



Tel: 312-856-9100  
Fax: 312-856-1379  
www.bdo.com

2013-220  
Comment Letter No. 38  
330 North Wabash, Suite 3200  
Chicago, IL 60611

May 13, 2013

Via email to [director@fasb.org](mailto:director@fasb.org)

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

RE: Proposed Accounting Standards Update, Recognition and Measurement of Financial Assets and Financial Liabilities (File Reference No. 2013-220)

Dear Ms. Cosper:

We are pleased to provide comments on the financial instruments exposure draft (the ED). We appreciate the Board's responsiveness to feedback received on the 2010 financial instruments proposal. While the ED is an improvement over the 2010 approach, we believe additional revisions are needed.

Most importantly, we recommend a model based on two categories instead of three. Consistent with our comments on the 2010 proposal, we would establish amortized cost as the default category for instruments i) with cash flows solely related to principal and interest, and ii) which are not held within a trading business model. Instruments that do not meet both criteria would be carried at fair value through earnings. Regardless of category, we believe instruments carried at amortized cost or fair value should be adjusted through earnings, rather than equity.

Adjusting financial instruments to fair value each period with portions of the change in fair value split between earnings and other comprehensive income lacks an apparent conceptual basis. While we understand some of the practical reasons for attempting to strike a balance between competing views, we believe that creating a new classification and attribution model without a cohesive principle will be problematic.

We also note the fair value of instruments carried at amortized cost can be presented parenthetically on the face of the balance sheet for users. As such, we believe a two-model approach would be operational. That is, while more instruments would be carried at amortized cost under our suggested approach, it would also present fair value information on the face of the financial statements.

In addition, we have concerns about carrying hybrid asset contracts at fair value in lieu of assessing particular features of a contract for bifurcation under the derivatives literature. We note many embedded derivatives have an immaterial value at inception and over their life. We do not believe immaterial embedded derivatives, by themselves, warrant carrying the entire hybrid instrument at fair value. Since the entire instrument would be adjusted to fair value if certain conditions are present under the ED, a disproportionate amount of income statement volatility will result from other features related to the instrument's value. For instance, a reasonably possible interest rate reset feature may result in *all* future changes in interest rates being

Technical Director  
Financial Accounting Standards Board  
Page 2 of 10

captured in the reporting entity's income statement. We are not certain this is an improvement over today's embedded derivative model, under which only the embedded derivative would impact earnings if and when its value becomes material. As such, we recommend either retaining today's bifurcation model or raising the reasonably possible threshold to capture only those instruments for which a higher probability of cash flow variability is expected. In this context, the Board might consider a "more-likely-than not" threshold.

In the appendix, we elaborate on these thoughts and provide additional responses to questions posed in the ED.

\* \* \* \* \*

We would be pleased to discuss our comments with the FASB staff. Please direct questions to Lee Graul, National Director of Accounting at (312) 616-4667 or Adam Brown, Partner in the National Accounting Department at (214) 665-0673.

Very truly yours,

Handwritten signature in blue ink that reads "BDO USA, LLP".

BDO USA, LLP

*Appendix*

*Note: We have responded to all questions other than those posed specifically to users.*

**Question 1: Do you agree with the scope of financial instruments included in this proposed Update? If not, which other financial instruments should be included or excluded from the guidance in this proposed Update and why?**

We note registration payment arrangements within the scope of 825-20-15-3 would be excluded. That paragraph specifies two conditions that must be present in order to separately account for the registration rights and the related financial instruments. The second condition is a requirement to transfer consideration to the counterparty if a registration statement is not declared effective (or its effectiveness is not maintained). We are aware of common registration rights agreements that do not contain a payment provision and therefore fail to meet this condition. As such, they are not within the scope of paragraph 15-3. While this situation exists under current US GAAP, the Board might consider clarifying the guidance that applies to such arrangements. Specifically, should they be viewed as a separate unit of account, or an attribute of the securities subject to the registration statement? If the Board doesn't address this point in the final amendments, it might consider addressing it as part of a separate agenda project (perhaps through the EITF) or in connection with the project on financial instruments with characteristics of equity.

With respect to 825-10-15-8b, the reference to Topic 480 is confusing since ASC 480 only applies to freestanding financial instruments, rather than components of a hybrid contract.

**Question 2: Do you agree with the industry-specific specialized guidance scope exceptions in paragraph 825-10-15-9? If not, why? What would you propose instead?**

We agree. Possible changes to specialized accounting would seem to be a broader undertaking in a separate project.

