



Tel: 312-856-9100
Fax: 312-856-1379
www.bdo.com

233 N. Michigan Ave., Suite 2500
Chicago, IL 60601

September 24, 2010

Via e-mail: director@fasb.org

Mr. Russell G. Golden
Technical Director
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

File Reference No. 1810-100—Proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*

Dear Mr. Golden:

BDO USA, LLP appreciates the opportunity to offer comments on the financial instruments exposure draft (ED). We do not support issuance of the ED as currently drafted. We understand that the Board developed this project jointly with IASB to replace the current mixed attribute model for financial instruments with a single converged model that enhances the quality and timeliness of information included in financial statements and reduces the complexity of financial reporting. However, we do not believe that the ED achieves its primary objectives, although we agree certain proposed changes represent an improvement. Our specific responses to selected questions posed in the ED are set out in the attached Appendix.

The IASB has differing views on classification and measurement of financial instruments, including impairment. If substantively different standards are issued by the Board and the IASB, it would exacerbate rather than resolve some of the issues that the G20 leaders wanted addressed through convergence. Mandating different models has the potential to create "accounting arbitrage" between the two sets of standards, which ultimately hurts investors and other financial statement users. For instance, the ability to reclassify securities under US GAAP, while prohibited at the time under IFRS, was a flashpoint of tension during the early part of the financial crisis. It's possible that more unintended consequences of that nature could arise if the differences between the Board and the IASB's guidance are not converged. We appreciate that the IASB and the Board intend to consider together the comments received in an attempt at more convergence. However, unless convergence is actually achieved, we believe it would be unfair and costly to force US issuers to make substantial changes to their accounting systems now when they might have to repeat the process (and the costs) if the SEC makes the determination next year to shift to IFRS. Further, if IFRS is mandated by the SEC, we would urge the Board to consider the benefits of just adopting the final IFRS model, instead of issuing this ED as an interim standard in the intervening period, irrespective of the differences in the approach taken by the Board and the IASB.

Beyond harmonizing the FASB and IASB models, we agree with the central objections of the two dissenting Board members who observed the proposal "would introduce fair value



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accounting for some nonmarketable, plain-vanilla debt instruments that are held for collection (long-term investment), and most liabilities held for payment, which they believe would not reflect the likely realization of those items in cash and, therefore, would not be the most relevant way to measure those items in the statement of financial position and comprehensive income." We find this point persuasive because investors and other capital providers have made and continue to make resource allocation decisions on the basis of mixed-attribute financial statements that in large part, portray the results of *the reporting enterprise's* operations and *its* financial condition—rather than market fluctuations and exit prices outside of the enterprise's business.

In short, we do not believe that the Board has adequately justified the costs of shifting from a focus on the enterprise's business to a focus on the market. The Board has proposed that most financial instruments, by default, be classified and measured at fair value, with changes in fair value recorded in net income. We do not believe that this fundamental presumption of mark-to-market through earnings faithfully portrays economic substance (i.e., the way that many financial instruments are managed) because few businesses operate their business on the basis of fair value. Reporting financial information in a manner divorced from the business strategy in which the information was created is inherently costly. But moving beyond the role of an enterprise's business strategy, it is our understanding that even investor groups are not uniformly agreed that fair value accounting through net income is the proper default for all financial instruments. As such - and acknowledging the merits of the arguments made by those investors who agree with this pervasive approach - we struggle to understand how the views of a subset of investors outweigh the objections of other investors, creditors, preparers, and auditors who are not convinced the proposal's perceived benefits outweigh its costs. These same cost/benefit concerns also appear evident in the four-year deferral that would encompass more than 90% of the entities for which the standard was intended.

Aside from cost concerns, we agree carrying more instruments at fair value through earnings reduces complexity because it reduces the frequency that other accounting models would apply. However, other instances of complexity will increase. For example, thorough technical analyses will be required to determine if certain instruments are eligible for an exception to mark-to-market accounting, and many instruments without quoted prices in active markets will often require the use of complex valuation models and highly subjective assumptions. As such, we question whether practitioners will derive a substantive net decrease in complexity and whether the quality of information provided to users would improve as a result of the ED.

For these reasons, we do not agree fair value should be the default category for a going concern. Instead, we would use a two-model approach. It would start with amortized cost for most debt instruments (loans and securities), but require fair value accounting through earnings for instruments held pursuant to a strategy intended to monetize fair value fluctuations in cash, for instance, instruments held for trading or derivatives. In this sense, we agree with the Board that the characteristics of the instrument and the reporting enterprise's business strategy are important considerations (although in contrast to the Board, we believe reclassifications would be necessary since business strategy changes). Similarly, we would retain a fair value option for most financial instruments.



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We also agree that most equity investments should be carried at fair value through earnings, other than those that require consolidation or equity method accounting and certain limited situations where it is not practicable to estimate fair value. However, we would not split portions of the change in fair value between earnings and equity for certain debt instruments. We think this sets a bad precedent for future standard-setting when the Board may be tempted to avoid making difficult decisions on contentious issues. We also believe it would be confusing to many financial statement users who are not accounting technicians or professional analysts.

With respect to credit impairment, we continue to believe recognizing liabilities and other losses should coincide with when they are incurred and be recognized in current earnings. We believe that the recognition threshold should be lowered from "probable", but not eliminated, and that an entity should recognize credit impairment in net income immediately when incurred. However, we believe an *expected* loss approach where initially expected credit losses are either recognized in earnings immediately or smoothed against earnings over time (similar to the IASB's model) is more of a prudential oversight issue and would prefer that it be addressed by regulators who are charged with safety and soundness considerations, rather than mandated through accounting standards.

Regarding interest income, we are not convinced that the proposed changes would improve the usefulness of financial instruments reporting. We agree with the alternative views in paragraph 250 that the proposal inappropriately comingles interest income and credit losses (including reversals, if any), while introducing subjectivity into both. While we appreciate the argument that interest income should be recognized net of the allowance for credit losses to avoid recognizing interest on amounts that will not be received, paragraph 250 of the ED states that feedback received from users of financial statements indicated that they preferred that yields be reported on the basis of the contractual terms of the instrument. In the absence of information on any positive feedback received, we fail to understand which constituent would benefit from the Board's new approach.

