issue. A majority of those that commented supports using the Statement 133 definition. Those who disagree did so for different reasons. One respondent, HSBC Holdings plc (Letter #23, page
2 of the Appendix), would prefer the definition in IAS 39, which excludes the “disincentive for non-performance” criteria. Another respondent, Standard & Poor’s (Letter #51, page 10), does not support a highly selective and optional approach and therefore would not limit the scope to forward contracts that meet the definition of firm commitments under Statement 133. The other respondent, Ernst & Young, would also extend the definition of firm commitments to include commodities and related commodity inventory positions in Phase 1 because of the following argument:

While commodity contracts are not technically financial instruments, in our view, fair value may be a more relevant measure for these contracts than for certain of the financial instruments that the Board is considering for inclusion within the scope of Phase I (e.g., warranty obligations). In addition, unlike many of the instruments we have recommended that the Board consider deferring until Phase II of this project, commodity contracts are typically risk managed on a fair value basis with no distinction made between cash-settled and physically-settled contracts. As such, we recommend that the Board consider including commodity contracts and related inventory positions within Phase I scope as this would serve to (i) reduce earnings volatility caused by accounting asymmetry, (ii) ease the burden of hedge accounting requirements, and (iii) bring financial reporting in line with how these positions are managed and performance evaluated; all of which represent objectives of the FVO Statement. [Letter #67, page 6 of Attachment A]

**Types of Entities Electing FVO for a Firm Commitment**

35. Only several respondents provided input on the types of entities (and contracts) that would avail themselves of the FVO for firm commitments. One respondent, Citigroup (Letter #3, page 2), suggested that the FVO would be beneficial for (a) a firm commitment to sell unlisted equity securities and (b) a firm commitment to acquire or dispose of an investment accounted for under the equity method. Another respondent, Federal Home Loan Bank (FHLB) of San Francisco (Letter #5, page 2),
added that the fair value option would be beneficial for firm commitments that are created with the purchase or sale of an asset or liability. A third respondent, Mortgage Bankers Association requested that the Board extend the FVO election scope to include:

...firm commitments involving the acquisition of loan servicing rights because many bulk (i.e. portfolio) and flow (i.e. loan-by-loan) mortgage servicing purchase contracts provide for fixed prices in advance of the closing of the acquisition. To the extent that an entity uses derivative instruments to manage risk associated with their fixed purchase prices, the option would allow the acquiring entity to recognize offsetting changes in the fair values of the instruments and firm commitments without having to apply hedge accounting. [Letter #64, page 3]

Investments That Would Otherwise Be Consolidated  [NFR Issue 4a]

36. About a fourth of all respondents commented on the scope exception for investments that would otherwise be consolidated. All of those who commented expressed support for the proposed scope exception.

37. Respondents suggested (a) changing the term investments to interests to clarify that interests in a variable interest entity should also be excluded from the scope of the FVO document and (b) clarifying in the case of partial and step acquisitions that the FVO would be precluded when the acquired company is first consolidated with the reporting entity.

Pension and Other Postretirement Benefits and Certain Compensation Arrangements  [NFR Issue 4b]

38. About one-fourth of all respondents who commented on the scope exception for pensions and other postretirement benefits and certain compensation arrangement agree with the scope exception. Nearly all of those who commented expressed support for the proposed scope exception.
Financial Liabilities Recognized under Lease Contracts [NFR Issue 4c]

39. About one-fourth of all respondents commented on the scope exception for financial liabilities recognized under lease contracts, with a vast majority agreeing with the proposed scope exception. Only a couple of respondents disagree with excluding lease contracts. Credit Suisse (Letter #30, page 3) stated its belief that leases should be included because they meet the definition of financial assets in FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.* It stated, “We recognize that the FASB intends to readdress lease accounting, but we do not believe this will be finalized in the near future.”

Other Scope Issues

40. The notice for recipients also requested respondents to consider whether (a) other financial assets with nonfinancial components that affect valuation should be excluded from the scope of the FVO document and (b) other financial assets and financial liabilities should be scoped out of the FVO document.

41. One respondent suggested that income tax assets and liabilities needed to be explicitly excluded from the scope for clarity and to avoid disputes with the Board’s position that they did not meet the definitions of a financial asset and a financial liability. (The Exposure Draft had simply mentioned income tax assets and liabilities in paragraph A6 of the basis for conclusions but not in the scope portion of the standards section.)
ELECTION OF THE FVO AND RELATED DOCUMENTATION

Required Contract-by-Contract Election

42. Nearly half of all respondents commented on the provision in the Exposure Draft that the FVO would be elected on a contract-by-contract basis. About two-thirds of those who commented expressed some concerns about the contract-by-contract election.

Support for Contract-by-Contract Election

43. Supporters of the contract-by-contract election noted that the additional flexibility provided would make the FVO more practical for preparers. BB&T Corporation (Letter #22, page 1) commented that a contract-by-contract election would enable entities to better align their accounting practices with their risk management activities. It was noted that this accounting symmetry would allow preparers to mitigate some of the earnings volatility associated with a mixed-attribute model. Grant Thornton (Letter #49, page 4) determined that an election of the FVO by class of financial assets or class of financial liabilities was conceptually preferable; however, that respondent noted that having fewer entities elect to report at fair value outweighed the potential benefits of any class-by-class election requirement.

