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Ms. Susan M. Cosper
Director of Major Projects and Technical Activities
Financial Accounting Standards Board
401 Merritt 7
Norwalk, CT 06856-5116

Dear Ms. Cosper,

Grant Thornton LLP is submitting this letter to request that the Financial Accounting Standards Board (either on its own, or with the assistance of the Emerging Issues Task Force) add a project to its agenda to provide guidance regarding the recognition of interest income on financial assets measured at fair value with changes in fair value recognized currently in earnings.

**Background**

Financial assets may be measured at fair value with changes in fair value recognized currently in earnings (FV-NI) for a variety of reasons under US GAAP. Most commonly, financial assets are measured at FV-NI for one of the following three reasons:

1. The reporting entity qualifies as an investment company under Accounting Standards Codification Topic (ASC) 946 or as a Broker Dealer under ASC 940
2. The financial assets are classified as trading securities under ASC 320
3. The reporting entity elects to carry the financial assets at FV-NI pursuant to the fair value option in ASC 825

For many entities that carry financial assets at FV-NI, it is common industry practice to present interest income as a separate item in their income statements, even though the financial assets are accounted for at FV-NI. US GAAP recognizes as much in ASC 325-40-15-7. However, there is little authoritative guidance regarding how entities should measure and report interest income on financial assets measured at FV-NI. As a result, it is our experience that there is diversity in practice today, and that diversity may be of increased importance after the adoption of the guidance in ASU 2016-13, as more entities may elect the fair value option for financial assets in the scope of ASC 326.

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**Authoritative Guidance**

US GAAP has several different models for recognizing interest income on financial assets, the applicability of each depends on a variety of factors. The methods, and their scope, are summarized below.

Amortization of Net Deferred Fees and Costs, and Premiums and Discounts – ASC 310-20

This subtopic provides guidance regarding the amortization of net deferred fees and costs on originated financial assets, as well as premiums and discounts initially recognized on all financial assets, to arrive at a level yield. The guidance in ASC 310-20 is referred to as the "interest method".

This guidance does not apply to financial assets measured at FV-NI (310-20-15-4).

Interest on Purchased Credit Impaired (PCI) Financial Assets – ASC 310-30

This subtopic provides guidance on the recognition of interest income on purchased financial assets that have experienced a more than insignificant deterioration in credit quality since origination.

This guidance does not apply to financial assets measured at FV-NI (310-30-15-2a).

Retrospective Interest Method – ASC 320-10

This guidance applies to investments in structured notes that are classified as held-to-maturity or available-for-sale (320-10-35-40). It, therefore, does not apply to structured notes classified as trading (nor, one would assume other financial assets also measured at FV-NI).

Interest on Certain Beneficial Interests – ASC 325-40

As noted above, this guidance applies to financial assets measured at FV-NI. However, this subtopic only provides guidance regarding the recognition of interest income on certain beneficial interests and excludes types other financial assets.

Accordingly, the general applicability of this guidance to financial assets measured at FV-NI that are not beneficial interests is unclear.

Debt Securities Held by Investment Companies – ASC 946-320

This subtopic provides guidance to investment companies regarding accounting for investments in debt and certain equity securities. Investment companies generally account for all such investments at FV-NI. Paragraph 946-320-35-20 states that investment companies should amortize premiums and discounts via the interest method, although it does not refer to specific guidance in other subtopics.

Additionally, the general applicability of this guidance to financial assets is unclear as ASC Topic 946 applies only to investment companies.

Summary

In summary, every interest income recognition model in US GAAP excludes financial assets measured at FV-NI from its scope, except for the guidance in ASC 325-40, Grant Thornton

whose scope is limited to only certain beneficial interests. Additionally, there is a paragraph in the investment company industry guidance which states that premiums and discounts on financial assets measured at FV-NI should be amortized using the interest method, but the general applicability of that guidance is unclear.

We believe that, in general, this issue does not impact the timing of income recognition but rather the classification of income between interest income and gains and losses due to changes in fair value for financial assets measured at FV-NI. However, we believe that interest income is a key performance metric for many entities with financial assets measured at FV-NI, and therefore believe this is a significant issue.

**Significance of the Issue**

We believe there are several reasons that this issue, which exists today, may be of increased importance after the adoption of the guidance in ASU 2016-13.

