



May 15, 2013

Technical Director
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

File Reference No. 2013-220

Dear Ms. Cospers:

The IMA's Financial Reporting Committee (FRC) appreciates the opportunity to share its views on the Financial Accounting Standard Board's (FASB or the Board) proposed Accounting Standards Update *Financial Instruments – Overall (Subtopic 825-10) Recognition and Measurement of Financial Assets and Financial Liabilities* (the proposed ASU).

The FRC is the financial reporting technical committee of the IMA.¹ The committee includes preparers of financial statements for some of the largest companies in the world, representatives from the world's largest accounting firms, valuation experts, accounting consultants, academics and analysts. The FRC reviews and responds to research studies, statements, pronouncements, pending legislation, proposals and other documents issued by domestic and international agencies and organizations.

The FRC supports the broad objectives of the project to improve and simplify the accounting for financial instruments. However, the FRC believes that the proposal, in its current form, does not achieve those objectives and instead would add to the complexity of the current accounting framework with different and new forms of complexity and judgment. In addition, we note that the proposed ASU would not achieve convergence with the IASB's proposed model in several important areas. For these reasons, the FRC believes that the proposed ASU does not represent a substantial improvement to current practice that justifies the significant costs of implementation.

The FRC believes that current U.S. GAAP represents the best starting point and that the following targeted amendments to current practice would better achieve the FASB's objectives, with reduced costs of implementation.

1. Align the accounting for loans and securities in a consistent framework including a trading category (fair value through net income), an available for sale category (fair value through Other Comprehensive Income (OCI) and held for investment category (amortized cost). Classification of particular financial asset portfolios within this framework would be dependent on the manner in which the company generally manages the assets under its intended business and risk management model.
2. Recognize the change in value of financial instruments due to changes in a company's own

¹ Additional information about the IMA's Financial Reporting Committee can be found at www.imafrfc.org.



credit standing (debit valuation adjustments or DVA gains and losses) through OCI, rather than net income. The FRC agrees that the income statement effects of changes in a company's own credit standing have been almost universally disregarded by users of financial statements and have complicated communication of financial results to investors.

3. Retain the fair value option for both assets and liabilities, but limit its use to a more narrowly-defined list of circumstances discussed below. While the FRC acknowledges that unfettered fair value options increase the complexity for financial statement users in theory, in current practice the fair value option is commonly used in a fairly narrow set of circumstances. Therefore, most of the benefits of the fair value option (aligning accounting models for related assets and liabilities) could be preserved.

Further, we believe that two aspects of current U.S. GAAP in particular are preferable to the changes in the proposed ASU, and recommend the following to the Board.

1. Retain the current guidance regarding the bifurcation of embedded derivatives from assets using the "clearly and closely related" concepts, rather than shifting to a new and untested "solely payments of principal and interest" (SPPI) test. While the FRC acknowledges that the bifurcation analysis for certain instruments is complex under the current framework, the FRC is concerned that the SPPI test appears no less complex, and may result in certain counterintuitive results (discussed below) that would require further review and perhaps exceptions to the SPPI test.
2. Retain the current accounting for equity securities (including classification at cost and fair value through OCI), with impairment recognized based on an "other than temporary impairment" (OTTI) test. While the FRC acknowledges that there are important judgments required in applying OTTI tests, the FRC does not believe that practice issues are significant enough to justify a wholesale change to require substantially all equity instruments to be marked to fair value through net income regardless of how a company expects to realize the value of its equity investments.

Below, we expand on these recommendations, and address in more detail our concerns with the proposed ASU in these areas.

Align accounting for loans and securities

Under the current accounting framework, there are at least five different accounting treatments for investments in debt instruments: fair value through earnings (trading securities or fair value option loans), fair value through OCI (available for sale securities), lower of cost or market (held for sale loans), amortized cost subject to OTTI (held to maturity securities) and amortized cost subject to loan loss reserves (held for investment loans). We agree that this framework is overly complex and that the development of financial markets has substantially reduced the economic differences between investments in debt securities and investments in loans.



We agree that a single accounting model for all investments in debt instruments is not appropriate. Companies hold various debt investments for different purposes and the accounting framework for these investments should reflect the manner in which companies generally expect to realize cash flows. We agree with the broad principle underlying the approach in the proposed ASU that distinguishes, on a portfolio basis,

- trading activities, where cash flows are frequently realized through sales, from
- investing activities where cash flows will be realized through a combination of contractual cash flows and sales and from
- lending or investing activities where cash flows are predominately realized through contractual cash flows.

However, in implementing this principle, the proposed ASU places significant restrictions on the circumstances in which a company can sell debt instruments held at amortized cost without calling into question its business model. The FRC believes that certain restrictions on sales are unnecessary and are inconsistent with prudent risk management. For example, the proposed ASU indicates that sales of debt instruments after an observable decline in borrower credit worthiness are consistent with a business model of holding financial assets to collect the contractual cash flows, but notes that sales to manage credit concentrations are inconsistent with such a business model. We believe there is no conceptual difference between sales to manage credit concentrations and sales in response to declines in a borrower's credit worthiness – in both cases the company intends to minimize credit losses and maximize the collection of contractual cash flows. Limiting credit concentrations is one important manner in which financial institutions proactively manage the credit risk of a loan portfolio and should not preclude the related loan portfolio from the amortized cost category.