Additional Clarification Needed for Contract-by-Contract Election

44. Auditors that responded to this issue highlighted a need for additional guidance on the application of a contract-by-contract election, specifically pertaining to the unit of account issue. Ernst & Young's comments were indicative of this need:

First, we recommend that the Board specifically define what the term “contract” is meant to represent within the context of the FVO Statement. Clarification on this matter would be helpful as constituents consider whether the fair value option could be
applied to individual units (e.g., bonds or shares), investments that are not unitized (e.g., L.P. interests), and multi-element revenue arrangements. Secondly, we recommend that the Board explicitly clarify if (and how) the requirement to elect the fair value option on a contract-by-contract basis impacts the determination of the unit of account that is to be used in estimating the fair value of the elected financial assets or liabilities for both initial and subsequent measurement purposes...we believe it is vital that the Board address the unit of account issue in this Statement. [Letter #67, page 2]

Measurement Issues with Insurance Contracts

45. Allowing for a contract-by-contract election was perceived as presenting measurement issues for insurance contracts. The AICPA summarized respondents’ views and stated:

   While the FVO Statement allows entities to elect fair value accounting on a contract-by-contract basis, rather than by broader categories, the level of aggregation that is normally applied to insurance and reinsurance contracts is at a portfolio level. Since insurance contracts are valued using actuarial methodologies that depend on the “law of large numbers” in estimating claim amounts, there is a question of whether a specific insurance contract’s value (rather than portfolio’s value) is credible. [Letter #65, page 2]

St. Paul's Travelers (Letter #34, page 4) pointed out that it is “a logical error to assume that what is true in the aggregate is true of any one individual policy.” To remedy this problem, the AICPA proposed that the Board not preclude election of the FVO at the portfolio level.

Entity-Wide Election or Election by Similar Asset or Liability Types

46. A majority of the respondents who disagree with the contract-by-contract approach claimed that the Exposure Draft does not provide a compelling rationale for allowing a contract-by-contract basis. North Shore Bank (Letter #14, page 2) claimed that the implementation of a contract-by-contract approach “will allow for gamesmanship and abuse in applying
the rules in order to obtain a desired outcome, rather than reflecting the
economic reality.” Respondents likewise argued that such an election
would decrease comparability and transparency in the financial
statements, which would increase the difficulty in analyzing an entity’s
performance. Notably, those respondents did not believe that increasing
disclosure requirements adequately compensates for this lack of
comparability. Qualcomm (Letter #66, page 3) stated that “the fair value
option directly contradicts parallel efforts to improve consistency and
comparability and will further exacerbate the current mixed-attribute
accounting that it purports to mitigate.”

47. As an alternative, some respondents suggested that the Board
instead require election of the FVO using one of the following conditions:
(a) an option to put either all financial assets and all financial liabilities at
fair value or none of them at fair value (entity-wide election), or (b) a
categorization of financial assets and financial liabilities and an option to
put all or none of the assets and liabilities in each category on fair value
(election by type). The American Accounting Association (Letter #55,
page 6) asserted that under either of these alternatives, “the market for
accounting information would, in equilibrium, choose the appropriate
accounting model for different entities” thereby providing consistency and
comparability for financial statement users.

**Election for a Portion of a Financial Asset or Financial Liability**

48. Bank of America (Letter #70, page #3) noted that a precedent exists
for permitting only a pro rata portion of an item to be fair valued by
analogizing to paragraph 21(a) of Statement 133, which allows the hedged
item to be “either all or a specific portion of a recognized asset or liability.”
Bank of America asserted that entities currently using hedge accounting
“for a portion of a recognized financial asset or liability or of an
unrecognized firm commitment will not benefit from the fair value option if it is available only on an all-or-nothing basis” and accordingly recommended that the Board permit the FVO for a pro rata portion of a contract.

49. JP Morgan Chase & Co. (Letter #63, page 2) pointed out that, in managing its credit risk, an entity may, upon the origination of a credit facility, “choose to hedge a certain amount of exposure to a borrower but may not hedge the entire amount of exposure to the borrower.” That respondent further stated that “the Board should consider allowing the designation of a proportion of a financial instrument at inception. This would further mitigate the accounting mismatch for credit hedges.” The Canadian Bankers Association (CBA) made the same point:

When our members extend corporate loans they generally would have a target hold threshold on the amount of credit risk they would want to take. The portion of the loan above the target hold is usually hedged with credit derivatives. To reduce an accounting mismatch, the FVO should only be applicable to that portion of the loan that is hedged via credit derivatives. Applying the FVO to the whole loan at the contractual level would result in an even larger accounting mismatch. The FVO should be allowed to be applied to a portion of a loan because, by nature, a loan can be legally split up into smaller portions....[Letter #33, page 3]

50. The CBA also cited a syndicated loan as another situation in which a bank might wish to elect the FVO for only a portion of the loan. CBA noted that a lead bank may advance a loan to a borrower before the loan is fully syndicated out to other lenders. Since the lead bank intends to keep only a certain percentage or a certain amount of the total loan, it would want to elect the FVO for only the portion of the loan it intends to keep.

51. Respondents from the insurance industry also noted that an issue exists concerning riders to insurance contracts. In MetLife’s comment letter, it stated:
Certain insurance contracts are routinely sold with an option to purchase riders that enhance the basic insurance policy or contract. The ED is not clear whether such riders may be measured as separated contracts or must be accounted for and measured at fair value together with the base policy or contract. We believe that the scope of the fair value option should be applied to the riders as separate components when existing accounting has already established that the components be accounted for separately. [Letter #53, page 2]

**Delayed Election of the FVO**

52. Very few respondents commented on the provision in the Exposure Draft that requires the election of FVO to occur only at initial recognition or upon a new-basis event. Freddie Mac (Letter #36, page 3) requested that the Board provide clarification as to the meaning of *initial recognition*, specifically whether the designation of the election should occur on the trade date or the settlement date. The CBA (Letter #33, page 4) also suggested additional clarification of the term *at inception*, noting that a clear understanding would prove beneficial in cases where the legal form of an instrument changes after initial recognition. The CBA contended that the FVO should be allowed whenever there is a change in the legal form and substance of an existing instrument, even if the change occurs subsequent to initial recognition. The CBA noted that this would have direct implications for Canadian mortgage-backed securities issuers.

