

December 9, 2010

Technical Director FASB 401 Merritt 7 PO Box 5116 Norwalk, CT 06856-5116

Re: May 26, 2010 Exposure Draft of a Proposed Accounting Standards Update (ASU), Financial Instruments (Topic 825): Accounting for Financial Instruments and Derivatives and Hedging (Topic 815): Revisions to the Accounting for Derivative Instruments and Hedging Activities [File Reference No. 1810-100]

Dear Sir or Madam:

One of the objectives that the Council of the American Institute of Certified Public Accountants (AICPA) established for the PCPS Executive Committee is to act as an advocate for all local and regional firms and represent those firms' interests on professional issues, primarily through the Technical Issues Committee (TIC). This communication is in accordance with that objective. These comments, however, do not necessarily reflect the positions of the AICPA.

TIC appreciated the opportunity to discuss its views on the ED with selected Board members and staff at the November 11, 2010 FASB/TIC Liaison Meeting and is now providing the following written comments for your consideration.

#### **GENERAL COMMENTS**

TIC cannot support the new fair value provisions of the ED and has concluded that the current recognition, measurement and disclosure standards for financial instruments are preferable for the financial statement users of nonpublic entities and smaller financial institutions. (In this letter, "smaller financial institutions" include those that are public, as well as those that are private, since smaller public banks will have many of the same issues as private entities in complying with this ED, if it is finalized as written.)

The ED explains the Boards' rationale for overhauling the accounting model for financial instruments in the context of the complexities and pervasiveness of global financial markets and discusses how the global financial crisis raised concerns about the inadequacies of the current model to a new level. However, the issues that arose stem from the activities of primarily large global financial institutions. Nonpublic entities and

smaller financial institutions utilize relatively simple financial instruments in comparison and do not need such a dramatic and pervasive change.

A one-size-fits-all standard for financial instruments is not appropriate if it will not be operational and relevant for all entities. The initial and ongoing costs to implement the ED are likely to far exceed the perceived benefits to the users of privately owned entities' financial statements. TIC believes that such users will disregard the new fair value measures because they are not relevant to their lending models. In addition, the proposed disclosures are too difficult and time consuming to prepare and have become so voluminous that TIC is concerned that users will never bother to read them. Therefore, many of the provisions of the ED would be irrelevant to both preparers and users of private company financial statements.

The standard would necessitate changes for community banks and other small financial institutions and would likely create differences between GAAP and regulatory accounting principles. Regulators are not likely to be interested in the fair value of a smaller bank's loans receivable or to permit a bank to write down core deposit liabilities, if carrying value should exceed fair value. Therefore, even in the banking industry, there is no perceived benefit for financial statement users.

Based on the above issues, TIC recommends that private entities and smaller financial institutions be provided a full exemption from the fair value provisions of the ED. New fair value measurements should be limited to large, global financial institutions that carry complex financial instruments. Before the Board increases the number of fair value measurements required in the financial statements of private entities and smaller financial institutions, additional outreach should be conducted among users to determine if such measures would be relevant to their needs. TIC believes the findings of such a study would indicate that the financial instruments issued or held by such entities should be exempt from new fair value measurements.

If the Board does not fully exempt private entities and smaller financial institutions, TIC recommends that all nonpublic entities and public financial institutions that have less than \$5 billion in assets should be excluded from mandatorily applying the changes proposed in the new model. A \$5 billion exemption threshold would limit the impact of the standard to large money-center banks, where the inadequacies of the current financial reporting model are evident and for whom the standard was intended.

Finally, if neither full nor partial exemption is acceptable, TIC recommends that the Board adopt the Alternative Views (discussed further below), which would provide a set of comprehensive principles that seem to be more closely aligned with the needs of private company users and would appropriately consider cost/benefit considerations. This model would be another viable solution to the problems posed by the ED, as currently written.

TIC has commented separately concerning the proposed changes to the hedging rules and the new credit impairment model. TIC appreciates the proposed simplifications to accounting for the hedging relationship at inception; however, the proposed changes to determining ineffectiveness will not be operational for most private entities.

TIC supports, in theory, the proposed credit impairment model as a replacement for the existing accounting rules pertaining to the recognition and measurement of loan losses. However, TIC believes the model will need further study to ensure that it can be implemented properly. Accompanying implementation guidance would be needed in the final standard to ensure consistency of application of the proposed model.