**Question 4: Do the proposed amendments appropriately convey the principle associated with the contractual cash flow characteristics assessment? If not, why? What would you propose instead?**

We believe the principle is clearly articulated in paragraphs 825-10-25-17 through 25-24. That is, a prerequisite for amortized cost accounting is that the cash flows of an instrument are limited to a transfer of principal and interest which fairly compensate the holder for time value and credit risk.

**Question 5: The proposed amendments define principal as the amount transferred by the holder at initial recognition. Should the definition of principal be expanded to include repayment of the principal amount at maturity or other settlement? If so, what instruments would fail (or pass) the contractual cash flow characteristics criterion as a result of this change?**

We agree with the proposed definition of principal.

**Question 6: Do the proposed amendments contain sufficient application guidance and illustrations on implementing the cash flow characteristics assessment? If not, why?**

With respect to Example 1, Instrument B (Variable Rate Instrument), it is not apparent how a variable rate mortgage or an auction rate security would be evaluated, two common instruments. Instrument B is a loan for which the borrower may choose between two different rates, each of which corresponds to a particular period of time (e.g., a 3-month rate that applies for 3 months). As long as the rate and tenor match, and also do not *extend beyond* the remaining maturity of the instrument, the cash flows are considered to be solely principal and interest (825-10-55-49). However, a five-year instrument that continually resets to a five year rate when its maturity is less than five years, may not qualify (825-10-55-51). The reason for this distinction is not apparent. That is, unless the rate and tenor actually coincide with the remaining term of the instrument, what is the basis for concluding it passes the principal and interest test? One might argue that variable rates with tenors either shorter or longer than the maturity of the debt instrument always represent a modified economic relationship. We do not sense that the Board intends that result, but believe further guidance is necessary to clarify the application to common variable rate products.

It is also unclear whether an investor who purchases a debt instrument in the secondary market would equate the acquisition price to “principal” or not. If not, it may be difficult for the investor to determine the literal amount of cash transferred between the original lender and borrower at inception, adjusted for any premium or discount. The issue is compounded in the context of a debt security, which represents multiple underlying borrowers. Additional guidance on these points would be necessary to address the accounting for debt investors that do not originate loans.

Lastly, we recommend providing guidance for whether a loan modification constitutes a “new” loan for purposes of classification and measurement. Perhaps the Board only intends for investors to derecognize a debt investment either through its maturity or a transfer that satisfies the sale requirements in Topic 860. However, we note borrowers have guidance in ASC 470-50 for distinguishing whether a loan amendment with the same lender is considered significant, and therefore treated as a new debt obligation. We recommend clarifying this point since loan modifications are common, e.g., refinancing with the same lender.

**Question 7: Should a financial asset with a contractual term that modifies the economic relationship (see paragraphs 825-10-55-17 through 55-20) between principal and interest be considered to contain cash flows that are solely payments of principal and interest? Should this be the case if, and only if, the contractual cash flows could or could not be more than insignificantly different from the benchmark cash flows as discussed in paragraph 825-10-55-19? If not, why? What would you propose instead?**

We are concerned that a limit based on an “insignificant” difference may be too stringent in conjunction with the requirement to consider all “reasonably possible” scenarios. By way of comparison under current US GAAP, certain features in debt hosts may require bifurcation under Topic 815 at the inception of the instrument based on the “double-double” test. However, there may be no significant financial reporting impact over the term because the low likelihood of certain scenarios occurring, which leads to an immaterial fair value for the embedded derivative.

In contrast, the entire debt instrument would be carried at fair value under the ED rather than only the feature itself that introduces potential cash flow variability. And since the entire instrument would be adjusted to fair value, a disproportionate amount of income statement volatility will result from other features related to the instrument’s value. For instance, a reasonably possible interest rate reset feature may result in *all* future changes in interest rates

Technical Director  
Financial Accounting Standards Board  
Page 5 of 10

being captured in the reporting entity's income statement. We are not certain this is an improvement over today's embedded derivative model, under which only the embedded derivative would impact earnings if and when its value becomes material.

As such, we recommend either retaining today's bifurcation model or raising the reasonably possible threshold in the ED to capture instruments for which a higher probability of cash flow variability is expected. In this context, the Board might consider a "more-likely-than not" threshold.