53. National City Corp. (Letter #60, page 3) recommended that a change in risk management strategy to hedge a financial asset or financial liability should be treated as a new-basis event and, therefore, be eligible for the FVO. Additionally, this respondent would like the Board to permit a revocation of the FVO when the hedging strategy is subsequently terminated.
Need for Qualifying Criteria for the FVO Election

54. A few respondents encouraged the Board to limit the FVO election to only certain financial assets or financial liabilities that meet specified eligibility criteria. The National Association of College and University Business Officers (NACUBO) referred to the eligibility criteria in IAS 39, which are also summarized in paragraph A22(d) of the Exposure Draft. NACUBO stated:

We believe that this kind of eligibility criteria would reduce the risk of the application of the “optional” fair value measurement only when it is advantageous to management to do so, and [we] would encourage the FASB to include this [sic] eligibility criteria in the standard. This would achieve the additional benefit of convergence with the IASB standards. [Letter #38, page 2]

55. The letter from the five federal financial institution regulatory agencies—Federal Reserve, FDIC, OCC, OTS, and NCUA—also referred to the eligibility criteria in IAS 39 and stated:

These conditions were included by the IASB to ensure that the option to elect a fair value measurement for financial instruments is applied only when its use would result in more relevant information.

Given the FASB’s stated objective of international convergence, the Board should reconsider the basis for its decision to exclude eligibility criteria from its Fair Value Option Standard. Regardless of the outcome of such reconsideration, the Board should clearly explain the rationale for its decision in the Basis for Conclusion. [Letter #69, page 3]

56. Standard & Poor’s Ratings Services similarly stated:

If the Board decides to move forward with the issuance of the Proposed Statement, we encourage the incorporation of minimum eligibility criteria (i.e., similar to those provided under the IASB’s fair value option framework). For example, the Board should consider permitting the fair value option where there is an appropriate risk-management element and where there is an
asset-liability mismatch, obviously coupled with appropriate disclosures. [Letter #51, page 4]

**Documentation Requirements for the FVO Election**

57. About one-eighth of all respondents commented on the proposed requirement that the FVO election be supported by concurrent documentation or a preexisting documented policy for automatic election. Nearly all of the few respondents that addressed this issue disagree with the concurrent documentation requirement proposed in the Exposure Draft. Those that disagree with concurrent documentation made two points: (a) the FASB should not address this issue, but rather leave this to internal control processes and (b) concurrent documentation takes away the primary benefits of the FVO, which are simplicity and flexibility.

58. The American Bankers Association articulated the second point and stated:

   The proposal requires either the concurrent documentation or a pre-existing documented policy for automatic election to support the election the fair value option for a financial asset or financial liability. We feel that the requirement for concurrent documentation may be too burdensome for practical application, in the same mold as that of SFAS 133, especially upon adoption when there could be large numbers of elections. Further, a pre-existing policy might serve to unintentionally limit the application for instruments with fact circumstances that do not fit a predetermined policy, even in situations where the election makes sense. In fact, the flexibility and reduced administrative burden are two of the most attractive features of the proposal, and any perceived potential for abuse through retroactive election is misconstrued. We feel that this also facilitates the application of an already optional accounting method. [Letter #73, page 6]

59. The International Swaps and Derivatives Association wanted greater flexibility in the interest of simplicity, and stated the following:
...we believe the Board has made this [concurrent documentation] requirement as an anti-abuse provision to prevent companies from retroactively applying the Fair Value Option as a means to manage earnings. We can understand this concern; however, we have reservations about addressing what we consider to be a company’s internal control matters within the confines of an accounting standard. We believe that the documentation should be required as part of the monthly close process and that it should be part of a company’s procedures supporting its internal controls. However, in order to prevent misuse of the Fair Value Option and meet the Board’s objectives of operationality and cost/benefit concerns, the Board could consider an alternative solution that requires documentation to be complete sometime after trade execution, but before month end. [Letter 8, page 2]

60. National City Corp. suggested in its comment letter that the documentation and election requirements be similar to those of FASB Statement No. 156, *Accounting for Servicing of Financial Assets*, and stated:

   The exposure draft only permits the fair value option to be elected at the date that a financial asset or liability is initially recognized, or upon an event that gives rise to new-basis accounting at fair value. We recommend that implementation of a risk management strategy to hedge a financial asset or liability should be considered an event that gives rise to new-basis accounting at fair value. This treatment would be consistent with SFAS 156 which allows fair value to be elected in future periods for classes of servicing assets based on risk management strategy. [Letter #60, page 3]

61. State Street (Letter #37, page 3) expressed the other point raised by those respondents who disagree with the documentation requirements and stated, “We believe that the documentation requirements should be left to the internal control processes of an individual entity making this election.”
RECOGNITION, MEASUREMENT, AND PRESENTATION ISSUES

Recognizing Changes in Fair Value in Earnings

62. About one-fifth of all respondents commented on the proposal to recognize in earnings the changes in fair value arising from the election of FVO. Most of those commenting on that immediate earnings recognition preferred unrecognized changes in fair value to be recorded in other comprehensive income (OCI) and not on the income statement within earnings. Mid-States Corporate Federal Credit Union (Letter #57, page 1) explained that recording fair value changes through earnings would increase volatility in earnings. Volatility in the valuation models would affect earnings, even though the underlying economics of the balance sheet are not materially changed. Additionally, the Pennsylvania Institute of Certified Public Accountants (Letter #35, page 2) indicated that this potential volatility in earnings could obscure the operating results of an entity. Instead, those respondents stated that recording changes in fair value in OCI would ensure that all unrealized gains and losses are presented consistently and improve the transparency and understandability of financial statements. The American Accounting Association (Letter #55, page 11) also endorsed the OCI model, noting that comparability would be improved between financial statements of preparers that have elected the FVO and those continuing to operate in the mixed-attribute model.

