Financial Instruments Developments Meeting

Wednesday, April 1st
2:45pm – 4pm
JW Marriot Desert Ridge Resort & Spa
Phoenix, AZ

Moderator:
Andrew Corsini, Partner, KPMG LLP

Panelists:
Steven Broadwater, SVP & CAO, Simon Property Group, Inc.
Daniel Gentzel, Managing Director, Chatham Financial
Serena Wolfe, Partner, Ernst & Young
Stephen Yarad, CFO, MFA Financial, Inc.

No. 2014-08
13 March 2014

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.

No. 2015-04
22 January 2015

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.

The proposal is expected to accelerate recognition of impairment losses in equity 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 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.

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.

No. 2015-16
12 March 2015

To the Point

FASB — proposed guidance

FASB poised to make significant changes to credit impairment model

Entities would be required to recognize lifetime expected credit losses rather than incurred losses.

What you need to know

- The FASB substantially completed redeliberations on credit impairment and plans to issue a final standard that would apply to all entities, not just those in financial services.
- An entity would recognize an allowance for management's current estimate of lifetime expected credit losses for loans, trade receivables, held-to-maturity debt securities and certain other financial assets measured at amortized cost.
- Today's other-than-temporary impairment model for available-for-sale debt securities would be modified to require an allowance for credit impairment rather than a direct write-down, among other things.
- Entities would be required to make disclosures about the credit quality of certain financing receivables by year of origination (i.e., vintage). This would significantly expand the volume of disclosures.
- The Board will decide on an effective date after the staff prepares a draft of the final standard. We expect the FASB to issue a final standard in the second half of 2015.

Overview

The Financial Accounting Standards Board (FASB or the Board) has substantially completed redeliberations on new guidance that would significantly change how entities measure and recognize credit impairment for certain financial assets. Today's incurred loss model would be replaced with one that requires management to estimate all contractual cash flows that it does not expect to collect over the lives of loans and other debt instruments measured at amortized cost.

Building a better working world

The FASB also decided to change today's other-than-temporary impairment (OTTI) model[1] for available-for-sale (AFS) debt securities. Entities would no longer be required to consider certain factors when determining whether an impairment should be recognized. They also would be required to recognize an allowance for credit impairment rather than a direct reduction of a security's cost basis. As a result, entities could reverse credit impairments.

The FASB has been working on ways to improve the accounting for credit impairment since the financial crisis in 2008. Today's guidance was criticized for delaying recognition of credit impairments of financial assets and for providing multiple models that were too complex. The FASB initially worked with the International Accounting Standards Board (IASB) to develop new guidance but the Boards ultimately were unable reach a converged solution. The FASB's decisions on credit impairment differ significantly from the three-stage impairment model the IASB finalized as part of IFRS 9.[2]

This publication summarizes the FASB's tentative decisions to date. We expect the FASB to issue a final standard in the second half of 2015. The FASB hasn't yet decided on an effective date.

Summary of proposed amendments

Financial assets measured at amortized cost

An entity would apply what the FASB calls the "current expected credit loss" (CECL) model to most financial assets measured at amortized cost as well as certain other items.

Illustration 1 — Scope of FASB's CECL model

Items in scope	Items out of scope
‣ Loans, including those made to meet a not-for-profit entity's mission (e.g., programmatic loans) ‣ Held-to-maturity (HTM) debt securities ‣ Trade, lease and reinsurance receivables ‣ Loan commitments ‣ Financial guarantees that are not accounted for as insurance or at fair value through net income	‣ Related party loans and receivables between entities under common control ‣ Loans made to participants by defined contribution employee benefit plans ‣ Policy loan receivables of an insurance entity ‣ A not-for-profit entity's pledges receivable (i.e., promises donors have made)

Under the CECL model, an entity would reserve for all contractual cash flows not expected to be collected from a recognized financial asset (or group of financial assets) or commitment to extend credit. The estimate of expected credit losses would consider all contractual cash flows over the life of the asset. The estimate would be developed based on historical loss experience for similar assets as well as management's assessment of current conditions and reasonable and supportable forecasts about the future.

Further, the FASB tentatively decided that an entity's estimate of expected credit losses should always reflect the risk of loss, even when that risk is remote. As a result, there would only be limited circumstances in which a reserve of zero would be appropriate.

