

International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH

15 September 2010

Dear IASB Board Members

Financial Instruments: Amortised Cost and Impairment

The global organisation of Ernst & Young is pleased to submit this follow-up letter on the above Exposure Draft (ED).

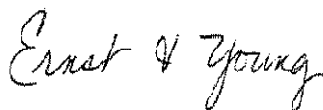
We submitted our comment letter on the ED on 30 June 2010. In that letter, we indicated that the Financial Accounting Standards Board's Proposed Accounting Standards Update, "Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities" (FASB ED) had been issued too recently (at that time) for us to have made a proper evaluation. Consequently, we did not provide any views on the merits of its approach to impairment or the extent to which it might provide an appropriate solution with respect to impairment. We mentioned that we would submit a letter that would include a more comprehensive assessment of both the FASB's and IASB's impairment approaches once our evaluation was complete.

We have subsequently assessed the proposed impairment approach in the FASB ED, and submitted our comments on this topic in a letter to the FASB on 10 September 2010, as attached.

In the *Impairment* section of our comment letter on the FASB ED (and our responses to Questions 37 to 47 posed by the FASB in Appendix A), we presented our views on the proposed impairment approach in the FASB ED and our suggestions for the development of a converged solution.

Should you wish to discuss the contents of this letter with us, please contact Tony Clifford at the above address or on +44 (0) 20 7951 2250.

Yours faithfully

A handwritten signature in cursive script that reads 'Ernst & Young'.

Mr. Russell G. Golden
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Financial Accounting Standards Board
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10 September 2010

Re: Proposed Accounting Standards Update, "Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities" (File Reference No. 1810-100)

Dear Mr. Golden:

We appreciate the opportunity to comment on the Financial Accounting Standards Board's (FASB or Board) Proposed Accounting Standards Update, "Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities" (the Proposed Update). Although this letter has been prepared by the US firm of Ernst & Young, the views expressed herein are those of our global organization.

We support the Board's efforts to address the issues raised by various constituents with respect to the accounting for financial instruments. As a result of the global financial crisis, the accounting for financial instruments has received a great deal of attention from the Board's constituents, including users and preparers, the Financial Crisis Advisory Group, the Financial Stability Board, the G20 and other political leaders. Fair value accounting, the timing of recognizing credit impairments and the overall complexity of the current requirements have been criticized as weaknesses in financial reporting that have reduced the credibility of financial reporting. We believe these are the right areas on which the Board and the International Accounting Standards Board (IASB, and together with the FASB, the Boards) should focus to address the criticism of their standards and difficulties in application in accounting for financial instruments.

We support the effort by the Boards to work jointly on significant projects to arrive at converged standards. Given the ongoing globalization of capital markets, there is a strong need for high-quality, internationally comparable financial information that is useful for decision-making. As we have stated before, we believe the best way to achieve this objective is to ultimately move to a single set of high-quality global financial reporting standards. Until this can be achieved, however, the continued convergence of standards is critical.

While we were pleased to see that the financial instruments project was to be a joint project, in deliberating issues separately the Boards have arrived at significantly different conclusions on several key issues. Although we appreciate the different views and the requests and needs of different

constituents, the Boards' financial instruments projects are not headed toward convergence, which is a departure from the Memorandum of Understanding in which the Boards committed to converge IFRS and US GAAP standards in many important areas.

Some have indicated, in the context of convergence, that the additional presentation and disclosure requirements included in the Proposed Update will allow users to make adjustments to US GAAP and IFRS amounts in order to arrive at information that is comparable. We question whether this is possible, particularly given the differences in the impairment models proposed by the Boards. Moreover, this is not convergence. We are encouraged by the IASB's outreach efforts in asking its constituents to provide the FASB with feedback on the Proposed Update, and we ask both Boards to use that feedback to work toward converging their finalized standards.

The remainder of this letter provides our high-level views on several key areas of the Proposed Update. Appendix A to this letter provides our detailed responses to the *Questions for Respondents* included in the Proposed Update. We have responded only to those questions in the Proposed Update highlighted as *Questions for All Respondents* or *Questions for Preparers and Auditors*.

Classification and measurement

Financial assets

The Proposed Update would expand the use of fair value to all financial instruments within its scope, with limited exceptions for short-term receivables and payables, certain other investments, core deposit liabilities and an entity's own debt. Although we continue to believe fair value provides users of financial statements with useful and relevant information and is a relevant measure for many financial instruments, we do not believe fair value should be the required measurement objective in all cases.

Specifically, we do not support requiring financial institutions (and other entities with similar investments) to report loans at fair value when those loans are held for the collection of contractual cash flows. In these circumstances, we believe loans should be eligible for measurement at amortized cost. Requiring the use of a fair value accounting model in such instances would be inconsistent with how the business is managed. In this regard, we highlight one of the findings of the FASB's Financial Instruments Outreach project, which noted "... that increased use of fair value reporting for certain financial instruments, such as deposits and loans, would not provide useful information. In fact, [many investors] believe the information could be misleading because it may not reflect that the entity intends to hold the instrument for collection or payment(s) of contractual cash flows rather than to sell or settle the instrument with a third party."¹ So as not to make an accounting distinction based on the legal form of a financial asset, we would also support extending this to all financial assets held for the collection of contractual cash flows, including debt securities that have observable fair values.

¹ See FASB's "Accounting for Financial Instruments – Constituent Outreach Summary (May 2010)."

In that regard, we support the IASB's approach to the classification and measurement of financial assets finalized in IFRS 9² (with certain exceptions described in Appendix A), and we urge the Board to adopt that approach. This will also promote convergence. Please see our response to Question 13 in Appendix A for further discussion of our views on the classification and measurement of financial assets.

We do, however, agree with the Board's decision to eliminate the bifurcation of hybrid financial assets. This is a significant step forward in reducing complexity. We also generally agree with the proposed approach for classifying hybrid financial assets whereby hybrid financial assets otherwise requiring bifurcation and separate accounting under existing guidance would be measured in their entirety at fair value with changes in fair value recognized in net income (however, see our comments related to hybrid financial liabilities, as well as our response to Question 1 in Appendix A for additional clarification). However, consistent with our view of adopting an IFRS 9 classification and measurement approach, those hybrid financial instruments that would not require bifurcation and separate accounting under existing guidance should be measured in their entirety at amortized cost if the holder's business strategy is to hold such financial instruments for the collection or payment of contractual cash flows.

Core deposits

We do not support the Board's proposed remeasurement approach for core deposits. The remeasurement approach was designed in part to capture the interest rate sensitivity of the deposit base, which offsets the interest rate risk inherent in the loans (now proposed to be measured at fair value). Because we do not support measuring loans at fair value when those loans are held for the collection of contractual cash flows, we do not perceive the need for core deposits to be remeasured.

Calculating the remeasurement amount will be a complex exercise requiring significant systems modifications. Putting operational difficulties (which we understand are significant) aside, we do not believe core deposits should be carried at an amount that is different from the amount that can be demanded at any point in time.

Also, because of the use of an average core deposit amount, future deposits are considered in the measurement, which results in the recognition of an internally generated intangible asset. While the intangible asset is meant to represent only the benefits associated with the core deposit that relate to its value as a cheaper source of funding (without considering the other intangible benefits that go along with the broader banking relationship, such as cross-selling opportunities), it is an intangible asset nonetheless. Under existing GAAP, the intangible asset related to a core deposit banking relationship is recognized only upon a business combination or asset acquisition; internally generated intangibles are not recognized. We do not believe an internally generated intangible asset should be permitted to be recognized in this context until a broader discussion surrounding the recognition of internally generated intangible assets occurs.

² International Financial Reporting Standard 9, *Financial Instruments*

Financial liabilities

We do not support the Board's approach to the classification and measurement of financial liabilities. We do not believe there needs to be symmetry in the measurement principles for financial assets and financial liabilities. Consistent with our views on the measurement of financial assets, we do not believe fair value is the most appropriate measurement for financial liabilities in all cases. We observe that most entities seldom transfer financial liabilities. Instead, most are settled with the counterparty in accordance with the contractual terms.

In that regard, we believe amortized cost should be the default measurement for financial liabilities. However, if measuring a financial liability at amortized cost would create or exacerbate a measurement attribute mismatch, we believe an entity should have the option of measuring the liability at fair value. Our views related to the classification and measurement of financial liabilities are discussed further in our response to Questions 15, 18, 29 and 30 in Appendix A.

We also generally do not support the Board's proposal to recognize changes in fair value related to an entity's "own credit" in net income for all financial instruments measured at fair value with changes in fair value recognized in net income. In our view, it is appropriate to recognize in net income changes in own credit risk related to liabilities that are traded (i.e., where the liability is incurred with an intention to repurchase or settle the liability in the near term, including derivative instruments that are not held for hedging purposes). However, for liabilities measured at fair value that are not traded (which would include derivative liabilities held for the payment of contractual cash flows – that is, designated in a hedging relationship), we believe changes in own credit should be recognized in other comprehensive income (OCI). We believe this approach is a practical alternative that would address the concerns of many stakeholders who believe that reporting gains in net income due to a deterioration in an entity's own credit is counterintuitive.

The Proposed Update requires hybrid financial liabilities otherwise requiring bifurcation to be measured in their entirety at fair value (i.e., no bifurcation) with changes in fair value recognized in net income. In these circumstances, changes in own credit related to the entire hybrid, including the host contract, would be recognized in net income. Assuming our suggestion to include changes in fair value related to own credit in OCI is accepted, we could support the Proposed Update's requirement for hybrid financial liabilities otherwise requiring bifurcation to be measured in their entirety at fair value with changes in fair value (other than those related to own credit) recognized in net income. We agree with the Board's view, as expressed in paragraph BC 114 of the Proposed Update, that retaining existing bifurcation requirements for financial liabilities while eliminating the requirements for assets would add unnecessary complexity. However, if our suggestion to include changes in fair value related to own credit in OCI is not accepted by the Board, an alternative way to address our concern is to reduce the number of financial liabilities measured at fair value. To that end, perhaps the Board could retain existing bifurcation requirements for hybrid financial liabilities containing embedded derivatives that otherwise would require bifurcation such that the host contract would be measured at amortized cost, similar to the approach proposed by the IASB in its exposure draft on financial liabilities that are measured at fair value under the fair value option.³

³ Exposure Draft, *Fair Value Option for Financial Liabilities*

We also believe that the amount representing “own credit” should be the change in fair value attributable to a change in an entity’s credit spread (i.e., the portion of the discount rate that is not the benchmark/risk-free interest rate). This would be consistent with the requirements of IFRS (see IFRS 7).⁴ In our view, the portion of the change in fair value related to changes in credit standing, excluding changes in the price of credit, is arbitrary and not observable. If the Board finalizes the Proposed Update such that own credit continues to be recognized in net income with separate presentation, we suggest that the presentation requirement be changed such that the amount to be presented on the face of the statement of comprehensive income is the change in fair value related to changes in the entity’s credit spread.