63. A minority of respondents chose to explicitly agree with the provision to recognize changes in fair value in earnings. Goldman Sachs (Letter #59, page 6) supported the Board’s proposal and suggested that this treatment would provide more relevant information for financial statement users. Ernst & Young (Letter #67, page 9) supported the recognition of all fair value changes in earnings, including changes that result from changes
in an entity’s own creditworthiness, noting that a measure that does not consider an entity’s credit standing does not represent fair value.

**Special Treatment for the Changes in a Liability’s Fair Value Attributable to Changes in a Debtor’s Creditworthiness**

64. The recognition in earnings of the portion of a liability’s changes in fair value that is attributable to changes in the reporting entity’s own creditworthiness is one of the more contentious issues among respondents. Yet, only about one-half of the respondents mentioned the issue. Of those, about two-thirds opposed recognizing in earnings the portion of its liability’s changes in fair value attributable to changes in its own creditworthiness; about a third expressed support for the Exposure Draft’s approach of not curtailing such recognition in earnings.

65. Respondents cited various reasons against a debtor recognizing in earnings the portion of its liability’s changes in fair value attributable to changes in its own creditworthiness, including that such recognition in earnings:

   a. Is not necessarily realizable because “for the most part, the only scenarios in which the debtor’s debt will be settled for less than par are when that debtor is faced with an event that could drive it into or near to default of its obligation.” Thus, the gain from a deterioration in creditworthiness may not be able to be monetized immediately
   
   b. May actually serve to delay an inevitable covenant violation based on the strength of the company’s balance sheet and prevent it from having a qualifying default event due to the company’s election to mark its debt obligations to market (American Council of Life Insurers [ACLI], letter #39; Illinois CPA Society, letter #42)
   
   c. Adds very little value or utility for financial statement users
   
   d. Adds complexity to the application of the FVO
   
   e. Requires comprehensive disclosures to prevent the financial statement users from misinterpreting the “artificial” gains associated with deterioration in creditworthiness (FIAC, letter #41, page 3)
f. Distorts current and future period earnings and balance sheet
equity capital; it is not reflective of the economic health of the
company and its true profitability.

66. The notice for recipients asks, “What alternative approaches or
additional disclosure requirements should the Board consider?” (Issue 6,
page iii). Only a few respondents included a suggestion about how the
proposed Statement should be modified. Merrill Lynch (Letter #45, page
2) suggested, “We would strongly recommend to the Board that the
changes in fair value attributable to the credit component of the company’s
own debt be included in equity (OCI) and only be recognized in earnings
when the debt is extinguished.” Other respondents did not explicitly refer
to the possibility of reporting the credit-related portion of a liability’s fair
value change in OCI, though a few respondents indirectly rejected that
alternative and stated that such credit-related gains and losses on liabilities
should not distort “net worth” or shareholders’ equity, thus implying that
they should not be in OCI.

67. Most respondents that objected to including in earnings the effect of
the entity’s own changes in creditworthiness did not indicate how the
proposed Statement should be modified. It was unclear whether they
believed one of the following:

   a. That no liabilities should be eligible for the FVO election

   b. That liabilities for the entity’s debt securities (that is, debt capital)
      should not be eligible for the FVO election, but other liabilities
      should be (similar to the alternative view in paragraph A26)

   c. That liabilities should be eligible for the FVO election but the credit-
      related portion should be bifurcated and reported in OCI (as
described in the preceding paragraph)

   d. That liabilities should be eligible for only the election of a non-fair-
      value measurement equal to a liability’s fair value reduced by the
      portion of the liability’s fair value change attributable to changes in
the entity’s own creditworthiness occurring after the date of the liability’s initial recognition.

68. Interestingly, the FHLB of San Francisco supports the proposed FVO election but suggested that the Board allow entities to avoid reporting credit-related gains and losses from their liabilities in earnings by permitting the choice of alternative (d) mentioned in the previous paragraph. The FHLB of San Francisco (Letter #5, page 2) stated, “The Board should modify the proposed Statement to allow an entity the irrevocable option of choosing either the full fair value or only fair value changes due to general market movements for its own liabilities.” The Hartford Financial Services Group, Inc. (Letter #24, page 2) also suggested that whether to include in earnings the effects of changes in credit standing should be optional, by entity, for financial liabilities.

**Limitations on Electing FVO for an Entity’s Debt**

69. Some credit rating agencies suggested limiting the circumstances when the FVO could be elected for financial liabilities. Moody’s Investor Services (Letter #71, page 3) stated, “Regarding our concerns about the usefulness of fair valuing a company’s own debt, the Board should consider limiting the FVO for a company’s own debt to cases in which the company manages its debt as part of a ‘matched book’ or it is likely the company will settle its debt in the near-term.” Similarly, Fitch Ratings stated, in the context of allowing valuation swings in reported debt resulting from changes in creditworthiness, “We think it would be helpful to users if FASB placed some restriction on the use of this option when other assets and liabilities are almost exclusively reported at historic cost” (Letter #19, page 2).
Opposition from Insurance Companies

70. Many insurance-related respondents not only criticized permitting the FVO election but also voiced opposition against recognizing in earnings the portion of an insurance liability’s changes in fair value attributable to changes in its own creditworthiness for many of the same reasons cited above. However, some insurance companies pointed out that the portion attributable to changes in the entity’s own creditworthiness would likely be negligible for insurance liabilities to policyholders. As noted by the ACLI, “many within the [life insurance] industry believe that issuer creditworthiness would not impact the fair value of insurance liabilities due to the regulatory nature of the life insurance industry” (Letter # 39, page 2). Several insurance-related respondents pointed out that because of the existence of state guaranty funds, policyholders will not accept less than the amount stated in the insurance contract. Policyholders are more secure than bondholders or other debt holders. Thus, the credit spread on an insurance company’s debt would not be an appropriate indicator of the credit risk associated with insurance liabilities. However, the ACLI acknowledged that an issuer’s creditworthiness will impact lapse rates and policyholder behavior and may ultimately have an impact on fair value determination.

