American Institute of CPAs
1211 Avenue of the Americas
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September 30, 2010

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

Re: File Reference No. 1810-100; Exposure Draft of a Proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*

Dear Mr. Golden:

The Financial Reporting Executive Committee (FinREC), formerly known as the Accounting Standards Executive Committee (AcSEC), of the American Institute of Certified Public Accountants appreciates the opportunity to comment on the Exposure Draft of a Proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* (the ED). FinREC shares the Board's concern about providing financial statement users with a more timely and representative depiction of an entity's involvement in financial instruments, while reducing complexity in accounting for those instruments. FinREC also supports the FASB's efforts to achieve greater convergence with the IASB. However, we believe that changes are needed in the proposed ED in order to achieve those important objectives more effectively.

We support a mixed attribute model for financial instruments over the "fair-value-for-almost-all-financial-instruments" approach proposed by the FASB. Through the utilization of fair value and amortized cost, the mixed attribute model allows the measurement and reporting of financial instruments to reflect the way these instruments are actually managed. FinREC agrees with the comments of dissenting FASB Board members who stated (in paragraph BC244) they, "… dissent from several aspects of the proposed guidance, primarily because it would introduce fair value accounting for some nonmarketable, plain-vanilla instruments that are held for collection (long-term investment), and most liabilities held for payment, which they believe would not reflect the likely realization of those items in cash and, therefore, would not be the most relevant way to measure those items in the statement of financial position and comprehensive income."

In our view, which mainly represents the perspectives of auditors and preparers but also some users, the IASB's mixed attribute classification and measurement model for financial instruments, included in International Financial Reporting Standards (IFRS) 9, *Financial Instruments*, and in the Exposure Draft, *Fair Value Option for Financial Liabilities*, and IAS 39, *Financial Instruments: Recognition and Measurement*, is generally superior to that of the FASB's proposed classification and measurement model. However, there are some aspects of the IASB's classification and measurement model that we do not support. In addition, we are opposed to the IASB's financial assets impairment model as proposed in the Exposure Draft, *Financial Instruments: Amortised Cost and Impairment*, and we also disagree with the FASB's proposed credit impairment model.

FinREC believes that the FASB's credit impairment model is impracticable and would be extremely difficult to implement as it mixes together interest income and the allowance for credit losses. These risks are managed separately and users may not find this mixed presentation useful in analyzing a reporting entity's results of operations. We recommend that the FASB retain the incurred loss model, but lower the threshold for when credit losses should be recognized from probable to more-likely-than-not. However, if our recommendations for retaining and improving an incurred loss impairment model are not accepted, we believe the FASB and IASB should work together on a single impairment model that would require the use of expectations for a reasonable period into the future (up to the full life of the asset). In addition, we believe that the impairment methodology should not make a distinction between assets that are originated and those that are purchased.

Further, we believe interest income recognition should be based on the financial asset's effective interest rate applied to the amortized cost balance, rather than amortized cost net of any allowance for credit losses as this provides a more accurate portrayal of the economic yield associated with the security and is not currently an area of U.S. generally accepted accounting principles (GAAP) that has been subject to debate or concerns by users. The accounting for the allowance for credit losses should not be commingled with the accounting for interest income. Also, we believe that the same interest income recognition model should apply to all impaired assets, regardless of whether the assets are evaluated for impairment on an individual or a pool basis.

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Although some changes are needed, we generally support the ED's provisions related to hedge accounting, including hedge designation by type of risk, requiring hedges to be reasonably effective rather than highly effective, and also support a qualitative effectiveness assessment instead of the current quantitative assessment. We believe that these changes would succeed in reducing complexity in this currently very complex area. However, we do not understand why hedge dedesignations without terminating the hedging instrument would not be allowed. Dedesignation and redesignation of hedge relationships reflects the dynamic nature of hedging as a prudent risk management practice. Prohibiting dedesignation only limits management's ability to manage risks through changing economic environments and balance sheet composition. Further, even though dedesignation is prohibited under the ED, it would be achievable anyway by terminating the hedging instrument, although at increased complexity and cost to the entity.

Finally, we do not support the proposed ED overall because it fails to achieve convergence on fundamental issues in a very significant area of GAAP. Without convergence, financial statements of U.S. companies reporting under U.S. GAAP and foreign companies reporting under IFRS would not be comparable. Additionally, when or if the SEC sets a date for the adoption of IFRS by U.S. registrants, we are very concerned that U.S. GAAP registrants will be required to implement significant changes in U.S. accounting standards for financial instruments that are not convergent with IFRS and shortly thereafter be required to undertake a second significant implementation effort when adopting IFRS. We encourage the FASB and IASB to work together on the financial instruments standard and reconcile the differences in their models. While both the FASB and IASB need to work together to arrive at a single converged standard for financial instruments, we believe that the FASB's classification and measurement model with its failure to reflect how businesses are managed has more serious deficiencies that should be changed in the convergence process. Therefore, we encourage convergence in this area towards the IASB model.
Our more specific comments as well as suggested improvements to the ED are provided in the enclosed attachment.

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We thank the Board for its consideration and would welcome the opportunity to further discuss this matter with Board members and their staff.

Sincerely,

September 30, 2010

Mr. Russell G. Golden
Technical Director
Financial Accounting Standards Board

Jay Hanson
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Attachment

General Comments

Convergence

> We realize that achieving convergence in accounting for financial instruments is a priority for the FASB and IASB. However, the provisions of the IASB's IFRS 9 on classification and measurement of financial assets, Exposure Drafts, *Financial Instruments: Amortised Cost and Impairment* and *Fair Value Option for Financial Liabilities*, and the FASB's proposals in the most important areas, such as financial instrument classification, measurement and impairment, are significantly divergent. If the goal of a single set of global high quality standards is to be achieved, a key area is convergence in the accounting for financial instruments. If the FASB and IASB finalize different models for financial instruments, the costs to financial institutions and other global parent companies with consolidated subsidiaries that apply IFRS for local reporting would be enormous. Moreover, financial statements of U.S. companies reporting under U.S. GAAP and foreign companies reporting under IFRS would not be comparable. With the SEC working on a timetable for the eventual adoption of IFRS for U.S. registrants, we are very concerned that U.S. GAAP registrants will be required to implement significant changes in U.S. accounting standards for financial instruments that are not convergent with IFRS and shortly thereafter be required to undertake a second significant implementation effort when adopting IFRS.

With respect to classification and measurement, IFRS 9 requires financial assets to be measured at amortized cost if:

1. The objective of the entity's business model is to hold the asset to collect the contractual cash flows.
2. The asset's contractual cash flows are solely payments of principal and interest.

For equity instruments that are not held for trading, an entity can make an irrevocable election at initial recognition to measure the equity instruments at fair value with changes in fair value recognized in Other Comprehensive Income (OCI). The remaining financial assets that do not meet any of these criteria are required to be measured at fair value through net income.
Most financial liabilities under the IASB's classification and measurement model, unless the fair value option is applied or the liabilities are held for trading, must be measured at amortized cost.

We believe that the IASB's mixed attribute classification and measurement model, overall, is conceptually superior to the FASB's proposed fair-value-for-almost-all-financial-instruments approach, because it better reflects the way businesses are managed. Therefore, we encourage convergence in this area towards the IASB model. However, we do not support the IASB's model in its entirety. The following are the two main areas where we disagree with the classification and measurement guidance issued by IASB:

- Bifurcation of an embedded derivative. In the IASB's proposed guidance on the fair value option for financial liabilities, if the host is a financial liability or a non-financial item, the bifurcation requirements in IAS 39 continue to apply. However, according to IFRS 9, there will be no bifurcation of an embedded derivative allowed where the host is a financial asset. We believe that bifurcation of an embedded derivative should be allowed regardless of whether the host is a financial asset or liability (see our comments regarding bifurcation in the section below entitled "*Bifurcation and Embedded Derivatives"*)**.**
- Recycling.[1] According to IFRS 9, an entity can elect on initial recognition to present the fair value changes of an equity investment that is not held for trading directly in OCI. While dividends on such instruments are recognized in income, realized gains and losses are never recycled. Also, in their Exposure Draft, *Fair Value Option for Financial Liabilities*, the IASB proposes that changes in fair value related to own credit risk should be recorded in OCI for liabilities classified as fair value through profit and loss, but without subsequent reclassification of the impact of changes in own credit risk from OCI to earnings. We believe realized gains or losses should always be recorded in earnings rather than left permanently in OCI. Our view is that in both cases, a gain or loss recognized in OCI should be recycled to earnings at the time it is realized when the equity security is sold or the liability extinguished.

