September 25, 2012

Technical Director
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
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RE: Financial Instruments (Topic 825)
Disclosures about Liquidity Risk and Interest Rate Risk
File Reference No. 2012-200

Gentlemen:/Ladies:

The Financial Accounting Standards Board (FASB) should be commended for issuing the proposed disclosure guidance on financial instruments to address several of the key risks identified by users, that is, liquidity risk and interest rate risk. This response is primarily concerned with the FASB's proposals on liquidity risk and is further limited to the disclosures proposed for nonfinancial institutions. This letter provides some general observations on the interaction of the proposed disclosures with the U. S Securities and Exchange Commission's ("SEC") rules, discusses the completeness of the information and how it may be used, and provides some detailed comments on specific provisions of the proposal.

GENERAL OBSERVATIONS

In the proposed guidance, the FASB uses the term "liquidity risk" to refer to the "the risk that an entity will encounter difficulty in fulfilling obligations associated with financial liabilities that are settled by delivering cash or another financial asset" (ASC ¶825-10-50-23D). The SEC's rules define liquidity as "the ability of an enterprise to generate adequate amounts of cash to meet the enterprise's needs for cash" (Instruction 5 to Item 303(a)(1) of Regulation S-K). In comparing the FASB's usage of the term liquidity with that of the SEC in its MD&A rules, it appears that liquidity under the SEC's rules is a broader indicator of corporate economic health, and is not limited to fulfilling financial liabilities. That said, financial liabilities and off balance sheet obligations may comprise the majority of liabilities and obligations for many companies.

While the SEC does require a table of contractual obligations (Item 303(a)(5) of Regulation S-K), which is similar to the FASB's table of cash flow obligations, the discussion of liquidity provided by public companies often goes well beyond a discussion of the contractual obligations table. As permitted by the SEC rules (Item 303(a) of Regulation S-K), discussions of liquidity are often combined with those of capital resources due to their complementary nature. SEC indicated in its proposing release for the table that "[t]he purpose of the contractual obligations table is to provide aggregated information about contractual obligations and contingent liabilities and commitments in a single location so as to improve transparency of a registrant's short-term and long-term liquidity and capital resources needs and to provide context for investors to assess

the relative role of off-balance sheet arrangements."[1] Notwithstanding the intent, based on my own observations from a casual review of some public company filings, the table of contractual obligations is often attached to the end of a long discussion of liquidity and capital resources with little attempt to integrate it into the discussion or to provide meaningful comments on it. Although the FASB's disclosures are intended to highlight the liquidity risks of financial instruments and complement the disclosures required by the SEC, it is not entirely clear whether focusing on only liquidity risks of financial obligations as distinct from the liquidity risks of the company generally is a completely meaningful exercise given that a similar table required by the SEC often seems to languish in relative isolation in company discussion's of liquidity and capital resources.

Whether looking at liquidity in such a narrow fashion (the risk associated with financial obligations versus liquidity risk generally) will be useful for the bulk of nonfinancial institutions remains to be seen. However, to the extent the FASB's approach at least adjusts for items missing from the SEC's table (e.g., short-term borrowings) or makes other improvements to the table to increase relevance (e.g., expected maturities versus contractual maturities, finer breakdown of the closest future time intervals), and provides in one location information on available liquid funds, then the ASC update will at least have resulted in improvement in the accessibility of the information. This improvement does come with the risk of potential duplication of information and possible confusion arising from different presentations of similar information.

The cash flow obligations and the available liquid funds tables together are not by themselves a sufficient indicator of "the risk that an entity will encounter difficulty in fulfilling obligations associated with financial liabilities that are settled by delivering cash or another financial asset." They are not sufficient because even when combined, the two tables provide an incomplete picture of the liquidity risk related to financial liabilities. However, if the intent is to present a somewhat stringent scenario, i.e., a measure of the company's ability to use only its existing cash or cash equivalents (and similar type assets) plus existing credit lines to pay off its existing financial liabilities and off balance sheet arrangements, then the tables may provide useful measures. The combined tables can be used to derive a measure that seems similar to what is often referred to as "net debt," which is used as a measure of financial health.[2]

Regarding items that are missing from the tables, the cash flow obligations table excludes nonfinancial obligations and includes only some operating cash outflows (e.g., interest and operating lease payments), and the available liquid funds table excludes some potentially liquid assets and other sources of cash, which maybe nonfinancial, not high quality, not readily

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[1] Securities and Exchange Commission. (2002) *Proposed rule: Disclosure in management's discussion and analysis about off balance sheet arrangements, contractual obligations and contingent liabilities and commitments.* Release Nos. 33-8144; 34-46767.