**Question 8: Do the proposed amendments contain sufficient application guidance in paragraphs 825-10-55-17 through 55-20 on assessing a modified economic relationship? If not, why?**

We recommend providing guidance as to whether the modified economic relationship test is purely qualitative, or if quantitative assessments are required. If so, in what circumstances?

**Question 9: For beneficial interests in securitized financial assets, the proposed amendments would require an entity to look through to the underlying pool of instruments in determining whether the tranche contains payments of solely principal and interest. Do you agree with this look-through approach? If not, why? What would you propose instead?**

We note the look-through approach was developed to assess whether a securitization modifies the credit risk associated with a pool of loans by introducing a subordination structure for the various tranches (BC114). While it may be possible for the initial investor to look-through a securitization to evaluate the underlying financial assets, we are not certain that secondary purchasers will be able to perform the same assessment in a timely manner or at a reasonable cost. The Board might consider additional outreach to debt investors who regularly trade in these instruments before finalizing this provision. In addition, consideration could be given as to whether high quality instruments might be exempted from this requirement, e.g., on the basis of a sufficiently high credit rating.

**Question 10: Do the proposed amendments appropriately convey the principle associated with the business model assessment? If not, why? What would you propose instead?**

As explained in our cover letter, we would establish amortized cost (AC) as the default category for instruments i) with cash flows solely related to principal and interest, and ii) which are not held within a trading business model. Instruments that do not meet both criteria would be carried at fair value through earnings (FV-NI). Regardless of category, we believe instruments carried at amortized cost or fair value should be adjusted through earnings, not equity (other than hedging activity recorded in OCI, which is excluded from the ED's scope).

Adjusting financial instruments to fair value each period with portions of the change in fair value split between earnings and equity (FV-OCI) lacks an apparent conceptual basis. While we understand some of the practical reasons for attempting to strike a balance between competing views, we believe that creating a new classification and attribution model without a cohesive principle will be problematic. We also note the fair value of instruments carried at amortized cost can be presented parenthetically on the face of the balance sheet for users.

**Question 11: Do the proposed amendments provide sufficient application guidance and illustrations on how to distinguish among the three business models, including determining**

Technical Director  
Financial Accounting Standards Board  
Page 6 of 10

**whether the business model is to manage assets both to collect contractual cash flows and to sell? Do you agree with the proposed guidance provided to describe those business models? If not, why?**

We believe some business models will be relatively easy to assess, while others will prove more challenging. For instance, a lender who routinely originates and sells loans (assuming the purchaser of the loans is not a consolidated securitization vehicle) will be easily distinguished from one that holds loans to maturity. Similarly, trading desks should be relatively easy to identify as inconsistent with a held for collection business model.

However, we have concerns about identifying FV-OCI strategies, particularly for nonfinancial institutions. For instance, Example 7 describes a nonfinancial entity that invests cash to earn a return to fund capital expenditures at a later date. If the entity selects debt investments with a term that exceeds the timing of the anticipated capex expenditure, it results in FV-OCI. However, if the entity selects short term investments that are continually reinvested at maturity until the future capital expenditure, an AC model applies. We struggle to see different business models in those two situations. Rather, both scenarios could be construed as the same business model, which is to invest idle funds for future capex needs.

In Example 6, we struggle with the rationale articulated in paragraph 825-10-55-78. We do not agree that a requirement imposed by a regulator to sell instruments that the entity otherwise holds to maturity changes the underlying business model.

We believe a two-model category as described in our cover letter would be easier to implement in practice. It would be clear that neither of the scenarios highlighted in Example 6 or 7 would fail the business model test we propose (i.e., whether the entity has a trading business model).

**Question 12: Should the classification and measurement model for financial instruments contain an explicit tainting notion or should it rely on the principle and exercise of professional judgment? Why?**

We do not support an explicit tainting notion.

**Question 13: The proposed amendments would require loan commitments, a revolving line of credit, or a commercial letter of credit (the potential creditor) to be measured on the basis of the likelihood of exercise of the commitment and the classification of the underlying loan that would be made upon exercise of the commitment. Do you agree with the proposed classification of loan commitments? If not, why? What would you propose instead?**

We agree.

**Question 14: Do you agree with the initial measurement principles for financial instruments? If not, why?**

We agree, particularly with the premise that transaction costs should be written off at inception only for FV-NI instruments.

