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PricewaterhouseCoopers appreciates the opportunity to comment on the proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* (the "Proposal").

We commend the FASB for attempting to address the accounting for financial instruments in one integrated proposal that includes classification and measurement, impairment, and hedging. We believe a thoughtful consideration of the interaction of these three areas is necessary as the FASB analyzes user and preparer input and current and proposed IASB guidance. We continue to support the FASB and IASB's (the "Boards") efforts to converge accounting standards, so we are disappointed that significantly divergent proposals have been released by the Boards on accounting for financial instruments. We are encouraged, however, that the Boards have committed to work together during the redeliberations phase to attempt to achieve convergence in this area. As the financial instruments area is fundamental to any convergence efforts, and the cost to the capital markets of divergence would be significant on many levels, we urge the Boards to work collaboratively during the redeliberations phase to resolve remaining substantive differences.

We support the FASB's objective of developing a model that increases the decision-usefulness of the information reported about financial instruments. However, we believe that the Proposal, taken as a whole, does not contain the most appropriate solutions to achieve that objective. Our most significant observations concerning the Proposal are as follows:

- We recommend use of a mixed measurement model consisting of amortized cost and fair value. We believe that amortized cost not fair value is the appropriate measurement attribute when an entity's business strategy is to hold financial instruments for collection or payment of contractual cash flows, and therefore provides more decision useful information for investors and other financial statement users. We agree, however, that fair value information is also useful when amortized cost is the measurement attribute and would support prominent disclosure of fair value information, at a minimum, on a disaggregated basis in the footnotes.
- We support having business strategy and instrument characteristics criteria for determining the
 classification and measurement of financial assets. However, we recommend that the
 business strategy criterion emphasize the primary purpose of the portfolio over the quantitative



factors, such as holding period relative to contractual maturity and frequency of sales. We are concerned that the proposed instrument characteristics criterion is too restrictive and too reliant on rules.

- While we support two measurement categories (amortized cost and fair value with changes in fair value recognized in net income), we acknowledge that certain financial asset portfolios do not fit easily into the two categories under the proposed business strategy criterion. Therefore, we recommend that the FASB modify the proposed approach, including allowing a sufficiently flexible business strategy criterion such that the need for a third category is reduced.
- While supportive of individual aspects, overall we disagree with the proposed credit impairment model. We believe that recognizing the entire life of asset credit loss in the first reporting period after origination would not faithfully reflect economic reality. Also, we do not agree with the proposal to limit the credit loss data to only historical events and current conditions, nor the proposed interest income recognition model.

Mixed measurement

We do not support the classification and measurement approach contained in the Proposal. On this matter we agree with the minority FASB members who support a mixed measurement model consisting of fair value and amortized cost for financial instruments. We believe that amortized cost should be the measurement attribute for instruments that are held for collection or payment of contractual cash flows. This measurement attribute is more consistent with how users evaluate investment decisions and how businesses are managed. We have spoken with a number of financial statement users, including investment professionals who cover financial institutions. These users were generally supportive of retaining amortized cost measurement for financial instruments held for the collection or payment of contractual cash flows, most notably for loans, core deposits, and issued debt. In addition, we agree that fair value with fair value changes recognized in net income is the most appropriate reporting basis for instruments held in trading portfolios.

Notwithstanding our view that fair value should not be the primary measure for financial instruments held for the collection or payment of contractual cash flows, we agree that fair value information is also useful for this category of financial instruments. Therefore, we recommend that the fair value of these instruments be disclosed prominently, at a minimum, on a disaggregated basis by instrument class in the footnotes to the financial statements.

Business strategy and instrument characteristics criteria for financial assets

We agree that an entity's business strategy should be the primary driver of financial asset classification. However, the proposed business strategy criterion, which focuses on the holding period relative to contractual maturity and frequency of sales, too narrowly defines a held-for-collection-of-cash-flows business strategy. While we agree these factors are relevant, focusing on these factors alone will result in debt instruments that are principally held for collection of cash flows being classified in a manner inconsistent with management's business strategy. The proposed approach does not recognize the primary purpose of certain portfolios, nor does it consider how users and management evaluate performance. For example, debt instruments held in a bank's liquidity portfolio or an



insurance company's current available-for-sale portfolio are primarily held for the collection of cash flows; however, individual assets in the respective portfolios may be sold prior to maturity in order to manage interest rate or duration risk or to satisfy liquidity needs. Accordingly, we believe that the evaluation of business strategy should focus on whether the primary purpose for holding debt instruments is to collect contractual cash flows, while acknowledging that ongoing adjustments to the portfolio may be needed and that those adjustments do not taint the portfolio's primary purpose.

We also agree that the characteristics of certain financial instruments may make it less likely that they are managed on the basis of collection of cash flows, and therefore those characteristics should also be relevant in determining the classification and measurement of a financial instrument. However, we do not support the proposed instrument characteristics criterion, which relies on the current embedded derivative criteria. We are concerned that reliance on those criteria will result in classification and measurement that is inconsistent with how the financial assets are managed. For example, many debt securities contain embedded derivatives that require separate accounting but have a non-substantive value throughout their lives. We believe the existence of these non-substantive features should not override the business strategy assertion.

We recommend that the FASB consider the IASB's finalized guidance on classification and measurement of financial assets (IFRS 9, *Financial Instruments*) as a starting point. While the IFRS 9 approach is also based on an entity's business model and an instrument's cash flow characteristics, it appears to allow for greater exercise of judgment in determining the classification and measurement of financial assets. We use the term "starting point" because we understand that some possible implementation issues have arisen as entities transition or prepare to transition to IFRS 9, which may need to be considered during the redeliberation process.

Two measurement categories for financial assets

While we broadly support a two category mixed measurement model for investments in debt instruments (i.e., amortized cost and fair value with changes in fair value recognized in net income), we acknowledge the difficulties associated with classifying certain portfolios into these two broad categories. For example, it is common for financial institutions to hold a portfolio of fixed income instruments as part of a broad strategy to (i) manage overall interest rate risk, (ii) manage overall liquidity risk, and (iii) invest cash while lending opportunities are not readily available. Similarly, non-financial entities commonly hold a portfolio of fixed income investments to earn yield and maintain flexibility and liquidity.

In order to reflect certain business strategies where the primary purpose of the portfolio is not to realize fair value changes, some constituents believe that it is necessary to have a third category - that is, fair value with changes in fair value recognized in other comprehensive income - similar to the existence of a third category preferred by the two dissenting FASB members. We understand that the primary strategy for these portfolios is not to capitalize on fair value changes. Therefore, in our view, the accounting model should provide sufficient flexibility to allow these portfolios to not be measured at fair value with changes in fair value recognized in net income. It seems to us that a two category model would achieve this objective if (i) the classification principles are sufficiently flexible such that the instances of instruments needing a third category is significantly reduced, (ii) an appropriate level of disaggregated fair value disclosures is required, and (iii) hedge accounting rules are relaxed to permit portfolio and macro hedging strategies to achieve hedge accounting as allowed under current IFRS. If



the FASB chooses to not provide this flexibility under a two category model, we would recommend the use of a third category to achieve this objective.

Impairment and interest income recognition

We support the FASB's efforts to address shortcomings in the current impairment model for debt instruments. We acknowledge that the current credit impairment model for loans sets a high threshold for recognizing an impairment loss and may contribute to credit losses being recognized "too little, too late." We also support the FASB's effort to create a single impairment model for financial assets that are held for collection of contractual cash flows, rather than evaluating impairment, as we do today, based on whether the instrument is a security or a loan (and whether the loan is acquired at a discount due to credit quality). Moving to a single impairment model will reduce complexity and promote a consistent approach to impairment analysis among different types of debt instruments.