In addition, we are concerned that FASB's model allows no reclassification from the fair value through OCI category to the fair value through net income category if an entity's business model changes. We support the IASB's classification and measurement model that would allow such reclassifications, along with an enhanced disclosure requirement regarding the rationale for the business model change and the reclassification impact.

Even if the FASB decides not to follow our recommendation of adopting the IASB's classification and measurement model for financial instruments, we believe that it is still crucial that the FASB and IASB work together to come up with a single converged standard for financial instruments.

Reducing Complexity

[1] Recycling refers to the recording in net income of changes in value that were previously recorded in OCI so that all OCI balances will eventually be reversed through net income, usually at the time of settlement. The IASB model does not support recycling and, as described below in this letter, would leave certain gains and losses in OCI permanently.

We support the Board's goal of providing financial statement users with a more timely and representative depiction of an entity's business model, while reducing complexity in accounting. However, we believe that changes are needed in the proposed ED in order to achieve those important objectives more effectively.

We do not believe the ED reduces complexity in accounting for financial instruments. While it does provide a single classification and measurement model that applies to both loans and securities and an impairment approach that is consistent for loans and securities reported at fair value with changes in fair value recorded in OCI, the ED requires entities to maintain two separate accounting and reporting systems (amortized cost and fair value through OCI) for instruments classified as fair value with changes in fair value recorded in OCI. This requirement adds complexity and significant costs for preparers because for instruments, such as loans, which are currently presented at amortized cost but will qualify for fair value measurement through OCI, the ED requires that fair value accounting and reporting be added to the reporting systems, while still maintaining the full amortized cost and credit impairment model. Although fair value information is currently disclosed, it is often prepared using manual processes performed outside of core loan processing and general ledger systems. This added requirement would require entities to expand systems capabilities for seemingly limited benefits to users of financial statements.

The ED also adds complexity by creating a new remeasurement method for core deposits and proposing to continue three distinct impairment approaches for financial assets (one for pooled assets, one for individually assessed assets, and one for purchased assets with a discount related to credit quality). Moreover, the ED introduces a complex methodology for reporting interest income that commingles credit and interest rate risk, which we believe will be confusing and not helpful to users.

Availability of Fair Value Information

Fair value is already a required disclosure today for financial instruments measured at amortized cost. The fair value information for such instruments is required to be disclosed in the notes. We understand that one of the reasons the FASB supports fair value through OCI as a financial statement measurement, rather than disclosure for instruments measured at amortized cost today, is the current delay in the presentation of fair value information for those financial assets and liabilities until the quarterly and annual filings of Forms 10-Q and 10-K . Some assert that if those financial instruments were measured at fair value in the financial statements, investors would receive fair value information earlier; at the time companies release their earnings, rather than having to wait until financial statements are issued quarterly and annually.

While we understand the desire for more timely information, we envision this could have a reverse effect. We are concerned that the requirement to provide fair value information would cause a delay in releasing earnings due to the additional time needed to produce and validate fair values for almost all financial instruments. For instruments without readily available market prices that are carried at amortized cost today, fair value is not included in the general ledger and is one of the last items to be determined before financial statements are issued. We believe the early availability of fair value data is particularly problematic for smaller financial institutions, such as community banks, which usually obtain their fair value information for financial instruments from third-party valuation companies just before issuing their quarterly or annual financial statements. Accordingly, we believe that the assumption about fair value being made available to investors significantly earlier than today may be incorrect.

Users' Views

There are indications that many users do not support a fair value model for all financial instruments. For example, a PricewaterhouseCoopers survey, entitled *What investment professionals say about financial instrument reporting* (see the survey at the following link: http://www.pwc.com/gx/en/audit-services/publications/financial-instruments-reporting.jhtml), which interviewed 62 investors and analysts, indicated that a majority of respondents across geographies and industry sectors favored a mixed measurement model with fair value measurement for shorter lived instruments and amortized cost reporting for longer lived instruments, such as loans and deposits. While the respondents did express a desire for improved fair value disclosures (which FinREC believes would be beneficial), they think it is important to keep net income free from fair value movements in instruments that are held for long-term cash flows rather than short-term trading gains.

<u>Classification and Measurement</u>

Business Model

FinREC supports a mixed attribute model that utilizes a combination of fair value and amortized cost. The mixed attribute model allows the measurement and reporting of financial instruments to reflect the way these instruments are actually managed. Not all companies follow the same business model. For example, even though investment/corporate banks and commercial banks/thrifts/credit unions are all financial institutions, they are not managed the same way. While investment banks are involved in more active trading of assets and liabilities, assets held by commercial banks, thrifts and credit unions are mainly funded by deposits and held longer term. Similarly, insurance companies' assets are held longer term and their portfolio is designed to provide funding for expected payouts on claims.

The FASB describes its model as a business activity-based model in paragraphs IG35 and IG36; however, the criterion to qualify for fair value through OCI accounting in paragraph 21(b) is based on an individual asset or liability assessment. Paragraph BC96 also confuses management of a portfolio with management of a single asset or liability. We recommend that the Board conform its language in paragraph 21(b) and also in the Basis for Conclusions to the Implementation Guidance, since companies do not manage a business activity one asset or liability at a time. Rather, they manage entire portfolios of financial instruments together. For businesses that are managed for cash flow purposes and not for trading purposes, at the time an asset is purchased or originated or a liability is issued, it is not possible to identify or predict which asset may ultimately be sold or which liability may be settled before maturity.

If an entity's underlying strategy for a portfolio of financial instruments is to actively trade and benefit from short-term variations in the value of financial instruments, it is appropriate for the entity to fair value such instruments and record fair value changes through net income because fair value represents the most relevant information for financial statement users. However, when an entity does not manage instruments on a fair value basis, amortized cost, which includes adjustments to reflect credit impairment, is the most appropriate way to estimate future cash flows. If a portfolio of financial instruments is held (or issued) by a business with a strategy to collect (or pay) principal and interest cash flows on an ongoing basis over time without the intent to profit from the expected short-term market movements, amortized cost is the most relevant measurement attribute. Moreover, amortized cost information provides users with the ability to forecast cash flows related to those assets and liabilities.
We are concerned that the requirement to use and report fair value as a measurement basis for assets and liabilities intended to be held longer term would result in artificial volatility in earnings or accumulated other comprehensive income. We believe that using fair value as the measurement basis for most financial instruments would give investors a false sense of comparability among financial statements of different types of companies and even across companies in the same industry (especially different financial institutions), since that presentation does not reflect how the financial instruments and companies are managed in practice. We believe FASB's fair value through OCI alternative would instead distort the results of an entity's business strategy for non-trading activities. While we believe fair value information should be disclosed in the footnotes or parenthetically on the balance sheet, its use as the default method in the financial statements would not result in the most useful reporting from the perspective of financial statement users.

We support IASB's mixed attribute classification and measurement model as it allows the measurement and reporting of financial instruments to reflect the nature of the business activities and the way these instruments are actually managed.

Lack of symmetry

The proposed model in the ED creates a lack of symmetry between debt security/loan and deposit accounting. According to the ED, all debt securities and loans should be measured at fair value with changes in fair value recorded in net income or, if they meet the relevant criteria, in OCI. However, for core deposits, which may be a significant portion of total deposits, the ED requires a remeasurement method that arrives at the present value of core deposits at each balance sheet date by discounting the average core deposit balances during the period using a discount rate that is the difference between the alternative funds rate and the all-in-cost-to-service rate. We disagree with this proposed remeasurement method (refer to our comments under the section *Exceptions to the Subsequent Measurement Principle – Demand Deposit Liabilities*). Since financial assets held by commercial banks, thrifts and credit unions are largely funded by deposits, we do not believe core deposits should be measured differently than other deposits. The measurement of all deposits should be at amortized cost. Given that we also believe the most appropriate measurement for loans held for the collection of interest and principal is amortized cost, we believe the same measurement basis should be available for deposits as well.