The restrictions in the proposed ASU, combined with the SPPI test discussed below, may result in many typical loan portfolios being classified as fair value through net income or fair value through OCI. This result was generally not supported in constituent responses to the exposure draft issued by the FASB in 2010. We believe that the FASB needs to re-evaluate the restrictions placed on the frequency and nature of sales of debt instruments classified in the amortized cost and fair value through OCI categories to ensure that the restrictions do not preclude prudent risk management of those portfolios. In addition, we believe that the model should not be so restrictive that it prevents classification at amortized cost for those instruments which were originated or acquired under a hold to collect business model simply because management sells from time to time in response to unanticipated events and circumstances. The Board should not create restrictions that effectively preclude prudent and appropriate decision making.

Eliminate the recognition of DVA in earnings

We agree with the Board's observation that recognizing DVA gains and losses in earnings has created additional complexity for both preparers and users of financial statements, as financial statement analysts and other users almost universally exclude such results from their analysis of a company's reported earnings.

While the proposed ASU would address this concern for fair value option liabilities by reporting related DVA gains and losses in OCI, DVA gains and losses on derivative instruments would continue



to be reported in earnings. It is not clear to us why DVA gains and losses on derivative instruments are any more relevant to financial statement users than DVA gains and losses on fair value option liabilities. In addition, because structured note liabilities remain eligible for either bifurcation or a fair value option under the proposed ASU, it appears that the DVA gain or loss related to bifurcated embedded derivative instruments would continue to be recognized in earnings, but would be reported in OCI if the fair value option were elected. We believe that this disparate treatment creates more complexity and believe it would be more consistent for DVA gains and losses on both derivative and fair value option liabilities to be recognized in OCI.

Limit the use of the fair value option for financial assets and liabilities

The FRC understands the Board's concern with respect to an unfettered fair value option for all financial assets, and the complexity that it could introduce for financial statement users in attempting to assess financial statements in a comparable manner. However, we believe that in most cases, the fair value option is used in a relatively narrow set of circumstances to a) recognize an instrument at fair value because the company expects to realize cash flows or risk-manage the instruments on a fair value basis, b) eliminate a mismatch in the accounting treatment between related assets, liabilities or economic hedges, or c) mitigate the complexities of bifurcating certain embedded derivatives. We believe that rather than eliminating the fair value option in its entirety, the Board should pursue limiting the fair value option to these and other identified circumstances so that the primary benefits of the fair value option are retained, while reducing the complexity for financial statement users of understanding its application.

We also believe that the fair value option should be applied consistently for assets and liabilities. It is not clear to us why the application of the fair value option for liabilities is less complex than for assets, and we believe that it would be less complex for users to have a similar framework applied to both assets and liabilities.

Retain bifurcation of embedded derivatives in assets using a clearly and closely related test

The FRC has noted in prior comment letters that the Board's definition of a derivative is so broad and inclusive that it has the undesirable effect of characterizing many ordinary features of financial instruments as embedded derivatives. Very often in practice, these features are minor and have an insignificant value. To require an entire instrument to be marked to market as a result of remote events or insignificant features seems inconsistent with the underlying economics and not beneficial to users of financial statements. For these reasons, we believe that the Board should continue with the present requirements of Topic 815 in this area, which permit but do not require the entire instrument to be marked to fair value.

Within this recommendation are two important points. First, we recommend retaining the ability to bifurcate and separately measure an embedded derivative. We believe that there should be a more direct relationship between the economic significance of the embedded feature and the accounting implications, and that relatively minor embedded features should not necessarily cause the entire instrument to be marked to fair value through earnings. In addition, we believe that the proposed ASU may result in practice issues in cases where minor features are inadvertently missed in the initial



analysis. Under current practice, even if a financial statement preparer inadvertently does not accurately identify an economically insignificant feature that could be bifurcated, the effect of the misstatement is often not material because the value of the missed embedded derivative is not significant. Under the proposed ASU, however, if a minor term is missed, the presence of the embedded derivative could require the entire instrument to be marked to fair value through earnings, resulting in a material effect on earnings driven by changes in the fair value of a component of the hybrid instrument that is unrelated to the component that failed the SPPI criterion. These situations in which a seemingly minor application error could have significant financial effects have proven problematic in the past (for example, the application of “short cut” hedge accounting) and we believe should be avoided where possible as these results do not provide meaningful information to users of financial statements.