While we support certain elements of the proposed impairment model, we do not support the model overall. We believe that further work is needed on a new credit impairment model for debt instruments. We recommend that the FASB continue to work with the IASB, investors, other financial statement users, and industry experts to consider a wider range of alternative impairment models, including leveraging the progress already made by the Expert Advisory Panel. These proposed impairment models should be subjected to extensive field testing. As part of this process, the Boards should balance conceptual and operational objectives.

We agree with eliminating the "probable" threshold as a trigger to recognize credit impairment. This change would permit entities a degree of flexibility in establishing an allowance and does not limit losses to be recognized based solely on objective evidence of impairment. We agree that entities should be allowed latitude in identifying and measuring credit impairment based on their specific facts and circumstances. For example, with respect to the measurement of credit impairment, using a best estimate of expected losses may be preferable in certain situations whereas probability weighting cash flows may be preferable in other situations.

We disagree with certain other elements of the proposed impairment model. For example, we believe that limiting the information that can be used in identifying and measuring credit impairment to historical information and current conditions is inconsistent with how market participants typically assess future losses. This approach ignores forward looking information that would likely be relevant to users and would be considered by management in pricing newly originated assets. Instead, we believe that forward looking information should be considered to the extent that it is based on reasonable and supportable forecasts. While we acknowledge the subjectivity inherent in the forecasting of estimated losses, we believe that enhanced disclosures of management's assumptions will provide financial statement users with valuable forward-looking information that is both transparent and enables comparability.

Conceptually, we see the merits of measuring credit losses over the life of an asset, rather than limiting loss measurement to those losses that have occurred and will occur over a loss emergence period. However, we do not agree with the recognition of expected life of asset losses in net income in the first reporting period as required in the Proposal. We do not believe this approach provides economically sound information to investors and other financial statement users. While we applaud the FASB's efforts to make the impairment model operational, this approach fails to acknowledge that lenders are compensated for losses by earning a credit spread that will be recovered over the life of the asset.



Losses are inherent in a pool of financial assets; however, investors are compensated for this risk in the form of future interest above the risk free rate. As noted above, we recommend that the FASB continue to work with the IASB and others to develop a conceptually sound but operationally feasible model

We oppose the proposed approach to recognizing interest income based on applying the financial asset's effective interest rate to the amortized cost balance net of any allowance for credit losses. We believe the proposed approach is likely to confuse many financial statement users. This is because the interest income line would no longer only reflect the contractual interest rate (adjusted for the accretion of any fees, premiums, and discounts) but would also be impacted by the subjectivity of and fluctuations in the allowance balance. As mentioned in the dissenting viewpoint on this matter, interest income is well understood by users of financial statements under the current model, and we understand from discussions with users that many would prefer the current model be retained. In addition, we believe that requiring interest income to be modified based on the results of credit analysis would represent a significant operational burden for preparers of financial statements and require significant systems changes.

In addition to the observations above, we have highlighted a few other important matters below.

Financial liabilities

Understanding that the Boards are working on other relevant projects, such as the financial instruments with characteristics of equity project, we recommend that the current U.S. GAAP accounting for financial liabilities not be significantly modified at this time. The current accounting model for financial liabilities broadly allows reflection of business strategies of issuing debt to realize fair value changes, or holding debt for the payment of contractual cash flows. Specifically, for most financial liabilities that are issued for financing purposes and require the payment of contractual cash flows, fluctuations in fair value during the holding periods are not ultimately realized; therefore, we believe amortized cost is the most appropriate measurement basis for those liabilities. Further, the FASB has not completed its work on the financial instruments with characteristics of equity project. Thus, to change current accounting runs the risk of requiring companies to make two changes for many liabilities that could be impacted by that project.

We are also concerned that the proposed instrument characteristics criterion and its reliance on the current embedded derivative rules will force more financial liabilities to be carried at fair value with changes in fair value recognized in net income. This treatment may increase the effect of changes in an entity's own credit risk on the financial statements. We believe the income statement volatility that would be reported under the Proposal for such instruments would not provide decision-useful information for investors and other financial statement users in these circumstances.

Reclassification and the fair value option

Consistent with our view that an entity's business strategy should be the primary factor behind classifying financial instruments, we do not support prohibiting subsequent reclassifications. Although we expect business strategies to change infrequently, when they do, any such changes should be reflected in the accounting model. The effect and frequency of these reclassifications should be



disclosed to ensure that users have a clear understanding of how and why the business strategy changed and the impact this has on the financial statements.

The ability to carry any financial asset or liability at fair value with changes in fair value recognized in net income is important, particularly to financial institutions that manage certain instruments on a fair value basis. Therefore, since we support a mixed measurement model overall, we continue to see the need for an unrestricted fair value option. We note that the requirement to designate a financial asset or liability at fair value at inception, the current disclosures, and the prohibition on subsequent reclassification after the option is elected, all of which we support, impose sufficiently stringent conditions on the selection of the option.

If the fair value option is elected for financial liabilities, we recommend that fair value changes of financial liabilities due to changes in an entity's credit risk be recognized in other comprehensive income unless doing so would create or exacerbate an accounting mismatch. This approach, which is largely consistent with the IASB's Exposure Draft, *Fair value option for financial liabilities*, provides an interim solution to address users' concerns about recognizing in net income changes in fair value due to an entity's own credit risk. Further, we recommend that the Boards reconsider whether fair value is the most appropriate measurement attribute for an entity's own debt where the effects of the entity's own credit risk cannot or are not expected to be realized.

Investment in equity instruments

We agree with the underlying premise in the Proposal that all equity instruments not accounted for under the equity method of accounting should be measured at fair value. However, we believe that the Boards should work together to define the purpose of other comprehensive income and the need for recycling before concluding on whether fair value changes should be recognized in net income or in other comprehensive income. We recognize that retaining an available-for-sale-like model would require that impairment testing be retained. We recommend that recoveries of impairments be recognized in net income in order to more closely align the impairment model for equity investments with the impairment model for debt instruments.

We also acknowledge the challenges of determining fair value for certain non-marketable equity securities. To address those challenges, we encourage the FASB to allow practical expedients in certain circumstances. In addition, we recommend that the FASB work with the IASB to develop a converged approach for application of the equity method and not change the current model at this time.

Hedge accounting

In view of the difficulties that practice has experienced applying hedge accounting, we support the FASB's overall efforts to simplify accounting for hedging activities and to improve transparency for users of financial statements. We are supportive of many of the specific amendments contained in the Proposal. We expect that several of them will help reduce the complexity of qualifying for hedge accounting and improve the consistency and comparability required in financial reporting. We support eliminating the high effectiveness threshold, as well as streamlining hedge documentation through the elimination of the current initial and ongoing quantitative effectiveness assessment requirements.



While we agree with the FASB's decision to retain the bifurcation-by-risk approach for financial instrument hedge accounting, the choice of measurement attribute should not be determinative of the hedge accounting approach. We believe that hedge accounting should reflect entities' risk management strategies. In practice, entities design risk management strategies to mitigate risk exposures relevant to their business. Typically, strategies related to financial instruments are executed on a specific risk component basis. We believe that the financial reporting model should be aligned with the risk management strategies entities employ, which is best reflected in the bifurcation-by-risk approach for financial assets and liabilities. Information regarding the economics associated with unhedged risk components would be better conveyed to users through disclosures, rather than in the primary financial statements. We encourage the FASB to work with the IASB to develop principles that would expand the ability of entities to hedge risk components of financial instruments beyond the current specific risks that are eligible and, as indicated earlier, to align other elements of hedge accounting, including portfolio and macro hedging. We believe that expansion of application of hedge accounting to these areas would align the accounting treatment for derivative transactions more closely with their business strategy and reduce complexity by diminishing asymmetrical treatment.

