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September 30, 2010

Ms. Leslie F. Seidman
Acting Chairman
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06865-5116

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

Dear Ms. Seidman,

CFA Institute,¹ in consultation with its Corporate Disclosure Policy Council (“CDPC”)², appreciates the opportunity to comment on the Financial Accounting Standards Board (“FASB” or the “Board”) Proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* (the “Proposed Update” or “Update”).

CFA Institute is comprised of more than 100,000 investment professional members, including portfolio managers, investment analysts, and advisors, worldwide. CFA Institute seeks to promote fair and transparent global capital markets, and to advocate for investor protections. An integral part of our efforts toward meeting those goals is ensuring that the quality of corporate financial reporting and disclosures provided to investors and other end users is of high quality.

¹ With offices in Charlottesville, VA, New York, Hong Kong, and London, CFA Institute is a global, not-for-profit professional association of more than 100,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 133 countries, of whom nearly 83,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 136 member societies in 57 countries and territories.

² The objective of the CDPC is to foster the integrity of financial markets through its efforts to address issues affecting the quality of financial reporting and disclosure worldwide. The CDPC is comprised of investment professionals with extensive expertise and experience in the global capital markets, some of whom are also CFA Institute member volunteers. In this capacity, the CDPC provides the practitioners’ perspective in the promotion of high-quality financial reporting and disclosures that meet the needs of investors.

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Overall Perspectives Regarding FASB's Proposed Update

We appreciate and support the FASB's efforts in proposing the recognition and measurement principles in this Proposed Update which will enhance the transparency and decision-usefulness of financial statements for investors. The FASB's efforts in releasing this Proposed Update and allowing consideration and comment on the issues around the fair valuation of certain financial instruments should advance understanding of the usefulness of fair value information. The Proposed Update has sparked interest, conversation and some degree of controversy. As with other advances in accounting standard setting, we believe the Proposed Update will result in greater transparency and relevance. We note that whenever a new paradigm is proposed, participants need time to understand the nature of the change and to adapt. Stock option accounting faced debate similar to that of this Proposed Update. It took time for preparers, auditors and investors to understand the valuation techniques and the fact that financial statements needed to reflect the economic reality of this compensation expense.

Purpose and Use of Financial Statements

The Proposed Update also requires preparers, auditors and investors to evaluate their fundamental beliefs regarding the underlying purpose of financial statements. In particular, does the statement of financial position represent a compilation or tabulation of past transactions or a statement which presents the current value of assets and liabilities? Similarly, respondents to the Proposed Update must also evaluate the purpose and use of the income statement and how, and what, this performance statement should reflect.

Based upon the market experience of our members and the relevant academic research, there is strong evidence that financial institution share prices incorporate the fair value of their financial instruments. The question for standard setters is whether the financial statements should likewise reflect financial instrument values in an attempt to mitigate the economic disconnect between book value and share price. We believe this is important to ensure financial statements are relevant for all investors in making investment decisions. What standard setters need to consider is whether all investors, not just some professional analysts or investors, can perform such analysis and valuation themselves and whether financial statements should assist all users and investors in the determination of the value of the enterprise. Decision-useful financial information such as the fair value of financial instruments, which represent nearly all assets and liabilities of a financial institution, should not bypass the basic financial statements.



CFA Institute’s Long-Standing Position of Fair Value Measures

CFA Institute’s long-standing support for fair value measures is premised on the relevance and reliability of fair value information to the investment decision-making process. These views were first formally articulated in our 1993 publication, *Financial Reporting in the 1990s and Beyond*, and again in our 2007 publication *A Comprehensive Business Reporting Model (“CBRM”)*.³

Our advocacy on accounting issues is premised upon our mission of educating analysts and investors about sound financial analysis and investment decision-making and in increasing the economic relevance, transparency and usefulness of financial reporting information for our charterholders⁴ who are major “users,” “investors” and ultimately “consumers” of financial information.

Our position is further supported by our member surveys which may be found in our [Summary of CFA Institute Member Surveys](#) (“Survey Summary”) on our website. Over the years we have conducted a variety of member surveys which have shown increasing support for the appropriateness of fair value measurements. During November 2009 we conducted a detailed survey of our members on various issues associated with the measurement of financial instruments the results of which are included in the Survey Summary but which again demonstrated support for fair value.

Given that much of the discussion regarding the Proposed Update has been focused on the singular issue of fair valuing loans, we felt it both timely and appropriate to check our members’ views, once again, on this issue. As can be seen in the Survey Summary our November 2009 survey showed that our members favored fair value over amortized cost measurements for loans by a 2:1 margin with 52% believing fair value was the most appropriate measure while 26% believing amortized cost was appropriate and 22% were unsure. Also as a part of this September 2010 survey, we asked our members whether CFA Institute should support the Proposed Update’s recommendations relating to accounting for loans. Our intention was simply to seek an “up or down vote” on the appropriateness of fair value measurement for loans and on whether CFA Institute should support the Proposed Update as it relates to the fair valuing of loans. Using a sampling technique consistent with our previous survey we asked our members to express their views in late September 2010. During the four business days the survey was open – compared to the two week survey period in November – the number of respondents nearly doubled from approximately 625 to 1,100. ***The results showed support for fair value of loans increased from 52% to 71% while the support for amortized cost increased only slightly from 26% to 29%. Further, 68% of respondents indicated that CFA Institute should support the FASB proposal regarding measuring loans at fair value. These results – subsequent to the significant public debate on the fair valuing of loans – reaffirm that CFA Institute members continue in their strong support for fair value as the preferred measurement basis for loans.***

³ *A Comprehensive Business Reporting Model*, CFA Institute, 2007.
(<http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2007.n6.4818>)

⁴ Administered by the CFA Institute, the Chartered Financial Analyst® (CFA®) Program is a graduate-level, self-study curriculum and examination program for investment specialists. To earn the CFA charter, you must successfully pass through the CFA Program which includes three comprehensive examinations which cover a broad-based curriculum with professional conduct requires to prepare charterholders for a wide range of investment specialties.



Decades of Similar Opposition to the Expansion of Fair Value Disclosures and Measurements

As we consider the comments of those opposing the Proposed Update, we find they are virtually identical to those made against every extension of the use of fair value since the early 1990's. Those who are arguing against the Proposed Update also opposed the inclusion of fair value disclosures in the financial statements with the adoption of SFAS 107, *Disclosures about Fair Value of Financial Instruments*, (Topic 825), the implementation of fair value to debt and equity securities with the adoption of SFAS 115, *Accounting for Certain Investments in Debt and Equity Securities*, (Topic 320), and the adoption of fair value for derivatives under SFAS 133, *Accounting for Derivative Instruments and Hedging Activities*, (Topic 815), and as they themselves acknowledge, they used the same arguments to oppose those advances of fair value. The debate over the disclosure and use of fair value for debt and equity securities and derivatives was equally as engaging. However, because of the widespread investor acceptance of such measures as relevant and decision-useful, even those opposing the Proposed Update have acknowledged the usefulness of these fair value measures. As we would expect, a similar education process, combined with experience in determining and using fair value measures, is necessary for preparers, auditors and investors to accept the relevance, transparency and decision-usefulness of fair value measures for other financial instruments such as loans and financial liabilities. In our long experience, as the relevancy of such measures become more clearly understood the reliability of such measures increases.

Proposed Update Represents Pragmatic Compromise

CFA Institute views the Proposed Update as a reasonable and pragmatic compromise by the FASB. Though the Proposed Update does not go as far as our historical position would suggest or recommend, we believe the FASB has achieved a balance between investor needs and potential regulatory capital considerations. We do not favour a mixed measurement model, as we do not believe it to provide decision-useful financial statements. We disagree with the view that management's intent should affect the reported measurement of a financial instrument. However, we believe the FASB has achieved a balance in providing fair value information within the basic financial statements, rather than simply providing it as a disclosure in the notes, and in maintaining elements of net interest margin, which some analysts find useful.

Organization of Our Comment Letter Response

Below we provide an overview of our responses to the questions posed in the Proposed Update. Our detailed responses are included in the **Appendix** attached to the comment letter. We also provide in this comment letter an overview of how we arrive at our position for supporting fair value as the measurement basis for financial instruments and we address several of the key arguments in opposition. Both our basis for supporting fair value and the consideration of arguments against fair value are more fully developed in detailed documents which can be accessed on our website through the links provided below.

Overview of Responses to Proposed Update Questions

Scope

We believe that the overarching consideration for inclusion of items within the scope of the financial instruments Proposed Update, ought to be whether the underlying economics suggest the item is a financial instrument rather than the existence of an artificial accounting construct which establishes the scope of the proposed standard. Accordingly, we support the extension of fair value to loan commitments (i.e. practicability exclusions for certain credit card commitments should be removed); financial liabilities of investment companies and broker-dealers; and to deposit type insurance contracts. As it relates to the proposed fair value treatment of money market funds, we believe the financial crisis demonstrated the importance of extending fair value to such instruments. We fully support the proposed guidance to account for equity method investments at fair value unless the investee can be demonstrated to be related to the entity's consolidated business.

Recognition & Measurement

Though we support a single fair value measurement model for financial assets and financial liabilities and find no conceptual basis for the inclusion of fair value measurements through accumulated other comprehensive income, we are supportive of the FASB's Proposed Update as a reasonable and pragmatic compromise toward the further extension of fair value to financial instruments, because the proposal maintains traditional income statement measures (e.g. net interest margins) which some investors find useful while at the same time increasing the transparency and relevance of the statement of financial position by including these relevant measurements in the statement of financial position, ensuring fair value measurements are prepared on the same basis (e.g. SFAS 157 (Topic 820)⁵ vs. SFAS 107) and providing them in a more timely manner. Consideration of the recognition and measurement provisions of the Update are as follows:

- 1) ***Fair Value vs. Transaction Price*** – We do not believe there is a conceptual justification for recording identical financial instruments at a different value depending upon whether they will be subsequently measured at fair value through net income (fair value) or through other comprehensive income (transaction price). We do, however, agree with the requirement that an entity consider whether other elements of a transaction may be present when transaction price and fair value are substantially different and that if such differences do not represent an asset or a liability – or do not represent differences associated with transaction fees or costs or because of prices in different markets – that they be recognized into net income immediately.
- 2) ***Transaction Costs*** – We are not supportive of a difference in the treatment of transaction fees and costs depending upon the subsequent measurement of financial instruments as we cannot find any conceptual justification for such a difference in treatment. Transaction fees and costs either meet the definition of an asset or liability or they do not and subsequent measurement is not a factor in that determination. We do not find in the Basis of Conclusions a justification for this difference in treatment.
- 3) ***Financial Liabilities*** – We support the measurement of all financial liabilities at fair value, both at inception and in subsequent periods because we believe fair value measurements provide information which is decision-useful to investors. Under the FASB's current proposal there are several measurement alternatives for financial liabilities. We find that these measurement choices imply that management intent changes the value of a financial liability, which cannot be true and the result in a lack of consistency within an entity's liabilities and of comparability among entities' liabilities which will create unnecessary complexity. See also our remarks

⁵ FASB Topic 820, *Fair Value Measurements and Disclosures*, formerly Statement of Financial Accounting Standards (SFAS) No. 157, *Fair Value Measurements*, defines fair value as an exit price and establishes a fair value hierarchy where fair value measurements are classified by the observability of their inputs. Level 1 measurements are based upon inputs which are quoted prices in active markets. Level 2 measurements are based upon inputs other than quoted prices within Level 1 but that are observable either directly or indirectly. Level 3 measurements are based upon inputs which are unobservable.

regarding financial liabilities under the Relevancy discussion (Item 1(i)) in the Basis of Support for Fair Value as the Appropriate Measure of Financial Instruments section which follows.

- 4) Recycling – Because we believe that deferral through accumulated other comprehensive income is not the appropriate accounting for the transactions noted above, we conceptually oppose the re-cycling of economic changes which have been included in other comprehensive income since the full effects of these transactions become difficult for investors to fully evaluate. That said, we believe the FASB’s decision to recycle items out of accumulated other comprehensive income to preserve the aspects of net interest margin which some financial institution investors find useful is a reasonable and pragmatic compromise toward the further extension of fair value to financial instruments and we prefer the FASB’s more consistent approach to recycling than the International Accounting Standards Board’s (“IASB”) inconsistent approach.
- 5) Reclassification – As we do not agree with the ability of management to use a classification based upon business strategy or holding intent – because such a strategy does not change the value of a financial instrument – we believe the need for such a reclassification decision is conceptually unnecessary. As a practical matter, we don’t support reclassification as it will likely be used to be used to justify entities’ recognizing gains and losses opportunistically which violates the spirit of the original intent based decision to hold instruments for contractual cash flows. From a theoretical perspective, we shouldn’t oppose reclassification of a financial instrument from fair value through other comprehensive income to fair value measurement through net income as we believe this is always the most appropriate measurement basis. However, we believe the need to ask the question regarding reclassification – and the existence of disclosure requirements – is indicative of the problems which will surely arise with the mixed measurement model in its practical/real world application. If reclassification is allowed, we believe the financial statements should be restated to reflect management’s revised intent and if there are substantial reclassifications over time (indicating the management did not have the ability to make reasonable classification decisions in the first place) that the entity should no longer be allowed to classify financial instruments on a basis other than fair value through the income statement.
- 6) Core Deposit Liabilities – The valuation of core deposit liabilities of a depository institution is a particularly challenging aspect of the Proposed Update. First, we find it unusual that the Proposed Update now implies that the core deposit intangible recognized in a business combination include multiple intangibles. If there were multiple intangibles associated with the core deposit intangible, the business combination literature would suggest they should have been separately identified and measured during the purchase price allocation process. Second, the Proposed Update indicates that the portion of a core deposit intangible related to the lower cost of funds can be measured and recognized without the consummation of a business combination. Both of these aspects of the Proposed Update make the question of how to value core deposit liabilities challenging.

Simultaneously, when considering the issue of how to value core deposit liabilities in the context of a fair value paradigm, recognizing the core deposit liability at the demand amount does not appear to be theoretically consistent with a fair value model. This theoretical inconsistency stems from the fact that there is a demonstrably low probability that the cash outflow for such liabilities will occur within a time period which suggests that the time value of money is irrelevant to the determination of their value. Further, when you consider the nature of core deposit liabilities in the context of financial instruments which have similar deposit characteristics but which may be accounted for under an expected cash flows approach in the Insurance Contracts Project, there appears to be a need to reconcile the conceptual inconsistencies.

We unequivocally believe that the core deposit intangible asset can be a major source of value for a depository institution, and a business combination should not be the only time that the value of an internally generated intangible asset is recognized. However, we believe that the concept of recognizing internally generated intangibles, such as what this measurement would represent, should be considered more broadly before recognition should be given for one intangible related principally to the banking industry. Further, we agree with the dissenting view that the guidance is proposing a new measurement attribute for core deposit liabilities that does not incorporate all the features of a full fair value measurement, and therefore, the measurement of the core deposit liability and its related intangible asset would not be completely captured by the computation being prescribed by the Board. The proposed measurement basis is also not equal to amortized cost, and therefore, we believe that the proposal would introduce a new element of complexity to the financial statements which may not be widely understood. Still further, the proposed approach would essentially net an element of the core

deposit intangible asset against the deposit liability which – if this is truly the valuation of an intangible asset – we find conceptually difficult to justify.

For all of these reasons, we believe this issue needs to be more fully deliberated and the matters noted above considered. What is unequivocally needed are enhanced disclosures regarding core deposit liabilities including data points, estimation techniques, and estimated values of core deposit liabilities and intangibles (purchased or internally generated) which will enable an analyst to better understand the value of these instruments and intangibles.

- 7) *Other Items* – Our views on redemption value for certain instruments, deferred taxes in other comprehensive income, convertible debt, hybrids, and short-term investments are included in the **Appendix**.

Credit Impairment & Interest Income

Overview

With a fair value based measurement method there would be no need for the determination of credit impairment estimates, interest income recognition pattern estimates, allowance accounts or changes in the definition of amortized as required by the FASB and/or IASB proposals. Below are some of our perspectives on credit and interest income provision of the Proposed Update and how they compare with the IASB's proposals:

- 1) *Credit Impairment* – As we stated in our letter to the IASB on its exposure draft related to impairments, we question whether the impairment methods – and interest income recognition methods – proposed by the FASB and IASB in these proposals are less subjective or less complex than the use of fair value and whether they more faithfully represent the underlying economics of the financial instruments to which they will apply. They each appear to be an “accounting construct” rather than a measurement method which is premised upon reflecting the underlying economics of the transactions currently occurring in the marketplace. We understand how differences of opinion may exist on the accounting for financial instruments as it relates to the use of fair value versus a mixed measurement model, but we are disappointed that the IASB and the FASB could not come to an agreement and reach a more converged solution as it relates to credit impairment as we believe that users of financial statements would benefit from a single impairment model. A single impairment model would improve consistency and comparability. Differences in the use of past and current information in the projection (expectation) of losses under the FASB and IASB approach illustrate that these measures – though sometimes both referred to as “expected loss approaches” – could produce substantially different credit, and interest income, recognition patterns over the life of a financial instrument and result in confusion for users regarding what economic expectations have, or have not, been incorporated into a preparers' estimates.

We are surprised by the fact that the FASB's proposal is progressive in its approach to the recognition and measurement of financial instruments, through the extension of fair value, but not as progressive in its determination of credit impairments in that it does not incorporate expectations regarding future events. Use of an expected loss model for credit impairment which incorporates past, existing and future conditions most likely minimizes the differences between a fair value model and an amortized cost/mixed measurement model. Said differently, if both fair value and a mixed measurement model incorporate future expectations of credit and interest rates are observable then the only significant estimation difference for debate is the pricing of liquidity.

- 2) *Interest Income* – Consideration of the appropriate recognition and measurement of interest income is inextricably linked to the consideration of the measurement of credit impairments. Some seem to suggest the use of an expected loss model for impairments while simultaneously seeking an interest income recognition pattern based upon the contractual cash flows of the financial instrument. The cash outflow for an investment and the cash inflow for its repayment, or failure to repay, are equated through either adjustments in credit impairment measurements or differences in measurement of net interest income. The FASB and IASB model simply equate the cash inflows and outflows differently, but, in either case, interest income is impacted by the discounting of the expected credit losses. Fair value would eliminate the need to make this artificial separation. Investors would simply need to see the cash flows and the associated remeasurements.



- 3) Amortized Cost – Because of the interconnectedness of the credit impairment and interest income measures and the IASB’s means of equating them through the use of an effective yield approach, they have changed the historical definition and objective of amortized cost measurement which we think is a concept many, except the most sophisticated, users/investors have not realized. As we considered the IASB’s proposal during its comment period, we were reminded that the definition of amortized cost has historically been different between U.S. GAAP and International Financial Reporting Standards (“IFRS”) – most significantly that the IASB definition included the allowance account in its definition and the U.S. GAAP definition did not. With the changes proposed in this Update, and the changes proposed by the IASB in their definition and objective of amortized cost, we believe the difference in definition and objective of amortized cost only further diverge rather than converge. Under the currently proposed IASB definition, amortized cost will continue to include the allowance account but will be modified to include the “write-up” for positive changes in expected losses because the definition includes the allowance account. We believe the inconsistency in the definition of amortized cost will not be widely understood and appreciated by investors, defies the objective of convergence and will result in a lack of comparability combined with confusion for users.
- 4) Understandability – These differences in incorporation of information and expectations combined with: a) differences in the definition of amortised cost, b) the highly complex methods of computing impairments, and c) the technical differences in calculating effective returns; will not only result in a lack of comparability between U.S. GAAP and IFRS preparers, but will likely only be understood by a small percentage of users and investors. Further, to obtain the most meaningful input from users and investors it would be helpful for the FASB and IASB to publish illustrations of the application of their respective models on similar instruments across time. Such illustrations would need to include examples of a fixed rate, variable rate and changing notional amount instruments. Illustrations would enable users to better understand, analytically, the impact of the proposed standards and allow for greater input from investors.

Consideration of Specific Questions Related to Credit Impairment & Interest Income

Provided below are a summary of our responses to the Update’s questions on Credit Impairment and Interest Income:

- 1) Credit Impairment Objective & Recognition and Expectation Changes –
 - a. Objective – Conceptually, we agree with the definition of a credit loss being an expectation that an entity will not collect all of the anticipated cash flows or as stated in the Update: “on the basis of an entity’s expectations about the collectability of cash flows, including the determination of cash flows not expected to be collected.” We do not agree, however, with the second portion of the objective which indicates: “An entity’s expectations about collectability of cash flows shall include all available information relating to past events and existing conditions but shall not consider potential future events beyond the reporting date.” We believe credit impairments should be based on an expected loss model considering an entity’s historical loss experience and estimates of future changes to those expectations. The objective does not articulate how the credit impairment should be measured, this is stated elsewhere, but implies that the recognition occurs when the expectation that all contract cash flows will not be received is satisfied. This results in an expectation of losses at inception and the immediate recognition of such losses under the FASB approach. We do not agree with the proposal to the extent that it will result in the immediate recognition of impairment upon the origination of a loan, or purchase of securities. Such expectations are priced and reflect the risk uncertainty inherent in the extension of credit and are included in the interest rate charged on the instrument. Such an approach is not consistent with a fair value notion. Under an approach where impairments are taken immediately, the financial statement valuation will result in financial assets being reflected at a value below fair value.
 - b. Recognition – We are supportive of the recognition of credit impairment over the life of the financial asset as the uncertainty is resolved which is how the market would recognize such losses. Our view on the timing of when to record the credit impairments is more in line with the IASB model whereby the original effective interest rate includes a provision for expected credit losses and the allowance is built over time – though we recognize this model is not consistent with a fair value approach in that it utilizes the original effective yield to determine its impairment loss (i.e. it discounts the revised expected cash flows using the original effective yield rather than a revised market yield which would likely be higher due to the deteriorating credit). We are more supportive of the IASB’s model which suggests an entity should recognize a credit impairment for the

difference between the original effective yield excluding credit impairments (i.e. the effective yield computed considering premiums and discounts but not potential future credit losses) and the effective yield including expected credit losses over the life of the asset. Unlike the IASB model, the FASB model does not attempt to entirely isolate the credit impairments from the interest income. While the impairment charge will occur earlier and will be separately identified at inception under the FASB model, there will be an increase in the impairment charge over the life of the instrument in interest income. This portion of the credit impairment will, like the IASB model, reduce interest income – just not as significantly as the IASB’s model – and will not be presented separately. Most users, investors, and analysts state they prefer separate identification of the impairment amount from the contractual interest amount.