Of all the convergence proposals, this ED was the most difficult to read and is far beyond what the average accountant or preparer can comprehend. TIC recommends that the Board establish an implementation group to assist all constituents with the transition to the final standard.

The section below provides further information on TIC's views concerning the fair value measurement, credit impairment and hedging proposals, and identifies the specific fair value and other provisions that will lack cost/benefit for TIC's constituency.

### **SPECIFIC COMMENTS**

# **Proposed Scope Exclusions**

TIC agrees with the stated exclusions to the proposed standard and recommends that nonpublic entities and smaller financial institutions be excluded from the fair value provisions of the ED for the following financial instruments:

- Financial assets without readily available fair values (e.g., long-term loans receivable for all entities and non-traded bond investments).
- Equity method investments that are unrelated to the consolidated entity—TIC disagrees with the change in the criteria for an investee to qualify to be accounted for under the equity method.
- Financial liabilities (including long-term loans payable, convertible debt, core deposit liabilities of banks).
- Standby letters of credit and nonrevolving loan commitments issued by creditors.

As explained in the General Comments above, "smaller financial institutions" include those that are public, as well as those that are private. Smaller public banks will have many of the same issues as private entities in complying with this ED, if it is finalized as written.

# Financial Instruments Held for Collection/Payment of Contractual Cash Flows

Valuation of financial assets and liabilities held for collection or payment at amortized cost currently works well for private entities. From the private entity perspective, the current accounting model is not broken and the proposed model is neither operational nor relevant to users. TIC therefore opposes fair value accounting for long-term

receivables, long-term payables, and cost method investments (including non-traded bonds) for which readily determinable fair values do not exist.

TIC agrees with the alternative views on fair value accounting for debt instruments, which state:

[The ED] 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.

For financial assets held by either banks or commercial/not-for-profit entities, TIC agrees with the three criteria presented in the alternative views. Under their proposal, fair value would not be appropriate for financial assets that:

- do not have either readily available quoted market prices or variable cash flows, and
- the reporting entity intends to hold to collect the contractual cash flows.

Fair value measurements for these instruments fail the cost/benefit test. TIC believes preparers would encounter significant operational difficulties in obtaining fair values for financial assets and liabilities that are held for collection or payment. These instruments will involve Level 3 inputs in most cases. To the best of TIC's knowledge, there are few provider resources available to value loans receivable for a community bank or other preparer. Assuming such a market develops, it will be very costly to obtain the necessary fair value measurements.

Some of the entities affected by this proposal are not-for-profit organizations, including hospitals and private colleges. Some universities have over 50% of their investment portfolios invested in financial instruments and as such would be required to adopt all of the provisions of fair value, including marking their own debt (e.g., revenue bonds) to market.

Financial statement users for private v. public companies have different information needs. Private company creditors do not use Level 3 fair values in their loan models when making lending decisions and tend to ignore fair value disclosures in the footnotes. Banks lend on expected cash flow and collateral and will not be interested in "the market's assessment of an entity's expectation of its future net cash flows" (page 4 of the ED). The period-to-period fluctuations in unrealized gains and losses would not be either meaningful or relevant to most users of private entity financial statements.

For the same reasons, TIC also opposes the proposed disclosure of fair value for those financial liabilities that qualify for measurement at amortized cost.

# **Proposed Accounting Changes Relating to Equity Method Investments**

For an investor to qualify for the equity method of accounting, the ED would require an entity to not only determine if it has significant influence over the investee as described currently in FASB *Accounting Standards Codification* 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.

TIC believes the proposed change to the equity method criteria will not be operational. TIC has no theoretical objection to the proposed change. However, it will not be workable for private entities and many not-for-profit organizations since it creates certain practical difficulties and implementation issues. The new criterion is too vague to be applied consistently. Some may analogize an "unrelated" operation to the old notion of "nonhomogeneous operations" from Accounting Research Bulletin No. 51, *Consolidated Financial Statements*. Under that standard, an investee with operations in the financial services industry would be considered "unrelated" to an investor whose primary operations were in manufacturing. Others will develop a rationale that interprets relatedness more broadly for investees and investors in disparate industries. (For example, any investee that is an operating company is necessarily "related" to the investor.) Vague requirements will allow preparers to invent ways to avoid fair value measurements for equity investees. For these reasons, related operations will not be an effective criterion.