Support for Recognizing the Effect of Creditworthiness Changes in Earnings

71. About a third of those commenting on this issue supported recognizing in earnings the portion of a liability’s fair value changes attributable to changes in the entity’s own creditworthiness. Citigroup commented:
On balance Citigroup supports including changes in the issuer’s own creditworthiness in the measurement of fair value and the resulting gains and losses reported in the income statement. The alternative—to somehow reverse all effects of issuer credit risk of every financial liability accounted for at fair value—disregards a component of fair value that is very important for many liabilities (particularly debt liabilities). [Letter #3, page 4]

72. PwC commented:

We believe that the broader issue of how to display changes in fair values in a business entity’s performance statement should be resolved [in the FASB’s project on financial performance reporting by business entities (now renamed financial statement presentation).] In the interim, we agree that changes in fair value of financial assets and liabilities for which a company has elected the FVO should be recognized in earnings with separate disclosures as required by the ED. [Letter #43, page 11]

73. Moody’s Investor Services also stated:

Although we are troubled with the prospect of companies measuring their debt at fair value, we do not support the idea of excluding the effects of a company’s own credit risk from fair value measurement (partial fair value). We find partial fair value measurement to be confusing and unhelpful. [Letter #71, page 3]

Disclosures

74. A few of the respondents that support reflecting the effect of the entity’s own creditworthiness changes in earnings recommend that the Board also require disclosure of the portion of the liability’s fair value changes attributable to changes in the entity’s own creditworthiness that are included in current earnings. However, none of those respondents suggested that difficulties could arise in determining how to determine that portion. In contrast, HSBC Holdings plc acknowledged the problem: “In
practice, it is difficult to precisely isolate the change in fair value attributable to changes in credit risk” (Letter #23, page 6).

75. Rather than focus on the portion of the liability’s fair value changes attributable to changes in the entity’s own creditworthiness, Ernst & Young recommended that the Board use the approach in IAS 32, *Financial Instruments: Disclosure and Presentation*. The firm stated:

> IAS 32 requires an entity to disclose the amount of change in the fair value of a financial liability that is not attributable to changes in a benchmark interest rate. We believe this disclosure to be superior to the qualitative disclosure currently proposed in the ED. [Letter #67, page 10 of Attachment A]

By focusing on the benchmark rate, the firm is including (in the disclosure) the portion of interest relating to the spread over the risk-free rate, which can change over time and thus affect the fair value of a liability even though the debtor’s creditworthiness may not have changed during that period.

76. Jack Ciesielski from R.G. Associates, Inc. recommended an expansion of the Exposure Draft’s proposed disclosures, to include the following:

a. The current period and cumulative amount (for all periods presented) of pre-tax and after-tax unrealized gains/losses due to changes in creditworthiness on financial liabilities reported at fair value, and

b. The circumstance giving rise to the change in creditworthiness. For example, a change in the firm’s credit rating by a rating agency; an announcement of a review with negative implications by a rating agency; or significant corporate events that may have affected the price of the financial liabilities. [Letter 18, page 2]
**How to Report Fair Value Changes Resulting from the FVO Election**

77. About one-fourth of all respondents commented on whether the Board should specify how entities should report changes in fair values of assets and liabilities that are subsequently measured at fair value pursuant to the fair value election.

78. Respondents that commented on this issue provided similar comments, suggesting that the effects of the FVO should be presented in a way that allows users of the financial statements to distinguish the changes attributable to initial and subsequent fair value measurements resulting from the fair value election. The Financial Institutions Accounting Committee (FIAC) articulated this view and stated:

> We encourage the Board to isolate the effect of the fair value measurement on the income statement in such a way that the reader can easily see the full effect of the fair value adjustments. For meaningfulness and comparability, the reader must be able to easily adjust the income statement and compare financial results on both a fair value basis and on a cost-method basis. We would like to see the fair value impact reported as one line item on the income statement with a footnote to include the breakdown of each significant component. [Letter #41, page 2]

79. HSBC Holdings plc (Letter #23, page 8) suggested that making the fair value effects apparent to users could be accomplished through convergence with IFRS 7. That respondent stated that “We believe that changes in the fair values of assets and liabilities subsequently measured at fair value as a result of a fair value election should be reported in the same manner as that prescribed by IFRSs. IFRS 7 ‘Financial Instruments: Disclosures’ requires separate presentation, either on the face of the financial statements or in the notes, of the net gains or net losses on
financial assets or financial liabilities designated at fair value through earnings (IFRS 7, paragraph 20).”