The Boards also have an ongoing project that would affect many of the financial liabilities covered by the Proposed Update. The tentative decisions reached to date in the Financial Instruments with Characteristics of Equity project (FICE project) would represent a significant change in practice in classifying and presenting instruments forming the capital structure of an entity. The Proposed Update addresses the measurement of many of these instruments, including convertible debt, which has been a popular financing vehicle over the past decade. If the Board continues with the proposed measurement guidance for financial liabilities, we believe that the Board should defer the application of that guidance to convertible instruments until the completion of the FICE project. We discuss our concerns further in the response to Question 21 in Appendix A.

Impairment

We support the Board’s view that one credit impairment approach should be used for all financial assets that are measured at fair value with changes in fair value recognized in OCI, for short-term receivables measured at amortized cost and for financial assets measured at their redemption value. The same would be true for all financial assets that would be measured at amortized cost if the Board adopted an approach for classification and measurement similar to IFRS 9. The existence of numerous impairment models in the current guidance has added to the complexity in the accounting for financial instruments.

The Proposed Update presents a model that would recognize credit impairment immediately in net income when the entity does not expect to collect all contractual amounts for originated financial assets and all amounts originally expected to be collected for purchased financial assets. This approach could require an entity to recognize a credit loss on a newly originated or acquired asset in the reporting period in which the financial asset is originated or acquired solely because it is included in a pool of similar financial assets (either because the financial asset is evaluated on a collective (pool) basis outright, or because it is collectively evaluated after first being individually evaluated where no credit loss was considered to exist) – a result that is neither intuitive nor comparable to an asset that is not pooled. The Proposed Update’s impairment approach is significantly different from the IASB’s proposed approach,⁵ which recognizes impairment losses over the life of a financial asset by including expected credit losses in the computation of the effective interest rate when the asset is

⁴ International Financial Reporting Standard 7, *Financial Instruments: Disclosures*

⁵ See Exposure Draft, *Financial Instruments: Amortised Cost and Impairment*.

first recognized (i.e., an allowance for credit losses is built up over the life of the financial asset). As previously stated, we believe that the Boards must converge the accounting in this important area.

As discussed in our comment letter to the IASB on its Exposure Draft, while we appreciate the technical merits of deferring income to reflect anticipated credit losses (it is consistent with revenue recognition principles), we do not support the IASB's proposed approach, primarily because of the complex operational aspects of such a model. Further, in determining credit impairments, we do not support the unlimited forecasting of future events or economic conditions not existing at the balance sheet date. In this regard, we believe it is important for the Board to provide more specific guidance surrounding the concept of "past events and existing conditions." In our view, existing conditions should be expanded to include present assumptions about relatively near-term trends (e.g., 12 to 24 months) in major economic factors that a preparer uses to forecast future cash flows. The use of near-term trends in major economic factors when estimating future expected cash flows is consistent with what we understand is acceptable by certain banking regulators for purposes of calculating various regulatory capital measures.

Consistent with our IASB comment letter, we would support a model that provides for recognizing an entity's initial estimate of credit loss over the life of the financial asset(s), with an incurred loss overlay⁶ so that the minimum allowance for credit losses includes all incurred losses. This impairment model is based on an approach discussed by members of the Expert Advisory Panel (EAP). We further expand on this proposed alternative in our response to Questions 37, 38 and 46 in Appendix A.

We acknowledge that the model described in Appendix A is not completely developed. It is offered as an alternative as the Boards develop a converged solution. We suggest that the Boards and the EAP further investigate, clarify and define such a model. Once more clearly defined, the proposed model should be field-tested among various entities, including financial (both large and small) and non-financial (i.e., commercial) institutions. Feedback on the ability to audit such a model should also be sought. If the field test results and auditor feedback are positive and the Boards agree on a converged solution, the converged model should be re-exposed for public comment.

Interest income

The Proposed Update would require interest income to be recognized by applying a financial asset's effective interest rate to its amortized cost less any allowance for credit losses. This methodology would result in recognizing income only on amounts an entity expects to collect. We agree that it is inappropriate to recognize income on an amount an entity does not expect to collect. However, we have two concerns about the proposed approach for the recognition of interest income. First, the proposed approach would not provide information as to the amount of contractual interest due (which we understand is important to many users) and, second, it would create operational challenges for pools of assets.

⁶ Incurred loss as used within this letter refers to the term as defined within existing US GAAP, rather than any implied or assumed definition from the Proposed Update.

The proposed approach would not provide users with information as to the contractual interest because the interest income recognized is net of interest on amounts not expected to be collected, and there is no requirement to separately present contractual interest. We understand that users want the net interest margin (which is a key metric for financial institutions) to reflect “gross contractual interest income” as the starting point. See our response to Questions 48 and 49 in Appendix A, where we suggest a presentation approach that will preserve the current presentation of the net interest margin.

The Board’s proposed approach will also create operational challenges for recognizing interest income on financial assets accounted for in pools. These challenges arise because credit allowances for pools will be determined at a pool-level unit of account, resulting in the need to determine a weighted-average effective interest rate for the pool that would be applied to the total amortized cost of the assets in the pool, less the pool’s allowance for credit losses. Determining a weighted-average effective interest rate for the pool will be challenging, as pools are typically not static (i.e., they are open in the sense that newly originated loans can be added to pools that have similar risk characteristics).

Hedge accounting

We support the Board’s efforts to simplify hedge accounting by moving from a “highly effective” standard to a “reasonably effective” standard for achieving hedge accounting. This change would be meaningful and would reduce (and perhaps eliminate) the need for companies to devote a significant amount of resources to perform quantitative statistical analyses (such as regression) to prove the effectiveness of relationships that can be easily assessed qualitatively. However, there are other aspects of the hedge accounting proposals that we do not support, including (a) the recording of hedge ineffectiveness for “underhedges” in cash flow hedges; (b) the elimination of voluntary de-designations, which will have the indirect effect of imposing transaction cost burdens on those hedgers that still seek to execute dynamic hedges under the hedge accounting model; and (c) the requirement (as opposed to an election) to expense the cost of an option when an option is used in a cash flow hedging relationship. As stated above, we support the Board’s proposal to simplify the accounting model by not bifurcating embedded derivatives in hybrid financial instruments. Our concerns regarding these items are more fully described in our responses included in Appendix A.

We also note that the Proposed Update does not carry forward language from the 2008 Exposure Draft on hedge accounting that would have effectively disqualified cash flow hedge accounting for forecasted foreign-currency-denominated intercompany royalty revenues in consolidated financial statements, which is the only level of financial statements for which constituents seek such accounting. We read the original Statement 133 Basis of Conclusions (paragraphs 481-484) as expressly memorializing the then Board’s intent to accommodate these types of hedges in consolidated financial statements, in acknowledgment of the real economic risk that multinationals functioning in multiple currency environments face. We continue to support cash flow hedge accounting for these intercompany cash flows and urge that the existing practice in this area not be curtailed in the final standard.

The Board's hedge accounting proposal has been exposed prior to the completion of the IASB's hedge accounting deliberations. We note that those deliberations may lead to a greater flexibility in the ability to define the "hedged risk" in various scenarios, particularly with respect to the ability to hedge components of non-financial risk. We have long believed that the arguments to permit hedging of components of non-financial risk are compelling and comparable to the arguments used to permit the hedging of components of financial risk. Accordingly, we urge the Board to continue to follow the outcome of the IASB hedging project and to evaluate its preliminary conclusions for possible incorporation into the FASB hedging model, paving the way for eventual convergence.

* * * * *

We would be pleased to discuss our comments with the Board members or the FASB staff at your convenience.

Very truly yours,

Ernst & Young LLP

Appendix A – Responses to specific questions raised in the Proposed Accounting Standards Update, “Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities”

Scope

Question 1:

Do you agree with the scope of the 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?

Response:

While we agree with the scope of the financial instruments included in this Proposed Update, we are concerned that the scope exceptions in paragraphs 4a and 4b will create gaps in the authoritative literature. Specifically, when considering the effect of the Proposed Update on instruments issued by the reporting entity, we believe that the Staff should address the following:

- ▶ Paragraph 4b would exclude from the scope of the Proposed Update any equity-classified components of convertible debt instruments issued by an entity. Equity-classified components could result from the application of the Cash Conversion guidance in ASC 470-20,⁷ the Beneficial Conversion Feature (BCF) guidance in ASC 470-20, or instances in which a convertible debt is issued at a “substantial premium” as discussed in ASC 470-20-25-13. The guidance addressing these equity-classified features was originated under an “amortized cost” accounting framework, which differs from the framework the Proposed Update will apply to convertible debt.

Because the principal in convertible debt is not assured of being returned to the investor at maturity (due to the presence of the conversion option), the entire convertible debt instrument would be accounted for at fair value through net income pursuant to the Proposed Update for most issuers.⁸ The conceptual basis for and application of the Cash Conversion, BCF and “substantial premium” literature to convertible debt instruments that are accounted for at fair value is unclear to us, given that the liability-classified component generally will be remeasured at fair value through net income.

As an editorial comment related to paragraph 4b, we believe that practice generally uses the term “bifurcate” to refer to the accounting for a feature apart from the host instrument as an embedded derivative and the term “separate” to refer to accounting for an equity component requiring recognition under either the Cash Conversion guidance or the BCF guidance. We recommend the Board consider consistently using these terms within the literature.

⁷ ASC 470, *Debt*

⁸ If a convertible debt instrument requires that, upon conversion, the accreted value of the obligation be paid in cash (the form of convertible debt often referred to as “Instrument C”), it appears that the liability component could potentially qualify for reporting changes in fair value through OCI (or qualify for amortized cost), while the equity component would continue to be accounted for in equity.

- ▶ Paragraph 4a would exclude instruments classified in their entirety as equity from the scope. The Proposed Update introduces a new definition of “debt instrument,” which is premised on the right to receive principal amounts at fixed or determinable dates. This differs from the traditional definition of a “debt security” in ASC 320-10-20,⁹ which is premised on a creditor relationship. Traditionally, in evaluating whether instruments issued by an entity should be classified as “equity” or a “liability,” practitioners would classify as equity only an instrument that, by its legal terms, did not create a creditor relationship.

Under the scope of paragraph 4a, and the revised definition of “debt instrument,” it is unclear whether perpetual debt (which has no principal amount due at a fixed or determinable date) should be classified as a liability (thereby being in the scope of the Proposed Update) or as equity. In fact, the Proposed Update could have the unintended consequence of allowing perpetual debt to be classified as equity. Further, the example in IG73-IG74 does not assist in this determination, as it addresses only the holder’s accounting, as opposed to the issuer’s accounting.

- ▶ Paragraph 4g scopes out non-controlling interests in a consolidated subsidiary. However, in some cases a non-controlling interest may be reported as a liability in the consolidated financial statements. We believe that the Board should clarify whether all non-controlling interests are excluded or just those classified as part of equity.

In addition, for instruments issued by an entity, we urge the Board to consider a scope exception for embedded features that are *de minimis* to the instrument as a whole. Under the Proposed Update, the size or significance of an embedded feature does not affect the determination of whether a hybrid instrument is eligible for reporting changes in fair value through OCI. Rather, a small or *de minimis* embedded feature, which is not clearly and closely related to the host instrument, could affect the required classification.

