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To the Point

FASB — proposed guidance

New guidance on classifying and measuring financial instruments is coming soon

The FASB has decided to retain the existing classification and measurement guidance for investments in debt securities and loans.

What you need to know

- The FASB has concluded redeliberations of its targeted amendments to the guidance for classifying and measuring financial instruments.
- Investments in equity securities would be measured at fair value through net income, unless they qualify for the proposed practicability exception.
- Changes in instrument-specific credit risk for financial liabilities that are measured under the fair value option would be recognized in other comprehensive income.
- Disclosure of the fair value of financial instruments measured at amortized cost would no longer be required for entities that are not public business entities.
- A final standard is expected to be issued in the second quarter of 2015. The FASB has not yet decided on an effective date.

Overview

The Financial Accounting Standards Board (FASB) has concluded redeliberations on its 2013 proposal[1] on classification and measurement of financial instruments and has tentatively decided to retain the existing guidance for financial assets and financial liabilities, except for investments in equity securities and financial liabilities that are measured under the fair value option. The FASB also decided to make other targeted amendments to certain disclosure requirements and other aspects of current US GAAP.

Building a better working world

The FASB's approach is a significant departure from the joint model it developed with the International Accounting Standards Board (IASB) and the final version of IFRS 9, *Financial Instruments*, which the IASB issued in July 2014. The FASB is expected to issue a final standard in the second quarter of 2015.

This publication summarizes the FASB's tentative decisions to date. The proposed disclosure requirements are summarized in the appendix.

Background

The FASB has been considering how to reduce complexity in the accounting for financial instruments since 2008. In May 2010, in response to the financial crisis, the FASB proposed[2] requiring greater use of fair value measurements. But the FASB backed away from that idea when many constituents objected. After jointly deliberating some issues with the IASB, the FASB issued the 2013 proposal that would have required all financial assets (regardless of legal form) to be accounted for based on their cash flow characteristics and the business model for managing them. The FASB abandoned that approach after constituents said it didn't achieve the FASB's objective of reducing complexity, choosing instead to make only targeted amendments to existing US GAAP.

Summary of proposed amendments

Investments in equity securities

The FASB's guidance will differ significantly from IFRS.

Investments in equity securities that do not result in consolidation and are not accounted for under the equity method would be measured at fair value at the end of each reporting period, with the changes in fair value recognized directly in net income (FV-NI). Under existing US GAAP, the changes in fair value for equity securities that are designated as available-for-sale (AFS) are recorded in other comprehensive income (OCI). Eliminating the AFS classification for equity securities may make earnings more volatile for certain entities.

A practicability exception would be available for investments in equity securities that don't have readily determinable fair values (i.e., cost method investments under current US GAAP). Entities would measure these investments at cost less impairment, if any, plus or minus changes resulting from observable price changes in orderly transactions for an identical investment or a similar investment of the same issuer.

The practicability exception would not apply to the following:

- A broker and dealer in securities that is subject to the guidance in Accounting Standards Codification (ASC) 940, *Financial Services — Brokers and Dealers*
- An investment company that is subject to the guidance in ASC 946, *Financial Services — Investment Companies*
- An investment in an equity security that qualifies for the practical expedient to estimate fair value in accordance with the ASC 820-10-35-59 (i.e., the net asset value practical expedient)

How we see it

We don't believe that entities will be required to perform exhaustive searches for observable price changes.

The FASB is expected to provide implementation guidance to help entities determine what constitutes a similar investment issued by the same issuer. It's not clear how much judgment will be required. Without any additional guidance, judgment would be required to determine whether the price of a preferred share (with a liquidation preference) should be considered an "observable price" when evaluating common shares (without a liquidation preference) issued by the same issuer, for example.

At each reporting period, an entity that uses the practicability exception to measure an investment in an equity security would be required to make a qualitative assessment of whether the investment is impaired.

If there is an indication that the investment is impaired (without considering whether the decline is other-than-temporary, as is the case under current US GAAP), the entity would be required to estimate the investment's fair value in accordance with ASC 820, *Fair Value Measurement*, and recognize an impairment loss in net income equal to the difference between the investment's carrying value and its fair value. The final standard will include impairment indicators that an entity should consider. This single-step model for assessing impairments is expected to accelerate recognition of losses in investments without readily determinable fair values.

Financial liabilities measured under the fair value option

For financial liabilities that are measured using the fair value option (FVO) election in ASC 825, *Financial Instruments*, the portion of the total fair value change caused by a change in instrument-specific credit risk would be presented separately in OCI. An entity may consider the portion of the total change in fair value that exceeds the amount resulting from a change in a base market rate (e.g., a risk-free interest rate) to be the result of a change in instrument-specific credit risk. This would be a significant change from current US GAAP, which requires the entire instrument's change in fair value to be recognized through earnings.