**Question 16: Should financial liabilities subsequently be measured at amortized cost, unless certain exceptions are met? If not, why?**

Technical Director  
Financial Accounting Standards Board  
Page 7 of 10

We agree with a presumption of amortized cost classification for financial liabilities since most of them do not trade.

**Question 17:** The proposed amendments would require a nonrecourse financial liability that is settled with only the cash flows from the related financial assets (see paragraph 825-10-35-11) to be measured on the same basis as those assets. Do you agree with the proposed amendments? If not, why? What would you propose instead?

We agree. Otherwise, mismatches would result from independent measurements, which would not be meaningful.

**Question 18:** The proposed amendments would require financial assets measured at amortized cost that are subsequently identified for sale to continue to be classified and measured at amortized cost less impairment and would prohibit recognition of the gain, until the sale is complete. Do you agree with the proposed classification and measurement requirements? If not, why?

We agree. In an AC context, we believe it is appropriate to recognize the gain at the time it is realized upon sale.

**Question 19:** The proposed amendments would provide a practicability exception for measuring equity investments without readily determinable fair values that do not qualify for the practical expedient in paragraph 820-10-35-59 (that is, the net asset value per share expedient) and a one-step impairment model for all equity investments subject to the practicability exception. Do you agree with the proposed amendments? If not, why?

We agree with the proposal to simplify the subjective other-than-temporary impairment analysis that exists in current GAAP.

We support the practicability exception for measuring equity investments at fair value, with one caveat. We note the practicability exception for instruments that lack a readily determinable fair value appears to apply to equity method investments that are held for sale. If so, its application seems to defeat equity-method accounting since the carrying amount would not be adjusted for the investor's share of the investee's operating results in periods for which the investment is held for sale. We suggest clarifying whether this is the Board's intent.

Separately, we believe additional guidance will be needed to determine whether different equity securities of the same issuer should be considered similar under paragraph 825-10-35-17. For example, would non-voting redeemable preferred stock be considered similar to nonredeemable voting common stock? Given the complexity of equity instruments that exists today and challenges that the Board has encountered in other projects related to an issuer's accounting for various types of equity securities, we recommend providing additional examples that compare and contrast this point.

**Question 20:** Should an entity evaluate the need for a valuation allowance on a deferred tax asset related to a debt instrument measured at fair value with qualifying changes in fair value recognized in other comprehensive income separately from the other deferred tax assets of the entity (rather than combined and analyzed together)? If not, why?

Technical Director  
Financial Accounting Standards Board  
Page 8 of 10

We agree with evaluating the need for a valuation allowance separately in this instance since an investor may be able to hold the security to maturity, at which point an unrealized loss would reverse.

**Question 21: Under the amendments in this proposed Update, hybrid financial assets would not be required to be analyzed for bifurcation under Subtopic 815-15 and would be assessed in their entirety on the basis of the proposed classification requirements. In contrast, hybrid financial liabilities would be assessed for bifurcation and separate accounting under Subtopic 815-15, and the financial liability host contract would be subject to the proposed amendments. Do you agree with this proposal? If not, why? What would you propose instead?**

See our response to Question 7 regarding the proposal to carry hybrid financial assets in their entirety at fair value.

Conceptually, we do not see a reason to assess hybrid financial liabilities for bifurcation, without doing the same for hybrid financial assets. However, we agree that the accounting for financial instruments with characteristics of equity is best addressed as a separate project. We continue to believe debt/equity accounting needs an overhaul and would support a decision to reactivate and complete that project.

**Question 22: The proposed amendments would require reclassification of financial assets when a change in business model occurs and prescribes how those changes should be subsequently accounted for. Do you agree with the proposed amendment on reclassifications? If not, why?**

We agree. Since the ED relies on an entity's business model to determine classification and measurement, it is consistent to update an initial decision when the business model changes.

**Question 26: The proposed amendments would require an entity to separately recognize in net income changes in fair value attributable to foreign currency gain or loss on foreign-currency-denominated debt securities measured at fair value through other comprehensive income (see paragraphs 825-10-45-14 through 45-15). Is the proposed fair-value-based method provided for computing the foreign currency gain or loss component operable? If not, why? What would you propose instead?**

Yes, it appears operational since entities will be able to measure the difference based on exchange rates at the beginning and end of the period.

**Question 29: Do you agree with the proposed disclosure requirements? If not, which disclosure requirement would you change and why?**

With respect to the disclosures proposed in items c. - e. of paragraph 825-10-50-34, we recommend limiting any required disclosures in interim periods to those that represent significant changes from the prior year-end. If an entity's valuation methods and processes are consistent with the last annual reporting period, we do not see a reason to repeat that information during the quarterly periods.

