



## A M E R I C A N   A C A D E M Y   *of*   A C T U A R I E S

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September 30, 2010

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

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

On behalf of the Financial Reporting Committee and the Life Financial Reporting Committee of the American Academy of Actuaries<sup>1</sup> we are pleased to provide comments to the Financial Accounting Standards Board (FASB) concerning File Reference No. 1810-100 - Proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*.

A major aspect of the actuarial profession's expertise is the valuation of investment contracts that may be defined as financial instruments. Such contracts include guaranteed investment contracts and term-certain payout annuities. Our comments primarily concern such investment contract liabilities. As we previously remarked in a 2009 comment letter<sup>2</sup> to the International Accounting Standards Board (IASB) regarding its discussion paper on *Credit Risk In Liability Measurement*, financial liabilities may need special consideration, and may need to be treated differently from financial assets when considering "fair value" measurement principles, in large part because liability valuation may need to take into account an entity's own credit risk – a factor that is not present in asset valuation. So, although the Proposed Accounting Standards Update may be appropriate for certain specific types of liabilities, we have some concerns about its broader applicability to all financial liabilities generally. In addition, fair value for liabilities may not be appropriate if the assets supporting the liability are not measured at fair value. Although we agree with emphasizing measurement principles rather than detailed implementation guidance, we believe that including some numerical examples reflecting financial liabilities would be helpful in clarifying the proposed principles.

Our specific comments are incorporated in our responses below to selected questions posed by the Proposed Accounting Standards Update. If you have any questions, please contact Tina Getachew, Senior Policy Analyst, Risk Management and Financial Reporting Council, by phone (+1 202/223/8196) or email ([getachew@actuary.org](mailto:getachew@actuary.org)). Thank you again for this opportunity to provide input.

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<sup>1</sup> The American Academy of Actuaries ("Academy") is a 17,000-member professional association whose mission is to serve the public on behalf of the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

<sup>2</sup> American Academy of Actuaries' letter to the International Accounting Standards Board, September 1, 2009.  
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Sincerely yours,



Rowen B. Bell  
Chair, Financial Reporting Committee  
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**Question 1:** *Do you agree with the scope of financial instruments included in this proposed Update? If not, which other financial instruments do you believe should be excluded or which financial instruments should be included that are proposed to be excluded? Why?*

The committees agree with the scope of financial instruments included in this proposed Update.

**Question 3:** *The proposed guidance would require deposit-type and investment contracts of insurance and other entities to be measured at fair value. Do you agree that deposit-type and investment contracts should be included in the scope? If not, why?*

Deposit-type and investment contracts are financial instruments and not insurance contracts, and so appear to belong within the scope of a financial instruments standard. We have concerns about a financial instruments standard requiring such contracts to be measured at fair value, in light of the impact of own credit on liability valuation, the lack of active exit markets for investment contracts, and questions over whether fair value is more relevant for certain investment contracts than amortized cost. However, if the assets backing the investment contracts are required to be measured at fair value, fair value for the investment contract itself may be appropriate to avoid an accounting mismatch.

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

We agree that for financial instruments measured at fair value with all subsequent changes in fair value recognized in net income, fair value is the appropriate initial measurement basis.

For financial instruments whose subsequent changes in fair value are recognized in other comprehensive income, we believe that, while fair value remains the most relevant measure, its comparative advantage over other measurement bases declines in view of the enterprise's business strategy. There is a presumption that the development of fair values, as compared to using the transaction cost, will result in significant additional costs and will result in only slightly improved information. As a result, we believe the transaction price, adjusted for relevant acquisition costs, is an appropriate measurement basis for these instruments.

We note that paragraph 13 of the exposure draft allows an adjustment for transaction costs, but appears to be specific to financial assets. We believe that initial values of both assets and liabilities would be inappropriately distorted if the value is not adjusted for transaction costs. We see no basis for making such an adjustment for assets but not for liabilities. As such, we would ask that paragraph 13 be clarified so that it applies to both financial assets and financial liabilities, consistent with the discussion in paragraph BC52.

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

We agree that a significant difference between the transaction price and the fair value on the transaction date should be recognized in net income if the significant difference relates to something other than fees

or costs or because the market in which the transaction occurs is different from the market in which the reporting entity would transact.

However, if the difference relates to transaction costs, we believe the difference should be recognized in the initial value of the financial instrument, whether that instrument is an asset or a liability.