- c. Expectation Changes – We are not supportive of revisions to expected future losses being entirely deferred – through a prospective only yield adjustment – and recognized over the remaining life of the financial assets. We believe market anticipated credit losses should be recognized as they occur and that an entirely prospective yield adjustment is not appropriate. As with fair value, we believe changes in credit impairments, upward or downward, should be reflected in income when expectations change.
 - d. Measurement – As we stated previously, in principle, we support an “expected loss” model which updates expectations each measurement period in place of the existing “incurred loss” model because expected loss model uses more forward-looking estimates of expected credit losses, which we believe is more consistent with the underlying pricing/valuation of such investments, and, therefore, is closer to a fair value approach. While we believe the expected loss model should incorporate future expectations and likely future economic conditions, we are not supportive of a “through-the-cycle” approach which considers these expectations but then “smoothes” the recognition through economic cycles. This detracts from the decision-usefulness of the information to investors in that it masks underlying risks. Both the FASB and IASB models discount expected losses at the original effective interest rate. Because original effective interest rates will be likely be lower than updated effective rates when credit begins to deteriorate, both models have the effect of increasing the amount of the credit impairment immediately recognized as the cash flows will be discounted at a lower rate than what the market might discount the rates. Fair value would provide a better economic reflect of the amount of the credit impairment.
- 2) Changes in Cash Flows Related to Other Than Credit – We find no conceptual justification for the retention of the foreign exchange gain or loss in accumulated other comprehensive income. We believe that the currency changes should be recognized as incurred through net income as, unlike the local currency principal amount, there is no basis for the assumption that the amounts will revert to the spot rate on the date the transaction was entered into simply because the financial instrument is being held for receipt or payment of contractual cash flows.
 - 3) Other Credit Impairment Related Questions – In the **Appendix** we present our views on historical loss rates, the use of individual versus pooled impairments, the removal of the probability threshold, and the impact of increases in expected cash flows on purchased assets.
 - 4) Interest Income Related Questions – Because of the interconnectedness of the credit impairment and interest income computations our views related to interest income recognition are evident from the discussion of credit impairment above. We believe recognizing interest revenue in a pattern consistent with expectations of the amount and timing of expected credit losses appears to be a consistent manner of allocating interest earned with expected credit risk. The use of the effective interest method as computed at the inception of the financial asset would appear to align with this revenue recognition objective and reflect the market’s pricing of the uncertainty associated with the credit risk of the instrument. Further, we note that at subsequent measurement dates the use of the original effective interest or effective spread method will not, however, reflect the market’s perception of the amount or timing of credit risk associated with the financial instrument and, as such, is not our preferred solution. Rather, we believe that resetting the effective yield for current market conditions based upon fair value would produce measurements that better reflect the economic characteristics of the instrument.

In the **Appendix** we present our views on the other specific interest income related questions in the Proposed Update.

- 5) Implementation Guidance and Illustrative Examples – As noted previously, we strongly suggest that the FASB and IASB both include further implementation guidance and illustrative examples to provide additional guidance on the credit impairment and interest income models in their proposals. We believe this is important for preparers to accurately prepare the estimates, auditors to audit the information and users to better understand



the results. Specific examples should include financial instruments with fixed rates, variable rates, and adjustable principal (e.g., inflation adjustable) along with examples of complex structured securities where multiple factors change during the same reporting period (e.g., credit, prepayment, interest rates, etc.). We draw particular attention to the need for guidance regarding how the effective interest rate is calculated and what it represents across a variety of scenarios.

Hedge Accounting

Overview

We appreciate that hedge accounting was introduced to minimize the measurement and recognition inconsistencies that may arise between the accounting treatment applied to hedging instruments, such as derivatives, and the accounting treatment applied to the hedged risk. Nevertheless, it is widely recognized by both users and preparers of financial statements that the application of hedge accounting has contributed to the overall complexity, inconsistencies and reduced transparency of financial reporting information.

We agree that the proposed widened application of fair value as a measurement basis for financial instruments should reduce the need for hedge accounting. We also fully support certain of the proposals to improve the depiction of hedge ineffectiveness, specifically the decisions to:

- Consistently treat under and over hedges of cash flow hedge accounting relationships;
- Eliminate the shortcut and critical terms method that require no assessment of hedge effectiveness after inception;
- Eliminate the de-designation of derivatives after election at inception so as to minimize gaming; and
- Provide additional disclosures including the cumulative fair value hedge accounting adjustments in the statement of financial position.

However, we are concerned by the inadequate definition of a reasonably effective threshold and the absence of robust qualitative criteria for determining hedge effectiveness. We support incorporating the qualitative criteria when making hedge ineffectiveness judgments, but in order to ensure consistent application by issuers and to allow the depiction of only legitimate economic hedging relationships, further development of such criteria is necessary.

Overall, we see the increased application of fair value accounting for financial instruments will result in greater reflection in the financial statements of the economic effects of risks and their hedging offsets. Further, changes in the measurement of cash flow hedging ineffectiveness to record both over and under hedges and the removal of the short-cut and critical terms method and the resulting requirement to measure ineffectiveness for all hedging relationships will result in a better reflection of the economics of such transactions in the financial statements. We are concerned, however, by the ability to use qualitative criteria to determine the effectiveness of a hedging relationship at their inception and the loosening of the effectiveness threshold when it comes to the hedging of forecasted cash flow transactions. We are concerned that these items taken together will result in an increased deferral of cash flow hedging losses in accumulated other comprehensive income which was a problem for several large financial institutions in the recent past.

Consideration of Specific Questions Related to Hedge Accounting

Provided below are a summary of our responses to the Update's questions on hedging:

1) Hedge Effectiveness –

- a. Modification of Effectiveness Threshold & Use of Qualitative Assessment Techniques – We are concerned by the absence of a robust and consistently understood criterion for determining eligibility for hedge accounting. We understand that the adoption of a “reasonably effective” instead of a “highly effective” threshold will lower the hedge accounting eligibility barriers and compliance costs for financial statement preparers. We acknowledge that rigid, bright -line tests (e.g. 80-125%) that are used in the high effectiveness assessment, often led to distortions in the judgment of economic hedge effectiveness by issuers. However, the failure to define what reasonably effective means and to provide guidance on qualitative criteria is a significant concern. An open ended definition of effectiveness, coupled with inadequate levels of disclosure on the criteria for determination of hedge effectiveness, is likely to impair the ability of users to make judgments on whether legitimate hedging relationships are in place and to assess whether they are, in fact, effective. We strongly believe the Board needs to provide a robust, qualitative assessment framework for making these judgments. Creating such a definition or framework is necessary so as to ensure consistent and comparable accounting across reporting entities. The Proposed Update delineates some elements that could go into determining effectiveness, including consideration of counterparty risk as part of hedge effectiveness testing, but the overall thrust, articulated by the Board in the Basis of Conclusions is to steer clear of providing any guidance on what reasonably effective means and this leaves it rather open-ended. In the absence of transparency on how this effectiveness determination is made, companies will have greater latitude to be inconsistent across reporting periods in their evaluation of hedge effectiveness. While this proposal will reduce the number of effective economic hedges that fail to qualify for hedge accounting, it will also likely increase the number of wrongly designated hedging relationships; especially as the judgment of effectiveness can be determined purely qualitatively. This will simply lead to a different type of misclassification and one that results in users underestimating rather than overestimating the risk exposures. Further, the misclassification will be especially problematic for cash flow hedge accounting, as it will increase the likelihood of inappropriate deferral of derivative gains and losses.
 - b. Elimination of Shortcut and Critical Term Matching Methods – We strongly support the elimination of the shortcut and critical terms method. The shortcut and critical terms methods required little or no ongoing monitoring of accounting hedges and exempted transactions from retrospective assessment. These methods also led to numerous restatements. We support the elimination of the shortcut and critical terms match methods for these reasons but also because the decision will enhance the consistency of financial reporting information by reducing the instances through which economically similar transactions can be accounted for differently, depending on managerial intent.
 - c. Ongoing Hedge Effectiveness Assessments – Consistent with our support for the elimination of the shortcut and critical terms method, we would not support the exemption of any derivatives instruments designated in hedging relationships from ongoing effectiveness evaluation under any circumstances. We are concerned about the proposal to move from the current approach of a periodic reassessment to a judgemental, discretionary reassessment of hedge effectiveness. This concern is exacerbated by the primary emphasis on a qualitative assessment of hedge effectiveness as proposed by the Update. This proposal may provide managers with greater latitude to mask derivative losses, as it is now easier, given the greater weight accorded to a qualitative assessment, to characterize hedges as being effective both at inception and on an ongoing basis. This is of particular concern for cash flow hedges where derivatives gains or losses are deferred through accumulated other comprehensive income. Further, we believe that with all hedges now requiring measurement of ineffectiveness the ability to make an ongoing quantitative assessment should be made easier for managers as significant ineffectiveness is a sign that the overall relationship is no longer effective.
- 2) Dedesignation of Hedging Relationships – We support the restriction of de-designation in situations other than when there is hedge ineffectiveness, termination, selling or exercising of derivative contracts. This restriction will minimize gaming through the opportunistic application of hedge accounting. This can occur in situations where managers arbitrarily get “in and out” of designated relationships for reasons other than those dictated by the underlying economic circumstances of the hedging relationship.

- 3) *Measuring and Reporting Ineffectiveness in Cash Flow Hedging Relationships* – Overall, we are supportive of the principles articulated in Update with respect to measuring ineffectiveness based on matching the value of derivative instruments to that of other derivatives instruments, which generate economically equivalent cash flow patterns relative to the hedged exposure (e.g. forecast transactions). We also support the use of the same credit risk for the matching pair of derivatives instruments. Disclosures should be improved so as to make users aware of where there is basis risk in cash flow hedging relationships. We support the adjustment to allow recycling of both over and under hedges because the partial recognition of over hedges made it difficult for users to interpret recycled cash flow hedge gains or losses. Incorporating both over and under hedges would make reported gains or losses to be a better representation of economic hedge ineffectiveness for designated cash flow hedging relationships. Users face a significant challenge in making meaningful economic interpretations of gains or losses that are shifted on an inter-temporal basis between other comprehensive income and net income, via deferral and recycling. As such, we do not support the Update’s continued ability to amortize the time value portion of options, when recycling to the income statement. Amortizing or smoothing the time value component of options, results in useless economic information as it results in partial recognition of gains or losses and contributes to gains or losses being recognized in unrelated reporting periods. Therefore the immediate recognition of the full time value portion for option contracts, when ineffective, should be required and entities should not be allowed under any circumstances to defer the recognition of changes in fair value in earnings related to the time value component of a purchased option when making ineffectiveness adjustments. This will allow the full income statement recognition of ineffective portions.
- 4) *Disclosures* – We support the proposed disclosure of cumulative fair value of items in hedging relationships accounted for as fair value hedges and we have no objection to the proposed disclosures related to hedging of own debt or other liabilities that are measured at amortized cost. We note that some of the proposed disclosure changes, though desirable, appear to be ad-hoc and not necessarily mapped to the fundamental hedge accounting model adjustments. We acknowledge that SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities* (included with the disclosure requirements of Topic 815), enhanced the required derivatives disclosures; however, there remains room for further improvement so as to better meet users’ analytical requirements. We would suggest that disclosures continue to be refined based on a holistic understanding of user analytical requirements as noted in our discussion of disclosures below.
- 5) *Additional User Concerns Not Addressed by Proposed Update* – Despite our support of some aspects of the proposals, the sum of these changes, can at best, only be considered as minor “tweaking” of the highly complex and anomalous approach that hedge accounting represents. To provide more useful information to investors, there remain areas that need further addressing so as to ensure a complete and accurate economic depiction of derivatives use and risk management activities. They include: a) bifurcation by risk; b) addressing the distortions of cash flow hedge accounting; and c) ensuring a converged approach by the FASB and IASB that yields the most decision-useful information. Our views are more fully articulated in the **Appendix**.

Presentation

We believe that the fair value and amortized cost information should be presented on the face of the statement of financial position for both financial assets and financial liabilities - not in the disclosures - and irrespective of whether the financial instrument is measured at fair value through net income, other comprehensive income or measured at amortized cost.

Presently, the Update does not require the presentation on the statement of financial position of amortized cost for financial assets and financial liabilities – other than financial liabilities which represent the entity’s own outstanding debt instruments – measured at fair value through net income. We believe amortized cost and fair value should both be presented on the face of the statement of financial position. We support the provision of the proposed reconciliation on the statement of financial position, for items that are recognized at fair value through other comprehensive income as prescribed in the Update. We would note the Update does not include a paragraph indicating that the fair value of financial liabilities measured at amortized cost should have their fair values disclosed on the face of the statement of financial position.



We support the separate presentation of the own credit risk component for financial liabilities that are recognised at fair value through net income. We believe there is substantial information content in such measurement and disclosure. However, while we understand the conceptual and theoretical underpinnings of the requirement to compute and separately present the entity specific portion of the own credit measurement movements due to changes in its credit standing from the systematic price of credit, we believe the practical measurement of such differences will be very difficult.

We agree with the provision of the Update which requires separate presentation of items measured at fair value through net income or through other comprehensive income. We would note, however, that the paragraph should be clarified to indicate that financial liabilities measured at amortized cost also be separately presented. Similarly, there should be separate presentation of core deposit liabilities based upon their unique measurement attributes.

Similar to the provision of the Update which requires the reconciliation of financial instruments measured at fair value through other comprehensive income, we support the proposals regarding the presentation of the elements of the core deposit liabilities measurement – should the remeasurement approach proposed remain in a final standard.

Given our views with respect to the recognition of foreign currency gains and losses as previously explained, we do not agree with the provisions of the Update which would not require separation of such foreign currency gains/losses.

Disclosures

We do not disagree with the disclosure additions being proposed; however, it is extremely difficult to assess holistically all of the required disclosures related to financial instruments and to determine if additional disclosures are necessary given that the disclosures have been codified over the many years and considering the following factors:

- 1) Financial instrument disclosures are included in various topics within existing codification.
- 2) Financial instrument disclosures are currently being modified.
- 3) Elements of this Proposed Update would change the accounting for certain financial instruments which would appear to necessitate the removal or combining of disclosures.

Without undertaking an extensive consideration of all the disclosure elements currently required across a wide range of financial instrument types (i.e., fair value measurements, credit impairments, derivatives, etc.) and analyzing them in conjunction with the new disclosures as proposed in the Proposed Update it is exceedingly difficult to ascertain with reasonable confidence that investors obtain the maximum benefit from the analytical content of the disclosures holistically.

Further, it is our observation that, in general, the disclosures proposed both in this Update and in relation to other existing financial instruments standards are in many ways in response to closing the gaps created by substandard recognition and measurement standards and, therefore, may not provide information essential to financial statement analysis. As noted above, there are many financial instrument disclosures interspersed throughout the existing body of accounting standards and it is difficult to obtain a clear picture of the analytical construct of the disclosures across the many financial instruments and their related accounting.

We recommend that the FASB dedicate itself to analyzing financial instruments disclosures in a comprehensive manner by capturing in one place all of the existing and proposed requirements across the wide-range of transaction types. Using this, the FASB should establish a conceptual framework for



financial instrument disclosures and determine whether or not the disclosures provide the various stakeholder groups, especially investors, with the ability to reconcile substandard recognition and measurement requirements as well as provide comprehensive analytical content that is essential to making informed capital resource allocation decisions.

Effective Date & Transition

Finally, we believe the transition provisions associated with the adoption of the Proposed Update need further consideration. A transition which does not provide comparative information is not useful to investors. We believe the most decision-useful information to investors would require full retrospective transition for all periods presented— even if that would require the deferral of the effective date.

Further, the various aspects of the Proposed Update may necessitate different transition considerations. For example, in computing the cumulative interest income adjustment and prospective interest income measurements, consideration needs to be given to the requirement to re-estimate credit allowances for each prior period to arrive at an accurate cumulative adjustment and prospective interest computation.

Basis of Support for Fair Value as the Appropriate Measure of Financial Instruments

The basis for our position can be found in our supplement to this letter, [Fair Value as the Measurement Basis for Financial Instruments](#) (“Basis Supplement”), which is accessible on the CFA Institute website. As more fully developed there, our support for fair value measurements emanates from several key principles:

1) **Relevance** –

- a. **Fair Value Reflects How Transactions Are Executed** – Transactions take place at fair value. Financial institutions only lend against fair value. Investors find this information equally valuable in making their decision on whether to invest in the securities of a financial institution.
- b. **Fair Value Reflects Economic Reality** – Fair values reflect the most current and complete expectation and estimation of the value of assets or obligations, including the amounts, timing, and riskiness of the future cash flows attributable to assets or obligations. For example, some parties object to fair value measurement’s inclusion of liquidity risk in valuations. We do not agree with this opposition since oftentimes liquidity for an instrument can dry up in response to the inherent risk of the financial instrument.
- c. **Amortized Cost is Outdated, Lacks Comparability And is Not Relevant** – Those supporting the retention of historical cost/amortized cost argue that is better because “it is the truth.” While it is true that historical costs represents the historical market value at which the entity entered into the transaction, these values are generally no longer representative of, and may have little relation to, current fair value of the assets and liabilities. Further, historic cost data are never comparable firm-to-firm because the transactions entered into by and between reporting entities were executed as of different dates and in different interest rates environments. When considering alternative investment choices amortized cost information is not decision-useful. Overall, fair value is needed because historical cost information is seriously outdated and lacks comparability because it reflects measurement of the assets and liabilities at different dates in the past. As noted in the Basis Supplement, academic research supports similar conclusions with regard to the lack of relevance of amortized cost measures. While the FASB and IASB (the Boards) may not see it as their role to provide comparable information across institutions competing in the same sector or industry, it is our position that the Boards have a responsibility to recognize that most investors evaluate companies by comparing them against other competing firms. Accordingly, providing decision-useful information to the investment community means that this reality has to be a central consideration in the contemplation of the appropriate accounting model. Given that relative valuation techniques such as the price-to-book ratio are among the most prevalent valuation techniques used by market participants evaluating financial sector stocks, it is not an appropriate position to argue that populating the ratio with non-comparable amortized cost information will yield an investor more decision-useful information than the same ratio populated with fair value information.
- d. **No Compelling Argument That Amortized Cost Results In Better Investment Decision-making** – In the Basis Supplement we provide a simple illustration, and reference examples provided by FASB Chairman Herz, as to why fair value provides more relevant information for investment decision-making. Based upon our review of comment letters and arguments of those proposing the use of amortized cost, there is no articulation or illustration of how better investment decisions can be made with amortized cost information. We find statements of belief, but there is neither a compelling argument nor conceptual basis presented which demonstrates that amortized cost information leads to better investment decision-making.
- e. **Surveys Suggest Mixed Measurement Model Is Not Most Decision-Useful** – CFA Institute member surveys have found that investors consider fair value to be highly relevant to the measurement of financial instruments. Interestingly, although a recent PricewaterhouseCoopers⁶ survey – purports to support retention of the existing mixed attribute model, a subtle reading of that survey supports the relevance of fair value measures and the lack of usefulness of current financial reporting practices. When asked whether investment professionals make significant adjustments to financial instrument information provided either in the primary financial statements or in the disclosures, 62% of respondents indicated they always or usually make adjustments with 33% occasionally making adjustments. The 62% of respondents who

⁶ PricewaterhouseCoopers; *What Investment Professionals Say About Financial Instrument Reporting*; June 2010; Page 9.

indicated that they always or usually make adjustments were asked why they make such adjustments. The survey found that that 53% of respondents indicated they make adjustments to reflect different valuation assumptions than those reported in the financial statements and 42% indicated they found the measurement/valuation basis not helpful. Additionally, 45% indicated they found that the financial statements did not appropriately reflect the asset/liability mismatch. These analysts are adjusting what is reported in the basic financial statements to another measurement basis as they did not find the current measurement basis in the financial statements helpful to analysis. This finding contradicts their apparent support for retention of the status quo in the measurement of financial instruments. While analysts will always make adjustments to forecast earnings and the value of the enterprise, the use of fair value measures which incorporate elements of valuation will result in more informative and useful adjustments.