We note the Board's decision to limit the disclosures related to the present value of core deposit liabilities to public entities on an annual basis. However, even annually, we are not certain the benefits of providing that information outweigh the related costs. There will be significant

estimates required to provide the information about weighted-average maturities and the all-in cost to service rate, particularly the expense of maintaining a branch network. We note the operations of many branches are broader than simply servicing deposit accounts. As such, a subset of the total branch network cost will need to be estimated. Further, it is unclear how a user benefits from this information since banks are not able to realize the difference between the present value of a deposit account (e.g., \$95) and the actual amount owed to customers (e.g., \$100).

**Question 30: Should an entity be permitted to early adopt only the proposed presentation requirements related to changes in instrument-specific credit risk for hybrid financial liabilities that would qualify for the fair value option under the proposed requirements? If not, why?**

While we do not support early-adoption in general if the ED is finalized, we agree with the option to adopt the presentation guidance related to instrument-specific credit risk. We note gains and losses related to an entity's own credit are often discounted by users when assessing financial performance. Therefore, we agree that highlighting these figures should be helpful.

**Question 31: Should the effective date be the same for both public entities and nonpublic entities?**

Similar to most other recent projects, we recommend providing private entities with an additional year.

**Question 32: How much time is needed to implement the proposed guidance?**

We expect several years would be needed in light of other major projects the Board expects to finalize in the near term. We suggest linking the effective date of this ED with the companion proposal on credit losses.

**Question 33: Are the transition provisions in this proposed Update operable? If not, why?**

We have not identified any operational constraints related to initial transition.

**Question 34: The proposed amendments would require investments that qualify for the equity method of accounting in Subtopic 323-10, Investments—Equity Method and Joint Ventures—Overall, to be subsequently measured at fair value with changes in fair value recognized in net income if the investment is held for sale at initial recognition. Are the proposed indicators/conditions operable? If not, why? What would you propose instead?**

We believe the indicators proposed in 323-10-15-20 are overly broad. It is not clear to us how specific or probable a "potential exit strategy" must be in order to qualify. Similarly, "a range of dates" seems open to interpretation. The Board might consider language closer to that specified in ASC 360-10-45-9 regarding long-lived assets that are held for sale. The conditions in that paragraph are more concrete and readily understood in terms of current practice.

**Question 35: The proposed amendments would change the current two-step impairment model for equity method investments to a one-step impairment model for all equity investments. Do you agree with the proposed one-step equity impairment model? If not, why? What would you propose instead?**

Technical Director  
Financial Accounting Standards Board  
Page 10 of 10

We agree. This proposal would simplify existing practice related to the impairment of equity method investments, as described in our response to question 19.

**Question 36: Do you agree that the current portfolio-wide option for not-for-profit entities, other than health care entities, to account for their equity method investments at fair value should be retained? If not, why? Should that option also be made available to not-for-profit health care entities that are within the scope of Topic 954, Health Care Entities?**

As noted previously, we believe any changes to existing industry-specific standards should be addressed outside of this project. However, we do not generally support creating new industry-specific guidance.

**Question 37: The proposed amendments would eliminate the fair value option for hybrid nonfinancial instruments in current U.S. GAAP and would provide a new fair value option for hybrid nonfinancial liabilities. For a hybrid nonfinancial liability, an entity would apply the bifurcation and separate accounting requirements in Subtopic 815-15 and account for the embedded derivative in accordance with Topic 815. The financial liability host that results from separation of the nonfinancial embedded derivative would be subject to the proposed amendments. However, an entity would be permitted to initially and subsequently measure the entire hybrid nonfinancial liability at fair value (with changes in fair value recognized in net income) if after applying Subtopic 815-15 the entity determines that an embedded derivative that requires bifurcation and separate accounting exists. In contrast, for a hybrid nonfinancial asset the proposed amendments would require the hybrid contract to be measured at fair value (with changes in fair value recognized in net income) if the hybrid nonfinancial asset contains an embedded derivative that would have required bifurcation and separate accounting under Subtopic 815-15. Do you agree with the proposed amendments? If not, why? What would you propose instead?**

As noted previously, we do not support different approaches related to the treatment of embedded derivatives in hybrid assets vs. hybrid liabilities.