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Re: File Reference No. 2013-220

Dear Ms. Cosper:

Grant Thornton LLP appreciates the opportunity to comment on proposed Accounting Standards Update (ASU), *Recognition and Measurement of Financial Assets and Financial Liabilities*. We support the efforts of the Financial Accounting Standards Board and the International Accounting Standards Board to reach a converged solution on recognition and measurement of financial assets and financial liabilities. While narrower targeted changes to existing U.S. GAAP might have achieved many of the benefits of this proposed framework, we believe the interests of convergence in this globally important area mandate the approach taken by the two boards.

We agree with the decision to consider the business model in which financial assets are managed in determining which of the three classification and measurement categories is appropriate and have provided comments on how we believe the business model guidance could be improved. However, we have significant concerns with the introduction of an entirely new method for evaluating contractual cash flow characteristics for purposes of determining the classification and measurement category for a debt instrument considered a financial asset in its entirety. While the "clearly and closely related" criterion in ASC 815-15, *Derivatives and Hedging*, and International Accounting Standards No. 39, *Financial Instruments: Recognition and Measurement*, can be difficult to apply, we believe it is generally applied in practice without significant issue by many entities that hold debt instruments. We are concerned that significant implementation guidance is needed for reporting entities to properly evaluate the contractual cash flow characteristics, and that we may be trading one set of complex implementation guidance for another.

Additionally, there are scenarios in current practice where an entity identifies an embedded derivative in a period subsequent to issuance of a financial instrument, and must analyze changes in the fair value of the embedded derivative feature when evaluating errors for potential financial statement restatement. Under the proposed standard, entities in such situations would be required to analyze the changes in fair value of the entire instrument when evaluating errors for potential financial statement restatement if a feature is found to cause the

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instrument to not meet the contractual cash flow characteristics. Overall, we believe that focusing on improving the operability of the current "clearly and closely related" criterion would lead to a better outcome.

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 generally agree with the proposed scope of the financial instruments included in the proposed ASU. However, we observe that this proposed ASU is inextricably linked to the FASB's proposed ASU on credit losses, as the classification of financial assets will determine which impairment model would apply, and thus the scope of the two proposals should be similar.

We believe the Board should reconsider or more fully explain the scope exception for financial assets and financial liabilities pertaining to a lease that is in the scope of ASC 840, *Leases*. The guidance in ASC 860, *Transfers and Servicing*, applies to sales of financing-type lease receivables, and in practice some lessors intend to sell these receivables at inception or might decide to sell them at some point during the lease term. In these situations, we believe the measurement categories in the proposed guidance are relevant to lease receivables.

Also, we note that lease receivables recognized by a lessor under ASC 840 are within the scope of the proposed credit loss model. While the FASB has indicated that lease receivables would be scoped out of this proposal due to the Board's separate project on leases, we are unclear why a lease receivable would be excluded from this proposal while credit losses related to such leases would be subject to the credit loss proposal.

We also believe that the Board should consider the costs and benefits of requiring an entity to evaluate the classification and measurement of short-term trade receivables and payables. Specifically, we believe the Board should consider whether there are situations in which a short-term trade receivables and payables should be measured at fair value.

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 with these industry-specific 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?

In our view, the proposed contractual cash flow characteristics assessment may obscure the principle and prove operationally challenging, overly complex, and unclear. While we appreciate and agree with the objective of a single model to differentiate between items that should be

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classified in one of the three classification and measurement categories, we are unclear as to the specific instruments the Board believes should not be classified at amortized cost or fair value with changes in other comprehensive income (FV-OCI). In other words, what instruments today does the Board believe are not correctly classified?

We believe that the proposed ASU would require an entity to develop internal controls to ensure that each individual asset meets the "solely payments of principal and interest" (SPPI) test and is properly classified. While this may not be a significant undertaking for many loans that are generated using standard forms and terms, certain loan products (for example, a commercial loan) may allow individual loan officers the flexibility to modify or add loan terms. Each individual loan term would then need to be evaluated to determine whether it would result in the loan failing the SPPI test. Further, under this requirement, entities would need to specifically evaluate all debt securities at recognition. This may be operationally burdensome for an entity depending on its current practices.