The final standard would also eliminate the guidance in Accounting Standards Codification (ASC) 310-30[3] that applies to purchased credit-impaired (PCI) financial assets. Under the new model, an entity would recognize a CECL allowance for expected credit losses on a PCI asset it acquires (based on an estimate of expected contractual shortfalls, as described above), and the initial cost basis of the asset would equal the sum of (1) the purchase price and (2) the estimate of expected credit losses as of the date of acquisition. The subsequent accounting for PCI assets would be the same as for originated loans.

The final standard is also expected to include guidance addressing:

- Information that management would consider in determining expected credit losses
- How expected prepayments, extensions, renewals and modifications should be considered
- Estimation on a collective (pool) basis and estimation on an individual basis
- Reversion to historical averages for periods beyond which management is able to make or obtain a reasonable and supportable forecast about the future
- Collateral-based practical expedients for estimating expected credit losses
- Cost-basis adjustments resulting from troubled debt restructurings

How we see it

While the concept of the CECL model is relatively simple, entities may face significant implementation challenges, including:

- Obtaining historical lifetime credit loss data and developing appropriate models and methodologies to aggregate and analyze such information
- Developing reasonable and supportable forecasts about the future and determining how to adjust historical data to reflect this information

Once a final standard is issued, we would expect the FASB, the American Institute of Certified Public Accountants, US banking regulators and industry associations to be involved with efforts to try to help entities, particularly smaller ones, manage the complexity of implementation. We believe it is critical that broad consensus be reached about reasonable ways of implementing the standard before entities spend time and resources designing and implementing new methods and models.

Entities may face significant implementation challenges.

Available-for-sale debt securities

The FASB tentatively decided not to apply the CECL model to AFS debt securities. Instead, the FASB decided to modify the existing OTTI model in ASC 320-10. Under today's guidance, an entity first determines whether a security is impaired (i.e., whether its fair value is less than its amortized cost basis). An entity then evaluates whether an impairment is other- than-temporary based on whether (1) the entity intends to sell the security, (2) it is more likely than not that the entity will be required to sell the security before recovering its cost basis or (3) the entity does not expect to recover the entire amortized cost basis of the security by collecting all contractual cash flows (i.e., whether a credit loss exists).

Under the new guidance, an entity evaluating whether a credit loss exists would no longer be required to consider (1) the length of time that the fair value of the security has been less than its amortized cost or (2) recoveries or additional declines in the fair value after the balance sheet date.

How we see it

It's unclear whether the FASB intends to preclude an entity from considering either of these two factors when evaluating whether a credit loss exists or whether an entity would still be permitted to consider them. We expect the final standard to provide clarity on this point.

Further, the FASB decided that entities would recognize an allowance for OTTI credit losses rather than reduce their cost basis as they do today. The new approach would allow an entity to recognize reversals of OTTI credit losses, which would immediately reduce the provision for credit losses. Today, a recovery of an OTTI credit loss is recognized as interest income over time.

Disclosures

For AFS debt securities, the existing OTTI disclosure requirements would be retained, but they would be updated to reflect the Board's other decisions about AFS debt securities (e.g., the change to an allowance approach that permits reversals).

For financial assets measured at amortized cost, an entity would disclose information about its method for developing its allowance as well as changes in the factors that influenced management's estimate of expected credit losses and the reasons for those changes (e.g., change in loss severity). This would be consistent with what the FASB proposed in December 2012.[4]

For financing receivables[5] measured at amortized cost (excluding revolving lines of credit such as credit cards), disclosures about credit risk would be expanded significantly. Specifically, an entity would be required to disaggregate each credit quality indicator by year of the asset's origination (i.e., vintage) for as many as five annual periods. The FASB has directed its staff to perform outreach on the operability and usefulness of the vintage disclosures while the staff prepares a draft of the final standard. The FASB may reconsider the requirement based on this feedback.

Transition and effective date

An entity would apply the guidance by recording a cumulative-effect adjustment to the statement of financial position as of the beginning of the first reporting period in which the guidance is effective. The final standard would also include transition provisions for PCI assets and debt securities. The Board hasn't decided on an effective date but plans to do so after the staff prepares a draft of the final standard and addresses any issues that arise as a result.

