

May 15, 2013

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

File Reference No. 2013-220

Dear Ms. Cospers:

McGladrey LLP is pleased to comment on the Proposed Accounting Standards Update, *Financial Instruments—Overall (Subtopic 825-10) Recognition and Measurement of Financial Assets and Financial Liabilities* (the “ASU”), as well as the companion document, *Proposed Amendments to the FASB Accounting Standards Codification* (the “Companion Document”). We are generally supportive of the provisions of the proposed ASU and commend the Financial Accounting Standards Board (the “Board”) for the efforts that went in to a new proposal that is responsive to feedback received on the May 2010 exposure document and better converged with International Accounting Standards. In the section that follows, we respond to specific questions posed in the ASU and Companion Document. In addition to responding to the questions, we would also like to state our belief that the proposed methodology to assess the contractual cash flows of a financial asset in the ASU appears to be inconsistent with an overall objective to reduce complexity. This requirement seems to add a notable amount of complexity to the model for accounting for financial instruments as reporting entities would need to continue to understand and apply the guidance in ASC 815-15 pertaining to embedded derivatives to financial liabilities and also learn and apply a new but in some ways similar model to financial assets. We believe that significantly more financial assets may need to be accounted for in their entirety at fair value through net income as a consequence of failing the cash flows criterion than necessitated bifurcation of an embedded derivative under current guidance. We encourage the Board to carefully evaluate if the benefit of instituting this new cash flows characteristic model justifies the additional costs and complexities brought about by having two separate but similar models in which financial assets are evaluated to determine if they can subsequently be measured at something other than fair value through net income and financial liabilities are evaluated to determine if an embedded derivative requires separate fair value recognition.

With regards to another general comment that does not pertain to a specific question posed in the ASU, given the desire to improve comparability of financial statements, we believe it would be beneficial if example financial statements were included in the implementation guidance, demonstrating how financial assets and liabilities may be grouped on the balance sheet based on subsequent measurement category and how the related activity may be grouped on the income statement.

Responses to specific questions posed in the ASU

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 are in agreement with the scope of financial instruments included in the ASU.

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 are in agreement with the industry-specific specialized guidance scope exceptions.

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?*

As is indicated in our responses to Questions 6, 8 and 9 that follow, the understandability of this principle could be improved with additional examples. It would also be helpful to clarify the sentence that follows in paragraph 825-10-55-47 to indicate how one may determine when indexing to the debtor's performance would and would not result in an adjustment that only compensates for changes in the credit quality of the instrument: "However, if the interest payments were indexed to another variable such as the debtor's performance (for example, **the debtor's net income**) or an equity index, the contractual cash flows would not be solely payments of principal and interest on the principal amount outstanding (**unless indexing to the debtor's performance results in an adjustment that only compensates for changes in the credit quality of the instrument**)." Additionally, the following sentence in paragraph 825-10-55-22 does not seem to allow the payment of an extension fee, no matter how insignificant that fee may be. If that is not the desired meaning, it would be beneficial to clarify. ("The terms of the contractual provision result in contractual cash flows during the extension period that **are solely payments of principal and interest on the principal amount outstanding.**") This is in contrast to the wording of paragraph 825-10-55-21 in the context of prepayment options, that requires the prepayment amount to **substantially represent** (rather than solely represent) unpaid amounts of principal and interest on the principal amount outstanding.

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?*

If principal were defined as the amount transferred at initial recognition and repaid at maturity or other settlement such that to meet the cash flows characteristic, the amount transferred at initial recognition had to be substantially the same as that amount repaid at maturity, it seems that instruments that are purchased at a significant discount or premium would fail the cash flows characteristic.

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

We believe that additional guidance and illustrations would be beneficial, including in the following areas:

- In the context of evaluating a prepayment option, we believe it would be beneficial to include examples of what may constitute reasonable versus unreasonable compensation for early termination of the contract
- Include examples of what it means for a prepayment amount to substantially represent unpaid amounts of principal and interest on the principal amount outstanding

- In the context of evaluating contingent features, we believe it would be beneficial to include examples of events that are and are not extremely rare, highly abnormal, and very unlikely to occur

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?*

As we indicated in our introductory paragraph, we believe that introducing this concept for financial assets combined with retaining the existing requirements for bifurcation of embedded derivatives from financial liabilities significantly increases complexity, which in part could be alleviated with additional application guidance and illustrations. We are in agreement that if the contractual cash flows characteristic is maintained in the final ASU, that it is important to give consideration to the significance of the potential difference in cash flows as otherwise, very insignificant differences could result in the entire instrument being required to be carried at fair value through net income, which does not seem appropriate.

