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Heads Up

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FASB Preparing to Issue "New" Classification and Measurement Guidance

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Introduction

The FASB is currently finalizing amendments to its guidance on the classification and measurement of financial instruments. In stark contrast to its February 2013 proposed ASU,[1] which outlined a new model (largely converged with the IASB) for classification and measurement of financial instruments, the guidance resulting from the Board's tentative decisions abandons the converged approach and retains much of the existing requirements in U.S. GAAP. However, the amendments include significant changes pertaining to (1) classification and measurement of investments in equity securities, (2) recognition of certain fair value changes in financial liabilities measured at fair value, and (3) elimination of the "entry" price valuation notion for disclosure of the fair value of loans.

This *Heads Up* provides a comprehensive summary of the FASB's changes to its existing classification and measurement model for financial instruments. It also briefly outlines the Board's other related financial instruments projects on credit impairment and hedging as well as its new project on disclosures about hybrid financial instruments that contain bifurcated embedded derivatives. In addition, the appendix to this *Heads Up* compares the classification and measurement models under current U.S. GAAP, the FASB's tentative approach, and IFRS 9.[2]

Editor's Note: The FASB plans to issue a final ASU on classification and measurement of financial instruments during the second quarter of this year. The IASB issued its final guidance on this topic in July 2014 (for information about the IASB's amendments to IFRS 9, see Deloitte's August 8, 2014, *Heads Up*).

Summary of Changes to U.S. GAAP on Classification and Measurement

Key proposed amendments based on the FASB's tentative decisions to date[3] are discussed below.

[1] FASB Proposed Accounting Standards Update, *Recognition and Measurement of Financial Assets and Financial Liabilities.*
[2] IFRS 9, *Financial Instruments.*
[3] Decisions are as of the FASB's January 14, 2015, meeting. Although the Board has nearly completed its deliberations in the project, the guidance in the final ASU may differ from that in the tentative decisions as a result of changes made during the finalization process.

Classification and Measurement of Equity Investments

The proposed amendments would require entities to carry all investments in equity securities (except investments that qualify for the equity method of accounting or for which a practicability exception to fair value measurement has been elected, as discussed below) at fair value through net income (FVTNI).

> **Editor's Note:** Under existing U.S. GAAP, marketable equity securities other than equity-method investments (those for which the investor has significant influence over the investee) are classified as either held for trading or available for sale (AFS). For AFS equity securities, any amounts in accumulated other comprehensive income (OCI) are recycled to net income upon sale or an other-than-temporary impairment. Investments in nonmarketable equity securities other than equity-method investments are measured at cost (less impairment) unless the fair value option has been elected. Because equity securities would no longer be accounted for as AFS securities or by using the cost method, entities that hold such equity investments could see significant volatility in earnings under the proposed guidance. For instance, this new requirement would have a significant impact on certain types of mutual funds (e.g., bond funds and fixed-income funds) that are currently accounted for as AFS securities. According to ASC 320-10-55-9,[4] a mutual fund that invests only in U.S. government debt securities is considered an equity security. Consequently, the proposed amendments would apply to mutual funds that meet the definition of an equity security.
>
> In addition, since the proposed amendments eliminate the cost method of accounting for equity securities, it is unclear whether options and forward contracts on nonmarketable equity securities (that are outside the scope of ASC 815) would also need to be measured at fair value and whether such investments would qualify for the practicability exception.

For investments in equity securities without a readily determinable fair value that do not qualify for the net asset value (NAV) practical expedient in ASC 820-10-35-59, an entity would be permitted to elect the practicability exception to fair value measurement, under which the investment would be measured at cost, less impairment, plus or minus observable price changes (in orderly transactions) of an identical or similar investment of the same issuer. This exception would not be available to reporting entities that are investment companies or broker-dealers in securities.

> **Editor's Note:** Entities that elect the practicability exception would still need to assess the equity investment for impairment. The FASB is expected to provide additional implementation guidance in the ASU to clarify how entities would apply the practicability exception.
>
> Furthermore, the proposed guidance on classification for equity investments would not apply to investments in Federal Home Loan Bank (FHLB) and Federal Reserve Bank (FRB) stock issued to member financial institutions. Instead FHLB and FRB stock would continue to be accounted for at cost less impairment. It is unclear whether the proposed impairment guidance (as discussed below) for an equity investment for which fair value is not readily determinable would apply to FHLB or FRB stock.

