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ERNST & YOUNG

Ernst & Young LLP
5 Times Square
New York, NY 10036

Tel: 212 773 3000
www.ey.com

Ms. Susan Cosper
Technical Director
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

15 May 2013

Re: Proposed Accounting Standards Updates, *Recognition and Measurement of Financial Assets and Financial Liabilities* and *Proposed Amendments to the FASB Accounting Standards Codification*

Dear Ms. Cosper:

We appreciate the opportunity to comment on the Proposed Accounting Standards Updates, *Recognition and Measurement of Financial Assets and Financial Liabilities* and *Proposed Amendments to the FASB Accounting Standards Codification* (the proposal or Proposed Updates).

We continue to support convergence with International Financial Reporting Standards (IFRS). The proposal would represent a big step toward convergence and would harmonize many aspects of accounting for certain financial instruments. We also support the effort by the Financial Accounting Standards Board (FASB or Board) to simplify the accounting in this complex area. We believe the proposal would significantly further that goal by introducing a single comprehensive model to classify and measure financial instruments.

However, we do not support finalizing the proposal in its current form. First, we believe that certain of the proposal's key provisions need to be clarified. We understand that the Board intended the guidance to be principles-based to converge with certain aspects of IFRS 9. However, we are not sure how certain provisions that would determine the classification and measurement of financial instruments should be applied. We believe certain provisions could be reasonably interpreted in several different ways, and that would result in significant differences in financial reporting.

In addition, we believe the proposal would inappropriately require too many financial instruments to be measured at fair value with changes in fair value recognized in net income (FV-NI). For example, based on our understanding of the proposal's requirements, any prepayable debt instrument acquired at a significant discount from par, including purchased credit-impaired loans, would be required to be measured at FV-NI. We don't believe the Board intended that result, because it contradicts the accounting for those instruments in the Board's separate proposal on accounting for credit losses on financial instruments. We also believe that certain common contingent interest provisions would cause financial instruments to be measured at FV-NI in their entirety, even if the fair value of the feature was clearly immaterial.

Before issuing any final guidance, we believe the Board should make sure that it has received the type of feedback required to issue a high-quality standard. We believe that the quality of the feedback the Board will receive could be negatively affected by an expectations gap about the proposal's effects and the timing of the proposal.

We believe there may be a fairly significant gap between how the proposal would affect current practice for classifying and measuring financial instruments and constituents' expectations of the proposal's effects. We believe that many constituents expect loans to continue to be measured at amortized cost, given the feedback they provided on the Board's May 2010 proposal. At that time, many constituents told the Board that the proposal would inappropriately require many instruments, including loans, to be measured at fair value. We are concerned that constituents may be incorrectly assuming that current practice would not be significantly affected because the Board has proposed retention of today's mixed-attribute measurement model.

The timing of the proposal also raises questions about whether constituents have had a chance to fully analyze the proposal and the related consequential amendments. The proposal was issued during the year-end reporting season for calendar-year companies. At the time, companies were also separately analyzing the Board's credit loss impairment proposal. Constituents may need additional time to make sure they fully understand the proposal's requirements and how it would affect their organizations.

That said, we believe the Board can make specific changes and clarifications that will improve the proposal's operability. We describe our suggestions in this letter. We believe that after changes are made during redeliberations, the Board should run common instruments, terms and provisions through the revised model and make sure it understands how those instruments would be classified and measured. That analysis should be shared with certain constituents, including the International Accounting Standards Board (IASB), to confirm that key concepts are being interpreted consistently and key differences between the FASB and IASB models are minimized. We believe it would be very helpful to constituents if the Board were to include certain parts of that analysis as implementation guidance in a final standard.

Cash flow characteristics assessment

We believe additional application guidance is needed to make the cash flow characteristics assessment operational and to enable companies to consistently apply it. For example, we're not sure whether, in considering interest rate reset features, an entity would have to evaluate any mismatch between the frequency of the reset and the period of time covered by the reset or only mismatches that introduce leverage through the use of a higher interest rate. The proposal's examples seem to suggest the latter. If the Board intends for any form of mismatch to be evaluated, we believe that the proposal would need to be changed to avoid the potential for common instruments, including certain variable-rate debt, to be measured at FV-NI.

In addition, we believe the Board should clarify how entities should compare instruments with leverage and/or interest rate reset mismatches to financial assets that do not contain the modification (benchmark instrument test). The proposal is silent on whether absolute cash flows, fair value or effective rates of return should be used in that evaluation. We found that those bases yielded significantly different results. If the Board is seeking consistency in application, it should specify the basis for the evaluation.

Further, in considering reasonably possible scenarios, we're not sure whether the current yield curve should be used or whether historical yield curves could be considered. We believe this is important because, in our analysis, the shape of the yield curve was a big driver in determining whether an instrument's cash flows were considered to be more than insignificantly different from the benchmark instrument.

We're also not sure what would constitute a "more than insignificant" difference in cash flows. While we had understood that the test should be more sensitive than today's "double-double" test, it's not clear whether "more than insignificant" means the same thing as "significant." To be sure, we do not expect the Board to provide overly detailed application guidance. We understand that bright-line or percentage tests would be rules-based requirements that could increase complexity and preclude an entity from using its judgment. However, additional application guidance would help make sure that, directionally, we understand which types of instruments the Board would require to be measured at FV-NI.

The proposal is silent on whether probability should be considered when analyzing prepayment and extension options. Assuming the prepayment guidance is to be applied at a "could" level, we believe many purchased credit-impaired loans would be measured at FV-NI. As explained earlier, we don't think the Board intended this result. One way to address this possible unintended consequence would be to provide an exception similar to the one in ASC 815 today. The exception could state that an instrument with a prepayment option wouldn't have to be measured at FV-NI if the option could be exercised only by the issuer and not the investor.

We believe the Board should clarify whether, in evaluating contingent payment features, the nature of the contingent feature has to be related to the credit of the borrower in all cases in order to pass the cash flow characteristics assessment. For example, some instruments require a payment if the borrower does not make timely filings with the US Securities and Exchange Commission (SEC). While that provision could be tied sufficiently to credit risk in some circumstances, a borrower may not file timely with the SEC for a variety of reasons that are not credit related. It's not clear to us whether the possibility of a contingent payment that is not related to the borrower's credit is enough to require the instrument to be measured at FV-NI.

We also don't believe that the proposal is clear on whether interest rates that are reset pursuant to contingent events would have to be evaluated to determine whether they are punitive, and if so, whether they require the instrument to be measured at FV-NI. It doesn't seem appropriate to require an instrument to be measured at FV-NI because a punitive rate or fee may result from a credit-related contingency. The Board may want to consider revising the proposal to include guidance similar to ASC 815's current guidance on credit-sensitive payments.

Business model assessment

We believe the Board should clarify whether the business model assessment should be performed on an instrument-by-instrument basis (similar to today's approach) or at a higher aggregation level (similar to the guidance in IFRS 9). We believe the proposal contains conflicting guidance. On one hand, the proposal notes that the business model assessment should be performed by "the entity's key management personnel on the basis of how the asset will be managed together with other financial assets within a distinct business model," which would imply that the evaluation should be performed at a higher level of aggregation. In addition, proposed ASC 825-10-55-28 seems to suggest that management reporting and compensation should be considered.

On the other hand, the application guidance for the hold-to-collect and sell business model notes that measurement at fair value with changes in fair value recognized in other comprehensive income (FV-OCI) would be appropriate if at initial recognition the entity has not yet determined whether it will hold the individual asset to collect contractual cash flows or sell the asset. This suggests that an instrument-by-instrument approach should be used. We note that IFRS 9 does not provide similar application guidance that would require entities to make such a determination at the individual instrument level.