- f. *Market Prices Demonstrate Investors Adjust Book Values* – The recent financial crisis saw many financial institutions’ share prices trade well below book value. This discount to book value is an indication that investors did not find the value of the assets and liabilities recorded within the financial statements to be true measures of economic value. This is evidence that historical cost measures reported within the basic financial statements are disconnected from economic reality.
- g. *Highly Relevant Information on Values Belongs on the Statement of Financial Position Rather Than As A Subsequent Disclosure* – Information which is so highly relevant to investment decision-making should not be relegated to the footnotes where it is often released weeks after the earnings release and prepared on a basis different (i.e. not exit value) than other financial instruments. Conference calls are typically held immediately after the earnings release date, and before the filing of the Form 10K or Form 10Q, which precludes analysts from questioning management about information they don’t have. Further, by providing the fair value information in the notes and expecting users to overlay the information themselves puts less sophisticated investors at a significant disadvantage.
- h. *Academic Research Finds Relevancy in Fair Value Measures* – Significant academic research has been conducted over the last two decades – as fair value measures have been incorporated into financial reporting either through disclosures or as the measurement basis within the basic financial statements – on the topic of the relevancy of fair value measures and how relevance is impacted by reliability. Overall, the research provides substantial evidence that recognized and disclosed fair value measures are relevant to investors and reliable enough to be reflected in share prices. In the Basis Supplement we consider and cite the empirical research of these academics in support of this conclusion.
- i. *Relevance of Financial Liabilities* – In an Appendix to the Basis Supplement we consider the relevance of the fair value measurement of liabilities separately as some view these as a “special case.” There we explain the decision-usefulness of such information across accounting periods and between organizations and provide simplified illustrations of the relevance of fair value measures for liabilities. We also address the arguments against fair valuing liabilities, including that the results are counterintuitive, the potential gains cannot be crystallized, the accounting mismatches which may result from the use of such fair value measures and the notion that contractual cash flows are the only relevant measure of liabilities. We provide examples of organizations that have recently realized these own credit gains and we consider the academic research on this topic which shows the value relevance of such measures.

In the **Appendix** to this letter we provide our responses to the specific questions in the Proposed Update related to financial liabilities, and we explain why we believe the Boards need to consider and resolve broader, more conceptual issues as it relates to their beliefs on how liabilities should be measured before reaching a conclusion on this standard. As we consider the projects before the Boards we find a lack of conceptual consistency with respect to how they are deciding liabilities should be measured within or between U.S. GAAP and IFRS. In the **Appendix** we outline several questions we think the Boards should reach conclusions with respect to the measurement of liabilities to ensure consistency across projects and between U.S. GAAP and IFRS.

2) *Reliability* –

- a. *Relevance Has Primacy Over Reliability* – The CBRM articulates twelve key principles of financial reporting, one of which is that relevance and timeliness have primacy over reliability. While we do not believe reliability is unimportant, the most reliable number may, however, only be known with perfect information at the time when that information may no longer be relevant. We believe that investors are better served with reported amounts that are approximately right rather than those that appear precise or easy to calculate, but have limited relevance.
- b. *Reliability is Not Dependant on Absolute Verifiability* – To be reliable a measure does not need to be perfectly verifiable. A Level 3 measurement is not unreliable because it cannot be “looked-up” somewhere. If it is representationally faithful and free from bias, it is reliable.
- c. *Amortized Cost: Verifiable But Not Representationally Faithful* – Amortized cost may be “verifiable” through comparing source documentation to a past transaction. However, it is not representationally faithful as it has little, if any, relation to the current value of assets or liabilities. As such, it is not reliable. Amortized cost fails to reflect current values because it is untimely historical information which does not reflect an update of future cash flows and risk-adjusted discount rates. Amortized cost essentially looks at factors such as interest rates and cash flow streams and makes simplifying assumptions that these factors should be held fixed through time. As a result of these simplifying assumptions, the amortized cost model is inconsistent with economic reality. Investors’ capital is needlessly put at risk when they are asked to depend on the flawed simplifying assumptions inherent in the amortized cost information included within the basic financial statements. The amortized cost model is particularly incapable of presenting representationally faithful information for long-duration financial instruments.
- d. *Issue of Relative Improvement in Reliability: Reliability of Fair Value Measures vs. Reliability of Historical Cost Measures* – The issue before accounting standard setters is one of relative improvement in estimates, information quality, transparency and decision-usefulness. The issue isn’t one of perfect reliability, or verifiability, as those who insist on calling fair value accounting “mark-to-market accounting” suggest – implying that market verifiability is an essential element of fair value accounting. Our view is that the use of fair value would introduce a measure of market discipline and result in relative improvement in measurement estimates, information quality, transparency and decision-usefulness. Central to this conclusion is that fair value includes the following attributes: a) a consistent definition as an exit value notion; b) incorporation of all relevant value inputs, c) emphasis on the maximum use of market observable inputs; and d) an ability to utilize unobservable inputs when necessary. These attributes are further strengthened when combined with high-quality disclosures of the observable and unobservable significant inputs along with estimation techniques and measurement ranges.

The reliability of fair value measures – like any management estimate – is dependent on the quality (i.e. representational faithfulness, neutrality and verifiability) of the underlying inputs and measurement techniques. Issues such as informational asymmetry and the potential for adverse selection combined with the moral hazard of having management apply the information to fair value measurements in a neutral and unbiased way are issues which may impact the reliability of such measures – particularly Level 3, and certain Level 2 valuations. The creation of the fair value hierarchy in SFAS 157 (Topic 820) was meant to communicate to investors and users the subjectivity, and potential degrees of reliability, of fair value measures by communicating the observability of inputs and the types of estimation techniques. Similarly, Topic 820’s disclosures are meant to assist investors in understanding and evaluating the quality of such measurements. Certainly, the more subjectivity involved in an estimate, the greater the potential for reliability concerns. This holds true for fair value measures and existing estimates (e.g. valuation allowances and impairments); however, fair value has a consistent definition and emphasis on market inputs and market discipline.

The issue for standard setters is not whether fair value is perfectly reliable but whether fair value is more relevant and at least as reliable as amortized cost (which we have discussed previously as being neither reliable nor relevant). Financial institutions and financial reporting were all failed by the use of amortized cost combined with allowance, provisioning or impairment techniques (i.e. incurred or expected loss) during the most recent financial crisis. Existing measurement techniques for determining impaired assets share estimation biases and difficulties similar to fair value measurement techniques but they lack the

requirement to reference inputs or estimation techniques to market forces as is required by fair value measurements.

- e. *Existing Estimates Also Have Reliability Issues: They Are Essentially Unobservable “Level 3” Estimates* – Those opposed to fair value measures and who highlight their “lack of reliability” as the basis for their opposition fail to acknowledge that the provision for credit losses on loans, for example, is subject to the same estimation issues and biases which they use to declare fair values unreliable. Credit loss provisions are, in fact, Level 3 estimates in that they utilize unobservable, entity specific inputs. Issues such as informational asymmetry, the potential for adverse selection and the moral hazard of having management arrive at such fair value measurements are equally applicable in the determination of the allowance for loan losses. The criticisms of the reliability of fair value measures – particularly Level 3 fair value measures – are also applicable to management’s estimates of loan provisions. Further, events of the recent financial crisis have raised significant questions regarding the reliability of such measures as they did not adequately communicate to investors the risks or losses inherent in the assets measured using this approach.

We would argue that non-fair-value measures are more suspect than fair value measures when it comes to incorporating “unobservable” inputs because their use of management discretion make no attempts to define a unifying benchmarking mechanism to align unobservable assumptions across firms economic reality.

Because of these factors, we question how the reliability of the existing measurement approaches could be deemed to be more reliable than fair value. Fair value attempts to invoke a standard measurement definition, reference to market based inputs, when observable, and to include all inputs which are relevant to the valuation of a financial instrument (e.g. the risk-free rate and liquidity in addition to credit.) In the Basis Supplement we consider the remarks of one bank analyst who noted the insufficiency of the current accounting for financial instruments, the issues with income statement focused bank valuation analysis, and the lack of reliability of management’s estimates during the recent financial crisis.

- f. *Fair Value Estimates Are Relevant Because They are Reasonably and Sufficiently Reliable* – Many who oppose fair value claim that fair value measurements should not be utilized because they – most specifically Level 3 measurements – are not reliable. In the Basis Supplement we consider the results of several academic research studies which find that fair value disclosures and measures – including Level 3 measurements – are sufficiently reliable to be incorporated into share prices. Further, we consider the impact of the uncertainty which might result from not having such fair value measurements. Fair value measures which have consistency in definition, incorporate all elements of financial instrument measurement, invoke some degree of market discipline and which are more relevant to investment decision-making are better measurements for recognition of financial instruments within the basic financial statements. This conclusion is based upon our review of the academic research which demonstrates the reliability and relevance of fair value measures and our consideration of the reliability of fair value measures relative to existing estimates which incorporate no element of market discipline.
- g. *Ability to Reliably Measure Expected Future Credit Losses But Not Reliably Measure Fair Values?* – Some parties who are unsupportive of the extension of fair value because of their claim that it lacks reliability in measurement simultaneously argue for an expected future credit loss model. There seems to be a contradiction inherent in the argument that current loan fair values cannot be reliably determined while, at the same time, asserting that credit risk over a long-term (e.g. thirty-year) loan can be reliably measured. Further, we would also observe the inherent contradiction of those who propose an expected loss model while simultaneously indicating fair value information will be pro-cyclical or create volatility – as expected loss models create similar economic effects. We support an expected cash flows approach which utilizes future expectations because this is more consistent with fair value. We do not support an expected loss approach which smoothes losses using a “through-the-cycle” approach. A comparison of an expected loss approach with a fair value measurement approach would suggest that if risk-free interest rates are observable and credit can be reliably measured, as suggested by those advocating an expected loss approach but opposing the Update, then liquidity is the only significant element of the fair value computation left to estimate. Liquidity is priced into long-term loans as they are made (i.e. upward sloping yield curve). This is a fact that many who call for the exclusion of liquidity in fair value computations seem to forget. We suggest in our Basis Supplement that disclosures regarding liquidity estimates to

enhance users understanding of such measures could be established to address concerns regarding the unobservable liquidity inputs. Such disclosures would allow entities to disclose what they may believe to be “liquidity discounts” while at the same time incorporating expected credit losses and movements in interest rates to make financial instrument valuations more relevant. Market participants could then decide whether such liquidity premiums or discounts should be priced into valuations or ignored.

- h. *Confidence in Level 3 Measures Can Be Increased by Management* – Academic studies demonstrate the reliability, and/or confidence in the reliability of Level 3 estimates can be increased by management through improved disclosures and effective corporate governance combined with strong internal controls. In the Basis Supplement we examine the findings of the academic research.
- i. *The Move From SFAS 107 Fair Value Disclosures to SFAS 157 Fair Value Recognition* – We believe the exemption – which carried over from SFAS 107 and permitted financial institutions to prepare loan fair value disclosures on a basis other than the exit value definition under SFAS 157, combined with the poor quality preparation of such disclosures as evidenced by the wide variability in loan carrying amount to fair values – has made the acceptance of the Proposed Update more difficult for certain members of the FASB’s constituency. Heretofore, investors have not been consistently exposed to the fair value disclosures on a SFAS 157 basis and now are simultaneously attempting to understand these valuations and determine their impact on the basic financial statements. These investors also question the reliability of the measures because of the poor quality and inconsistency of the SFAS 107 disclosures to date. The lack of perfect transparency regarding the impact of recognition versus disclosures is making the transition more difficult for certain users.

As an aside, we note that many calling for convergence as a means to adopt a mixed measurement model, and avoid the implementation of fair value on an exit value basis for recognition or disclosure, for financial instruments such as loans, would not be precluded from disclosing the fair value of loans on an exit value basis under IFRS as there is no exemption provided for loans under IFRS as there is under U.S. GAAP.

- j. *Reporting Fair Values in Financial Statements Would Increase Reliability* – Presently, fair value measurements – such as that for loans – are not as relevant as they could be because they do not include all elements of fair value, they are overly aggregated and because the disclosures are generally not prepared or audited with the same level of rigor as information contained in the basic financial statements. As such, we expect the inclusion of fair value measurements in the basic financial statements as a catalyst to improve the quality and reliability of such measures because what gets measured matters and is what gets monitored. As with the other advancements in fair value, with time market best will emerge, disclosures will improve, and market discipline will improve. Further, investors, preparers and auditors will come to better understand and utilize the measures.
- k. *Fair Value Measures Are Already in Use: Should Investors Consider Them Unreliable?* – Arguments against the Proposed Update which are premised on the lack of reliability of fair value measurements should raise questions by investors regarding how preparers can determine and recognize fair value measurements today on identical financial instruments – simply in different contexts. There are numerous illustrations of where fair value measurements are already included in the financial statements. They include the following:
 - i. *Fair Value Application in Purchase Accounting* – Financial institutions apply fair value measurements to all assets and liabilities – including financial assets and liabilities – as a part of the application of purchase accounting. There are many financial institution acquisitions which were consummated as a result of and during the financial crisis which resulted in the inclusion of fair value measurement adjustments – including sizeable liquidity marks – being included in accretible yield. Do such yield measures and financial results lack reliability because of the use of fair value measures (asserted to be unreliable) in the application of purchase accounting for business combinations – particularly during a period of market instability?
 - ii. *Fair Value Allocation in Goodwill Impairment Testing* – Many financial institutions experienced goodwill impairment charges during the recent financial crisis. To arrive at the amount of the goodwill impairment the fair value of the reporting entity must be determined and such fair value must be assigned to the individual assets and liabilities of the entity in order to determine the remaining goodwill, which is compared to the existing goodwill. The difference is the impairment charge. Without the ability to reliably measure the financial assets and financial liabilities, determination of the amount of goodwill impairment cannot be reliably determined. Were such measurements of impairment charges not reliable because they were based on fair value measurements for such financial instruments?

- iii. Fair Value Application in Certain Asset Impairment Testing – When certain, not all, assets are impaired they are written down to fair value. How can fair value measurements be appropriate and reliably estimated when determining impairments but not routinely for recognition of financial instruments? Why is there an asymmetrical application of fair value accounting?
- iv. Fair Value Measurements of Pension Assets – Pension plan assets are measured at fair value and are netted against the pension obligation to arrive at the net pension asset/obligation that impacts common equity. With the implementation of new disclosures in 2009, pension assets such as loans, real estate and private equity investments have been fair valued as Level 3 measurements. How can such assets be reliably measured for pension plans but not by entities sponsoring the plan?
- v. Fair Value Option – Many argue financial liabilities cannot be reliably measured at fair value, yet with the issuance of SFAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, a significant number of large financial institutions elected the fair value option and were able to measure selected financial liabilities at fair value. When there is a will to measure at fair value, or a perceived benefit to an entity's financial condition, there seems to be a way to measure at fair value. We would prefer that such measurement not be optional, as accounting optionality is not investor friendly.
- vi. More Complex Instruments Are Already Measured Using Fair Value – Presently, there are many debt and equity securities as well as derivatives valued as Level 3 fair values. Such valuations include private placement debt securities, below investment grade debt securities, bank loans classified as securities by life insurers, embedded derivatives and other complex derivatives. These instruments were not the subject of the fair value measurement debate which ensued during the financial crisis because they were always Level 3 measurements. Rather, instruments at the center of that debate were Level 2 instruments for which there were observable prices, but they were prices which preparers claimed were distressed, disorderly or inactive markets. Many argued that such prices should be ignored and Level 3 measurements utilized. Given the proliferation of complex instruments which are already measured at fair value utilizing Level 3 techniques – and which are not necessarily held for trading purposes – why can't loans be fair valued reliably?
- vii. Fair Value in Note Disclosures – Fair value measures are currently disclosed in the footnotes to audited financial statements. We are concerned that opponents' arguments against the Proposed Update, may in part, signal to investors that the fair value disclosures are less reliable than represented.

3) **Additional Observations Regarding Relevance and Reliability of Fair Value Measurements** –

- a. Fair Value Accounting is Not “Mark-to-Market” Accounting and Does Not Lack Reliability Because It Precludes the Incorporation of Entity Specific Assumptions – Some who are unsupportive of the Proposed Update believe that the application of Topic 820 regarding fair valuing loans implies “mark-to-market” accounting and the lack of markets means fair values cannot be reliably determinable. Still further, some indicate that this “mark-to-market” accounting results in a lack of reliability because of the incorporation of market rather than entity specific assumptions – hence resulting in values which are not representationally faithful of their financial instruments. Neither of these beliefs is correct. The application of fair value accounting does not require the existence of deep and liquid markets to be applied and entity specific assumptions can be utilized when observable market inputs are not available. In the Basis Supplement we examine illustrative quotes which highlight the misunderstanding regarding observability and nonobservability of markets and inputs. When considering the comment letters of those who are making such claims, the FASB should evaluate the merit of such arguments in light of the respondents' misstatement of current U.S. GAAP requirements.
- b. Arguing Against the Reliability of Fair Value Measurement or Application of Fair Value Accounting? – When considering the reliability argument of those who may be unsupportive of the further extension of fair value as proposed in this Update, we note that the foundation of their argument is really an opposition to the fair value definitions and principles (i.e. exit value) as set forth in Topic 820, formerly SFAS 157, rather than the subject of this Proposed Update. Said differently, some who are unsupportive of the proposal are commenting upon an existing standard rather than the proposals set forth in the Update.

The position that suggests that all valuations which are not based upon an active quotable market are not reliable means that all Level 3 fair value measurements are not reliable and a significant number of Level 2 instruments (e.g. matrix priced securities) may not be reliable.

We would observe that the debate about exit value as the relevant measurement of fair value was previously considered and resolved with the adoption of SFAS 157. The Proposed Update is about the

application of fair value measurement. In our view, some are debating the merits of SFAS 157 rather than the changes contemplated in the Proposed Update.

4) **Conclusions Regarding Relevance & Reliability** –

- a. **Summary of Our Views** – Overall, we believe there is significant evidence that fair values are substantially more relevant than amortized cost measures. As to reliability, the issue for standards setters is not whether fair value measures are perfectly reliable, but whether they are as reliable as existing measurements or proposed alternative measurements such as expected loss models, and whether they are sufficiently reliable given that they are significantly more relevant. Our view is that fair values improve information quality, transparency and decision-usefulness.
- b. **Summary of Other Views In Support of Fair Value** – In the Basis Supplement we excerpt various quotes from academic studies and organizations which have studied these issues. Each finds fair values to be more relevant than amortized cost. Below are portions of such excerpts which should be read in connection with the full excerpt in the Basis Supplement:

Landsman (2007)⁷ noted the following:

“...The key question for policy makers and academic researchers alike is whether fair value based financial statements improve information investors receive relative to information provided by historical cost-based financial statements. The overall conclusion from the research I review is that investors do indeed benefit from having access to fair value information.”

Barth et al. (2010)⁸ makes the following comments regarding the relevance and reliability of fair value measures and their impact on share price:

“...Taken together, the fair value literature, including the studies that focus on banks, provides rather substantial evidence that recognized and disclosed fair values are relevant to investors and reliable enough to be reflected in share prices.”

The IMF in a 2009 Working Paper⁹ concludes the following as it relates to fair value accounting and its application to financial institutions:

“The paper finds that, while weaknesses in the FVA methodology may introduce unintended procyclicality, it is still the preferred framework for financial institutions.”

In a presentation to the October 2009 Credit Risk Summit¹⁰, World Bank staff made the following remarks regarding fair value accounting for loans which supports fair value over amortized cost:

- ***Fair value is the best (not the only) measure of financial instruments.***
- ***Fair Value or Unfair Value: What difference does it make if an asset is held-to-maturity?***
- ***Fair value does not drive outcomes; it measures them.***
- ***Reduce mixed attribute accounting: The mixed attribute model in IFRS and U.S. GAAP has embedded volatility and is pro-cyclical.***
- ***Relevance: Loans are not tradable, but associated credit risk can be traded and valued.***
- ***Prudence:***
 - ***Is it prudent to value loans at par until impairment?***
 - ***Increased transparency***
 - ***Forward-looking method***
- ***Feasibility: We can do it – and so can they!***

⁷ Landsman, Wayne R.; *Is Fair Value Accounting Information Relevant and Reliable? Evidence from Capital Market Research*; International Accounting Policy Forum; 2007.

⁸ Barth, Mary E. and Landsman, Wayne R.; *How Did Financial Reporting Contribute to the Crisis?*; European Accounting Review; July 2010.

⁹ Novoa, A., Scarlata, J., Sole, J.; *Procyclicality and Fair Value Accounting*; IMF Working Paper; March 2009.

¹⁰ D. Ghosh & D. Bangert; *Fair Value-Sovereign Loans*; Presentation to the credit Risk Summit; October 2009.

Considerations of Arguments Against Fair Value Measurement for All Financial Instruments

As noted previously, those who do not support the further extension of fair value as proposed by the Update have opposed all previous advancements of fair value reporting and many of the arguments against the further advancement of fair value are the same. Below we briefly consider several of the most prevalent arguments against fair value, which are more fully explained in a document entitled [Consideration of the Arguments Against Fair Value as the Measurement Basis for Financial Instruments](#) (“Arguments Against Supplement”), which may be found on the CFA Institute website.