As debt instruments issued by an entity often have at least one small embedded feature that requires bifurcation (often related to relatively common default provisions or contingent events where the probability of occurrence is deemed even less than remote), the presence of these small features would dictate the measurement attribute for such hybrid instruments (i.e., fair value through net income). We do not believe comparability or transparency is improved by having two similar instruments measured differently due solely to a *de minimis* embedded feature. While acknowledging that any exception based on significance would be judgmental, we suggest that the Board include a scope exception that allows such *de minimis* features to be excluded from the analysis of how an instrument issued by an entity is required to be subsequently measured.

⁹ ASC 320, *Investments – Debt and Equity Securities*

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?

Response:

Although there is no theoretical basis to exclude these loan commitments from the Proposed Update, we support the Board's decision on practical grounds.

As indicated in our response to Question 13, we believe loans that are held for the collection of contractual cash flows should be eligible to be measured at amortized cost. To the extent that the Board agrees with this view and finalizes guidance permitting loans to be measured at amortized cost, any loan commitments related to loans that, when funded, will be subsequently measured at amortized cost, should also be measured on a comparable basis.

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?

Response:

Because the instruments described in the question are considered financial instruments (and not insurance contracts), we agree that they should be included in the scope of the Proposed Update.

However, we believe that the Board should be mindful of making any changes in the short term, only to have the contracts ultimately be classified as insurance pursuant to the ongoing joint FASB/IASB insurance contracts project. Indeed, the IASB exposure draft's definition of an insurance contract would cause some investment contracts of insurance entities to be considered insurance contracts.

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?

Although we do not object to the proposed change to the criteria for equity method accounting, we observe that the proposed amendment to ASC 323¹⁰ will create a significant US GAAP/IFRS difference. We believe that any fundamental change to the equity method of accounting should be part of a comprehensive review that is deliberated jointly by the FASB and the IASB. In that regard, we suggest either the IASB change its criteria to match the proposed amendment to the US GAAP criteria, or the FASB not adopt the proposed change.

In addition, the principle being articulated regarding the "related" criteria is unclear. While the guidance for assessing significant influence in evaluating whether to apply the equity method of accounting includes a rebuttable presumption (e.g., 20% equity investment in corporations), there are a number of judgmental factors (ASC 323-10-15-6) that are considered in determining whether an enterprise has significant influence. Many of those factors are similar to the factors proposed by the Board for evaluating if the operations of an investee are related to the investor's consolidated operations. Given the factors proposed by the Board, it is unclear whether the Board is focusing more on participating in governance and decision-making, the similarity of products and services or economic interdependence in making the "related" assessment. Lacking a clearly articulated principle, the proposed changes may not be operational.

The proposed amendments will require certain equity investments that are currently accounted for in accordance with the equity method to be measured at fair value (indeed, the Proposed Update would require all equity investments not qualifying for the equity method to be measured at fair value with changes in fair value recognized in net income), which may prove to be costly and time-consuming for certain preparers. Therefore, we encourage the Board to consider carefully the concerns of preparers regarding the practicability of measuring the fair value of investments that would no longer qualify for equity method accounting under the proposed guidance.

¹⁰ ASC 323, *Investments – Equity Method and Joint Ventures*

*Initial Measurement***Question 8:**

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

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?

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?

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?

Response:

We agree with the initial measurement principles and do not believe that a single initial measurement principle is required, regardless of whether changes in fair value of a financial instrument are recognized in net income or OCI. For financial instruments classified at fair value through net income, the difference between initially measuring the financial instrument at fair value or transaction price is essentially one of geography in the performance statement.

We do not object to the proposed accounting for transaction costs and fees, which provides for different treatment for transaction costs and fees depending on whether the financial instrument is classified at fair value through net income (i.e., expensed immediately) or fair value through OCI (i.e., deferred and amortized as a yield adjustment). For financial assets classified at fair value through OCI, deferring transaction fees and costs associated with these financial assets would preserve net interest margin in a manner that is consistent with current accounting standards.

Although we support the proposed initial measurement principles and proposed accounting for transaction costs and fees, we have the following observations for the Board to consider:

- ▶ The Board should state that entities that measure financial instruments at fair value through net income are not required to apply the interest recognition model applicable to financial instruments measured at fair value through OCI. Consider an entity with two identical bonds acquired on the same date: one is classified at fair value through net income, while the other is classified at fair value through OCI. Should the interest income recognized on the two bonds be the same? While it may appear that they should, that requirement would be very burdensome for many entities (such as investment companies) to track.

In order to apply the Proposed Update's interest income recognition model, an investment company would need to separately track credit impairments (on a historical cost basis). Financial assets classified at fair value through net income are not subject to the impairment guidance in the Proposed Update and, therefore, no allowance for credit losses would be recognized for these assets.

Similar to how this issue is currently addressed for entities that elect the fair value option under ASC 825,¹¹ we suggest that the Board require entities to disclose a description of how interest (and dividends) is measured for financial assets classified at fair value through net income. While we acknowledge that this method could result in inconsistent interest income application between certain debt instruments whose changes in fair value are recognized in net income versus OCI, we believe this is an acceptable result, particularly given the cost/benefit relationship.

- ▶ The proposed guidance would significantly change practice for investment companies who follow ASC 946.¹² Investment companies generally include transaction costs (e.g., commissions) in the cost of securities purchased and deduct them from the proceeds of securities sold. Upon subsequent remeasurement of the securities at fair value, the transaction costs are recognized as part of unrealized gain or loss. The Proposed Update would require investment companies to expense transaction costs as incurred. Accordingly, commission activity would be moved from unrealized gains/losses to expenses.

This accounting may significantly affect funds' expense ratios, which is a significant metric currently used by many investors in making investment decisions. Consider two investment funds that both produce net returns (after transaction fees and costs) that are equal, yet one investment fund is more actively managed (and thus incurs higher transaction fees and costs). Investors evaluating potential investments based on the expense ratio may be inappropriately misled by this ratio, concluding that the fund with higher expenses is less desirable. We expect this change in practice to have significant effects on the mutual fund industry. Before the Board reaches any conclusions in this area, we recommend that it perform additional outreach with industry representatives.

¹¹ ASC 825, *Financial Instruments* (formerly Statement 159, *The Fair Value Option for Financial Assets and Financial Liabilities*)

¹² ASC 946, *Financial Services – Investment Companies* (formerly, AICPA Audit and Accounting Guide, *Investment Companies*)

- ▶ Some have interpreted the guidance in the Proposed Update to no longer permit or require the deferral of transaction fees and costs related to debt issuances and their subsequent amortization over the life of the debt instrument. This is likely because paragraph BC 52 states: “Accordingly, for financial instruments whose qualifying changes in fair value are recognized in other comprehensive income, the Board decided that the recognition of fees and costs should be consistent with existing guidance in Subtopic 310-20.” ASC 310-20¹³ deals with receivables, not issued debt. We believe transaction fees and costs related to the issuance of debt instruments that will be classified at fair value through OCI or amortized cost should be deferred and amortized over the life of the debt instrument. We suggest that the Board clarify this in the final Accounting Standards Update (ASU).
- ▶ The Proposed Update does not provide guidance on the initial measurement for short-term receivables and payables that will be subsequently measured at amortized cost. The guidance in paragraph 12c applies only to financial liabilities subsequently measured at amortized cost. In addition, the Proposed Update indicates that core deposits should be initially measured at transaction price. The consideration of the fair value of core deposits generally includes significant non-financial components, such as an intangible asset related to the customer relationship. This would automatically create a significant difference between the fair value of the core deposit and the transaction price. We understand that the Board’s intent is for core deposits to be initially measured at transaction price. We suggest that the Board clarify these two points in the final ASU.
- ▶ If an entity issues convertible debt in combination with a share-lending agreement, the accounting guidance generally requires that the share-lending agreement be measured at fair value, with the offset accounted for as a debt issuance cost. It is not clear how that accounting is affected by this guidance, and the Board should provide that clarification.

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?

Response:

We observe that paragraphs 14 and 15 of the Proposed Update provide that an entity should first determine whether the significant difference is at least partially due to the existence of other element(s). If other element(s) are identified, the entity should give proper recognition of the other element(s) under other US GAAP and only then, to the extent that the other element(s) are not separately recognized and no other element(s) can be identified, should the difference between fair value and transaction price be recognized in net income.

¹³ ASC 310-20, *Nonrefundable Fees and Other Costs*

Given this clarification, we agree with this approach because it is generally consistent with existing US GAAP guidance for transactions where other rights and/or privileges exist. The existing guidance generally requires the value of those rights or privileges to be first given accounting recognition in accordance with their substance (e.g., ASC 835-30¹⁴ or ASC 505-30-30¹⁵).

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?

Response:

We believe that the proposed guidance is operational, recognizing that the determination of whether there is a difference between transaction price and fair value will require considerable judgment.

While we understand that the Board may not want to provide a bright line for the determination of "significant difference," we believe that additional guidance (some of which may be through additional examples) is needed.

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?

Response:

Although we continue to believe fair value is a relevant measure for many financial instruments, we do not believe fair value should be the required measurement in all cases. We believe a debt instrument that an entity expects to hold for the collection or payment of contractual cash flows, rather than to hold for the expected realization of short-term movements in fair value, should be eligible for amortized cost. This determination should focus on the entity's business strategy for managing financial instruments, similar to the Proposed Update's criteria for use of fair value through OCI and the IASB's criteria in IFRS 9 for amortized cost. The determination should also focus on the characteristics of the debt instrument.

¹⁴ ASC 835, *Interest*

¹⁵ ASC 505, *Equity*

We do not support requiring banks (and other entities with similar investments) to report loans at fair value when those loans are held for the collection of contractual cash flows. In these circumstances, we believe loans should be eligible for measurement at amortized cost. We also support extending this concept to all financial assets meeting the above-referenced criteria, including debt securities that have observable fair values. In that regard, we support the IASB's approach to the classification and measurement of financial assets in IFRS 9 (with certain exceptions), and we urge the Board to adopt such an approach. This will also promote convergence.

We do not, however, support the adoption by the FASB of IFRS 9's approach to the classification and measurement of equity securities whereby, upon initial recognition, an entity may make an irrevocable election to recognize subsequent changes in fair value in OCI for equity securities not held for trading, without recycling. If such an election is made under IFRS 9, only dividends are recognized in net income, and other amounts recognized in OCI will never be recognized in net income (i.e., no recycling). It is challenging to justify a different treatment for dividends (in net income) and for other components such as gains and losses on disposal, impairments, etc. (through OCI), since the value of many equity instruments is, to a large extent, the value of the expected future dividend stream.

Also, as a general matter, we see no basis for excluding fair value changes that have been recognized in OCI from net income when those gains and losses have been realized upon disposal. However, because permitting fair value changes to be recognized in OCI with recycling will require an appropriate impairment model (something that has so far seemed impossible to achieve), we support all equity securities within the scope of the Proposed Update being measured at fair value with changes in fair value recognized in net income.