Bifurcation and Embedded Derivatives

For the classification of hybrid instruments for subsequent measurement, the ED carries forward the rules in current GAAP for determining whether an embedded derivative in a hybrid instrument needs to be bifurcated from the host and accounted for separately. If the hybrid instrument requires bifurcation under the current U.S. GAAP criteria, the ED requires the entire hybrid to be measured at fair value with changes in fair value recorded in net income. Under the ED, if no bifurcation is required, the entire hybrid instrument could qualify for fair value classification with changes in fair value recorded in OCI. However, despite retaining the bifurcation criteria, the ED eliminates an entity's ability to actually bifurcate the embedded derivative from the host contract and account for the two parts separately. We disagree with this provision and ask that the Board continue to allow bifurcation and separate accounting for hybrid instruments (both assets and liabilities). The ability to bifurcate is necessary because the existence of insignificant embedded derivatives (or "de minimus" embedded derivatives as described in the following paragraph) would cause the entire hybrid instrument to be classified as fair value through net income. We believe that entities should be allowed to bifurcate such an embedded derivative and apply separate measurement criteria to the host and the embedded feature.

Alternatively, if the Board disagrees with allowing bifurcation for hybrids, we ask that the FASB introduce a concept of "de minimus" for embedded derivatives. A hybrid instrument containing a de minimus embedded derivative should be exempt from the requirement to be bifurcated even if it would otherwise have to be bifurcated. For example, many financial instruments include settlement clauses contingent upon an IPO or as a result of adverse developments in the tax law. While these clauses are very common, the value of such an embedded feature is close to zero, based on the very low probability attributable to the occurrence of the contingency. We ask that the Board specify a principle for recognizing a de minimus embedded derivative, which would not trigger a requirement to classify the entire hybrid in fair value with changes recorded in net income.

Scope

We believe that loan commitments, letters of credit, and financial guarantees should be excluded from the scope, because accounting for these instruments under the FASB's proposed approach as illustrated in the Implementation Guidance would become very complicated. Also, we are not convinced a change in accounting is needed, since we are not aware of any current practice problems in the area of accounting for these instruments, nor concerns expressed by users. Additionally, scoping them out would conform the scope of the FASB's financial instruments project to that of the IASB.

We agree with the rest of the proposed scope and scope exceptions in the ED.

Glossary

All-In-Cost-To-Service Rate - We believe that the definition of the all-in-cost-to-service rate needs to be clarified if the FASB decides to retain the proposed core deposit remeasurement method. Specifically, the expense of maintaining a branch network can vary significantly depending on which costs are included or excluded. We believe it would be helpful to clarify whether FDIC insurance premiums and ATM costs, for example, should be included in the branch network maintenance expense.

Amortized Cost – The definition of the amortized cost in the ED includes, among other adjustments, amortization or accretion of any original issue discount or premium. The definition of amortized cost should also include a purchased discount or premium.

Financial Assets Evaluated for Impairment Individually – Please note that this comment is not related to any of the terms defined in the glossary of the ED. According to paragraph 62 of the ED, which applies to financial assets evaluated for credit impairment individually, “If the present value of cash flows expected to be collected is less than the amortized cost of the financial asset, an entity shall recognize a credit impairment in net income and establish an allowance for credit losses.” We believe this sentence omits the term “accrued interest,” which needs to be added to the amortized cost for the purposes of evaluating whether an allowance for credit losses for a financial asset is required. We suggest correcting that sentence in paragraph 62 as follows (suggested insertion underlined): “If the present value of cash flows expected to be collected is less than the amortized cost plus accrued interest ~~of~~ on the financial asset, an entity shall recognize a credit impairment in net income and establish an allowance for credit losses.”

Subsequent Measurement

Clarification Regarding Qualification for Fair Value With Changes Recognized in OCI (or Qualification for Amortized Cost)

As stated above, we disagree with the requirement to recognize a change in fair value in OCI for debt instruments held for the collection or payment of cash flows and believe that such instruments should be measured at amortized cost. We also think that additional clarification is needed regarding measurement criteria to determine which instruments are, and which ones are not, required to be measured at fair value with changes in fair value recorded in net income.

The FASB’s criteria for allowing the alternative to fair value through net income accounting classification effectively requires evaluation of the entity’s business strategy for the individual financial instrument. As we noted above, we recommend that the Board conform its language in paragraph 21(b) and also in the Basis for Conclusions, paragraph BC96, to the Implementation Guidance, paragraphs IG35 and IG36, which properly describes a business strategy. This is a significant problem for many entities, including all financial institutions, since financial instruments are generally managed on a portfolio, rather than an individual instrument, basis. For example, a financial institution managing structural interest rate risk performs its risk management activities through the purchase and sale of investment securities. While securities used for risk management may be held for long periods of time, changing economic factors (e.g., reduced liquidity in certain markets, recessions) and balance sheet composition (e.g., increase in lending, business combinations) may require the sale of some securities prior to the end of their contractual or expected lives. Such sales do not represent a change in business strategy to hold similar securities for the long term, but represent a risk management reaction to a significant market or business change in order to keep risk within defined parameters. We do not believe that the details of this prudent risk management activity fit into the criteria of the proposed model for fair value through OCI accounting.

Since financial instruments are usually managed on a portfolio rather than individual basis, we believe the proposed criteria for fair value through OCI classification (which we believe should be at amortized cost as in the IASB's classification and measurement model) are too restrictive and do not properly take into account business practices for managing non-trading activities. As discussed in BC97, we understand the Board's objective is to eliminate the tainting notion. However, we envision a number of implementation issues, including the following example: the proposed criteria that all instruments classified as fair value through OCI would need to be held near to maturity or prepayment, since it is unclear how often an entity can sell any instruments from the "held to collect or pay contractual cash flows" portfolio. We believe that an entity should be allowed to sell some of the instruments from such a portfolio, while the overall holding strategy for the entire portfolio does not change. We recommend that the FASB identify a principle to use when evaluating what amount of portfolio turnover (i.e., the rate at which existing instruments may be sold and new instruments added to the portfolio) is acceptable without disqualifying the individual (or pool of) financial asset(s) for the fair value through OCI classification. As part of that clarification, the ED should specify whether the requirement to hold a security for a substantial portion of the contract's term refers to contractual maturity or expected maturity.

The ED should also clarify whether an entity would be allowed to liquidate the entire portfolio of financial assets in situations where the strategy to hold a portfolio of financial assets has changed during the holding period (and therefore the strategy to hold has changed for individual assets as well), or whether there is some type of "tainting" involved that would require fair value through net income classification by the entity for all assets and liabilities in the future. While we are not seeking bright lines, we are seeking some incremental implementation guidance and recognition by the FASB of how non-trading portfolios are managed.

Management of Non-trading Risks

Certain risk measures are more useful than fair value for managing specific financial risks. For example, structural interest rate risk is often managed using "earnings at risk" measures focused primarily on earnings sensitivities to changes in current and anticipated interest rate curves. These types of earnings sensitivities can be a more useful measure than fair value, because changes in margin (the spread between interest rates earned on assets and paid on liabilities) or near term cash flows as a result of market, business and economic factors are more transparent than when using fair value measures. Since the risk management is defined by margin and not fair value, requiring fair value measurement through net income or OCI would not best represent the actual underlying risk management activities being employed.

Application to Specialized Industries - Investment Companies

Investment companies include transaction fees and costs in the cost basis of securities purchased and deduct transaction fees and costs from the proceeds of securities sold. While these costs are not recognized as an expense in a fund's statement of operations, they are immediately deducted from the fund's net assets, either increasing unrealized depreciation (decreasing unrealized appreciation) on purchases or decreasing realized gains (increasing realized losses) on sales. These amounts are reflected in a mutual fund's net increase (decrease) in net assets resulting from operations.

The Basis for Conclusions indicates that the Board believes transaction costs should be reflected as current period expenses, rather than capitalized and deferred, because such costs do not directly relate to the financial asset or liability's fair value. We note that existing investment company GAAP does not enable funds to capitalize and defer transaction costs. As described above, these costs are immediately recorded in a fund's results of operations by including them in the gain or loss on the fund's investment securities. Funds' measurement of their investment securities at fair value is entirely consistent with Topic 820 in that transaction fees and costs are not included within the fair value of the security.