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 believe it would be beneficial to include additional application guidance, including to demonstrate the following:

- Examples of terms that introduce leverage and examples of how such terms may be assessed for significance in comparison to a benchmark instrument
- How one would assess significance using the actual financial asset versus a hypothetical financial asset

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?*

It is not apparent what the justification is for the requirement to consider credit risk of the underlying exposure when this is not a consideration for financial assets that are not beneficial interests. Additionally, we question if the information necessary to look-through to the underlying pool of instruments will generally be available to reporting entities. Lastly, if this guidance is finalized as proposed, we believe it would be beneficial to include additional guidance on how to determine the exposure to credit risk such as elaborating on the type of additional assessment that may be performed on the subordinated tranche referred to at proposed paragraph 825-10-55-67.

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

We believe that clarification is warranted as it pertains to the interplay between the following statements, which seem to contradict one another. It may be beneficial to elaborate on 825-10-25-30 to provide specific examples of when this may be applicable and how the subsequent accounting and tracking would work given that assets may subsequently be sold that may or may not be part of the percentage that was allocated to a category other than to hold for the collection of contractual cashflows.

Paragraph 825-10-55-35 states the following (with bolding added for emphasis), that is consistent with paragraph 825-10-25-25: *Financial assets would qualify for subsequent measurement at fair value with qualifying changes in fair value recognized in other comprehensive income if the assets are held and*

*managed within a business model that has the objective of both holding financial assets for collection of contractual cash flows and selling financial assets to realize changes in their fair values. **That is, at recognition, the entity has not yet determined whether it will hold the individual asset to collect contractual cash flows or sell the asset to meet certain objectives.***

In contrast, paragraph 825-10-25-30 states the following: *Upon recognition of a pool of similar financial assets, such as a pool of loan receivables, an entity may expect to sell a portion of the pool and to continue to hold and manage the other portion to collect the contractual cash flows. If upon recognition an entity has not yet identified specific assets that it will subsequently sell and the assets in the pool meet the contractual cash flow characteristics criterion in paragraph 825-10-25-17, the entity shall classify a percentage of the pool into one of the three classification categories in paragraph 825-10-25-25.*

Question 11: *Do the proposed amendments provide sufficient application guidance and illustrations on how to distinguish among the three business models, including determining 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 it is important to state in paragraph 825-10-55-32 that sales necessitated by a violation of a legal lending requirement and sales required by a regulator, that could not have been reasonably anticipated at the time of the original classification, would not be considered inconsistent with the objective of amortized cost classification. Without this explicit statement, it may be difficult for certain regulated institutions to classify any assets in the amortized cost category as it would be difficult to predict what, if any, assets may need to be sold as a result of a legal lending requirement or directive from a regulator. While paragraph 825-10-55-34 notes that circumstances that cause a regulator to direct an institution to sell securities possibly could be considered an event that is isolated, nonrecurring, and unusual, we are concerned that this will not be operational. Once a regulated institution is experiencing circumstances that necessitate sales for these reasons (such as a significant decline in capital), additional sales may be necessary over a prolonged period of time, such that the sales would become recurring and otherwise inconsistent with the objective of amortized cost classification.

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?*

While we appreciate the reasons expressed by the Board for not including an explicit tainting notion, we believe that in the absence of additional guidance, informal rules and outcomes will evolve in practice that do not have the benefit of being appropriately vetted through the deliberation and exposure to public comments processes. For this reason, we believe it would be beneficial to include guidance to illustrate the potential ramifications, which could be accomplished by in part incorporating the concept expressed in paragraph BC131 in to the final ASU (... *situations may arise in which an entity's sales of financial assets held in its amortized cost category should call into question the entity's credibility for asserting that it holds financial assets for the primary objective of collecting contractual cash flows*).

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 are in agreement with the proposed classification of loan commitments.

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

We are in agreement with the initial measurement principles that are expressed in the ASU. We would suggest however that the guidance be expanded to address scenarios in which multiple financial

instruments are issued or acquired in the same transaction and how the transaction price would be allocated to the various financial instruments under a scenario where two or more instruments would be subsequently measured at amortized cost or fair value through OCI and others would be subsequently measured at fair value through net income.

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

Yes, we are in agreement with financial liabilities being measured at amortized cost unless certain exceptions are met.

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 are in agreement with the amendments as proposed.

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 are in agreement with the proposed requirements.

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 are in agreement with this practicability exception and the related one step impairment model. We believe it would be beneficial to elaborate on what may constitute an observable price change and what efforts a reporting entity would be expected to put forth to determine if observable price changes occurred.

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?*

We are in agreement that such deferred tax assets should be evaluated separately from other deferred tax assets that are ultimately expected to generate tax losses.

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?*

We are concerned that the two different approaches will result in additional complexity rather than reduced complexity.

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 are in agreement with the proposed amendments on reclassification of financial assets.