[2] The term "net debt" seems to have varying definitions but often seems to be defined as the sum of short and long-term interest bearing debt less cash and cash equivalents. It generally would not involve subtracting cash available from credit lines or similar funding sources since that would just add to the liabilities as well, nor does net debt typically include off balance sheet arrangements, and certain other cash outflows found in the cash flow obligations table. As defined by Farlex, net debt is "A measure of a company's ability to repay all debt if it were called immediately. It is calculated by adding short-term and long-term debt and subtracting all cash and cash equivalents. Many investors use net debt in making investment decisions, as it gives them an idea of a company's financial health and its level of leverage compared to liquid assets." The Free Dictionary by Farlex available at http://financial-dictionary.thefreedictionary.com/Net+Debt.

convertible into cash or are based more on a flow concept, such as cash flow from operations. The tables when taken together seem to assume, among other things, that nonfinancial liabilities do not compete with financial liabilities for funds and that financial liabilities cannot be repaid for example with future cash generated by noncontractual cash flows from operating activities. These assumptions are of course unrealistic, but the information obviously can be combined with other financial data to provide a more complete picture. Presuming the ultimate goal is to predict financial distress, recent financial distress prediction models tend to include measures of profitability, leverage and capital structure generally, short-term liquidity, size, and certain stock price related measures and some include certain measures or proxies associated with cash flow from operations.[3] As mentioned above, the tables do not incorporate in flow variables to measure profitability or cash flow from operations, which are important inputs in evaluating the risk of not fulfilling the obligations.

While one could debate the sufficiency of the information in the tables for the purposes contemplated, an alternative approach would be to consider that the tables will be used with other information to assess liquidity and then to design the requirements in a manner that will facilitate this approach. The proposed ASC Update does require that the information in the cash flow obligations table be reconciled to the balance sheet, enabling the user to identify the obligations that are included versus excluded from the table. However, relating the information in the cash obligations table to other important sources of information on liquidity, such as the statement of cash flows, seems somewhat more challenging. In this regard, the FASB could make the integration process simpler if it were to require that the cash flow obligations in the table be categorized consistently with the categories in the cash flow statement.

DETAILED COMMENTS

Cash flow Obligations

Although not a defined term in the proposal, the term "cash flow obligations" apparently is intended to include the undiscounted amounts of financial liabilities and off-balance sheet obligations (ASC ¶825-10-50-23M). While not an exhaustive list, the sample table includes short-term borrowings, long-term debt, interest payments, lease payment obligations, commitments, purchase obligations, contributions to defined benefit plans, other obligations and derivatives (ASC ¶825-10-55-5D). While the ASC Update indicates that the obligations in the table can be grouped based on nature, characteristics, or risks, preparers likely will look to the table for guidance on what is intended to be included. For some of the categories it is not entirely clear what is intended. For example, "short-term borrowings". Is that term intended to include all short-term liabilities that are financial instruments, for example, accounts payable and notes payable or is it only intended to include notes payable and other forms of "funded debt" such as commercial paper, bonds payable, etc.? What is a purchase obligation? Is this intended to include items that meet the definition of "unconditional purchase obligation[s]" in the ASC

[3] While different studies include different measures, the measures cited are often included in studies predicting bankruptcy or financial distress. Recent studies include Campbell, J., J. Hilscher, and J. Szilagyi, 2011, "Predicting Financial Distress and the Performance of Distressed Stocks," *Journal of Investment Management*. 2nd Quarter. 3. Campbell, J., J. Hilscher and J. Szilagyi, 2008, "In search of distress risk," *Journal of Finance* 63, 2899-2939; Chava, S. and R. Jarrow, 2004, "Bankruptcy prediction with industry effects," *Review of Finance* 8, 537-569; Shumway, T., 2001, "Forecasting bankruptcy more accurately: A simple hazard model," *Journal of Business* 74, 101-124; Beaver, W., M. McNichols, and J. Rhie, 2005, "Have financial statements become less informative? Evidence from the ability of financial ratios to predict bankruptcy," *Review of Accounting Studies* 10, 93-122.

glossary? Is "commitments" as used in the table intended to be the same as "firm commitment" in the ASC glossary? While asking about the instruments to be included in each category may seem to be focusing in too much detail on the sample table, the benefits of standardized disclosures could be compromised by inconsistent presentations in the table.