- 1) ***Fair Value Measures Are Not Relevant Or Reliable*** – Under our preceding discussion of CFA Institute’s support for fair value measures we consider opponents of the Proposed Update’s claim that such measures are not relevant or reliable.
- 2) ***Mixed Measurement Model (Management Intent Matters) & Volatility (Created, Unnecessary & Irrelevant)*** –
 - a. ***Why Some Support A Mixed Measurement Model*** – Some do not support the FASB’s Proposed Update because they believe a mixed attribute model is a better measurement approach. They arrive at this conclusion through the following beliefs:
 - i. ***Management Intent & Business Model Matters*** – Management intent and management’s business model should impact the reported value of a financial instrument.
 - ii. ***Volatility Created by a Fair Value Model is Unnecessary & Irrelevant*** – Supporters of a mixed measurement model believe fair value fluctuations are irrelevant when an enterprise intends to hold a financial instrument to maturity.
 - b. ***Why CFA Institute Does Not Support A Mixed Measurement Model*** – We do not support the mixed measurement approach where some financial instruments are at fair value and some are at amortized cost because:
 - i. ***Fair Value is the Relevant Measure*** – Fair value is the most relevant measure when making a capital allocation decision. We have demonstrated amortized cost has limited relevance to decision-making;
 - ii. ***Management Intent Does Not Alter the Value of a Financial Instrument*** – Management intent does not alter the value of a financial instrument. A financial instrument’s “value” is not different because it will be held by one financial institution and sold by another. Such reporting flexibility creates differences in appearance but not actual valuation. Further, intent can change over time or with management change and this should not alter the valuation of the instrument. An investor who is attempting to determine whether to buy a particular financial institution’s securities should not be willing to pay a different price because of different measurements of an identical basket of securities held by the institution who intends to hold the basket to maturity and another which intends to hold the basket for sale;
 - iii. ***Lack of Consistency*** – Utilizing different measurement methods creates a lack of consistency and confusion in measurement across the reporting entity and a lack of comparability between reporting entities. It promotes a difference in measurement for the exact same instrument across two different enterprises, which cannot provide investors with useful information; and
 - iv. ***Economic Mismatches Are Not Evident*** – Economic mismatches are hidden by the reporting of assets at fair value and liabilities at amortized cost. Fair value highlights these mismatches by reporting the changing value of assets and liabilities.
 - c. ***Lack of Conceptual Justification & Illustration of Why Management Intent Matters*** – In our review of the Basis of Conclusions to the Proposed Update, we do not see a conceptual justification for the alternative view which would retain a mixed measurement model. The basis for the alternative view seems to be a repetition of the conclusion rather than a logical explanation or conceptual basis for the superiority of a mixed measurement approach. Further, while this “belief” is stated or asserted in comment letters as a reason not to support the Proposed Update, there is no illustration or empirical evidence cited to support that intent-based accounting alters the value of a financial instrument to an investor. If the FASB considers the alternative view, there should be an articulate and coherent argument as to why the business model impacts the reported value of a financial instrument and how amortized cost results in better investment decisions.

- d. *Volatility Is Not Unnecessary or Irrelevant Because It is a Reflection of Economic Reality & Valuation Changes Are Important to Investors* – Connected to the argument against the use of a fair value measurement model and toward a mixed measurement attribute model is the notion that volatility reported by a fair value measurement model is unnecessary and irrelevant to financial reporting. The financial statement volatility is relevant if an investor's holding period is not the same as the enterprise's entry and exit times and prices. Management/enterprise intent and enterprise holding periods and investor intent and holding periods are rarely the same. Accordingly, there is always a need to know the current value to make efficient capital/investment allocation decisions regardless of whether the financial instrument is held-for-sale or held for receipt of contractual cash flows (held-for-investment). Fair valuing the financial instrument enables an investor to ascertain whether the assets of the enterprise are providing market returns and what price they should pay for the securities of the enterprise. Because a loan may be held-to-maturity and its value converge to its original notional value (i.e. not necessarily either historical or amortized cost) does not mean that the volatility is irrelevant. While there may be short-term fluctuations and volatility within the financial statements, the presentation of fair value along with amortized cost will provide those who are interested in the current value of the assets and liabilities with greater information on the price they want to pay. While the movements may not be realized by the enterprise, they are relevant to the investor, as they will be crystallized by the investor who has a different holding period.
- e. *Only Investors With Volatility Plays Are Interested in Fair Value Accounting* – Some who are not in favor of the Proposed Update indicate that fair value information is only needed or useful to short-sellers and those making volatility plays. This is not correct. Investors making long-term investment decision want and need to know whether the price they are paying for a security of a financial institution is appropriate for the risk being undertaken by the institution. Even a long-term investor wants to know the appropriate value of an investment so as to know when to buy and sell their investment, and fair value information is helpful for all investors to make their own assessment of the risks and ask more informed questions of management. Finally, all investors need to understand the volatility of the enterprise's assets and liabilities.

Consider a very simple example. If a company has issued a 20-year, 3% coupon bond and the market interest rate for comparable bonds being issued in today's environment is 7%, it is irrational for an investor to pay the amortized cost for such an instrument. Such an instrument should trade at a discount to the instrument with the 7% coupon and comparable risk. Given this reality, placing a large number of instruments such as those described above into a portfolio and placing them into a holding company that trades as an equity investment should not make the amortized cost information – that is not relevant at the instrument level – relevant at the holding company portfolio level.

- f. *Volatility Is Created by Fair Value Accounting* – Some argue that volatility in capital, or net income, is created by the use of fair value measurements. This argument is unsupported. Reporting fair values does not create volatility it merely reports the existing economic volatility.

When investors make trading decisions they are not reacting to accounting, they are reacting to the implied risks and rewards of their stake in the bundle of investments that the financial institution represents. If they perceive their risk of loss to be higher due to a series of events, they will be willing to pay a lower price for the aggregate portfolio than they would have prior to the incorporation of that new information.

- g. *Additional Observations on Business Model Based Accounting Standards* – Supporters of the mixed measurement model indicate a preference for the IASB's measurement model because they believe it better represents the business model of the organization. We have two additional observations regarding the concept of business model in the context of accounting standard setting:
- i. *Is the IASB Model Better for All Businesses?* – The IASB's approach to the measurement of financial assets does not better match the business model for insurance enterprises when taken together with the IASB's Insurance Contracts project. The Insurance Contracts project would call for an update of expected cash flows and discount rates for insurance liabilities while the assets would most likely be held at amortized cost. While banks believe the IASB's approach results in a better reflection of their business model, the same statement cannot be made for insurance enterprises. Further, a financial institution which owns both a bank and insurance enterprise may be remeasuring its more complex insurance financial instruments through net income while retaining its banking liabilities at amortized cost while both the banking and insurance operations have a "hold-to-maturity" business model. We raise this issue to highlight that accounting standard setters cannot build accounting standards that

accommodate all possible business models nor the business models of one particular industry. Business model based accounting standards can never be conceptually consistent across all industries and enterprises and can only result in confusion and complexity for investors.

- ii. *Business Model of the Enterprise* – There appears to be a misconception that support for fair value which is, in part, premised on the belief that business model and management intent do not alter the value of a financial instrument is a suggestion that business model is unimportant to the valuation of the enterprise. This is not the case. Valuation of the enterprise incorporates its use of financial instruments (both asset and liabilities), intangibles assets, and other assets and liabilities over time to match and mitigate risks and produce spread/cash flows given the market timing of such cash flows for the enterprise. As such, the perception that supporting fair value irrespective of management intent for specific financial assets and liabilities is a dismissal of a financial institution’s business model is mistaken.

3) ***Fair Value Accounting is Procyclical & Caused the Financial Crisis*** –

- a. *Popular Beliefs Regarding Fair Value Accounting, Procyclicality & Their Contribution to the Financial Crisis* – Hand-in-hand with the volatility argument comes the pro-cyclicality argument against fair value accounting. Pro-cyclicality is an economic, not accounting, phenomenon. Accounting does not create pro-cyclicality, it simply reflects changes in the values of assets and liabilities in the periodic financial statements used by investors to make their decisions. However, those who do not support fair value accounting declare it to be “pro-cyclical” and indicate that, at a minimum, it exacerbated, if not directly contributed to, the recent financial crisis. Critics have said that current standards, particularly those relating to the use of fair value measurements, impose “procyclical burdens” on financial institutions and can cause instability in the financial system. Opponents argue fair value accounting required institutions to write down the value of their investments to amounts that were the result of inactive, illiquid or irrational markets and that did not reflect the underlying economics of the securities. They claim that these writedowns created the need to raise additional capital and led to a negative impact on markets and prices, leading to further writedowns and financial instability. Further, there is a popular misconception that the standard on fair value accounting (SFAS 157 or Topic 820) that went into effect in 2007 somehow caused a wholesale expansion of fair value accounting by financial institutions that escalated the depths of the financial crisis. In the Arguments Against Supplement we consider the statements of those perpetuating these incorrect claims. We believe that banking regulation is responsible for creating to enforce counter-cyclical regulations; that is not the function of financial reporting.
- b. *What Studies Subsequent to The Financial Crisis Find Regarding Fair Value Accounting, Procyclicality & Causes of the Financial Crisis* – When the market is provided with information it may act on it. Hence, all transparent, relevant, decision-useful information – not just accounting information – can be seen as being pro-cyclical if market participants act upon it when they receive it. The question before accounting standard setters is whether this information pro-cyclicality was exacerbated by financial reporting standards. In the Arguments Against Supplement document we cite numerous academic studies, a Securities and Exchange Commission report to Congress, and a Federal Reserve Bank of Boston report which each found fair value accounting was not procyclical and had little effect in creating the financial crisis. We also review the IMF Working Paper which found there may have been some unintended procyclical effects of fair value accounting but that fair value accounting is still the appropriate measurement framework for financial institutions. In this same section in the Arguments Against Supplement we also present the remarks of several well known academics on this issue of procyclicality. Further, we consider their views on the pro-cyclicality of the incurred loss model, expected loss model and fair value.
- c. *Conclusion: Fair Value Accounting Did Not Create or Exacerbate the Crisis* – It is clear that neutral parties who have studied whether fair value accounting was procyclical did not find that fair value accounting in and of itself contributed additional levels of procyclicality beyond the amounts that were inherent in the risks and rewards of the economics of the associated financial instruments or that it unnaturally amplified the economic phenomenon of procyclicality.

Though the immediate causes of the recent financial crisis are complex, it is clear that a decline in lending standards; poor lending and investing decisions; an increase in risk-taking in a quest for higher yields; inadequate risk management; the use of off-balance sheet transactions; the increased use of derivatives without sufficient collateralization; abuse of the securitization mechanism and a system-wide increase in

financial leverage were all important contributors to the crisis rather than fair value accounting. Fair value measurement is only the messenger, reporting economic changes as they occur.

CFA Institute believes that fair value accounting provides greater transparency to a company's financial condition and can, therefore, be useful in bringing certain problems to the attention of the financial markets earlier than amortized cost measurements, allowing such problems to be dealt with expeditiously. In contrast, the mixed-attribute system often masks information that investors need to effectively assess firm value and risk. Fair value accounting is, therefore, especially important during the early stages of firm stress so that investors can make appropriate decisions regarding the deployment of capital. As we describe below, we find that much of what those opposed to the Proposed Update want is a U.S. GAAP reporting policy which reflects their regulatory interests rather than the interests of investors.

- 4) ***Accounting Standards Should Address Prudential Regulatory Concerns*** – Many opponents the Update are unsupportive because they believe the proposals will change regulatory reporting for banks who presently utilize U.S. GAAP as a starting point for their regulatory filings and because the inclusion of fair value adjustments will increase bank capital requirements.
- a. ***Investor and Regulator Interests are Different*** – For the reasons more fully articulated in the Arguments Against Supplement, investor interests and prudential interests are quite different and prudential regulators have an informational advantage over credit and equity investors. Prudential regulators can also mandate accounting and reporting requirements and they can, and do, force financial institutions to take actions which they think are in the best interest of not only the institution but also the safety and soundness of the financial system in a broader economic context.
 - b. ***Accounting Standards & Regulatory Reporting Should Recognize These Differences in Interest*** – CFA Institute's long-standing position – because of the difference in investor and regulator interests, and because of the legal right of regulators to command information and develop their own reporting basis – is that accounting standards such as U.S. Generally Accepted Accounting Principles ("U.S. GAAP") and International Financial Reporting Standards ("IFRS") should primarily serve the interests of investors. In the Arguments Against Supplement we cite academic literature that supports this view.

If the pursuit of a regulator's mandate to promote financial stability implies that decision-useful information must be withheld from current and prospective investors, there is a very real risk that investors will be unable to make informed capital allocation decisions. If addressing the needs of regulators results in limiting relevant, decision-useful information at times when investors are making investment decisions, then the Boards may be exposing investors to elevated risk and the potential loss of investor capital. From our perspective, given that the needs of regulators can and will diverge, the FASB and IASB have a responsibility to select either investors or regulators as their primary constituents. Given that regulators have the ability to request additional or alternative information and have the freedom to select any valuation approach they see fit for their purposes whereas the filings issued in compliance with standards of the FASB and IASB are the dominant means of information collection for most investors, the Boards have a responsibility to focus on the needs of investors. It is not appropriate for regulatory concerns to result in inadequate or potentially misleading information being provided to investors as this practice has the very real possibility of impairing the operation of the capital markets and causing a destruction of investor capital that could have been avoided with more decision-useful information.

- c. ***FASB's Proposed Update is a Pragmatic Compromise*** – While the research we reviewed was uniform in its acknowledgement of the differences in the objectives of financial reporting for investors and regulatory reporting for purposes of capital adequacy determination to prudential authorities it also recognizes a need to balance these interests and find common ground. CFA Institute's view is that this Proposed Update is a reasonable and pragmatic compromise by the FASB that seeks that common ground. We believe the FASB has achieved a balance between investor needs and potential regulatory capital considerations as suggested by the research. The Proposed Update advances the transparency and market discipline that can benefit both market participants and regulators. The reporting of fair values allows the market to self-regulate and also allows regulators to see the impact of fair value on capital requirements and take prudential actions as they see necessary. Simultaneously, it preserves the reporting format that certain investors find useful to their analysis.

- d. *Is A Case Being Made Against Regulatory Reform or GAAP Accounting Reform?* – Those against the FASB’s Proposed Update cite political and regulatory bodies and representatives of those bodies in defense of their position to maintain the status quo. We do not find such arguments compelling because the primary objective of accounting standards and financial reporting is to serve the informational needs of investors, while regulators have the ability to mandate public or private dissemination of additional information that serves their interests. Accounting standards are meant to serve investor interests. Both Boards have at various times openly stated they believe investors are their primary constituency.

5) ***Fair Value Disclosures Are A Sufficient Substitute for Recognition & Measurement*** –

- a. *As A Substitute for Recognition & Measurement* – Many have argued that fair value as a measurement basis is not necessary given that fair value information, which they acknowledge is highly relevant to investors, is already provided in the footnotes. They declare this approach sufficient for investors. We find it paradoxical to argue that such information is highly relevant but should not be provided when it would be most beneficial to investment decision-making. Our views regarding why fair value information should be included within the basic financial statements are described above in our discussion of the relevance of fair value measurements.
- b. *Too Costly* – Many preparers of financial statements have expressed concern that it will be too expensive to provide fair value information, especially if the information must be provided at the time of the earnings release. We note, however, that if fair value information is already provided reliably in the footnotes the incremental cost to preparers is only the cost of moving the production of these estimates up by approximately two to three weeks. Given that managers closely monitor loan cash flows and other inputs, that banks have highly sophisticated technological capabilities, and that many estimates are made prior to the close of the financials (e.g. estimates regarding impairment of assets) their work can be done before the quarter close to approximate these estimates which can then be updated if market conditions change significantly by the end of the accounting period. We also note that if a full fair value approach were adopted the time to prepare the credit impairment computations would be eliminated, thereby partially offsetting any incremental costs. More importantly, we believe that when considering these costs, one must also factor in the economic cost of not having information relevant to the investment decision-making process at the time of the earnings release. Also the cost of having multiple analysts make estimates of fair value – that are prone to significant amounts of estimation error given limited public information – rather than the entity incorporating the effects using its detailed, non-public information about the financial instruments adds needless market volatility and increases risk premiums. Risk premiums rise because market participants incorporate greater uncertainty into their fair value estimates due to lack of information (i.e. information asymmetry). Uncertainty whether: a) caused by the inherent risks and rewards of an investment, or b) an outgrowth of poor disclosures and non-transparency, is factored into a company’s cost of capital. While inherent risks and rewards cannot be altered, the risk associated with appropriate fair value measures and disclosures based upon all available information can be mitigated. These costs, or lost benefits, must be considered as well.
- c. *Some Preparers Presently Don’t Prepare Fair Value Disclosures* – Lastly, the fact that certain small financial institutions do not prepare audited U.S. GAAP financial statements (i.e. they simply prepare regulatory filings where the information is prepared on a U.S. GAAP basis, without fair value footnotes) and will have to prepare fair value measurements for the first time should not drive the need for reforms in financial instrument accounting. Regulators can make accommodations for such entities, as they deem necessary.



- 6) ***Convergence Has Primacy*** – CFA Institute members have overwhelmingly supported the premise of one set of high-quality, understandable, and enforceable global accounting standards. CFA Institute members have repeatedly emphasized that high-quality accounting standards are more important than convergence and that convergence should not be an objective in-and-of-itself.

As a part of our IFRS Financial Instruments Accounting Survey (2009 FI Survey) conducted in November 2009 just subsequent to the release of International Financial Reporting Standard 9 (“IFRS 9”), *Financial Instruments: Classification and Measurement*, we asked members about their views on the most important objectives as it relates to changes in financial instrument accounting. We found that improving decision-usefulness and reducing complexity were substantially more important than seeking a converged solution.

In other words, convergence is a noble goal, but it needs to be subordinated to other, sometimes competing, goals. In terms of priorities, the majority of our membership believes creating an accounting model that seeks the highest quality accounting standard – one that produces decision-useful information – is a higher priority than convergence. If convergence means adopting a lower quality standard, then convergence should not be pursued. We would rather accept lower quality information for jurisdictions unwilling to move to the higher-quality standard than to have all jurisdictions adopt the model producing the lower quality information in the name of convergence. Such a policy of mandatory convergence does a disservice to jurisdictions attempting to pursue more progressive approaches in hopes of producing more transparent, decision-useful information.

The position promulgated by those who are against the Proposed Update suggests that the IASB’s IFRS 9 accounting and recognition model be adopted because it has already been issued by the IASB is not consistent with the spirit of the convergence process and promotes what some refer to as “a race to the bottom.” The convergence process should not be governed by a race to see which standard setter can produce a standard first accompanied by the notion that such standard should be adopted because it was issued first. Such thinking and advocacy efforts promote “first adopter inertia,” a race to lower quality standards, and a diminution of convergence efforts.

As noted previously, the call for convergence to IFRS to avoid the fair valuing of loans would preclude fair valuing loans in the basic financial statements for IFRS, but IFRS does not provide the same exemption as in U.S. GAAP to allow preparation of loan fair values on a basis different than that required by the fair value measurement standard (e.g. exit value).

The Arguments Against Supplement provides the results of our survey question on this topic and several other questions.

- 7) ***FASB’s Dual-Measurement Model is Less Decision-Useful than IASB’s Mixed Measurement Model*** – Some have adopted a position that the IASB’s “mixed measurement” model is more decision-useful than the FASB’s “dual measurement” approach. It is a perspective that places its supporters in a position of denying, or at least substantially delaying, the need for fair value information, which empirically has been demonstrated to be both more value relevant and conceptually superior.

Given that the classification criteria adopted by the FASB and IASB in their respective models is relatively similar, a financial statement user has the ability to compare the amortized cost information in the FASB’s dual measurement category to the amortized cost category in the IASB. Putting aside the issue of non-comparable impairment approaches in the two models, the FASB model provides amortized cost information for a comparable class of financial instruments as does the IASB’s model. The FASB approach is additive in that it also provides the fair value information. Those supporting the mixed measurement approach obtain the intent-based information they desire and those who prefer fair value are provided with the information they require at the same time as the amortized cost information but with greater quality given the measurements are reflected in the basic financial statements. How then could the FASB’s model be less decision-useful as these supporters claim?

We highlight this issue because there is nothing compulsory about the use of fair value information by a financial statement user. The FASB model maintains amortized cost information for the most controversial financial instruments while strengthening the decision-usefulness of the financial statements by allowing users the ability and freedom to focus on the information that they believe allows them to make the most informed investment decisions. An investor can either: 1) focus solely on the amortized cost information, 2) focus solely on the fair value information, or 3) factor both types of information into their analysis. It is counterintuitive that users would want to deny themselves timely information which has been empirically demonstrated to be linked to the valuation of financial institutions' share price. What is the "net subtraction" of the FASB's dual measurement approach for IASB supporters of a mixed measurement model?

As stated previously, some users who express disagreement with the FASB's proposal to incorporate the fair value information on the face of the statement of financial position often make the argument that the information is not reliable. While we do not agree with them, we believe that they are entitled to their perspective and have full discretion to ignore the fair value information presented for dual measured financial instruments. Inherent in their position that they do not rely on fair value information is that other market participants should not have the ability to rely on that information either. As evidenced by: a) the results of our numerous surveys of our members, and b) the research which demonstrates a correlation between fair value measurements and financial institution share price; there are clearly users who believe fair value information is decision-useful.

It appears much of the controversy associated with the Proposed Update stems from an implied recognition that there is not a universal dismissal of the fair value information. If fair value information was not decision-useful and was dismissed by all users, then there would not be such strong opposition to its incorporation into the financial statements because the existing amortized cost information is provided and there would be no expectation that it would alter anyone's investment decisions. With this in mind, if someone is stating that they do not use the fair value information, then their opinion on whether it should be disclosed should not be relevant to the IASB and FASB because these constituents have no stake in whether it is recognized in the financial statements, disclosed in the notes to the financial statements, or entirely omitted from the financial statements. If one party to a potential trade uses only amortized cost information and the counterparty uses just fair value information or both amortized cost and fair value information, an accounting model that does not provide the fair value information is leaving the user of fair value information at an unfair disadvantage that exposes that party to unnecessary risk associated with the timing difference in the information release of earnings reports and footnote information as well as the relaxed auditing and measurement practices of footnote disclosures. Material omissions of relevant information such as fair value measurements result in changes in investment decisions of those who would rely on the information being omitted and increases the implied risk attached to the decision.

Ultimately, it is paradoxical that some can argue that the IASB is a more decision-useful model given that it reduces the availability and timeliness of information used in investment decision-making and thereby increases the risk associated with an investment decision.