We also believe the FASB should relax the restrictions for non-credit-related sales from the amortized cost category. IFRS 9 (including the limited amendments proposed in November 2012) would permit a level of infrequent (even if significant) or insignificant (even if frequent) sales from the amortized cost category. Allowing these types of sales from the amortized cost category that are not linked to the credit deterioration of the issuer would provide creditors (e.g., banks) with the flexibility they need to sell loans (e.g., to manage credit concentrations and liquidity needs) without calling into question their ability to measure loans at amortized cost. We believe this change would be consistent with the flexibility creditors currently have to sell loans under US GAAP.

We also encourage the FASB to reconsider whether it would be more appropriate for the FV-OCI measurement category to be the residual category. We're finding that some constituents are confused by a business model that involves both holding and selling financial assets. It might be easier for constituents to apply the business model concept if the two ends of the classification spectrum were well defined (i.e., amortized cost and FV-NI), with FV-OCI as the residual category. In addition, that approach would be consistent with today's guidance in ASC 320.

Other suggested amendments to the proposal

Although we understand the FASB's concerns about comparability, we continue to support the use of the fair value option for certain financial assets and financial liabilities that is currently in ASC 825. We believe the comparability issues highlighted in the proposal are not different from those that existed when the FASB decided to provide entities with the ability to elect the fair value option for most financial assets and financial liabilities.

If the FASB intends to move forward with limiting the fair value option, we believe that certain clarifications are needed to address the effects of eliminating the unconditional fair value option. For example, we believe the held-for-sale criteria for equity method investments are so broad that they could be viewed as requiring investments in entities with stated lives, such as certain partnerships, to be measured at FV-NI, even if the investor has no intention of selling the investment in the near term. We don't believe that the Board intended that result.

We also understand that the proposal would extend the proposed practicability exception for equity investments without readily determinable fair values to equity method investments classified as held for sale. Because many equity method investments do not have readily determinable fair values, companies would be able to account for those investments under the modified cost method and not apply the equity method. It's not clear whether the Board contemplated that result.

We believe that the proposed guidance on nonrecourse liabilities would better link the measurement of those liabilities to the related assets and reduce the potential for accounting mismatches. However, we believe that, given the introduction of this basis of accounting, additional implementation guidance is required. For example, the proposed guidance states that the nonrecourse liability should be measured on the same basis and at the same amount as the related financial assets, but it doesn't address situations where there is overcollateralization, the assets are measured under different bases (e.g., amortized cost, FV-OCI and/or FV-NI) or an entity issuing the liability also holds nonfinancial assets.

These recommendations are more fully discussed in Appendix A to this letter, which provides our detailed responses to selected questions. Appendix B to this letter provides our responses to the questions posed on the proposed amendments to the Codification. Appendix C to this letter provides an example to support our response to Question 17 related to the nonrecourse financial liability guidance being proposed.

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We would be pleased to discuss our comments with the Board or its staff at your convenience.

Very truly yours,

Ernst & Young LLP

Appendix A: Responses to selected questions raised in the Proposed Accounting Standards Update, *Recognition and Measurement of Financial Assets and Financial Liabilities*

Scope

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?

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?

Response:

We generally agree with the scope of the financial instruments included in this proposal, including the industry-specific specialized guidance scope exceptions in proposed ASC 825-10-15-9. However, as the proposal is currently drafted, we believe there are some inadvertent or omitted references to certain financial instrument literature.

ASC 480 does not provide guidance for determining whether an instrument should be classified in stockholders' equity, as suggested in the scope section. The primary guidance for classifying instruments in stockholders' equity is in ASC 815-40 (e.g., forwards and options on an entity's own shares) and ASC 505. It is also unclear whether proposed ASC 825-10-15-8(a) and 8(b) would be applicable to both the investor and issuer.

For example, a literal reading of the proposal could result in a purchased call option on another entity's shares being scoped out by the holder if the option is classified in stockholders' equity by the issuer. We don't believe this was the Board's intent and recommend the following changes to ASC 825-10-15-8(a) and 8(b) in the proposal:

> *a. An instrument held or issued ~~an~~that is classified in its entirety in ~~the entity's~~ stockholders' equity of the reporting entity in accordance with the guidance in ~~Topic 480~~ Subtopic 815-40 and Topic 505.*
>
> *b. An equity component that has been separated from a hybrid instrument and classified in an entity's stockholders' equity in accordance with the guidance in Topic 470 ~~480,~~or another topic that requires separate accounting for the components of a hybrid financial instrument.*

ASC 480 describes three types of instruments that are accounted for as financial liabilities. We understand the Board did not intend to change US GAAP for those instruments. As such, we believe the Board should consider a broad scope exception for instruments in the scope of ASC 480 and remove ASC 825-10-15-8(n) and 8(o) or scope out each instrument in the scope of ASC 480.

We also recommend a more explicit scope exception for instruments accounted for in accordance with ASC 470-20 (refer to Question 21).

We believe the proposal's scope may also create unintended consequences. ASC 815-40, which is applied only to instruments that have not been classified as liabilities in accordance with ASC 480, is used to evaluate whether equity-linked instruments that meet the definition of a derivative under ASC 815-10 are eligible for an exception from derivative accounting (ASC 815-10-15-74(a)). ASC 815-40 is also used to determine whether equity-linked instruments that do not meet the definition of a derivative should be classified in equity or as an asset or liability.

The guidance currently in US GAAP is not clear in all cases on the subsequent measurement of instruments that are required to be classified as an asset or liability in accordance with ASC 815-40. As a result, the proposal's subsequent measurement guidance may change current practice for certain instruments, particularly for financial liabilities. We believe the Board should carefully evaluate the scope for an issuer's own equity-linked contracts that are classified as assets or liabilities before issuing a final standard.

Cash flow characteristics assessment

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?

Question 6:

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

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?

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?

Response:

We believe that clarifications to the proposed cash flow characteristics assessment are needed. We are not sure how certain common features should be analyzed under the proposal. In addition, it appears that the proposal would require too many debt instruments to be measured at FV-NI. We have some recommendations that would slightly expand the notion of solely payments of principal and interest to explicitly provide for features intended to mitigate risk and/or protect the investor in the debt instrument.

Leverage and interest rate reset features

As we explain in our cover letter, we're not sure whether the proposed guidance on considering interest rate reset features would require an evaluation of every mismatch between the frequency of the reset and the period of time covered by the reset to be evaluated or only those mismatches that introduce leverage through the use of a higher interest rate (e.g., an instrument that resets quarterly but always resets to a five-year rate).

The proposal's examples seem to suggest the latter. If any form of mismatch is required to be evaluated, we believe that the proposal would need to be changed to prevent common instruments, including certain variable-rate debt, from being required to be measured at FV-NI.

The proposal would require an entity to determine whether the cash flows of a benchmark instrument without the leverage or mismatch features would be more than insignificantly different from those of the actual instrument. However, the proposal does not specify how to evaluate these differences. As a result, different methods that may yield significantly different results could be used. Possible methods include comparing the following:

- Absolute aggregate cash flows of the actual and benchmark instruments (undiscounted)
- Fair value of the feature giving rise to the difference and the fair value of the entire instrument
- Effective rates of return of the instruments

We believe that comparing the instruments' effective rates of return would be the most appropriate method because it considers the time value of money and avoids the complexity of developing a fair value estimate in accordance with ASC 820.

We also note that it isn't clear whether an entity would look at the contractual life of the instrument or its expected life by considering prepayment options. We believe the test should be based on an instrument's expected life because this would reflect the instrument's expected economics.

In addition, the proposal does not provide guidance on what constitutes more than an insignificant difference in cash flows. It therefore isn't clear whether the Board intends this to mean "significant" or a lower threshold. Although either definition would require entities to apply judgment, we believe the term "more than insignificant" could be too narrowly applied.