Impairment Assessment of Equity Investments That Are Measured by Using the Practicability Exception

In an effort to simplify the impairment model for equity securities for which an entity has elected the practicability exception, the proposed guidance eliminates the requirement in U.S. GAAP to assess whether an impairment of such an investment is other than temporary. Under the proposed guidance, as of each reporting period, an entity would qualitatively consider the following indicators (from paragraph 825-10-35-18 of the proposed ASU) to determine whether the investment is impaired:

> a. A significant deterioration in the earnings performance, credit rating, asset quality, or business prospects of the investee
>
> b. A significant adverse change in the regulatory, economic, or technological environment of the investee

[4] For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's *"Titles of Topics and Subtopics in the FASB Accounting Standards Codification."*

c. A significant adverse change in the general market condition of either the geographic area or the industry in which the investee operates

d. A bona fide offer to purchase, an offer by the investee to sell, or a completed auction process for the same or similar investment for an amount less than the cost of that investment

e. Factors that raise significant concerns about the investee's ability to continue as a going concern, such as negative cash flows from operations, working capital deficiencies, or noncompliance with statutory capital requirements or debt covenants.

If the entity determines that the equity security is impaired on the basis of the qualitative assessment, it would recognize an impairment loss equal to the difference between the security's fair value and the carrying amount. In contrast, the existing guidance in ASC 320-10-35-30 requires entities to perform a two-step assessment under which an entity first determines whether an equity security is impaired and then evaluates whether any impairment is other than temporary.

Presentation of Fair Value Changes Attributable to Instrument-Specific Credit Risk for Fair Value Option Liabilities

The proposed guidance would establish a new recognition and disclosure requirement, in addition to the disclosure requirements in ASC 825, related to the presentation of fair value changes of financial liabilities for which the fair value option has been elected. Under this guidance, an entity would be required to separately recognize in OCI the portion of the total fair value change attributable to instrument-specific credit risk. For derivative liabilities, however, any changes in fair value attributable to instrument-specific credit risk would continue to be presented in net income, which is consistent with current U.S. GAAP.

An entity would measure the portion of the change in fair value attributable to instrument-specific credit risk as the excess of total change in fair value over the change in fair value that results from a change in a base market risk, such as a risk-free interest rate. Alternatively, an entity would be permitted to use another method that it considers to more faithfully represent the portion of the total change in fair value resulting from a change in instrument-specific credit risk. In either case, the entity would disclose the method it used to determine the gains and losses attributable to instrument-specific credit risk and would be required to apply the method consistently from period to period.

Editor's Note: During the financial crisis, many stakeholders expressed concerns about the counterintuitive impact on earnings of recording changes in the fair value of financial liabilities, specifically related to an entity's own debt for which the fair value option had been elected. Under U.S. GAAP today, for financial liabilities measured at fair value, an entity would recognize a gain in earnings when there is an increase in instrument-specific credit risk or a loss when there is a decrease in instrument-specific credit risk. The proposed guidance seeks to eliminate this counterintuitive result by requiring entities to present in OCI changes in fair value that result from changes in an entity's own credit risk.

Although the FASB has yet to discuss the ASU's effective date, given the relevance of this issue to financial institutions, we believe the FASB may consider allowing entities to early adopt the final guidance.

Valuation Allowance on a Deferred Tax Asset Related to an AFS Debt Security

The proposed guidance would eliminate the diversity in practice related to an entity's evaluation of the need for a valuation allowance for debt securities that are classified as AFS. Under current U.S. GAAP, entities perform this evaluation either separately from their other deferred tax assets (DTAs) or in combination with them. The proposed guidance would clarify that an entity is required to make "the assessment of a valuation allowance for a [DTA] to an [AFS] debt security . . . *in combination* with the entity's other [DTAs]."

Proposed Disclosure Requirements

The proposed guidance amends certain existing disclosure requirements in U.S. GAAP and adds new ones. Summarized below are some of its more notable amendments and additions.