Misinformation Regarding Provisions of the Proposed Update

There has been significant dissemination of disinformation about the Proposed Update. Much of this disinformation focuses the media and investors solely on the fair valuing of loans rather than considering all aspects of the Proposed Update and recognizing that the FASB has arrived at a reasonable compromise between those who prefer amortized cost reporting and those who prefer fair value. This distraction is also keeping investors who still seek an amortized cost approach (net interest margin focus) from moving beyond the recognition and measurement provisions of the Update to the credit impairment and interest income provisions – which will, in fact, change the net interest margin – even if the recognition and measurement provisions were abandoned. (We found few analyst reports, possibly just one analyst report, which included a comprehensive discussion of the interest income provisions of the Proposed Update and their impact on interest income.) Below we consider various misconceptions and/or misunderstandings which interfere with a complete understanding of the Update’s impacts on the financial statements.

- 1) ***Loans Will Be Fair Valued Through Net Income*** – Some are connecting the Proposed Update, with the FASB’s project on Other Comprehensive Income with what would appear to be the intent of conveying that: the fair value adjustments are through “income”; the definition of other comprehensive income is changing; or that OCI is a “new category.” The OCI project is simply a change in presentation of information already located in the equity statement or in the notes to the financial statements. In the Arguments Against Supplement, we consider excerpts from comment letters that indicate the misunderstanding of OCI and how opponents’ communications are creating such confusion.
- 2) ***Net Interest Margin Will Disappear*** – There appears to be a misconception that the fair valuing of loans will result in the loss of net interest margin. Some analysts/investors calling for the retention of the existing model don’t seem to realize that if loans are classified as held for receipt of contractual cash flows, that net interest margin will be retained through the recycling provisions in the Proposed Update. Those who are interested in net interest margin should be most focused on is the credit impairment and interest income provisions of Proposed Update. The computation of interest income will change with the inclusion of the allowance account, yet this is rarely discussed with analysts/investors by those against the Proposed Update. In the Arguments Against Supplement we quote one analyst’s observation of this same point.
- 3) ***Bank Capital Will Be Adversely Impacted by Fair Valuing Loans*** – There is misinformation regarding the Proposed Update and its impact on bank regulatory capital. Some indicate the Proposed Update would result in the “mark-to-market” of loans, which would be a charged to bank capital, potentially destroying capital, capital ratios and resulting in further systemic risk. However, Tier One capital computations for banks currently exclude the unrealized gains or losses on debt securities and will likely do the same for loans held for contractual cash flows fair valued through other comprehensive income. Further, regulators have different means of obtaining information as well as measuring and monitoring banks – which investors do not – and U.S. GAAP should not be driven by the regulatory needs of one industry. Bank regulators can adjust their definitions of bank capital to mitigate this perceived risk.
- 4) ***Fair Value Accounting Is Mark-to-Market Accounting*** – As we previously noted in our consideration of reliability issues associated with fair value measurements we have found that greater understanding is needed with respect to how fair value measurements are determined – particularly where market prices do not exist and where inputs are unobservable. Through review of comment letters and discussion with investors we have found the colloquial use of the term “mark-to-market” has resulted in a misconception regarding how fair value measurements are determined where market prices may not exist. We have found that investors do not have a deep understanding or appreciation of the fair value measurements concepts (e.g. observable vs. unobservable inputs) in Topic 820 (SFAS 157).



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Despite the considerable efforts of the FASB staff to communicate the provisions of the Update, the comment letters posted on the FASB website highlight these and other misconceptions regarding the Proposed Update. We believe the FASB should review the comment letters received, and as one of their redeliberation objectives, ascertain whether there is an appropriate level of understanding regarding all key aspects of Proposed Update.

Our review of the letters to the FASB suggests there are many commentators on the single issue of fair valuing loans and that many such commentators do not have an appreciation of the fair value measurements concepts nor do they express views, or alternative approaches, on how credit impairments or interest income should be measured. The measurement of credit impairment and interest income under the Proposed Update should be of interest to those who advocate retaining a mixed measurement model.

We believe the FASB should undertake a broader educational campaign clarify these misunderstandings and misconceptions regarding the Proposed Update and to seek input from a broader constituency on all aspects of the Proposed Update.



Closing Remarks

We appreciate and support the FASB's efforts in proposing the recognition and measurement principles in this Proposed Update. The CFA Institute's view is that this Proposed Update is a reasonable and pragmatic compromise by the FASB. Though we are not supportive of all aspects of the Proposed Update we believe the FASB has achieved a balance in providing fair value information within the basic financial statements, rather than simply providing it as a disclosure in the notes, and in maintaining elements of net interest margin, which some analysts find useful. We also note that while capital requirements for financial institutions are not within the FASB's purview, the FASB's proposal results in such fair value measures not impacting Tier One capital computations for banking institutions, which some view as a positive outcome.

We believe the FASB should consider the following as it redeliberates the Proposed Update:

- 1) ***Evaluate Whether Opponents to the Proposed Updates Views Are "Belief Statements" or "Conceptually and Empirically Supported Positions"*** – As we review the comment letters posted to date we find many of the positions articulated to be belief statements without conceptual or empirical support. Examples include: management intent and business model justify a different value of a financial instrument for different entities; amortized cost information leads to better investment decision-making; fair value accounting "creates" volatility; fair value accounting for financial instruments changes the concept of comprehensive income in the FASB's Conceptual Framework; fair value accounting is synonymous with "mark-to-market" accounting; fair values cannot be determined with sufficient reliability to be relevant to the financial statements or share price; fair value information is less reliable than existing measurement techniques; fair value accounting was procyclical and caused the financial crisis; U.S. GAAP reporting should accommodate regulatory concerns; etc. We find little empirical or conceptual justification for many of the belief statements and we believe the FASB should, as a part of their redeliberations, evaluate the support for the positions asserted to assess their validity.
- 2) ***Evaluate Whether Arguments Against the Proposed Update Represent a Cohesive, Well Constructed Argument in Support of A Mixed Measurement Framework or An Ad-hoc Collection of Arguments Which Promote Retention of The Status Quo*** – We find the arguments in opposition to the Update to be ad-hoc complaints regarding the proposal rather than a well-constructed, cohesive argument which contemplates and articulates the benefits and decision-usefulness to investors of the mixed measurement approach and its merits in comparison to the single measurement approach suggested by fair value or as set forth in the Update. We believe such an explanation should include how management intent can alter the value of a financial instrument, how standard setters can build business model based standards which will accommodate all businesses and industries and how investors can make better investment decisions, with improved comparability of investment alternatives, by retaining the status quo of amortized cost adjusted for impairments in light of the recent financial crisis.
- 3) ***Determine if Arguments Against The Proposed Update Should Be Addressed by Accounting Standard Setters or Regulators*** – As we consider the arguments against the Proposed Update we find many of them to be positions supportive of a regulatory reporting regime rather than one based upon providing information to providers of capital (i.e. investors). For example, the newly created term "cash value to the bank" would imply that investors only care to know the ultimate cash to be collected by the enterprise rather than the return their cash will yield when invested in the enterprise. This "cash value to the bank" notion is a liquidity or solvency notion rather than a measurement which facilitates an investor making an informed investment decision.

Further, those mounting opposition to the FASB's Proposed Update cite political and regulatory bodies and representatives of those bodies in defense of their position to maintain the status quo. We do not find such arguments relevant or compelling because accounting standards are primarily meant to serve investor interests.

- 4) ***Consider Arguments Against the Proposed Update in Context of Past Opposition to Fair Value Advances*** – Consider the arguments in opposition to the Proposed Update in the context of previous advances in fair value. Evaluate whether such arguments have been made before and whether the negative effects previously asserted have materialized as a result of the change in accounting standards. Recognize that fair value information which was once opposed – and is now currently included within or disclosed in the financial statements – has become commonly and widely accepted as decision-useful.
- 5) ***Increase Education on Proposed Update & Address Counter Arguments*** –The public “discussion” regarding the Proposed Update has been filled with disinformation and focuses on one particular topic – the fair valuing of loans. The FASB needs to address the misunderstandings and misconceptions being promulgated by those opposed to the Update respond to the incorrect counter arguments to the Proposed Update. This will allow the discussion regarding the Update to be more inclusive than a discussion of the recognition and measurement provisions of one financial instrument. Other aspects of the Update – credit impairments and interest income – need to be thoroughly advanced, promoted, and considered. Further, how the information is additive and useful needs to be more broadly understood. By issuing the Exposure Draft the FASB has advanced the understanding of fair value measurements and their use in the basic financial statements, and as we noted at the opening of our letter, change takes time because it stems from increased education and understanding.
- 6) ***Remember What The Statement of Financial Position Is Intended to Represent And Who Financial Statements Are Primarily Prepared For*** – This Proposed Update requires preparers, auditors and investors to evaluate what they believe is the underlying purpose of the statement of financial position and whether it represents a compilation or tabulation of past transactions or a statement which presents the current value of assets and liabilities. The use of fair value measurements also requires a convergence of accounting, finance and valuation knowledge which may not be familiar to all preparers, auditors and investors. When reviewing the comment letters we believe that the FASB should consider whether there is a clear understanding of what the statement of financial position is to represent and if it is a measure of current value of the assets and liabilities upon which investors can make market based capital allocation decisions, an accumulation of past and future cash transactions to the enterprise which have no economic relation to current market conditions, or a regulatory construct which is principally concerned with liquidity and solvency. We believe the statement of financial position should reflect the value of assets and liabilities in the context of current economic conditions such that they can inform investment decisions.
- 7) ***Consider Whether Fair Value Is a Relative Improvement in Relevance Without Loss Reliability*** – The issue before accounting standard setters is one of relative improvement in estimates, information quality, transparency and decision-usefulness. The issue isn't one of perfect reliability, or verifiability. We have seen that existing measurement and estimation techniques have not worked because they are asymmetrically focused and invoked only upon loss triggers which can be deferred by management. The question is whether the addition of fair value measurements are as at least as reliable as these techniques and whether they are more relevant.

Our view is that the use of fair value would install a measure of market discipline and result in relative improvement in measurement estimates, information quality, transparency and decision-usefulness. Central to this conclusion is that fair value includes the following attributes: a) a consistent definition as an exit value notion; b) incorporation of all relevant value inputs, c) emphasis on the maximum use of market observable inputs; and d) an ability to utilize unobservable inputs when necessary. These attributes are further strengthened when combined with high-quality disclosures of the observable and unobservable significant inputs along with estimate techniques and measurement ranges. Fair value measurements are unequivocally more relevant to investment decision-making and we believe at least as reliable as existing measurement techniques.

Also consider that economic reality is that transactions take place at fair value, that financial institutions lend based upon fair values and that investors in financial institutions would like to be able to do the same. Remember that fair values measures are already in use in different contexts for the instruments covered by this Update.



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- 8) ***Justify Why Economic Reality Related to Value Should Appear in Footnotes Notes Rather Than Financial Statements*** – When considering if recognition or disclosure is more appropriate, consider the economic reality that markets price such fair values and that investors crystallize the underlying fair value measurements as enterprise and investor holding periods are rarely identical. These fair value measurements are not like other disclosures – they don't explain the valuation of assets and liabilities – they reflect the value of assets and liabilities. Footnotes are meant to explain the basic financial statements, not be the source of measurements.
- 9) ***Seek Convergence But Not At The Cost of High Quality Standards*** – Seek a reasonable convergence agenda but do not pursue convergence as an objective in-and-of-itself. Our membership has been very clear that they support convergence but that convergence should not come at the cost of lower standards. Convergence is not a race to see which standard setter can issue a standard first.

Thank you for your assistance in increasing our understanding of all the aspects of Proposed Update. We hope your find our response useful and we would welcome any questions or comments you may have.

Sincerely,

/s/ Kurt N. Schacht

Kurt N. Schacht, JD, CFA
Managing Director
Standards & Financial Markets Integrity Division
CFA Institute

/s/ Gerald I. White

Gerald I. White, CFA
Chair
Corporate Disclosure Policy Council

cc: Corporate Disclosure Policy Council

Response to Proposed Update Questions

Scope

Overall (Questions #1 & #3)

The inconsistent treatment of financial instruments has been a long standing feature of existing accounting literature. This has partly been driven by the scope exclusions and differing timetables in completing projects. We note that certain financial instruments remain excluded from the scope of this Proposed Update due to their being addressed in and having pending decisions related to other projects. There are also other¹ items excluded as scope exceptions.

We believe that the overarching consideration for inclusion of items within the scope of the financial instruments Proposed Update, ought to be whether the underlying economics suggest the item is a financial instrument rather than the existence of an artificial accounting construct which establishes the scope of the proposed standard. As a general principle, the burden of proof should be to those who would exclude an item that is economically equivalent to a financial instrument from the Proposed Update and/or not account for them at fair value. On this basis, we do not agree with certain of the exclusions presently listed in the Proposed Update as such exclusions will only perpetuate the current inconsistencies of financial instrument accounting. Warren Buffett makes an interesting observation in support of our economic view regarding how the economics of insurance contracts on bond insurance and certain derivatives are in fact economically the same, but the accounting requires different treatment in his 2008 Letter to Shareholders²:

*“At the request of our customers, we write a few tax-exempt bond insurance contracts that are similar to those written at BHAC, but that are structured as derivatives. **The only meaningful difference between the two contracts is that mark-to-market accounting is required for derivatives whereas standard accrual accounting is required at BHAC.**”*

We strongly agree with the inclusion of investment contracts issued by insurance and other entities to be measured at fair value as they economically represent financial instruments – as noted through the quote above. Because the underlying economics of the following contracts are such that they are financial instruments (i.e. investment contracts or derivatives) we disagree with the exclusion of items such as the following:

- Derivatives that are not traded on exchanges and have non-financial assets as the underlying risk factor.
- Investment contracts related to post-employment benefits
Policyholder investments in life insurance contracts as many such contracts are entered into for investment purposes and contain features that justify their being accounted for at fair value

¹ Scope exceptions have been allowed in relation to:

- Regular two way trades due to the decision to continue to allow settlement date accounting;
- Derivatives which are not traded on exchanges and have non-financial assets as the underlying as these are considered to be equivalent to insurance contracts;
- Derivatives that prevent sale accounting as the value of these are implicit in recorded assets;
- Forward contracts for repurchase of shares due to being addressed under liability/equity project;
- Investments in life insurance contracts due to being addressed under the insurance accounting projects
- Investment contracts related to post employment benefits
- Contracts between an acquirer and seller to enter into a business combination at a future date due to being addressed under the business combination project

² Buffet, Warren; 2008 Letter to Shareholders, p. 19.

Loan Commitments (Question #2)

Because loan commitments are in substance derivatives we agree with their inclusion in the Proposed Update, but we don't agree that their measurement should be determined by the subsequent measurement of the loan as they are distinct financial instruments – some of which won't result in the issuance of a loan. Because commitments such as these are economically derivatives, we don't agree with a practicability exclusion for loan commitments related to items such as the revolving line of credit under a credit card arrangement. Projections can be made of the ultimate use of such commitments. If they can be priced at issuance, these commitments can be measured at fair value for financial reporting purposes. Further, we believe the scope of the Update should include commitment to provide capital for equity fund investments.

Equity Method Accounting (Question #4)

We fully support the proposed guidance to account for equity method investments at fair value, unless the investee can be demonstrated to be related to an entity's consolidated business, because, it is no different from any investment made in the expectation of financial gain. We are satisfied with the criteria and indicators provided in Paragraph 130 of the Update as a means of determining whether an investee operations are closely related to the investor's consolidated operations. We support the elimination of the fair value option.

Investment Companies, Money Market Funds and Broker-Dealers (Questions #5, #6 & #7)

We are aware that there exist concerns regarding the application of fair value for liabilities of leveraged investment companies, its impact on the net asset value (NAV) and the perception that this will result in wealth transfer between redeeming and long-term shareholders. The relatively higher liquidity and redemption frequency of investment companies should not alter the fundamental imperative of providing decision-useful information to current and prospective investors. Investors in such funds need to know the current relative funding cost of the investment company when they make a decision to invest in the fund. In addition, fair value changes in these liabilities may offset economically similar changes in investment company assets. There is no conceptually sound justification for treating investment companies differently, and accordingly, we support the fair value treatment of financial liabilities for investment companies on the premise of it being the most relevant information.

Similarly, we support the application of the provisions related to financial liabilities for broker dealers.

As it relates to the proposed fair value treatment of money market funds, we believe the support for such funds being recognized at fair value should be unequivocal. The recent economic crisis illustrated the need for greater transparency regarding the underlying valuations of investments which support money market funds and demonstrated that such funds can result in loss of principal/deposit values. Such funds should not be immune from fair value reporting.

Recognition & Measurement**Measurement Principles & Alternatives (Questions #8, #10, #13, #15, #22, #23 & #28)**

We support the FASB's movement toward fair value for financial instruments as we believe it is the most relevant measurement approach for investment decision-making. Our perspective is that fair value, with changes through net income, shouldn't be referred to as the "default" measurement for financial instruments, but **the** measurement basis for financial instruments – whether they create financial assets or financial liabilities. Our basis for this conclusion is summarized in the text of our comment letter and more thoroughly developed and supported in the Basis Supplement, which may be found on the CFA Institute website ([Fair Value as the Measurement Basis for Financial Instruments](#)). Our position is further supported by our member surveys which may be found in our Survey Summary, on our website ([Summary of CFA Institute Member Surveys](#)). In a document entitled Arguments Against Supplement, which may be found on the CFA Institute website ([Consideration of the Arguments Against Fair Value as the Measurement Basis for Financial Instruments](#)), we consider the arguments of those opposed to the use of fair value measurement.

Rather than adopting a mixed measurement model which enables certain financial assets and liabilities to be measured at fair value through net income – or for those held for collection of contractual cash flows through OCI – we believe fair value as the single measurement approach should be adopted as management intent does not change the value of a financial instrument to an investor. Further, as we explain in greater detail below and at the Basis Supplement, financial liabilities should also be accounted for using a single measurement model – fair value. We have not supported the use of the fair value option because selective application of fair value is not the appropriate answer and implies management intent alters financial instrument value. Under the Proposed Update there are at least three, or four should the liability be considered a core deposit liability, measurement alternatives for financial liabilities. We find these measurement choices imply that management intent changes the value of a financial liability, which cannot be true, and results in a lack of consistency and comparability within and among an entities liabilities which will artificially create complexity. We also find there to be a result of a lack of conceptual framework for the measurement of liabilities – with emphasis on financial liabilities – by both the FASB and IASB.

Based upon our review of the Basis of Conclusions to the Proposed Update, we do not see a conceptual justification for the alternative view which would retain a mixed measurement model. The basis for their conclusion seems to be a repetition of the conclusion rather than a logical explanation or conceptual basis for the superiority of a mixed measurement approach. Further, while this "belief" is stated or asserted in comment letters as a reason not to support the Proposed Update, there is no illustration or empirical evidence cited to support the belief statement that the business model for the financial instrument alters its value to an investor. We believe the FASB should be presented with an articulate and coherent argument as to why the business model impacts the value of a financial instrument and how amortized cost results in better investment decisions. Included in this analysis we would also like for those presenting or supporting the alternative view to explain how the holding periods of an investor and the enterprise are sufficiently similar to enable amortized cost reporting to be reflective the value and yield of the investor. Further, we would be interested in how those supporting the alternative view would use amortized cost information to value a closed end fund that invests in loans and how such information contributes to the valuation of the securities in of financial institutions.

As described more fully in our response to Question #14 on recycling of items out of accumulated other comprehensive income ("AOCI") we reiterate our long-held views regarding the lack of a conceptual basis of AOCI and the need to recycle items. The Proposed Update promotes further expansion of the use of this conceptually unjustified financial statement category.

Though we support a single fair value measurement model and find no conceptual basis for the inclusion of fair value measurements through AOCI, we are generally supportive of the FASB's Proposed Update as a reasonable and pragmatic compromise as well as a step toward the further extension of fair value to

financial instruments. The proposal maintains net interest margin and traditional income statement measures which some investors find useful while at the same time increasing the transparency and relevance of the statement of financial position by including more relevant fair value measurements in the statement of financial position, ensuring fair value measurements are prepared on the same basis (e.g. SFAS 157 vs. SFAS 107) and providing them in a more timely manner.

Our views relative to the presentation of fair value and amortized cost information are included in the Presentation section which follows.

Initial Measurement Difference – Fair Value vs. Transaction Price (Questions #8, #9, #10 & #12)

As noted above, we believe fair value is the appropriate measurement basis for all financial instruments. We do not, however, believe there is a conceptual justification for recording identical financial instruments at a different value depending upon whether they will be subsequently measured at fair value through net income (fair value) or through other comprehensive income (transaction price). The Basis of Conclusions does not provide us with insight into the basis for this conclusion. As such, we cannot support this aspect of the proposal. We believe there should be a single measurement approach.

We do, however, agree with FASB's proposals in Paragraphs 14 and 15 of the Proposed Update regarding the requirement that entity's consider whether other elements of a transaction may be present when transaction price and fair value are substantially different and that if such differences do not represent an asset or a liability – or do not represent differences associated with transaction fees or costs or because of prices in different markets – that they be recognized into net income immediately. Said differently, we are supportive of day one gains or losses if they are reflective of the underlying economic reality of the transaction. The treatment of negative goodwill would be analogous. When there are no other assets or liabilities to fair value, the residual gain is recognized in income.

We believe the determination of differences between fair value and transaction price is operational, what we think should be clearer for auditors is whether there is a presumption that they must undertake a review, and how extensive that review must be, to determine this for each transaction.

Transaction Costs (Question #11)

We are not supportive of a difference in the treatment of transaction fees and costs depending upon the subsequent measurement of financial instruments as we cannot find any conceptual justification for such a difference in treatment. Transaction fees and costs either meet the definition of an asset or liability or they do not and subsequent measurement is not a factor in that determination. We do not find in the Basis of Conclusions a justification for this difference in treatment.