At issue is whether transaction fees and costs should be recognized as an explicit expense in the statement of operations, as the Board has suggested in Question 11, or whether such fees and costs should be included in the gains or losses on the fund's investment portfolio, consistent with current practice. We believe transaction fees and costs should not be expensed for the reasons described below:

- Current accounting recognizes transaction costs and fees as the cost of purchasing and selling portfolio securities – as opposed to a recurring operating expense – and causes these costs and fees to be recorded as a loss on investments when presenting gain/loss on the statement of operations.[2] Transaction fees and costs are inextricably linked to the acquisition and sale of investment securities and must be offset against the portfolio in order to present an accurate assessment of the gain/loss from investing activities. The ED would inappropriately characterize these fees and costs as recurring operating expenses, similar to management, shareholder servicing, and other ongoing expenses;

[2] *See* Topic 946-320-40-1.

- Portfolio transactions and the amount of transaction costs and fees incurred by a fund can vary substantially from year to year, due to, for example, shareholders entering and exiting the fund, changes in investment strategy, and general economic conditions. If transaction fees and costs are characterized as an operating expense, we are concerned that it will introduce significant volatility into the expense ratio and diminish its effectiveness as a measure of the regular, recurring costs associated with an investment in the fund;

- If transaction fees and costs are characterized as an explicit expense, it would reduce the fund's reported net investment income ratio and SEC defined yield, which are presented after deduction of expenses. We are concerned that such a change would understate the income return associated with an investment in the fund. These measures of income would also be subject to the volatility described above; and

- Tax law requires transaction fees and costs to be included in the cost basis of securities purchased (and deducted from proceeds of sales) when determining gain/loss, similar to current GAAP. By characterizing transaction fees and costs as operating expenses, the ED will cause reported GAAP net investment income to decline relative to taxable ordinary income. We anticipate investment company income distributions, which are based on taxable ordinary income, will remain the same. Accordingly, the ED would cause GAAP-based net investment income to decline relative to, and be less representative of, the income distribution amounts a shareholder would receive from the fund.

The ED also requires investment companies to measure their financial assets and liabilities at fair value and include all changes in their fair value in the net increase (decrease) in net assets for the period. Neither the option to report changes in fair value through OCI nor the amortized cost option for qualified financial liabilities is available to investment companies. We believe that the FASB's model results in an enterprise value for the reporting entity that would only be appropriate for investment companies if the entire entity could be sold or merged into another reporting entity. However, investment companies are not generally available for sale or merger into another investment company. Therefore, we think that, for the financial liabilities of an investment company (other than for derivative and trading liabilities that should continue to be reported at fair value as they are today), amortized cost is a more relevant measure, because equity investors in investment companies (if the investment company does not intend or is not required to settle the liability) do not view the fair value of the liabilities as relevant information, nor are investors responsible for settling the liabilities at fair value. The relevant value for investors is the equity redemption value or net asset value, which would be equal to the total investment company assets net of trading and derivative liabilities at fair value, less liabilities at amortized cost. If the U.S. GAAP financial statements of an investment company were required to reflect liabilities at fair value, investment companies' primary financial statements would display a net asset value that does not correspond to the actual redemption value. We do not believe this would be useful to investors in the investment company or to other users.

Exceptions to the Subsequent Measurement Principle – Demand Deposit Liabilities
As noted above, we disagree with the proposed remeasurement method for core deposit liabilities. We believe the proposed remeasurement method lacks conceptual basis. The remeasurement amount is not the amount for which the core deposit liability can be settled. It appears as if the Board's intent was to include the core deposit intangible asset in the measurement of core deposit liabilities. We do not believe it is appropriate to embed an intangible asset, which is not a financial instrument, in a deposit liability that is a financial instrument. We also observe that, to the extent a purchased core deposit intangible asset has already been recorded, embedding another core deposit intangible as part of the present value of the core deposit liability appears to be double counting the asset. Moreover, we do not understand why internally generated core deposit intangible assets should be recognized while other internally generated intangible assets are not. Often intangible assets, such as credit card relationships, also reflect the value of long-lived customer relationships. To be consistent with FASB's proposed framework in this ED, we do not understand why internally developed credit card relationships should not also be recorded on the balance sheet. We are concerned that the approach for recording core deposit liabilities would amend the FASB's long-standing view that internally developed intangibles should not be recognized. That aside, we recommend that all deposits (not just core deposits) be recorded at amortized cost, because that is how deposits are managed and is consistent with our view that amortized cost should be the basis of accounting for loans and debt securities held for collection of cash flows.

The proposed core deposit remeasurement method uses the average core deposit amount during the reporting period to arrive at the present value measurement for core deposits. Using the average rather than the period-end balance as the basis for balance sheet recognition is inconsistent with the balance sheet concept of recording asset and liability amounts as of the end of the reporting period. Since the amount due on demand would be presented separately on the face of the balance sheet, the present value of the difference between the actual and average balance of core deposits would be recognized as an adjustment to the recorded balance through OCI. It is not clear what that OCI amount would represent for a user of financial statements.

In addition, we believe that the proposed remeasurement method for core deposit liabilities is very subjective and could result in vast differences across entities depending on the inputs used. If the FASB disagrees with our recommendation not to use the proposed core deposit remeasurement method, we recommend developing a more precise definition for the all-in-cost-to-service rate to minimize inconsistencies and subjectivity across entities. Further, we believe that additional discussion of how to determine the alternative funds rate would also be helpful.

While we disagree conceptually with the proposed remeasurement method for core deposit liabilities, we also do not understand the proposed calculation for the core deposit liabilities under the remeasurement approach. Although we believe that the calculation is attempting to capture a portion of the core deposit intangible as discussed above, the calculation described in the ED is not the same as that used by practitioners in valuing the core deposit intangible asset in a business combination. We are unsure whether the calculation difference is intended and, if so, the purpose behind the difference. In practice, core deposit intangible assets are valued by estimating post-tax annual cost savings generated by core deposits (i.e., the difference in costs arising from core deposits versus the next available and most cost-effective source of funds). These net annual cost savings are then discounted at the weighted average cost of capital or cost of equity. In comparison, the ED states that "An entity shall measure its core deposit liabilities at the present value of the average core deposit amount during the period discounted at the difference between the alternative funds rate and the all-in-cost-to-service rate over the implied maturity of the deposits." This calculation differs from standard valuation practice in two respects: (1) the amount discounted is an average balance instead of a series of cash flows, and (2) the discount rate is the difference between two cost rates instead of a commonly understood discount rate. While we do not agree with the decision to remeasure core deposits for the reasons discussed above, if the Board decides to require such remeasurement in the final standard, we recommend that the Board include a basis for the specific calculation method in comparison to established practice for valuing core deposit intangible assets and include a detailed numerical example in the implementation guidance.

Exceptions to the Subsequent Measurement Principle – Qualifying Financial Liabilities Measured at Amortized Cost

We support the IASB's measurement model for issued debt, which allows debt instruments issued with the intent to pay the contractual cash flows rather than with an intent to settle before maturity to be recorded at amortized cost. We also agree with the IASB's approach of allowing a fair value measurement option for such issued debt. We believe that the FASB's proposed criteria for being able to recognize financial liabilities at amortized cost establishes a bright line test and will often be hard to apply in practice.

For example, an operating segment, which has slightly less than 50% of consolidated recognized assets measured at fair value, issues and records a liability at amortized cost. In the following period the operating segment uses the funding to purchase additional assets recorded at fair value so that more than 50% of total assets are now recorded at fair value. It is unclear whether the liability and all the debt that the operating segment has previously issued would no longer meet the criteria for amortized cost. However, we believe the debt would still be measured at amortized cost since the ED prohibits subsequent reclassifications.

Therefore, we support a principles-based approach rather a than bright-line threshold for classification at amortized cost and, consistent with our comments above about the need for allowing subsequent reclassification of instruments initially classified as fair value through earnings or fair value through OCI when there is a business strategy change, we believe that reclassifications from and into amortized cost should also be allowed if the business strategy for the portfolio of financial instruments changes.