The proposed guidance appears to have been drafted with larger financial institutions in mind, rather than the full range of entities that report using US GAAP. While the global financial crisis has naturally focused attention on larger financial institutions and improvements that might be made to their financial reporting, guidance proposed for all US GAAP constituents should consider the circumstances of that wide range of entities. It would appear that, while the proposals might be capable of being applied by a sophisticated preparer of financial statements, many smaller and mid-size entities will find the requirements taxing, if not impossible to apply without additional significant investments in the financial reporting function. Further, given the expanded use of judgment and valuation techniques that would be required to implement the proposal, even by a sophisticated preparer, this may contribute to a false sense of comparability if the underlying application varies widely in practice. As part of the Board's and the IASB's joint outreach activities, we note that an Expert Advisory Panel (EAP) provided input on the operational aspects of the IASB's proposed revisions to the impairment of financial assets. We understand the EAP raised certain concerns about whether simplifications would be needed for smaller banks and non-financial institutions to apply the underlying



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principles of the IASB proposals. We have similar concerns about the Board's financial instrument proposal in general.

In any event, if the Board ultimately adopts the proposal similar to its present form, we believe the Board should reach out to a representative sample of preparers to determine the number of years necessary to implement the ED, with the smaller private companies benefiting from the initial experience of larger public companies. In this regard, information system changes will be pervasive and time-consuming.

As described more specifically in the Appendix, we believe that many of the proposed revisions to hedging activities would simplify current practice and improve financial reporting. Therefore, we support issuing them separately, soon after the Board considers the comments it receives on the ED. We see no reason why the hedging improvements can't proceed apart from the larger project.

Lastly, we note the Board's decision not to provide detailed amendments to the Codification, which the Board does not believe are necessary for an understanding of the proposals. Given the significance of the financial instruments and other MOU projects, it seems likely any final amendments will require a separate exposure period to mitigate unintended consequences that otherwise would only be identified through post-implementation reviews or additional standard setting.

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We would be pleased to discuss our comments with the FASB staff. Please direct questions to Lee Graul, National Director of Accounting at 312-616-4667.

Very truly yours,

BDO USA, LLP

BDO USA, LLP



APPENDIX

(Questions that we have not responded to are omitted)

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

We believe that loan commitments (see our response to question 2) should not be in the scope of the ED. Further, in our responses to questions 8, 21 and 25, we propose limited exceptions for certain non-marketable equity securities, convertible debt, and hybrid financial instruments with nonsubstantive or de minimis embedded features.

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

We agree. Further, we believe that in general, any loan commitment, whether related to a revolving line of credit or otherwise, should not be measured at fair value, unless the commitment and/or the underlying loan is held for sale pursuant to the entity's business strategy. A loan commitment is defined in ASC 815-10-20 as a legally binding commitment to extend credit to a counterparty under certain pre-specified terms and conditions. The fair value of the commitment can be thought of as a sunk cost or even an opportunity cost of doing business. However, unless the commitment and/or the underlying loan is held for sale, the commitment will not be monetized. Therefore measuring it at fair value would not represent the entity's business strategy, and consequently it would not provide meaningful financial information.

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

We agree these types of financial instruments should be in the scope of the ED. However, as discussed in our cover letter and in our response to question 8, we would account for them under a two-model approach rather than the provisions in the ED.

Question 4: The proposed guidance would require an entity to not only determine if they have significant influence over the investee as described currently in Topic 323 on accounting for equity method investments and joint ventures but also to determine if the operations of the investee are related to the entity's consolidated business to qualify for the equity method of accounting. Do you agree with this proposed change to the criteria for equity method of accounting? If not, why?

We disagree with the proposed change to the eligibility criteria for applying the equity method of accounting. Equity method accounting is an extension of consolidation guidance. As such, we do not believe that a proposed change to the current criteria for



applying equity method accounting should be revised as part of the financial instruments project. Further, we do not perceive significant current practice problems related to the existing scope of equity method accounting that would necessitate standard-setting.

However, if the Board moves forward with this proposal, evaluating whether the operations of the investee are related to the investor's consolidated operations may lead to diversity in practice, particularly when the investment is made pursuant to a long term strategy where the investor and investee operations are not currently the same, but are envisioned to converge in the future. In addition, questions will likely arise about whether all, a majority, or some other portion of a diversified company's operations must be related to the investee's operations for purposes of equity method accounting. While the criteria established by the Board will aid in this determination, we believe that additional illustrative guidance should be provided to make the proposed scoping change more operational. Further, while we understand the Board's rationale in paragraph BC 25 of the ED, we are not convinced the option to apply fair value accounting necessarily ought to be rescinded, if for various reasons, a reporting enterprise would prefer to carry these investments at fair value.

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

We disagree. As stated in our cover letter, we do not believe that the Board's proposed default category of classifying and measuring financial instruments at fair value, with changes recorded in net income, faithfully portrays the way that many financial instruments are managed, although it may be representative of a few specialized businesses, for instance, investment companies. The alternative views in paragraph BC 244 state that the proposed guidance would introduce fair value accounting for some nonmarketable, plain-vanilla debt instruments that are held for collection (long-term investment), and most liabilities held for payment, which would not reflect the likely realization of those items in cash and, therefore, would not be the most relevant way to measure those items in the statement of financial position and comprehensive income.

We agree with this alternative view and would extend it to any financial assets or liabilities, whether marketable or non-marketable, that possess basic loan features and are managed on a yield basis¹ that was contracted at origination or expected at acquisition in accordance with the entity's business strategy. That is, we would make amortized cost the default category for instruments meeting those criteria. Instruments that do not meet those criteria would be carried at fair value, including most equity securities, as well as those where a fair value election was made. Regardless of category, we believe instruments carried at amortized cost or fair value should be adjusted through earnings, not equity (other than hedging activity recorded in OCI).

