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To the Point

FASB — proposed guidance

FASB sets path on changes to accounting for financial instruments

The FASB scaled back its proposal to overhaul the classification and measurement of financial instruments.

What you need to know

- The FASB tentatively decided to retain key elements of the current US GAAP approach to classifying and measuring debt securities and loans. Equity securities would be measured at fair value with changes in fair value recognized in net income, as the FASB proposed.
- The FASB confirmed that its proposed "current expected credit loss" model would be applied to financial assets that are debt instruments measured at amortized cost. Impairments on financial assets measured at fair value with changes in fair value recognized in other comprehensive income would follow a slightly different approach.
- In making these decisions, the FASB signaled that the US GAAP guidance on these topics will continue to differ from the guidance in IFRS.
- The FASB expects to issue a final standard in the second half of 2014.

Overview

The Financial Accounting Standards Board (FASB or Board) tentatively decided to retain the separate models in current US GAAP for classifying and measuring loans and debt securities, rather than overhaul its guidance in this area, as it had proposed in 2013. Equity securities would be measured at fair value with changes in fair value recognized directly in net income (FV-NI), as the FASB had proposed.

Building a better working world

The FASB also confirmed that companies would apply the current expected credit loss (CECL) model it has developed to financial assets measured at amortized cost. Financial assets measured at fair value with changes in fair value recognized in other comprehensive income (FV-OCI) would follow a slightly different approach. The FASB had proposed applying the CECL model to all debt instruments.

The decisions capped several months of redeliberations in which the FASB has moved away from its earlier effort to converge certain parts of financial instrument accounting between US GAAP and IFRS. Meanwhile, the International Accounting Standards Board is moving ahead with its proposals and expects to issue final guidance in the coming months.

This publication summarizes this week's FASB decisions and other key decisions the FASB has made in redeliberations.

Key decisions

Classification and measurement

The FASB tentatively decided to retain the current US GAAP classification and measurement models for loans and debt securities rather than require all financial assets to be classified and measured based on their contractual cash flow characteristics and an entity's business model for managing them, as it had proposed.

In doing so, the FASB acknowledged that concerns raised by preparers about the differences in how they manage portfolios of debt securities and loans could not be reconciled in a single model. For example, it would not be practical to restrict sales of loans measured at amortized cost in the same way as held-to-maturity debt securities because certain financial institutions need more flexibility to manage credit concentrations and exposures. The FASB also considered providing flexibility for sales of both debt securities and loans measured at amortized cost but decided against that approach.

Instead, the FASB decided that there would be no change to how companies classify and measure debt securities. Equity securities would be measured at FV-NI.

Companies would continue to measure loans at amortized cost if the loans are held for investment. There would be no change to the accounting for loans held for sale.

The FASB asked the staff to research how to resolve certain practice issues that arise in determining whether a debt instrument is a loan or a security for accounting purposes.

How we see it

While the FASB tentatively decided to require equity investments to be measured at FV-NI, we expect it will discuss at a future meeting whether to keep its proposals on the practicability exception for equity investments without readily determinable fair values and equity method investments held for sale.

Credit losses

Under the FASB's CECL model, a company's allowance for credit losses would represent its current estimate of contractual cash flows it does not expect to collect over the life of the debt instrument, taking into consideration the time value of money, the risk of loss, and reasonable and supportable forecasts.

While the FASB made a distinction between loans and debt securities in its latest decisions on classification and measurement, the Board decided that it was not necessary to make that distinction for credit losses. As such, the FASB confirmed that the CECL model would apply to all financial assets that are debt instruments measured at amortized cost (e.g., loans held for investment, held-to-maturity debt securities). The Board hasn't yet addressed whether the CECL model should be applied to trade and lease receivables and commitments to extend credit, as it had proposed.

The FASB also agreed that the CECL approach should be applied to financial assets measured at FV-OCI (i.e., available-for-sale debt securities) when the fair value of the debt security is below amortized cost. However, the allowance for credit losses would be limited to the difference between fair value and amortized cost (i.e., the net carrying value of the asset would not be less than fair value).

No expected credit losses would be recognized when the fair value of a debt instrument measured at FV-OCI is greater than or equal to amortized cost.

The FASB asked the staff to consider whether unit-of-account guidance for measuring expected credit losses (i.e., individual versus pooled assets) might be needed in light of the decision on financial assets measured at FV-OCI.

The FASB is moving ahead with its plan to have entities record lifetime expected credit losses.

How we see it

The Board's decisions don't resolve concerns raised by constituents about the recognition and measurement of credit losses for highly rated debt instruments. We believe the Board will discuss this issue at a future meeting.

Other recent decisions

Classification and measurement

The FASB previously decided:

- To retain existing guidance for bifurcating embedded derivative features from hybrid financial instruments
- Not to require a separate evaluation of the cash flow characteristics of (1) a host instrument from which an embedded derivative is bifurcated and (2) other financial assets that do not require bifurcation
- To allow an irrevocable fair value option for both hybrid financial assets and liabilities with embedded derivative features that require bifurcation

Credit losses

The FASB previously made the following decisions to clarify aspects of its CECL model:

- When considering how to incorporate forecasts into the estimate of cash flows not expected to be collected, a company would use historical average loss experience for future periods beyond which it can reasonably forecast.
- When estimating credit losses, a company would consider expected prepayments but would not consider expected extensions, renewals and modifications unless a troubled debt restructuring (TDR) with a borrower is reasonably expected.

- A company would not be able to apply the proposal's approach for purchased credit impaired debt instruments to purchased assets that are not credit impaired on the purchase date.
- The FASB rejected preparer feedback that the TDR classification would no longer be relevant. The FASB decided to require that if the basis adjustment resulting from a TDR causes an increase in the cost basis of the financial asset, then an equal and offsetting increase in the entity's allowance for credit losses would be recognized.

The Board also indicated it will provide implementation guidance that describes the factors that should be considered when adjusting historical loss experience for current conditions and reasonable and supportable forecasts.

What's next

We expect the FASB will redeliberate several other classification and measurement topics, including:

- Fair value option
- Practicability exception for equity investments without readily determinable fair values
- Equity method investments held for sale
- Nonrecourse financial liabilities
- Valuation allowances on deferred tax assets related to financial assets measured at FV-OCI

We also expect the Board to discuss several topics related to credit losses, including the recognition, measurement and presentation of market and/or credit losses when (1) an entity identifies a financial asset for sale or (2) it is more likely than not that the entity will be required to sell a financial asset before recovering its amortized cost basis.

The FASB expects to finish redeliberations in the coming months and issue a final standard in the second half of 2014.