Changes in an Entity's Own Credit Standing
We disagree with the ED's proposed approach regarding the classification of own-credit valuation adjustments for liabilities classified in fair value with changes recorded in earnings. Instead, we support the IASB's approach of including all changes in own credit for such liabilities in OCI (the IASB's proposed approach is presented in the Exposure Draft ED/2010/4, *Fair Value Option for Financial Liabilities*). We agree that the changes in own credit related to trading liabilities should be recorded in net income. We believe the approach proposed by the IASB for changes in own credit appropriately addresses the widespread criticism of the current accounting for liabilities classified as fair value through net income that produces counterintuitive results (i.e., it results in gains in earnings when credit deteriorates and losses in earnings when credit improves) that may never be realized. However, as discussed below, we disagree with the IASB's proposal not to allow recycling and believe a gain or loss originally recognized in OCI for a change in the entity's own credit should be recorded in earnings if and when that liability is extinguished. We believe that the determination of own credit valuation changes will be very difficult for smaller, unsophisticated preparers, as they do not have the necessary expertise in-house.

Investments That Can Be Redeemed Only for a Specified Amount
Overall, FinREC supports the guidance in paragraph 34, which addresses subsequent measurement for restricted types of assets. However, we are concerned with this guidance in three areas: the evaluation of impairment, the unintended scope consequences and the changes resulting from application to the National Credit Union Share Insurance Fund (NCUSIF).

Federal Home Loan Bank (FHLB) stock has long been evaluated using an ultimate recoverability threshold (Accounting Standards Codification (ASC) 942-325-35-3). When this guidance was first developed as part of the AICPA Audit and Accounting Guide for Banks & Savings Institutions, and later included in Statement of Position 01-6, "Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others "(the SOP), AcSEC's belief was that the evaluation should be performed based on ultimate recoverability given the uniqueness of this asset, particularly as a government-sponsored entity. The SOP includes criteria to assess ultimate recoverability. FinREC believes that for FHLB stock, impairment should be measured based on ultimate recoverability (using the existing criteria in ASC 942-325-35-3) rather than using the impairment guidance as proposed in paragraph 37(c) of the ED. FinREC believes that Federal Reserve stock should also be measured based on ultimate recoverability. FHLB and Federal Reserve stock are unique investments with ties directly to the U.S. Government.

We are concerned that the broad scope in paragraph 34 will have unintended consequences. There are many types of cooperative arrangements for which this guidance may not be appropriate. In this paragraph, one example that is mentioned is agricultural cooperatives. In the Basis for Conclusions (paragraph BC148), another example is the NCUSIF, which is not an investment in the same sense, as discussed below. Other examples, not included in the proposal, are the membership capital shares and paid-in capital, which are held by natural person credit unions in corporate credit unions. It is unclear whether the Board intends to include these types of investments in the scope. Because these instruments do not have the same unique characteristics as the FHLB stock and Federal Reserve stock, FinREC believes inclusion may be an unintended consequence. As such, FinREC encourages the Board to give careful consideration to the possible scope implications.

Lastly, FinREC is very concerned with the suggestion in the Basis for Conclusions that the NCUSIF qualifies under paragraph 34. The NCUSIF assets are not certificates and do not represent any type of equity ownership. Rather, these are funds that are on deposit with the National Credit Union Administration (NCUA) for insurance purposes, similar to FDIC deposit insurance. For banks and savings institutions, premiums paid to the FDIC are not capitalized, but rather are expensed. However, unlike the FDIC, the NCUA holds these funds on deposit. Adjustments are made depending on the operating results of the fund. When this guidance was first developed as part of the AICPA Audit and Accounting Guide for Credit Unions, and later included in SOP 01-6, AcSEC acknowledged the uniqueness of the asset and established criteria for recognition and measurement. That guidance is contained in ASC 942-325-25-3 which states: "For credit unions and corporate credit unions, amounts deposited with the National Credit Union Share Insurance Fund shall be accounted for and reported as assets as long as such amounts are fully refundable." ASC 942-325-35-4 provides sufficient guidance for subsequent measurement. FinREC recommends that the NCUSIF reference be removed from the Basis for Conclusions and explicitly scoped out of paragraph 34, because we believe the guidance in ASC 942-325-25-3 and ASC 942-325-35-4 is the relevant guidance for this asset.

Deferred Tax Assets

We are concerned that the FASB is addressing this one area of income tax accounting guidance in isolation without a full consideration of the judgments that are necessary to evaluate the need for a valuation allowance on a deferred tax asset related to such investments in debt instruments.

For this reason, we do not support the proposal requiring an entity to consider its deferred tax assets related to debt instruments for which qualifying changes in fair value are recognized in other comprehensive income in combination with its other deferred tax assets in evaluating the need for a valuation allowance as part of this ED.
Some have taken the view that a deferred tax asset related to a debt instrument should be considered in combination with other deferred tax assets, but the entity may assert it has a tax planning strategy such that any future increases in the value of the debt instrument to the maturity date of the instrument can be considered when determining whether its deferred tax assets are realizable. It is unclear whether the proposal in the ED was intended to disallow this "tax planning strategy" approach or whether the FASB considered this current practice in coming to its conclusion.

Many judgments are made when assessing the realizability of deferred tax assets. ASC 740-10-30-18 states, "Future realization of the tax benefit of an existing deductible temporary difference or carryforward ultimately depends on the existence of sufficient taxable income of the appropriate character (for example, ordinary income or capital gain) within the carryback, carryforward period available under the tax law." That paragraph also includes numerous examples of the types of information that are considered in making such realization assessments. If an entity has the intent and ability to hold a debt instrument until the recovery of its amortized cost basis (which may be at maturity), increases and decreases in the debt instrument's fair value will reverse out of other comprehensive income over the contractual life of the investment. This results in no cumulative change in the entity's comprehensive income or future taxable income over the contractual life of the debt instrument. In this respect, the temporary differences associated with unrealized gains and losses on debt instruments marked to market through OCI are unlike other types of temporary differences, because they do not affect the income statement or the tax return if held until recovery of the debt instruments" amortized cost.

While we are not advocating a particular view on this issue, we believe that if the FASB desires to eliminate the diversity in practice regarding income tax accounting guidance, it should do so in a comprehensive income tax accounting project. This proposal has little to do with the accounting changes being proposed for financial instruments in the ED. If the FASB rejects our recommendation to remove this proposal from the ED, it should consider the issue more completely and determine if more guidance should be provided on how the phenomenon of holding a debt instrument measured at fair value with certain changes being recorded in other comprehensive income should be considered when assessing the related deferred tax assets for realizability.

Presentation

Changes in an Entity's Own Credit Standing

Paragraph 94 of the ED requires presentation on the face of the statement of comprehensive income of the amount of significant changes in the fair value of its financial liabilities arising from changes in an entity's own credit standing during the period. We are concerned that the term "significant changes" may cause confusion. Although we understand that this section is intended to deal with presentation rather than measurement of own credit, we believe that a reporting entity may conclude based on the wording in paragraph 94 that, if the change in fair value of liabilities related to its own credit during the period is not significant, such amount would not have to be reported in the statement of comprehensive income. We assume that changes due to own credit would always need to be included in the statement of comprehensive income, just not separately presented if insignificant, and recommend that the FASB remove the word "significant" to avoid any confusion about the required presentation of changes in an entity's own credit standing. If the change due to own credit is insignificant, entities would still be able to decide not to provide separate presentation or disclose the fact that no change is separately presented based on immateriality.

FinREC is also concerned with the proposed disclosure of changes in an entity's own credit standing for nonpublic entities, particularly for smaller entities. While all entities would include some value for changes in credit for recognition purposes, we believe nonpublic entities will be challenged to indentify and separate the changes in credit for purposes of disclosure. Many nonpublic entities do not have a verifiable credit rating by an independent credit rating agency. Without a verifiable credit rating, we are challenged to understand how a change in credit rating would be determined for purposes of this disclosure. As such, FinREC suggests that nonpublic entities be scoped out of this disclosure.

Credit Impairment

Credit Impairment Model
FinREC believes that the FASB's credit impairment model is impracticable and would be extremely difficult to implement.

The ED requires interest income to be recognized based on application of the effective interest rate to the amortized cost balance, net of any allowance for credit and interest losses. We believe that interest income and the allowance for credit losses should not be mixed together, because these risks are separately managed and users will not find this mixed presentation useful in analyzing an entity's results of operations. Thus, we believe the measurement and recognition of interest income should not be changed from the current accounting: interest income should continue to be accrued based on the amortized cost of the asset.