Furthermore, we believe the bifurcation-by-risk approach for financial instrument hedge accounting should be expanded to include non-financial hedged items. Non-financial items are hedged by risk component in a similar manner to financial instruments. As such, the distinction between financial and non-financial items is arbitrary and in some case gives rise to anomalous results. We believe expanding bifurcation-by-risk to non-financial hedged items would improve financial reporting as financial statement users would better understand how successful management has been in managing those exposures. We encourage the FASB to work with the IASB to develop those principles.

We do not view the ability to de-designate hedging relationships to be problematic or an area of abuse under the current model. Hedge accounting by its nature is elective and, therefore, the ability to discontinue it is consistent with this notion. Many de-designations occur because entities that manage their risks on an enterprise-wide basis must apply hedge accounting on a transaction-by-transaction basis. Also, it is common for entities that hedge forecasted transactions for foreign currency risk through to the expected payment date to de-designate the hedging relationship upon recognition of the transaction for administrative ease.

We understand that the FASB is currently evaluating the ability to obtain hedge accounting for intercompany transactions. The FASB had proposed a change in this area in its 2008 derivatives amendment exposure draft. At that time, we indicated that the Board's intent was unclear and in the absence of further guidance it was difficult for us to comment on whether we agreed or had specific concerns with the proposed amendment and its impact on practice. As this issue was not raised in the Proposal, we do not believe it has received appropriate attention by FASB constituents. Should the FASB decide to make any amendments to the current accounting in this area, because of the time that has elapsed since the 2008 proposal and in light of the broader financial instruments proposals, we recommend that such amendments be exposed for comment.

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We appreciate the opportunity to express our views on this Proposal. If you have any questions regarding our comments please contact Michael Gallagher at (973) 236 4328, Paul Kepple at (973) 236 5293, or Greg McGahan at (973) 236 5250.

Sincerely,

PricewaterhouseCoopers LLP

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Appendix - Responses to the Questions for Recipients Contained in the Proposal

Scope

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?

Only certain financial guarantees are excluded from the scope of the Proposal. However, we understand that many financial guarantees and similar instruments may fall within the scope of the FASB and IASB's insurance project. This raises the potential that the accounting for financial guarantees that are not specifically excluded from the scope of the Proposal could change twice - once when the Proposal becomes effective and again if a new insurance model becomes effective. Therefore, we encourage the FASB to exclude all financial guarantees and similar instruments from the scope of the Proposal and retain the current accounting for those instruments pending completion of the insurance project.

The Proposal also lacks clarity on whether the determination of hybrid instruments that are within its scope should be made by reference to the host contract or the entire hybrid instrument. We believe that the FASB intends that only hybrid instruments with financial hosts be within the scope of the Proposal unless the financial host is specifically excluded from the scope. We recommend that this be clarified.

The Boards should continue to work together to address existing differences between U.S. GAAP and IFRS as they relate to the scope of financial instruments and the definition of a derivative. We also encourage the Boards to consider developing a more principles-based approach for identifying embedded derivatives.

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 believe certain financial assets that are held for the collection of their contractual cash flows, such as held-for-investment loans, should be measured at amortized cost. Accordingly, we believe that commitments to issue such instruments should be measured similarly. If the business strategy is to trade these commitments or the loans upon funding, we believe subsequent fair value remeasurement would be appropriate.

If the FASB proceeds with its approach to fair value loan commitments, we recommend that all revolving financing arrangements be excluded from the scope of the Proposal. Further, the Proposal does not address commitments issued that would result in trade receivables eligible for amortized cost measurement. For example, some non-financial services entities provide financing commitments for customers to purchase their products. We believe those commitments should not be measured at fair value and should also be scoped out of the FASB's Proposal.

As a practical matter, it seems counterintuitive to us that secured financing arrangements, such as home equity lines of credit, would be measured at fair value with changes in fair value recognized in



net income or other comprehensive income (OCI) while unsecured commitments under credit card arrangements would not. Accordingly, while we agree with the FASB that revolving lines of credit issued under credit card arrangements should not be measured at fair value for practical reasons, we recommend that it consider whether other similar arrangements should also be excluded from the fair value measurement requirement, whether for practical or other reasons.

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 contracts should be included within the scope and not be treated any differently than other financial instruments held or issued under our preferred mixed measurement approach.

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 do not support the proposed changes to when the equity method of accounting can be applied. While we acknowledge the difficulties experienced in practice in applying the equity-method, we recommend the FASB not move forward with this aspect of the Proposal without a more in-depth study of the issues and the involvement of the IASB. Further, we believe the equity-method of accounting should be considered together with any proposed changes to the broader consolidation model.

It is unclear whether the criteria for the equity method of accounting would be evaluated only at inception or whether the evaluation would be an ongoing test. For example, it is unclear whether the investment should be reclassified if an investee's operations subsequently become related to the investor's (that also has significant influence over the investee) or conversely if an investee's operations subsequently become unrelated to the investor's.

Initial Measurement

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

We understand the conceptual merits of measuring financial instruments initially at fair value. We support the notion that multiple elements of transactions involving financial instruments should be identified and separately accounted for where appropriate. However, there may be instances when initial measurement at fair value may not be appropriate. For example, there is no accounting guidance that allows for the recognition of internally generated customer relationship intangible assets that may be attributable to core deposit liabilities. We believe initial recognition at the demand amount would therefore be more appropriate for core deposits. Another example would be issued debt whose initial recognition is on the settlement date as opposed to the trade or pricing date. Recognizing a day one gain or loss at the settlement date may not be the most appropriate treatment.

In addition, we believe that there are a number of other complex issues that have not been fully analyzed by the FASB. These include the interaction between the initial recognition of individual



financial instruments and the recognition of intangible assets associated with groups of financial instruments under a business combination. Consequently, we recommend that the FASB consider whether there are other instances similar to core deposits where initial measurement at fair value is not appropriate, and determine if further guidance is necessary for similar elements in arrangements where it has determined that little or no guidance exists.

Question 9: For financial instruments for which qualifying changes in fair value are recognized in other comprehensive income, do you agree that a significant difference between the transaction price and the fair value on the transaction date should be recognized in net income if the significant difference relates to something other than fees or costs or because the market in which the transaction occurs is different from the market in which the reporting entity would transact? If not, why?

Yes, but see our response to Question 8. We do not believe that it is necessary to include a "significance" notion in assessing these differences. However, we acknowledge that there may be circumstances when these differences may be insignificant to the financial statements taken as a whole.

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?

See our response to Question 8. Further, it is unclear to us why the FASB is making a distinction in paragraph 12 of the Proposal between instruments accounted for at fair value with changes in fair value recognized in net income and instruments where fair value changes are recognized in OCI. We believe the requirement in paragraph 15 of the Proposal to identify other elements due to a difference between transaction price and fair value and potentially account for those elements under other accounting guidance should be applicable for all financial instruments regardless of the subsequent measurement attribute.

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?

Yes. However, transaction fees and costs are not defined in the Proposal. While transaction fees and costs can be easily quantified for certain financial instruments, such as brokerage commissions on equity trades, other transactions, such as principal trades in fixed income and over-the-counter equity and derivative transactions, do not have explicit transaction costs, but rather implied costs included within the bid-ask spread. Because of the complexity involved in quantifying transaction costs and fees, we recommend the FASB consider providing additional guidance on the costs and fees that would be covered to promote consistent application.