Endnotes:

[1] ASC 320-10, *Investments — Debt and Equity Securities.*

[2] IFRS 9, *Financial Instruments,* July 2014.

[3] ASC 310-30, *Receivables — Loans and Debt Securities Acquired with Deteriorated Credit Quality*.

[4] FASB Proposed Accounting Standards Update, *Financial Instruments — Credit Losses (Subtopic 825-15),* issued 20 December 2012.

[5] ASC 310-10, *Receivables*, defines a financing receivable generally as a financing arrangement that is both a contractual right to receive money (on demand or on fixed or determinable dates) and is recognized as an asset on the balance sheet, with certain exceptions.

NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

May 15, 2013

Ms. Susan Cosper
Technical Director
File Reference No. 2013-220
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, Connecticut 06856-5116
director@fasb.org

Delivered Electronically

Re: File Reference No. 2013-220, Financial Instruments – Overall (Subtopic 825-10): *Recognition and Measurement of Financial Assets and Financial Liabilities*

Dear Ms. Cosper:

This letter is submitted by the National Association of Real Estate Investment Trusts® (NAREIT) in response to the Proposed Accounting Standards Update (Proposed ASU or the Proposal) from the Financial Accounting Standards Board (FASB or the Board) on Financial Instruments – Overall (Subtopic 825-10): *Recognition and Measurement of Financial Assets and Financial Liabilities*.

NAREIT is the worldwide representative voice for real estate investment trusts (REITs) and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other businesses throughout the world that own, operate, and finance income-producing real estate, as well as those firms and individuals who advise, study, and service those businesses.

REITs are generally deemed to operate as either Equity REITs or Mortgage REITs. Our members that operate as Equity REITs acquire, develop, lease, and operate income-producing real estate. Our members that operate as Mortgage REITs finance housing and commercial real estate, by originating mortgages or by purchasing whole loans or mortgage backed securities in the secondary market.

A useful way to look at the REIT industry is to consider an index of stock exchange-listed companies like the FTSE NAREIT U.S. Real Estate Index, which covers both Equity REITs and Mortgage REITs. This Index contained 172 companies representing an equity market capitalization of $603.4 billion at 2012 year end. Of these companies, 139 were Equity REITs representing 90.2% of total U.S. listed

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REIT equity market capitalization (amounting to $544.4 billion)[1]. The remainder, as of December 31, 2012, was 33 publicly traded Mortgage REITs with a combined equity market capitalization of $59 billion.

NAREIT's Recommendation

NAREIT recommends that the FASB continue with its approach in the Proposal to provide companies with the ability to recognize and measure financial assets and financial liabilities based on a business model assessment. NAREIT commends the Board for working with the International Accounting Standards Board (IASB) (collectively, the Boards) in developing a mixed attribute model for the recognition and measurement of financial assets (*i.e.*, amortized cost, fair value through other comprehensive income, and fair value through net income) and financial liabilities (*i.e.*, amortized cost and fair value through net income). NAREIT has supported a mixed attribute model for financial instruments previously. For example, NAREIT recommended that the Board develop a mixed attribute model in its September 30, 2010 submission[2] regarding the FASB's Proposal on Financial Instruments (Topic 825) and Derivatives and Hedging (Topic 815): *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities.*

In NAREIT's view, a mixed attribute model would be consistent with the business models of companies that own and operate real estate, as well as companies that finance transactions involving real estate. These companies typically hold or issue financial assets and financial liabilities for collection or payment of contractual cash flows for principal and interest. We believe that the amortized cost method more accurately reflects this business strategy, rather than measuring these financial instruments at fair value implying that the intention is to trade financial instruments. In addition, for companies that hold mortgage backed securities for collection or payment of contractual cash flows for principal and interest or for sale, we believe that the fair value through other comprehensive income method appropriately reflects this business strategy. For financial instruments held for trading purposes, we agree with the Board that fair value through net income is a more appropriate method.