We believe that the incurred loss model for recognition of credit impairment should be retained since we believe losses should not be recognized until there is a triggering event. However, we share the FASB's concern about the delayed recognition of credit losses under current GAAP and agree that an entity should not wait to recognize expected losses until they become probable. Accordingly, we support the elimination of the "probable" threshold for recognizing credit losses and would favor replacing that threshold with a lower threshold, such as "more-likely-than-not." However, we recognize that lowering the threshold for recognizing potential future losses could exacerbate the pro-cyclical concerns faced during the recent financial crisis.

In the event that the FASB decides not to retain the incurred loss model, we offer the following comments about the proposed credit impairment model.

We believe that a credit impairment model that considers future expected losses should reflect an entity's best estimate of the expected losses over the life of the asset. However, we believe the ED's proposed model will not accomplish this. According to the ED, paragraph 42, "an entity should 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." Later in the same paragraph, the following guidance is provided: “In estimating cash flows expected to be collected for its financial assets at each reporting date, an entity shall assume that the economic conditions existing at that point in time would remain unchanged for the remaining life of the financial assets. An entity shall not forecast future events or economic conditions that did not exist at the reporting date in determining whether a credit impairment exists.” We do not understand why, under the proposed model, the estimated collectability of **future** cash flows should be limited to knowledge of past and current economic conditions, when expectations about the future are required to determine the fair value of these same financial instruments that would be the primary measure reported in the balance sheet. The FASB encourages the use of historical data and statistical information; however, such data is useful only because it assists an entity in forecasting what future cash flows and credit losses are likely to occur. We do not believe it is appropriate to limit the permissible information to past and current conditions for measuring impairment under the proposed model. We believe such a limitation would not provide useful financial information to users about potential asset losses to users.

The ED’s proposed impairment model would require entities to book significant credit reserves at the bottom of the economic cycle without allowing them to assume that conditions would ever improve; this would result in overestimation of the actual expected credit losses. The opposite would happen at the top of the economic cycle when entities would have to record only minimal credit reserves, because their model inputs are not allowed to assume that the economy would deteriorate in the future. We believe this result is counterintuitive and do not understand why future business cycles should be ignored in projecting cash flows. Also, we believe that under the proposed approach, the financial statements would not be meaningful for financial assets, such as loans. In the current economic environment, significant credit loss reserves would be recorded for the loans based on the assumption that the economy would stay in recession indefinitely. The fair value estimate for those same loans would likely be much higher than the net carrying amount, because the fair value includes forward-looking adjustments based on the expected economic recovery in the future. Therefore, the balance sheet would have to reflect the loan’s positive net carrying value adjustment to fair value as a credit to OCI.

Under the proposed impairment model in the ED, an entity would need to forecast cash flows to the maturity of the loan, but those derived cash flows would not represent the entity’s best estimate of the amounts of those cash flows, because of the restrictions on looking forward to expected business and economic conditions. Thus, the resulting forecasted impairment losses would represent neither management’s best estimate of future expected losses nor losses incurred to date.

The ED effectively uses separate credit impairment models for originated and purchased financial assets, because the changes in cash flows are handled differently. Increases in cash flows are recognized prospectively for assets purchased with a discount for credit issues, while increases in cash flows are recognized immediately for originated assets. We believe that this complexity should be eliminated by applying the same credit impairment model to both types of financial assets. While the effective interest rate for purchased assets should be based on expected cash flows at the time of purchase, any subsequent change in expected cash flows should result in either immediate loss (for decreases in expectations) or gain (for increases in expected cash flows) through net income. This approach of recording increases or decreases in expected cash flows through net income, rather than over time, by adjusting the effective yield on the purchased asset, would be consistent with how changes in expected cash flows would be recorded on originated assets. To reflect the fact that credit-impaired purchased assets are purchased at a large discount, we believe this single model can accommodate this fact by setting the effective interest rate based on the purchase price, rather than the asset's original effective interest rate, but not resetting this rate thereafter. Currently, many reporting entities are applying the provisions of ASC 310-30 (formerly SOP 03-3, "Accounting for Certain Loans or Debt Securities Acquired in a Transfer") manually because many reporting systems are unable to handle the recurring assessment of the effective interest rates.

If no impairment is found for an individually evaluated asset, under the ED, the asset should then be evaluated as part of a pool of similar assets. Although this is consistent with existing GAAP for loans, we believe that continuing this process with expanded scope that includes additional financial assets would be unduly burdensome for preparers who could potentially have to evaluate each individually assessed asset for impairment twice. We believe that if a financial asset has been individually evaluated, that evaluation should suffice.

The proposed ED requires excess interest collections over the amount reported as interest income to be added to the allowance. However, if the allowance exceeds the expected credit losses on the assets, then that excess is recorded as a recovery in the provision for credit losses in the income statement. We believe that characterizing interest collections as recoveries distorts the income statement and will not assist users in understanding the entity's results of operations or the nature of expected losses on financial assets. Accordingly, FinREC believes credit losses should not be linked to the recognition of interest income.

It is unclear whether or not the FASB intends for the expected losses on assets evaluated as part of a pool to be discounted to reflect the life-of-loan expected losses and the elimination of the probable threshold. We believe that not discounting this component of the impairment would be inconsistent with the model for individually evaluated assets. Conforming the impairment models for originated and purchased financial assets, along with discounting the impairment for pooled assets, would help to achieve a single conceptually consistent impairment model. If the FASB decides to require discounting of the impairment for assets evaluated as part of a pool, we recommend that the Board provide guidance on how to determine the pool's effective interest rate.

It is also not clear whether the FASB's proposed credit impairment model would allow the impairment analysis to be applied on an "open pool" basis, which means assets may be aggregated into pools for each reporting period, versus a "closed pool" basis, which means assets are aggregated initially and the integrity of the pool is retained throughout the life of the pool without additions or removals. Allowing only closed pools would be a significant problem, because the number of pools would grow exponentially and quickly become unmanageable. Therefore, we recommend that the Board clarify that the credit impairment analysis may be applied on an open pool basis.

Finally, we suggest that a correction be made in paragraph 51 of the ED in the following sentence (suggested insertion underlined):

> "51. An entity shall recognize in net income at the end of each financial reporting period <u>the change in</u> the amount of credit impairment related to all contractual amounts due for originated financial asset(s) that the entity does not expect to collect…"

However, if this paragraph is intended to apply only to the recording of impairment determined when the asset is first recorded, then the paragraph is correct as it is currently worded and that limited intent should be clarified.

Impairment Related to Changes in Foreign Exchange Rates

According to paragraph 46 of the ED, changes in cash flows expected to be collected that relate to changes in foreign exchange rates used to remeasure foreign-currency-denominated financial assets should not give rise to credit impairment. While we agree that the impairment due to changes in foreign currency exchange rates (FX impairment) should not be recorded as credit impairment, the ED is not clear what approach, if any, should be used to evaluate when FX impairment has occurred and should be recorded in earnings. The ED seems to indicate (although it is not clear) that an entity would defer all foreign currency rate-change-related gains and losses through OCI until the asset is sold or settled at maturity. If that is in fact what is being proposed, we disagree with that approach. Our suggestion would be to record all foreign-currency-denominated asset changes related to movements in exchange rates in net income. This approach would be consistent with how similar changes would be measured on the funding side. IFRS today already requires such changes in foreign-currency-denominated financial assets due to currency exchange to be recorded in net income. In addition to being conceptually the best approach in our view, it would also achieve greater convergence with the international accounting standards.

If the FASB disagrees with our suggestion, we recommend that, at a minimum, there should be an other-than-temporary-impairment type analysis required to evaluate whether the entity expects to recover the cash flows related to losses due to changes in foreign currency exchange rates (i.e., while devaluations should be considered permanent, it is unclear about rate fluctuations). If the entity does not expect to recover the losses, the FX impairment should be recorded in net income immediately.

Interest Income Recognition

For financial assets evaluated individually for credit impairment, the ED requires interest income to be recognized based on application of the effective interest rate to the amortized cost balance, net of any allowance for credit and interest losses. We disagree with the mixing of interest income and the allowance for credit losses and propose that the recognition of interest income should not be changed from the current accounting (i.e., we believe that interest income should be accrued based on the effective interest rate being applied to the amortized cost balance). We believe application of the ED's proposals would result in distortion of a key indicator that analysts follow for banks – net interest margin – which is consistent with our reasoning that interest income recognition should be based on amortized cost rather than amortized cost net of any credit allowance.