With the notable exception of separating credit from other factors in other-than-temporary impairments, most parties accept or support adjustments made to instruments carried at amortized cost being recorded in earnings. Similarly, most constituents agree that instruments held for trading and derivatives should be marked-to-market through earnings. However, carrying non-trading, non-derivative instruments at fair value with portions of the change in fair value split between earnings and equity seems to lack an apparent conceptual basis. While we understand some of the reasons for attempting to

¹ Yield basis in this context refers to both amounts received or paid in cash as returns to the creditor for a significant portion of the instrument's contractual term.



strike a balance between competing views, we believe that creating a new classification and attribution model without a cohesive principle will be problematic in practice. Therefore, we support the two-category approach of amortized cost and fair value with changes recognized in earnings.

In determining whether financial instruments have 'basic loan features' and are 'managed on a yield basis,' the criteria in paragraphs 21a and 21b of the ED, or a more principles-based variation of the same, could be used. These criteria should apply to debt securities and loans. They should be applied at origination or acquisition of the instrument and as stated in the response to question 16, reassessed if and when there is a change in the entity's business strategy.

While we agree that fair value is a superior measurement attribute for equity securities, we believe there may be situations where it is not cost/beneficial to estimate fair value due to lack of readily available input information, such as investments in certain private entities. Consequently, we suggest that fair value measurement for equity securities should leave room for an impracticability exception, similar to ASC 825-10-50-16 to 825-10-50-19. If it is impracticable to obtain a reliable fair value, the cost method (subject to impairment) would apply. Clearly, an impracticability exception should be a high threshold to ensure sufficient rigor.

Where a cost method is applied to equity securities, additional disclosures should be required to the extent feasible to explain why it has been impracticable to obtain a reliable fair value, including information pertinent to a measurement of fair value. While retaining the cost method would necessitate ongoing impairment assessments, we believe that much of the reluctance in practice to recording impairments and the difficulties associated with determining the timing of impairment would be diffused if the proposal to permit reversals of impairment losses is ultimately adopted.

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

We agree with a single initial measurement principle, which we believe should be transaction price unless reliable evidence indicates a significant difference between the transaction price and fair value. We believe this notion is resident in US GAAP today by virtue of Topic 820's guidance on measuring only attributes of the unit of account in question, as well as ASC 505-30-30-2. Formalizing this concept would be helpful; however, we do not believe this principle provides a basis for establishing the category of financial instruments carried at fair value with qualifying portions of the change in fair value recorded in other comprehensive income (FV-OCI).

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

For items marked-to-market through earnings, we agree transaction fees and costs should be expensed since they are not an attribute of the instrument. For instruments that would



be subject to amortized cost accounting under our view, we would apply other appropriate US GAAP, which in many cases would result in deferral and amortization through earnings. If the Board moves forward with its proposal, we agree with the defer and amortize approach for instruments in the FV-OCI category.

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

It would be helpful for the Board to clearly state whether it believes this should result in a significant change to current practice. In this regard, we note BC 46 indicates "the Board observed that in many cases, the transaction price will equal the exit price...." If so, determining whether there is reliable evidence of a significant difference between transaction price and fair value is likely to require the use of judgment, particularly in applying the terms "significant" and "reliable evidence." For instance, how restrictive is the "significant" criterion intended to be? Does "significant" mean "more than insignificant" or is the threshold intended to be higher? While the criteria established by the Board will aid in this determination, we believe that additional illustrative guidance should be provided to assist in making the above proposals operational if the Board perceives a need to change current practice.

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

See our response to question 8.

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

As noted previously, we do not support establishing the FV-OCI category. However, if the Board moves forward with the proposal, we believe foreign exchange gains and losses should be recorded in net income. We agree with the Board's prior conclusions in Statement 52 (paragraphs 123-124): "Transaction gains and losses have direct cash flow effects when foreign-denominated monetary assets or liabilities are settled in amounts greater or less than the functional currency equivalent of the original transactions. The Board has concluded that such gains or losses should be reflected in income when the exchange rates change rather than when the transaction is settled or at some other



intermediate date or period. This is consistent with accrual accounting; it results in reporting the effect of a rate change that will have cash flow effects when the event causing the effect takes place.”

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

Yes, we believe subsequent measurement principles should be the same—allowing for a two category approach of fair value and amortized cost, both of which would be adjusted through earnings. See our response to question 8.

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

We agree that an unrestricted reclassification option would be inappropriate. However, if measurement of financial instruments with basic loan features is linked to an entity's business strategy, in circumstances where it is clear that an entity's business model has changed then we believe reclassification is appropriate and should be required. For example, an entity might hold a portfolio of 20-year maturity bonds which are measured at amortized cost and, at the beginning of year 5, undergo a business restructuring that changes the way in which it manages those bonds such that, if they were acquired after the restructuring, they would be required to be measured at fair value. Under the ED, the entity would be precluded from remeasuring the bonds to their fair value.

More generally, we believe that the assessment of an instrument's characteristics and the entity's business strategy should be an ongoing evaluation. That is, unless an instrument possesses basic loan features and is managed on a yield basis as described in our response to question 8, it should be carried at fair value with changes recognized in earnings if and when those conditions are no longer satisfied.

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

We disagree. The remeasurement approach proposed in the ED would generally result in core deposits being carried at less than their redemption amount. We are not convinced that this would improve the usefulness of financial instruments reporting. Further, carrying a liability at less than its redemption amount or never accreting to its redemption amount implies that an intangible asset has been adjusted against the liability. We do not believe this adjustment is appropriate. Further, we don't believe guidance on intangible assets should be created piecemeal in connection with the financial instruments project,



particularly when internally-generated intangible assets are not recorded under other US GAAP.

As management's determination of the rate at which to discount its core deposits would be based on the entity's specific facts and circumstances and not on market participant assumptions, the remeasurement approach also digresses from the premise in the ED that fair value is the appropriate default basis for measuring financial instruments.

We believe a better way to convey a financial institution's exposure to interest rate risk would be to disclose inputs that would otherwise be used in a remeasurement calculation, such as the implied maturity of core deposits and the institution's alternative funding rates. See also our response to question 31.