The financial statements of entities in a number of specialized industries (e.g., investment companies, and non-profit institutions) are typically dominated by investments measured at fair value with all changes in fair value recognized in the performance statement. For those entities, the measurement of efficiency of investment operations is distinctly separate from measuring the efficiency of business operations; for example, investment companies report an expense ratio composed principally of operating expenses, while non-profit organizations are widely measured on the operating efficiency



with which they employ contributions received. Additionally, for all of these specialized entities, investment transactions are an inevitable outgrowth of their funding activity (investments must be made with the proceeds of investment company share purchases, and contributions received by non-profits) and thus are not under the same degree of management control as, and are inherently more volatile than, recurring operating expenses. We are concerned that requiring transaction fees and costs to be included in expenses would inappropriately mingle separate measures of operating and investing efficiency into one combined measure that would detract from, rather than enhance, user understanding. We also believe that this mingling is inconsistent with the current thinking reflected in the recent staff draft on financial statement presentation, which attempts to present financial statements consistent with the three criteria of operating, investing, and financing activities. Therefore, we recommend that the FASB not prescribe the classification of transaction costs within the performance statement.

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?

As noted in our response to Question 9 above, we believe that it is not necessary to include a "significance" test in assessing these differences.

Subsequent Measurement

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?

We do not believe that the default measurement for financial instruments should be fair value. As discussed in our cover letter, on this matter we agree with the minority FASB members who support a mixed measurement model consisting of fair value and amortized cost for financial instruments. We believe that amortized cost should be the measurement attribute for instruments that are held for collection or payment of contractual cash flows and that meet the instrument characteristics criterion. This measurement attribute is more consistent with how users evaluate investment decisions and how businesses are managed. We have spoken with a number of financial statement users, including investment professionals who cover financial institutions. These users were generally supportive of retaining amortized cost measurement for financial instruments held for the collection or payment of contractual cash flows, most notably for loans, core deposits, and issued debt.

Notwithstanding our view that fair value should not be the primary measure for financial instruments held for the collection or payment of contractual cash flows, we agree that fair value information can be useful for this category of financial instruments. Therefore, we recommend that the fair value of these instruments be disclosed prominently, at a minimum, on a disaggregated basis by instrument class in the footnotes to the financial statements.



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?

Yes. We believe all foreign exchange transaction gains and losses on monetary items should be recorded in net income. The Proposal would create a difference in the accounting for foreign currency transaction gains and losses between monetary items carried at fair value through OCI and amortized cost. Like credit impairments, foreign exchange movements will result in realized gains and losses if the monetary item is held to contractual maturity; this is in contrast to other fair value changes (e.g., due to market interest rates) where unrealized gains and losses will reverse if the financial instrument is held to term. Also, forcing the foreign currency mark into OCI could expand the need for hedge accounting for entities that hedge foreign currency risk on existing monetary items, whereas a natural offset in net income may occur today between the foreign currency hedged item and hedging instrument.

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

No, we do not believe that the classification and measurement of financial liabilities should be required to be driven by the assets they finance. In certain circumstances, liabilities are issued to fund specific assets. However, generally in both financial and non-financial institutions, financing needs of business segments are aggregated to determine corporate financing needs. Business segments generating excess cash fund other business segments in need of cash. On a net or aggregated basis, corporate entities approach the market for financing. This consolidated forecast of cash needs drives the maturity and terms of the liabilities issued. As a result, liabilities are frequently not allocated to specific assets. We believe any model designed to approximate such an allocation would be arbitrary, rules based, and not yield effective results.

We also question the usefulness of requiring investment companies that redeem investors' interests at net asset value to report their financial liabilities, including their own debt, at fair value and recognize changes in fair value as an increase (or a decrease) in net assets. This requirement could result in investor redemptions in cash at a fair value based net asset value having a dilutive or antidilutive effect to the benefit or detriment of the remaining equity holders or even debt holders, as the ultimate repayment of debt will occur at the original settlement amount. To avoid these consequences, we understand that most entities that redeem interests at net asset value will likely exclude the changes in fair value of their own debt from cash redemption values. This would cause a difference between net asset values for financial reporting purposes and those actually realizable from the investment and inherently reduce the relevance of the GAAP financial statements.

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?



As discussed in our cover letter, consistent with our view that an entity's business strategy should be the primary factor behind classifying financial instruments, we do not support prohibiting subsequent reclassifications. Although we expect business strategies to change infrequently, when they do, any such changes should be reflected in the accounting model. The effect and frequency of these reclassifications should be disclosed to give users a clear understanding of how and why the business strategy changed and the impact this has on the financial statements.

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 do not support the proposed measurement attribute for core deposit liabilities. In our preferred mixed measurement model, we would report demand deposits at the amounts payable on demand, which we believe best reflects an entity's business strategy related to these instruments. In our view, it is likely to be counterintuitive for financial statement users that core deposit liabilities are generally presented at an amount that is less than what is payable on demand, resulting in an initial gain recognized either in net income or OCI. This counterintuitive outcome worsens when a financial institution's financial condition deteriorates and its alternative funding rate increases, thereby lowering the amount at which its core deposits are recognized and generating a gain in OCI or net income. Many users have questioned the appropriateness of recognizing gains due to declines in an entity's own credit risk in net income or equity. This proposed measurement approach would exacerbate this issue because as an entity's credit risk declines, its alternative funding rate increases, which in turn results in a lower remeasurement value.

In addition, this measurement approach captures a portion of an intangible asset in the remeasurement value. We believe that capturing only a portion of an intangible asset in the remeasurement value is not appropriate because it does not reflect the entire economic value of the customer relationship. Further, recognizing a portion of an intangible asset is inconsistent with the accounting for other intangible assets acquired, which are not remeasured, and other internally generated intangible assets which are not recognized except in a business combination.

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 with the alternative view of the minority FASB members that this option is rules-based and does not reflect a clear principle.

If, however, the FASB proceeds with its proposed approach, some form of amortized cost option would be necessary to prevent the likely issues that would arise for most non-financial institutions due to measuring their own debt at fair value, including the creation of new measurement mismatches and the recognition in earnings of fair value changes due to an entity's own credit risk. Further, we are concerned that the instrument characteristics criterion would preclude many debt issuances from being eligible for amortized cost measurement due to the existence of minor embedded derivatives, which



would create measurement mismatches with the assets being funded. Therefore, we suggest that only the business strategy criterion be applied together with the requirement that fair value measurement would create or exacerbate a measurement mismatch in order to determine whether an instrument is eligible for amortized cost measurement.

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 that fair value measurement would not make sense for these instruments and that the redemption amount is the appropriate measurement attribute. We are not aware of any specific changes that should be made to the criteria that must be met in order to qualify for this measurement attribute. We note, however, that the proposed impairment model would also apply to financial assets recognized at the redemption amount. It is unclear how to think about the impairment model in the context of these instruments, which generally do not have contractual cash flows; as such, we believe additional guidance is needed. It seems inappropriate that impairment for these instruments would be recognized based on a liquidation value that assumes all holders would redeem their instruments at the same time. Instead, we suggest that the Board consider an approach that takes the overall fair value of the interest into account, including the benefits associated with the membership interest.

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 are concerned that financial statement users may find certain outcomes from applying the proposed principles to be misleading and inconsistent with an entity's business strategy of holding debt instruments for collection of their contractual cash flows. The tax effects of establishing a deferred tax asset are recognized in OCI for unrealized losses on debt instruments that are measured at fair value with fair value changes recognized in OCI. However, a valuation allowance established on these deferred tax assets (in a subsequent year) is recognized in net income. This will undoubtedly lead to recognizing losses (i.e., higher tax expense), which is counter-intuitive since an actual tax loss is not expected to ever materialize based upon the entity's business strategy. This outcome would not occur if, as recommended above, amortized cost were the measurement attribute for debt instruments that are held for collection of their contractual cash flows. And while this incongruity already exists under U.S. GAAP, the issue is exacerbated under the Proposal as additional unrealized gains and losses are reflected in OCI. Accordingly, if the FASB proceeds with its proposal to recognize fair value changes on certain debt instruments in OCI, we recommend it consider whether this counter-intuitive outcome is decision-useful to financial statement users.

