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April 10, 2013

VIA EMAIL TO: director@FASB.org

Technical Director
File Reference No. 2013-220
Financial Accounting Standards Board
401 Merritt 7
Norwalk, CT 06856-5116

Re: Proposed Accounting Standards Update, *Financial Instruments—Overall (Subtopic 825-10)*

To Whom It May Concern:

Our firm, Financial Reporting Advisors, LLC, provides accounting and SEC reporting advisory services, litigation support services, and dispute resolution services. We specialize in applying generally accepted accounting principles to complex business transactions. We appreciate the opportunity to provide comments on the FASB's Proposed Accounting Standards Update, *Financial Instruments—Overall (Subtopic 825-10)* (the ED).

Our comments in this letter focus solely on the proposed guidance on evaluating the need for a valuation allowance on a deferred tax asset related to unrealized losses on a financial instrument classified in the fair value through other comprehensive income category.

Over the life of this project, the FASB has considered two alternatives for how an entity should evaluate the need for a valuation allowance on a deferred tax asset related to unrealized losses on a financial instrument classified in the fair value through other comprehensive income category. In the Basis for Conclusions, these alternatives are identified as Alternative A—require an entity to evaluate the need for a valuation allowance for a deferred tax asset related to unrealized losses on a financial instrument classified in the fair value through other comprehensive income category separately from the entity's other deferred tax assets and Alternative B—require an entity to evaluate the need for a valuation allowance for a deferred tax asset related to unrealized losses on a financial instrument classified in the fair value through other comprehensive income category in combination with the entity's other deferred tax assets. The 2010 proposed Update would have required the use of Alternative B whereas the ED requires the use of Alternative A. We disagree with the Board's most recent conclusion.

Future realization of the tax benefit of an existing deductible temporary difference or carryforward ultimately depends on the existence of sufficient taxable income in the same tax jurisdiction of the appropriate character (for example, ordinary income or capital gain) within the carryback or carryforward period available under the tax law. If a reporting entity can conclude it will have sufficient taxable income of the appropriate character within the carryback or carryforward period available under the tax law in the tax jurisdiction in question to realize the tax benefit from its deductible temporary differences and carryforwards without considering future taxable income from future operations (that is, future taxable income exclusive of reversing temporary differences and carryforwards), the reporting entity will not recognize a valuation allowance for its deferred tax asset related to unrealized losses on a financial instrument classified in the fair value through other comprehensive income category under either Alternative A or Alternative B. However, a reporting entity that (a) will need to generate future income from future operations in order to realize a tax benefit from its existing deductible temporary differences and carryforwards and (b) has concluded it is not appropriate to anticipate future income from future operations when assessing the need for a valuation allowance for its deferred tax assets likely will report significantly different valuation allowances under Alternative A and Alternative B for its deferred tax asset related to unrealized losses on a financial instrument classified in the fair value through other comprehensive income category. Accordingly, our comments are focused on reporting entities with this set of circumstances.

We believe that Alternative B is consistent with the requirements of Topic 740, *Income Taxes,* produces financial reporting that is more representationally faithful of the reporting entity's tax position, and results in financial statements that are internally consistent. Alternative B has three principal advantages over Alternative A. Alternative B does not require attribution of taxes to an individual item—a process that the Board has acknowledged as being inherently arbitrary.[1] Second, because Alternative B is consistent with the principles of Topic 740, Alternative B does not require the FASB to carve out yet another exception to the principles of Topic 740. Third, Alternative B does not send a "mixed message" regarding the existence of a gain or loss resulting from the remeasurement of the financial instrument to fair value.

In support of Alternative A, paragraph BC242 states that, "The Board decided that a valuation allowance may not be necessary because a deferred tax asset related to such unrealized losses results from the interaction of Topic 740 and Topic 320 and, therefore, is unique." We understand this argument to be that, as long as the reporting entity has the intent and ability to hold the debt instrument until its maturity (or until it recovers in value), the temporary difference related to the unrealized loss will reverse without a loss being realized (that is, the principal amount of the debt instrument will be recovered at maturity and no loss will be realized) and therefore the deferred tax asset will be realized. Hence, there is no need for a valuation allowance for this deferred tax asset regardless of the reporting entity's overall tax position or expectations of future income.[2]

[1] Paragraph 7 of FASB Statement No. 109, *Accounting for Income Taxes*, states "the tax payment or refund that results from a particular tax return is a joint result of all the items included in that return…(and)…taxes that will be paid or refunded in future years are the joint result of events of the current or prior years and events of future years…As a result, attribution of taxes to individual items and events is arbitrary…"

[2] Note—this entire analysis assumes there are no issues with respect to collectability of amounts due under the debt instrument. If there are issues with respect to collectability of amounts due under the debt instrument, we believe supporters of Alternative A would agree it would not be appropriate to apply Alternative A to the evaluation of whether a valuation allowance was needed for the deferred tax asset.

We believe there are several flaws with the argument given in support of Alternative A.