For those financial instruments measured at amortized cost, we believe fair value information should be appropriately disclosed in the notes to the financial statements, as is currently required by ASC 825.¹⁶ We also suggest that the Board clarify, if it has not already done so in other pending projects, that the amounts disclosed pursuant to ASC 825 related to the fair value of loan receivables be measured in accordance with ASC 820¹⁷ (i.e., an exit price). As the Board is aware, ASC 825 currently includes an example of a disclosure that was previously included in Statement 107 (see ASC 825-10-55-3) that has been interpreted to mean that the fair value amounts disclosed for loan receivables can be an entry price.

Please refer to our response to Questions 15, 18, 29 and 30 for our views on fair value as a measurement attribute for financial liabilities.

¹⁶ ASC 825, *Financial Instruments* (formerly Statement 107, *Disclosures about Fair Value of Financial Instruments*)

¹⁷ ASC 820, *Fair Value Measurements and Disclosures*

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?

Response:

See our response to Question 13, which discusses our support for the IFRS 9 classification and measurement model. In the event the Board finalizes the Proposed Update with a fair value through OCI category, then we agree that interest income or expense, credit impairments and reversals (for financial assets), and realized gains and losses should be recognized in net income for financial instruments measured at fair value with changes in fair value recognized in OCI.

In addition, we believe foreign exchange gains and losses should also be recognized in net income for financial instruments classified at fair value through OCI. While ASC 830-20-35-6 (previously EITF 96-15)¹⁸ currently provides that the entire change in the fair value of a foreign currency-denominated available-for-sale debt security be reported in OCI, inclusive of the portion attributable to changes in exchange rates, we do not believe there is any basis to continue such a practice. Instead, consistent with ASC 830-20-35-1, we believe changes in fair value of financial instruments due to movements in foreign currency exchange rates should be recognized in net income. That accounting will align US GAAP more closely with the requirements of IFRS 9. While computing the changes in fair value of financial instruments attributable to changes in foreign currency exchange rates may add some complexity to financial reporting, we note that the IFRS preparers have not voiced significant concerns in this area.

¹⁸ Emerging Issues Task Force Topic 96-15, "Accounting for the Effects of Changes in Foreign Currency Exchange Rates on Foreign-Currency-Denominated Available-for-Sale Debt Securities" (subsequently codified in ASC 830, *Foreign Currency Matters*)

Question 15:

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

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?

Question 29:

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

Question 30:

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

Response:

We do not believe there needs to be symmetry in the measurement principles for financial assets and financial liabilities. Consistent with our views on the measurement of financial assets, we do not believe fair value is the most appropriate measurement for financial liabilities in all cases. We observe that most entities seldom transfer financial liabilities. Instead, most are settled with the counterparty in accordance with the contractual terms. Under such circumstances, we question the usefulness of reporting unrealized gains and losses that are unlikely ever to be realized.

In that regard, we believe amortized cost should be the default measurement for financial liabilities. To the extent that measuring the liability at amortized cost creates or exacerbates a measurement attribute mismatch because a related asset(s) is measured at fair value, an entity should be permitted to elect to measure the financial liability at fair value with changes in fair value recognized in net income, with the exception of changes in fair value related to own credit, which would be recognized in OCI. In cases where the credit risk of an entity's liabilities may specifically reflect the risk of an entity's assets rather than wider enterprise risk (e.g., a consolidated trust, special purpose entity or investment partnership where the entity's creditors have recourse only to its assets in the event of default), we believe that changes in the credit risk of the liability could be recognized in net income.

With respect to whether measuring a financial liability at fair value is operational, we observe that fair value measurements for financial liabilities are determined today for those financial liabilities that were elected to be accounted for pursuant to the fair value option under ASC 825 as well as for disclosure purposes due to the requirement of ASC 825. Although measuring a liability at fair value is more operationally challenging than simply measuring a liability at amortized cost, we are not aware of any significant operational difficulties in determining such measurements. Here the views of preparers will be most relevant.

We also observe that the Board has already issued additional guidance on measuring the fair value of liabilities through the issuance of ASU 2009-05.¹⁹ We believe that the guidance provided in ASU 2009-05 was helpful in addressing some of the practice issues relating to “how to” measure the fair value of financial liabilities, as these liabilities generally have corresponding assets. However, in its re-deliberations and interactions with constituents, the Board may want to further consider the effects on other accounting areas as a result of measuring debt at fair value. For example, measuring financial liabilities at fair value will raise questions as to how to present the current and non-current portions of long-term debt that is measured at fair value in a classified balance sheet. As another example, it is not clear how the cash flow test for evaluating whether debt has been modified or extinguished under ASC 470-50²⁰ would be applied if the debt were measured at fair value through OCI.

With respect to the criteria to qualify for measuring a financial liability at amortized cost, see our response to Question 28 for our views on the application of the criteria for qualifying to recognize changes in fair value in OCI (which is a criterion that must be met to qualify to measure a financial liability at amortized cost). The guidance in the Proposed Update regarding criteria to assist in determining when a measurement of a financial liability at fair value would create or exacerbate a measurement attribute mismatch has the potential to establish bright lines and introduce somewhat arbitrary distinctions when generally the Board has been supporting more principles-based guidance under US GAAP. As a result, the application of the proposed criteria would result in measurement attribute mismatches in circumstances in which 49% or less of the operating segment or consolidated recognized assets are measured at something other than fair value.

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?

Response:

We do not believe there is a strong technical argument for prohibiting reclassifications, as this seems to be an arbitrary rule rather than a principle. Although it may occur infrequently, it seems to us that reclassifications should be permitted upon a true change in the business strategy. Requiring newly acquired or issued financial instruments to be classified based on the new business strategy while continuing to classify existing financial instruments based on the prior strategy does not appear appropriate; both the newly acquired/issued and existing financial instruments are subject to the same (changed) business model, yet they are classified differently. Further, this distinction would last for the remaining duration of the existing instruments, potentially years.

¹⁹ ASU 2009-05, *Measuring Liabilities and Fair Value*

²⁰ ASC 470-50, *Debt – Modifications and Extinguishments*

While this discussion focuses solely on the business strategy criterion, similar issues arise in connection with the criteria related to the characteristics of the financial instrument. For example, assume an entity issues a financial liability and appropriately elects to subsequently measure the financial liability at amortized cost. Assume further that the financial liability is subsequently modified in such a way that it is not required to be accounted for as a new debt instrument (i.e., the modification is not substantial). However, the modification introduces a feature that would have precluded its initial classification at fair value through OCI (e.g., if either a non-substantial conversion feature or fixed-price term-extending option were added). In this case, a financial instrument that contains features that are not consistent with the fair value through OCI category is nevertheless measured at amortized cost.

Notwithstanding these concerns, we are conscious of the debate and historical difficulties associated with requiring and allowing reclassifications. We also acknowledge that allowing reclassifications would require additional rules and criteria, thereby adding to, rather than reducing, complexity. Nevertheless, for the reasons outlined above, we believe reclassifications should be required when the business strategy for managing financial instruments changes.

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?

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?

Response:

We do not believe that the proposed remeasurement approach for core deposit liabilities is appropriate, either on the face of the financial statements or disclosed in the notes to the financial statements. As mentioned in our cover letter, we strongly support a converged approach to reporting financial instruments under US GAAP and IFRS. While we understand the Board's intention with respect to the proposed core deposit liability remeasurement approach, we believe that the complexity it introduces is not supported by the benefits.

First, financial institutions do not manage their core deposit bases using a present value notion. Second, we do not believe that the change in equity resulting from the remeasurement approach will be understandable by users of the financial information. For example, the use of an average rather than period-end balance on the balance sheet is inconsistent with other financial instrument measurements and could result in significant differences between the amount due on demand at a

reporting date and the amount reflected on the balance sheet, notwithstanding any applicable discount rate. Third, the determination of the rates used to discount the average balance will be extremely subjective and potentially difficult to determine on a period-by-period basis. Although the amount due on demand will be separately presented on the balance sheet, the subjectivity of the remeasurement calculation and the ability to recognize changes in the remeasurement amount within net income or OCI will limit comparability.

Although the expectation may be that the discount rate differential would result in the recognition of a core deposit liability less than the actual amount due on demand, an entity could have an all-in-cost-to-service rate that exceeds its alternative funds rate. This would result in a remeasurement amount that exceeds the demand deposit amount (i.e., a loss or reduction in equity) and would produce a counterintuitive result. Although we understand that this is not intended to be the result, it does not seem to be prohibited by the Proposed Update. If the Board finalizes the guidance on core deposits as proposed, we suggest that this point be clarified in the final ASU.

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?

Response:

We believe that the examples of financial instruments included in the proposed guidance that qualify for measurement at the redemption amount are appropriate. We also believe that the language used in paragraph 34 of the Proposed Update is appropriately drafted not to be all-inclusive and allows for other types of investments to potentially qualify for measurement at the redemption amount.

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?

Response:

Assuming that it is the Board's intention (as expressed in paragraphs 35 and BC 166) that deferred tax assets related to qualifying financial instruments revalued through comprehensive income should be aggregated with other deferred tax assets and be assessed for realizability in the same manner, then yes, we agree. This does, however, present several key issues that should be addressed before concluding on the accounting for deferred tax assets related to these instruments.

First, is the recovery in value of the debt instrument that gave rise to the deferred tax asset a projection of future income? We would presume it is, but the FASB's view on this as well as if this projection of future income is subject to the limitations on projections of future income noted in ASC 740²¹ should be specifically acknowledged. For example, ASC 740-10-30-21 notes: "Forming a conclusion that a valuation allowance is not needed is difficult when there is negative evidence such as cumulative losses in recent years." Does this mean that losses (and related reversals) recorded through comprehensive income on debt instruments are considered when determining if an entity is in a cumulative loss position in recent years? Also, is the reversal and resulting income viewed differently than other forms of projected future income? Consider the following example. Company A has experienced recurring losses from continuing operations over the past several years. In addition, the company has recorded qualifying changes in fair value for certain debt instruments in comprehensive income that resulted in a corresponding deferred tax asset. When assessing the realizability of deferred tax assets, the only potential source of realizability is projections of future income, including the contractual reversal of decreases in fair value recorded to comprehensive income related to debt instruments. However, in order to conclude that there will be taxable income in the period of reversal, Company A would also need to forecast income (or losses less than the reversal amount) in future periods. This fact pattern would be further complicated in a jurisdiction that would view losses on debt securities as capital losses versus operating losses.

Second, by reflecting the decline in value of a qualifying debt instrument in comprehensive income, the Board appears to be saying that this loss is different than other declines in value in that the accounting and presentation is predicated on an expected recovery in value. This view contrasts markedly with the corresponding income tax accounting, which assumes that the related deferred tax asset will arise at the tax-effected amount and therefore needs to be assessed for realizability. We believe this general inconsistency should at least be acknowledged in the final standard, along with why the Board felt this inconsistency should be preserved.