Amendments to Disclosures in ASC 825

For financial instruments not recognized at fair value in the statement of financial position, the proposed amendments would eliminate the requirement to provide the disclosures[5] in ASC 825-10-50 about fair value for entities that do not meet the definition of a public business entity. In addition, for such financial instruments, public business entities would not be required to disclose (1) the information in ASC 825-10-50-10(b) and 50-10(c) related to the methods and significant assumptions they used to estimate fair value or (2) a description of the changes in the methods and significant assumptions they used to estimate fair value. However, the proposed amendments would retain the current requirements in U.S. GAAP for public business entities to provide fair value information about (1) financial instruments not recognized at fair value in the statement of financial position either in the body of the financial statement or in accompanying notes and (2) the level of the fair value measurement hierarchy in which financial instruments are classified (i.e., Level 1, Level 2, or Level 3).

Editor's Note: On the basis of the FASB's redeliberations, it is unclear whether the concept of "practicable to estimate fair value" in ASC 825-10-50-17 would be retained as a practical expedient for public business entities or whether it would be eliminated. This expedient was eliminated in the proposed ASU.

The proposed amendments would clarify U.S. GAAP by eliminating the guidance in ASC 825 that had been interpreted to permit an "entry" price notion for estimating the fair value of loans for disclosure purposes. The proposed amendments would require a public business entity to disclose the fair value, in accordance with the "exit" price notion in ASC 820, of financial assets and financial liabilities measured at amortized cost, except for receivables and payables due within one year and demand deposit liabilities.

Editor's Note: Practitioners may have interpreted the illustrative guidance in ASC 825-10-55-3 to allow entities to disclose the fair value of loans on the basis of an "entry" price notion. The requirement to disclose fair value on the basis of an "exit" price notion may represent a major shift for some entities that have continued to disclose the fair value of loans on the basis of entry price.

The proposed guidance would also require public business entities to disclose the fair value of financial assets measured at amortized cost by major class of assets. Furthermore, all entities would be required to disclose in the notes to the financial statements all financial assets and financial liabilities grouped by (1) measurement category (i.e., amortized cost or fair value — net income or OCI) and (2) form of financial asset (i.e., securities and loans/receivables).

Equity Investments Without Readily Determinable Fair Values

Entities that have elected the practicability exception to fair value measurement (discussed above) would be required to disclose (1) the carrying amount of investments without readily determinable fair values and (2) the amount of the adjustment made to the carrying amount due to observable price changes and any impairment charge during the reporting period.

Transition and Effective Date

To adopt the proposed guidance, entities would be required to make a cumulative-effect adjustment to beginning retained earnings as of the beginning of the first reporting period in which the guidance

[5] ASC 825-10-50-10 states that "a reporting entity shall disclose all of the following:

a. Either in the body of the financial statements or in the accompanying notes, the fair value of financial instruments for which it is practicable to estimate fair value
b. The method(s) and significant assumptions used to estimate the fair value of financial instruments consistent with the requirements of paragraph 820-10-50-2(bbb) except that a reporting entity is not required to provide the quantitative disclosures . . . by that paragraph
c. A description of the changes in the method(s) and significant assumptions used to estimate the fair value of financial instruments, if any, during the period
d. The level of the fair value hierarchy within which the fair value measurements are categorized in their entirety (Level 1, 2, or 3)."

becomes effective. Entities would prospectively adopt the practicability exception and disclosure requirements. The effective date of the final guidance will be determined at a future FASB meeting.

Developments in Other Projects Related to Financial Instruments

Disclosures About Hybrid Financial Instruments Containing Bifurcated Embedded Derivatives

At its January 14 meeting, the FASB voted to issue a proposed ASU on disclosure requirements for bifurcated embedded derivatives. Under the proposal, an entity would be required to disclose the carrying amount and measurement attribute (i.e., amortized cost or fair value) as well as the financial statement line items in which bifurcated embedded derivatives and related host contracts are presented. The proposal's comment period is expected to end on April 30, 2015. Entities would apply this guidance prospectively.

> **Editor's Note:** The FASB is proposing the disclosure requirements because of concerns raised by financial statement users about a lack of transparency in an entity's financial statements about bifurcation and separate accounting for a hybrid financial instrument. The FASB decided to draft a separate proposal on this topic because it has not been exposed for public comment. It expects to issue the proposal in the near future.

Hedge Accounting

At its meeting on November 5, 2014, the FASB voted to move its current research project on hedge accounting to its active agenda. In deliberating the project, the FASB will discuss the following issues:

- Hedge effectiveness requirements.
- Whether the shortcut and critical-terms-match methods should be eliminated.
- Voluntary dedesignations of hedging relationships.
- Recognition of ineffectiveness for cash flow underhedges.
- Hedging components of nonfinancial items.
- Benchmark interest rates.
- Simplification of hedge documentation requirements.
- Presentation and disclosure matters.