**Question 10:** *Do you believe that there should be a single initial measurement principle regardless of whether changes in fair value of a financial instrument are recognized in net income or other comprehensive income? If yes, should that principle require initial measurement at the transaction price or fair value? Why?*

We agree with the exposure draft's use of a dual initial measurement principle. For financial instruments whose changes in fair value will be subsequently recognized in net income, it makes sense for initial recognition to be at fair value. But for other financial instruments, the transaction price, appropriately adjusted for transaction costs, will be similar to the fair value but less costly to determine.

**Question 11:** *Do you agree that transaction fees and costs should be (1) expensed immediately for financial instruments measured at fair value with all changes in fair value recognized in net income and (2) deferred and amortized as an adjustment to the yield for financial instruments measured at fair value with qualifying changes in fair value recognized in other comprehensive income? If not, why?*

We agree. However, we are concerned that paragraph 13 of the exposure draft explicitly refers to deferring and amortizing the transaction fees and costs only for financial assets. We believe that the principle should be stated in paragraph 13 consistent with how question 11 is worded, namely, that deferring and amortizing transaction costs and fees as an adjustment to the yield for financial instruments measured at fair value with qualifying changes in fair value recognized in other comprehensive income should apply to all financial instruments.

**Question 12:** *For financial instruments initially measured at the transaction price, do you believe that the proposed guidance is operational to determine whether there is a significant difference between the transaction price and fair value? If not, why?*

We believe the guidance is operational.

**Question 13:** *The Board believes that both fair value information and amortized cost information should be provided for financial instruments an entity intends to hold for collection or payment(s) of contractual cash flows. Most Board members believe that this information should be provided in the totals on the face of the financial statements with changes in fair value recognized in reported stockholders' equity as a net increase (decrease) in net assets. Some Board members believe fair value should be presented parenthetically in the statement of financial position. The basis for conclusions and the alternative views describe the reasons for those views. Do you believe the default measurement attribute for financial instruments should be fair value? If not, why? Do you believe that certain financial instruments should be measured using a different measurement attribute? If so, why?*

We believe that certain financial instruments should be measured using different measurement attributes, depending upon the characteristics and business applications of the instruments. Even if the default measurement attribute is fair value, sufficient recognition and scope should be given to other measurement attributes. In particular, we note that no well-functioning market for certain investment

contracts issued by insurance companies exists. This makes the development of fair values fairly expensive, relative to the benefit provided by reporting these elements at fair value.

**Question 14:** *The proposed guidance would require that interest income or expense, credit impairments and reversals (for financial assets), and realized gains and losses be recognized in net income for financial instruments that meet the criteria for qualifying changes in fair value to be recognized in other comprehensive income. Do you believe that any other fair value changes should be recognized in net income for these financial instruments? If yes, which changes in fair value should be separately recognized in net income? Why?*

We concur with the exposure draft's determination that interest income or expense, credit impairments and reversals, and realized gains and losses be recognized in net income, and that any other fair value changes be recognized in other comprehensive income (for financial instruments that meet the criteria).

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

We do not believe that subsequent measurement principles need be the same for financial assets and liabilities. In particular, we note that allowing certain liabilities to be measured at amortized cost is reasonable in light of their characteristics. The approach the IASB has taken for measuring financial liabilities may be preferable, particularly given issues with own credit in liabilities, which is not an issue for assets. We believe that a fair value option should be permitted for the purpose of mitigating or eliminating accounting mismatches within particular portfolios of assets and liabilities that are managed together.

**Question 16:** *The proposed guidance would require an entity to decide whether to measure a financial instrument at fair value with all changes in fair value recognized in net income, at fair value with qualifying changes in fair value recognized in other comprehensive income, or at amortized cost (for certain liabilities) at initial inception. The proposed guidance would prohibit an entity from subsequently changing that decision. Do you agree that reclassifications should be prohibited? If not, in which circumstances do you believe that reclassifications should be permitted or required?*

We agree that reclassifications should usually be prohibited. However, there may be circumstances in which we believe a reclassification would be appropriate. In particular, we note that, as technology improves, it may be reasonable to allow for reclassification to fair value with a change recognized in net income.