Finally, and perhaps most importantly, the continued prohibition on backwards tracing continues to result in illogical accounting. As noted in our original comment letters on Statements 115 and 130,²² in our view, it is counterintuitive to record the tax effects of transactions in comprehensive income but to record a change in those related tax effects (e.g., change in tax law and a change in valuation allowance) as a component of income from continuing operations. While we recognize that this is beyond the scope of this project, we continue to believe that the general prohibition against backwards tracing, coupled with the inconsistency with which comprehensive income is used in the present accounting framework, further highlights why this prohibition should be revisited.

²¹ ASC 740, *Income Taxes*

²² Statement 115, *Accounting for Certain Investments in Debt and Equity Securities* (primarily codified in ASC 320, *Investments – Debt and Equity Securities*) and Statement 130, *Reporting Comprehensive Income* (primarily codified in ASC 220, *Comprehensive Income*)

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?

Response:

We recommend that the Board consider providing an exception for convertible debt instruments until the joint project on the classification and measurement of financial instruments with characteristics of equity (the FICE project) is completed. The FICE project has the potential to change the classification of various instruments that are also subject to the Proposed Update, including convertible debt, mandatorily redeemable preferred stock and perpetual instruments. In particular, that project will determine whether convertible debt should continue to be classified as a liability in its entirety or whether the bifurcation of the instrument into a liability component and an equity component is required. Depending on the final decision by the Board on the accounting for convertible debt under the FICE project, the accounting for convertible debt could change significantly from what is proposed in the Proposed Update.

However, during the interim period, if the Board decides to finalize the subsequent measurement guidance for convertible debt as proposed, we believe that clarifications to either the Proposed Update or the implementation guidance are necessary. The Proposed Update could result in inconsistent measurement models for issuers of convertible debt, depending on the types of instrument. These convertible debt instruments are prevalent in the marketplace.

For example, if a convertible debt instrument requires that, upon conversion, the accreted value of the obligation be paid in cash (often referred to as "Instrument C"), it appears that the liability component could potentially qualify for reporting changes in fair value through OCI (or qualify for amortized cost), as the principal amount would be settled in cash, while the equity component would continue to be accounted for in equity. The same may be true for convertible debt that could be settled in any combination of cash or shares at conversion (often referred to as "Instrument X"), depending on the interpretation of "will be returned" in paragraph 21a.1. For all other types of convertible debt, because they would not meet the "transfer of a principal amount" criterion in paragraph 21a.1, the entire instrument would be accounted for at fair value through net income.

The Proposed Update excludes from its scope an equity component that has been bifurcated from a hybrid instrument and classified in an entity's stockholders' equity (e.g., a beneficial conversion feature). It is unclear what effect, if any, the Proposed Update will have on the accounting for convertible debt that has a beneficial conversion feature at issuance, or, similarly, convertible debt

that is issued with a substantial premium. In both cases, the issuer is required to recognize an equity component separately from the remaining instrument under existing US GAAP. However, the equity component is not the fair value of the conversion option, but rather an alternative measurement of the equity component (e.g., intrinsic value).

Importantly, the liability component that remains is not initially measured at fair value at issuance under existing GAAP, but rather is recorded at the residual amount of the proceeds after recording the equity component. If the Proposed Update intends to require an issuer to measure the liability component (which excludes the initial intrinsic value of the conversion option but includes the initial time value of the conversion option) at fair value through net income, we question whether the Board needs to amend the current beneficial conversion literature as to initial measurement, or otherwise address the “day one adjustment” to account for the liability component at fair value. For example, does the ongoing accounting for the liability component include changes in the time value of the conversion option that was left behind when the intrinsic value was separated? Or does the very next remeasurement of the liability component effectively derecognize the option time value and leave a pure liability component (essentially the contractual terms of the debt minus the conversion option) to be measured at fair value subsequently?

Another question would be how this guidance would affect the model for separating a conversion feature from a convertible debt instrument once it becomes a beneficial conversion option following the resolution of a contingency. That is, it is not clear how the accounting for a contingent beneficial conversion option is affected upon the resolution of the underlying contingency.

Overall, pending the resolution of the FICE project, we question whether different measurement models for convertible debt that essentially represent the same economics, although with different settlement methods, improve comparability and consistency across issuers.

The accounting for convertible instruments is very complex, and there are many variations in the terms of those instruments. Without an exception for convertible instruments pending the completion of the FICE project, there may be other implementation issues that will arise in practice from the intersection of the legacy GAAP for these instruments and the measurement in the Proposed Update. However, at a minimum, it would be helpful if the Board could clarify the points identified above for constituents.

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?

Response:

As a general matter, we believe that the criteria are operational, but additional implementation guidance is required related to the application of the business strategy criterion in paragraph 21b.

Paragraph 21a deals with characteristics of the debt instrument. These criteria are generally clear and, in the case of paragraph 21a.3, well established. However, as alluded to in the response to Question 21, there may be different interpretations of the phrase “will be returned” in paragraph 21a.1. If read to mean “contractually required to be returned,” it would imply that convertible debt subject to the Cash

Conversion literature would not qualify for changes in fair value recognized in OCI. However, if it is interpreted to be based on an issuer's stated intent or policy regarding its choice of settlement methods upon a holder's conversion, then those instruments could be considered to qualify. In addition, it is not clear if the "additional contractual cash flows" under paragraph 21a.2 include contingent cash flows that would be required by the contract once the contingency was resolved.

Likewise, paragraph 21c, which deals with hybrids, is clear and the application of the bifurcation guidance in ASC 815 is well established. However, see our comment in Question 1 related to *de minimis* embedded features.

Given the judgment involved in applying the "business strategy" criteria and the lack of application guidance in the Proposed Update, this likely will be the most challenging of the three criteria when determining whether an entity may recognize changes in fair value of a financial instrument through OCI. Although entities will be required to exercise judgment, additional guidance should be provided to assist in determining whether an entity's business strategy for managing financial instruments meets the principles specified in paragraph 21b.

As discussed in paragraph 22 of the Proposed Update, an entity's business strategy should be to hold instruments for a significant portion of their contractual terms, yet it is clear a certain level of sales activity is permitted without calling into question the business strategy. The Proposed Update provides limited guidance to assist in evaluating whether a certain level of sales activity will be consistent with a business strategy of holding for the collection or payment of contractual cash flows. For example, the Proposed Update uses words such as "an occasional sale or settlement" in describing what might be an acceptable level of sales or settlements, as well as "a large number of sales or settlements" in vaguely describing what might not be appropriate. Although we support the Board's desire to provide principles-based guidance by not specifying detailed guidelines about assertions of management intent, number of sales or settlements or holding periods, we believe that further implementation guidance and illustrative examples may help promote consistent application.

One example of the need for additional guidance is with respect to a life insurer that periodically rebalances its investment portfolio in order to maintain a duration that matches the duration of its insurance liabilities (i.e., as part of its asset-liability management program). While the overall strategy may be to hold the financial assets for the collection of contractual cash flows, a certain level of sales activity will be necessary to maintain the appropriate duration of its financial assets with the changing duration of its insurance liabilities. These sales may be more than "occasional" but may not be "large" in number. It is unclear whether, in this scenario, changes in the fair value of the life insurer's financial assets would qualify to be recognized in OCI.

Another example is a property and casualty insurer. Property and casualty insurers collect premiums and invest those premiums in connection with a business strategy of collecting contractual cash flows from those financial assets. Liquidity needs for normal claims activities may be handled by current cash flows (i.e., out of incoming premiums), but in the event of a significant increase in claims activity, the insurer would need to sell financial assets to fund those claims. This is a common business model for property and casualty insurers. It is also unclear whether, in this scenario, changes in the fair value of the insurer's financial assets would qualify to be recognized in OCI.

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?

Response:

Generally, we do not support the Board's proposal for recognizing changes in fair value related to an entity's own credit in net income for those financial instruments measured at fair value with changes in fair value recognized in net income. In our view, it is appropriate to recognize in net income changes in own credit risk related to liabilities that are traded (i.e., where the liability is incurred with an intention to repurchase or settle the liability in the near term, including derivative instruments that are not held for hedging purposes). However, for liabilities measured at fair value that are not traded (which would include derivative liabilities held for the payment of contractual cash flows – that is, designated in a hedging relationship), we believe changes in own credit should be recognized in OCI consistent with the proposals by the IASB in its exposure draft on financial liabilities measured at fair value under the fair value option. For those financial liabilities that are measured at fair value with all changes in fair value recognized in net income, it is our understanding that users generally reverse amounts related to changes in fair value due to changes in own credit (i.e., non-performance risk) when analyzing net income. For this reason, we support the recognition of gains or losses arising from changes in own credit risk through OCI. We believe that this approach would meet the demands of various stakeholders who believe that reporting gains in the income statement due to a deterioration in an entity's own credit is counterintuitive.²³

However, as discussed in our recent comment letter to the IASB,²⁴ we believe that in certain circumstances changes in own credit should be allowed to be presented in the income statement. For example, where the credit risk of a liability specifically reflects the risk of a specific asset or group of assets (i.e., the liability is non-recourse where the performance on the liability is tied solely to the performance of the specific assets) rather than wider enterprise risk, we believe that changes in the credit risk of the liability could be recognized in net income when the fair value changes of the related assets are recognized in net income. An example would be a fund or special purpose entity (SPE) where the entity's creditors have recourse only to its assets in the event of default. In these circumstances, we believe that changes in own credit risk related to financial liabilities issued by the fund or SPE would be best recognized in net income for financial liabilities designated at fair value, assuming that the assets of the fund or SPE are also recorded at fair value through net income. For a consolidated SPE, this would apply only if the financial liabilities of the SPE are not guaranteed by the group, because if they were guaranteed by the group, the risk of default would not be linked directly to the performance of the assets.

²³ This was also recognized in the report issued by the Financial Crisis Advisory Group in July 2009.

²⁴ Comment letter, 16 July 2010, Exposure Draft, *Fair Value Option for Financial Liabilities*

We also do not support separating changes in fair value due to price of credit from changes in credit standing, as we believe that any such bifurcation is arbitrary. Further, the market generally does not distinguish between the changes, and the separation is operationally difficult to implement, with significant costs involved. Please refer to our response to Questions 33 and 34 for further discussion of our views.

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.

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.

Response:

As stated in our response to Question 32, we do not support separating changes in fair value due to the price of credit from changes in credit. We question the usefulness of separating changes in fair value due to the price of credit from changes in credit standing and do not believe that the Board has effectively articulated why such a split is superior (within a cost-benefit context) to simply considering the change in an entity's credit spread as own credit. While such a bifurcation may be of interest to some users, we believe that users generally do not differentiate between the price of credit and changes in credit standing, including liquidity risk, while assessing changes in credit risk of an entity. In addition, the change in fair value due to the price of credit is no more realizable than the change due to an entity's credit standing.

Notwithstanding this view, if the Board decides to require such a split in financial instrument guidance, we have the following comments on the proposed methods.