Formal deliberations on the hedging project are expected to begin in the near future.

> **Editor's Note:** For the latest information about this project, see the hedging project page on Deloitte's US GAAP Plus Web site.

Credit Impairment

In late 2012, the FASB issued a proposed ASU to obtain feedback on its current expected credit loss (CECL) model. Under the proposed CECL model, an entity would recognize as an allowance its estimate of the contractual cash flows not expected to be collected. The CECL model would apply to most debt instruments (other than those measured at fair value), lease receivables, reinsurance receivables that result from insurance transactions, financial guarantee contracts, and loan commitments. However, AFS debt securities would be excluded from the model's scope and would continue to be assessed for impairment under ASC 320. The FASB has proposed limited changes to the impairment model for AFS debt securities in ASC 320.

The FASB is continuing to redeliberate its credit losses proposal and expects to discuss disclosure requirements, transition, and the standard's effective date in the near future. It plans to issue an ASU in the second half of 2015.

Editor's Note: For the latest information about this project, see the impairment project page on Deloitte's US GAAP Plus Web site.

Appendix — Comparison of Classification and Measurement Models

The table below compares the classification and measurement models under current U.S. GAAP, the FASB's tentative approach, and IFRS 9.

Subject	Current U.S. GAAP	Proposed Guidance (Tentative Approach)	IFRS 9 (2014)
Classification and measurement categories for financial assets other than equity investments	Under ASC 320, entities use one of the following three categories to classify and measure investments in securities: • Trading (FVTNI). • AFS. • Held to maturity (amortized cost). Under ASC 310, entities use one of the following two categories to classify and measure loans: • Held for investment (amortized cost). • Held for sale (lower of cost or fair value).	No changes would be made to the U.S. GAAP requirements.	Three categories: • Amortized cost. • Fair value through other comprehensive income (FVTOCI). • Fair value through profit or loss (FVTPL).
Classification and measurement categories for equity investments	Under existing U.S. GAAP, marketable equity securities other than equity-method investments (those for which the investor has significant influence over the investee) are classified as either held for trading (FVTNI) or AFS. For AFS equity securities, any amounts in accumulated OCI are recycled to net income upon sale or when the security becomes other-than-temporarily impaired. Investments in nonmarketable equity securities other than equity-method investments are measured at cost (less impairment) unless the fair value option has been elected.	Entities would carry all investments in equity securities that do not qualify for equity method of accounting at FVTNI. For equity investments that do not have a readily determinable fair value, entities could elect a practicability exception and measure the investment at cost less impairment plus or minus observable price changes. The exception would not be available to investment companies, broker-dealers, and investors in equity investments that apply the NAV practical expedient under ASC 820-10-35-59.	Equity investments other than equity-method investments are accounted for at FVTPL with an option to irrevocably designate equity investments that are not held for trading at FVTOCI at initial recognition. For FVTOCI equity investments, any amounts in accumulated OCI are not transferred to profit or loss, even if the investment is sold or impaired. In limited circumstances, "cost may be an appropriate estimate of fair value."
Classification and measurement categories for financial liabilities	Nonderivative financial liabilities (primarily an entity's own debt) are accounted for at amortized cost unless an entity elects to use the fair value option. Derivative financial liabilities and short-sale obligations are measured at fair value.	No changes would be made to U.S. GAAP on accounting for financial liabilities, except for the presentation of certain fair value changes for fair value option liabilities (see below).	Financial liabilities are carried at amortized cost, except for derivative and trading liabilities and those designated under the fair value option (see below).
Method for classifying financial assets	For securities, the classification depends on whether the entity holds the security for trading or has the intent and ability to hold it to maturity. For loans, the classification depends on whether the entity intends to hold the loan to maturity or for the foreseeable future.	No changes would be made to the U.S. GAAP requirements.	The classification is based on both the entity's business model for managing the financial assets and the contractual cash flow characteristics of the financial asset.