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

We agree that the liabilities in question should be measured at amortized cost and adjusted through earnings.

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

We agree with the examples in the ED and are not currently aware of others that should be included. However, since these instruments are not held for appreciation or the collection of cash flows, we are not entirely convinced that they should be assessed for credit impairment, as proposed. But since they will be carried at redemption amount, that measurement attribute seems to imply a consideration of the credit risk and financial viability of the issuer. The Board may need to consider additional guidance in this regard.

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

We disagree. We are aware of two views currently in practice on this topic, and believe a decision to eliminate one in favor of the other would be better suited to the Board's income tax project (if it was reactivated), or perhaps as an EITF issue. Either of those approaches would facilitate a more robust due process on the question of whether holding a debt instrument to term and evaluating the recoverability of the associated deferred tax asset in isolation is appropriate, or acceptable compared to a combined assessment with other deferred tax assets of the entity.

Question 21: The Proposed Implementation Guidance section of this proposed Update provides an example to illustrate the application of the subsequent measurement



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

We would rather the Board address convertible debt in the context of its separate project on financial instruments with characteristics of equity. Existing guidance on this topic is a patchwork of evolving views, without a foundation. We acknowledge this is due in part to the complexity of the instruments themselves and market innovation. That said, practice has recently normalized with the latest installments of pre-Codification EITF Issue 07-5 and FSP APB 14-1 and their place in the waterfall of US GAAP for convertible instruments, such as Statements 150, 133, EITF Issues 07-5, 00-19, FSP APB 14-1, EITF Issues 00-27, 98-5 and APB 14 (to name a few). This area of US GAAP is one of the most complex and needs a comprehensive overhaul, rather than another temporary change. Therefore, we believe the most cost/beneficial approach would be for the Board to provide a general exception in the ED for convertible instruments until the Board can resolve the issue in the context of its project specific to debt and equity.

Question 25: For hybrid financial instruments that currently would require bifurcation and separate accounting under Subtopic 815-15, do you agree that recognizing the entire change in fair value in net income results in more decision useful information than requiring the embedded derivative to be bifurcated and accounted for separately from the host contract? If yes, how will the information provided be used in the analysis of an entity? If not, for which types of hybrid financial instruments do you believe that it is more decision useful to account for the embedded derivative separately from the host contract? Why?

Users are best-positioned to determine whether reporting a hybrid instrument in its entirety at fair value provides better information than separately presenting the host contract and any embedded derivatives. The ED would require measurement of the entire hybrid instrument at fair value, instead of only the bifurcated component assuming bifurcation is required. As a practical matter, through our discussions with valuation practitioners, we understand that measuring the fair value of a hybrid instrument in its entirety is relatively less complex than measuring a bifurcated embedded feature in isolation (however, we note that fair value of the embedded derivative would still have to be considered with other characteristics of the instrument when determining the fair value of the hybrid). As such, if users and valuation practitioners express a preference for measuring the entire hybrid at fair value, an opportunity exists for the Board to simplify the rules governing whether bifurcation is required so preparers and auditors could apply US GAAP more efficiently. The goal would be a net reduction in complexity for all constituents.

As written, the ED's reliance on existing bifurcation requirements may result in additional diversity in practice. For example, different models exist for separating puts and calls



(e.g., conversion options) from debt hosts. In that context, judgment is required to determine whether a cash-settled “conversion” feature should be evaluated as a put or call option, a point on which Topic 815 offers no guidance. Since different models may yield different answers about bifurcating the embedded derivative, practitioners may reach different conclusions under the ED as to whether the hybrid instrument itself should be carried at fair value. We think the Board should give the existing guidance in Topic 815 additional consideration before “bolting on” new requirements when the interaction between the two may result in unintended consequences.

Further, we note many embedded derivatives have an immaterial value at inception and/or over their life. We do not believe immaterial embedded derivatives, by themselves, warrant carrying the entire hybrid at fair value. Therefore, we believe the Board should explore an exception for nonsubstantive and/or immaterial embedded derivatives, similar to the guidance in ASC 480-10-25-1 that indicates “nonsubstantive or minimal features shall be disregarded in applying the classification provisions of this Section.”

As discussed in the response to question 16, if and when an embedded derivative requiring bifurcation becomes substantive and/or material, the hybrid instrument’s classification would be reassessed.

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

We believe that the cash flow criteria for financial instruments in paragraph 21a of the ED are operational. However, we believe that the paragraph 21b requirement to consider the business strategy would benefit from additional illustrative guidance, based on the following:

- Should an entity consider its long term strategy in determining whether this criterion has been met or its short term strategy, since short term strategy is more susceptible to change in response to prevailing economic conditions? Further, how is a long term strategy distinguished from a short term strategy?
- Is strategy just meant to signify intent for a portfolio, as opposed to intent for an individual instrument, or is strategy a broader concept? In this light, we believe additional clarification is needed to distinguish an entity’s business *strategy* under the ED from *intent*, as currently applied in determining trading, available-for-sale or held-to-maturity classification.
- Does the Board have a higher threshold in mind for assessing significance under paragraph 21b than it does in paragraph 14 in determining whether transaction price differs “significantly” from fair value—even though the words are the same? We sense it does. Since recognizing qualifying changes in fair value in other comprehensive income requires a business strategy to hold instruments for a significant portion of their contractual terms, there may be inconsistent assessments of “significance,” especially for prepayable instruments.

While we do not necessarily believe that the terms “business strategy” or “significant portion of contractual terms” need to be specifically defined, we do suggest that illustrative guidance be provided to assist in making the proposed criteria operational to mitigate potential diversity in practice.



We believe there should be a requirement to disclose the entity's business model and policies as they relate to determining whether the business strategy criterion has been met. This requirement would assist users of financial statements in their understanding of the entity's business strategy in managing its financial instruments. For the same reason, we believe any changes to an entity's strategy and policies would also need to be disclosed. We propose that the disclosures include the circumstances in which financial assets might be sold, and financial liabilities settled, without affecting the overall strategy of the portfolio. This may assist in further clarifying the "occasional sale" notion in paragraph IG37.