Method 1 in Appendix B of the Proposed Update demonstrates measuring the change in an entity's credit standing based upon changes in credit rating during the given period. While a large number of public companies have reliable independent ratings available, a vast number of private companies (e.g., hedge funds, private equity funds and all other entities that would be required to measure own debt at fair value) are not rated by independent rating agencies. Consequently, the application of a model based on credit ratings is limited. Method 1 also assumes that if there has been no change in an entity's credit rating from the beginning to the end of the period, the entity would assume that there has been

no change in fair value for the period attributable to a change in the entity's credit standing, excluding the change in the price of credit. As evidenced in the recent financial crisis, changes in credit rating may lag the event that caused an immediate change in the credit spread level for an entity. In reality, change in credit standing is a dynamic process, with market indications regarding credit evolving as additional information is absorbed by the market. Thus, an event that may have an imminent impact on credit ratings may not be reflected immediately in the rating of an entity, leaving a possible gap in the analysis. While credit ratings of an entity provide an estimation of an entity's creditworthiness as of a given point in time, a method based purely on change in credit ratings has shortcomings.

Method 2 in Appendix B of the Proposed Update may not be operational for many entities. One of the major challenges associated with this method is that it may be difficult to find a comparable benchmark, as theoretically no two entities have identical capital structures. Further, as contemplated in paragraph B5 of Appendix B of the Proposed Update, it might be difficult for entities to ascertain changes in credit standing based on a comparable benchmark, as they may or may not have debt instruments with the same credit rating (if rated at all) traded in the marketplace. We believe that isolation of change due to changes in price of credit versus changes in credit standing may be operationally difficult to achieve, with significant costs involved. In our view, use of this method would lead to more confusion in practice among the preparer community.

In our view, credit spreads derived through reliable market information (which includes both changes in price of credit and changes in credit standing) provide the most decision-useful information to the users of financial statements. We do not support requiring separation of changes in credit risk due to changes in the price of credit and changes in credit standing, as we believe any split between the two is likely arbitrary, because the market does not distinguish between them.

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?

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: Amortized 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?

Question 46:

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

Response:

The Proposed Update would require any credit impairment to be recognized immediately in net income when the entity does not expect to collect all contractual amounts for originated financial assets and all amounts originally expected to be collected for purchased financial assets. This approach could require an entity to recognize a credit loss on a newly originated or acquired asset in the reporting period in which the financial asset is originated or acquired solely because it is included in a pool of similar financial assets (either because the financial asset is evaluated on a collective (pool) basis outright, or because it is collectively evaluated after first being individually evaluated where no credit loss was considered to exist) – a result that is neither intuitive nor comparable to an asset that is not pooled.

The Proposed Update's impairment approach is significantly different from the IASB's proposed approach, which recognizes impairment losses over the life of a financial asset by including expected credit losses in the computation of the effective interest rate when the asset is first recognized (i.e., an allowance for credit losses is built up over the life of the financial asset). Changes in credit loss expectations are reflected in catch-up adjustments to net income. As previously stated, we believe that the Boards must converge the accounting in this important area.

As discussed in our comment letter to the IASB on its Exposure Draft, while we appreciate the technical merits of deferring income to reflect anticipated credit losses (it is consistent with revenue recognition principles), we do not support the IASB's proposed approach primarily because of complex operational aspects of such a model. Further, in determining credit impairment, we do not support the

unlimited forecasting of future events or economic conditions not existing at the balance sheet date for purposes of recognizing credit impairment on assets classified at fair value with changes in fair value recognized through OCI. In this regard, we believe it is important for the Board to provide more specific guidance surrounding the concept of “past events and existing conditions.” In our view, existing conditions should be expanded to include present assumptions about relatively near-term trends (e.g., 12 to 24 months) in major economic factors that a preparer uses to forecast future cash flows. The use of near-term trends in major economic factors when estimating future expected cash flows is consistent with what we understand is acceptable by certain banking regulators for purposes of calculating various regulatory capital measures.

Although the FASB’s impairment approach in the Proposed Update is less complex and addresses the primary concern with the current incurred loss model (i.e., that the current incurred loss model delays the recognition of a credit loss until a loss is determined to be probable), we believe that the recognition of all losses in the reporting period in which a pool of loans is originated results in financial reporting that is inconsistent with the business purpose of extending such credits and therefore, does not appropriately reflect the economic results of all lending transactions. Financial institutions extend loans with the expectation that there will be some level of credit loss within certain loans, regardless of how well an individual loan is underwritten. The financial institution is compensated for this risk through the credit spread in the interest rate, with the acknowledgment that a portion of that spread is intended to cover actual credit losses. Consistent with our IASB comment letter, we would support a model that provides for the recognition of an entity’s initial estimate of credit loss over the life of the financial asset(s), with an incurred loss overlay so that the minimum allowance for credit losses includes all incurred losses. Such a model is described further as follows:

- ▶ The total expected losses for a portfolio of financial assets (comprising assets with similar risk characteristics) would be estimated at initial recognition, and the portion of income representing such losses would be deferred over the average life of the portfolio, so as to build up an allowance.
- ▶ When a financial asset in the portfolio is known to be impaired (because the asset is either in default or has been restructured due to financial difficulty, or it is probable that it will default or be restructured), the asset would be transferred out of the currently performing portfolio of assets (“good book”) into a non-performing portfolio (“bad book”). An impairment loss, representing the difference between the asset’s recorded amount and the cash flows expected to be received from that asset, discounted at the effective interest rate, would be recorded in the income statement.
- ▶ The expected losses for the remaining portfolio of performing assets would be re-estimated at each reporting date to reflect changing experience and circumstances. The allowance for credit losses related to the performing portfolio would be adjusted to reflect the proportion of the average life of the performing portfolio that has so far elapsed. This would have the effect of adjusting the allowance for credit losses on the performing portfolio as if the revised expected losses had always been assumed in the deferral of income. Hence, for instance, if on average two years have elapsed on a portfolio with an average life of five years, two-fifths of the revised expected loss is compared to the amount so far deferred, and the difference is recorded in net income.

This impairment model is based on an approach discussed by members of the EAP. It is also described as "Alternative Model C" in the IASB Staff Paper 4C to the 3 August 2010 IASB meeting.

The IASB approach would require the inclusion of the effects of estimated future economic events and conditions over the life of the financial asset in the determination of estimates of cash flows expected to be collected. The Proposed Update, on the other hand, does not permit the use of forward-looking information in estimating cash flows expected to be collected. We recognize that at any balance sheet date, certain currently observable trends may indicate an improving or worsening scenario when it comes to expected credit losses. As stated above, we believe that present assumptions about relatively near-term trends (perhaps for a limited period, say 12 to 24 months) in major economic factors should be considered in estimating cash flows expected to be collected. To be clear, however, we would not support a model that allows for simulations of future economic conditions not currently evidenced to be projected over the entire life of a financial asset, because such economic conditions necessarily represent a singular view and not a view that can be corroborated by current market participant behavior or current observations.

We acknowledge that this model is not completely developed. It is offered as a "straw man" of a possible way forward for the Boards to develop a converged solution. We suggest that the Boards and the EAP further investigate, clarify and define such a model. Once it is more clearly defined, the proposed model should be field-tested among various entities, including financial (both large and small) and non-financial (i.e., commercial) institutions. Auditor feedback as to the ability to audit such a model should also be sought. If the field test results and auditor feedback are positive and the Boards agree on a converged solution, the converged model should be re-exposed.

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?

Response:

We agree that changes in foreign currency rates, changes in expected prepayments and changes in variable interest rates should not result in credit impairments. These changes are generally not related to credit factors.

See our response to Question 14, where we indicate our belief that foreign exchange gains and losses should be recognized in net income.

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?

Response:

We do not believe that a specific methodology should be required for purposes of determining historical loss rates. For example, determining appropriate segmentation of the portfolio, determining “look-back” periods for historical net charge-off rates, and considering qualitative and environmental factors in determining the appropriate allowance for credit losses are highly judgmental determinations and are not conducive to a prescribed methodology. Any prescription, while potentially providing greater comparability across entities, could reduce reliability of the credit impairment measurement. Please refer to Question 42 for an area related to historical loss rates where additional information could be useful.

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?

Response:

We agree that subsequent increases in cash flows expected to be collected on purchased financial assets should be recognized as yield adjustments rather than as immediate gains in net income. This is consistent with the existing guidance for purchased credit-impaired instruments.²⁵ The increase in cash flows on a purchased financial asset from those originally expected does not represent a recovery of a previously recognized credit impairment and therefore should not be recognized immediately in net income.

²⁵ See ASC 310-30, *Receivables – Loans and Debt Securities Acquired with Deteriorated Credit Quality* (formerly SOP 03-3).

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?

Response:

We agree with the requirement to assess a financial asset together with other financial assets that have similar risk characteristics when an individual assessment of the financial asset indicates no impairment. We believe that the Board's intent is to prevent an entity from assessing an entire portfolio on an individual basis and concluding that the allowance for credit losses is zero when it is generally accepted that some instruments within the portfolio, although not individually identifiable, will have credit losses. However, the impairment approach set out in the Proposed Update could require an entity to recognize a credit loss on a newly originated or acquired asset in the reporting period in which the financial asset is originated or acquired solely because it is included in a pool of similar financial assets. As discussed in our response to Questions 37, 38 and 46, we believe that the recognition of all losses in the reporting period in which a pool of loans is originated results in financial reporting that is inconsistent with the business purpose of extending such credits and therefore does not appropriately reflect the economic results of all lending transactions. We refer to our response to Questions 37, 38 and 46 where we set forth a "straw man" of an alternative model that the Boards should consider in developing a converged model. Once again, we believe that the Boards must converge the impairment approaches.

The above notwithstanding, we believe that the Board should explicitly clarify whether an entity must look to third-party information such as historical loss rates for loans and securities when assessing financial assets for collective impairment. This could be especially important when an entity does not have similar instruments but the instruments are common to other entities, or when an entity has similar instruments but no loss history. For example, a financial institution may have a loan to an entity for the ongoing operations of a large hotel, secured by the property. The financial institution may have no prior experience with hotel loans and thus have no loss history. If the financial institution assesses the loan and believes that it does not have indicators of being individually impaired, the Proposed Update is unclear if the financial institution should look to third-party loss history information for purposes of determining an appropriate allowance for credit losses. This same issue could also apply to an entity that holds a single corporate bond.

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)?

Response:

We agree that using historical loss rates (adjusted for existing economic factors and conditions) can be a useful method for determining credit impairment for loans, as most entities already maintain that data for loans and trade receivables. However, we believe that such an approach will result in a change in practice for securities, as entities do not currently assess securities on a collective basis and generally do not maintain historical loss rates. However, we acknowledge that such information is publicly available for many classes and types of securities.

Historical loss rates generally represent net annualized charge-off rates and currently may not be tracked by vintage. Therefore, historical loss rates used in existing credit impairment measurements typically do not reflect cash flows that the entity does not expect to collect over the life of the financial asset. It is unclear how an entity would adjust its annualized charge-off rates to reflect the cash flows that the entity does not expect to collect over the lives of the financial assets.