First, we believe that some entities are considering electing the fair value option in ASC 825 on financial assets that they have previously measured at amortized cost. These entities have indicated that they believe measuring their financial assets at FV-NI is either (a) operationally simpler than applying the CECL model introduced by ASU 2016-13, or (b) better represents the economics of their business than the CECL model (or both). Accordingly, we believe more entities may measure their financial assets at FV-NI after the adoption of ASU 2016-13 than today.

Second, we understand that some entities that measure financial assets at FV-NI may apply the guidance in ASC 310-30 by analogy to recognize interest income. These entities apply the guidance in ASC 310-30 because they either (a) acquire financial assets that would be in the scope of ASC 310-30 were they not measured at FV-NI, or (b) they believe the expected cash flow model in ASC 310-30 best reflects the economics of their investments in financial assets measured at FV-NI. However, ASU 2016-13 eliminates subtopic ASC 310-30.

Finally, we believe there is a lack of clarity regarding how to apply the guidance in ASC 325-40 to certain beneficial interests that are measured at FV-NI after the adoption of ASU 2016-13. This issue was acknowledged by the FASB staff in its cover memo (Memo 14) to the Transition Resource Group for Credit Losses (TRG) in advance of the TRG's November 1, 2018 meeting.

**Agenda Request**

We respectfully request the FASB add a project to its agenda to provide guidance regarding the recognition of interest income for financial assets measured at FV-NI.

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If you have any questions, please contact Graham Dyer, Partner, at 312.602.8107 or Graham.Dyer@us.gt.com.

/s/ Grant Thornton LLP (typed)

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**Authoritative Guidance**

**310-20-15 Scope and Scope Exceptions - General**

**15-4** The following table outlines the applicability of this Subtopic to various types of assets.

| Types of Assets | Basis of Accounting | Applicability of This Subtopic |
|---|---|---|
| Loans or debt securities held in an investment portfolio | Historical or amortized cost[(b)] | Yes |
| Loans held for sale | Lower of cost or fair value[(b)] | Yes |
| Loans or debt securities held in trading accounts by certain financial institutions | Fair value, changes in value are included in earnings | No |
| Loans or debt securities, available-for-sale [(a)] | Fair value, changes in value reported in other comprehensive income | Yes |

(a) This includes financial assets subject to prepayment as defined in paragraph 310-10-35-45 and debt securities classified as available for sale under Topic 320.

(b) Entities may choose, at specified election dates, to measure eligible items at fair value (the fair value option). See Section 825-10-15 for guidance on the scope of the Fair Value Option Subsections of the Financial Instruments Topic.

**310-30-15 Scope and Scope Exceptions - General**

**> Transactions**

**15-2** The guidance in this Subtopic applies to all loans with evidence of deterioration of credit quality since origination acquired by **completion of a transfer** for which it is **probable** , at acquisition, that the investor will be unable to collect all **contractually required payments receivable** , except for any of the following:

a. Loans that are measured at **fair value** if all changes in fair value are included in earnings or, for an NFP, loans that are measured at fair value if all changes in fair value are included in the statement of activities and included in the performance indicator if a performance indicator is presented. Examples include those loans classified as trading securities under Topic 320 : and Subtopic 948-310 :

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**320-10-35 Subsequent Measurement - General**

**35-40** Entities shall use the **retrospective interest method** for recognizing income on structured note securities that are classified as available-for-sale or held-to-maturity debt securities and that meet any of the following conditions:

a. Either the contractual principal amount of the note to be paid at maturity or the original investment amount is at risk (for other than failure of the borrower to pay the contractual amounts due). Examples include principal-indexed notes that base principal repayment on movements in the Standard& Poor's S&P 500 Index or notes that base principal repayment on the occurrence of certain events or circumstances.

b. The note's return on investment is subject to variability (other than due to credit rating changes of the borrower) because of either of the following:

1. There is no stated coupon rate or the stated coupon is not fixed or prespecified, and the variation in the return on investment or coupon rate is not a constant percentage of, or in the same direction as, changes in market-based interest rates or interest rate index, for example, the London Interbank Offered Rate (LIBOR) or the U.S. Treasury Bill Index.

2. The variable or fixed coupon rate is below market rates of interest for traditional notes of comparable maturity and a portion of the potential yield (for example, upside potential for principal) is based on the occurrence of future events or circumstances.(Examples of instruments that meet this condition include inverse floating-rate notes, dual-index floating notes, and equity-linked bear notes.)

c. The contractual maturity of the bond is based on a specific index or on the occurrence of specific events or circumstances outside the control of the parties to the transaction, excluding the passage of time or events that result in normal covenant violations. Examples of instruments that meet this condition include index amortizing notes and notes that base contractual maturity on the price of oil.