**Question 17:** *The proposed guidance would require an entity to measure its core deposit liabilities at the present value of the average core deposit amount discounted at the difference between the alternative funds rate and the all-in-cost-to-service rate over the implied maturity of the deposits. Do you believe that this remeasurement approach is appropriate? If not, why? Do you believe that the remeasurement amount should be disclosed in the notes to the financial statements rather than presented on the face of the financial statements? Why or why not?*

We note that the definition of core deposits is unclear for entities other than commercial banks. For example, insurers often issue retained asset accounts, which we believe may qualify as core deposits. However, we believe that the current remeasurement approach is too complex for this business, and believe that providing additional flexibility to use an alternative measurement attribute (e.g., amortized

cost) would be preferable.

**Question 18:** *Do you agree that a financial liability should be permitted to be measured at amortized cost if it meets the criteria for recognizing qualifying changes in fair value in other comprehensive income and if measuring the liability at fair value would create or exacerbate a measurement attribute mismatch? If not, why?*

We agree. As noted above, we believe amortized cost can be appropriate for many liabilities under broader circumstances than just those provided for in the exposure draft.

**Question 28:** *Do you believe that the proposed criteria for recognizing qualifying changes in fair value in other comprehensive income are operational? If not, why?*

We believe the proposed criteria are operational.

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

We believe the measuring financial liabilities at fair value can be operational. However, we have concerns about the usefulness and reliability of financial liabilities at fair value, due to issues such as own credit and the lack of genuine exit markets for most financial liabilities. As we noted in significant detail in our 2009 comment letter<sup>3</sup> to the IASB regarding its discussion paper on *Credit Risk In Liability Measurement*, the presence of own credit risk complicates the measurement of liabilities at fair value, and means that, absent a confirming transaction or event, the value of a liability is not necessarily the same as the value of the corresponding asset to the counterparty (for an entity to assume that it will default on its obligations is, in some ways, fundamentally inconsistent with the pervasive assumption of a going-concern operation).

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

We believe the proposed criteria are operational.

**Question 32:** *For financial liabilities measured at fair value with all changes in fair value recognized in net income, do you agree that separate presentation of changes in an entity's credit standing (excluding changes in the price of credit) is appropriate, or do you believe that it is more appropriate to recognize the changes in an entity's credit standing (with or without changes in the price of credit) in other comprehensive income, which would be consistent with the IASB's tentative decisions on financial instrument liabilities measured at fair value under the fair value option?*

To the extent it is feasible, separate presentation of changes in an entity's credit standing (excluding changes in the price of credit) seems more appropriate. Changes in the price of credit not related to a change in credit standing represent a market variable, and not separating those changes from the rest of a liability fair value could result in artificial mismatches between financial assets and liabilities measured at fair value with all changes in fair value recognized in net income. That is because the change in the

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<sup>3</sup> American Academy of Actuaries' letter to the International Accounting Standards Board, September 1, 2009.  
[http://www.actuary.org/pdf/finreport/iasb\\_sep09.pdf](http://www.actuary.org/pdf/finreport/iasb_sep09.pdf)

asset fair value would include the impact of changes in market prices of credit while the associated liability would exclude those changes.

To the extent that a “fair value” of a liability includes the effects of credit standing, we believe it is important to separate the impact on a financial liability fair value that results from a change in credit standing, since such impacts are of a different nature than other items in the financial statement.

However, as described in our response to Question 33, we have significant concerns about the feasibility and practicality of separating credit standing from other market variables, and suggest that other market-based measures that do not rely on entity-specific credit standing may be more appropriate.

**Question 33:** *Appendix B describes two possible methods for determining the change in fair value of a financial liability attributable to a change in an entity’s credit standing (excluding the changes in the price of credit). What are the strengths and weaknesses of each method? Would it be appropriate to use either method as long as it were done consistently, or would it be better to use Method 2 for all entities given that some entities are not rated? Alternatively, are there better methods for determining the change in fair value attributable to a change in the entity’s credit standing, excluding the price of credit? If so, please explain why those methods would be better measure that change.*

For a number of reasons, we believe that both method 1 and method 2 have significant weaknesses, and that determining the effects of change in credit standing (excluding the changes in the price of credit) may ultimately prove to be neither feasible nor reliable.