80. National City suggested that the Board should eliminate the trading and available-for-sales designations of Statement 115 because of the preferable treatment afforded by the FVO. That respondent stated:

We recommend that the trading and available-for-sale classifications be eliminated from the accounting literature and the face of the balance sheet. We believe that companies should be allowed to elect fair value for their securities and that all changes in fair value should be recognized in the income statement rather than having some changes recognized in other comprehensive income (OCI). The OCI presentation is deficient in terms of clarity and credibility and is essentially meaningless to nontechnical readers of financial statements. Securities could then be clearly presented on the balance sheet in one of two categories—securities recognized at fair value or securities recognized at amortized cost. We believe that management’s intent related to holding the securities can be adequately disclosed in the notes and MD&A. [Letter #60, page 2]

81. Some respondents expressed concerns that the FVO could be abused if the Board did not provide a framework for presenting fair value information. Even without abuse, some respondents suggested that guidance on the presentation of fair value information could increase comparability by preserving much of the information contained in current financial statements by separating fair value measures from traditional net income in an approach similar to OCI. Those respondents indicated that the Board could provide this guidance through a presentation framework or by illustrating presentation via examples. The Financial Accounting Standards Committee of the American Accounting Association (the AAA Committee) suggested that providing a framework for fair value measurement presentation would facilitate the usefulness of all the information presented and allow users to fill their disparate information
needs (Letter #55, pages 10 and 11). The Committee was concerned that in the absence of a Board-proscribed presentation framework important measures, such as net interest margin, could be distorted or manipulated through use of the FVO. Some respondents had similar comments to the suggestions of the AAA’s Committee. They suggested that the Board address broader presentation of fair value information in the Board’s financial statement presentation project.

**Aggregating Fair Value Changes in the Income Statement**

82. About one-fifth of all respondents commented on how changes should be presented in the income statement. Specifically, respondents commented on the appropriateness of aggregating the changes in fair values with other similar financial assets and financial liabilities without providing separate display of those changes on the income statement. About two-thirds of those commenting opposed such aggregation.

83. Some respondents stated that isolating the effects on the income statement either in one line item or through other separate reporting on the income statement would provide useful information and may help mitigate some of the comparability problems associated with elective accounting. Other respondents expressed a preference for including the effects of the FVO in OCI. Generally, while respondents disagree on the method, they stated that it was important to understand the impacts of the FVO on earnings.

84. Some respondents requested clarification of the proper unit of account and whether or not unrealized gains and losses needed to be reported separately. The Hartford Financial Services Group (Letter #24, page 3) suggested that the Board clarify that “although the election is made on a contract by contract basis, the measurement of the financial assets or
financial liabilities should be measured at the appropriate unit of account. For insurance liabilities, the appropriate unit of account would be a portfolio of contracts and not the individual contract. Attempting to fair value an individual contract based on estimated weighted average cash flows would not be statistically reliable due to the significant standard deviation associated with the single estimate.”

85. The FHLB of San Francisco does not agree that changes in fair values should necessarily be aggregated with other financial assets and financial liabilities. It expressed concern that doing so may skew certain performance or other metrics. It stated:

We would like the Board to specifically address where gains and losses on assets and liabilities measured using the Fair Value Option should be reported on the income statement. In order to fully inform financial statement users of the impact that such an election presents in earnings, we believe that the impact of changes in the fair value of assets and liabilities measured pursuant to the Fair Value Option should be stated separately on the face of the income statement within an “other income” or similar category. Changes in fair value should not be included within interest income or interest expense for assets and liabilities for which the Fair Value Option has been elected. Interest income and interest expense should continue to be presented as components of net interest income. This presentation is consistent with the treatment for unrealized gains and losses on securities classified as trading under FASB Statement No. 115 and for designated hedged items under FASB Statement No. 133. We believe that when evaluating the financial performance of an entity with significant amounts of interest-bearing financial instruments, historical interest income and expense is highly relevant to financial statement users and therefore, it should be disclosed distinctly from other components of financial performance, such as fair value changes. [Letter #5, page 3]
Distinguishing between Fair Value and Non-Fair-Value Carrying Amounts in the Statement of Financial Position

86. The Exposure Draft proposes that fair value and non-fair-value carrying amounts may be aggregated provided that the total of fair value amounts is disclosed parenthetically on face of the balance sheet. About one-eighth of all respondents commented on the appropriateness of aggregating fair values and other measurement attributes on the face of the balance sheet provided that the total fair value amount is shown parenthetically on the balance sheet. Their views were somewhat evenly split.

87. In the combined comment letter from the Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, Office of Thrift Supervision, and National Credit Union Administration those respondents stated:

   The Agencies support the requirement in paragraph 10 for separate presentation of instruments measured at fair value under the Fair Value Option to provide transparency about the entity’s asset-liability management strategy and liquidity expectations. However, the Standard should clarify what items should be classified as “trading” to stress that not all items measured at fair value each period, with gains and losses recognized in earnings, should be considered “trading.”

   While commonly thought of in terms of securities, other financial assets and liabilities (such as derivative contracts) are also designated as “trading” under certain circumstances. The Agencies believe that the “trading” categorization should be limited to positions that an entity has determined are being used for trading purposes, and not for longer-term investment holdings of securities or other instruments. Accordingly, the Agencies recommend that the FASB reevaluate the “trading” classification and the criteria for the types of instruments that should be included in that category. [Letter #69, pages 6 and 7]
88. Respondents who disagree with the Exposure Draft on this issue stated that parenthetical disclosures provide no value and that they increase complexity. State Street (Letter #37, page 3) specifically disagrees with paragraph 10(a) because “if the Board allowed a separate line item for each fair value and non-fair value carrying amount, it would complicate the face of the statement of financial position and could potentially confuse users of the financial statements.” However, some respondents provided opposing comments. Those respondents said that they would like to have separate presentation of fair value and non-fair value measurements by item on the balance sheet. This tension reflects some respondents’ preference for a simple or clean presentation on the balance sheet and other respondents’ preference for information on the face of the balance sheet that discretely shows the effects of fair value measurements from election of the FVO.