Proposed ASC 825-10-55-16 states that, "[i]f the contractual cash flows include payments that are unrelated to principal, the time value of money, and the credit risk, the contractual cash flows do not represent solely payments of principal and interest." Although the SPPI concept appears clear and straightforward, its application to common types of financial instruments indicates otherwise. In considering the application of this principle to various financial instruments within the scope of the proposed ASU, we have the following questions or areas where we believe further clarity is needed to make the SPPI test operational.

- It is common for loans to require various contractual fees at origination and/or on an ongoing basis. Would the fact that the lender is entitled to various fees result in the lender failing the SPPI test? What are examples of contractual fees that would not cause an instrument to fail the SPPI test?
- If an entity has a receivable that does not include an interest component, would such financial instrument fail the SPPI test? Further, would one get a different answer for a "principal-only strip" versus a trade receivable?
- Would a variable interest rate debt instrument indexed to the lender's prime rate meet the SPPI criterion? According to the proposed guidance, interest payments would satisfy the SPPI criterion if they reflect consideration for the time value of money and for credit risk associated with the instrument. Although LIBOR is generally accepted as a "risk free" interest rate, and therefore reflects the time value of money, a bank's prime rate is not generally viewed as a "risk free" proxy and may reflect factors other than the time value of money in the current lending environment. A bank's prime rate is not reset at the same frequency as LIBOR, and the prime rate reset feature in many loan agreements does not match the time period covered by the prime rate. We note that although proposed ASC 825-10-55-50 indicates an entity would evaluate an instrument that provides the choice between the lender's published one-month and three-month interest rate similarly to an instrument that provides the choice between one- and three-month LIBOR, the referenced analysis concerns the alignment of the reset frequency with the term of the selected rate rather than the characteristics of the rate itself.

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- Are there certain indices for variable rate instruments the Board believes would cause the instrument to fail the SPPI test?
- Would the ability of the debtor to choose (and change) between an index tied to LIBOR or prime result in the instrument failing the SPPI test?
- Would an instrument that results in a low introductory rate (which is often the case for credit cards) or a teaser-rate for other loans result in the financial asset failing the SPPI test?
- Would a clause that provides a creditor with yield protection in the event of a change in laws or regulations (for example, FDIC insurance assessments, Dodd-Frank Wall Street Reform and Consumer Protection Act, or bank regulatory capital adequacy regulations) result in the instrument failing the SPPI test? It appears that such a clause would not meet the exception set forth for contingent payment features in proposed ASC 825-10-55-24 that would only exclude contingent provisions that are "extremely rare, highly abnormal, and very unlikely to occur."
- If a line of credit is payable on-demand, would it fail the SPPI test as there is generally no specified repayment date for the principal balance?
- If a bank checking account customer has an overdraft on the checking account, how would the resulting overdraft receivable asset be classified?
- If a bank has a practice of making loans based on a five year or longer amortization, but writes the loan such that it matures annually as a method for monitoring the loan and the bank has a historical practice of renewing the loan, would the annual maturity date be considered substantive such that the SPPI test would be met?
- It is unclear how *insignificant* leverage would be measured (as explained in proposed ASC 825-10-55-17). For example, a bank may enter into a loan participation that fails the requirements for sale accounting in ASC 860 because the loan does not meet the participating interest definition that requires the contractual cash flows to be pro-rata. For example, this may be the case if the interest rate on the underlying loan and the interest rate passed onto the participating lender are different. Would such situations automatically fail the SPPI test? Would the conclusion differ if the loan is not participated at original recognition, but is participated subsequent to original recognition? Would a market based servicing fee arrangement be considered significant considering that a 25 basis point servicing fee may be considered a market rate for certain loans while a 100 basis point may be considered a market based fee for other loan types? Would 100 basis points still be considered insignificant?
- Would financial instruments that include a paid-in-kind component pass the SPPI test?
- Would a clause that allows for a reduction in the payment amount if the receivable is paid early result in the trade receivable not meeting the SPPI test?
- Would terms that require the borrower to make higher interest payments because certain cash flow or other metrics are met result in the loan failing the SPPI test? The guidance in proposed ASC 825-10-55-47 is unclear on this.