Overall, we believe transaction costs should be expensed immediately as the exit based fair value measurement will incorporate the purchaser's expectations of transaction costs and fees and will include any market-based remuneration to the originator/producer of the asset for the services they have completed.

We would observe that the FASB should undertake an exercise to determine the various methods/treatments of transaction costs with existing U.S. GAAP literature and in the projects under consideration and develop a conceptual basis for the accounting treatment of such costs.

Financial Liabilities (Questions #15, #18, #28, #29 & #30)

Fair Value as the Relevant Measurement Basis for Financial Liabilities

We support that all financial liabilities should be measured at fair value, both at inception and in subsequent periods because we believe fair value measurements provide information which is decision-useful to investors. We acknowledge that cash flow information related to financial liabilities is important to some users, such as credit analysts whose predominant analytical focus is on contractual cash flows. These users want information regarding contractual cash obligations associated with liabilities assuming they are satisfied at maturity. To accommodate their needs we believe parenthetical or side-by-side disclosure of the contractual cash flow amounts due should be required. We do not, however, believe that this need for cash flow information supersedes the need for fair value information as the fair value information provides information on the relative cost of financing for an enterprise and the economic value of the liabilities – consistent with our view that statements of financial position should reflect the value of assets and liabilities.

As a part of our IFRS Financial Instruments Accounting Survey (2009 FI Survey) conducted in November 2009 just subsequent to the release of International Financial Reporting Standard 9 (“IFRS 9”), *Financial Instruments: Classification and Measurement*, we asked members about their views on the appropriateness of fair value for financial liabilities. Of our approximately 630 respondents, 59% believed it was appropriate to fair value financial liabilities; 21% believed it was inappropriate and 20% were unsure. See Summary of CFA Institute Member Surveys.

In the Appendix to Fair Value as the Measurement Basis for Financial Instruments which may be found on the CFA Institute website as noted above, we describe in more detail the basis for our support for fair valuing financial liabilities including the decision-usefulness of the information regarding borrowing costs it provides, the measurement independent of timing and consistency it provides in valuations across enterprises. We also provide an illustration of how fair value for financial liabilities can be useful and economically intuitive. Finally, we consider the concerns some have regarding the measurement of financial liabilities at fair value and the inclusion of own credit risk in the measurement of financial liabilities. Specifically, we address concerns regarding realization of fair value gains or losses, the counterintuitive results some believe the measurement provides, the accounting mismatch some think result as well as the concern that fair value doesn’t reflect the true liability of the enterprise. Our response to the questions posed in the Proposed Update are provided below in the context of our views presented in this supplemental document.

Conceptual Framework for the Measurement of Financial Liabilities & Convergence

Before responding to the Proposed Update questions on the measurement of financial liabilities, we believe it is also necessary to consider a broader more conceptual issue. That issue being that the FASB and IASB appear to have no conceptual framework for the determination of how liabilities should be measured within either U.S. GAAP or IFRS. As we step back and consider all of the projects currently under consideration by the Boards, it is our observation that the IASB, and the FASB, are developing very different liability measurement models within and between U.S. GAAP and IFRS. Depending upon whether a liability is covered by the Insurance Contracts Project, the IAS 37 Replacement Project, the Leasing Project, the Revenue Project or the Financial Instruments Project, the measurement of economically similar liabilities can be significantly different.

While many are debating the merits of a mixed measurement model for financial assets few seem to be considering the ad-hoc nature with respect to how liabilities, specifically financial liabilities will be measured and the significant disparity in measurements which exists with respect to these measurements. If you consider for a moment the IASB’s measurement of liabilities, certain of their projects will result in complex liabilities being updated for movements in measurement attributes such as discount rates (e.g. insurance and IAS 37 liabilities) while other projects do not (i.e. operating lease obligations, bank deposits, own debt). Some are calling for the convergence to IASB’s “better” financial instruments model because it presents a better reflection of their business model. This may be true for banking

institutions, but the IASB's model for measurement of insurance liabilities will result in an insurance enterprise's insurance liabilities being closer to fair value with their assets being presented on mixed measurement model. Further, an insurance enterprise which owns a bank will have its most complex liabilities (i.e. insurance contracts) updated for cash flows and discount rates with its banking liabilities, leasing contracts and own debt not updated for changes in discount rates.

We believe that users of the financial statements need a conceptual framework from which to understand the measurement basis of liabilities and the rationale for differences in such measurements. Further, they need a conceptual justification as to why measurement optionality such as that proposed in the IASB's Proposed Update, *Fair Value Option for Financial Liabilities*, enhances the decision-usefulness of the financial statements. We believe the IASB and FASB need to make certain conceptual decisions regarding the measurement of liabilities including, but not limited to, the following before reaching conclusion on this Proposed Update:

- 1) What characteristics of a liability, specifically financial liabilities, make fair value more or less decision-useful?
- 2) How should the inability to exit or transfer certain liabilities affect their measurement when a measurement model is based upon exit value notion?
- 3) Should the measurement attributes of financial liabilities be market based or entity specific?
- 4) Should cash flows be determined on an expected value basis? How often should they be updated?
- 5) How are risk adjustments defined? How should they be measured?
- 6) What are the key elements of discount rate: risk free rate, credit, liquidity?
- 7) Do discount rates need to be updated? How often?

In our view, taking time to develop of a conceptual framework for the measurement of such liabilities would be useful in achieving greater consistency among and between U.S. GAAP and IFRS and would be helpful to pursuing the objective of convergence as set forth in the 2006 Memorandum of Understanding. It is our observation, that a significant amount of time is being spent rebating the same conceptual issues on each of the respective projects.

The Proposed Update's Alternative Measurement Basis for Financial Liabilities

Under the FASB's current proposal there are at least three – or four, should the liability be considered a core deposit liability – measurement alternatives for financial liabilities. We find that these measurement choices imply that management intent changes the value of a financial liability – as we have explained before for financial assets – and creates a lack of consistency among an entity's liabilities and of comparability among entities' liabilities which creates unnecessary complexity. We also don't support the use of other comprehensive income as suspense account for financial liabilities which should be measured at fair value through net income for the same reasons articulated for financial assets.

We do not support the ability to measure certain liabilities at amortized cost. We agree with the dissenting view as articulated in Paragraph BC249 that the amortized cost exception for certain financial liabilities lacks an underlying concept and is rules-based in nature, and could therefore require further interpretation and cause compliance issues in practice. We find the "rule" whereby the financial liability can be classified at amortized cost if a majority of the assets are held at cost to be arbitrary and potentially "gameable" – particularly at the operating segment (i.e. not necessarily reportable segment) level. It is certainly operational – in response to Proposed Update Question #30 – the question should be whether the rule can be "managed."

While we understand that this approach is being proposed to address a potential asset-liability mismatch, again, we believe that the primary question should be what is the right accounting for liabilities, and the answer should not be constrained by sub-optimal accounting (i.e. mixed measurement attribute) for assets. Further, we find the use of a mixed measurement model for financial assets and financial liabilities also permits management to mask the underlying asset/liability mismatch inherent in their business model. The alternative measurement classifications actually work against the portrayal of an asset/liability mismatch as the net interest margin presented in a financial/performance statement prepared on a mixed

measurement basis does not illustrate the duration mismatch which can be seen through the use of fair value. This mismatch – lending long and borrowing short – was a major cause of the demise of several large financial institutions during the most recent financial crisis.

Our views on the remeasurement valuation approach proposed for core deposit liabilities are described in the section which follows.

Presentation of Credit Risk Changes Associated with the Measurement of Financial Liabilities

See discussion regarding changes in credit risk in the Presentation section which follows.

Reclassification (Question #16)

The Proposed Update would require an entity to decide whether to measure a financial instrument at fair value with all changes in fair value recognized in net income, at fair value with qualifying changes in fair value recognized in other comprehensive income, or at amortized cost (for certain financial liabilities) at initial recognition. An entity would be prohibited from subsequently changing that decision. As we do not agree with the ability of management to use a classification based upon business strategy or holding intent for the reasons previously articulated, we believe the need for such a reclassification decision is conceptually unnecessary. As a practical matter, we don't support reclassification as it will likely be used to justify entities' recognizing gains and losses opportunistically which violates the spirit of the original intent based decision to hold the instrument for contractual cash flows.

We would note, however, that conceptually – not practically – it seems counterintuitive to allow management to make this alternative measurement election at the onset based upon business strategy – which can change over time – and not allow reclassification when business strategy changes. If reclassification were permitted, it would tell the investor that the business strategy has changed, information that might not otherwise be conveyed. Further, from a theoretical perspective, we shouldn't oppose reclassification of a financial instrument from fair value through other comprehensive income to fair value measurement through net income as we believe this is always the most appropriate measurement basis.

However, we believe the need to ask the question regarding reclassification – and the existence of disclosure requirements – is indicative of the problems which will surely arise with the mixed measurement model in its practical/real world application. If reclassification is allowed, we believe the financial statements should be restated to reflect management's revised intent and if there are substantial reclassifications over time (indicating the management did not have the ability to make reasonable classification decisions in the first place) that the entity should no longer be allowed to classify financial instruments on a basis other than fair value through the income statement.

As written, it would appear that the guidance in IFRS 9, Paragraph 4.9 is more flexible on this reclassification issue than the FASB's Proposed Update. The Implementation Guidance Paragraphs B5.9 to B5.12 of IFRS 9 provides additional guidance and indicates that such reclassifications should be very infrequent. We believe this is a point the IASB and FASB should be able to reach consensus on.

Any final document should include more prescriptive guidance on how to address the accounting consequences of these "reclassifications – or "misclassifications," as the case may be – because it is unrealistic to assume that entities won't sell financial assets or settle early financial liabilities if they believe it will be economically advantageous to do so.

Recycling (Question #14)***Conceptual Considerations***

As noted in the CBRM, we believe there to be no conceptual justification for, or useful definition of, other comprehensive income and its use seems to be predicated on the mistaken belief that OCI is not a category to which investors devote substantial attention. Accumulated other comprehensive income essentially acts as a suspense account that contains key elements of a reporting entity's performance and risk and, in essence, renders income statements less meaningful. The effect of the OCI category is to disconnect the inherent volatility associated with a business from the volatility of its earnings – that is, earnings are made to artificially appear less volatile than they truly are. We believe this conceptually unsupported use of OCI does a considerable disservice to investors. We believe that the accounting consequences of economic events should be recorded in the period in which those events occur and that recognizing (portions of) such consequences in subsequent periods reduces the usefulness of financial statements.

We have stated on various occasions that there are significant transactions accounted for through OCI without any conceptual basis. Such transactions include fair value changes associated with available-for-sale securities, gains and losses on cash flow hedges, foreign currency translation effects and post-retirement benefit adjustments. Adding yet further items – as is suggested by this Proposed Update – to the significant list of recognition and measurement changes in OCI simply adds another category of economic events to this list of conceptually unsupported transactions. Their deferral in OCI, and subsequent recycling through net income, makes it difficult for investors to fully evaluate the economic meaning of these transactions as they occur. Though only a presentational change, we are generally supportive of the FASB's proposal to require presentation to require a single statement of comprehensive income.

In our document Arguments Against Supplement, we consider the views of those opposing the Proposed Update and their view that: “fair value accounting changes the concept of “comprehensive income” within FASB's Conceptual Framework.” As we note there, the inclusion of one additional measurement in other comprehensive income does not change the fact that it lacks conceptual justification.

Further, there seems to be even greater confusion – or less conceptual support – for the decisions which are being made by the IASB regarding what should be recycled from AOCI to net income. For example, IFRS 9, Paragraph 5.4.4 and 5.4.5 allows an irrevocable election to be made to hold an equity instrument at fair value through AOCI. Upon making this election the fair value changes – including capital appreciation or depreciation upon sale – are never recognized through net income. Only dividends are recognized through net income. This is conceptually inconsistent with the economics of why equity securities are purchased. Still further, under proposed IFRS own credit changes related to financial liabilities for which the fair value option has been elected will never be recycled out of AOCI. The FASB seems to have a more consistent policy of recycling items out of AOCI after they have been placed in this “suspense” account. We believe the IASB and FASB should develop a conceptual justification for the inclusion of items in accumulated other comprehensive income and a rationale for what items are or are not to be recycled.

As a part of our 2009 FI Survey conducted in November 2009 just subsequent to the release of IFRS 9, we asked members about their views on recycling. Of our approximately 630 respondents, 55% believe it was appropriate to prohibit recycling from other comprehensive income to net income; 12% believed it was inappropriate and 33% were unsure.

Practical Considerations

Because we believe that deferral through AOCI is not the appropriate accounting for the transactions noted above, we conceptually oppose the re-cycling of economic changes which have been included in OCI since the full effects of these transactions become difficult for investors to fully evaluate. That said, we have two practical observations/perspectives on recycling provisions of this Proposed Update:

- 1) We believe the FASB's decision to recycle items out of AOCI to preserve the aspects of net interest margin is a reasonable and pragmatic compromise when combined with the further extension of fair value to financial instruments. The Proposed Update maintains the concepts of net interest margin and traditional income statement measures which some investors find useful while at the same time increasing the transparency and relevance of the statement of financial position by including more relevant fair value measurements in the statement of financial position in a timely manner.
- 2) We are more supportive of the FASB approach to recycling elements of OCI than the IASB's ad-hoc approach to recycling. An inconsistent approach to the recycling of items out of AOCI will only create greater confusion for investors. Either all items should be entirely recycled out of AOCI or they should remain there. Said differently, we need a recycling "principle."

We would note that the hyper-focus on the fair valuing of loans in the Proposed Updated has distracted some investor's from the fact that the elements of the net interest margin computation have been maintained through these recycling provisions. Before making a decision on this Proposed Updated, we believe the FASB should confirm broader awareness and understanding of this issue with investors.

Core Deposit Intangibles (Questions #17 & #31)

The valuation of core deposit liabilities of a depository institution is a particularly challenging aspect of the Proposed Update. First, we find it unusual that the Proposed Update now implies that the core deposit intangible recognized in a business combination include multiple intangibles. If there were multiple intangibles associated with the core deposit intangible, the business combination literature would suggest they should have been separately identified and measured during the purchase price allocation process. Second, the Proposed Update indicates that the portion of a core deposit intangible related to the lower cost of funds can be measured and recognized without the consummation of a business combination. Both of these aspects of the Proposed Update make the question of how to value core deposit liabilities challenging.

Simultaneously, when considering the issue of how to value core deposit liabilities in the context of a fair value paradigm, recognizing the core deposit liability at the demand amount does not appear to be theoretically consistent with a fair value model. This theoretical inconsistency stems from the fact that there is a demonstrably low probability that the cash outflow for such liabilities will occur within a time period which suggests that the time value of money is irrelevant to the determination of their value. Further, when you consider the nature of core deposit liabilities in the context of financial instruments which have similar deposit characteristics but which may be accounted for under an expected cash flows approach in the Insurance Contracts Project, there appears to be a need to reconcile the conceptual inconsistencies.

We unequivocally believe that the core deposit intangible asset can be a major source of value for a depository institution, and a business combination should not be the only time that the value of an internally generated intangible asset is recognized. However, we believe that the concept of recognizing internally generated intangibles, such as what this measurement would represent, should be considered more broadly before recognition should be given for one intangible related principally to the banking industry. Further, we agree with the dissenting view that the guidance is proposing a new measurement attribute for core deposit liabilities that does not incorporate all the features of a full fair value measurement, and therefore, the measurement of the core deposit liability and its related intangible asset would not be completely captured by the computation being prescribed by the Board. The proposed

measurement basis is also not equal to amortized cost, and therefore, we believe that the proposal would introduce a new element of complexity to the financial statements which may not be widely understood. Still further, the proposed approach would essentially net an element of the core deposit intangible asset against the deposit liability which – if this is truly the valuation of an intangible asset – we find conceptually difficult to justify.

For all of these reasons, we believe this issue needs to be more fully deliberated and the matters noted above considered. When a core deposit intangible is recognized, there should be enhanced disclosures, including data points, estimation techniques, and estimated values of core deposit liabilities and intangibles (purchased or internally generated) which will enable an analyst to better understand the value of these instruments and intangibles.

Redemption Value for Certain Instruments (Question #19)

We agree that the four criteria listed in Paragraph 34 of the Proposed Update are appropriate, and that for these instruments, a subsequent measurement approach based on redemption value is most appropriate. However, we do raise one hypothetical situation for the FASB’s consideration regarding the qualifying criteria. We can envision a situation whereby a financial instrument can be transferred at a future date between two eligible restricted owners at either a premium or discount to its redemption value. In this situation, we do not believe that redemption value is the appropriate subsequent measurement. Accordingly, the FASB may wish to consider revising the second criterion to indicate that redemption value is an appropriate measurement principle only in those situations where the financial instrument cannot be redeemed *or transferred* for an amount greater than the entity’s initial investment. We do not believe this situation is captured by the first criterion, as a reader could conclude that if the financial instrument can be transferred to only one other party, that does not constitute a “market” nor does it result in a “readily determinable fair value.”

Deferred Taxes in Accumulated Other Comprehensive Income (Question #20)

The exact issue the guidance in Paragraph 35 in the Proposed Update is attempting to address is not entirely clear and the Basis of Conclusions Paragraph BC 166 does not articulate it more precisely. What is clear is that where the tax treatment is different for capital gains and losses than it is for ordinary income, or where these sources of taxable income are required to be evaluated separately, that the deferred tax asset valuation allowance evaluations must be done separately for financial instruments with unrealized gains or losses in other comprehensive income. This is the case for insurance enterprises. Further, if management makes the assertion in its financial statements that it intends to hold certain financial assets or liabilities for receipt of contractual cash flows, the timing of the recognition or reversal of deferred items must reflect this intention. Accordingly, we find the language contained Paragraph 35 to be too general and may need further refinement to allow for circumstances where the evaluation should not be made with all other deferred tax assets because of operation of tax law (i.e. the tax code treats the sources of taxable income differently) and the Proposed Update should consider that intent with respect to financial statement classification of the financial instrument should have bearing on the deferred tax asset recoverability evaluation.

Convertible Debt (Question #21)

We support the Board’s proposed guidance to require convertible debt instruments to be measured at fair value with changes recorded in net income for the aforementioned reasons. We note that the implementation guidance (Paragraph IG65) makes clear that from an issuer’s perspective, convertible debt will not meet the criterion for a debt instrument to qualify for changes in fair value to be recognized in other comprehensive income. However, reading the criteria set out in Paragraph 21, we are not sure that it is entirely clear that the instrument would not meet the condition stipulated in paragraph 21(a)(1). Although we acknowledge that ultimate settlement of the instrument is outside the issuer’s control the principal amount transferred to the issuer will be returned to the creditor at maturity, if the conversion option is not exercised by the issuer. We believe that rather than relying on the implementation guidance to make this conclusion clear, the FASB should refine the wording in the Proposed Update to clarify that

to qualify for recording changes in fair value through comprehensive income, the return of the principal amount to the creditor is within the debtor's control.

From the perspective of an entity that invests in a hybrid financial instrument, the total fair value of the instrument will better reflect the current economic and interest rate environment; and therefore, gives a better picture of the likelihood of conversion (in the case of convertible instruments), or of variability, in the case of leveraged instruments.

From the perspective of an entity that issues a hybrid financial instrument, we support reporting the entire change in fair value for all the reasons that we support reporting an entity's own debt at fair value. That is, subsequent measurement at fair value conveys important information regarding the effective interest rate of borrowings and refinancing requirements, as well as the market's assessment of a company's overall asset quality, thereby enabling investors to better assess the relative strengths and risks of a company as compared to its peer group.

Hybrids (Questions #25 & #26)

We agree that recognizing the entire change in fair value in net income results in more decision-useful information than requiring the embedded derivative to be bifurcated and accounted for separately from the host instrument. Our reasoning is articulated in the preceding response on convertible debt.

From a practical standpoint, we believe that eliminating the requirement to bifurcate the derivative from the host instrument removes an element of subjectivity from the valuation process, specifically, the judgments made regarding how to separately identify the two components of the hybrid instrument. Eliminating the bifurcation requirement, therefore, improves the overall reliability and comparability of financial information.

We believe that the FASB's proposed approach is superior to that set forth by the IASB in IFRS because it eliminates the bifurcation of hybrid financial assets and liabilities and requires their initial and subsequent measurement at fair value. As currently proposed, the IASB will not require bifurcation of a hybrid held as a financial asset and the financial asset containing a hybrid can be measured at fair value or amortized cost based upon management's intent. Bifurcation of a hybrid contained in a financial liability will be required and the embedded will be fair valued, but the host will be reflected at amortized cost. Under the IASB's model, the same instrument will be accounted differently by the holder than by the issuer.

Short-Term Instruments (Question #27)

We agree that short-term payables and receivables should not be required to be measured at fair value, given that these instruments are generally not held for trading or risk management reasons and generally do not have a significant difference between amortized cost and fair value because of their duration. We also agree that the FASB has appropriately restricted this category to instruments that are due in one year or less, and for which an entity's business strategy is to hold the instrument for collection or payment of contractual cash flows. We believe the information will be useful in assessing the short-term liquidity needs and working-capital profile of an entity. We also believe it is appropriate to continue to subject these instruments to ongoing tests of impairment.

See above for our views on the treatment of money market funds.

Credit Impairment & Interest Income

Overall Considerations

CFA Institute has consistently articulated our support for recognition and measurement principles for financial assets based on fair values. With a fair value based measurement method there would be no need for the determination of credit impairment estimates, interest income recognition pattern estimates, allowance accounts or changes in the definition of amortized as required by the FASB and/or IASB proposals. These discussions/debates could be eliminated with the use of fair value and the elimination of these “artificial accounting constructs”.