**Proposed Cash Flow Reporting Changes**

89. A few respondents commented on the proposed changes to cash flow reporting contained in the Exposure Draft. Those changes removed the required “operating” treatment for trading securities’ cash flows. Most of those commenting agree with the changes to cash flow reporting, but they also raised clarification or modification issues. One respondent suggested that the Board should clarify how cash flows should be classified for financial assets and financial liabilities that are intended to be economic hedges of other financial instruments. Another respondent suggested that the Board require gains and losses associated with financial assets and financial liabilities accounted for under the FVO to be a reconciling item in the statement of cash flows. PwC believes that the treatment of cash flows was unclear in certain situations. That respondent stated:
Paragraph 15: This paragraph indicates that if a company elects the FVO for an available-for-sale security or held-to-maturity security, the company is “effectively” reclassifying that security as a trading security. The implications of this “effective” reclassification for the cash flow statement are not clear. We believe that the presentation of cash flows related to items that a company elects for the FVO should be based on the nature and purpose of those items and that such cash flows should not be automatically combined with the cash flows for securities that are classified as “trading.” However, we observe that there could be potential differences in the classification of cash flows of substantially similar investment securities dependent solely on whether the security is classified as “trading” under FAS 115 or is elected for the FVO under the ED. We recommend, therefore, that the Board consider whether the classification of cash flows for “trading” securities under FAS 115 should also be based on the nature and purpose of the security rather than automatically classifying them as “operating”. [Letter #43, page 13]

90. Deloitte disagrees with the changes to cash flow reporting and expressed an approach similar to the approach articulated by PwC. Deloitte stated:

    We disagree that the classification of cash flows produced by assets and liabilities carried at fair value due to election of the fair value option shall 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. [Letter #47, pages 12 and 13]

91. Deloitte also suggested that the Board “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” (Letter #47, page 12).
DISCLOSURES

92. About one-fourth of all respondents provided comments on the adequacy of the disclosure provision of the Exposure Draft. Generally, respondents commented that better disclosures should be required to provide sufficient information to understand the balance sheet and income statement impact of electing the FVO for certain or all financial instruments. Respondents noted that the provisions contemplated by the fair value measurement project could provide useful information in the context of the FVO. Those respondents suggested that a robust disclosure framework is necessary for all fair value measurements. Some respondents stated that disaggregated information would be more useful. One respondent, Freddie Mac (Letter #36, page 4), suggested that disclosures should address comparability issues resulting from an extended effective date and the ability to early adopt the FVO.

The Difference between a Liability’s Carrying Amount and the Aggregate Principal Amount

93. Only a few respondents provided comments on the proposed ongoing required disclosure of the difference between carrying value and the aggregate principal amount for liabilities for which the FVO is elected. In particular, those respondents addressed whether the disclosure provided meaningful information.

94. Three rating agencies (Moody’s Investor Services, S&P, and Fitch) commented on balance sheet disclosures presenting similar points. Moody’s Investor Services (Letter #71, page 3) captured the rating agencies’ concerns when it stated that “the proposed standard requires the disclosure of ‘the difference between the carrying amount of any financial liabilities reported at fair value…and the aggregate principal amount…[due] at maturity.’ This will not provide a financial statement user with sufficient
understanding of the timing of future cash outflows related to debt servicing. We believe the proposed standard should require the disclosure of an annual debt maturity schedule at contractual value with a reconciliation in aggregate to amortized cost.” These comments highlight the agencies’ preference for amortized cost in some cases. This preference did not preclude their support for fair value measures in other areas.

**Information Sufficient to Understand the Effect of Subsequently Measuring at Fair Value under the FVO Election**

95. About one in seven of all respondents provided comments on the proposed required disclosure to provide sufficient information to allow users of the financial statements to understand the impact of subsequent fair value measurements of items for which the fair value election was made.

96. Respondents commenting on this issue were split in their views. The respondents that agree did not provide any further explanation for their support of the proposed disclosure. Generally, respondents that disagree with the proposed disclosures believe that the disclosure provision in the Exposure Draft is too broad to implement in practice. Those respondents that disagree stated that more specific disclosure requirements regarding key drivers of changes in fair values would be more useful in helping users of the financial statements understand the effect on earnings from electing the FVO. Some respondents who disagree with this disclosure issue said that the disclosure did not require sufficient information to understand changes due to changes in interest rates and credit. They explained that this information is particularly important in the context of loans and other receivables. Some respondents stated that only disclosure, not recognition in the financial statements, should be required.
Quantitative Information regarding Where Fair Value Changes Are Reported in the Income Statement

97. A few respondents provided comments on the disclosure provisions in the Exposure Draft that require quantitative information by line item about gains and losses resulting from initial and subsequent fair value measurements pursuant to the FVO reported in the income statement. For the most part, respondents choosing to comment disagree with the required disclosure of the Exposure Draft to quantify information by income statement line item indicating where gains and losses from subsequent measurements due to the FVO are reported. Most respondents who disagree with the disclosure provisions of this issue believe that the Board should specify where gains and losses from the FVO should be reported and provide examples of the related disclosures.

98. Deloitte raised concerns of conflicting disclosure guidance when securities previously accounted for pursuant to Statement 115 are accounted for under the provisions of the FVO. That respondent stated:

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 requirement 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(e) 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). [Letter #47, page 10]

99. Respondents to this issue also expressed concern regarding the lack of disclosures sufficient to understand changes in the fair value of liabilities, especially changes in a company’s own debt.

Additional Disclosures

100. A quarter of all respondents commented on the need for additional disclosure provisions beyond those included in the Exposure Draft.