In addition, we believe that an entity would face operational issues in obtaining timely and cost/beneficial fair values of financial instruments at each reporting period, for instance loan portfolios held for investment, given (1) the time involved to do so, especially for public entities with filing deadlines, and (2) the fact that liquid markets may not exist for such instruments. Providing fair value estimates in the footnotes, as opposed to the face of the financial statements (even parenthetically), mitigates these operational timing challenges since footnotes generally aren't included in press releases.

For the paragraph 21c requirements related to hybrid financial instruments, see our response to question 25.

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

Plainly, fair value estimates can be developed for almost anything, including financial liabilities. However, outside of trading instruments and derivatives, we do not believe measuring other financial liabilities at fair value is cost/beneficial or meaningful, particularly since many parties discount the relevance of changes in the fair value of financial liabilities because they find the impact on performance metrics counter-intuitive (whether recorded in earnings or OCI). Further, most liabilities are settled at their contractual amounts, not an estimate of fair value built on potentially subjective assumptions.

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

Yes, we believe the guidance in paragraph 30 is operational, although we believe certain clarifications would help. With respect to whether a measurement mismatch exists:

- We note the ED requires using recognized assets as of the end of the immediately preceding reporting period in applying these quantitative tests. For a nonpublic company, the time lag between issuing debt and the end of the immediately preceding reporting period could be significant, whereas for a public company, this would not normally be more than a quarter. In any event, additional guidance to address situations where a company's balance sheet has changed significantly from the prior period balance sheet date should be provided, for example to account for the impact of business combinations, major fixed asset expenditures, deconsolidations, etc.
- Paragraph 30a refers to contractual linkage between a financial liability and an asset. While nonrecourse debt and collateral arrangements are clear, it isn't apparent whether lines-of-credit or similar arrangements would qualify. For instance, if an asset is part of a borrowing base calculation where the borrowed



- funds can be used for any general corporate purpose, would that arrangement satisfy the test?
- We assume the term “50% of recognized assets” in paragraphs 30 b. and c. refers to dollars, as opposed to some other measure, such as the number of assets. A clarification such as “50% of the carrying amount of recognized assets” would be useful.
 - Private companies may need to apply the segment guidance in Topic 280 for the first time. We do not foresee any operational difficulties here; however, a sentence or footnote to highlight this possibility would be helpful.

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

As discussed previously, we do not support this new measurement attribute.

However, if it is retained, we believe it will pose significant operational challenges. Identifying transient and surge balances that are excluded from core deposits, estimating the alternative funds and all-in-cost to service rates, as well as the implied maturity of the deposits is likely to lead to hypothetical and highly subjective determinations by management, which will erode comparability. The ED appears to assume that branches are used only for gathering of core deposits, which is not true. They are also used to originate and service other products such as loans, safe deposit boxes, insurance products, etc. Therefore, use of the “all-in” cost does not seem appropriate.

Further, we note that the ED describes the alternative funds rate as a rate associated with the next available source of funds if core deposit liabilities are not available. Since the next source of funds could be other core deposits, albeit with a higher rate of interest, the definition of alternative funds rate could pose circular challenges. Accordingly, clarification would be needed, such as whether the alternative funds rate would be restricted to non-deposit sources, and if so, why it would be appropriate.

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

For financial liabilities measured at fair value with changes recorded in earnings (apart from the question as to whether fair value is appropriate), we agree with the separate presentation of changes in an entity's credit standing in net income.

However, if the Board requires fair value for financial liabilities beyond those that are traded or are derivatives, we believe that changes in the fair value of an entity's financial liabilities that arise from changes in the entity's own credit standing should be recorded in OCI. This would preserve the relevance of earnings per share (EPS), a performance



indicator that we believe should be unaffected by the counter-intuitive effects of changes in an entity's own credit standing. Further, we observe that using a "significance" threshold for determining separate presentation of an entity's credit standing may result in inconsistent application and recommend that the Board provide additional guidance on this aspect.

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

Credit ratings of the entity and/or its financial liabilities are not readily available for most entities. In the absence of readily available credit ratings, significant judgments and operational challenges would be involved in applying either Method 1 or Method 2 of Appendix B. An entity's credit spread generally consists of factors relating to liquidity, uncertainty and credit risks. As a practical matter through our discussions with valuation practitioners, we understand that it is difficult to isolate the individual effects of liquidity, uncertainty and credit risks from the total change in the credit spread. We do not believe that excluding changes related only to the price of credit based on the application of subjective judgment is a better measure than including these changes when computing an entity's credit standing. Therefore, we believe that determining changes in an entity's credit standing, the entire credit spread (including the price of credit) should be considered. We believe this will also promote comparability.

However, if the Board moves forward with the ED, our thoughts are:

- The strength of Method 1 is that it appears to be a direct comparison of the subject entity's credit. However, we believe that the Board should provide more clarity regarding the use of credit ratings in applying Method 1. Scenario A in Appendix B appears to illustrate a credit rated debt instrument; however, Scenario B does not appear to make a distinction between the entity's own and the debt's credit rating. This may create confusion as to which credit rating to use, the entity's or the debt's, in applying Method 1. Further, if diversity exists between the ratings provided by the different credit rating companies, it is not clear whether the lowest, average or highest credit rating would have to be considered when applying Method 1.
- The weakness of Method 1 is that credit ratings can become stale and outdated and are expensive for smaller entities. For example, sudden changes to an entity's financial condition, whether positive or negative, may not be accounted for in the credit ratings, and if the condition(s) are not known by an appraiser this could have an impact on any concluded values.
- The strength of Method 2 is that the subject entity does not have to have its own credit rating which is true of most private companies. However, the credit rating could be estimated using a synthetic credit rating model, a comparable entity



approach, or other broad based models. Using other methods would be a function of the available data to perform such an analysis.