We also recommend that the proposed tax guidance be clarified to better support preparers in assessing the realizability of the deferred tax asset. In particular, we encourage the Board to clarify that the recovery of value in connection with debt instruments that are measured at fair value but are held for collection of their contractual cash flows does constitute an objectively verifiable source of future taxable income. However, such future taxable income should be considered in conjunction with the other expected results of the entity and not in isolation.

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We would also observe that there are occasions where it is appropriate and necessary to evaluate deferred tax assets related to debt instruments distinctly (i.e., not *in combination with* other deferred tax assets). This would be the case, for example, with regard to a deferred tax asset related to an unrealized loss on a financial instrument that would become a capital loss if realized in a tax regime in which capital losses may only be offset against capital gains. In such instances, we believe it would be necessary to evaluate the realizability of such *embedded* future capital losses in a manner that considers the characteristics of the entity's future taxable income. In particular, in the absence of prudent and feasible tax-planning strategies, an entity would not be able to avoid a valuation allowance if the entity believes it is more likely than not that there will be future taxable income on an aggregate basis but is unable to reach such a conclusion with regard to future capital gains.

We also believe it is important for the FASB to re-emphasize the requirements of Topic 740 to consider the expected *realizability* of a deferred tax asset as opposed to its mere *reversal*, and that for purposes of assessing realizability, an entity would need to consider the extent to which the deferred tax asset is expected to result in a reduction of taxes payable (or an increase in taxes refundable) on future taxable income. In this regard, it would not be sufficient to avoid a valuation allowance if the entity believes it is more likely than not that a deferred tax asset related to a debt instrument will reverse over time as the instrument nears maturity but at the same time concludes that there is insufficient objective evidence regarding the existence of future taxable income on an overall basis.

For these reasons, we recommend the following edits to the proposed language in paragraph 35 of the Proposal. We also recommend that the basis for conclusions contained in BC 166 of the Proposal be aligned with these proposed changes.

35. An entity shall evaluate the need for a valuation allowance on a deferred tax asset related to a financial instrument for which qualifying changes in fair value are recognized in other comprehensive income in a manner that is consistent in combination with the entity's other deferred tax assets. The need for a valuation allowance should be determined by considering the realizability of the deferred tax asset, that is, the extent to which the deferred tax asset is expected to result in a reduction of taxes payable (or an increase in taxes refundable) on future taxable income. (See Topic 740 for guidance on accounting for income taxes.)

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 disagree with the conclusion in Example 10 that all convertible debt instruments would be measured at fair value with changes in fair value recognized in net income by issuers. For convertible debt where only the conversion spread is settled in cash or shares while the par amount is settled in cash (Instrument C), our understanding is that because the conversion option is separated and accounted for as an equity component, which is outside the scope of this Proposal, the remaining



liability will be returned to the investor at maturity or other settlement. It therefore can qualify for fair value changes to be recognized in OCI and the amortized cost option subject to meeting the other criteria. Further, we do not agree that all convertible debt issuances should be measured at fair value with changes in fair value recognized in net income because it may be inconsistent with an entity's business strategy of holding the instrument for payment of its contractual cash flows. And, by requiring fair value measurement with fair value changes recognized in net income, the proposed approach would exacerbate the extent to which change in an entity's own credit risk affects net income.

We are also concerned about the prospect that this proposal would be effective sooner than the guidance resulting from the financial instruments with characteristics of equity project. This could result in entities having to change their accounting for the same instruments twice. We recommend that the FASB retain the current accounting for financial liabilities until the financial instruments with characteristics of equity project is completed.

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?

As stated in our cover letter, we believe the business strategy and instrument characteristics criteria should be applied in the context of a mixed measurement model. We recommend that the FASB consider the IASB's finalized guidance on classification and measurement of financial assets (IFRS 9, *Financial Instruments*) as a starting point. While the IFRS 9 approach is also based on an entity's business model and an instrument's cash flow characteristics, it appears to allow for greater exercise of judgment in determining the classification and measurement of financial assets. We use the term "starting point" because we understand that some possible implementation issues have arisen as entities transition or prepare to transition to IFRS 9, which may need to be considered during the redeliberation process.

If the FASB proceeds with its proposal, in addition to the issues raised in our cover letter, we believe that further clarity is needed on how to apply the business strategy criterion in the following areas:

- In order to be eligible under the business strategy criterion for OCI treatment, the entity's business strategy must be to hold the instruments for a "significant portion of their contractual term." In many instances, instruments are not held for a significant portion of their contractual terms because they are prepaid. Consequently, many instruments may not be eligible even if they are held for a significant portion of their expected or weighted-average lives. Although we disagree with this, if the FASB continues on this path, we recommend changing the reference to "contractual term" to "expected life." This would be internally consistent with the premise in the Proposal that embedded calls and puts do not prevent the business strategy criterion from being met.
- It is common for entities to securitize portions of their asset portfolios after origination. In some cases, assets are originated under a business strategy to sell (e.g., conforming mortgages sold to government-sponsored enterprises). In many other cases, an entity does not know which assets and how many will be sold into securitizations or other financing vehicles. For these latter cases, we believe the measurement model should reflect the primary purpose for originating the assets, which is to hold them for collection of their contractual cash flows. We strongly object to a model where any sales would create a presumption that the business strategy does not reflect that primary purpose or would taint the strategy.



• Entities that legally transfer assets to securitization vehicles are often required to consolidate those vehicles, which themselves are contractually prevented from selling the underlying assets except under certain circumstances. It is unclear whether the assets of the subsidiary securitization vehicle can meet the business strategy criterion. We recommend the Proposal be clarified to focus on the business strategy in the context of the accounting outcome for the consolidated financial statements. Sales into consolidated securitization vehicles should not taint the business strategy assertion to hold for collection of contractual cash flows, as the securitization vehicle is in fact doing that.

We are also concerned that the proposed instrument characteristics criteria may preclude many instruments from qualifying for fair value changes to be recognized in OCI.

- Clarity is needed regarding the embedded derivative criterion. The Proposal does not appear to allow for the existence of any embedded derivatives that would otherwise require bifurcation. An embedded derivative with a non-substantive value in relation to the contractual terms should not be determinative of the classification and measurement of the entire hybrid financial instrument. At a minimum, consideration should be given to whether an embedded derivative that is non-substantive at inception is likely to become substantive at a later stage.
- Paragraph 21(a)(1) of the Proposal refers to "an amount transferred at inception that will be returned." Not all financial instruments arise due to a transfer of cash. We believe the criterion should focus on the return of principal rather than the economic events that led to the recognition of the debt instrument.

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

Determining the fair value for these instruments may be challenging especially where there is not a market for the same assets. Of greater concern is the repercussions of fair valuing an entity's own debt and recognizing changes in fair value due to an entity's own credit risk in net income when those gains or losses are unlikely to be realized.

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

No. We agree with the alternative view of the minority FASB members that this option is rules-based and does not reflect a clear principle. Further, it does not seem appropriate that the same or a similar liability instrument could be measured differently depending on when it is issued because the criteria are only applied at a specific point in time.

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?

We are not supportive of the proposed measurement approach for core deposits. The proposed approach will be challenging for entities to implement and will not provide useful information to investors and other financial statement users.



If the Board proceeds with this approach, we recommend there be improved clarity on a number of aspects of the proposed approach. For example, it is unclear how an entity would apply the measurement methodology if the all-in-cost-to-service rate exceeds the entity's alternative funding rate, which may occur in a low interest rate environment, or whether the determination of the alternative funding rate should consider the current ability of the capital markets to absorb all other institutions funding needs or only the needs of the institution.