Also, contingent payment features could cause an instrument to fail the SPPI criterion because (1) these features often provide compensation for factors other than the time value of money and credit risk and (2) the proposed guidance specifically prohibits consideration of the

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contingent event's probability, unless the event is "extremely rare, highly abnormal, and very unlikely to occur." We expect there would be significant diversity of interpretation for this quoted phrase. Some might interpret it as such a high threshold that it would effectively never be met, while others might interpret it as an accommodation for protective payment provisions often embedded in financial assets.

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 believe that the proposed definition of principal should be clarified. We do not believe the definition should be expanded to include repayment of the principal at maturity or other settlement, but should instead focus on the holder's investment. A creditor could enter into a lending arrangement (for example, a line of credit or a credit card loan) whereby incremental amounts are borrowed on dates subsequent to date the arrangement is entered into. In this scenario we believe principal should include each draw or advance rather than only the initial draw or advance. Likewise, a lending arrangement might include a "paid-in-kind" (PIK) interest feature, whereby accrued interest is added to the principal amount outstanding. Again, in this scenario we would view the principal as each PIK capitalization (that increases the principal balance). Overall, our view is that principal amounts can arise subsequent to the inception of a lending arrangement, and that the proposed definition of principal should clarify these situations.

The proposed definition also appears to imply that a cash amount is transferred by the holder at initial recognition. In many financial instruments there is no *cash* amount transferred by the holder at initial recognition. For example, when a manufacturer initially recognizes a receivable for goods sold, there is no cash amount transferred by the holder of the receivable. We believe that "amount transferred" should be clarified to explain how non-cash transfers that result in a financial asset should be evaluated and considered.

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

As noted above in our response to Question 4, we believe the cash flow characteristic assessment requires significant additional clarity. While the illustrations are helpful, significant additional implementation guidance is warranted to clearly articulate the cash flow characteristic assessment.

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

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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 do not agree with the proposed guidance that a financial asset with a contractual term that modifies the economic relationship between principal and interest should be considered to contain cash flows that are not solely payments of principal and interest if, and only if, the contractual cash flows could be more than insignificantly different from the benchmark cash flows. We do not believe that such criteria should automatically cause the entire financial asset to be recognized in the fair value through net income (FV-NI) category when the creditor intends to hold a loan to maturity.

As we discussed in the forepart of this letter, we believe that application of the "clearly and closely related" criterion in ASC 815-15 and IAS 39 (for determining whether an embedded feature in a debt host should be accounted for as an embedded derivative) would capture fair value changes of instruments that should not be included in an amortized cost category.

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?

Based on the application guidance in paragraphs 825-10-55-17 through 55-20, it is difficult to envision a scenario where a constant maturity bond would meet the SPPI criterion. Presumably there would often be a reasonably possible scenario where the relationship between the constant maturity rate and the reset term rate could change during the life of the bond such that the contractual cash flows would be more than insignificantly different from the cash flows of the benchmark instrument. In addition, contingent features that result in premiums being paid upon redemption would often result in modifications to the economic relationship that are unrelated to the time value of money. In our view, an example in which the SPPI criterion is met and an example in which the SPPI criterion would not be met for these types of instruments would be helpful.

We also believe that the Board should explicitly explain what is meant by "leverage" as used in the proposed ASU.

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 have concerns as to whether application of the proposed look-through approach will be operational. This proposed approach may be operational if the beneficial interest holder both securitizes and services the financial assets, thus having the ability to look-through. However, others who hold a beneficial interest may not have sufficient information to look-through to the underlying pool of instruments to determine whether the tranche they hold contains solely

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payments of principal and interest, especially if beneficial interests are purchased subsequent to the initial securitization. We also note that proposed ASC 825-10-55-27 requires that "[i]f the holder of a beneficial interest in securitized financial assets cannot assess the criteria in the preceding paragraph at recognition, the beneficial interest must be measured at fair value with all changes in fair value recognized in net income." We do not believe a preparer's lack of transparency to securitized assets at initial recognition should preclude it from categorizing beneficial interests in the amortized cost category.

The proposed amendments seem intended to capture securitized financial assets that are designed to provide credit enhancement to senior securitized financial assets, so that securitized financial assets that are net providers of credit enhancement would be classified as FV-NI, while securitized financial assets that are net receivers of credit enhancements would be eligible for other classification categories. While we understand the Board's rationale for requiring financial instruments that may include an embedded credit derivative in the FV-NI category, we are concerned that significant operational issues will be encountered by entities trying to apply the look through approach. The likely consequence would be that entities would default to classification of beneficial interests in securitizations in the FV-NI category unless the beneficial interest represents the most senior tranche in the securitization.