We are also not sure how to apply the reasonably possible scenario analysis. Based on our analysis, we found that a key driver of differences between an instrument with a mismatch feature and a benchmark instrument is the shape of the yield curve. Companies therefore could reach significantly different conclusions by using their judgment to determine which yield curve to use (i.e., current or historical) and the number of scenarios to be considered. We believe the Board needs to clarify these points.

Prepayment options

We believe any final guidance should state clearly whether an entity would be able to take into account probability when analyzing prepayment options.

The proposal indicates that a contingent prepayment feature would not be consistent with the solely principal and interest concept unless the future event is to protect the holder against credit deterioration of the issuer, a change in control of the issuer or changes in relevant taxation or law, regardless of the amount of the prepayment. We note that many financial instruments are contingently prepayable upon equity financing or other circumstances that are not identified as permissible events under the proposed guidance and thus would be measured at FV-NI.

We believe the guidance for analyzing prepayment options should be based only on whether prepayment amounts represent principal and interest on the principal amount outstanding and reasonable compensation for the early termination of the contract. We do not believe the nature of the prepayment contingency should affect an instrument's classification and measurement because these events may be challenging to evaluate.

For example, a lender may want to reduce its risk and require repayment when a borrower's sales exceed a certain amount. It's not clear why this type of provision should require the instrument to be measured at FV-NI if the prepayment amount represents principal and interest on the principal amount outstanding and reasonable compensation for the early termination of the contract.

We believe the elimination of this proposed requirement would be consistent with the current guidance in ASC 815, which generally considers contingent prepayment options to be clearly and closely related to the host contract if they can be exercised only by the issuer. Refer to our response to Question 5 on the proposed definition of principal, which may also have unintended consequences when evaluating prepayment options.

Under the proposed guidance, the amount received upon a prepayment would have to substantially represent unpaid amounts of principal and interest on the principal amount outstanding and could include reasonable additional compensation, in order to be consistent with the solely principal and interest concept. It's unclear to us what the Board considers to be "reasonable additional compensation."

For example, commercial loans may have prepayment penalty features such as yield maintenance clauses that are designed to protect lenders from prepayment by a borrower. If prepayment is required to be considered without regard to probability, these types of features could cause the instrument to fail the cash flow characteristics assessment because the return may not be commensurate with the principal amount outstanding. This financial reporting result does not seem appropriate. The Board should provide an example and clearer guidance on how the term "reasonable additional compensation" should be interpreted.

Contingent features

A contingent payment feature would be consistent with the solely principal and interest concept if (1) the nature of the contingency is to maintain an appropriate rate of return on the instrument that represents compensation for the time value of money and credit risk and (2) the contingent feature results in cash flows that are solely payments of principal and interest on the principal amount outstanding (ASC 825-10-55-25). As such, it appears that both the nature of the contingency and the amount of the potential payment would be required to be considered.

Many debt instruments have features that can trigger additional payments. Although these features are often not clearly and closely related to the host, their fair value is typically de minimis. An example is a payment for failure to file timely with the SEC. It's not clear to us whether such a provision would require the entire instrument to be measured at FV-NI because the payment could be triggered by an event that is not credit related or whether the provision is consistent with the solely principal and interest concept because there are circumstances in which the lack of a timely filing may correlate to a decline in the issuer's credit rating.

In addition, ASC 825-10-55-25 would appear to indicate that a contingent feature that could cause an interest rate to be reset to a "punitive" rate would not be consistent with the solely payment of principal and interest concept because the resulting payments would not be considered compensation for the time value of money and credit risk, even if the nature of the contingency is credit related. It's not clear to us how a company would determine what constitutes a punitive rate of return.

The proposal would introduce complexity as compared to current US GAAP because credit-sensitive payments are assumed to be clearly and closely related to the host instrument under ASC 815. The Board should consider carrying forward this provision.

We also note that there are other common debt instruments such as auction rate securities that have long-term maturity dates, but their interest rate resets more frequently based on the outcome of an auction. If an auction fails (i.e., there are insufficient buyers of the bond to establish a new rate), the rate resets to a penalty rate. It is not clear whether the penalty rate could be considered compensation to the holder for credit risk or lack of liquidity for the instrument following the auction failure or whether the rate would be viewed as punitive. We believe the Board should provide further application guidance.

Specific instruments

<u>Nonrecourse financial assets</u>

Unlike IFRS 9, the proposed guidance does not address the accounting for nonrecourse financial assets. We believe that the guidance for nonrecourse financial assets should state that the collateral's value should not be considered in the cash flow characteristics assessment if, upon initial recognition, an entity expects to receive cash flows from the financial asset and not to obtain the underlying collateral. We believe the Board should make this point clear in any final standard.

Dual currency bonds

The proposed guidance notes that the assessment of whether contractual cash flows are solely principal and interest would be based on the principal amount outstanding in the currency in which the financial asset is denominated.

It's unclear whether all dual currency debt instruments (e.g., principal denominated in one currency, interest payable in another) would automatically fail the cash flow characteristics assessment or an entity could consider the correlation between the currencies (because exchange rates are affected by differences in interest rates) to assess whether the modifying feature results in more than an insignificant difference in cash flows when compared to a benchmark instrument.

It's also unclear whether a dual currency bond could be viewed as the combination of a zero-coupon bond denominated in one currency and a stream of fixed payments denominated in another currency. If these elements are analyzed separately (by analogy to the Instrument C discussion in ASC 825-10-55-52 and 55-53 in the proposal), the instrument may meet the cash flow characteristics assessment. We believe this point should be clarified.

Perpetual instruments

Instrument G, as described in ASC 825-10-55-60 through 55-63 in the proposal, seems to suggest that perpetual instruments would pass the cash flow characteristics assessment as long as interest continues to be accrued on all overdue amounts, including interest. That is, the proposal seems to suggest that payment of principal is not specifically required. What's unclear is whether this guidance is meant as an exception to the general rule or there is an underlying principle that can be applied when evaluating other instruments under the cash flow characteristics assessment.

We are also unsure whether issuers should consider this guidance when evaluating whether the instrument should be classified as debt or equity on the issuer's balance sheet. Given that our understanding is that the Board did not intend to change the issuer's accounting, we don't believe that the proposal would require issuers to classify perpetual instruments as liabilities. Because perpetual preferred stock instruments may have other features that need to be evaluated against a host contract, the Board should make clear that the investor's accounting should not necessarily affect the issuer's conclusion on the nature of the host instrument.

Reconsideration of the cash flow characteristics assessment for financial instruments that are modified after origination or acquisition

The proposal states that a financial asset's classification should be determined at inception and implies it should generally not be reconsidered. It appears to us that if a feature is later added that does not create a new unit of account (i.e., a modification rather than an extinguishment) for the entire instrument, that feature should not be considered in evaluating the solely principal and interest criteria. We believe this point should be clarified.

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?

Response:

We believe that if the proposed definition of "principal" is retained, some instruments would be inappropriately measured at FV-NI. For example, purchased credit-impaired loans that are prepayable at par by the issuer could result in the investor receiving an amount that is more than outstanding principal and interest plus reasonable additional compensation. This would require the instrument to be measured at FV-NI. Other common instruments such as callable zero coupon bonds and prepayable principal-only strips would also be required to be measured at FV-NI.

We don't believe the Board intended for purchased credit-impaired loans to be classified at FV-NI, given that it recently proposed changes to account for impairments of purchased credit-impaired loans that would retain an accrual-based approach. One way to address this issue is to state clearly in the classification and measurement guidance that a prepayment option whose exercise is in control of only the issuer should not affect the investor's accounting. This would be similar to the existing guidance in ASC 815. We also believe that an instrument that could be contractually prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment should not pass the cash flow characteristics assessment.

We believe that changing the definition of principal to the contractual settlement amount (e.g., the instrument's par value) would also address this concern, but may lead to other unintended consequences that would need to be thought through more fully.