The credit spread for an entity’s publicly traded debt includes a number of factors, including credit standing, the price of credit, investor preferences, market perception of the company, the specific terms and embedded options of the debt, etc. While the total net credit spread is observable, the individual components are not. These differences in valuation are readily apparent when one looks at the market spread in yields of bond issues that are otherwise homogenous on the surface. (For example, valuing pension and other post-retirement obligations requires determining the “market” rate on AA-rated bonds. Even limiting the sample to non-callable bonds produces yields that can be 100 – 300 basis points different at a given maturity). When other features of non-traded or non-rated liabilities are taken into account, trying to isolate the entity’s credit standing becomes even more problematic.

Method 1 would ignore changes in an entity’s credit standing until a rating change occurred, including potentially significant changes in credit standing within a credit band; Method 1 also proceeds from the false assumption, noted above, that there is a well-defined “market” rate for a particular credit rating. Method 2 might capture changes in the market’s perception of an entity’s credit standing in advance of any rating change, although that begs the question of whether the market’s “perception” of credit standing reflects an actual change in credit standing, or just a change in investor preference. However, Method 2 would create distortions due to changes in credit standing not reflected in rating changes among the comparable companies. To the extent an industry has only a limited number of comparable competitors at a given rating class, this distortion could be significant. Method 2 could also introduce distortions from changes in competitors’ credit spread that relate to factors other than their own credit, such as liquidity. This might have been particularly significant for insurance companies during the 2008 financial crisis. Furthermore, Method 2 will attribute to change in credit standing any change in fair value that is due merely to the passage of time or the behavior of either party within the reporting period.

We note that both Method 1 and Method 2 are oversimplified relative to how they would need to be applied to specific liabilities. In particular, adjustments would be needed to reflect credit enhancements, such as collateral, in the instrument being valued. This is particularly important for many liabilities valued by actuaries, given that these liabilities are often highly regulated and have a higher claim standing than the company's debt. Hence, just looking at differences in credit spreads on a company's debt would not translate directly to the appropriate adjustment (if any) to the credit standing of a company's regulated liabilities without some further adjustment.

**Question 34:** *The methods described in Appendix B for determining the change in fair value of a financial liability attributable to a change in an entity's credit standing (excluding changes in the price of credit) assume that the entity would look to the cost of debt of other entities in its industry to estimate the change in credit standing, excluding changes in the price of credit. Is it appropriate to look to other entities within an entity's industry, or should some other index, such as all entities in the market of a similar size or all entities in the industry of a similar size, be used? If so, please explain why another index would better measure the change in the price of credit.*

In some industries, size is an important variable in determining the price of credit. A large company may have a significantly lower cost of debt than a smaller company with the same credit rating. To the extent that there are important variables that influence credit spreads, these variables need to be taken into account so that the estimate of the change in credit standing is not distorted.

An alternative would be to use an approach to discounting financial liabilities similar to that used for pension liabilities. The financial liability discount rate could be mandated to be a high-quality corporate bond rate. This would produce comparable liability values across entities, and would reflect changes in the price of credit.

**Question 50:** *The proposed guidance would permit, but would not require, separate presentation of interest income on the statement of comprehensive income for financial assets measured at fair value with all changes in fair value recognized in net income. If an entity chooses to present separately interest income for those financial assets, the proposed guidance does not specify a particular method for determining the amount of interest income to be recognized on the face of the statement of comprehensive income. Do you believe that the interest income recognition guidance should be the same for all financial assets?*

We believe that interest income recognition guidance should be consistent for all financial assets that are debt instruments, in order to facilitate comparability. This would not apply to non-debt instruments, such as equities or derivatives. We believe this principle should also apply to recognition of interest expense on debt liabilities.

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

While the Level 3 Measurement Uncertainty Analysis provides excellent information, we are concerned with the additional cost of preparing these disclosures, and consequently we believe this disclosure should not be required.

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

This depends heavily on decisions yet to be made in the Insurance Contracts project, particularly the definition of insurance and unbundling. Items that are currently classified as financial instruments other than insurance contracts are calculated at fair value for disclosure purposes, so such values are available. However, putting those values on the balance sheet or income statement will likely require significant changes to the control environment.

Developing systems to produce the Level 3 Measurement Uncertainty Analysis will also be time consuming. If additional items are classified as financial instruments as a result of decisions in the Insurance Contracts project, valuation systems may need to be developed from scratch.

As a result, we believe a lead time of at least two years will be necessary to implement this guidance. In addition, it should not be made effective prior to the effective date of any new comprehensive Insurance Contracts standard.