The proposal is expected to accelerate recognition of impairment losses in equity investments without readily determinable fair values.

The proposed guidance would allow entities to use other methods that they believe result in a more faithful measurement of the fair value change attributable to instrument-specific credit risk. Consistent application and disclosure of the alternative method used would be required.

Upon derecognition of the financial liability, the accumulated gains and losses due to changes in the instrument-specific credit risk would be reclassified from OCI to net income.

How we see it

For financial liabilities (including derivatives) that are required to be measured at FV-NI, the effect of an entity's own credit risk would continue to be reported in net income, resulting in continued earnings volatility resulting from changes in an entity's nonperformance risk.

Deferred tax assets

The remeasurement of a financial instrument at fair value generally creates a temporary difference between the reporting basis and the tax basis of the instrument under ASC 740, *Income Taxes*, because the tax basis generally remains unchanged. This difference requires recognition of deferred taxes. Unrealized losses can give rise to deferred tax assets (DTAs), which must be assessed for realizability. The FASB has tentatively decided that entities would make the assessment of the realizability of a DTA related to an AFS debt security in combination with the entity's other DTAs.

Currently, there are two acceptable methods for assessing the realizability of DTAs related to unrealized losses on AFS debt securities recognized in OCI. The FASB is proposing to eliminate the method that allows an entity to consider its intent and ability to hold debt securities with unrealized losses until maturity, akin to a tax planning strategy. Under that method, a valuation allowance wouldn't be necessary for DTAs on unrealized losses, even when significant negative evidence (e.g., recent cumulative losses) exists related to the realizability of other DTAs because the specific DTAs are expected to reverse as time passes.

Presentation and disclosure

The proposed guidance would change the disclosure requirements for financial instruments but would retain current US GAAP balance sheet presentation requirements. Entities would disclose all financial assets and liabilities grouped by both measurement category and form. Public business entities would continue to be required to disclose the fair value of financial assets and liabilities measured at amortized cost (except for current trade receivables and payables and demand deposit liabilities). In a significant change from current practice, nonpublic entities would no longer be required to disclose the fair value of financial instruments measured at amortized cost.

Transition and effective date

An entity would apply the guidance to all outstanding instruments and record a cumulative-effect adjustment to beginning retained earnings as of the beginning of the first reporting period in which it becomes effective (i.e., a modified-retrospective approach), with two exceptions. The FASB tentatively decided that the new disclosure requirements and the practical expedient for recognizing and measuring nonmarketable equity securities would be effective prospectively. The FASB has yet to decide on an effective date for the proposed amendments.

Endnotes:

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[1] FASB Proposed Accounting Standards Update (ASU), *Financial Instruments — Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*, February 2013.

[2] FASB Proposed ASU, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*, May 2010.

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Appendix: Summary of proposed disclosure requirements

Instruments and features affected	Proposed disclosure requirements
Financial assets and financial liabilities	Entities would disclose in the notes to the financial statements all financial assets and financial liabilities grouped by measurement category (e.g., amortized cost, FV-NI) and form of financial assets (i.e., securities versus loans/receivables).

Financial assets and financial liabilities measured at amortized cost (except for receivables and payables due within one year and demand deposit liabilities)	A public business entity (PBE) would be required to disclose the fair value of financial assets and financial liabilities measured at amortized cost either parenthetically on the face of the balance sheet or in the notes to the financial statements.
	▸ A PBE would also be required to disclose the level of the fair value hierarchy (i.e., level 1, 2 or 3) within which the fair value measurement of financial instruments measured at amortized cost is categorized in their entirety.
	  ▸ Disclosure about the fair value of financial assets measured at amortized cost would be disaggregated into major categories (i.e., securities and loans/receivables) of those assets.
	▸ A PBE wouldn't be required to disclose the following information:
	  ▸ The method(s) and significant assumptions used to estimate the fair value of financial instruments consistent with the requirements of paragraph ASC 820-10-50-2(bbb).
	  ▸ 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.
	Non-PBEs would be exempt from disclosing the fair value of financial instruments measured at amortized cost.

Fair value measurements only for disclosure purposes	The exception in ASC 825 that allows entities to calculate fair values of certain financial instruments using an entry price notion rather than the exit price notion of ASC 820 would no longer be allowed.
Investments in equity securities without readily determinable fair values measured using the practicability exception	An entity would disclose the carrying amount of investments in equity securities measured using the practicability exception and the amount of adjustments made to the carrying amount due to observable changes and impairment charges during the reporting period. ▸ An entity would not have to disclose the information that it considered in reaching the carrying amount and upward or downward adjustments resulting from observable price changes.