- The weakness of Method 2 is that there is no guarantee that an appraiser's judgment of the credit rating is accurate. To some extent it is only as good as the data selected in determining a conclusion.
- While it is always preferable to have a direct measure of an entity's credit standing, this data is not always available, for instance, for most private companies. Further, there may be times when data is available to apply to Method 1, and at other times, data may not be available or updated and therefore an indication that Method 2 should be the preferred method. Nonetheless, whichever method is chosen, it should be consistently used, assuming continued availability of data.

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

We believe the decision to utilize industry data, comparable company data, or index data should be a function of what data is available. Similar to other types of valuation, using a broad set of comparable companies such as industry index along with a more defined set of comparable companies would be preferred. In most cases, valuation literature recommends the use of multiple methods and multiple sources of data. Considering specific comparable companies and their interaction with the broader industry and overall economy is a more thorough way of determining a specific entity's credit standing than looking at just the comparable companies or the industry. Looking to other comparable companies within an entity's industry will give a potential opportunity to understand the risk and how those risks correlate with the entity's capital structure. Further, looking at the credit change associated with a specific size grouping may also be appropriate since the price of credit may fluctuate within different sizes of companies. However, truly comparable company data may not be available. When this is the case, the broader industry may be the best option to find comparable data.

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

We do not support proposed objective. We believe the recognition threshold for incurred losses should be reduced, for instance to a more-likely-than-not level, rather than eliminated. If the Board adopts an expected loss approach (or some variant thereof), where initially expected credit losses are either recognized immediately or smoothed against earnings over time, we believe a consideration of forward looking information based on reasonable assumptions that are objectively verifiable should be allowed when assessing impairment. This would recognize that credit risk is dynamic. Otherwise, recognition of a foreseeable loss may be delayed because entities at the peak of a "credit



bubble” would be forced to assume the bubble will never pop. Conversely, “excess” impairments may be recorded at the bottom of a credit cycle because entities would have to assume defaults and similar activity will not abate.

If the Board moves forward with the ED, we believe that additional illustrative guidance would be necessary. For instance, should positive and negative historical trends be treated or weighted differently? What would the role of hindsight and lagging economic indicators published after the reporting date be—for instance, changes in the consumer price index and unemployment rates? The Expert Advisory Panel discussed similar issues regarding a “loss emergence” period, but no conclusions appear to have been reached.

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

As noted previously, we continue to believe recognizing liabilities and other losses should coincide with when they are incurred. We believe that the “probable” threshold should be lowered and an entity should recognize credit impairment in net income immediately when incurred for originated financial assets and purchased financial assets.

However, we believe an expected loss approach where initially expected credit losses are smoothed against earnings over time (similar to the IASB’s model) is more of a prudential oversight issue and would prefer that it be addressed by regulators who are charged with safety and soundness considerations, rather than mandated through accounting standards.

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

We agree, since by definition, credit losses reflect the borrower’s ability to repay.

We also agree with the view in paragraph 50 of the ED that “when changes in expected cash flows due to variable rates or prepayments cannot be separated from the overall decline in expected cash flows, an entity shall account for the entire decline in cash flows expected to be collected as a credit impairment.” We observe that for many financial



instruments, especially structured instruments, it may be difficult to isolate the cash flow effects of changes in prepayment rates, which will have a direct effect on the cash flows to be collected. In those cases, we believe the entire change (including foreign exchange effects) should be recorded in earnings.

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

We do not believe that a specific method should be prescribed for determining historical loss rates. This is an operational decision that an entity should determine and disclose, including key judgments and assumptions. However, the Board may wish to summarize prevalent practices in this regard for illustrative purposes.

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

In the interest of reducing complexity, we believe that a single model should apply to both originated and purchased assets. We generally believe that gains based on increased cash flows determined on a "good faith" basis be recognized immediately. This would be symmetric with our view of recognizing losses immediately. Indeed, we do not see a compelling reason why credit gains should be treated differently than credit losses.

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

We disagree. We believe the Board's proposal is inconsistent with the individual unit of account. If an individual financial asset is assessed for impairment and none exists, it should not be evaluated again as part of a pool of similar assets. Any losses identified in the second analysis would be based on something *other than* the individual unit of account. Those other indicators may include market assumptions affecting the price of the loans in a sale, but that is not the objective of a credit impairment assessment.

It would appear that the notion of a second evaluation based on a pool calls into question whether the pool's losses have been properly accounted for. If an entity attempts to avoid or manage the timing of losses by virtue of whether assets are evaluated individually or collectively, we believe this is more of a practice issue than it is a problem to be fixed through standard-setting.



However, if the Board retains its proposal, we recommend providing additional application guidance to illustrate whether the historical loss rate of the pool should be adjusted based on individual assets that are added to or removed from the pool. Further, there may be situations in which an entity does not have pools with characteristics similar to its individually evaluated loan, where additional examples would be instructive.

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

As noted in our response to question 37, we believe that consideration of forward looking information that is based on reasonable assumptions that are objectively verifiable should be allowed when assessing credit impairment under an expected loss approach. However, we do not support an expected loss model, which requires consideration of all potential future scenarios largely because it is inconsistent with the concept of recording losses when incurred.

We would prefer a new threshold for recognizing losses that is lower than the current "probable" recognition standard. However, if the Board moves forward with an expected loss approach, we recommend working jointly with the IASB, perhaps in conjunction with the Expert Advisory Panel, to address the operational aspects of factoring in reasonable and objectively verifiable forward looking information to avoid assumptions that do not contemplate the reality of credit cycles.

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

We believe that this approach does not necessarily represent a significant change in practice. However, since diversity currently exists in applying historical loss factors, we recommend that the Board provide additional illustrative guidance to narrow practice. For instance, if the annual losses averaged 5% over the historical period and a loan portfolio has an average life of 3 years, should a 5% rate, 15% rate or a loss rate between those two be applied under the ED in the period of origination or acquisition?



