

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

The Accounting Principles Committee of the Illinois CPA Society (Committee) appreciates the opportunity to provide its views on the proposed Accounting Standards Update, *Recognition and Measurement of Financial Assets and Financial Liabilities*. The Committee is a voluntary group of CPAs from public practice, industry and education. Our comments represent the collective views of the Committee members and not the individual views of the members or the organizations with which they are affiliated. The organization and operating procedures of the Committee are outlined in Appendix A to this letter.

We support the Board's efforts to provide financial statement users with more decision-useful information about financial instruments while reducing complexity. However, we are concerned about the operationality of the proposed guidance and the duration of the comment period. Because the first several months of the calendar year are a busy time for many CPAs, and given the complexity and scope of the proposed guidance, we request an extension of the comment period. We believe that additional time is necessary to fully examine operationality issues, a few of which we describe below.

The remainder of this letter summarizes certain of our concerns regarding the operationality of the proposed guidance.

### **Contractual cash flows**

The proposed guidance states that a contractual term that is contingent on a future event or circumstance could result in cash flows that are solely payments of principal and interest provided that the contingent payment is compensation for time value of money and credit risk. However, entities would be required to disregard contingent payment terms that result in payments that are not solely principal and interest if the contingent event is "extremely rare, highly abnormal, and very unlikely to occur."

We anticipate disagreements in practice as to whether an event is "extremely rare, highly abnormal, and very unlikely to occur," given the potential consequences for classification and measurement of a financial asset at fair value as opposed to amortized cost. Some might interpret this language as "virtually impossible," while others might view it as encompassing certain protective provisions that would require a payment from the issue upon an unlikely event but one that evidently was contemplated in drafting the investment agreement. We realize that judgment will be necessary and anticipate that guidelines will develop in practice in this area, but in our view it would be helpful to have examples of items that are expected to qualify as "extremely rare, highly abnormal, and very unlikely to occur."

## **Business model**

According to proposed ASC 825-10-55-31, as part of managing financial assets for collection of contractual cash flows, an entity would focus on managing the credit risk of those assets to maximize collection of contractual cash flows. The proposed guidance goes on to clarify that sales of financial assets in response to significant deterioration in the issuer's creditworthiness would not preclude amortized cost classification for those assets, so long as the sales are intended to maximize the collection of contractual cash flows. However, this paragraph also notes that sales resulting from an entity's attempt to manage credit exposure due to concentrations in credit risk would be inconsistent with amortized cost classification.

We question the distinction made in this paragraph between sales intended to respond to (a) deterioration in creditworthiness and (b) concentrations in credit risk. In practice it might be difficult to distinguish between the two. For example, an event might impact the creditworthiness of all entities in a particular industry, and in response an investor might decide to reduce its exposure to financial assets issued by entities in that industry. On one hand, the investor is responding to deterioration in issuers' creditworthiness, whether viewed on an issuer by issuer basis or by industry, while on the other hand, the investor has determined that it has too high a concentration of credit risk attributable to its investments in the affected industry. In these situations it could be very difficult to determine whether these sort of financial asset sales are consistent with amortized cost classification.

In our view, further clarity is needed, such as specifying that sales to address concentrations of credit risks that are not associated with deterioration in issuers' creditworthiness are inconsistent with amortized cost classification.

## **Hybrid financial assets**

The proposed guidance would eliminate the bifurcation of embedded derivatives from hybrid financial assets on account of its incompatibility with the contractual cash flows criterion for financial asset classification. We disagree with that proposal.

We would prefer to first apply the existing bifurcation criteria and, depending on the outcome, apply the contractual cash flow criterion to either the host contract if the leverage feature is bifurcated or to the hybrid instrument if the leverage feature is not bifurcated.