Unlike public entities that may have elected the fair value option when the investee's operations were not considered related to those of the investor's consolidated operations (per paragraph BC25 of the ED), most private entities and not-for-profit organizations have not adopted a preference for fair value. The existing standards for equity method accounting along with the fair value option work well for private entities. TIC therefore continues to support a fair value option for equity method investments and disagrees with the proposal in paragraph 131 to eliminate its use.

In many cases, the investees have no market, and the related assets are not available to creditors in case of default by the investor. TIC also asks the Board to consider that, although the equity method investment is a financial instrument, the underlying fair value measurement, especially with real estate, is of a nonfinancial asset. Given the difficulty that private companies already have in obtaining fair values for Level 3 investments and the difficulty that auditors encounter in auditing these investments, TIC opposes any proposal that would add more fair value measurements to private company financial statements.

The difficulty in obtaining fair value measurements for various types of private investments accounted for under the equity method is a cost factor that cannot be justified by commensurate user benefits. TIC believes users of private company financial statements will disregard the fair values obtained, since they are not used in lending models. The investor generally does not have the ability to realize its "fair value" in the illiquid private entity in the near term.

# **Credit Impairment Model**

TIC agrees that the incurred loss model that originated with FAS 5, *Accounting for Contingencies*, is no longer functional and needs to be modernized. TIC has noted that regulators seem to be adopting the expected loss model. However, TIC believes the credit impairment model is preferable because, unlike the expected loss model, the credit impairment model does not include forecasting future events or economic conditions that did not exist at the end of the reporting period. In theory, TIC believes the credit allowance should be based on existing conditions and known trends.

Eliminating the forecasting factor should make the credit impairment model more operational. However, TIC is uncertain whether this would be the case. It is difficult to create an intellectual bright line between forecasting on known events and circumstances and forecasting based on future trends. As a result, the prohibition in paragraph 42 against forecasting future events or economic conditions that did not exist at the end of the reporting period presents an operational dilemma that raises considerable implementation issues. TIC believes this concept needs further study before the credit impairment model is adopted in final form. If the credit impairment model is retained in its present form, TIC recommends that the Board provide implementation guidance around the concept of forecasting based on known events and circumstances and forecasting based on future trends.

# **Measuring Interest Income on Debt Instruments Held**

TIC opposes the recognition of interest income at other than the contract amount since it is not reflective of a true net yield. The proposal would allocate a portion of the loan loss to interest, which would distort the recognition of the contractual cash received. The proposed change also adds too much complexity to the calculation of interest income. It would require major system changes for community banks and therefore would not be readily operational. Although some consultants are available to perform these valuations, TIC believes the demand for these services would readily exceed the available supply of qualified professionals, further raising preparation costs. TIC noted the objections raised in the dissent to the ED (paragraph BC250) and questions any methodology that would not be acceptable to financial statement users.

## **Core Deposit Liabilities**

TIC supports the position expressed in the Alternative View of the ED (paragraph BC248). TIC believes the fair value of core deposit liabilities is impossible to determine unless the bank has purchased the deposits from another institution. Determining the fair value of purchased core deposits already presents significant challenges in terms of cost and the time needed to derive the value, which can take five months or more. Without the benefit of an acquisition to use as a valuation parameter, valuing originated core deposits would never be operational.

In addition, the fair value changes from period to period would be meaningless. For example, if the fair value of core deposits declined, the liability would be reduced. However, depositors that cash out their accounts receive full value, not fair value. As discussed in the Alternative Views, deposits should be reported in the statement of financial position at the amount able to be drawn on demand.

# Standby Letters of Credit and Nonrevolving Loan Commitments Issued by Creditors

TIC believes that these commitments do not have a determinable fair value. Obtaining a fair value for each commitment is impossible because the funding date for the commitment is not known. There are too many missing variables to apply fair value measurement techniques. TIC is uncertain whether a hypothetical market exists whereby others would buy a bank's loan commitment. One of the factors would need to be the underlying credit risk in the entity that has the commitment; however, that analysis may not be readily available.