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?

Response:

We generally agree with the proposed requirement for an entity to look through to the underlying pool of instruments to determine whether the beneficial interest tranche contains payments of solely principal and interest, but we believe the test should be more qualitative in nature. We believe the Board should provide additional guidance on the level of detail an entity would need to evaluate about the underlying instruments (e.g., offering memorandum rather than the individual loans) to credibly assert that the underlying instruments have cash flows that are solely principal and interest. We do not believe it would be reasonable for each investor to scour each of the securitization entity's loans to identify any features that are not consistent with the solely principal and interest concept.

The proposal would require beneficial interests that have exposure to credit risk that is greater than the exposure to credit risk of the underlying pool of instruments to be carried at FV-NI; however, it's not clear why this credit distinction would apply only to beneficial interests and not to other financial assets. We note that subordinated debt or junior lien loans are economically similar to lower tranches of securitized financial assets because they provide credit protection for the senior holders, yet these assets would not fail the cash flow characteristics assessment based on that fact alone.

We also believe that the proposed guidance to determine whether a tranche's credit risk is equal to or lower than the underlying pool of financial instruments would be challenging to apply, especially for more complex structures. The proposal doesn't include any application guidance to make this assessment. An entity may have to perform a detailed assessment, including potentially developing various credit-loss scenarios for the underlying pool of financial instruments. If the Board intends to keep this guidance, we believe application guidance is needed on how the evaluation should be performed.

We also note that the proposed guidance in ASC 825-10-55-26(a) states that a tranche would meet the solely payments of principal and interest criteria if the only thing preventing the tranche from meeting the criteria is a prepayment occurring in the underlying pool. This guidance appears to contradict the guidance for prepayment options in ASC 825-10-55-21 and might allow a AAA-rated interest-only strip to pass the cash flow characteristics assessment if one can ignore the prepayment in the underlying pool, which we don't believe was the Board's intent. The Board should clarify this point.

Business model assessment

Question 10:

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

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?

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?

Response:

We believe that financial assets that pass the cash flow characteristics assessment should be classified and measured based on how the asset is managed together with other assets within a distinct business model. We agree that how an entity manages its financial instruments affects the entity's future cash flows and should be linked to the measurement. We also support the Board's efforts to converge the business model criterion in the proposal with the guidance in IFRS 9 (including the limited amendments proposed in November 2012). However, we are concerned that differences between the application guidance in US GAAP and the guidance in IFRS could result in different outcomes for the same fact patterns.

Hold-to-collect business model

Assets held in a business model to collect contractual cash flows would be subsequently measured at amortized cost under both the FASB and IASB models. However, the FASB's application guidance clearly indicates that subsequent sales of financial assets classified in the amortized cost category for reasons other than a significant deterioration in the issuer's creditworthiness should be very infrequent. Permitted sales could also be because of circumstances that are described in ASC 320-10-25-6.

Like the FASB proposal, IFRS 9 (including the limited amendments proposed in November 2012) permits sales out of the amortized cost category when the credit quality of the financial asset has deteriorated. However, IFRS 9 notes that sales that occur for other non-credit reasons may also be consistent with a business model whose objective is to hold financial assets to collect contractual cash flows if such sales are infrequent (even if significant) or insignificant both individually and in the aggregate (even if frequent).

We encourage the Board to consider more closely aligning its application guidance for the hold-to-collect business model with the application guidance in IFRS 9 (including the limited amendments proposed in November 2012). We believe that the FASB proposal, as written, is too restrictive and would unnecessarily require too many debt instruments (e.g., loans) to be measured at fair value. Allowing for a level of infrequent (even if significant) or insignificant (even if frequent) sales from the amortized cost category that are not linked to the credit deterioration of the issuer would give creditors (e.g., banks) the flexibility to sell loans after recognition without affecting their ability to classify and measure future loans at amortized cost. We think this approach would better align the guidance with the way creditors manage their loans, selling some at times for business or regulatory reasons.

If the proposal is not amended, creditors would have less flexibility than they do today to sell loans from the amortized cost category, and more instruments would be measured at fair value. We understand that broadening the sales criteria could also result in more debt securities being held at amortized cost than we have today. However, we believe it is important to amend the guidance in this area to make it more operational for preparers and more meaningful for the users of financial statements.

If the Board decides not to pursue a more converged solution, we suggest that it consider changing the objective of the hold-to-collect business model to make it similar to the guidance in current US GAAP for loans held for investment. That is, we recommend not requiring an entity to assert at recognition that it expects to hold the asset solely to collect contractual cash flows. Instead, we suggest that entities should be able to classify their financial assets in the amortized cost category if they can assert that they have the intent and ability to hold the assets for the foreseeable future or until maturity or payoff.

Under this approach, entities would not have to distinguish between assets they expect to hold until maturity or payoff and assets they expect to hold for the foreseeable future. We also recommend that, when an entity changes its intention, it should be required to make appropriate disclosures and re-measure the financial asset to the lower of cost or fair value.

If the Board were to relax the restrictive sales guidance for the hold-to-collect business model, we believe an explicit tainting notion would not be necessary. A tainting provision would increase complexity and would contradict the objectives of determining the business model by evaluating the frequency and volume of sales in prior periods, why sales have occurred in the past and expectations about future sales activity.

Hold-to-collect and sell business model

The proposal is clear that the business model assessment should be performed by the entity's key management personnel on the basis of how the asset will be managed together with other financial assets within a distinct business model (i.e., at a higher level of aggregation). The proposal is unclear, however, on whether an individual instrument assessment (i.e., to hold or sell) should be performed before the business model assessment.

We believe the Board should clarify whether it intends to carry forward today's instrument-by-instrument approach to classifying financial assets. If not, the Board should eliminate the application guidance in ASC 825-10-55-35 in the proposal that would require entities to make the determination at the individual instrument level.

Fair value through net income as the residual category

We encourage the Board to reconsider whether it would be more appropriate to designate the FV-OCI measurement category as the residual category (consistent with current US GAAP in ASC 320) rather than the FV-NI measurement category, as proposed. We believe it might be easier for constituents to apply the business model concept if the two ends of the classification spectrum were well defined (i.e., amortized cost and FV-NI), with the middle category (i.e., FV-OCI) being the residual.

Defining a business model that involves both holding and selling financial assets would raise a number of interpretation issues and potential divergence in application. Instead, the Board should consider clearly defining the types of business activities that would meet the objectives of an FV-NI business model (e.g., acquiring financial assets for the sole purpose of selling them). Indeed, the proposed consequential amendments include a definition of trading activities that may be helpful.

Other considerations

We believe that the proposed recognition guidance on pools of similar financial assets would be difficult to apply because there is no additional guidance on subsequent accounting (e.g., sales of individual assets) for pools allocated by percentage to the various business models. We believe that this guidance could be used by an entity to "cherry pick" the instruments to be subsequently identified for sale, and those assertions would be difficult to audit.

Entities commonly originate loans with the intention of selling part of the loan (and achieving sale accounting under ASC 860) to manage their credit risk. It is not clear whether the entity could look at the loan as two different units of account (i.e., the percentage of the loan that it intends to keep and the percentage that it intends to sell). We believe this point should be clarified in any final guidance; otherwise, loans with participating interests would likely be measured in their entirety at FV-NI, which we don't believe is appropriate.

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?

Response:

We generally believe that the proposed model for amortized cost assets that are subsequently identified for sale is appropriate. We note, however, that financial assets classified at FV-OCI that are subsequently identified for sale would be accounted for differently under the proposal. That is, an entity would record any declines in fair value below the FV-OCI asset's net carrying amount in OCI rather than in net income. We believe the FASB should clarify that write-downs through earnings are not required when an entity decides to subsequently sell a loan measured at FV-OCI whose fair value is less than its net carrying value.