While NAREIT supports the FASB's mixed attribute model, we recommend the following enhancements to the Proposal:

- **Synchronize embedded derivatives guidance for financial assets with financial liabilities**

- **Eliminate the assessment for cash flows based solely on principal and interest**

- **Converge the Proposal's impairment guidance with the FASB and IASB respective Credit Impairment models in allowing for the reversal of previously recorded impairment charges**

[1] http://returns.reit.com/reitwatch/rw1301.pdf at page 20.
[2] http://www.reit.com/~/media/Files/Policy/NAREITFinancialInstrumentsLetter1810-100.ashx

- **Clearly articulate the threshold for sales and the consequence of selling financial assets that are classified in the amortized cost category**

- **Ensure that interim disclosures are not a mere repeat of the annual disclosures unless there is a material change**

Synchronize embedded derivatives guidance for financial assets with financial liabilities

NAREIT contends that the Proposal, as written, creates asymmetry between financial assets and financial liabilities. While financial liabilities would continue to be evaluated for bifurcation of embedded derivatives, the corresponding embedded derivative guidance for financial assets would no longer exist. As a result, the *mere existence* of an embedded derivative in a financial asset, even if of quite limited magnitude, would cause the entire financial instrument to be subject to the cash flow characteristics and business model assessment to determine its classification and measurement. In NAREIT's view, this could result in different accounting treatment for economically similar arrangements.

Common investments amongst NAREIT's membership are debt investments, which may have embedded derivatives designed to remove uncertainty about future cash flows. NAREIT believes that to the extent that an embedded derivative *exists* in debt instruments, these instruments would fail the proposed cash flow characteristics test. Consequently, these investments would be measured at fair value with changes in value recognized in net income. Thus, NAREIT believes that it is not the existence of the derivative, but the function of the derivative that should matter. An instrument with an embedded derivative that is economically similar to an instrument that qualifies for amortized cost should be accounted for at amortized cost (*i.e.*, a single instrument). If an embedded derivative is not clearly and closely related to the host contract, it should be bifurcated and accounted for separately.

NAREIT recommends that the FASB retain existing embedded derivatives guidance for financial assets, which would create symmetry with financial liabilities. NAREIT does not believe that the current embedded derivative guidance for financial assets is broken. Currently, an embedded derivative is bifurcated and accounted for separately if it is not clearly and closely related to the host contract. Preparers account for the host contract separately from the embedded derivative, which is measured at fair value with changes in value recognized in net income. In this manner, changes in fair value are isolated to the embedded derivative only, as opposed to the entire financial asset as required by the Proposal.

Eliminate the assessment for cash flows based solely on principal and interest

NAREIT believes that the criteria to classify financial instruments at amortized cost are too restrictive. For example, many financial instruments that currently are held for the collection of cash flows and are therefore measured at amortized cost would be precluded from such classification under the Proposal. Additionally, financial assets with early redemption features could fail the assessment of cash flows based solely on principal and interest when acquired at a premium or discount. Another example is an investment in subordinated tranches of a mortgage securitization. In NAREIT's view, current U.S. GAAP that requires an embedded derivatives assessment more faithfully presents the underlying economics of the transaction. Therefore, NAREIT recommends that the FASB eliminate the assessment for cash flows based solely on principal and interest from the Proposal, and maintain existing embedded derivatives guidance for financial assets.

NAREIT also notes that the proposed cash flow test would *add* to complexity because the embedded derivative bifurcation rules would still be needed for financial liabilities. And no doubt, the proposed new test would lead to more questions and interpretation.

Converge the Proposal's impairment guidance with the FASB and IASB respective Credit Impairment models that allow for the reversal of previously recorded impairment charges

NAREIT understands that the Proposal would eliminate current impairment guidance on other-than-temporary-impairments (OTTI) for equity investments not measured at fair value through net income. The new impairment model would be based on a qualitative assessment (*i.e.,* more likely than not) as to whether the carrying amount of the investment exceeds fair value.

While we welcome the simplified approach to recording impairment charges, we are concerned that the Proposal would only allow preparers to record downward adjustments and not reverse those losses in situations where the fair value of investments subsequently increases. With the benefit of hindsight, we could observe whether market downturns are sustained. To the extent that markets stabilize, we believe that an accounting model that allows for reversals of previously recorded impairment write-downs would more accurately reflect the financial position of a company. In our view, this symmetric accounting model would provide the best information to users of financial statements.