Credit Impairment

As we stated in our letter ³ to the IASB on its exposure draft related to impairments, we question whether the impairment methods – and interest income recognition methods – proposed by the FASB and IASB in these proposals are less subjective or less complex than the use of fair value and whether they more faithfully represent the underlying economics of the financial instruments to which they will apply. They each appear to be an “accounting construct” rather than a measurement method which is premised upon reflecting the underlying economics of the transactions currently occurring in the marketplace. We understand how differences of opinion may exist on the accounting for financial instruments as it relates to the use of fair value versus a mixed measurement model, but we are disappointed that the IASB and the FASB could not come to an agreement and reach a more converged solution as it relates to credit impairment as we believe that users of financial statements would benefit from a single impairment model. A single impairment model would improve consistency and comparability. Differences in the use of past and current information in the projection (expectation) of losses under the FASB and IASB approach illustrate that these measures – though sometimes both referred to as “expected loss approaches” – could produce substantially different credit, and interest income, recognition patterns over the life of a financial instrument and result in confusion for users regarding what economic expectations have, or have not, been incorporated into a preparers’ estimates.

We are surprised by the fact that the FASB’s proposal is progressive in its approach to the recognition and measurement of financial instruments, through the extension of fair value, but not as progressive in its determination of credit impairments in that it does not incorporate expectations regarding future events. Use of an expected loss model for credit impairment which incorporates past, existing and future conditions most likely minimizes the differences between a fair value model and an amortized cost/mixed measurement model. Said differently, if both fair value and a mixed measurement model incorporate future expectations of credit and interest rates are observable then the only significant estimation difference for debate is the pricing of liquidity.

Considering all of the above, we strongly support the initiative by the FASB to establish a single impairment model to be applied to all financial assets which we believe should reduce complexity and provide comparable and more decision-useful information to users of financial statements.

Interest Income

Consideration of the appropriate recognition and measurement of interest income is inextricably linked to the consideration of the measurement of credit impairments. Some seem to suggest the use of an expected loss model for impairments while simultaneously seeking an interest income recognition pattern based upon the contractual cash flows of the financial instrument. The cash outflow for an investment and the cash inflow for its repayment, or failure to repay, are equated through either adjustments in credit impairment measurements or differences in measurement of net interest income. The FASB and IASB model simply equate the cash inflows and outflows differently, but, in either case, interest income is impacted by the discounting of the expected credit losses. Fair value would eliminate the need to make

³ CFA Institute Comment Letter to IASB on IASB Exposure Draft *Financial Instruments: Amortised Cost and Impairment*; July 1, 2010.

this artificial separation. Investors would simply need to see the cash flows and the associated remeasurements. Because of the interconnection of the two concepts responding to the questions posed in the Proposed Update separately is not entirely possible as you will see through our responses below.

Amortized Cost

Because of the interconnectedness of the credit impairment and interest income measures and the IASB's means of equating them through the use of an effective yield approach, they have changed the historical definition and objective of amortized cost measurement which we think is a concept many, except the most sophisticated, users/investors have not realized. As we considered the IASB's proposal during its comment period, we were reminded that the definition of amortized cost has historically been different between U.S. GAAP and IFRS – most significantly that the IASB definition included the allowance account in its definition and the U.S. GAAP definition did not. With the changes proposed in this Update, and the changes proposed by the IASB in their definition and objective of amortized cost, we believe the difference in definition and objective of amortized cost only further diverge rather than converge.

Under the currently proposed IASB definition, amortized cost will continue to include the allowance account but will be modified to include the “write-up” for positive changes in expected losses because the definition includes the allowance account. The IASB definition will now require that all write-offs be taken through the use of an allowance account – a modification we see as an improvement that will promote consistency between IFRS reporting entities. Under the FASB proposal amortized cost under U.S. GAAP will not include the allowance account, only direct write-offs of principal, and, as proposed, will include foreign currency adjustments (i.e. not explicitly stated in IASB definition). We believe the inconsistency in the definition of amortized cost will not be widely understood and appreciated by investors, defies the objective of convergence and will result in a lack of comparability combined with confusion for users.

Understandability

These differences in incorporation of information and expectations combined with: a) differences in the definition of amortised cost, b) the highly complex methods of computing impairments, and c) the technical differences in calculating effective returns; will not only result in a lack of comparability between U.S. GAAP and IFRS preparers, but will likely only be understood by a small percentage of users and investors. Further, to obtain the most meaningful input from users and investors it would be helpful for the FASB and IASB to publish illustrations of the application of their respective models on similar instruments across time. Such illustrations would need to include examples of a fixed rate, variable rate and changing notional amount instruments. Illustrations would enable users to better understand, analytically, the impact of the proposed standards and allow for greater input from investors.

Credit Impairment Objective & Recognition and Expectation Changes (Questions #37, #38 & #44)
Objective

As we consider the objective of credit impairment as articulated in Paragraph 36 of the Proposed Update we find there are several questions to resolve:

- 1) What is the definition of a credit impairment?;
- 2) What information should be utilized to determine if a credit impairment meeting the definition exists?;
- 3) How should the credit impairment be measured?; and
- 4) When should the credit impairment be recognized?

Conceptually, we agree with the definition of a credit loss being an expectation that an entity will not collect all of the anticipated cash flows or as stated in the Update: “on the basis of an entity’s expectations about the collectability of cash flows, including the determination of cash flows not expected to be collected.” We do not agree, however, with the second portion of the objective which indicates: “An entity’s expectations about collectability of cash flows shall include all available information relating to past events and existing conditions but shall not consider potential future events beyond the reporting date.” For the reasons articulated below, we believe credit impairments should be based on an expected loss model considering an entity’s historical loss experience and estimates of future changes to those expectations. The objective does not articulate how the credit impairment should be measured, this is stated elsewhere, but implies that the recognition occurs when the expectation that all contract cash flows will not be received is satisfied. Inherently, however, when loans are priced there is an uncertainty premium charged based upon the notion that, on average, certain loans will experience a loss. This results in an expectation of losses at inception and the immediate recognition of such losses under the FASB approach. We do not agree with the proposal to the extent that it will result in the immediate recognition of impairment upon the origination of a loan, or purchase of securities, based upon the notion that a historical loss ratio suggests, on average, a portfolio of loans, or securities, will produce a particular level of credit impairments. Such expectations are priced and reflect the risk uncertainty inherent in the extension of credit and are included in the interest rate charged on the instrument. To recognize the loss immediately results in a reduction of income today and higher interest income in the future. Such an approach is not consistent with a fair value notion. If a financial instrument is issued at a market interest rate (which includes an expectation of credit risk) a fair value based recognition model would not result in an immediate impairment because the risk charge would be reflected as interest income on the instrument. When the degree of credit risk uncertainty changes in the marketplace the fair value will adjust upward (downward) based upon the market’s perception of the decrease (increase) in risk or the price of such credit risk. Under an approach where impairments are taken immediately, the financial statement valuation will result in financial assets being reflected at a value below fair value – and if sold immediately thereafter result in the recognition of a gain upon disposal.

Recognition

For the aforementioned reasons, we are supportive of the recognition of credit impairment over the life of the financial asset as the uncertainty is resolved which is how the market would recognize such losses. Our view on the timing of when to record the credit impairments is more in line with the IASB model whereby the original effective interest rate includes a provision for expected credit losses and the allowance is built over time – though we recognize this model is not consistent with a fair value approach in that it utilizes the original effective yield to determine its impairment loss (i.e. it discounts the revised expected cash flows using the original effective yield rather than a revised market yield which would likely be higher due to the deteriorating credit). We are more supportive of the IASB’s model which suggests an entity should recognize a credit impairment for the difference between the original effective yield excluding credit impairments (i.e. the effective yield computed considering premiums and discounts but not potential future credit losses) and the effective yield including expected credit losses over the life of the asset. Unlike the IASB model, the FASB model does not attempt to entirely isolate the credit

impairments from the interest income. While the impairment charge will occur earlier and will be separately identified at inception under the FASB model, there will be an increase for the impairment charge – which appears to be the unwinding of the discounting of the credit impairment – over the life of the instrument in interest income. This portion of the credit impairment will, like the IASB model, reduce interest income – just not as significantly as the IASB’s model – and will not be presented separately. Most users, investors, and analysts state they prefer separate identification of the impairment amount from the contractual interest amount.

Expectation Changes

We are not supportive of revisions to expected future losses being entirely deferred – through a prospective only yield adjustment – and recognized over the remaining life of the financial assets. We believe market anticipated credit losses should be recognized as they occur and that an entirely prospective yield adjustment is not appropriate. As with fair value, we believe changes in credit impairments, upward or downward, should be reflected in income when expectations change.

Measurement

As we stated previously, in principle, we support an “expected loss” model which updates expectations each measurement period in place of the existing “incurred loss” model because expected loss model uses more forward-looking estimates of expected credit losses, which we believe is more consistent with the underlying pricing/valuation of such investments, and, therefore, is closer to a fair value approach. We believe the incurred loss model results in delayed recognition of credit losses, which we do not believe results in decision-useful information for investors.

In deriving expected loss estimates we support an approach that would include forecasting of future events or economic conditions that did not exist at the end of the reporting period to the extent that they would be based on reasonably reliable factors. Including a wider range of future economic scenarios into the measurement of the credit risk of financial assets provides decision-useful information to investors (when properly disclosed) and would be a better reflection of the ultimate economic reality of the true collectability of the contractual cash flows. Although we understand the Board’s concern that it would be difficult to accurately forecast the expected cash flows over the life of the financial asset, we none-the-less believe that an entity should be required to make these forecasts and consider them where necessary.

While we believe the expected loss model should incorporate future expectations and likely future economic conditions, we are not supportive of a “through-the-cycle” approach which considers these expectations but then “smoothes” the recognition through economic cycles. This detracts from the decision-usefulness of the information to investors in that it masks underlying risks.

Both the FASB and IASB models discount expected losses at the original effective interest rate. Because original effective interest rates will be likely be lower than updated effective rates when credit begins to deteriorate, both models have the effect of increasing the amount of the credit impairment immediately recognized as the cash flows will be discounted at a lower rate than what the market might discount the rates. Fair value would provide a better economic reflect of the amount of the credit impairment.

Changes in Cash Flows Related to Other Than Credit (Question #39)

We find no conceptual justification for the retention of the foreign exchange gain or loss in accumulated other comprehensive income. We believe that the currency changes should be recognized as incurred through net income as, unlike the local currency principal amount, there is no basis for the assumption that the amounts will revert to the spot rate on the date the transaction was entered into simply because the financial instrument is being held for receipt or payment of contractual cash flows. Holding the financial instrument for receipt of contractual cash flows does not immunize the organization from the recognition of these market value changes. Further, many times significant currency losses are not evaluated for income statement recognition (i.e. impairment) when included in accumulated other comprehensive income.

Historical Loss Rates (Question #40 and #45)

As noted above, we believe future expectations should be utilized in the determination of expected credit losses. That said, we believe that it is appropriate to compute historical loss rates for each individual pool of financial assets with similar risk characteristics. We agree with the Board that historical loss experience should be considered along with the implications of existing conditions for an individual pool of loans.

We concur with the Board's decision not to prescribe a particular methodology for determining historical loss rates given that there are enough individual circumstances among entities that it would be impractical to require a uniform methodology. Common industry practices will emerge. We do, however, believe overall guidance/principles would be useful in that they will ensure that entities consider, at a minimum, certain essential characteristics. For example, we believe that the data should extend to cover the life of the financial asset.

Increases in Expected Cash Flows on Purchased Assets (Question #41)

Under a fair value approach some portion of the increase in expected cash flows on a purchased asset would be recognized immediately and some portion would be an adjustment in the future yield which would result in the prospective recognition of a portion for any remaining unresolved uncertainty. In very simple terms, under the FASB's model there appears to be a recalculation of the effective interest rate for positive changes in expected cash flows on purchased assets but no downward adjustment in the effective interest rate should there be decreases in expected cash flows. Downward adjustments are reflected as credit impairments. The updating of the effective interest rate on purchased assets is different than the treatment for other financial assets under the proposal. This inconsistency will create artificial complexity for users and consideration should be given to how to develop a more consistent approach in their treatment.

Individual vs. Pooled Impairment (Question #42)

It is our position that the FASB should develop an expected loss impairment model and it should be defined in such a way that it would not make a difference whether it applied to individual or pooled financial assets.

Removal of the Probable Threshold (Question #43)

We support the removal of the "probable" threshold for recognizing credit impairments since it should result in an entity recording credit impairments in a more timely fashion and not be based on a specific triggering event – which is an artificial accounting construct rather than a reflection of economic reality. Theoretically, removal of this threshold removes management's subjective discretion in the determination to delay recognition of losses which is a positive outcome. Practically speaking, however, the subjective nature of the threshold's implementation and the ability to incorporate future projected losses based upon existing conditions makes the actual impact difficult to assess in that such estimates will be highly subjective as well.

Interest Income and Impact of Impairments (Questions #48, #49, #52, #53 & #54)

As noted above, we believe recognizing interest revenue in a pattern consistent with expectations of the amount and timing of expected credit losses appears to be a consistent manner of allocating interest earned with expected credit risk. The use of the effective interest method as computed at the inception of the financial asset would appear to align with this revenue recognition objective and reflect the market's pricing of the uncertainty associated with the credit risk of the instrument. Further, we note that at subsequent measurement dates the use of the original effective interest or effective spread method will not, however, reflect the market's perception of the amount or timing of credit risk associated with the financial instrument and, as such, is not our preferred solution. Rather, we believe that resetting the effective yield for current market conditions based upon fair value would produce measurements that better reflect the economic characteristics of the instrument.

As it relates to the specific questions we make the following comments:

- 1) Question #48 – We understand the need to compute the interest income net of the allowance account given the mechanics of the approach selected, but we believe contractual or original effective interest and subsequent changes for credit should be separately presented rather than commingled under the approach proposed in the Update.
- 2) Question #49 – Mechanically we understand the need to adjust the allowance for the difference in the interest accrued and the contractual amount due; however, for the reasons noted above, we believe the credit and interest components should be separately presented.
- 3) Question #52 – As noted elsewhere in our response, we prefer fair value through the income statement, but we recognize others prefer the maintenance of more traditional income statement measures and the FASB has arrived at a pragmatic compromise. Accordingly, we agree with the FASB's compromise solution to reflect interest income on items fair valued through other comprehensive income.
- 4) Question #53 – For reasons similar to those in our response to Question #48 and our discussion of credit impairments above, we believe the cumulative credit losses recognized in income should be equal to the amount recognized in the allowance account.
- 5) Question #54 – Our response to this question is included within our discussion of credit impairments.

Interest Income for Financial Assets Fair Valued Through Net Income (Question #50)

See response to Question #50 under Presentation section which follows.

Implementation Guidance and Illustrative Examples (Question #51)

As noted previously, we strongly suggest that the FASB and IASB both include further implementation guidance and illustrative examples to provide additional guidance on the credit impairment and interest income models in their proposals. We believe this is important for preparers to accurately prepare the estimates, auditors to audit the information and users to better understand the results.

Specific examples should include financial instruments with fixed rates, variable rates, and adjustable principal (e.g., inflation adjustable) along with examples of complex structured securities where multiple factors change during the same reporting period (e.g., credit, prepayment, interest rates, etc.). Examples should include the complex financial instruments which would be classified at amortized cost under IFRS including structure products (CLOs, CDOs, etc.). We draw particular attention to the need for guidance regarding how the effective interest rate is calculated and what it represents across a variety of scenarios. Detailed implementation guidance and illustrative examples would facilitate consistent and accurate application and understanding of the proposed guidance.

Cease Accrual if Overall Yield is Negative (Question #55)

We agree that an entity should cease accruing interest on a financial asset if the expectations about cash flows expected to be collected indicate the overall yield on the financial asset will be negative.

Hedging***Overall Assessment of Hedging Proposals (Question #59 & #60)***

We appreciate that hedge accounting was introduced to minimize the measurement and recognition inconsistencies that may arise between the accounting treatment applied to hedging instruments, such as derivatives, and the accounting treatment applied to the hedged risk. Nevertheless, it is widely recognized by both users and preparers of financial statements that the application of hedge accounting has contributed to the overall complexity, inconsistencies and reduced transparency of financial reporting information.

We agree that the proposed widened application of fair value as a measurement basis for financial instruments should reduce the need for hedge accounting. We also fully support certain of the proposals to improve the depiction of hedge ineffectiveness, specifically the decisions to:

- Consistently treat under and over hedges of cash flow hedge accounting relationships (Paragraph 123);
- Eliminate the shortcut and critical terms method that require no assessment of hedge effectiveness after inception (Paragraph 115);
- Eliminate the de-designation of derivatives after election at inception so as to minimize gaming (Paragraph 119-121);
- Provide additional disclosures including the cumulative fair value hedge accounting adjustments in the statement of financial position (Paragraph 127).

However, we are concerned by the inadequate definition of a reasonably effective threshold and the absence of robust qualitative criteria for determining hedge effectiveness (Paragraphs 113, 114, 116 and 117). We support incorporating the qualitative criteria when making hedge ineffectiveness judgments, but in order to ensure consistent application by issuers and to allow the depiction of only legitimate economic hedging relationships, further development of such criteria is necessary.

Overall, we see the increased application of fair value accounting for financial instruments will result in greater reflection in the financial statements of the economic effects of risks and their hedging offsets. Further, changes in the measurement of cash flow hedging ineffectiveness to record both over and under hedges and the removal of the short-cut and critical terms method and the resulting requirement to measure ineffectiveness for all hedging relationships will result in a better reflection of the economics of such transactions in the financial statements. We are concerned, however, by the ability to use qualitative criteria to determine the effectiveness of a hedging relationship at their inception and the loosening of the effectiveness threshold when it comes to the hedging of forecasted cash flow transactions. We are concerned that these items taken together will result in an increased deferral of cash flow hedging losses in accumulated other comprehensive income which was a problem for several large financial institutions in the recent past.

In the final subsection entitled Additional User Concerns Not Addressed by Proposed Update, we provide our thoughts on aspects of hedging accounting which are of concern to users but which do not have been addressed by the Update.

Bifurcation of Embedded Derivative Features

As described more fully in our response to Questions #25 and #26 related to hybrid instruments and our response to Question #21 related to convertible debt in the Recognition and Measurement section we are supportive of the elimination of the need to bifurcate embedded derivative instruments from their host contracts.

Hedge Effectiveness***Modification of Effectiveness Threshold (Question #56) & Use of Qualitative Assessment Techniques***

Current U.S. GAAP requires a quantitative assessment to qualify for hedge accounting. The Update would propose to require only a qualitative assessment but notes that a quantitative one may be necessary in certain situations.

We are concerned by the absence of a robust and consistently understood criterion for determining eligibility for hedge accounting. We understand that the adoption of a “reasonably effective” instead of a “highly effective” threshold will lower the hedge accounting eligibility barriers and compliance costs for financial statement preparers. We acknowledge that rigid, bright-line tests (e.g. 80-125%) that are used in the high effectiveness assessment, often led to distortions in the judgment of economic hedge effectiveness by issuers. However, the failure to define what reasonably effective means and to provide guidance on qualitative criteria is a significant concern. An open ended definition of effectiveness, coupled with inadequate levels of disclosure on the criteria for determination of hedge effectiveness, is likely to impair the ability of users to make judgments on whether legitimate hedging relationships are in place and to assess whether they are, in fact, effective.

We strongly believe the Board needs to provide a robust, qualitative assessment framework for making these judgments. Creating such a definition or framework is necessary so as to ensure consistent and comparable accounting across reporting entities. The Proposed Update delineates some elements that could go into determining effectiveness, including consideration of counterparty risk as part of hedge effectiveness testing; but the overall thrust, articulated by the Board in the Basis of Conclusions (Paragraph BC 220) is to steer clear of providing any guidance on what reasonably effective means and this leaves it rather open-ended. In the absence of transparency on how this effectiveness determination is made, companies will have greater latitude to be inconsistent across reporting periods in their evaluation of hedge effectiveness.

While this proposal will reduce the number of effective economic hedges that fail to qualify for hedge accounting, it will also likely increase the number of wrongly designated hedging relationships; especially as the judgment of effectiveness can be determined purely qualitatively. This will simply lead to a different type of misclassification and one that results in users underestimating rather than overestimating the risk exposures. Further, the misclassification will be especially problematic for cash flow hedge accounting, as it will increase the likelihood of inappropriate deferral of derivative gains and losses.

Elimination of Shortcut and Critical Term Matching Methods

We strongly support the elimination of the shortcut and critical terms method. The shortcut and critical terms methods required little or no ongoing monitoring of accounting hedges and exempted transactions from retrospective assessment. These methods also led to numerous restatements⁴ (e.g. AIG, Bank of America, Fannie Mae, Freddie Mac, Ford Motor Credit and GE Capital⁵). We support the elimination of the shortcut and critical terms match methods for these reasons but also because the decision will enhance the consistency of financial reporting information by reducing the instances through which economically similar transactions can be accounted for differently, depending on managerial intent. The shortcut method can result in the selection of derivative instruments for administrative convenience rather than for the economic optimality of the selected risk management strategy. At the same time, the short cut method left investors susceptible to unanticipated risk exposures in situations where managers have selected sub-optimal hedging strategies driven by their desire to qualify for the shortcut accounting treatment

⁴ Comiskey.E.E and Mulford.C.W; *The Non-Designation of Derivatives as Hedges for Accounting Purposes*; The Journal of Applied Research in Accounting and Finance; 2008.

⁵ Ramirez, J.; *Accounting for Derivatives*; John Wiley & Sons; 2007. “GE having to restate \$381 million in its earnings in 2005, after an audit review showed that there was a misclassification of interest rate swaps as eligible for shortcut hedge accounting treatment.”