Subject	Current U.S. GAAP	Proposed Guidance (Tentative Approach)	IFRS 9 (2014)
Criteria for carrying financial assets at amortized cost	The following financial assets are carried at amortized cost: • Debt securities that the entity has the positive intent and ability to hold to maturity. • Loans that the entity has the intent and ability to hold to maturity or for the foreseeable future.	No changes would be made to the U.S. GAAP requirements.	Financial assets are carried at amortized cost if they satisfy both of the following criteria: • They meet the cash flow characteristics criterion (i.e., solely payments of principal and interest). • They are held in a business model whose objective is to hold assets for the collection of contractual cash flows.
Criteria for measuring financial assets other than equity investments at FVTOCI	The following financial assets other than equity investments are measured at FVTOCI: • Investments in debt securities that are not classified as either trading or held to maturity. • Loans not classified as held for trading if the investor is contractually at risk of not recovering substantially all of its initially recorded investment.	No changes would be made to the U.S. GAAP requirements.	Financial assets other than equity investments are measured at FVTOCI if they satisfy both of the following criteria: • They meet the cash flow characteristics criterion. • They are held in a business model in which assets are managed both to collect contractual cash flows and for sale.
Criteria for measuring financial assets other than equity investments at FVTNI (or FVTPL)	The following financial assets other than equity investments are measured at FVTNI: • Debt securities bought and held principally for trading. • Loans bought and held principally for trading if the investor is contractually at risk of not recovering substantially all of its initially recorded investment. • Financial assets elected under the fair value option (see below).	No changes would be made to the U.S. GAAP requirements.	The following financial assets other than equity investments are measured at FVTPL: • Financial assets that fail to qualify for either amortized cost or FVTOCI. • Financial assets designated under the fair value option (see below).
Criteria for measuring financial assets at the lower of cost or fair value	Loans held for sale.	No changes would be made to the U.S. GAAP requirements.	Not applicable.
Unrealized foreign currency gains and losses on financial assets accounted for at FVTOCI	For AFS debt securities, unrealized foreign currency gains and losses are deferred in OCI in a manner similar to how other unrealized gains and losses are deferred.	No changes would be made to the U.S. GAAP requirements.	Unrealized foreign currency gains and losses on nonequity investments accounted for at FVTOCI are recognized in profit or loss.
Hybrid financial assets	Embedded derivatives in hybrid financial assets are bifurcated and accounted for separately at FVTNI when certain conditions are met.	No changes would be made to the U.S. GAAP requirements.	An entity measures and classifies a hybrid financial asset in its entirety, taking into consideration the instrument's contractual cash flow characteristics and the business model in which the instrument is managed. Bifurcation of embedded derivatives in hybrid financial assets is prohibited.

Subject	Current U.S. GAAP	Proposed Guidance (Tentative Approach)	IFRS 9 (2014)
Fair value option — qualifying conditions	For financial instruments within the scope of the guidance, an entity is not required to meet qualifying conditions before electing the fair value option.	No changes would be made to the U.S. GAAP requirements.	The fair value option may be elected only if qualifying conditions are met. An entity may elect the fair value option for a financial asset if exercising the option would eliminate or significantly reduce an accounting mismatch. An entity may elect the fair value option for a financial liability if either of the following conditions applies: • Exercising the option would eliminate or significantly reduce an accounting mismatch. • A "group of financial liabilities or [a group of] financial assets and financial liabilities is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity's key management personnel." In addition, an entity may elect the fair value option for a hybrid financial liability unless either of the following conditions applies: • The embedded derivative or derivatives do not "significantly modify the cash flows that otherwise would be required by the contract." • "[I]t is clear with little or no analysis when a similar hybrid instrument is first considered that separation of the embedded derivative(s) is prohibited."
Presentation of fair value changes attributable to instrument-specific credit risk for financial liabilities designated under the fair value option	There are no similar requirements under existing U.S. GAAP.	The portion of the total fair value change caused by a change in instrument-specific credit risk would be recognized in OCI. Any accumulated amount remaining in OCI would be reclassified to earnings when the liability is extinguished.	The portion of the total fair value change caused by a change in the liability's credit risk is recognized in OCI unless such treatment would create or enlarge an accounting mismatch in profit or loss. This amount is not subsequently transferred to profit or loss.
Reclassification of financial assets other than equity investments	Reclassification is permitted in certain circumstances. Transfers from the held-to-maturity category and transfers into or out of the trading category are expected to be rare.	No changes would be made to the U.S. GAAP requirements.	Reclassification is required if the business model changes. Recorded as of the first day of the period after the period in which the business model changes.

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