Currently, entities use the emergence period concept, which represents the average time between the loss event occurring (e.g., job loss) and discovery or confirmation of the event (e.g., first missed payment), to estimate the amount of probable incurred losses that exist at the balance sheet date that the entity is not yet aware of (i.e., an allowance for incurred but not reported losses). It is unclear how this concept should be applied in the proposed impairment model.

Because the removal of the probable threshold for determining when a loss is recognized would require entities to estimate the amount of credit loss they expect over the life of the loan, and not just the amount that has been incurred at the measurement date, it is unclear how the emergence period should be adjusted to reflect this. Should the emergence period reflect the average duration of the pool of financial assets? We do not believe so. We suggest that the Board provide additional clarification (including examples) as to the application of the proposed impairment 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?

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?

Response:

Although we see technical merit in the proposed interest income recognition model, we do not believe that the recognition of interest income should be affected by the recognition or reversal of any credit impairments. We understand that users prefer the presentation of gross interest income, as many believe that interest income should be separately presented from credit risk. Net interest margin is a common and important banking industry metric. We would support a requirement to present gross interest income (i.e., contractual interest) and gross interest expense to arrive at a net interest margin that is consistent with the current guidance. A line item could then follow the net interest margin amount that would represent the current-year portion of the amount of credit losses expected over the life of the assets (determined consistent with the method described above related to the impairment model). This approach will provide users with the amount of contractual interest, will maintain the net interest margin line item that we have today, and will recognize an entity's initial estimate of credit losses as a reduction of revenue.

The Board's proposed approach will also create operational challenges for interest income recognition on financial assets accounted for in pools. These challenges arise because credit allowances for pools will be determined at a pool-level unit of account, resulting in the need to determine a weighted-average effective interest rate for the pool that would be applied to the total amortized cost of the assets in the pool, less the pool's allowance for credit losses. Determining a weighted-average effective interest rate for the pool will be challenging, as pools are typically not static (i.e., they are open in the sense that newly originated loans can be added to pools that have similar risk characteristics). For the reasons discussed herein, we do not believe that the recognition of interest income should be affected by the recognition or reversal of any credit impairments.

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?

Response:

We believe that additional implementation guidance and illustrative examples are needed to more clearly articulate the proposed credit impairment model. This issue is crucial to the implementation of any complex standard. Additional examples could help provide further clarity, especially in relation to bridging the gap between historical loss rates and cash flows not expected to be collected over the life of the financial asset. Examples could also help illustrate the credit impairment model for collective assessments of debt securities.

Hedge Accounting**Question 56:**

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

Response:

We support the Board's efforts to simplify hedge accounting by moving from a "highly effective" standard to a "reasonably effective" standard for achieving hedge accounting. We are not particularly concerned that the Board has not defined "reasonably effective," and we hope that regulators and others would not seek to assign a specific mathematical range. We believe that hedgers are motivated by their own self-interest to construct hedge relationships that would be considered "highly effective," and we do not believe a relaxation of the standard would promote the proliferation of poor hedge designs that would place pressure on the need to define "reasonably effective." Further, we support the Board's efforts to clarify that qualitative assessments are permissible even when all terms of the derivative and the hedged item do not perfectly match. We believe this clarification reinforces the flexibility of hedge effectiveness assessment methods that were always present in the original Statement 133. Such a clarification would reduce and perhaps eliminate the need for companies to devote a significant amount of resources to perform quantitative statistical analyses such as regression to prove the effectiveness of relationships that can be easily assessed qualitatively with a minimum amount of financial intuition.

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?

Response:

We support the Board's decision to continue to require a reassessment of hedge effectiveness after inception if circumstances suggest that the hedging relationship may no longer be reasonably effective. Because a hedge must be expected to be reasonably effective over the life of a hedge relationship, and circumstances may change throughout the life of a hedge relationship that may affect its effectiveness, a subsequent reassessment of hedge effectiveness should still be required to be performed to ensure that the hedge continues to be reasonably effective if indicators suggest otherwise. In addition, we agree with the Board that hedge accounting should be discontinued if a hedge becomes ineffective. We do not believe such a requirement to be onerous, given that the standard for qualifying for hedge accounting is being revised from "highly effective" to "reasonably effective."

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 hedge relationships would be discontinued? Why or why not?

Response:

We believe the hedge effectiveness assessment provisions of the Proposed Update would result in a reduction in the number of times hedging relationships would be discontinued, but we believe this is a favorable development. We expect that the proposed effectiveness requirements would virtually resolve the "the law of small numbers" issue, which can occur during periods where the underlying to the hedge relationship is momentarily stable. Many companies today using dollar-offset assessment methodologies sometimes must terminate their hedge relationships during these periods of stability, even though the economic relationship of the derivative and the hedged item remain strong. Often, a more robust assessment methodology such as regression would have supported the continuation of such hedge relationships had the company chosen to incur the time and expense necessary to conduct such a methodology.

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?

Response:

We generally support the Board's decision to eliminate the shortcut method and references to "critical terms matching" in the literature. Further, we support the general statement that an entity should independently determine the changes in fair value of the hedged item for fair value hedges and the cumulative change in the present value of expected future cash flows on the hedged transaction. We also support the guidance proposed in paragraph 124 of the Proposed Update that reconfirms concepts from the original discussion on DIG Issue G7 that the credit risk adjustment for the hedged item in a cash flow hedge mirrors that of the actual derivative as long as the hedged cash flows are probable of occurring. Finally, we believe that the guidance proposed in paragraphs 118 and 126 of the Proposed Update would be very helpful for allowing hedgers to practically deal with slight timing differences in hedge relationships, although we are surprised to see the Board propose a model in which a known source of ineffectiveness is ignored for measurement purposes (although we recognize that such ineffectiveness is not significant to the hedging relationship, which may support such an approach). The Board may wish to clarify in its final drafting how the prohibition of a "critical terms matching" construct reconciles with paragraphs 118 and 126, in which a slight lack of matching is not viewed as an obstacle to recording no ineffectiveness. To that end, we suggest that the Board appears to recognize that it is reasonable for certain types of hedges and certain size companies to use a precision level less than the "same day" in measuring hedge ineffectiveness (perhaps "same week" or "same month," for example) when (1) the benefit of using that "same day" precision level does not outweigh the cost of such precision, and (2) the hedger has confirmed at the inception of the hedge that the forward rate differential between the use of such different precision levels is minimal.

However, there are other aspects of the proposed model for calculating ineffectiveness in a cash flow hedge that we do not support. Specifically, we do not support the recognition in earnings of "ineffectiveness" for cash flow hedges due solely to "underhedging." Further, we do not support the Board's proposal that the option premium in a cash flow hedge always should be expensed over time. Finally, it is not clear based on the Proposed Update whether, in an effort to reduce complexity, the Board intends to require that all cash flow hedgers utilize the same methodology to measure ineffectiveness, and what that methodology might be. We have expanded on these topics below.

Elimination of shortcut method and "critical terms matching" references

The shortcut method is non-operational as long as the Board believes that it must continue to include ASC 815-20-25-104(g) (formerly paragraph 68(e)) in the guidance, which can always undermine any well-intentioned application of the shortcut method, allowing it to be second-guessed. While we believe many of the restatements related to the shortcut method originated from companies attempting well-intentioned compliance with the literature, we perceive that the history of second-guessing is irreversible and that therefore elimination of the method is warranted. With respect to elimination of the term "critical terms match," we do not necessarily object, given the mythology that has developed over time that somehow "critical terms match" was an explicit "method" that allowed an inappropriate assumption of no ineffectiveness. We do not believe that Statement 133 ever created such a

methodology, and we always believed that a critical terms match approach was illustrative of an acceptable qualitative analysis. We believe that this Proposed Update will allow a similar qualitative approach, and that it represents a return to the original intent of the guidance in Statement 133.

Recognition of ineffectiveness due to “underhedging” in cash flow hedges

We do not support the Update’s proposals to record ineffectiveness for “underhedges” within the cash flow hedge accounting model. Considering the historical perspective, we believe that in 1998 the Board exhibited a significant degree of wisdom in its decisions to create a different construct for cash flow hedging and to treat overhedges differently from underhedges. We believe that cash flow hedges are markedly different than fair value hedges due to the fact that a fair value hedge includes two units of account that are recorded on the balance sheet (the hedged item and the hedging instrument) while a cash flow hedge has only a single unit of account recorded on the balance sheet (the hedging instrument). Consistent with this “single unit of account concept,” the Board has previously noted that “there is no conceptual basis for providing special accounting for cash flow hedges other than achieving a synthetic instrument accounting result.”²⁶ Keeping that in mind, in 1998, the Board considered the issue of recording ineffectiveness due to “underhedging” in a cash flow hedge. In doing so, the Board concluded that such an approach was not appropriate because “the result would be to defer in OCI a nonexistent gain or loss on the derivative and to recognize in earnings an offsetting nonexistent loss or gain.”²⁷ As we expressed in our comment letter on the 2008 ED, we continue to support the Board’s 1998 decision that underhedges in a cash flow relationship should not be reported as hedge ineffectiveness. In a cash flow hedge scenario, a model that records ineffectiveness for underhedges inherently imagines that the hedged item is a recognized asset or liability (which it is not) and gives accounting recognition to “phantom” gains and losses that in theory represent lost opportunities. Such information is of questionable forward-looking benefit to the user, and does not seem to represent meaningful information with respect to management’s performance from a backward-looking perspective. Without entering into the debate of whether hedge accounting should be permitted for cash flow hedges, we challenge how the proposal is not worse from a conceptual viewpoint.

Uncertainty and questions regarding the method for calculating ineffectiveness in cash flow hedges

For cash flow hedges, it is unclear whether the Proposed Update requires a specific approach to measuring hedge ineffectiveness, or whether multiple methods of measuring hedge ineffectiveness will continue to be permitted, as currently provided for in ASC 815. We agree that complexity would be reduced and compliance with the documentation requirements automatically enhanced if all entities were required to use the same method for measuring cash flow hedge ineffectiveness. From our experience, the prevailing practice by hedgers is to utilize the “hypothetical derivative method.” We would support embracing that method as the single method to be utilized by all cash flow hedgers. Further, based on the language included in paragraph 122, it is unclear which method the Proposed Update is requiring hedgers to utilize, as the verbiage includes components of both the current “change in fair value method” and the “hypothetical derivative method” from ASC 815. We urge the Board to clarify its intent on this matter.

²⁶ Paragraph A30 of the 2008 ED, with similar comments in paragraphs 327-328 of Statement 133’s Basis for Conclusions.

²⁷ Paragraph 379 of Statement 133’s Basis for Conclusions.