We believe that a securitization entity that is the issuer might be able to provide a practical expedient to investors by obtaining a credit rating of a hypothetical single tranche securitization in addition to the credit ratings that are obtained on certain of the securities issued. Essentially, securities rated higher than the credit rating of the hypothetical single tranche securitization would be eligible for the amortized cost or FV-OCI categories while securities that are unrated or rated lower than the credit rating of the hypothetical single tranche securitization would be classified in the FV-NI category.

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 generally believe that the proposed amendments appropriately convey the principle associated with the business model assessment but that additional implementation guidance is needed to explain this principle. We believe that ASC 825-10-25-25(a) should be modified (based on the implementation guidance) as follows:

> The asset is held and managed within a business model that has the <u>primary</u> objective of holding the assets to <u>maximize the</u> collect<u>ion of</u> contractual cash flows <u>through the management of credit risk</u>.

We also believe that the proposed ASU should clarify at what level the business model should be assessed. For example, would it be evaluated at an entity level, by business segment, or by financial asset type (e.g. U.S. Treasuries or mortgage backed securities)?

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We are also concerned about implementation issues associated with the proposed business model assessment for non-bank entities and entities holding non-traditional financial assets. We believe that many non-bank entities, whose operations are not focused on managing portfolios of financial assets, may lack protocols for determining how a financial asset will be managed together with other financial assets within a distinct business model. Moreover, for entities that do not routinely originate or purchase financial assets, this determination might be especially difficult. These entities are also more likely to hold bespoke instruments for which the determination of whether the objective is to hold for collection of contractual cash flows or to sell to maximize fair value realization might be difficult.

In general, we believe additional examples and implementation guidance aimed at non-bank entities should be provided to address these issues.

Additionally, we noted that 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 clarifies 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 carried out to manage credit exposure due to concentrations in credit risk would be inconsistent with amortized cost classification. In our view, sales intended to respond to (a) deterioration in creditworthiness and (b) concentrations in credit risk might be difficult to distinguish. There may be scenarios where a sale made in response to deterioration in creditworthiness could also be characterized as a response to a concentration in credit risk, and vice versa. We believe that 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. In addition, it is our view that sales made in response to a regulatory requirement to reduce concentration to a single borrower, to reduce concentration in a sector, or to improve a bank's liquidity, are not inconsistent with amortized cost classification.

We believe the proposed guidance should indicate that sales of financial assets from the amortized cost category are permissible provided they are infrequent and in response to specific isolated events as we indicated in the previous paragraph.

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?

As mentioned in our response to Question 10, we believe the application guidance and illustrations should address non-bank entity scenarios to assist these entities with implementation.

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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 agree that the proposed model should not contain an explicit tainting notion as currently exists under U.S. GAAP for debt securities. However, we are concerned that the proposal contains an implicit tainting notion. We believe that the proposal should not include an implicit tainting notion, and should be flexible to recognize that various situations may require an entity to sell assets, as indicated in our response to Question 10.

Further, it is our view that guidance should be provided for situations in which an entity decides to sell a financial asset at initial recognition, but later determines that the requirements for sale accounting in ASC 860 are not met. We note that this fact pattern is different than the example provided in proposed ASC 825-10-55-76, which appears to assume that the transferor knows at initial recognition that the requirements for sale accounting would not be met. We believe that consideration should be given to whether failing sale accounting would allow an entity to reclassify the assets from the FV-NI category.

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 with the proposed classification of loan commitments.

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

We agree with the initial measurement principles, but believe that the interaction between the proposed guidance and other areas of U.S. GAAP that provide initial measurement guidance should be clarified. For example, in a business combination accounted for under ASC 805, *Business Combinations*, the acquirer is required to initially measure all acquired financial assets and liabilities at fair value. Similarly, we note that ASC 860 requires that a transfer of financial assets accounted for as a sale be initially recognized by the transferee at fair value. However, under the proposed ASU, financial assets and financial liabilities classified as amortized cost or FV-OCI would be initially recognized at transaction price (entry price), which may not equal fair value (exit price). We believe the Board should clarify whether the initial measurement guidance in the proposed ASU would be applied to financial instruments recognized as a result of a business combination or a transfer.