**325-40-15 Scope and Scope Exceptions - General**

**> > Beneficial Interests Classified as Trading**

**15-7** For income recognition purposes, beneficial interests classified as trading are included in the scope of this Subtopic because it is practice for certain industries (such as banks and investment companies) to report interest income as a separate item in their income statements, even though the investments are accounted for at fair value.

**946-320-35 Subsequent Measurement - General**

**35-20** Premiums and discounts shall be amortized using the interest method.

**Illustrative Example**

Background

A reporting entity ("Investor") on 1/1/X1 acquires a loan with the following terms:

- Unpaid principal balance (UPB) of $1,000,000
- Stated interest rate of 10.0%
- Principal and interest payments, on a fully amortizing basis, due quarterly for three years

Investor acquires the loan with a purchase price of $900,000 and elects to carry the loan at FV-NI pursuant to the fair value option in ASC Topic 825.

Investor expects that it will receive each contractually required payment (quarterly payments of $97,487), except for 10th, 11th, and 12th payments, when it expects cash shortfalls as depicted in the box below. The fair values are based on expected future cash flows, discounted at the expected yield.

**Acquired Loan**

| | |
|---|---|
| UPB | 1,000,000 |
| Amortized Cost | 900,000 |
| Stated Rate | 10.0% |
| Expected Yield | 7.7% |
| Term | 3 years |

**Cash Flows**

| | Q1X1 | Q2X1 | Q3X1 | Q4X1 | Q1X2 | Q2X2 | Q3X2 | Q4X2 | Q1X3 | Q2X3 | Q3X3 | Q4X3 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Contractual** | 97,487 | 97,487 | 97,487 | 97,487 | 97,487 | 97,487 | 97,487 | 97,487 | 97,487 | 97,487 | 97,487 | 97,487 |
| **Expected** | 97,487 | 97,487 | 97,487 | 97,487 | 97,487 | 97,487 | 97,487 | 97,487 | 97,487 | 50,000 | 50,000 | 25,000 |

**Fair Values**

| Q1X1 | Q2X1 | Q3X1 | Q4X1 | Q1X2 | Q2X2 | Q3X2 | Q4X2 | Q1X3 | Q2X3 | Q3X3 | Q4X3 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 900,000 | 819,896 | 738,245 | 655,017 | 570,181 | 483,707 | 395,562 | 305,715 | 214,133 | 120,781 | 73,114 | 24,526 |

For the sake of this example, assume that Investor's cash flow expectations are consistent with a market participant's expectations, that those expectations do not change over the life of the loan, that market interest rates do not change over the life of the loan, and that actual cash flows exactly match expected cash flows.

The following two boxes illustrate the application of (1) the interest method found in ASC 310-20, as well as (2) an expected cash flow model (such as ASC 310-30 or ASC 325-40) to the fact pattern described above.

**Application of Interest Method Model (310-20)**

| | Q1X1 | Q2X1 | Q3X1 | Q4X1 | Q1X2 | Q2X2 | Q3X2 | Q4X2 | Q1X3 | Q2X3 | Q3X3 | Q4X3 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| UPB | 1,000,000 | 927,513 | 853,214 | 777,057 | 698,996 | 618,984 | 536,971 | 452,908 | 366,744 | 278,426 | 235,386 | 191,271 |
| Discount | (100,000) | (86,439) | (73,590) | (61,517) | (50,285) | (39,965) | (30,631) | (22,361) | (15,237) | (9,345) | (4,776) | (780) |
| Amortized Cost | 900,000 | 841,074 | 779,624 | 715,540 | 648,711 | 579,018 | 506,340 | 430,547 | 351,507 | 269,081 | 230,610 | 190,491 |
| | | | | | | | | | | | | |
| Contractual Interest | 25,000 | 23,188 | 21,330 | 19,426 | 17,475 | 15,475 | 13,424 | 11,323 | 9,169 | 6,961 | 5,885 | 4,782 |
| Discount Amortization | 13,561 | 12,849 | 12,073 | 11,232 | 10,320 | 9,334 | 8,270 | 7,124 | 5,892 | 4,568 | 3,996 | 3,380 |
| Interest Income | 38,561 | 36,037 | 33,404 | 30,658 | 27,795 | 24,809 | 21,695 | 18,447 | 15,061 | 11,529 | 9,881 | 8,162 |
| | | | | | | | | | | | | |
| Cash | 97,487 | 97,487 | 97,487 | 97,487 | 97,487 | 97,487 | 97,487 | 97,487 | 97,487 | 50,000 | 50,000 | 25,000 |
| | | | | | | | | | | | | |
| UPB | 927,513 | 853,214 | 777,057 | 698,996 | 618,984 | 536,971 | 452,908 | 366,744 | 278,426 | 235,386 | 191,271 | 171,053 |
| Discount | (86,439) | (73,590) | (61,517) | (50,285) | (39,965) | (30,631) | (22,361) | (15,237) | (9,345) | (4,776) | (780) | 2,600 |
| Amortized Cost | 841,074 | 779,624 | 715,540 | 648,711 | 579,018 | 506,340 | 430,547 | 351,507 | 269,081 | 230,610 | 190,491 | 173,652 |
| | | | | | | | | | | | | |
| Fair Value | 819,896 | 738,245 | 655,017 | 570,181 | 483,707 | 395,562 | 305,715 | 214,133 | 120,781 | 73,114 | 24,526 | - |
| MTM Gain/(Loss) | (21,178) | (20,201) | (19,145) | (18,007) | (16,782) | (15,466) | (14,055) | (12,542) | (10,925) | (9,196) | (8,469) | (7,688) |
| | | | | | | | | | | | | |
| Total P&L | 17,383 | 15,836 | 14,259 | 12,651 | 11,013 | 9,343 | 7,640 | 5,905 | 4,136 | 2,333 | 1,412 | 474 |