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?

Response:

We agree with the Board's decision to require reclassification of financial assets when an entity's business model changes. However, we believe further clarification is needed. The proposed guidance indicates that the decision must be made by the entity's senior management. We believe this would mean a broader group and not the consolidated group's chief operating decision maker. If that is not the Board's intent, it should clarify this point.

The proposal also indicates that reclassification of financial assets would be permitted only if, among other things, the change in business model is demonstrable to external parties. It's unclear how a reporting enterprise that does not have separate external reporting responsibilities would meet the "demonstrable to external parties" criterion. It's also not clear for public companies how external parties would necessarily know whether there has been a change in the business model. We think part of the confusion here is because proposed ASC 825-10-35-22 uses the term "entity," and many reporting enterprises are comprised of various entities, each of which could have a different business model. To avoid confusion, we believe the Board should define what is considered an "entity" for purposes of applying the proposed guidance.

Loan commitments

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?

Response:

If the Board follows our recommendations to change the cash flow characteristics and business model assessments, we generally would agree with the proposed classification of loan commitments. Our primary concern is that the proposal, as written, would result in too many loan commitments, including those involving revolving lines of credit, being measured at fair value.

Initial measurement

Question 14:

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

Response:

We generally agree with the initial measurement principles outlined in the proposal. However, we believe the treatment of transaction fees and transaction costs related to financial assets and financial liabilities initially measured at FV-NI should be clarified. That is, ASC 825-10-30-3 in the proposal states that transaction fees and transaction costs would be included in net income. Given that the definition of transaction costs refers to the costs to sell an asset (or transfer a liability), this guidance could be read to imply that transaction costs associated with the future sale of a financial asset (or transfer of the financial liability) would need to be recognized in net income at initial recognition.

We do not believe this is what the Board intended. Instead, we believe the FASB intended that transaction costs and fees be recognized as expenses in net income when incurred. If our understanding is correct, we believe this distinction should be made clear.

We have several questions about the proposed initial measurement guidance when the transaction price includes consideration for something other than the financial instrument issued. First, it isn't clear whether both parties to the transaction must record the financial instrument at fair value when, for example, credit is extended in a structured transaction at a below-market interest rate.

The guidance suggests that if the creditor cannot identify another asset, the difference between the fair value of the loan and its par amount should be expensed. It is unclear to us whether the debtor would be required to similarly recognize a gain by initially measuring the debt at fair value.

Furthermore, the "other components" guidance appears to contemplate only a situation in which the consideration paid is for a single financial instrument and another component. It's not clear how the transaction price would be allocated upon initial measurement when multiple financial instruments are issued that are required to be measured at fair value (e.g., pro rata allocation of fair values).

Proposed ASC 825-10-55-41 seems to indicate that long-term loans and receivables that carry a stated interest rate of zero would always be required to be initially measured at FV-NI. This seems inconsistent with BC155, which indicates that the receivable would not need to be initially measured at fair value if the instrument was offered to a broad population of borrowers rather than a specific borrower. The Board should clarify this point.

Fair value option

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?

Response:

Group of financial assets and financial liabilities

We believe the Board should clarify what constitutes a group of financial assets and financial liabilities that would be eligible for the fair value option. For example, an entity may want to avoid the complexity of fair value hedge accounting by electing the fair value option by grouping its interest rate swap derivatives with its liabilities (i.e., own debt). However, since the proposal doesn't define what constitutes a "group," it's not clear whether an entity could elect the fair value option for its own debt that is hedged by a single derivative, in order to avoid hedge accounting.

We also believe that the proposed guidance that would allow entities to elect the fair value option for a group of financial assets and financial liabilities managed on a fair value basis could be interpreted too broadly. This guidance, coupled with the guidance in the proposed ASU, *Accounting for the Difference between the Fair Value of the Assets and the Fair Value of the Liabilities of a Consolidated Collateralized Financing Entity*, could be interpreted to indicate the Board is seeking to expand use of the measurement exception (sometimes referred to as the portfolio approach) in ASC 820.

It is our understanding that the measurement exception described in ASU 2011-04 was designed primarily to allow entities to continue existing valuation practices for determining derivative valuation adjustments for credit risk and bid-ask spreads on a net basis. However, the proposed guidance could be read to permit the measurement exception to be used much more broadly, potentially resulting in significant changes in practice.

As a simple example, it's not clear whether a financial institution would be able to assert that because it manages its group of loans and deposits on a fair value basis, it would be able to measure the fair value of its net exposure (i.e., net interest spread) using the measurement exception rather than measuring the fair values of the loans and deposits separately. As such, we believe the Board should clarify its views about the scope of the measurement exception (i.e., broad or narrow use).

Hybrid financial liabilities

We believe the terms "significantly modify" and "little to no analysis" in ASC 825-30-15-3(a) and 3(b) in the proposal are ambiguous and don't clearly describe the limited conditions where the fair value option is prohibited from being elected for hybrid financial liabilities. In addition, we don't understand why a "similar hybrid" would be considered rather than the actual instrument when performing the evaluation required by ASC 825-30-15-3(b). These points should be clarified.

Financial liabilities

Question 16:

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

Response:

We agree that most liabilities should be subsequently measured at amortized cost because financial liabilities are generally not transferred to another entity in the market but are settled with the creditor.

We also agree that fair value is the most relevant measurement attribute for financial liabilities that result from short sales or that are incurred by an entity whose business strategy is to subsequently transact at fair value. However, proposed ASC 825-10-35-10(a) notes that an entity should subsequently measure its financial liabilities at FV-NI if the entity's business strategy when it incurs the liability is to subsequently transact at fair value.

We understand that certain entities (e.g., broker-dealers in securities) that issue publicly traded debt may subsequently transact at fair value as part of their market-making activities. However, the business strategy of these entities may not have been to subsequently reacquire the debt at fair value. We recommend that the Board clarify this point.

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?

Response:

We believe the nonrecourse financial liability guidance would be helpful in addressing the mismatches between the values of assets and liabilities. In addition, we believe that, if our understanding of how the guidance should be applied is correct, it will be easier to apply in practice than the FASB's proposed amendments to Topic 810, *Accounting for the Difference between the Fair Value of the Assets and the Fair Value of the Liabilities of a Consolidated Collateralized Financing Entity*.

That being said, we believe additional clarification and implementation guidance is necessary. For example, the proposed guidance in ASC 825-10-35-11(b) indicates that the nonrecourse financial liability should be measured at the same amount as the related financial assets. We do not believe this would always be the case given overcollateralization and other factors associated with the way many variable interest entities (VIEs) are structured. Please refer to Appendix C for an example that illustrates this point.

In addition, while the proposal notes that nonrecourse financial liabilities that require settlement from cash flows associated with both financial and nonfinancial assets would not apply the proposed guidance in ASC 825-10-35-11, it is not clear whether the Board intended this to include situations in which nonfinancial assets may be held temporarily (e.g., as a result of a default associated with a financial asset). We believe that temporary holdings should not disqualify an entity from using the nonrecourse financial liability guidance.

Finally, we note that the guidance does not address situations in which the financial assets whose cash flows will be used to settle the nonrecourse liability have different measurement objectives (e.g., a consolidated entity holds assets that are measured under each of the three measurement attributes).

Hybrid instruments

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?

Response:

We believe that the elimination of the bifurcation requirement for hybrid financial assets would simplify the accounting in this area. However, as described previously, we are concerned that the criteria for evaluating changes to the amount and/or timing of cash flows would require too many instruments to be measured at FV-NI in their entirety. We would support not bifurcating embedded derivatives from hybrid financial assets if our concerns are addressed by the Board.