Further, no guidance is provided in the Proposal on whether any recycling needs to occur from OCI to net income and how sales of core deposits impact the cumulative remeasurement change contain in accumulated OCI. In addition, the interaction between recognizing an intangible asset as part of the remeasurement value for core deposits and any intangible assets recognized in a business combination is unclear, and may result in potential double-counting. These aspects would need to be clarified.

Presentation

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?

We support the FASB's efforts to increase the level of transparency associated with fair value changes due to changes in an entity's own credit risk. However, separate presentation only partially addresses the issue because no changes are being proposed to the measurement attribute or to the location where those fair value changes would be recognized. Under the Proposal, more financial liabilities will be measured at fair value with changes in fair value recognized in net income, which will increase the extent to which the fair value changes due to changes in an entity's own credit risk can significantly impact net income.

If the fair value option is elected for an entity's own debt, we recommend that fair value changes resulting from changes in an entity's own credit risk be recognized in OCI unless doing so creates or exacerbates an accounting mismatch. This approach, which is largely consistent with the approach in the IASB's Exposure Draft, *Fair value option for financial liabilities*, provides an interim solution to address users' concerns about recognizing in net income changes in fair value due to an entity's own credit risk. We acknowledge that there are circumstances where such risk can be defined such that accounting mismatches are created or exacerbated. For example, an entity that consolidates a financial SPE may elect fair value measurement for assets and liabilities in the SPE. If the liabilities are marked to exclude changes in the entity's own credit risk, then a mismatch with the mark on the assets would result. Therefore, an entity's own credit risk should not be considered when liabilities are contractually linked to assets (there are no other sources of cash/assets to pay down the liabilities).

Further, we recommend that the Boards consider whether fair value is the most appropriate measurement attribute for an entity's own debt where the effects of the entity's own credit risk cannot or are not expected to be realized.



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.

As described in our response to Question 32, we do not support the FASB's proposed approach. The two methods demonstrate the difficulty of accurately separating changes in credit standing from changes in the price of credit. For example, under Method 1, when there is a decline in credit rating, the calculation includes fair value changes relating to changes in an entity's credit standing but also captures some fair value changes due to changes in the price of credit because credit spreads continue to move even under stable market conditions. Further, any methodology that uses credit ratings as a basis is likely to be flawed because of the lag in the data considered in establishing those ratings.

We believe that entities should have flexibility in determining the portion of fair value that relates specifically to an entity's own credit risk provided that they disclose their methodology and apply it consistently. We understand that flexibility is afforded to entities applying IFRS 7 in measuring the fair value due to an entity's own credit and propose that the FASB adopt that guidance.

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.

If the FASB proceeds with this aspect of the proposal, we suggest that it not advocate a particular method but allow entities to apply a methodology that best captures the change in an entity's credit standing. The reference data that should be used may depend on a number of factors, such as the breadth and depth of the industry, and the availability of industry specific and comparable entity data. An entity may also need to consider whether there are company-specific factors that are distorting the comparable credit spreads or index.

Credit Impairment

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 the objective as proposed. The objective of a credit impairment model should be to record an allowance that reflects an appropriate amount of credit losses. This objective depends on whether the assets are performing or non-performing, as entities will manage their assets based on the credit worthiness (and expected credit worthiness) of the debtor at the reporting date. As such, we believe that a credit impairment model should reflect management's outlook. Although a life of asset approach for measuring losses for pools has conceptual merit, the appropriate timing of when to



recognize those losses is subject to considerable debate (i.e., recognized currently or spread over the expected life of the pool of assets). Our cover letter describes our concerns with the proposed model and notes that we believe further work, with input from interested parties, is needed to develop a new credit impairment model for debt instruments.

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?

We do not believe an entity should immediately recognize a credit impairment in net income when it does not expect to collect contractual cash flows. Refer to our cover letter for a detailed discussion. As discussed in our response letter on the IASB's Exposure Draft, *Financial Instruments: Amortized Cost and Impairment*, we conceptually support an expected loss approach to accounting for the impairment of financial assets carried at amortized cost. We believe an impairment model based on expected losses would better reflect the economic effects of credit losses and recognize those losses on a more timely basis. However, we noted a number of conceptual shortcomings with the IASB's proposed approach and expressed concern with the significance of the operational challenges that the IASB's proposed model presents.

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 that credit impairment generally should be evaluated based on the ability of the borrower to repay amounts due rather than be influenced by foreign exchange rates, changes in expected prepayments, or changes in a variable interest rate. We acknowledge that there may be certain situations where these variables (singularly or in combination) affect the ability of the borrower to repay amounts due and it is difficult to isolate the effect of a change in a variable from the overall change in cash flows. In those situations, we agree with the FASB's conclusion in paragraph 50 of the Proposal that the overall decline in expected cash flows be considered a credit impairment. For example, prepayment speeds may impact default rates while yield curve projections may impact interest rate resets. In both situations, it may be difficult to argue that the variables are not linked and that the resulting effect on expected cash flows relate to credit impairment generally. Also, exchange rates



may impact a borrower's ability to repay its obligations; for example, borrowers in highly inflationary countries whose currencies are rapidly depreciating may be subject to the same economic difficulties plaguing the country. In this situation, the effect of exchange rates should not be ignored in assessing credit impairment.

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?

As discussed in our cover letter, we applaud the FASB for developing a proposal that can be operationalized. We agree that entities should be allowed latitude in measuring credit impairment based on their specific facts and circumstances. Although there will be challenges in calculating a life of asset pool loss, as current impairment measurement methods and business management practices are aimed at calculating a loss over a loss emergence period, we support the decision to not require a specific methodology, such as the calculation of expected cash flows based on a probability weighting of cash flows. We believe an entity should have the flexibility to use its best estimate of expected losses in determining whether a credit impairment has occurred.

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?

The ASC 310-30 model was recently subjected to rigorous and widespread use following the financial crisis when banks that acquired other failed banks' loan portfolios had to maintain and present two sets of data consisting of the ASC 310-30 portfolio and the remainder of the loan book. This dual reporting of the loan book has proven to be both onerous to maintain and confusing to financial statement users. Therefore, we do not believe that the ASC 310-30 model is a viable long term solution and recommend that it not be carried forward under a new credit impairment and interest income recognition framework.

We believe that any credit impairment model that is developed for debt instruments should be applied consistently irrespective of whether the assets are originated or acquired by the entity; we believe this to be the case because assets acquired with a credit impairment are not managed any differently than originated assets that subsequently become impaired. However, we also believe interest income on assets acquired with specifically identified credit impairment should not be recognized based on an asset's contractual cash flows because that approach would overstate the effective yield on that asset. It is difficult for us to provide detailed suggestions regarding a purchased impaired asset model until the principles and mechanics of an overall credit impairment model have been established. However, we believe that there are more operationally efficient models that will substantively achieve the goals of ASC 310-30.

If the FASB proceeds with the proposed impairment and interest income recognition model, we are concerned about the potential broadening of the application of this model to purchases of performing loans. The concern arises from the removal of the probability threshold from the scope of paragraph 79 of the Proposal, which implies that assets other than those that are high quality will be exempt from applying the expected cash flow approach. This broader application would result in purchased and originated assets accounted for differently, even if the purchased asset is performing. We believe the



current scope of ASC 310-30 (i.e., acquired financial assets where credit losses are probable) should apply to the scope of paragraph 79 in the Proposal.

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 a 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 do not believe it is appropriate to force an evaluation of credit impairment for an individual asset as if the entity also held a group of similar financial assets. We believe the relevance and decision-usefulness of impairment decisions made under such a provision is questionable. In these circumstances, a single best estimate approach may provide more relevant information. As such, we recommend the FASB allow preparers the ability to select an approach that yields the best estimate of expected loss in their particular circumstances. Although paragraphs 63 and BC181 of the Proposal appear to respect an evaluation that an asset is not individually impaired if it has unique risk characteristics, paragraph 65 appears to require the use of a pooled approach even if the pool does not exist (i.e., a hypothetical pool). We believe paragraph 65 should not override paragraphs 63 and BC181.