**Application of an Expected CF Model (310-30 / 325-40)**

| | Q1X1 | Q2X1 | Q3X1 | Q4X1 | Q1X2 | Q2X2 | Q3X2 | Q4X2 | Q1X3 | Q2X3 | Q3X3 | Q4X3 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| UPB | 1,000,000 | 927,513 | 853,214 | 777,057 | 698,996 | 618,984 | 536,971 | 452,908 | 366,744 | 278,426 | 235,386 | 191,271 |
| Discount | (100,000) | (107,617) | (114,969) | (122,040) | (128,816) | (135,278) | (141,410) | (147,194) | (152,612) | (157,645) | (162,272) | (166,745) |
| Amortized Cost | 900,000 | 819,896 | 738,245 | 655,016 | 570,181 | 483,706 | 395,562 | 305,715 | 214,132 | 120,781 | 73,114 | 24,526 |
| | | | | | | | | | | | | |
| Contractual Interest | 25,000 | 23,188 | 21,330 | 19,426 | 17,475 | 15,475 | 13,424 | 11,323 | 9,169 | 6,961 | 5,885 | 4,782 |
| Discount Amortization | (7,617) | (7,352) | (7,072) | (6,775) | (6,462) | (6,132) | (5,784) | (5,418) | (5,033) | (4,628) | (4,472) | (4,308) |
| Interest Income | 17,383 | 15,836 | 14,259 | 12,651 | 11,013 | 9,343 | 7,640 | 5,905 | 4,136 | 2,333 | 1,412 | 474 |
| | | | | | | | | | | | | |
| Cash | 97,487 | 97,487 | 97,487 | 97,487 | 97,487 | 97,487 | 97,487 | 97,487 | 97,487 | 50,000 | 50,000 | 25,000 |
| | | | | | | | | | | | | |
| UPB | 927,513 | 853,214 | 777,057 | 698,996 | 618,984 | 536,971 | 452,908 | 366,744 | 278,426 | 235,386 | 191,271 | 171,053 |
| Discount | (107,617) | (114,969) | (122,040) | (128,816) | (135,278) | (141,410) | (147,194) | (152,612) | (157,645) | (162,272) | (166,745) | (171,053) |
| Amortized Cost | 819,896 | 738,245 | 655,016 | 570,181 | 483,706 | 395,562 | 305,715 | 214,132 | 120,781 | 73,114 | 24,526 | (0) |
| | | | | | | | | | | | | |
| Fair Value | 819,896 | 738,245 | 655,016 | 570,181 | 483,706 | 395,562 | 305,715 | 214,132 | 120,781 | 73,114 | 24,526 | (0) |
| MTM Gain/(Loss) | - | - | - | - | - | - | - | - | - | - | - | - |
| | | | | | | | | | | | | |
| Total P&L | 17,383 | 15,836 | 14,259 | 12,651 | 11,013 | 9,343 | 7,640 | 5,905 | 4,136 | 2,333 | 1,412 | 474 |