Recognizing that the ordering of words does matter, we would like to point out that the reference in paragraph 122 to the “present value of the cumulative change in expected future cash flows on the hedged transaction [emphasis added]” preserves confusing verbiage from the “Change in Fair Value Method” (i.e., Method 3) as codified in ASC 815-30-35-31 through 35-32. In our experience, most preparers who use Method 3 look to the “cumulative change in the present value of expected future cash flows” in preparing their Method 3 calculation, which is consistent with the word order in ASC 815-30-55-35 (formerly paragraph 141 of Statement 133), which illustrates Method 3 numerically. Briefly, the “present value of the change” and the “change in present value” are markedly different calculations. Specifically, the verbiage in paragraph 122 (i.e., the present value of the change) executes a single present value calculation by discounting the change in cash flows using only the end-of-period yield curve. This amount is then compared to the change in fair value of the derivative, which executes two present value calculations by (a) discounting the cash flows as of the beginning of the period, (b) discounting the cash flows as of the end of the period, and calculating the difference between those two present value (and in this case, fair value) figures. We do not believe the “apples to oranges” comparison suggested by the verbiage carried forward to paragraph 122 of the Proposed Update (i.e., the “present value of the cumulative change”) has as sound of a financial theoretical basis as using the “cumulative change in present value” and urge the Board to neither preserve nor impose such a method, given the less-than-sound theoretical basis upon which it rests. In practice, we are aware that Method 3 is the least used of the methods available, and that the “change in present value” approach is used by the overwhelming majority of hedgers using Method 3, as that approach (a) is consistent with the illustration in ASC 815-30-55-35 and (b) has a sound theoretical basis from a financial perspective. To the extent the Board is interested, we have illustrated this difference in Example 11 of Chapter 6 in our publicly available *Financial Reporting Developments, Derivatives and Hedge Accounting (December 2009)*. We would be happy to provide a copy or discuss this nuanced, but important, distinction further at the Board or its Staff’s convenience.

Expensing of option premium for cash flow hedges

We do not support the Board’s proposal in paragraph 125 of the Proposed Update that would require hedgers to expense on a “rational basis” the cost of an option if measuring effectiveness based on total changes in the option’s cash flows (as opposed to based on the option’s intrinsic value). However, we would support this methodology as a pre-documented accounting policy election.

We have both theoretical and operational concerns with expensing the option premium on a “rational basis.” From a theoretical perspective, we believe the proposal would eliminate the current symmetry between the accounting for the use of (a) an option and (b) a forward in a cash flow hedge. Specifically, the cash flow model currently allows the “cost” of hedging with a forward contract (i.e., the time value element that distinguishes between the spot rate and the forward rate) to be included as part of hedge effectiveness and recognized at the same time as the hedged item affects earnings. The Board’s proposal would eliminate this symmetry with forward contracts and treat options differently, forcing certain portions of the option’s “cost” to be recognized before the hedged item affects reported earnings. Given that the Board originally decided to allow hedgers to choose whether to include or exclude the time value of an option or forward in the assessment and measurement of ineffectiveness, we do not see how the Board’s current proposal to eliminate the symmetry between the cash flow hedge accounting for using options and cash flow hedge accounting using forward contracts benefits the users of the financial statements.

On a more practical operational level, there are numerous concerns with expensing the option premium on a “rational basis,” including (a) the question of whether straight-line expensing is “rational,” considering that from an economic perspective, the decay of time value in an option is not constant, and (b) how any intrinsic value present in the option contract at inception would interact with the computation of “cost of the option,” considering that the intrinsic value of an option affects that option’s time value, such that the time value of an option differs when the option is “at,” “in,” or “out” of the money at inception. We believe these theoretical and operational challenges were part of the Board’s original thinking when it concluded in Statement 133 (and later as part of DIG Issue G20) that the decay of such amounts may be included in the effective portion of a cash flow hedge. We do not believe that any perceived theoretical benefits of such a change (of which we are not aware) would warrant the costs to hedgers of operationally dealing with these practical issues.

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?

Response:

We do not foresee any significant operational concerns for constituents in creating processes that will determine when circumstances suggest that a hedging relationship may no longer be reasonably effective.

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?

Response:

We disagree with the proposal in paragraphs 119 through 121 of the Proposed Update that would eliminate an entity’s ability to voluntarily remove the designation of an effective hedging relationship after it has been established. Effectively, this change will eliminate voluntary de-designations and will require hedge accounting to continue until either the derivative or the hedged item no longer exists (or is no longer probable), or until the hedge is no longer expected to be reasonably effective. As the Proposed Update acknowledges, any entity can achieve a de-designation under the proposal by terminating the derivative. This proposed change will increase transaction costs for entities that use dynamic hedging strategies; that is, that seek to reuse derivatives that formerly were in hedge relationships in new hedge relationships, or move them into trading portfolios. We do not believe that the benefits of this change (as described below) outweigh the costs of implementing the change.

This proposed guidance, when originally drafted in 2008, was somewhat surprising in that the notion of voluntary de-designations had not been previously highlighted as a particularly complex element of ASC 815, nor had it been the center of restatement controversies, nor had it been called out as an

earnings management concern by users of the financial statements. We are unaware that voluntary de-designations have ever been a practice problem, the source of diversity of applications, an issue with auditors and regulators, or an instance of abuse. Many de-designations that the Board may believe are voluntary are not. We often see dynamic hedging strategies of portfolios of loans held for sale. Often these hedges are de-designated and re-designated every day. However, ASC 815 requires such de-designations if even one loan in the portfolio pays off or is sold, or if one new loan is added to the portfolio.

We understand that the root of this proposal relates to the Board's concerns about potential earnings management. Specifically, concerns have been expressed that banking institutions may seek to manage their net interest income and net cash flows in a given period by entering into receive-fixed interest rate swaps (to increase their net interest income or cash flow in the current period) or pay-fixed interest rate swaps (to decrease their net interest income or cash flow in the current period). This phenomenon occurs when the yield curve is upward-sloping (as is typically the case) because the blended fixed-rate swap rate is greater than the then-current variable rate at the inception of a hedge (i.e., the fixed rate blends the cash flows on the upward-sloping yield curve, which benefits the fixed-rate receiver in the early periods only to offset that benefit in later periods). It is argued that this allows an entity to increase or decrease cash flows and interest income or interest expense, respectively, and record the offset in other comprehensive income (when cash flow hedge accounting is utilized) or gain/loss on derivative (when no hedge accounting is applied).

We do not support this proposal because we challenge whether this is a serious problem that needs to be addressed, because the proposed "fix" will not change the accounting arbitrage that the Board appears to believe is abusive, and because the proposal is an overreaction in that it would unfairly affect single cash flow forward and option contracts, where such issues are not present. Specifically, given that de-designations currently must occur contemporaneously (that is, without the benefit of being able to reliably predict the derivative's subsequent changes in fair value), we question whether de-designations actually represent a particularly effective tool to manage earnings. Any use of swaps to manage interest rate margin for short-term gain is inherently discouraged by the "whipsaw" effect of the "back end" of the swap, which cannot be avoided by de-designating, because the amount remaining in OCI (or in the carrying value adjustment of the debt instrument for fair value hedges) will still impact future earnings even after a de-designation.

In addition, we note that the proposed change would not necessarily eliminate this practice, as an entity could still cash out of a swap in later periods and achieve the same result. Finally, even if the Board believes that this is a serious problem that needs to be addressed, and believes that this proposal addresses the issue for swaps, we challenge whether the extension of this proposal to all hedging instruments (e.g., options and forwards with single cash flows at settlement) is appropriate, as such instruments do not provide the same forward-curve averaging recognition opportunity as do swap instruments.

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?

Response:

While we conceptually disagree with eliminating a hedger's ability to voluntarily de-designate a hedge (as described in the response to Question 63), apart from the inherent documentation and process burden for preparers, we do not 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.

However, paragraphs 120 and 121 of the Proposed Update do need to be clarified. Currently, derivatives are "effectively terminated" by entering into offsetting derivatives at market (e.g., no transaction price) that neutralize the floating leg, resulting in a fixed annuity to be paid over the remaining life from the party in the loss position to the party in the gain position when the original derivative and the offsetting derivative are viewed in unison. We cannot tell if paragraph 120 is permitting this practice to constitute an "effective termination" or not.

Paragraph 121 states that adding a derivative to an existing hedging relationship "would not result in the termination of the hedging relationship, although the documentation for the hedging relationship would need to be updated." We believe the paragraph intends to say that adding a derivative to an existing hedging relationship does not result in "a *prohibited* termination of the hedging relationship as described in paragraph 119." Such an addition *does* result in the termination of the original hedge relationship, because ASC 815 requires that hedge relationships be specific to exact derivatives, formally documented. Changing the composition of the derivatives in a hedging relationship always results in the termination of the original relationship, necessitating all-new hedge documentation and hedge effectiveness assessments.

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?

Response:

Overall, we support the Board's efforts to enhance the disclosure requirements and believe such requirements provide useful information to those seeking to analyze an entity's exposure to risks from financial instruments. However, while we agree with the objective to improve transparency surrounding financial instruments, we believe that the Board should complete the overall disclosure framework project before new disclosure requirements are imposed on a piecemeal basis across various accounting standards.

Effective date and transition

Question 68:

Do you agree with the transition provision in this Proposed Update? If not, why not?

Question 71:

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

Response:

We agree with the Board's proposal to require a cumulative-effect adjustment to the balance sheet immediately before the effective date, with that balance sheet restated in the first set of financial statements issued after the effective date. While we believe that an adjustment to all prior-period financial statements (e.g., income statements, cash flow statements, statements of changes in equity) presented for comparative purposes to reflect the period-specific effects of applying the new guidance would provide users the most meaningful comparable information, given the scope and breadth of the proposed changes, we believe it would be onerous.

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 not?

Response:

We believe that a long implementation period should be provided for all entities, not just smaller ones. If the Board believes there are significant challenges to implementing the Proposed Update, then all entities should be given the same period of time to implement it.

We do not agree with the proposed delayed effective date for certain aspects of the proposed guidance for non-public entities with less than \$1 billion in total consolidated assets. We believe that the \$1 billion threshold is a bright-line and rule-based criterion and could result in an entity becoming subject to the proposed guidance in any year during the four-year deferral if it crosses the threshold. This may require an entity to adopt the new guidance in a very short time frame.

We also believe that larger entities should not be used as a testing ground to determine whether the guidance in the Proposed Update is operational. While larger entities tend to be more sophisticated and have more resources to adopt a complex standard, they also tend to be more complicated and deal with financial instruments much larger in size, volume and complexity than smaller entities. These complex instruments present their own set of unique challenges. Also, the delayed effective date will apply to the vast majority of banks in the United States, many of which face the same issues that the Proposed Update is meant to address.

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

Although this is a question best answered by preparers, given the magnitude and complexity of changes proposed, we believe that implementation of the proposed guidance would require significant commitment of resources (e.g., personnel, systems) from the preparers' perspective. The time required for implementation would depend upon the complexity and size of an entity's financial instruments portfolio, but in our view the implementation effort could take several years.

We also believe that the significantly changing regulatory landscape (e.g., financial regulatory reform) coupled with unprecedented and expedited changes in accounting guidance are posing extensive administrative burdens on the resources of many entities. The Board should accordingly try to balance the time frame for new guidance to address urgent reporting issues with the cost and effort involved to achieve the same.