As a practical matter, if financial assets cannot be pooled or the pool is small, then the application of loss rates (which are based on a population) in these situations would be misleading. In these situations, such an approach would require entities to make a credit loss provision for individual assets even though they believe it is probable or even likely that the asset will generate all of its contractual cash flows (e.g., investments in corporate debt or leveraged loans). We are not supportive of a "hypothetical pool" concept.

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 collectibility 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?

We believe limiting the amount of information that can be used to historical information and current conditions is inconsistent with the principle of considering losses that may occur in the future; rather, we believe a point in time estimate should consider information beyond the balance sheet date if it is based on reasonable and supportable forecasts, as required under the impairment model for debt securities in ASC 320-10-35. Although entities will likely have differing views of economic conditions,



the subjectivity inherent in the forecasting of expected losses is unlikely to be more difficult than in other areas of financial reporting, such as fair value determination, impairment of non-financial assets, and pension accounting. With the appropriate disclosure of management's assumptions, such inherent subjectivity can be made transparent and comparable while providing valuable information to financial statement users

As a practical matter, assuming that the economic conditions existing at the end of the reporting period would remain unchanged for the remaining life of the financial asset(s) may require adjustment of relevant data that typically reflects the effects of forecasted future events or economic conditions to eliminate those effects. The complexities involved in doing that should not be underestimated. Also, requiring cash flows to be derived from static economic conditions divorces the cash flow estimate from those used in a fair value measurement, which would include assumptions about future economic conditions.

As described in our response letter to the IASB's Exposure Draft, *Financial Instruments: Amortized Cost and Impairment*, we believe it is important to allow entities the ability to establish an overall framework for estimating expected losses that is reflective of their circumstances. Entities should have the flexibility to estimate losses over a reasonable period into the future that is appropriate given their systems, financial products, and economic environment and to assume a long-term average loss rate for the remaining term. This will help alleviate concerns over estimating the effect of economic cycles over a long term, as well as enable the model to be responsive to the unique nature of each entity. These comments reflect the findings from the Expert Advisory Panel regarding the operationality of using longer term estimates under a point in time framework.

We recommend that the phrase "the appropriate interest rate or index as it changes over the life of the asset" in paragraph 67 of the Proposal not be explicitly defined as the spot interest rate. The phrase exists in current GAAP and there is diversity in practice in how it is interpreted. We understand that the concern in using the forward rate is that some believe that a forward curve includes projections of future economic conditions. However, the forward rate is not a projection; it is derived from a spot curve. For example, a one year LIBOR rate includes the 3-month spot rate and the 9 month forward rate in 3 months. We recommend the FASB provide guidance on which rate is more appropriate as the impairment model is further developed.

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)?

Based on our understanding and observations of collective provisioning for pools of financial assets, we believe a loss rate approach would be more operational than an expected cash flow approach to determine the appropriate amount of credit impairment. We also understand this is more consistent with how the portfolios of instruments held for the collection of cash flows are managed. However, there will be challenges in calculating a life of asset pool loss as current impairment measurement methods and business management practices are aimed at calculating a loss over a loss emergence period.



Additional Comment on Impairment

We believe the FASB should clarify the interaction between the Proposal and the recent released proposal related to revenue recognition. The latter proposes an impairment model for trade receivables that appears to conflict with the former in that the revenue recognition proposal requires the use of probability weighted cash flows. Also, it is unclear whether subsequent changes in estimates of collectability would be addressed by the Proposal or the revenue recognition model.

Interest Income

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 oppose the proposed change to require that the credit allowance reduce the amortized cost of an asset for the purposes of recognizing interest income. Although we understand the conceptual underpinning of the proposed change, which is not to recognize interest income on expected losses, we believe this approach will add unnecessary complexity to the calculation of interest income. As highlighted in the Expert Advisory Panel's findings on the proposed FASB credit impairment model (dated April 5, 2010), the proposed formula for calculating interest income will create implementation issues as bank interest rate systems are generally not aligned with a bank's risk or credit systems.

From a user's perspective, the result is likely to confuse many financial statement users because the interest income line would no longer only reflect the contractual interest rate (adjusted for the accretion of any fees, premiums, and discounts) but would also be impacted by the subjectivity of and fluctuations in the allowance balance. In addition, the provision line item would no longer only reflect changes in credit impairment estimates but also the excess of contractually due interest over interest income. As mentioned in the dissenting viewpoint on this matter, interest income is well understood by investors and other users of financial statements under the current model, and we understand that users would prefer the current model be retained.

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 do not agree. As discussed in our response to Question 48, we believe recognizing interest income based on the gross balance less allowance is not appropriate. It follows that we do not believe any excess of interest contractually due over interest income should be recognized as additional allowance. Interest income is well understood by users of financial statements and we believe that the interaction between the allowance and interest income proposed by the FASB will confuse investors and other users of financial statements. Further, under the Proposal, that excess would be released to the provision line item in the income statement if the additional allowance is not needed. Such a reversal could occur in the same reporting period because the allowance would have been deemed appropriate before the "excess" was added. When applied to assets evaluated for impairment on a pooled basis where loss rates are not discounted, the effect would be to reclassify interest income into a reduction in provision on the income statement. Paragraph BC206 of the Proposal makes a similar conclusion that for financial assets evaluated in pools, "it may be necessary for the entity to recognize



a reversal of credit impairment expense...." The FASB itself has acknowledged the forcing of lower interest income through this mechanism.

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 agree with the discussions in paragraphs BC154 and BC156 of the Proposal that an entity may elect to present amortized cost and the required buildup to fair value on the balance sheet as well as disaggregated changes in fair value related to interest, dividends, credit losses, and unrealized or realized gains and losses in the statement of comprehensive income. If an entity elects to present interest income separately for investments in debt instruments, then we generally believe the entity should calculate interest income including amortization of the premium and discount arising at acquisition, similar to that prescribed under ASC 320-10-35. However, there may be instances where it is not practical, such as for market-makers of securities.

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 believe the implementation guidance and illustrative examples are helpful but additional guidance will promote greater consistency in the application of the requirements. If the FASB decides to move ahead with the Proposal, we recommend including the following examples:

- Impairment of pools and corresponding interest income recognition what are the journal entries at origination and first reporting period, given loss rate assumptions and changes in expectations
- Impairment of individually significant originated assets what are the journal entries at inception and subsequent to initial recognition assuming no additional impairment
- Impairment of individually significant purchased assets what are the journal entries at inception and subsequent to initial recognition assuming no additional impairment
- Purchased loans example indicates a clear event (arrear interest) evidencing a decline in credit quality - show an example of a purchased asset pool of performing loans

Additional Comment on Interest Income

The Proposal provides that interest accrual should cease when the asset is in a negative yield position. We support separating interest income and impairment calculations as discussed in earlier responses and also agree with suspending interest accrual on loan amounts that are charged off. However, we believe the issue of when to put an asset on nonaccrual status should be addressed as part of the overall discussions on developing converged impairment and interest income recognition models, balancing conceptual and operational objectives.



Hedge Accounting

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

We support lowering the threshold in order to apply hedge accounting on the basis that it should enable entities to better align their accounting with their existing risk management strategies. As a result, entities should have an increased expectation of achieving and maintaining hedge accounting treatment for their risk management strategies. We believe that qualification for hedge accounting should not be based upon specific quantitative thresholds, similar to how practice has evolved under the current hedge accounting model. Robust controls exist in the vast majority of companies over establishing hedge programs and executing derivative transactions such that sufficient analysis is performed to determine that they meet their objectives. We do not believe that companies have difficulties in distinguishing between hedging and non-hedging activities. Given this fact and that hedge ineffectiveness is generally recognized and disclosed, we believe arbitrary quantitative definitions should not be required in interpreting reasonably effective.