Another issue regarding the cash flow obligations intended to be included in the table is whether all the items listed in the sample table are actually financial instruments? The sample table (ASC ¶825-10-55-5D) includes lease obligations but does not indicate whether these are related to capital leases or operating leases. While there should be fewer operating leases in the future because of the FASB project on leases, the question remains on why operating leases would be included in the table, if that is the intent. While obviously an operating lease represents a commitment to pay cash in the future, operating leases are being accounted for as payments for the use of an asset, not collections arising from an off-balance sheet obligation, thus such leases do not seem to be financial instruments[4]. Also, not all derivatives are financial instruments, since some require or permit delivery of a nonfinancial asset. Perhaps the ASC Update could provide more guidance and require disclosure on the items that are included in the various table categories to reduce the potential for confusion.

Available Liquid Funds

Regarding available liquid funds, the SEC MD&A requirements do require companies to identify and discuss any internal and external sources of liquidity but these sources need not be displayed in a tabular format (Item 303(a)(1) of Regulation S-K). The latitude permitted for presentation may lead to nonstandarized reporting that could make the information more difficult to identify and use. Thus, the FASB's required table of available liquid funds does provide information on cash and cash equivalents and similar resources all in one place for more ready comparison with the cash flow obligations table (¶BC 13).

In the table of available liquid funds, the items to be included are "unencumbered cash and high-quality liquid assets as well as the entity's borrowing availability" (ASC ¶825-10-50-23S). Liquid assets would include unrestricted cash, cash equivalents and unpledged high quality liquid assets that are readily convertible to cash. In this context, "high quality" is to be understood in the context of a fixed-income type instrument. It is clear that the disclosures are intended to provide information allowing the user to assess the risk that an entity will encounter difficulty in fulfilling obligations associated with financial liabilities, but it is not entirely clear why investments in equity securities with quoted market prices in active markets are excluded from liquid assets? It is assumed that equities are excluded because equity instruments may decline in value after the balance sheet date (or perhaps because they have to be sold to generate cash), but the guidance does not say that these instruments must be readily convertible into "known amounts of cash" as is true for cash equivalents (ASC glossary).

Another issue is the lack of information in the available liquid funds table on the maturities of fixed income investments that are not cash equivalents. The table does not provide maturity information on the noncash assets that are not cash equivalents. Is that intended to imply that all

[4] While I could not locate any specific guidance on this issue in the Accounting Standards Codification, under the IASB's IAS 32, *Financial Instruments: Presentation*, paragraph AG9, indicates that as the operating lease is regarded as in essence similar to a fee for service, it is not a financial instrument except for individual payments currently due and payable.

noncash instruments should have maturities of less than a year? Investments in high quality government bonds with maturities in excess of three months would be of little use in immediate repayment of obligations unless sale versus collection of these assets is contemplated. If sale of the assets is contemplated then why not include equity securities with quoted market prices in active markets in the table since these can be sold as readily as government bonds? If the concern is that equity instruments are at risk for changes in value, government bonds with maturities in excess of three months also may not have an insignificant exposure to changes in value from changes in interest rates. The table also does not appear to provide expiry information on the credit lines although the credit lines may expire before some of the long-dated liabilities mature and may be unavailable to fund repayment. Further, any cash obtained from such sources would give rise to more debt.

Expected Maturities

As one of the benefits of the liquidity disclosures, the FASB requires presentation of the cash obligations by expected maturities, rather than contractual maturities as is required by the SEC. This will likely enhance the usefulness of the obligation information (¶BC 12 & 33), but only to the extent there are material differences between expected and actual maturities. If there are material differences, expected maturities should enable more accurate predictions of future cash flows. Some companies already show puttable liabilities as due at the first put date in the SEC's contractual obligations table. For those entities, if there were no obligations with debtor call or prepayment rights or if early exercise of such rights is not contemplated, there may be little difference between expected and contractual maturities, at least for nonfinancial companies.

Time Intervals

Generally the time intervals required for the cash obligations table appear reasonable as they provide for more detailed information about shorter-horizon cash flows.

If you have questions about these comments feel free to contact me.

Sincerely,

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