In practice, we envision the coupling of interest income and credit losses would cause significant operational challenges because many financial institutions typically store the effective interest rate data and risk information about expected losses in separate systems (i.e., separate and apart from the core loan subsidiary ledger). The FASB's proposed approach would require integration of the data in the two systems. Plus, it would change a loan-by-loan focus to a portfolio focus for interest income recognition for loans evaluated as part of a pool.

Additionally, interest income recognition represents revenue earned during a reporting period. As such, we believe it should be based on actual asset balances held throughout the period. The wording in the ED suggests that interest should be accrued based upon amortized cost and allowance balances at period end as illustrated in Example 20 of the Implementation Guidance. If FASB accepts our recommendation, we recommend that Example 20 in the Implementation Guidance be changed to reflect loan balances that amortize throughout the reporting period and allowance balances that are usually adjusted only once a quarter. In addition, we recommend that implementation guidance be provided which clarifies how to apply the proposed interest recognition model to a pool of assets whose balances change throughout the reporting period.

We recommend that the Board clarify how or whether the model for individually assessed assets is intended to be applied to assets evaluated as part of a pool. Although the ED is silent about recognition of interest income for pooled assets, it appears that interest income recognition models are inconsistent for individually evaluated and pooled assets, since the approach required for individual assets would not work for pools, unless credit reserves for pooled loans are also discounted (see our recommendation in the *Credit Impairment Model* section above). Otherwise, we do not understand how this model works for pooled assets.

Financial Assets for Which No Accrual of Interest Shall be Made
According to paragraph 82 of the ED, "An entity shall cease accruing interest income on a financial asset only if the entity's expectations about cash flows expected to be collected indicate that the overall yield on the financial asset will be negative." The same paragraph then clarifies that this situation occurs when the total cash flows expected to be collected are less than the original principal amount. We do not understand this guidance and are concerned, because we believe that analysts use the amount of non-accrual loans to assess the quality of banks' loan portfolios.

Consider the following example:

Loan contractual principal	$100
Contractual interest over life of loan	30
Total contractual cash flows	$130
Revised Estimated Cash Flows	$85
Present Value of Revised Estimated Cash Flows	$70
Impairment Recorded ($100-$70)	$30
New Book Value, Net of Allowance	$70

Since $85 is less than the principal of $100, the ED would require that interest accrual be discontinued. However, since total expected cash flows exceed the book value, we believe that interest should be accreted up to the $85 of total expected cash flows rather than all recognized at the end.

Also, it is not clear how to apply the guidance to collateral-dependent loans that are still considered accrual loans, because the collateral value is sufficient to cover the entire unpaid principal balance. It is unclear what interest should be accrued if no cash will be collected for such loans, since the loans would not meet the definition of non-accrual loans.

We are concerned that under the ED far fewer loans would be classified as nonaccrual than is current practice, where nonaccrual status is determined by delinquency status, rather than by the yield on the loan. We believe that nonaccrual loan data is very important information for users of bank financial statements and the current practice is well understood by those users. Accordingly, we believe the definition of nonaccrual should not be changed.

Hedge Accounting

Bifurcation-by-Risk

We support the FASB's decision to allow designation of particular risks in financial items as the risks being hedged in a hedging relationship. However, we disagree with the statement in paragraph BC232 in Basis for Conclusions that, if the use of amortized cost were broadened, hedge accounting for the variety of separate risks currently permitted should be significantly limited. We believe that the decision to allow designation of particular risks as hedged risks would be appropriate even if the proposed classification and measurement framework is revised to broaden the use of amortized cost.

Without an ability to designate particular risks as hedged risks, a company that has elected to hedge an item measured at amortized cost would have to assess effectiveness based on changes in the present value of the entire cumulative change in expected future cash flows on the hedged item in a cash flow hedge. For fair value hedges, both the assessment of hedge effectiveness as well as measurement of the hedged item would have to mirror 100% of the change in value of the hedged item. Requiring hedge accounting to be based on the entire change in fair value or expected cash flows is not reflective of the intent of risk management. For example, a company that has elected to hedge only its interest rate risk in its own issued debt and has executed a perfectly effective interest rate hedge may experience significant earnings volatility due to credit spreads where bifurcation by risk is not permitted. Economically, the hedging company has reduced risk, but is penalized with additional volatility for its risk management decision to hedge only interest rate risk. For instruments (or companies, if hedging own issued debt) with volatile credit spreads, this is a significant penalty. In some cases, volatility in credit spreads is so significant it would preclude hedge accounting because the hedge would fail to be reasonably effective. Therefore, we believe that designation of particular risks in financial items as the risks being hedged in a hedging relationship should be allowed even if the hedged item is measured at amortized cost.

While non-financial items are beyond the scope of this ED, we note that the IASB also plans to permit hedge accounting for contractually specified risk components for non-financial items.

Dedesignation/Redesignation

The ED provides that an entity shall not voluntarily dedesignate a hedge relationship unless the hedge relationship fails to meet qualification requirements (e.g., reasonably offset criterion) or the derivative is terminated, sold or expires. A hedging instrument may be considered effectively terminated (and thus no longer meet the reasonably offset criterion), if another derivative is entered into and is expected to fully offset future changes in the fair value or cash flows of the original derivative (evidenced by concurrent documentation). If a derivative designated in a qualifying hedge is expected to be fully offset by another derivative in order to terminate the hedge relationship, neither the original derivative nor the offsetting derivative is permitted to be designated in a new hedge accounting relationship in the future.

The proposed change prohibiting entities from voluntarily removing the hedge designation would have a significant operational and economic impact on companies that execute dynamic hedging strategies, such as hedges of mortgage loan originations or delta neutral hedging strategies, or certain fair value hedges of interest rate risk, which are dedesignated and redesignated pursuant to targeted portfolio duration/interest rate risk management strategy. The prohibition against removing hedge designation also adds unnecessary complexity. Banks which use hedging along with dedesignations and redesignations as an important part of their risk management activities would need to set up a database to track all their dedesignated hedging derivatives and their offsets. Considering the significance of hedging activities for most banks, the amount of such derivatives that could not be redesignated as hedging instruments could grow significantly over just a short period of time. Additionally, the ED is not clear whether the proposed changes related to the inability to dedesignate a hedge without entering into an offsetting hedge applies to net investment hedges. These positions are often hedged with foreign-currency-denominated debt. If dedesignation were to require termination of the hedging instrument or execution of an offsetting position, it is unclear to us how this could be executed when the hedging instrument is a foreign-currency-denominated cash instrument, rather than a derivative.

Also, since the hedge can be dedesignated at additional cost to the entity by settling the existing hedging instrument or entering into another derivative offsetting the original derivative, thereby effectively removing the designation of the hedging relationship, we do not understand why dedesignation by simply removing the hedge designation should not be allowed. Instead of dedesignating a hedge, keeping the existing derivative and treating it as a trading position after dedesignation, the ED allows the same result to be achieved by first entering into a derivative offsetting the original hedging instrument, and then into a separate trading derivative with the same terms as the hedging instrument. Since the same accounting result can be achieved under both alternatives, we do not understand why the FASB is proposing not to allow entities to follow the first less costly alternative.

Additionally, the proposed provisions regarding an effective termination do not appear to address the issue of how the changes in fair value or cash flows of a derivative executed under current market conditions are expected to fully offset a derivative executed under different market conditions. Therefore, the proposed provisions regarding effective terminations raise questions as to whether an entity can ever terminate a hedge accounting relationship without either a) terminating the derivative or b) entering into an off-market derivative.

We believe that dedesignation and redesignation of hedges without terminating the hedging derivative should be permitted. As balance sheet composition constantly changes, reporting entities manage the risks on their balance sheets by adjusting the notional amounts of the derivative hedging instrument, through dedesignations and redesignations. We are not aware of any major practice issues, complexities or abuses, nor concerns expressed by users related to dedesignations and redesignations of existing hedges. Dedesignation and redesignation of hedge relationships only reflects the dynamic and multi-faceted nature of hedging as a risk management practice. Dedesignations cannot be used as a tool to manage earnings, since this must occur contemporaneously without the benefit of hindsight. Instead of disallowing hedge dedesignations and to address potential concerns regarding hedge dedesignations, we recommend that any dedesignations of significant hedges when the entity leaves the hedged position unhedged going forward should be disclosed in the notes to the financial statements.