The guidance in proposed ASC 825-10-30-4 through 30-6 regarding a transaction price that includes consideration for something other than the financial instrument is not clear as to the instruments the Board has in mind. We believe specific examples should be provided.

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Question 15: The proposed amendments would eliminate the unconditional fair value option (for financial instruments within the scope of this proposed guidance) in existing U.S. GAAP and, instead, permit an entity to elect to measure at fair value, with all changes in fair value recognized in net income, all of the following:

a. **A group of financial assets and financial liabilities if the entity both:**
   1. **Manages the net exposure relating to those financial assets and financial liabilities (which may be derivative instruments) on a fair value basis**
   2. **Provides information on that basis to the reporting entity's management.**
b. **Hybrid financial liabilities that meet certain prescribed criteria.**
c. **Financial assets that meet the contractual cash flow characteristics criterion and are managed within a business model that has the objective of both holding financial assets to collect contractual cash flows and selling financial assets (in accordance with paragraph 825-10-25-25(b)).**

Do these options provide decision-useful information? If not, why?

We agree with the proposed scope for the fair value option, except for the elimination of the unconditional fair value option for equity method investments. In our view, the guidance should retain an unconditional fair value option for equity method investments. Although some entities that currently elect the fair value option for equity method investments will meet the held for sale criteria in the proposed guidance and therefore will not experience any change in measurement basis, other entities would be deprived of the benefits associated with the option to carry equity method investments at fair value, including more prominent fair value information for financial statement users about a company's investments and, in cases where fair value information is readily available, less accounting complexity. While we acknowledge that the proposed amendments would bring U.S. GAAP closer to IFRS as it relates to fair value for equity method investments, we are not aware of a compelling reason to eliminate the unconditional fair value option for equity method investments and believe it should be retained.

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

We agree that financial liabilities should subsequently be measured at amortized cost subject to certain exceptions.

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 with the principle behind the proposed amendments as to when a financial liability should be measured on the same basis as the related financial asset. However, we believe that this measurement provision should not be limited to situations in which the financial liability is settled with *only* the cash flows from the related financial assets. For example, the repayment of

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a financial liability might be dependent on the underlying loans, but there may be credit enhancements. We do not believe that this should prevent an entity from measuring the financial asset and liability on the same basis to reduce a measurement mismatch. We also note that ASC 820 has been modified to address, and EITF Issue 12-G is addressing, differences between the fair value of the assets and related liabilities.

We also believe that adjusting the carrying amount of financial liabilities that can only be settled with cash flows of financial assets which have been impaired using an expected credit loss model will be challenging, considering how credit losses are absorbed by different beneficial interests in a securitization.

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 with the guidance in proposed ASC 825-10-35-14.

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 proposed amendments.

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 believe that an entity should 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 in combination with other deferred tax assets of the entity. We do not agree that the interaction between the guidance in ASC 320 and ASC 740 creates a unique circumstance that requires an exception to existing income tax accounting principles.

In our view, the proposed guidance should be consistent with ASC 740-10-30-18, *Income Taxes*, which states that future realization of the tax benefit associated with a temporary difference or carryforward is dependent on the "existence of sufficient taxable income of the appropriate character (for example, ordinary income or capital gain …" We believe that the recovery of the book basis should be considered in the overall assessment concerning the need for a valuation

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allowance and not viewed separately. For instance, in situations in which an entity has a recent history of cumulative losses and projects future losses for the next several years, any taxable income related to the recovery of an investment's book basis may only reduce future losses of the entity and would not result in realization of the related deferred tax asset.

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 ASC 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?

As stated previously, we do not agree with this proposal. We believe that application of the contractual cash flow characteristics criterion to financial assets may prove to be just as challenging as application of the current guidance for identifying embedded derivatives, with no apparent benefit. While we appreciate that a hybrid financial asset containing a leverage factor could potentially "pass" the double-double test in current guidance and "fail" the contractual cash flow criterion in the proposed guidance, we do not believe this necessitates the elimination of the embedded derivative guidance for financial assets.

Additionally, in our view a key question 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 non-derivative and derivative components entirely as derivative instruments and (b) non-derivative 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.