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

We are not convinced that the proposed guidance would improve the usefulness of financial instruments reporting. We agree with the alternative views in paragraph 250 that the proposed guidance inappropriately comingles interest income and credit losses (including reversals, if any), while introducing subjectivity into both. Paragraph 250 of the ED states that feedback received from users of financial statements indicated that they preferred that yields be reported on the basis of the contractual terms of the instrument. In the absence of information on any positive feedback received, we fail to understand which constituent would benefit from the proposed guidance. Further, as an unintended effect, interest that is effectively recorded on a cash recovery basis under current guidance for non-performing loans could be recorded on an accrual basis, as long as the overall yield is positive, under the proposed guidance.

We are also concerned with the operational issues of linking the computation of interest income on financial assets to the related allowance. Interest income is generally an automated process based on the effective interest rate, while the allowance is frequently a separate manual process (albeit with spreadsheets). Historically, we understand many regional and community banks have tended to focus more on the allowance process on a quarterly basis, with less attention during the intervening months, so the intervening months' interest income may not be as exact as it should be. Further, financial assets can be reclassified if circumstances change. For instance, loans can and do move from one loan grade pool to another over time. As such, the ED would pose challenges to synchronize different processes and systems to calculate interest income.

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

We disagree, and share the alternative view in paragraph 250 that objects to excess interest income characterized as a credit impairment recovery. We believe that the proposed guidance will primarily affect the manner and amount of interest income recognized on loans, rather than securities, and present operational challenges for many existing accounting systems, with no discernible benefit.

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



We believe the method should be an accounting policy election, consistently applied and disclosed.

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

We suggest that additional illustrations be provided for evaluating financial instruments on a collective (pool) basis, including considerations when financial assets were not considered impaired on an individual basis but were nevertheless deemed to represent a credit loss. Under an expected loss model, if the Board accepts our recommendation to contemplate the effect of credit cycles, examples of incorporating relevant future events such as expected foreclosure trends would also be useful.

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

We generally agree with the proposed changes to the requirements for assessing hedge effectiveness. By lowering the required effectiveness threshold to reasonably effective and eliminating the periodic effectiveness assessments unless there is a change in circumstances, the Board both simplifies the accounting and improves financial reporting for hedge activities. However, we recommend the Board provide additional guidance to illustrate the intended application of that guidance.

The Board introduces new terminology in the ED such as "reasonably effective," "reasonable period of time," and "minimal difference." We are concerned that without guidance from the Board, diversity in practice will emerge with respect to how different entities determine the following:

- What is considered to be reasonably effective
- When a quantitative (as opposed to only a qualitative) assessment of effectiveness is required
- Which types of circumstances would suggest that a hedging relationship may no longer be reasonably effective
- Whether a difference between forward rates on the actual derivative and the perfect hypothetical derivative is minimal, thus indicating that the time period is reasonable.

We understand that application of the guidance requires judgment, and we are not suggesting that the Board provide prescriptive rules for these situations. But, to achieve consistent application of this "principles-based" guidance, the Board's intent and meaning must be clear. For example, paragraph BC220 states that all the facts and circumstances must be considered in determining whether a hedging relationship is reasonably effective, including, "consideration of whether the objective of applying hedge accounting was to compensate for accounting anomalies or to achieve a fair value measurement option for items not currently eligible for fair value measurement." We request clarity on what the Board intends by this statement. Does it mean that an entity would not be allowed to apply hedge accounting due to its "objective" for applying hedge accounting, even if the hedging derivative would be reasonably (or highly, or even perfectly) effective in achieving



offsetting changes in fair value or cash flows attributable to the hedged risk? If so, where is this point articulated?

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

The ED states "After inception of the hedging relationship, an entity shall qualitatively (or quantitatively, if necessary) reassess effectiveness only if changes in circumstances suggest that the hedging relationship is no longer reasonably effective in offsetting." We agree effectiveness should be reassessed on an exception basis. As noted in our response to question 56, we recommend that the Board provide additional guidance to illustrate the intended application of this guidance

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

We note the question does not specify a benchmark against which to measure potential reductions in the number of times hedging relationships would be discontinued due to the level of ineffectiveness. The absolute number of hedges that will qualify for specialized accounting should increase as a result of the proposed 'reasonably effective' threshold relative to the prior 'highly effective' threshold. However, it is less clear whether the frequency of hedging relationships that "fall out of bounds" will decrease or not. That is, there will always be hedging relationships at the margin of acceptable effectiveness—whatever that margin is. As noted in our response to question 57, we recommend that the Board provide additional guidance to illustrate the types of circumstances that would suggest a hedging relationship may no longer be reasonably effective.

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

See our response to question 56. We recommend that the Board provide additional guidance to illustrate the intended application of the proposed guidance for cash flow hedging relationships in which the designated forecasted transaction is the variability in cash flows related to a group of transactions within a specific time period and the hedging instrument is either a forward or a purchased option.

In addition, we disagree with the requirement to record ineffectiveness for underhedges because the "result would be to defer in other comprehensive income a nonexistent gain or loss on the derivative and to recognize in earnings an offsetting nonexistent loss or gain," as stated in paragraph 379 of Statement 133, *Accounting for Derivative Instruments and Hedging Activities*.

Question 62: Do you foresee any significant operational concerns or constraints in creating processes that will determine when changes in circumstances suggest that a hedging relationship may no longer be reasonably effective without requiring



reassessment of the hedge effectiveness at each reporting period? If yes, what constraints do you foresee and how would you alleviate them?

See our response to question 57 where we recommend that the Board provide additional guidance to illustrate the types of circumstances that would suggest a hedging relationship may no longer be reasonably effective; for instance, financial distress of counterparty or where the cumulative dollar offset used for measuring hedge ineffectiveness indicates a less than reasonably effective offset.

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

We do not understand the problem paragraphs 119-121 of the ED aim to address. In our experience, entities rarely de-designate hedge relationships voluntarily, except in response to changes in circumstances or as an overall hedge strategy. We do not think de-designation has been "used as a tool for changing measurement attributes and/or managing the classification of certain items reported in earnings" in practice.