We understand the Board generally did not intend to change the accounting for hybrid financial liabilities. In addition, we understand that the Board provided an exception to the subsequent measurement guidance described in ASC 825-10-35-10 for a financial liability host contract accounted for in accordance with ASC 470-20, which includes instruments subject to the cash conversion and beneficial conversion feature guidance. If that is the case, we believe the guidance in ASC 825-10-25-27 should be made clearer because ASC 470-20 provides subsequent measurement guidance for both the equity and liability components of a hybrid financial liability. Therefore, any instrument subject to ASC 470-20 should be explicitly scoped out of the proposal. We therefore recommend the following changes be proposed to ASC 825-10-25-27:

> *For a hybrid instrument that is a financial liability, an entity shall first apply the guidance in Subtopic 815-15, Topic 470 and Topic 480. ~~on whether to separate the hybrid instrument into its derivative and nonderivative components.~~ To the extent the host instrument or instrument that is recognized in its entirety as a financial liability is not subject to subsequent measurement guidance in ASC 470 or ASC 480 an entity shall then measure the financial liability host contract or the instrument that is recognized in its entirety as a financial liability in accordance with the guidance in paragraph 825-10-35-10~~, absent specialized guidance in Subtopic 470-20~~.*

We also note that the Board has retained the existing guidance on indexed debt (ASC 470-10-25-3 through 25-4 and 35-4), increasing rate debt (ASC 470-10-35-1 through 35-2) and participating mortgage loans (ASC 470-30). However, it is not clear to us how those models would be incorporated into the proposal for the purpose of applying the proposed model to hybrid financial liabilities (825-10-25-27 and 825-10-35-10).

For example, if an indexing feature were not required to be bifurcated from a debt host pursuant to ASC 815, the proposed model could be read to require that the host be subsequently measured at amortized cost pursuant to ASC 825-10-35-10. We recommend that any final guidance make clear that the initial and subsequent measurement models in ASC 470 described previously should continue to be applied as part of an amortized cost measurement for those instruments.

Equity and equity method investments

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?

Response:

We support the proposed practicability exception for equity investments without readily determinable fair values. However, while we understand the concept of adjusting the measurement when observable price information from orderly transactions is available, we believe the Board should clarify what constitutes a similar investment of the same issuer.

For example, for an entity that holds common shares of a private company, the issuance of preferred shares by that private company could be viewed as a similar investment of the same issuer that provides observable price information. However, given the differences between the rights and features of the preferred shares and those of the common shares, determining the fair value of the common shares using the observable price of the preferred shares may require the use of complex valuation techniques, limiting the relief provided by the practicability exception.

In addition, we note that the proposal would amend the definition of readily determinable fair value to exclude stock with a restriction that terminates within one year (if the unrestricted shares are quoted on a registered securities exchange, NASDAQ or Pink Sheets LLC). However, the proposal would appear to require companies that elect the practicability exception to adjust the value of the equity investment for changes in the observable price of similar investments by the same issuer when the otherwise identical unrestricted shares trade in a public market. If our understanding is correct, we believe that the Board should clarify how restrictions should be considered when the practicability exception is elected and there are observable prices of similar investments by the same issuer.

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?

Response:

Application of the "held for sale" indicators

We believe the Board should retain today's fair value option for equity method investments. We believe that some users of financial statements may prefer that investments that are quoted in an active market (i.e., Level 1) be measured at fair value, even when the investor has the ability to exercise significant influence over the investment.

If the Board decides to eliminate the fair value option for equity method investments and retain the held-for-sale concept, the proposed held-for-sale indicators should be clarified. For example, because nearly every investment has a potential exit strategy when acquired, the indicators could be read to require equity method investments to be classified as held for sale even when management does not intend to sell them in the near future. In addition, because an investor would not be required to exit the investment within a limited period of time, the exit date indicator could be interpreted broadly to permit investments to be sold over long periods of time (e.g., 40 years).

Therefore, even if an investor did not purchase the investment with an intention to sell it, an equity method investment could be classified as held for sale because the investor might sell it at a future date. In addition, the indicators could be read to require that equity method investments in limited-life entities be classified as held for sale because investors have a potential exit strategy with a defined time (liquidation at the end of an entity's life). We don't believe this was the Board's intent. The indicators could also imply that any puts or calls associated with an investment would cause the equity method investment to be considered held for sale.

For the held-for-sale indicators to be operational, we suggest that they be consistent with the held-for-sale criteria in ASC 360-10-45. The term "held for sale" is already established in US GAAP and understood by preparers and users. Using ASC 360's criteria would promote greater consistency across accounting topics. In addition, we believe the Board should consider how the held-for-sale criteria proposed for ASC 323 would align with the proposed ASU, *Reporting Discontinued Operations*, with regard to equity method investments.

Initial and subsequent classification

We do not believe the assessment of whether an equity method investment is held for sale should be made only upon initial qualification for equity method accounting. We believe that a reassessment should be required when circumstances and/or management's intent change, consistent with the guidance in ASC 360. While assessing the held-for-sale criteria only upon initial qualification for the equity method would align with the initial recognition principles for other financial instruments, it would be inconsistent with the model used for consolidated subsidiaries and asset groups. The equity method of accounting is generally viewed as a form of one-line consolidation, and its principles are generally more consistent with the accounting for consolidated subsidiaries than with the accounting for financial instruments. Therefore, we believe the assessment of whether an investment is held for sale should follow the approach used for consolidated subsidiaries, and not the proposed guidance.

Practicability exception

We understand that if an equity method investment is held for sale, the practicability exception could be applied, allowing equity method investments to be measured at modified cost if the investment does not have a readily determinable fair value. Because the held-for-sale criteria are so broad and many equity method investments are not in public companies, it would appear that companies would be able to avoid applying the equity method. It's not clear whether the Board intended that result. Therefore, that point should be clarified. As drafted, the amendments to ASC 323 will further decrease comparability, because investments over which the investor has the ability to exercise significant influence could be measured based on (1) the equity method, (2) FV-NI or (3) modified cost.

Unit of account

The Board should clarify the unit of account for equity method investments in the final standard and should consider how the guidance would be applied in common fact patterns. For example, the Board should clarify whether the entire equity method investment would be considered held for sale if a partial sale is anticipated (e.g., an investor holds 40% and intends to sell 15% and retain a 25% stake that would allow it to maintain significant influence). Similarly, the Board should clarify the accounting for step acquisitions of an investment held for sale (e.g., an investor holds 25% classified as held for sale and acquires an additional 10% interest). It is not clear from the proposal whether the additional acquired interest would maintain the same classification or the investment would be reassessed.

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?

Response:

We agree that there should be a one-step equity impairment model, but we believe the proposed indicators should be consistent with ASC 350-30-35-18B. It may be confusing for preparers and users to have multiple sets of impairment indicators within US GAAP for different types of investments. The guidance in ASC 350 was recently deliberated, and we believe it is working well in practice. The final guidance also should make clear that the list of indicators is not all inclusive, as has been done in other final standards.

If the standard is amended as proposed, we would expect impairments to become more frequent for equity method investments because an investor would no longer be able to consider its intent and ability to hold an investment until any temporary impairment is recovered. ASC 323 currently lacks any specific guidance or examples on how to record the impairment charge, and how to apply the effect of the impairment to the investor's basis differences. As a result, there is diversity in practice. To address the expected increase in the number of equity method investment impairments and to reduce diversity in practice, we suggest that additional implementation guidance be added to ASC 323.

We believe that the final standard also should clarify how to calculate the amount of the impairment charge. We suggest that wording similar to proposed ASC 825-10-35-19 be included in ASC 323. Further, we think that the Board should address the classification of an impairment charge in the income statement (i.e., the same or different line within equity method earnings).

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?

Response:

We support retaining the portfolio-wide option for not-for-profit entities to account for their equity method investments at fair value. In many cases, due to legal or donor-related restrictions, not-for-profit entities are required to make operating decisions based on the fair value or rate of return of their investment portfolios. For example, a not-for-profit entity may have a spending policy based on a percentage of the fair value of the investment portfolio that limits program-related expenditures. We believe it is more transparent to allow not-for-profit entities to measure and report these investments using the same criteria they use to make operating decisions (i.e., fair value).