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 with the proposed amendment, but believe the Board should ensure that reclassifications are rare and that sufficient implementation guidance is provided. For example,

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the proposed guidance states that a change in business model that requires reclassification of financial assets must be "demonstrable to external parties." We are unclear whether this criterion refers to a press release or other public assertion, or whether some other evidence would be sufficient. As a related matter, we believe this criterion could prove difficult for private companies in terms of providing evidence that a change in business model is "demonstrable to external parties." Accordingly, further examples of ways that an entity could demonstrate to external parties that its business model has changed in such a way that it requires reclassification of financial assets would be helpful.

It does not appear an entity would reclassify a financial asset upon a change in the instrument meeting or ceasing to meet the SPPI test. We note that the SPPI test is only applied at (initial) recognition (proposed ASC 825-10-25-16). It is unclear why the Board has determined that a financial asset should only be reclassified with a change in the business model. We believe that the Board should consider whether the requirement that the SPPI test only be applied at initial recognition would provide a structuring opportunity.

We also believe that guidance should be provided as to the impact of a non-contractual modification. We note that U.S. GAAP only provides guidance for assessing whether a non-troubled debt restructuring is a new loan or a continuation of an existing loan. However, similar guidance does not exist for other financial instruments.

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 for computing the foreign currency gain or loss component operable? If not, why? What would you propose instead?

We believe 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 believe that the disclosure package for financial instruments should be considered holistically once this project and the impairment project is completed, together with all existing disclosures and the disclosure framework project.

We do not agree with the requirement for public companies to disclose certain information for core deposit liabilities. We are unclear how such information relates to the recognition and measurement project. We believe such disclosures should be considered as part of the *Liquidity and Interest Rate Disclosures* project, as we believe such information is more intended to assist a user in understanding liquidity and interest rate risk.

Question 30: Should an entity be permitted to early adopt only the proposed presentation requirements related to changes in instrument-specific credit risk for

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hybrid financial liabilities that would qualify for the fair value option under the proposed requirements? If not, why?

In our view, this option should be available more broadly to all financial liabilities that are measured at fair value subject to the fair value option currently available under either ASC 825 or ASC 815-15, rather than only to hybrid financial liabilities. If this option is only available to hybrid financial liabilities it would have limited applicability and the application of this option by an entity with both hybrid financial liabilities and other financial liabilities measured at fair value would be confusing to users.

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

We generally believe that nonpublic entities should be afforded a one year deferral. However, we encourage the Board to discuss this matter with the Private Company Council.

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

It is too early to assess how much time will be needed for implementation. However, we believe that the implementation period for this proposed ASU should be the same as that provided for the proposed ASU on credit losses since these proposals are inextricably linked. We generally believe that the proposed credit impairment model will take longer to implement than the proposed recognition and measurement model.

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

In our view, the transition provisions are generally operable. However, it is unclear as of what date an existing instrument would be evaluated at transition. Would it be as of the date the instrument was originally recognized by the entity or the date of initial adoption of this standard? For example, how would an instrument that may have failed the SPPI test at initial recognition (say 2003), but has either been amended to eliminate problematic terms or where the problematic terms expired, be evaluated at 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 proposed indicators/conditions are operable, although consistent with our response to Question 15, we believe that the unconditional fair value option should remain available for equity method investments.

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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 agree with the proposed one-step equity 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 agree with retaining 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.

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?

We do not agree with the proposed amendments. In our view, the accounting for hybrid nonfinancial assets and hybrid nonfinancial liabilities should not be asymmetrical. Consistent with our response to Question 21, we believe that the accounting for hybrid financial assets and hybrid financial liabilities should be symmetrical, which eliminates the need for different accounting for hybrid nonfinancial assets and liabilities under the proposed model.

Other comments

- We believe that the proposed definition of amortized cost should be amended to allow for subsequent increases as a result of a new advance (for example, with a line of credit).
- We believe the Board should clarify why it is necessary to separately define a debt instrument and a financial instrument.

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We would be pleased to discuss our comments with you. If you have any questions, please contact Mark K. Scoles, Partner, Accounting Principles Consulting Group, at 312.602.8780 or Mark.Scoles@us.gt.com; or Jamie Mayer, Managing Director, Accounting Principles Consulting Group, at 312.602.8766 or Jamie.Mayer@us.gt.com.

Sincerely,

/s/ Grant Thornton LLP