If voluntary de-designation really is a problem in practice, it is unlikely that the ED would curb such abuse. An entity could simply terminate the derivative and enter into a new derivative with the same hedging objective. Alternatively, the entity could enter into two additional offsetting derivatives, one offsetting the original hedging derivative and the other mimicking the effect of the original hedging derivative. In both of these situations the entity is in exactly the same economic position (except possibly for additional transaction costs), and yet the accounting has changed. We believe this provision merely forces an entity to jump through another hoop to de-designate a hedging relationship and certainly does not simplify accounting, improve financial reporting, resolve practice issues, or address recognition and measurement anomalies.

Similarly, we do not understand why an entity should not be allowed to re-designate the original hedging derivative or the offsetting derivative in a hedging relationship. The Board provides no explanation for this change in the basis for conclusions, and we fail to see the principle that leads to this requirement. Like the preceding paragraph, this requirement is easily circumvented by entering into transactions with little or no overall economic impact.

In addition, paragraph BC 223 indicates that the ED would not affect many hedge strategies traditionally involving a periodic de-designation if documented differently. It appears that entities can still achieve the same accounting if they document that they will "de-designate in advance." This creates additional complexities in preparing hedge documentation, and we believe it will cause considerable difficulties in implementation, especially for smaller entities that lack technical accounting resources. We do not believe this change meets any of the objectives set forth in the ED.

Separately, we observe that contrary to paragraph BC 222 and the proposals prohibiting discontinuance of hedge accounting by simply de-designating (or removing the designation of) the hedging relationship, paragraph 121 appears to allow an arbitrary partial de-designation and re-designation. We request the Board clarify its intent in this regard.



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

See our response to question 63 above.

Other Comments on Hedging:

We disagree with the Board's view in paragraph BC 232 that "If the use of amortized cost would be broadened, the Board may choose to significantly limit hedge accounting for the variety of separate risks currently permitted by Section 815-20-25." We believe that, regardless of whether the use of amortized cost is broadened or not, limiting the bifurcation-by-risk approach would not reflect the economic rationale for entering into a hedge and further, actually increase complexity and make application of hedge accounting far more challenging. It would not provide a faithful representation of the reporting entity's risk management activities and it is unclear to us why the Board believes this approach would be more useful if the use of amortized cost is broadened. We are especially concerned that limiting the bifurcation-by-risk approach might lead entities to forsake economically efficient and effective hedging strategies due to the adverse accounting consequences. We further recommend that to more appropriately reflect an entity's risk management strategy, the bifurcation-by-risk approach be extended to non-financial hedged items.

We observe that the Board has revised the guidance for purchased options in paragraph 125. We recommend the Board provide additional guidance differentiating between options that are "at," "in," or "out" of the money at inception to illustrate the intended application of this guidance.

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

We believe the unprecedented volume of proposed disclosures in current and recent standard setting has reached a point of diminishing marginal returns. This is true of, but not unique to, the financial instruments ED. We urge the Board to right-size existing and proposed disclosure requirements through its disclosure framework project.

With respect to the ED, we are concerned that the disclosure requirements appear to have been drafted primarily in the context of financial institutions. We recommend that the Board consider reducing the level of disclosure for non-financial institutions by redrafting the disclosures into two sections, one which includes disclosures for all entities and another setting out additional disclosures required for financial institutions and other entities whose core business is the provision of financial services. Even for financial institutions, we encourage the Board to reconsider whether the extent of disclosures, in aggregate, would lead to an overload of information. Further, to make disclosures operational as well as retain its usefulness, we suggest the disclosures be made at the portfolio segment level, instead of by class.

While we understand the Board's objective of providing financial statement users with an indication of the uncertainty inherent in recurring fair value measurements categorized



within Level 3, we believe that the preparation and audit costs of the proposed Level 3 uncertainty disclosures, as currently drafted, will likely exceed the benefits that financial statement readers are likely to derive. See our comments to the separate proposed Accounting Standards Update, *Amendments for Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*, where we have suggested what we believe to be more cost beneficial alternatives. Further, we recommend that the Board encourage (rather than require) stress testing disclosures and provide illustrations to indicate how it is anticipated this disclosure might be made.

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

We agree.

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

We believe the proposed delay reflects the fundamental shortcomings of the ED. Nevertheless, if the Board adopts the proposal, we agree with the deferral for private companies with less than \$1 billion in total assets. However, we believe a complete deferral would be appropriate, rather than only deferring portions of the ED.

We believe the deferral should last at least through the Board's post-implementation review of entities that would be part of the initial adoption. After the Board determines whether any changes are appropriate based on its review, it will be in a position to gauge what a reasonable lead time would be prior to effectiveness for private companies subject to the deferral. This approach would minimize the transition and implementation costs that private companies with less than \$1 billion in assets would otherwise incur in the periods preceding the effective date. That is, under the Board's approach, they would incur costs getting ready to apply the initial standard, only to incur more costs stemming from any changes the Board makes as a result of the post-implementation review.

In addition, we note the language in paragraph 134a refers to loans for which qualifying changes in fair value that "would be" recognized in other comprehensive income. Since that treatment is an election, it effectively means companies must apply the model and determine whether they will make the election. That situation seems to defeat the purpose of a deferral.

We believe the Board should evaluate feedback on its proposed revisions to derivatives and hedging separately, and consider issuing those changes on stand-alone basis in the near-term.

Lastly, we do not believe eligibility for the deferral should be reassessed on an annual basis. Instead, the deferral should apply until an entity otherwise adopts the entire standard.

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



We recommend that the Board reach out to a representative segment of preparers for this question. Further, before determining the implementation period, we believe that convergence issues should be resolved and due consideration given to the SEC's determination next year about whether to incorporate IFRS into the financial reporting system for U.S. issuers.

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

We believe some grandfathering would be helpful, or additional guidance concerning how to apply the proposal to each of the major elements of the proposal would be necessary:

- How would preparers assess business *strategy* using hindsight, particularly if the strategy that was in place at the inception of the instrument no longer applies? A literal read of the ED could result in a classification that is inconsistent with the current business strategy. Depending on the term of the instrument, that result could last for decades.
- How would existing short cut hedging relationships and voluntary de-designations that occur before the effective date be addressed?