- An expectation of recovering the principal amount of an investment in a debt instrument does not create a unique situation either in general or in the context of accounting for income taxes. The debt instrument is recognized in the statement of financial position at its fair value which encompasses the market's expectation of all future cash flows (principal and interest) related to the debt instrument, discounted for the time value of money. Therefore, the recovery of the "principal" at the maturity of the debt instrument is simply part of the market-demanded return on investment and should not be thought of any differently from future cash flows from the contractual interest payments of the debt instrument.[3] In other words, the recovery of the "principal" of the debt instrument is simply part of the expected future income from holding this debt instrument. All non-troubled debt instruments are expected to generate future interest income, but future interest income is not looked at in isolation under Topic 740—it is simply part of the reporting entity's expected overall income or loss for a period in the applicable tax jurisdiction. Hence, the interaction of Topic 320 with Topic 740 does not create anything that is unique in the evaluation of a need for a valuation allowance for a deferred tax asset.

- The reversal of a temporary difference is not the same as realization of the related deferred tax asset. To illustrate this point, assume a reporting entity with an unrealized loss in other comprehensive income related to an investment in a debt instrument breaks even in future years (total comprehensive income of zero) and the unrealized loss in other comprehensive income reverses as the debt instrument matures. In that situation, assuming for simplicity that the temporary difference related to the investment in the debt instrument is the reporting entity's only temporary difference, the reporting entity's total deferred tax assets do not change—the deferred tax asset related to the unrealized loss temporary difference will be replaced by a deferred tax asset for an operating loss carryforward in the same amount. The deferred tax asset related to the unrealized loss in other comprehensive income can only be realized if the reporting entity generates comprehensive income (and ultimately taxable income of the proper character in the tax jurisdiction in question in the necessary time period). Otherwise, the reporting entity is simply substituting one deferred tax asset for another deferred tax asset. Paragraph 740-10-55-37 discusses this tax benefit substitution phenomenon:

  > An operating loss or tax credit carryforward from a prior year (for which the deferred tax asset was offset by a valuation allowance) may sometimes reduce taxable income and taxes payable that are attributable to certain revenues or gains that the tax law requires be included in taxable income for the year that cash is received. For financial reporting, however, there may have been no revenue or gain and a liability is recognized for the cash received. Future sacrifices to settle the liability will result in deductible amounts in future years. *Under those circumstances, the*

[3] The FASB makes this same point in its Frequently Asked Questions document issued March 25, 2013, related to its Proposed Accounting Standards Update, *Financial Instruments—Credit Losses*.

> As an aside, the Board recognizes that some individuals view the amount recognized on the balance sheet for a loan to be *principal* as opposed to an amortized cost amount that implicitly reflects the time value of money. While the amortized cost amount may happen to be the same as the principal amount outstanding, the amortized cost recognized on the balance sheet will not equal the principal amount outstanding if the loan is issued at a premium or a discount. As a result, the Board does not believe that it is accurate to suggest that the amount recognized on the balance sheet is *principal* or an *undiscounted* amount.

> *reduction in taxable income and taxes payable from utilization of the operating loss or tax credit carryforward gives no cause for recognition of a tax benefit because, in effect, the operating loss or tax credit carryforward has been replaced by temporary differences that will result in deductible amounts when a nontax liability is settled in future years.* The requirements for recognition of a tax benefit for deductible temporary differences and for operating loss carryforwards are the same, and the manner of reporting the eventual tax benefit recognized (that is, income or as required by paragraph 740-20-45-3) is not affected by the intervening transactions reported for tax purposes. (*Emphasis added*)

- Building on the above points, absent the reporting entity generating taxable income in future periods in the appropriate tax jurisdiction with the proper character and in the necessary time period, Alternative A will result in no valuation allowance being provided for deferred tax assets that will not be realized. The deductible temporary difference will morph into a net operating loss and, absent the reporting entity generating taxable income, the resulting net operating loss carryforward will expire unused.

- By creating an exception for this specific type of deferred tax asset, the Board is sending a mixed message regarding the measurement basis for financial instruments in the fair value through other comprehensive income category. If the Board has concluded that (a) fair value is the most relevant measure for financial instruments in this category and (b) other comprehensive income is a meaningful measure of economic performance for the reporting period, then it is inconsistent to assert that the economic loss is not meaningful for purposes of evaluating the resulting deferred tax asset's realizability. If the Board believes there is a basis to assert that the deferred tax asset is realizable because no loss will result if the instrument is held to maturity, then why is a loss being reported in the financial statements?

Finally, as with any exception to stated principles, there is a significant risk of unintended consequences if the Board adopts Alternative A. We believe Alternative A guidance will be analogized to when a reporting entity is assessing the need for a valuation allowance for other deferred tax assets that it believes to be "unique." At a minimum, therefore, if the Board moves forward with Alternative A, we would ask that the Basis for Conclusions provide a specific explanation regarding the Board's rationale for creating an exception to the principles of ASC 740.

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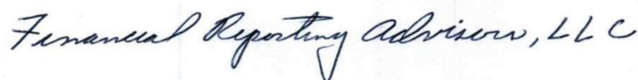
Once again we appreciate the opportunity to comment on the ED. If there are any questions, please contact Richard R. Petersen at 312-345-9102.

Sincerely,

Very truly yours,



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