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?*

We believe that the proposed fair-value-based method is operable.

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

We are in agreement with the proposed disclosure requirements.

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?*

We agree that the ability to early adopt should be limited to the presentation of instrument-specific credit risk for hybrid financial liabilities.

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

We believe that nonpublic entities should have at least a one year delayed effective date from the public entity effective date.

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

We believe the time needed to implement is at least two full years from the date a final standard is issued for public entities and three full years for nonpublic entities.

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

While we are generally in agreement that transition should be by means of a cumulative-effect adjustment to the statement of financial position as of the beginning of the first reporting period in which the guidance is effective, we believe there are areas for which transition in this manner may be challenging, thereby potentially necessitating special transition provisions or illustrative guidance. The following are examples of such areas that come to mind:

- How the adoption date carrying amount would be determined for an equity security without a readily determinable fair value for which the practicability exception is elected. Presumably a reporting entity would need to do an impairment analysis under the proposed new one step approach as of the adoption date. We anticipate questions would arise in how consideration would be given to adjustments to the initial carrying amount for price changes that were observable prior to the adoption date.
- Clarify if the cash flows criterion should be assessed based on the terms of the instrument from the adoption date forward or based on the terms at the entity's initial recognition of an asset. (As an example, if a financial asset had a contingent prepayment option that expired before the adoption date but would have otherwise caused the instrument to fail the cash flows criterion, would an entity

conclude upon transition that the instrument failed the criterion despite the problematic prepayment option no longer existing as of the adoption date?

- How would the transition provisions be applied for items that were accounted for at fair value through net income or other comprehensive income prior to adoption but would be accounted for at amortized cost subsequent to adoption, which may occur for example for items for which the fair value option was elected that are no longer eligible for the fair value option under the proposed ASU? Similar to the reclass provisions proposed in 825-10-35-23, would the adoption date fair value become the initial carrying amount/amortized cost?

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?*

To promote consistency with the treatment of other financial assets and minimize the potential for abuse, we question if it may be better to base this determination off of management's business strategy for the asset at initial recognition. With the proposed indicators, entities could attempt to find a way out of fair value accounting by stating that the potential exit strategy or time of exit has not been defined.

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?*

We are in agreement with the proposed one-step impairment model.

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?*

We are in agreement with retaining this option.

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 is indicated in our introductory paragraph, we have concerns with the additional complexity associated with having separate but similar models for financial assets and liabilities. Additionally, as a general comment pertaining to the fair value option, we believe it would be beneficial to provide examples of what would be acceptable in terms of electing this option for a group of financial assets and liabilities measured on a net basis to minimize the potential of abuse brought about by too broad of an interpretation.

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Responses to specific questions posed in the Companion Document

Question 1: *Do you believe that the proposed consequential amendments that would result from the proposals in the proposed Update on financial instruments have been appropriately reflected? If not, what alternative amendment(s) do you recommend and why?*

We question if it would be beneficial to continue to include *Example 7: Net Settlement—Readily Convertible to Cash—Effect of Daily Transaction Volumes* beginning at 815-10-55-99 in the guidance of ASC 815 by changing references to “*from the investor’s perspective*” to “*from the issuer’s perspective*” under the assumption that this guidance was intended to be applied by analogy to evaluations from the issuer’s perspective. Additionally, we question if paragraph ASC 310-10-30-7 pertaining to the recognition of loans purchased under standby commitments should be superseded.

Question 2: *Do you believe that all guidance related to financial instruments in various Topics in the FASB Accounting Standards Codification® (for example, Topics 310 and 470) should be consolidated into a single Topic?*

We believe there are merits to moving all such guidance to the single topic on financial instruments if the topic for financial instruments can be logically structured in such a manner that would facilitate finding all relevant guidance specific to an overall category of financial instrument (such as debt obligation, receivable, equity security, etc).

Question 3: *The proposed amendments also would eliminate the fair value option (for financial instruments not within the scope of the proposed Update on financial instruments) in current U.S. GAAP (see paragraph 825-10-15-4), related to guarantees, contingencies, rights and obligations of insurance contracts and warranties, written loan commitments, and firm commitments. Do you agree with the proposed elimination and the effective date and transition guidance? If not, why? What would you propose instead?*

We believe there would be merits to retaining the fair value option (or requiring fair value treatment) for certain firm commitments, particularly in situations when the commitments pertain to the sale of a financial asset and the underlying financial asset is or will be accounted for at fair value through net income.

We appreciate this opportunity to provide feedback on the proposed guidance and would be pleased to respond to any questions the FASB or its staff may have concerning our comments. Please direct any questions to Rick Day (563-888-4017) or Faye Miller (410-246-9194).

Sincerely,



McGladrey LLP