The key question, in our view, is whether bifurcation provides more decision useful information, which does not appear to be addressed in paragraph BC201 of the Exposure Draft. Similar to the guidance for evaluating hybrid financial liabilities, the guidance for evaluating hybrid financial assets is established and understood in practice, and was initially implemented via FASB Statement 133, *Accounting for Derivative Instruments and Hedging Activities*, because the Board determined "(a) it was inappropriate to treat instruments that include both nonderivative and derivative components entirely as derivative instruments and (b) nonderivative instruments should only be eligible as hedging instruments in selected circumstances." In our view, the issue of whether hybrid instruments should be subject to bifurcation of embedded derivatives is intertwined with the accounting for derivatives and hedging activities in general. We believe the Board should consider the implications of the tentative decision to eliminate bifurcation for hybrid financial assets on the upcoming deliberations on derivatives and hedging, and endeavor in the meantime to retain the bifurcation guidance for both hybrid financial assets and liabilities. Also, we believe the Board should consider whether bifurcation of financial assets provides more decision useful information than a model that permits only a single unit of account for hybrid financial assets.

We commend the Board on its efforts to date and for their consideration of constituent feedback following the 2010 Exposure Draft. However, we believe that the Board's constituents will be best served by allowing

additional time for comments on this Exposure Draft to ensure that adequate consideration is given to areas of concern, including those we have mentioned in this letter.

We appreciate the opportunity to offer our comments.

Sincerely,

## Scott G. Lehman, CPA

Chair, Accounting Principles Committee

# Amanda M. Rzepka, CPA

Vice-chair, Accounting Principles Committee

### APPENDIX A

### ACCOUNTING PRINCIPLES COMMITTEE ORGANIZATION AND OPERATING PROCEDURES 2013-2014

The Accounting Principles Committee of the Illinois CPA Society (Committee) is composed of the following technically qualified, experienced members appointed from industry, education and public accounting. These members have Committee service ranging from newly appointed to more than 20 years. The Committee is an appointed senior technical committee of the Society and has been delegated the authority to issue written positions representing the Society on matters regarding the setting of accounting standards. The Committee's comments reflect solely the views of the Committee and do not purport to represent the views of their business affiliations.

The Committee usually operates by assigning Subcommittees of its members to fully study and discuss exposure documents proposing additions to or revisions of accounting standards. The Subcommittee ordinarily develops a proposed response that is considered, discussed and voted on by the full Committee. Support by the full Committee then results in the issuance of a formal response, which at times includes a minority viewpoint. Current members of the Committee and their business affiliations are as follows:

### **Public Accounting Firms:**

Large: (national & regional)

Ryan Brady, CPA Grant Thornton LLP
Todd Briggs, CPA McGladrey LLP
Brian Chmiel, CPA Crowe Horwath LLP

Frank Dery, CPA PricewaterhouseCoopers LLP

John Hepp, CPA Grant Thornton LLP

David Jamiolkowski, CPA Baker Tilly

Scott Lehman, CPA (Chair)

Elizabeth Prossnitz, CPA

Robert Sledge, CPA

Crowe Horwath LLP

BDO USA LLP

KPMG LLP

Medium: (more than 40 professionals)

Timothy Bellazzini, CPA Sikich LLP

Christopher Cameron, CPA

Michael Kidd, CPA

Mowery & Schoenfeld LLC

Gary Mills, CPA

Tad Render, CPA

Steven Roiland, CPA

Kutchins Robbins & Diamond Ltd

Mowery & Schoenfeld LLC

Frost Ruttenberg & Rothblatt PC

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Kessler Orlean Silver & Co., PC

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Peggy Brady, CPA Selden Fox, Ltd.
Brian Kot, CPA Cray Kaiser Ltd CPAs

Jeffery Watson, CPA Miller Cooper & Company Ltd

**Industry:** 

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Farah Hollenbeck, CPA Abbott Laboratories

Joshua Lance, CPA N Pritzker Capital Management LLC

Marianne Lorenz, CPA AGL Resources Inc.
Michael Maffei, CPA GATX Corporation
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