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?

We support eliminating the requirement to perform an initial and ongoing quantitative assessment of effectiveness and to only require a qualitative assessment at inception, with a quantitative assessment performed where deemed necessary. That being said, there may be circumstances where unforeseen events cause a hedging relationship to not achieve its goals. We would expect that prudent accounting and risk management policies and practices would warrant revisiting the conclusion of reasonable effectiveness under said circumstances. It is our belief that the vast majority of companies have such risk management practices whereby hedge strategies are revisited to ensure that they are accomplishing their stated goals.

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?

Since dedesignation would not be permitted unless the derivative instrument is terminated, this question is difficult to answer. As we noted in our cover letter, we do not support the proposed prohibition on dedesignation. However, we do believe that the proposed model would result in a reduction of the number of times hedging relationships would be discontinued. This is particularly true with a hedge accounting model where practice would not require specific "rules" or quantitative thresholds governing what is considered 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?



An entity that records amounts in accumulated other comprehensive income based upon a perfect instrument may need to record an offsetting impact on a hedged transaction based upon a derivative instrument that was never entered into by the entity. Users of the financial statements may have difficulty viewing this as the economic substance of the combined transactions. We believe that the current model for recognizing ineffectiveness for cash flow hedges is appropriate.

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?

No. We believe that the vast majority of companies have such policies and procedures in place independent of the accounting requirements. In addition, any recognition in current earnings from the measurement of ineffectiveness that is not within the expectations and tolerances will in all likelihood trigger evaluations under an entity's risk management policies as to the initial conclusions reached of the derivative as a reasonably effective hedge.

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 dedesignating the hedging relationship? If yes, what constraints do you foresee and how would you alleviate them?

We disagree with the removal of the current ability to dedesignate hedging relationships - we do not see this to be problematic or an area of abuse, and note that hedge accounting, by its nature, is elective. Under the Proposal, entities can only achieve the impact of re-designation by terminating (or offsetting) existing derivatives and entering into new derivatives. This will add unnecessary expenses by increasing transaction costs. Therefore, we recommend that the FASB not modify existing guidance as it relates to de-designations.

Many of the de-designations that occur are because many entities manage their risks on an enterprise-wide basis, but the current and proposed hedge accounting model requires the application of hedge accounting on a transaction-by-transaction basis. Application of hedge strategies are frequently made more difficult due to the restrictive similarity-of-hedged item tests required to hedge portfolios of risk. Derivative portfolios must be rebalanced based upon enterprise level risks and such rebalancing may impact individual hedge relationships. It is also common for entities that hedge forecasted transactions of foreign currency risk through to the expected payment date to dedesignate the hedging relationship upon recognition of the transaction for administrative ease.

Paragraph 121 of the Proposal states that adding a new derivative to an existing hedging relationship that does not fully offset an existing derivative and does not reduce the effectiveness of that relationship would not be deemed a dedesignation. While this appears to be intended to accommodate dynamic hedging strategies, it does not appear to address a common scenario where the hedged items designated in the hedging relationship are changed. This strategy is common when a pool of financial instruments are hedged in a single hedging relationship. Another example is in the case of net investment hedges where dedesignation may be required due to the volatility of the net investment balance. We believe that dynamic hedging strategies should be eligible for hedge accounting and recommend that the FASB clarify the guidance accordingly.



Also, the Proposal states that a hedging instrument may be considered effectively terminated when an offsetting derivative instrument is entered into. It is unclear how differing counterparty credit risks in the "offsetting" derivative instruments should be considered in determining whether they offset and are thus terminated. We suggest the FASB consider clarifying the impact that different counterparty credit risk may have on determining whether a derivative instrument has been terminated with an offsetting instrument.

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?

Yes, to meet the proposed conditions necessary for dedesignation of a hedge relationship under the Proposal, we do foresee some operational concerns and constraints. The proposed language indicates that effective termination of a hedging derivative is accomplished by entering into a derivative instrument that fully offsets the hedging derivative instrument. The term "fully offset" is not defined. In practice, we anticipate difficulties in entering into derivative instruments that are the mirror image of the one previously entered into. One example where this could be an issue is when a pre-existing derivative instrument has a remaining maturity with a less liquid profile than it had at inception. Another example may be when an existing derivative instrument has a significant fair value. Offmarket derivative terms are generally less liquid and more expensive due to the embedded financing component of an off-market derivative. As previously noted, we would suggest permitting dedesignations as currently allowed in order to solve this problem.

Additional Comment on Hedge Accounting

Paragraph 126 of the Proposal provides for the measurement of ineffectiveness_on a cash flow hedging relationship using a derivative that would settle in a reasonable time relative to the hedged cash flows, provided that differences between the forward rate on that derivative and the forward rate on derivatives that would exactly offset the hedged cash flows are minimal. We recommend that the reference to "minimal" be replaced with *insignificant* in this paragraph to better convey the intent of the guidance. Furthermore, the FASB may wish to consider clarifying that the guidance may be applied to both forward and option-based hedging strategies.

Disclosures

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

As discussed earlier, we prefer a mixed measurement model for financial instruments with prominent disclosure of fair value information in the footnotes. Fair value disclosures should, at a minimum, include greater disaggregation of fair value information by product type and a tabular comparison with amortized cost information in a single footnote. This will enable increased transparency and comparability between fair value information and amounts recognized in the financial statements. In addition, enhanced disclosures on the use of the fair value option and reclassifications between measurement categories over an extended period of time could give financial statement users insight into the entity's business strategy and changes to the business strategy.



Effective Date and Transition

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

We generally would prefer full retrospective application in order that financial statement users are provided with comparable information. However, we recognize the challenges of retrospective application and depending on where the FASB comes out on the final standard, this may not be feasible. In particular, determining the fair values of instruments and impairment of financial assets at historical points in time will likely be challenging. Therefore, if the FASB decides to proceed with its proposed classification and measurement approach, we would agree with the Proposal to require a cumulative effect adjustment to the statement of financial position for the reporting period that immediately precedes the effective date.

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 that this accommodation is made necessary by the FASB's selection of a classification and measurement model that is not the most appropriate for all entities. As discussed in our cover letter, we prefer a mixed measurement approach for financial instruments. Under our preferred approach, depending on the credit impairment model, a delayed effective date may not be needed for certain types of entities.

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

The amount of time necessary to implement the Proposal will depend on the final accounting model, and also the types and complexity of financial instruments originated by, invested in, or issued by an entity. If the FASB decides to move forward with its proposal, we recommend an effective date that would provide a generous period of time for implementation given how pervasive the changes would likely be for many entities. This would not need to be as generous if the FASB adopts our preferred mixed measurement model.

We support the Boards' plan to issue a document to solicit stakeholder input regarding the effective date and transition methods for major Memorandum of Understanding projects. If the FASB moves forward with changes to the accounting for financial liabilities, we recommend that the Boards agree on a consistent effective date for any changes to the accounting for financial liabilities and the final document issued at completion of the financial instruments with characteristics of equity project in order to prevent multiple changes in the accounting for certain financial liabilities by U.S. entities.

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

We believe that it is not practical for entities to go back in time in order to apply the initial measurement requirements in the Proposal. Further, no specific transition provisions are provided for hedge accounting. For example, if an entity previously applied the shortcut method, it is unclear how they should account for the cumulative ineffectiveness that may exist in the hedging relationship. Also, for hedging relationships that resulted from past de-designations, it is unclear whether hedge accounting for subsequent hedging relationships should be unwound and the accounting done as if the original relationships were still intact as of transition date.