Second, we do not support the SPPI test in the proposed ASU. We acknowledge that the current framework for evaluating embedded derivatives is complex and often is based on nuanced characteristics of a particular instrument. However, the SPPI test appears no less complex, and already questions have been raised regarding whether the SPPI test would require debt instruments in relatively common circumstances (for example, adjustable rate mortgages or debt instruments purchased at a discount) to be classified in the fair value through net income category. We do not believe that the practice issues arising from the current bifurcation tests are so significant as to merit the introduction of a new and complex SPPI test. The proposed SPPI test is certain to have its own implementation issues and unintended consequences, which would be entirely incremental to the complexities of the current bifurcation analysis that is retained for liabilities under the proposed ASU.

Retain current accounting for equity securities

The FRC acknowledges the apparent simplicity of accounting for substantially all equity securities (including non-marketable equity securities) at fair value, in large part due to the judgment required in current practice to evaluate whether a decline in value of an equity security is considered “other than temporary” and therefore must be recognized in earnings. However, we do not believe that a single accounting treatment for all equity securities is consistent with the different ways in which companies manage these equity investments, or the manner in which companies expect to realize value from the investments.

The FRC acknowledges the significant judgment required in assessing equity securities for OTTI, and in particular the consideration of the length of time an equity investment has been impaired. However, we believe that practice issues in this area could be addressed more directly by the FASB and do not merit abandoning the existing accounting model for equity investments simply to avoid the need to consider the impairment framework.

The FRC believes that the proposed “one-step” impairment model to compare estimated fair value and carrying value is not appropriate for certain investments. For example, the FRC is particularly concerned about the application of the impairment guidance in the proposed ASU to equity method investments. We note that the carrying value of equity method investments reflects not only the purchase price, but is also influenced by the earnings and OCI effects of the investee. Due to these complications, we do not believe that a simple comparison between an investment’s fair value and its



carrying value is determinative for evaluating impairment for equity method investments and believe that the current impairment framework is the most appropriate means to deal with this issue.

Other Matters

- The FRC agrees with the proposed ASU's approach in measuring nonrecourse debt secured by financial assets. We believe that matching the earnings effect of the related assets against the nonrecourse debt is consistent with the economics of the nonrecourse debt and is an effective solution to current practice issues in this area.
- The FRC agrees with the proposed ASU's approach in recognizing foreign currency gains and losses on instruments measured at fair value through OCI. Recognizing these gains and losses through earnings is consistent with the treatment of other foreign-currency denominated assets and will eliminate the need to apply hedge accounting for foreign currency derivatives that are frequently used to mitigate the foreign exchange risk in these assets. However, we do not believe that the foreign currency gains and losses should be based on the fair value of the instrument. We believe that foreign currency gains and losses should be measured based on the amortized cost of the investment, consistent with the approach for financial assets measured at amortized cost and under IFRS.
- The FRC does not agree with the significant expansion of disclosures for quarterly reporting. The FASB is currently attempting to develop a disclosure framework in a separate project, and we believe that the FASB should complete that project prior to requiring such a significant expansion of disclosures.
 - The FRC disagrees that parenthetical presentation of fair values on the balance sheet should be required. The face of company financial statements has become overloaded with extra information and we do not believe such complex presentation is useful. Instead, we believe that disclosures provided in the footnotes to the financial statements, with appropriate context, provide clear and transparent information to financial statement users.
 - The FRC notes that for non-public entities, the current requirement to disclose the fair value of financial instruments would be removed. However, the proposed ASU does not explain why fair value information would not be as relevant to users of these financial statements as it is to users of financial statements for public companies.
- The proposed ASU would continue to permit loan receivables held at amortized cost to be designated as hedged items for hedges of interest rate risk, while debt securities would be precluded from being hedged items in such relationships. Given that one objective of the proposed ASU is to align the accounting for debt securities and a loan, the FRC does not understand the justification for different treatment with respect to hedge accounting. We believe that both loans and securities carried at amortized cost should be permitted to be designated as hedged items.



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The FRC continues to believe that a converged accounting standard with respect to recognition and measurement of financial instruments would be a preferable outcome. However, the FRC also believes that it is important that the final standard represent an improvement to current U.S. GAAP and also consider the regulatory and legal environment in the U.S. The FRC does not believe that the IFRS 9, *Financial Instruments*, is a standard that could be adopted efficiently in the United States. We believe there are critical areas within IFRS 9 which would require substantial interpretive guidance to result in an acceptable level of consistency in practice, given the regulatory and legal environment in the United States.

Finally, the FRC believes that it is imperative that the Board engage in further detailed field testing of the proposed ASU along with any further amendments the Board incorporates. The proposed ASU's provisions in some cases represent very significant departures from current practice, and as constituents have studied the proposed ASU, many important questions have been raised regarding the application of the proposed ASU to fairly common fact patterns. We believe it is important that the Board consider these issues prior to issuing a final standard, rather than leave them as practice issues to be resolved in implementation.

We appreciate the Board's consideration of these comments. We are available to discuss these matters at your convenience.

Sincerely,

A handwritten signature in blue ink, reading 'N. Schroeder', is displayed on a light blue rectangular background.

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cc: Hans Hoogervorst, International Accounting Standards Board