In contrast, we do not believe it is necessary to extend this option to not-for-profit health care entities. These entities are generally business oriented, so under current guidance their financial statements are largely comparable to those of their for-profit peers. We believe that continues to be a reasonable objective for not-for-profit health care financial reporting.

Deferred tax assets

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?

Response:

We do not support the use of a separate model for assessing the realizability of deferred tax assets (DTAs) related to financial instruments that are measure at FV-OCI, unless the Board addresses the following key operational issues:

- Lack of guidance on what the separate model is and how it is to be applied
- Scope of application of the separate model

Lack of guidance

The proposed guidance in ASC 825-10-35-16, on its own, is not operational. This guidance directs constituents to ASC 740 for guidance on accounting for income taxes. However, ASC 740 does not contemplate a separate model for assessing the realizability of DTAs and thus provides no further guidance. While the discussion in the proposal's Basis for Conclusions (e.g., BC240 and BC 242) provides some clarity, we believe the final standard (or ASC 740 as part of a consequential amendment) should provide guidance with respect to the "separate" evaluation. For example, the guidance should state that the entity's intent and ability to hold the related financial instrument until recovery of unrealized losses that have been recognized in OCI could be considered sufficient positive evidence regarding the realizability of these DTAs.

Implementation guidance also should be provided to improve consistency in application. For example, the Board should clarify whether the separate evaluation of DTAs should be on (1) a gross basis without consideration of deferred tax liabilities (DTLs) related to financial instruments measured at FV-OCI or (2) a net basis after consideration of DTLs related to financial instruments measured at FV-OCI. We believe that the DTAs should be evaluated net of the DTLs related to financial instruments measured at FV-OCI and any net DTA should be subject to the separate evaluation of the need for a valuation allowance.

Further, it's not clear whether an entity in a net DTL position related only to financial instruments measured at FV-OCI should consider that net DTL as a source of income when evaluating other DTAs outside of OCI. We believe any net DTLs could be considered a source of income for other DTAs of the entity.

Scope

The proposed guidance in ASC 825-10-35-16 refers to "unrealized losses on a financial instrument classified in the fair value through other comprehensive income category." In addition to investments in debt instruments measured at FV-OCI, financial instruments classified in FV-OCI also would include (1) nonrecourse financial liabilities and the associated financial assets that are measured at FV-OCI and (2) the amount presented in OCI related to the change in the instrument-specific credit risk when the conditional fair value option is applied to a financial liability. We do not believe a separate model for assessing the realizability of a DTA should be created for these items.

Finally, the prohibition on backwards tracing continues to result in illogical accounting. We believe it is counterintuitive to record the tax effects of transactions in OCI but to record a change in those related tax effects (e.g., change in tax law, change in valuation allowance) as a component of income from continuing operations. While we recognize that this is beyond the scope of this proposal, we continue to believe that the general prohibition against backwards tracing, coupled with the inconsistency with which comprehensive income is used in the present accounting framework, further highlights why this prohibition should be revisited.

While the proposed guidance would, in certain circumstances, alleviate this illogical accounting, it is unclear how narrowly the Board intends to apply this proposed approach. For example, would the Board object to entities separately evaluating other items that are recorded in OCI that could be expected to reverse over time? If the Board intends for this guidance to be applied narrowly, the final standard should explicitly prohibit analogizing to this guidance.

Foreign currency gains or loss on foreign-currency-denominated debt instruments measured at FV-OCI

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?

Response:

To promote convergence, we would not take exception to the proposed amendment that would require an entity to separately recognize in net income changes in fair value attributable to foreign currency gains or losses on foreign-currency-denominated debt instruments measured at FV-OCI. However, we're not aware of any significant practice issues or concerns of financial statement users that warrant a change in this area.

Transition and effective date

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?

Question 31:

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

Question 32:

How much time is needed to implement the proposed guidance?

Question 33:

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

Response:

We support the Board's proposal to allow entities 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.

We believe additional transition guidance is needed. The proposal doesn't provide any specific transition guidance on the accounting for items where there would be a change to current US GAAP upon the adoption of the proposal such as held-for-sale equity method investments, nonrecourse financial liabilities, and the more limited use of the fair value option, among others.

We believe that constituents would need a relatively long period of time to implement the proposal. Constituents would need to individually review their contracts for provisions that could modify the amount or timing of cash flows and separately analyze those features. That would not be an easy undertaking. We strongly encourage the Board to carefully consider the feedback from preparers before finalizing an effective date for both public and nonpublic entities. The Board should use field testing to make sure transition issues and concerns are identified and fully deliberated before issuing a final standard.

Appendix B: Responses to questions on the proposed consequential amendments in the Proposed Accounting Standards Update, *Proposed Amendments to the FASB Accounting Standards Codification*

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?

Response:

We generally support the proposed consequential amendments to the Codification, but we recommend the following changes be made to avoid unintended consequences:

Glossary

- The Glossary would provide a new definition of amortized cost, but it is unclear whether this definition would apply to both investors and issuers. Applying the new definition to an issuer could change current practice. For example, item "d" suggests that amortized cost includes adjustments for debt instruments accounted for in a fair value hedge relationship. Under current US GAAP, an issuer's adjustments to the carrying amount of liabilities from fair value hedges do not require amortization until the hedge is terminated. It is not clear whether the proposed definition is intended to require amortization during the life of the instrument while a hedge is still in place. The Board should clarify this point in its final standard.

- The proposed amendments define a "debt instrument" by focusing on its terms rather than its legal form. Certain preferred share instruments such as fixed-rate perpetual preferred shares and convertible preferred shares with a mandatory redemption date are accounted for as equity instruments today (from an issuer's perspective) based on their legal form, but may meet the proposed definition of a debt instrument under the proposal. We recommend that the Board clarify whether these instruments should be considered debt instruments from both an investor and issuer perspective. It's also unclear whether puttable or redeemable preferred stock should be classified as debt or equity instruments from an investor's perspective. This should also be clarified.

- The proposal defines a hybrid instrument as a contract that embodies an embedded derivative and a host contract. We believe the Glossary should also define hybrid financial assets, hybrid nonfinancial assets, hybrid financial liabilities and hybrid nonfinancial liabilities because guidance is being proposed both in ASC 825 and ASC 815 for these types of instruments.

Topic 310

- ASC 310-10 provides guidance on acquisition, development and construction arrangements that are considered loans, but the Board has not proposed amending this guidance or providing a scope exception for these financial instruments in ASC 825-10-15. Further, it's not clear whether these instruments would be able to pass the cash flow characteristics assessment. We recommend that the Board clarify the accounting for these arrangements.

- ASC 310-10-30-7 states that loans purchased under standby commitments should be recognized at cost on the settlement date. We believe this guidance should be updated so it does not conflict with the guidance in the proposal.

Topic 320

- The proposed amendments would supersede the interest income recognition guidance for structured notes in ASC 320-10. Although we believe most, if not all, of these instruments would be measured at FV-NI under the proposal, some entities would still be required to separately report interest income for these instruments. It's not clear which model they would use if this guidance were eliminated.

Topic 323

- Example 4 of ASC 323-10-55 provides guidance that is widely used in practice to determine how to apply equity method losses to other investments in the investee. We believe that this example was deleted from the proposed amendments to ASC 323-10-55 because it uses preferred stock classified as an available-for-sale security to demonstrate the guidance and this stock would be measured as FV-NI under the proposal. We believe the example would still be relevant for loans and debt securities classified as amortized cost or FV-OCI. We recommend that the Board retain the example and update it appropriately for any final guidance issued.