# **Hedge Accounting**

TIC appreciates the measures that the Board is proposing to simplify hedge accounting. TIC agrees with the Board's decision to lower the effectiveness threshold for designating a hedging relationship at inception to "reasonably effective" (from "highly effective" under the existing standard). TIC also supports the proposed evaluation of a hedge's effectiveness at inception using qualitative criteria, which would replace the current requirement to quantitatively assess effectiveness each quarter.

TIC believes that subsequent evaluation of hedge effectiveness should be required under certain circumstances, even if, at inception, the hedging relationship was deemed to be reasonably effective over the expected hedge term. Adverse circumstances can occur and should not be ignored. For example, a hedge could become ineffective as a result of substantial prepayment of a mortgage that was hedged at inception or as a result of mismatched interest rates over time.

Although TIC agrees that subsequent evaluation of hedge effectiveness cannot be eliminated, TIC believes the proposed subsequent measurement criteria will not be operational for plain vanilla interest rate swaps, which serve as cash flow hedges. In particular, the proposed elimination of the critical-terms-match method will be a problem for private entities. Private entities do not have access to the methodology underlying the determination of the fair value of swaps, since the counterparty does not provide this information. Most entities do not have the internal resources to develop their own methodologies for determining the effectiveness of these relationships. As a result, they will be unable to determine the split between the effective portion and ineffective portion of a hedge.

To achieve the Board's goal of simplification in hedge accounting, TIC recommends that the proposed methodology be replaced by a practical and relatively simple methodology to determine ineffectiveness. TIC recommends a trigger-type model for interest rate swaps. That is, if the cash flow hedge qualifies at inception based on the criteria and it is the intention of the entity to hold the liability to make contractual cash flows, then all changes in fair value would be classified as other comprehensive income. If there is a change in circumstance (such as an extraordinary repayment, etc.) then the entity would recognize a correspondent charge (or perhaps the hedge is considered terminated) and all future changes in fair value must be recognized in net income. In other words, if a swap qualifies as a hedge at inception and it is reasonably effective in converting variable-rate debt to fixed-rate debt, the entity gets the benefit. If the entity's intention changes, the hedge terminates without exception. TIC believes this solution would work well for most smaller entities that invest in these instruments since it eliminates the need for ineffectiveness measurements unless a significant subsequent change occurs.

TIC also recommends that the requirement for concurrent designation and documentation at hedge inception in FASB *Accounting Standards Codification* paragraph 815-20-25-3 be eliminated in favor of the GASB's approach. The GASB rejected the need for a documentation requirement at inception because, among other reasons, the Board believes that "the existence or absence of documentation generally should not determine an accounting outcome" (Source: GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*, paragraph 112). Instead, the GASB concluded that hedge accounting should be applied when a derivative instrument is effective in significantly reducing the identified financial risk. Effectiveness would be established if the changes in cash flows of the potential hedging derivative instrument substantially offset the changes in cash flows of the hedgeable item (Source: GASB Statement No. 53, paragraph 27). A formal evaluation of effectiveness is not required at inception. The GASB believes that "a government that enters into a derivative instrument with an intention of hedging an identified financial risk would have evidence that suggests the derivative instrument is effective at inception" (Source: GASB Statement No. 53, paragraph 120).

The GASB concluded that effectiveness should be evaluated at the end of each reporting period using an acceptable method as described in the standard. In the very unusual circumstance that the hedge was truly ineffective at inception, the interest rate swap would be written off to income at the end of the first reporting period. TIC believes this practical expedient would also work in the private company environment.

Some TIC members believe that hedge accounting for cash flow hedges should be eliminated completely if the proposed requirements as to subsequent measurement cannot be simplified.

### **Level 3 Fair Value Measurement Uncertainty Analysis**

TIC's comment letter dated September 17, 2010, on the Proposed ASU, *Topic 820: Amendments for Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and* IFRSs, discussed TIC's opposition to the proposed disclosure of measurement uncertainty for Level 3 financial instruments (paragraph 109 of this ED). TIC opposes all additional disclosures that are not deemed useful to private company financial statement users.

TIC appreciates the opportunity to present these comments on behalf of PCPS member firms. We would be pleased to discuss our comments with you at your convenience.

Sincerely,

Philip J. Santarelli, Chair

PCPS Technical Issues Committee

cc: PCPS Executive and Technical Issues Committees