Finally, the ED states that a hedging instrument may be modified for an existing relationship by adding a derivative to that existing relationship that would not fully offset the existing derivative and would not reduce the effectiveness of the relationship. Since adding another derivative to the existing hedge would be considered a hedge dedesignation today, it is not clear why this would no longer be considered a dedesignation event. It is also not clear what the impact would be of the addition of a forecasted transaction to the relationship. FinREC believes that it would be more effective for the Board to require disclosure of why an entity uses dedesignation and redesignation in its hedging activities and the extent of those activities, rather than to preclude it or require costly alternatives.

Reasonably Effective Criterion
We support the adoption of the “reasonably effective” instead of current “highly effective” threshold. However, we believe more clarification is required of the term “reasonably effective,” without establishing a bright line, and when a qualitative analysis without applying a quantitative effectiveness evaluation is sufficient. Without further guidance or clarification of a principle that is intended to be interpreted specific to each set of facts and circumstances, we expect that accounting firms and regulators will face similar pressures to fill the void with bright lines as was experienced with the original issuance of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (FAS 133). Accounting firms and regulators formulated rules for effectiveness testing independently outside of the standard setting arena, making consistent and informed implementation and application difficult.

Measuring and Reporting Ineffectiveness in Cash Flow Hedging Relationships
The ED requires the ineffectiveness to be measured based on the difference between the cumulative change in fair value of the actual hedging instrument and the present value of the cumulative change in the hedged cash flows. While the effective portion of the hedging instrument would be recorded in OCI, all ineffectiveness associated with cash flow hedges must be recognized in earnings. This proposed method of measuring hedge ineffectiveness will require both overhedging and underhedging associated with cash flow hedges to be recorded in net income. We disagree with this proposed method and think that the FASB should retain the existing cash flow ineffectiveness measurement method that requires only ineffectiveness related to overhedges to be recorded in income. Before the issuance of FAS 133, the FASB debated the same issue and came to the following conclusion (from the Basis for Conclusions, FAS 133):

> ***Measure of Hedge Ineffectiveness***
>
> 379. The Board believes that, in principle, earnings should reflect (a) the component of a derivative gain or loss that is excluded from the defined assessment of hedge effectiveness and (b) any hedge ineffectiveness. However, the Board had concerns about the effect of that approach on other comprehensive income and earnings for a period in which the change in the present value of the future expected cash flows on the hedged transaction exceeds the change in the present value of the expected cash flows on the derivative. In that circumstance, the result would be to defer in other comprehensive income a nonexistent gain or loss on the derivative and to recognize in earnings an offsetting nonexistent loss or gain. For example, if the derivative hedging instrument had a $50 loss for a period in which the change in the present value of the expected cash flows on the hedged transaction was a $55 gain, an approach that reflected all hedge

> ineffectiveness in earnings would result in reflecting a $55 loss in other comprehensive income and reporting a $5 gain in earnings.
>
> 380. To avoid that result, the Board decided that only ineffectiveness due to excess expected cash flows on the derivative should be reflected in earnings. The Board discussed whether that approach should be applied period by period or cumulatively and decided that the ineffectiveness of a cash flow hedge should be determined on a cumulative basis since the inception of the hedge.

We concur with the Board's conclusion in FAS.133 above, because in situations where the cumulative change in the actual derivative is less than the present value of the cumulative change in the hedged cash flows, we agree that the hedging entity would have to record in OCI a nonexistent gain or loss on the hedging instrument, and an offsetting non-existent gain or loss in earnings. We are not aware of any relevant changes that have occurred since the Board reached that conclusion and, therefore, we believe that the ineffectiveness measurement approach for cash flow hedges should not change by having to include in earnings ineffectiveness related to underhedges. However, if the Board decides to retain the requirement to include the ineffectiveness related to underhedges in earnings, we recommend including the current Board's rationale in the Basis for Conclusions.

The ED allows the assessment of effectiveness and measurement of ineffectiveness for cash flow hedging relationships of groups of transactions occurring within a specific time period to be performed using as a benchmark a derivative that would settle within a reasonable time period of the cash flows related to the hedge transactions. The time period is reasonable if there is no more than a minimal difference between the forward rate on the derivative and the forward rate on the derivative or derivatives that would exactly offset the changes in the hedged transactions. We believe more clarification is required of the term "minimal." We are not seeking bright lines; rather, we are asking for incremental guidance in order to be able to better understand the Board's intent.
DIG G20 was well thought out at the time and has worked reasonably well in practice. We do not understand the need to change it. It would represent a major change for companies using options in cash flow hedges to hedge forecasted cash flows.

<u>Disclosures</u>

FinREC is supportive of improved fair value disclosures.

The ED is proposing significant incremental disclosures for derivatives, purchased assets, sensitivity for level 3 fair value measurements, allowance for credit losses, and more.

While each disclosure taken by itself can be rationalized, we ask the Board to step back and look at the entire package. Our sense is that it is too much and needs to be reevaluated.

Equity Method of Accounting

We disagree with the ED's proposed elimination of the fair value option for entities that would otherwise be required to account for their investments under the equity method where the investor has significant influence over the investee and the operations of the investee are considered related to the investor's consolidated operations. In those situations, we believe investors should be allowed to elect to account for investments that qualify for the equity method under the proposed criteria in the ED at full fair value with changes in fair value recorded through income as is currently allowed. While we understand the Board's intent to eliminate all options to account for a financial instrument at fair value, we believe such an option should be available for equity method investments, because entities often do not have access to the information needed to apply the equity method of accounting to the investments (or may not have access to it on the timely basis needed for financial reporting). Given that fair value with changes recorded through income is FASB's preferred methodology (the default option) for all financial instruments, we believe the fair value measurement option should be available for equity method investments.

Also, many equity instruments measured either at cost or under the equity method today would be required to be measured at fair value under the ED's proposed classification and measurement. Our concern is that entities may not be able to apply fair value to a large population of illiquid non-marketable equity instruments because of the lack of fair value information. Therefore, we ask that the FASB provide a practicability exception to measure at cost equity instruments that are measured today either at cost or under equity method, but which would no longer qualify for the equity method under the new proposed criteria. Our suggestion is that such an equity instrument would qualify for the practicability exception only after the investor has unsuccessfully made a reasonable effort to apply fair value accounting to the non-marketable equity instrument.

Under ASC 323-30-555 and 599 (formerly Emerging Issues Task Force Topic D-46), the equity method is currently required to be applied for limited partnerships and LLCs unless the investors' interests are considered so minor (deemed to be less than 3% to 5%) that the investor has virtually no influence over the partnership's operating and financial policies. It is unclear whether such an investment would be considered "significant" under the ED. In addition, it is not clear how a conglomerate or a financial services company would determine whether an investee's operations are related to the investor's consolidated operations. Further, we believe the ED should clarify whether an impairment test for enterprise value declines is still needed for equity method investments.

Effective Date

Due to the significant systems modifications and valuation models that preparers will need to develop to implement the proposed ED, we believe at least 3 years beyond the actual issuance of the final standard need to be allowed before the standard becomes effective.

*Delayed Effective Dat*We support the Board's proposal to delay the effective date for nonpublic entities with less than $1 billion in consolidated assets. However, we believe that this delay should apply to the entire proposal, rather than only for valuing loans, loan commitments and core deposit liabilities. We understand the Board intends to perform a post-implementation review two or three years after the initial effective date but before the requirements become effective for all entities. By delaying the proposal in its entirety for all nonpublic entities with less than $1 billion in consolidated assets, a more comprehensive review of all the provisions of the standard would be permitted. In addition, it would allow more time for smaller entities, which are already resource constrained, to implement all the changes, rather than a piecemeal type of adoption.

FinREC is also concerned with the reevaluation that must occur annually during the deferral period to determine whether a nonpublic entity still qualifies for the deferral. Given the depth and breadth of this proposal, we believe it is unfair to have an uncertain effective date for those entities. As such, we recommend the Board eliminate the required reevaluation during the deferral period.

Transition

We support the ED's prospective transition through a cumulative effect adjustment to the statement of financial position for the reporting period that immediately precedes the effective date.

Given that a number of major accounting standards would be implemented at the same time as the financial instruments standard, we believe that requiring prospective application on all those standards may be very helpful to the preparers and users.