Topic 340

- The proposed amendments would supersede guidance on insurance contracts that do not transfer insurance risk (ASC 340-30). We do not believe this Subtopic should be superseded because the guidance is consistent with the model in the proposal (i.e., financial liabilities measured at amortized cost) and would provide useful guidance to insurers.

Topic 470

- The Board proposed retaining the fair value option prohibition in ASC 470-20-25-21 for instruments that are in whole, or in part, classified by the issuer as a component of shareholders' equity (including temporary equity), but we note that the scope exception that was previously noted in ASC 825-10-15-5(f) was removed in the proposal. We recommend adding the above referenced prohibition to the scope section of ASC 825-30 to prevent an issuer from inadvertently electing the fair value option if it looks only at ASC 825-30 to determine eligibility.

Topic 740

- The citation of ASC 825-10-35-16 should be more prominent in ASC 740. As proposed, it would be referenced in ASC 740-10-45, but this section deals only with presentation. We recommend adding a reference to ASC 825-10 in ASC 740-10-30, where subsequent measurement is discussed, or a paragraph in the relationship section in ASC 740-10.

Topic 815

- ASC 815-10-55-2 contains a diagram of the process for determining whether a freestanding contract is within the scope of ASC 815-10 that includes references to loan commitments issued to potential borrowers. If retained, the diagram should be updated for the effects of the proposal.

- ASC 815-15-35-1A provides guidance for hybrid instruments that are nonfinancial assets and would be required to be separated into a host financial contract and a derivative instrument (i.e., subsequently measure the entire hybrid instrument at FV-NI). However, no subsequent measurement guidance is provided if the embedded nonfinancial derivative was not required to be separated from the financial asset host. We recommend that guidance be provided for the accounting for such instruments.

- ASC 815-15-55-25 provides application guidance for specific debt instruments. The proposed amendments would remove the guidance for mortgage-backed securities for both the investor and the issuer. We believe the guidance for the issuer of a mortgage-backed security would still be relevant to constituents in applying the embedded derivative guidance and should be retained.

- It appears that the Board has proposed superseding certain examples in the implementation guidance to ASC 815 (e.g., ASC 815-10-55-76, 55-101 to 55-110, and ASC 815-15-15-9) because that guidance describes transactions from the perspective of the investor, and may no longer be relevant based on the proposed amendments (i.e., elimination of the bifurcation requirement for hybrid financial assets). However, these examples provide guidance that is currently used by both the investor and the issuer. We recommend that these examples be retained and amended to clarify that they apply only to issuers of the instrument.

- The implementation guidance in ASC 815-15-55-165 (i.e., Cases V through AB) would be superseded because these cases describe beneficial interests that would be in the scope of ASC 825-10. Although the guidance in ASC 825-10 affects investors in beneficial interests, it does not affect issuers of the beneficial interests. Therefore, we recommend retaining those cases in ASC 815-15-55-165 describing the issuance of beneficial interests.

Topic 825

- The guidance on electing the fair value option for eligible items of a subsidiary, acquiree or consolidated VIE by a parent, acquirer or primary beneficiary in the consolidated financial statements, as described today in ASC 825-10-25-6, was deleted as part of the consequential amendments. The FASB should clarify whether it intends to limit the election of the fair value option by parents, acquirers or primary beneficiaries. If not, the paragraph should be moved to ASC 825-30 in the proposal.

- It's not clear why the implementation guidance for concentrations of credit risk in ASC 825-10-55-2 through 55-3 would be superseded by the proposed consequential amendments but the disclosure requirements for concentrations of credit risk were retained.

Topic 942

- It is not clear why the Board proposed elimination of the disclosures in ASC 942-320, which provides specific disclosure requirements for depository and lending institutions.

Topic 958

- ASC 958-325-35-16, which provides guidance on agency transactions of other investments (i.e., equity method investments and investments that are not financial instruments), would be superseded by the proposed consequential amendments. Similar guidance was retained for financial instruments in ASC 958-325. We do not believe equity method investments and other investments should be treated differently. Thus, we recommend retaining ASC 958-325-35-16.

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?

Response:

We believe all guidance related to financial instruments should be consolidated into a single Topic. Moving the guidance from various Topics to a single Topic would better organize the guidance related to financial instruments and remove some confusion about the location of applicable guidance in the Codification.

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?

Response:

We continue to support the unconditional fair value option as provided in current US GAAP, but if the Board moves forward with limiting it, certain transition guidance and exceptions may need to be provided, particularly for rights and obligations of insurance contracts. For example, if the effective date of the final insurance contracts standard is not aligned with the effective date of the final classification and measurement of financial instruments standard, we believe the fair value option for rights and obligations of insurance contracts should be retained until the final insurance contracts standard is effective.

Appendix C: Accounting for nonrecourse obligations example

On 1 January 20X1, a special-purpose entity (SPE) issues nonrecourse debt of $900 and $100 of equity and uses the proceeds to purchase $1,000 of securities that are classified as FV-OCI.

Additional facts:

Date	Fair value of assets	Fair value of nonrecourse debt	Cumulative expected credit losses
1 Jan 20X1	$ 1,000	$ 900	$ –
31 Dec 20X1	$ 950	$ 880	$ 30
31 Dec 20X2	$ 750	$ 700	$ 180

Below are the balance sheets and income statements of the SPE as of 31 December 20X1 and 20X2 and for the years then ended. To simplify this example, certain items have been ignored.

Balance sheet	31 December 20X1	31 December 20X2
Assets		
Securities – FV-OCI		
Net amortized cost ($970 (20X1), $820 (20X2))	$ 950 [1]	$ 750 [2]
Total assets	$ 950	$ 750
Liabilities		
Nonrecourse debt		
Net cost ($900 (20X1), $820 (20X2))	$ 900 [1]	$ 750 [3]
Total liabilities	900	750
Shareholders' equity		
Unrealized gains		70
Unrealized losses	(20)	(70)
Additional paid-in capital	100	100
Accumulated deficit	(30)	(100)
Total shareholders' equity	50	–
Total liabilities and shareholders' equity	$ 950	$ 750
Income statement	**Year ended 31 December 20X1**	**Year ended 31 December 20X2**
Credit losses on securities	$ (30)	$ (150)
Decrease in value of nonrecourse debt	–	80
Net loss	$ (30)	$ (70)

Footnotes:

1 At 31 December 20X1, expected credit losses of $30 are recognized in earnings, and $20 is recognized in OCI to present the securities at their fair value of $950. No portion of the expected credit losses or unrealized losses is allocated to the nonrecourse debt because both the fair value and net amortized cost of the securities exceed the par value of the nonrecourse debt. Accordingly, the debt's carrying value is $900, and the fair value of the debt is not considered in measuring the debt.

2 At 31 December 20X2, an additional $150 of expected credit losses are recognized in earnings. The net amortized cost of the securities is $820, and $70 of unrealized losses on the securities is recognized in OCI, in order to present the securities at their fair value of $750. Because the current estimate of expected credit losses ($180) exceeds the equity investment of $100, to avoid having the SPE shareholders recognize uneconomic losses that would be absorbed by the lenders, the credit losses allocable to the nonrecourse debt of $80 are recognized by writing down the value of the debt with an increase to earnings.

3 At 31 December 20X2, the nonrecourse debt carrying value of $750 is determined as follows:

Carrying value, beginning of period	$ 900
Less:	
Allocable credit losses (see footnote 2)	80
Unrealized gain on value of debt	70 [4]
Carrying value, end of period	$ 750

4 The $70 is recorded in OCI as an unrealized gain, so the carrying value of the debt ($820) is adjusted to equal the fair value of the assets (which are measured at FV-OCI) so uneconomic losses aren't reported in shareholders' equity. That is, once the assets' fair value declines below the par amount of the debt, only the lender would receive the benefits of the assets.