Ongoing Hedge Effectiveness Assessments (Question #57 & #58)

Consistent with our support for the elimination of the shortcut and critical terms method, we would not support the exemption of any derivative instruments designated in hedging relationships from ongoing effectiveness evaluation under any circumstances. We are concerned about the proposal to move from the current approach of a periodic reassessment to a judgemental, discretionary reassessment of hedge effectiveness. This concern is exacerbated by the primary emphasis on a qualitative assessment of hedge effectiveness as proposed by the Update. This proposal may provide managers with greater latitude to mask derivative losses, as it is now easier, given the greater weight accorded to a qualitative assessment, to characterize hedges as being effective both at inception and on an ongoing basis. This is of particular concern for cash flow hedges where derivatives gains or losses are deferred through accumulated other comprehensive income. Further, we believe that with all hedges now requiring measurement of ineffectiveness the ability to make ongoing quantitative assessment should be made easier for managers as significant ineffectiveness is a sign that the overall relationship is no longer effective.

Dedesignation of Hedging Relationships

We support the restriction of de-designation in situations other than when there is hedge ineffectiveness, termination, selling or exercising of derivative contracts as outlined in Paragraphs 119 to 121. This restriction will minimize gaming through the opportunistic application of hedge accounting. This can occur in situations where managers arbitrarily get “in and out” of designated relationships for reasons other than those dictated by the underlying economic circumstances of the hedging relationship.

Measuring and Reporting Ineffectiveness in Cash Flow Hedging Relationships

Paragraphs 122 to 126 of the Update outlines the approaches related to measuring and reporting ineffectiveness in cash flow hedging relationships. Overall, we are supportive of the principles articulated in Paragraphs 122, 124 and 126 with respect to measuring ineffectiveness based on matching the value of derivative instruments to that of other derivative instruments, which generate economically equivalent cash flow patterns relative to the hedged exposure (e.g. forecast transactions). We also support the use of the same credit risk for the matching pair of derivatives instruments. Disclosures should be improved so as to make users aware of where there is basis risk in cash flow hedging relationships.

We support the adjustment proposed in Paragraph 123 so as to allow recycling of both over and under hedges because the partial recognition of over hedges made it difficult for users to interpret recycled cash flow hedge gains or losses. Incorporating both over and under hedges would make reported gains or losses to be a better representation of economic hedge ineffectiveness for designated cash flow hedging relationships. Users face a significant challenge in making meaningful economic interpretations of gains or losses that are shifted on an inter-temporal basis between other comprehensive income and net income, via deferral and recycling. As such, we do not support the Update’s continued ability to amortize the time value portion of options, when recycling to the income statement (Paragraph 125). Amortizing or smoothing the time value component of options, results in useless economic information as it results in partial recognition of gains or losses and contributes to gains or losses being recognized in unrelated reporting periods. Therefore the immediate recognition of the full time value portion for option contracts, when ineffective, should be required and entities should not be allowed under any circumstances to defer the recognition of changes in fair value in earnings related to the time value component of a purchased option when making ineffectiveness adjustments. This will allow the full income statement recognition of ineffective portions.

Additional Disclosures Related to Derivative Instruments and Hedging Activities

Overall

We note that some of the proposed disclosure changes, though desirable, appear to be ad-hoc and not necessarily mapped to the fundamental hedge accounting model adjustments. We would suggest that disclosures continue to be refined based on a holistic understanding of user analytical requirements. Overall, disclosure adequacy should be judged by the extent they enable users to understand:

- Hedged versus un-hedged risk exposures;
- The extent to which the hedge accounting election is applied;
- Economic hedges that are excluded from hedge accounting treatment;
- Derivatives that are used for taking active positions;
- Effectiveness of hedging relationships.

We acknowledge that SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities* (included with the disclosure requirements of Topic 815), enhanced the required derivatives disclosures; however, there remains room for further improvement so as to better meet users' analytical requirements. For example, existing disclosures do not address un-hedged risk exposures. Similar to the hedged risk profile, the un-hedged risk profile affects overall firm performance and is of great interest to investors. We would concur with observations⁶ that even after adopting the changes promulgated by SFAS 161 more useful disclosure for investors is required, including:

- The percentage of risks hedged;
- How the percentage of risks hedged changes over time;
- The effect of derivatives on current period cash flows.

Specific Disclosures Within The Proposed Update

We support the proposed disclosure of cumulative fair value of items in hedging relationships accounted for as fair value hedges in Paragraph 127. These disclosures will help inform on overall hedge effectiveness and the same disclosures should be provided for cash flow hedges. We also support the disclosure of carrying amounts of assets or liabilities that are part of a hedging relationship. This should be disaggregated so as to differentiate between amounts adjusted for and those excluded in the fair value hedge accounting relationship. This will help users to make an evaluation of the extent to which a particular item has been hedged and what the un-hedged exposures are.

We have no objection to the proposed disclosures related to hedging of own debt or other liabilities that are measured at amortized cost (Paragraph 128). We would observe, however, that this is a disclosure required because of the creation of an accounting treatment rather than one required if the economics of the transaction had been appropriately reflected in the financial statements.

Additional User Concerns Not Addressed by Proposed Update

Despite our support of some aspects of the proposals, the sum of these changes, can at best, only be considered as minor “tweaking” of the highly complex and anomalous approach that hedge accounting represents. To provide more useful information to investors, there remain areas that need further addressing so as to ensure a complete and accurate economic depiction of derivatives use and risk management activities. They include: a) bifurcation by risk; b) addressing the distortions of cash flow hedge accounting; and c) ensuring a converged approach by the FASB and IASB that yields the most decision-useful information.

⁶ Zion, David; SFAS 161, *Derivatives Emerging from the Shadows*; Credit Suisse Research Report; March 26, 2008.

Bifurcation by Risk

In our comment letter, dated August 15, 2008, to the then FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (“SFAS 133”) Amendments Exposure Draft⁷, we were supportive of the considerations in that document to either eliminate or restrict the bifurcation of discrete risk categories to interest and foreign currency risk in determining hedge accounting eligibility. Due to the inadequacy of disclosures required to enable users to differentiate between hedged and un-hedged risk exposures, the ability by preparers to designate discrete risk categories for hedge accounting purposes, lowered the overall transparency regarding hedging relationships. This Proposed Update does not limit the bifurcation requirements, and we consider this to be a missed opportunity.

Cash Flow Hedge Accounting Economic Distortions

We believe that more needs to be done to reduce the distortion of economic reality and overall complexity that is created by current cash flow hedge accounting requirements. In contrast to fair value hedge accounting, cash flow hedge accounting adjusts the derivative accounting treatment to conform to that of the hedged item. The optionality and inconsistency between cash flow and fair value hedge accounting can result in differing accounting treatments for the same derivative risk instruments and essentially same risk exposure⁸ depending on the asserted nature of risk transformation being undertaken. The deferral and subsequent recycling of gains and losses of derivative instruments necessary to achieve the effects of cash flow hedge accounting is both complex and in several cases contributes to the distortion in reflection of the underlying economic reality. Troubling aspects with current cash flow hedge accounting rules still remain in place, including the:

- *Treatment of Time Value of Option Contracts* – As discussed earlier in the section on measuring and reporting ineffectiveness in cash flow hedging relationships, the time value portion of options should be recycled consistent with the treatment of the intrinsic value portion.
- *Lengthy Deferral Periods* – As noted in a previous comment letter, a number of high-profile restatements have illustrated how the current cash flow hedge accounting requirements can result in the delayed recognition of realized derivative losses. For example, a Bloomberg article⁹ cites the case of Freddie Mac applying cash flow hedge accounting on the derivatives used to hedge its own debt. In the process, there has been the deferral of gains and losses for periods of up to 26 years. A study¹⁰ of Dow Jones constituent companies found that the deferral periods ranged from 6 months to 30 years, and this variability contributes to the interpretive difficulties in understanding what lies in and what is transferred from accumulated other comprehensive income. Hence, the current deferral requirements contribute to investors' difficulties in understanding the income and cash flow effects of derivatives designated for cash flow hedge accounting purposes.
- *Earnings Management* – An academic study¹¹ based on 434 bank holding companies with data from 1995 to 2005, provides empirical evidence showing that cash flow hedge accounting deferrals are used for earnings management. The study finds that after adjusting reported income by reversing cash flow hedge accounting deferrals, a statistically significant number of reported earnings increases are effectively transformed into earnings decreases. However, there is no corresponding statistically significant evidence of adjusted reported earnings decreases/declines being transformed into effective earnings increases. The study interprets this

⁷ FASB Exposure Draft, *Accounting for Hedging Activities: An Amendment of FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities*.

⁸ For example, a receive fix and pay floating interest rate swap will result in different accounting treatment if it is used to hedge fair value risk associated with a fixed rate debt asset or liability then when it is used to hedge the cash flow risk resulting from a floating rate debt asset or liability.

⁹ Jonathan Weil (December 5, 2007), Bloomberg.
http://www.bloomberg.com/apps/news?pid=20601039&refer=columnist_weil&sid=ahoxGPj68WN0

¹⁰ Hamlen and Largay III; *Has SFAS 133 Made Derivatives Reporting More Transparent? A Look at the Dow Jones 30?*; Journal of Derivative Accounting; 2005.

¹¹ Zhou H.; *Does Fair Value Accounting for Derivatives Improve Earnings Quality?*; Working Paper; University of Illinois at Urbana Champaign; 2009.

finding as being systematic evidence of unidirectional earnings management where cash flow hedge accounting deferrals are used to reverse and mask earnings declines.

- *Flawed Anticipation of Hedge Effectiveness* – The rules of the former SFAS 133, currently Topic 815, require the forecast of AOCI amount expected to be recycled in the next period. Results of the previously cited study of Dow Jones constituent companies and their application of SFAS 133 showed that there is significant forecast error – an average error of 63% – in the expected versus actual AOCI adjustment. Cash flow hedge accounting is premised on managerial intent, and the existence of significant forecast error shows that managerial anticipation of hedge effectiveness is more often than not inaccurate.

We would prefer the recognition of all derivative gains and losses through the income statement. However, under a cash flow hedge accounting deferral approach we would recommend implementing ways of *limiting deferral periods*. One of the ideas proposed in the IASB's September 19, 2008 Discussion Paper *Reducing Complexity for Financial Instruments* was that reporting entities should state at inception when a hedged transaction is expected to affect earnings and to reclassify gains and losses at that time regardless of the realisation of the forecasted transaction. We would support this idea as it can limit lengthy deferral periods.

Convergence

Similar to recognition and measurement approaches, there seems to be a likely departure in approaches to hedge accounting between FASB and IASB. We encourage both Boards to evaluate and jointly adopt the most decision useful approach.

Presentation***Presentation of Fair Value & Amortized Cost Information (Question # 24 & #35)***

We believe that the fair value and amortized cost information should be presented on the face of the statement of financial position (with equal prominence) for both financial assets and financial liabilities irrespective of whether the financial instrument is measured at fair value through net income, other comprehensive income or measured at amortized cost. Presently, Paragraph 85 does not require the presentation on the statement of financial position of amortized cost for financial assets and financial liabilities – other than financial liabilities which represent the entity’s own outstanding debt instruments – measured at fair value through net income.

We support the proposed reconciliation on the statement of financial position, for items that are recognised at fair value through other comprehensive income as prescribed in Paragraph 86.

We would note that the Presentation section of the Proposed Update does not include a paragraph indicating that the fair value of financial liabilities measured at amortized cost should have their fair values disclosed on the face of the statement of financial position.

Presentation and Determination of Own Credit Risk Component (Question #32, # 33, #34 & #36)

We support separate presentation of the own credit risk component for financial liabilities that are recognised at fair value through net income. As noted in our discussion of the fair value of financial liabilities, we believe there is substantial information content in such measurement and disclosure.

While we understand the conceptual and theoretical underpinnings of the requirement to compute and present separately the entity-specific portion of the own credit component, separating changes in its credit standing from the systematic price of credit, we believe the practical measurement of such differences will be very difficult. Further, we believe that the change in fair value is more complex than the Proposed Update suggests. For all of these reasons, any measurement of the elements of the change in fair value may imply a level of precision which will be difficult to achieve in practice, and the reliability is low. Therefore, we are not sure that any benefit is derived by providing this information to users would outweigh the cost of obtaining the information by preparers. In addition, given the fact that including changes in the fair value of credit risk in the ongoing measurement of financial liabilities is still somewhat controversial, we believe it may be premature to attempt to separate a change in credit risk into its component pieces until changes in credit risk are better understood and accepted in the marketplace.

Further, if the entity specific portion due to changes in credit standing is to be the portion that is separately presented in the income statement, we do not think the FASB should prescribe one method over another (i.e. the two methods described in Appendix B of the Update). This determination should be left to the judgment of reporting entities and appropriately described in the disclosures.

Finally, we would note that the presentation requirements as articulated in Paragraph 94 would require the separate presentation of changes in own credit due to changes in credit standing, but they do not require that the total change in own credit be presented or disclosed separately. The entire change in own credit needs to be presented or disclosed to users. If there is a decision to retain the provisions of the Update which require separate disclosure of the changes in the credit standing these should be separately disclosed along with a disclosure of the total change in own credit.

Income Statement Presentation for Items Measured at Fair Value Through Net Income (Question #50)

We think the presentation requirements in Paragraph 90 could be made clearer. As we read the requirements as stated, we believe the guidance is mandating the presentation of one amount which includes both unrealized and realized gains; however, some may interpret this to mean that one amount is required for realized gains or losses and another amount is required for unrealized gains or losses. Additionally, in our view, the opening phrase “at a minimum” does not explicitly convey the ability to present more detailed information. Only through review of Update Question #50, and after being pointed to Paragraph BC 156, was this apparent. While we do not want to discourage more detailed disaggregation, we are concerned by the optionality that this paragraph may imply to certain preparers. We clearly support separate presentation of the cash and remeasurement elements of this income statement caption. We are, however, concerned that certain preparers may use this optionality to create “non-GAAP” type measures of interest income or impairment which will diminish comparability between entities. We believe that the guidance in any final standard should explicitly require separate presentation of the cash and remeasurement elements and the unrealized and realized gains or losses, but disallow any imputed measures of interest income or impairment.

Other Presentation Considerations

Though questions were not asked regarding the following provisions of the presentation section of the Proposed Update, we provide the following comments for your consideration:

- *Separate Presentation Based Upon Subsequent Measurement* – We agree with the provision of Paragraph 84 which require separate presentation of items measured at fair value through net income or through other comprehensive income. We would note, however, that the paragraph should be clarified to indicate that financial liabilities measured at amortized cost should also be separately presented. Similarly, this paragraph should require the separate presentation of core deposit liabilities based upon their unique measurement attributes.
- *Core Deposit Liabilities* – Similar to the provision in Paragraph 86 related to the reconciliation of financial instruments measured at fair value through other comprehensive income, we support the proposals in Paragraph 87 regarding the presentation of the elements of the core deposit liabilities measurement. We further support the proposals towards statement of comprehensive income presentation of financial instruments recorded at fair value through OCI and those at amortised cost. The amortised cost information contained within these reconciliations will be helpful towards users making judgements related to contractual cash flows.
- *Foreign Currency Presentation in Accumulated Other Comprehensive Income* – As noted previously in our response to Question #39 under Credit Impairment we find no conceptual justification for the retention of the foreign exchange gain or loss in accumulated other comprehensive income. This currency fluctuation should be recognized as it is incurred through net income as, unlike the local currency principal amount, there is no basis for the assumption that the amounts will revert to the initial spot rate on the date the transaction was entered into. Holding the financial instrument for receipt of contractual cash flows does not immunize the organization from the recognition of these market value changes. Further, many times significant currency losses are not evaluated for income statement recognition (i.e. impairment) when included in accumulated other comprehensive income. Given our views with respect to the recognition of foreign currency gains and losses, we do not agree with the provisions of Paragraph 92 which would not require separation of such foreign currency gains/losses. Without separate presentation there is virtually no likelihood that significant currency devaluations/impairments will be recognized.

DisclosuresAgreement with Disclosure Requirements (Question #65) & Additional Disclosure Requirements (Question #67)

We do not disagree with the disclosure additions being proposed; however, it is extremely difficult to assess holistically all of the required disclosures related to financial instruments and to determine if additional disclosures are necessary given that the disclosures have been codified over the many years and considering the following factors:

- 4) Financial instrument disclosures are included in various topics within existing codification [e.g. fair value measurement disclosures are included in SFAS 157 (Topic 820); fair value disclosures are included in SFAS 107 (Topic 825); derivative disclosures are included in SFAS 133 and 161 (Topic 815); loans disclosures are included in SFAS 114 (Topic 310); and investment security disclosures are included in SFAS 115 (Topic 320).];
- 5) Financial instrument disclosures are currently being modified [e.g. fair value measurement changes under SFAS 157 (Topic 820) are currently under exposure and new disclosures have recently been added related to the credit quality of receivables and the allowance for credit losses (Topic 310).]
- 6) Elements of this Proposed Update would change the accounting for certain financial instruments which would appear to necessitate the removal or combining of disclosures [e.g. debt securities (previously covered by SFAS 115, Topic 320) and loans (previously covered by SFAS 114, Topic 310) will be similarly treated under the proposed update so elements of the disclosures will need to be merged. Further, the accounting under EITFs 96-12, 99-20 and SOP 03-3 will be replaced which should result in the disclosures associated with these instruments being removed or modified.

Without undertaking an extensive consideration of all the disclosure elements currently required across a wide range of financial instrument types (i.e., fair value measurements, credit impairments, derivatives, etc.) and analyzing them in conjunction with the new disclosures as proposed in the Proposed Update it is exceedingly difficult to ascertain with reasonable confidence that investors obtain the maximum benefit from the analytical content of the disclosures holistically.

Further, it is our observation that, in general, the disclosures proposed both in this Update and in relation to other existing financial instruments standards are in many ways in response to closing the gaps created by substandard recognition and measurement standards and, therefore, may not provide information essential to financial statement analysis. As noted above, there are many financial instrument disclosures interspersed throughout the existing body of accounting standards and it is difficult to obtain a clear picture of the analytical construct of the disclosures across the many financial instruments and their related accounting.

We recommend that the FASB dedicate itself to analyzing financial instruments disclosures in a comprehensive manner by capturing in one place all of the existing and proposed requirements across the wide-range of transaction types. Using this, the FASB should establish a conceptual framework for financial instrument disclosures and determine whether or not the disclosures provide the various stakeholder groups, especially investors, with the ability to reconcile substandard recognition and measurement requirements as well as provide comprehensive analytical content that is essential to making informed capital resource allocation decisions.

The objective of financial reporting is to provide information that is useful to present and potential investors, creditors, and other market participants in making rational investment, credit, and similar resource allocation decisions. Improving qualitative and quantitative disclosures for financial instruments to increase transparency and provide analytical content for investors to use in their financial statement analysis is essential for an investor to make informed investment decisions.

Purchased Financial Assets (Question #66)

We agree with the proposed disclosures for purchased financial assets for which qualifying changes in fair value are recognized through other comprehensive income. Given the ability to recompute the effective interest rate on the purchased assets (i.e. unlike for other financial assets) under the Proposed Update when cash flows are higher than original anticipated and to decrease the original effective interest rate – although not lower than the original effective interest rate – when cash flows are lower than originally expected we believe information regarding this change in effective rate and its impact on the current and future periods would be useful to investors.

*Effective Date & Transition**Transition Considerations (Question #68, #70 & #71)*

We believe the transition provisions associated with the Proposed Update need further consideration. A transition which does not provide comparative information is not useful to investors. Accounting changes create a discontinuity that makes it difficult or impossible to discern the underlying operating trends. Restatement can mitigate that concern by providing the investor with data for one or more prior periods that are comparable to the post change period. Accordingly, rather than the proposed cumulative effective adjustment to the statement of financial position at the beginning of the year in which the propose standard would become effective, we believe the most decision-useful information to investors would require full retrospective transition – even if that would require the deferral of the effective date.

Further, the various elements of the Proposed Update may necessitate different transition considerations. Examples of transition matters that may require additional consideration include the following:

- *Interest Income* – For interest income, will the original effective yield and the cumulative interest earned upon adoption be computed giving consideration to the allowance as computed under the new provisions of the Proposed Update since inception? If so, won't the credit impairments and allowances have to be re-estimated for all periods since the inception of existing loans? Or, will an effective yield as of the date of adoption, and giving consideration to the revised allowance at the date of adoption, be computed?
- *Hedging* – For derivatives in cash flow hedging relationships will under and over hedges be recomputed since inception of the hedging relationship, or will the new provisions to measure over and under hedges be entirely prospective?
- *Disclosures* – Will the new disclosures only be required for the first period of adoption?

Delayed Effective Date for Nonpublic Entities (Question #69)

We agree with the proposed delayed effective date for certain aspects of the proposed guidance for nonpublic entities with less than \$1 billion in total consolidated assets.

Administrative Considerations

We have several administrative comments which would make the contents of the Proposed Update more “useable.” The Proposed Update was difficult to review as the major and minor section headings were difficult to identify. This will likely be resolved when such provisions are incorporated into the respective codification topics, but this is a consideration for future Proposed Updates. As this Update does not reflect what Codification sections will be removed, modified or added, before issuing a final document, the contents of the final standard should be incorporated into the respective Codification topics so that users can see the changes in the context of their final form. This would be particularly helpful in sections such as derivatives (Topic 815) where many of the former Derivative Implementation Group (DIG) Issues are codified. The ability to see how the provisions of this Proposed Update will modify that existing guidance would be helpful. Finally, we also believe it may be useful to articulate the accounting for financial assets and financial liabilities separately.