101. Several respondents suggested that the Board require disclosure of the reasons that the FVO is elected for financial assets and financial liabilities. Several respondents also commented that the disclosure provisions of the FVO should incorporate the required disclosures of IAS 39. Other respondents suggested the following disclosures:

   a. Disclose the underlying causes for changes in fair value of a company’s own liabilities by significant type (Standard & Poor’s Ratings, Letter #51)

   b. Require all disclosures related to the FVO in one note (Prudential Financial, Letter #44)

   c. Require disclosures that separately display changes in fair value of creditor’s loans relative to borrowings (FRB/FDIC/OCC/OTS/NCUA, Letter #69)

   d. Require disclosure of methodology used to calculate fair value

   e. Disclose significant drivers of changes in fair value (Ernest & Young, Letter #67)

   f. Disclose changes in fair value according to different valuation hierarchy levels, the reasons for movements at each hierarchy level and between levels, and qualitative disclosure for fair value changes in Level 3 (NAIC, Letter #27).
EFFECTIVE DATE

102. Over a quarter of all respondents commented on the effective date proposed in the Exposure Draft. The respondents commenting on this issue generally support delaying the proposed effective date for the following reasons:

a. Extra time is needed to allow entities to make necessary system changes
b. An entity only has one opportunity to elect the FVO for existing assets and liabilities
c. The effective date should match the effective date of the forthcoming Fair Value Measurement Statement.

103. Constituents expressed concern about the feasibility of implementing system changes to capture the necessary fair value information and, thus, recommended at least a one-year delay in the date of required adoption. MetLife suggested that this additional time would allow companies to “develop necessary system enhancements, operational procedures and financial reporting controls to properly implement the new guidance” (Letter #53, page 3). AmSouth Bancorporation articulated this point and stated:

Not all systems currently support fair value accounting. In order to fully implement fair value accounting on a broad basis, many obstacles must be overcome such as development of more robust accounting models (and time to fully test them), construction of enhanced controls that will comply with the Sarbanes-Oxley environment, and enhanced processes involving selection of assumptions and extensive education. A few months are not enough time to accomplish these objectives. [Letter #40, page 2]

104. Additionally, constituents including the AICPA (Letter #65, page 2) noted that an entity could lose its one-time chance to elect the FVO for existing financial assets and financial liabilities if it was not able to adopt the proposed Statement at the effective date. The proposed transition only
allows for a fair value election upon initial adoption of the Statement for assets and liabilities existing at the effective date. Following the adoption, an election can occur only upon the initial recognition of an asset or a liability or upon an event that gives rise to a new basis of accounting. In light of this situation, XL Capital (Letter #31, page 3) recommended that the effective date be delayed by one year to give companies a sufficient amount of time to assess their existing asset and liability portfolios to determine whether a FVO election is a prudent business decision. Furthermore, respondents noted that a decision to postpone the effective date should not create any additional implementation issues because companies will maintain the ability to early adopt the proposed Statement.

105. Several respondents to this issue also recommended that the Board delay the effective date to be either concurrent with or later than the effective date for the proposed Statement on fair value measurements. Their comments indicated that the guidance in the proposed Statement on fair value measurements will provide a framework for measuring assets and liabilities whose values are inherently uncertain. In addition, the disclosure requirements in the fair value measurement document could provide useful information to users who are trying to understand the effect of an entity’s election of the FVO.

**Early Application**

106. The majority of the respondents to this issue indicated that earlier application should be permitted only as of the beginning of a fiscal year that begins after the issuance of the final Statement, consistent with the proposal in the Exposure Draft. Even respondents that believe the effective date should be delayed for the issuance of the fair value measurement document commented that early adoption should remain an alternative for companies. The American Bankers Association (Letter #73,
page 5) stated support for a delayed effective date with early adoption permitted to provide an alternative that will reduce the burden of the extensive hedging and documentation requirements under Statement 133. Additionally, HSBC Holdings plc (Letter #23, page 1) “encourage the Board to allow early adoption in financial statements for fiscal years ending after the issuance of the final Statement, expected in Q3 2006, for foreign registrants who adopt the FVO under IFRS in their primary statements as this would eliminate a sizeable GAAP difference in the reconciliation to US GAAP.”

**Permit Limited Retroactive Application and Restatement**

107. Fannie Mae (Letter #12, page 4) disagrees with the Exposure Draft’s proposal to require adoption of the FVO at the beginning of a fiscal year, instead, noting that companies should be permitted to apply the fair value option retroactively. Its response noted that “retroactive application would provide useful historical comparative information of a company electing fair value. Retroactive application, however, should be limited to those instances where a company elects to apply fair value to all financial assets and financial liabilities.”

**DIVISION OF THE FVO PROJECT INTO PHASES**

108. Nearly one-fifth of all respondents commented on the phased approach to the FVO project. Of those that responded, most support a phased approach but noted that Phase 2 could be further divided into subphases to facilitate the Board’s prioritization of issues. For example, a couple of respondents cited a need to allow the FVO for physical commodities and commodity-related contracts as soon as possible. Credit Suisse (Letter #30, page 3) recommends that Phase 2a should include loan commitments, demand deposits, leases, and other financial
instruments that have been scoped out of Phase 1, in addition to physical commodities. Phase 2b would later address other non-financial assets and non-financial liabilities. State Street agrees with this approach and noted that:

We believe that demand deposit accounts should be addressed in the first of these additional subphases. Although the fair value components of demand deposit accounts (an indeterminate maturity product) contain complexities, we believe that there are accepted valuation techniques to determine the fair value that can be relied upon for financial statement reporting and disclosure. In addition, we recommend that the Board consider deliberating other items that will be more difficult to address in other subsequent phases. [Letter #37, page 2]

109. Two respondents disagree with pursuing Phase 2 of the FVO project at this time. The Association for Financial Professionals (Letter #29, page 2) suggested a delay for Phase 2 until a more developed financial performance model is in place.