Further, NAREIT observes that the proposed impairment model is divergent from the models proposed by the FASB and the IASB in their respective Credit Impairment models. NAREIT notes that both the FASB and IASB Credit Impairment proposals allow for the reversal of previously recorded allowance for credit losses. In our view, providing companies with the ability to reverse previously recorded impairment write-downs would serve as an opportunity for the FASB to synthesize impairment guidance within U.S. GAAP with respect to financial instruments and achieve convergence with the IASB at the same time.

Clearly articulate the threshold for sales and the consequence of selling financial assets that are classified in the amortized cost category

NAREIT understands that the Proposal would eliminate the concept of "tainting" from U.S. GAAP that occurs when a company sells financial instruments that are classified as held to maturity. Under the Proposal, the FASB indicates that such sales should be rare and infrequent. However, the Proposal does not articulate how many times such sales could occur. Nor does the Proposal indicate what the consequences are of executing sales from the amortized cost category. In order to reduce the possibility for improper sales from the amortized cost category, and work towards reducing situations whereby some companies might try to "game the system," NAREIT recommends that the FASB clearly articulate a threshold for sales (and the consequence of selling beyond this threshold) of financial assets that are classified in the amortized cost category.

Ensure that interim disclosures are not a mere repeat of the annual disclosures unless there is a material change

As NAREIT indicated in its November 30, 2012 submission[3] on the FASB's *Disclosure Framework* discussion paper, NAREIT has observed a growing trend in accounting pronouncements that requires companies to prepare the same types of disclosures at both interim and annual reporting dates. NAREIT questions whether detailed information can continue to be disclosed at interim periods given shorter quarterly SEC financial reporting deadlines (*i.e.,* 40 days for both large accelerated filers and accelerated filers, and 45 days for non-accelerated filers[4]) when compared with annual SEC financial reporting deadlines (*i.e.,* 60 days for large accelerated filers, 75 days for accelerated filers, and 90 days for non-accelerated filers[5]). According to APB 28: *Interim Financial Reporting*, each interim period is an integral part (as opposed to a discrete part) of the annual reporting period. Therefore, NAREIT suggests that the Board consider the approach that the SEC utilizes for changes in financial condition and quantitative and qualitative disclosures of market risks. The SEC requires these disclosures in annual reports. To the extent that there has been a material change since the date of the most recent annual report, the SEC requires disclosures in quarterly filings as well. By taking this approach, the SEC has effectively reduced unnecessary disclosure duplication. NAREIT believes that the FASB would achieve its objective by taking a similar approach.

Other Comments

NAREIT notes that in the FASB's consequential amendments document, hedge accounting for interest rate risk is not permitted for debt securities measured at amortized cost, but apparently is permitted for loans measured at amortized cost. NAREIT found this difficult to understand given that the Proposal overall treats securities and loans in the same manner. NAREIT believes hedge accounting should be permitted for both loans and securities which would be consistent with good treasury risk management practices (*e.g.,* see paragraph 825-10-55-73 in the Proposal).

NAREIT observes that the proposed held-for-sale criteria for equity method investments may be interpreted very broadly. We are concerned that this may result in certain investments being inappropriately reported at fair value through net income, which may be contrary to the Board's intention. For example, investments reported under the equity method of accounting (*e.g.,* investments in joint ventures, partnerships and limited liability companies) might be considered held-for-sale investments simply because (1) the underlying arrangements may contain explicit or implied end/termination dates or (2) management often considers a wide range of exit plans depending on future developments over a long time horizon. NAREIT does not believe this result would represent the most useful financial reporting and questions whether or not the Board intended this result.

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[3] http://www.reit.com/~/media/Files/Policy/Letter-to-FASB-on-Disclosure-Framework-11-30-12.ashx

[4] http://www.sec.gov/answers/form10q.htm

[5] http://www.sec.gov/answers/form10k.htm

In summary, we urge the FASB and the IASB to remain committed on their convergence efforts. As the Boards near the completion of the convergence projects, we implore the FASB and IASB to work together to reduce differences in their respective Financial Instruments models. This will benefit preparers, users, auditors, and regulators alike.

We thank the FASB for the opportunity to comment on the Proposal. If you would like to discuss our views in greater detail, please contact George Yungmann, NAREIT's Senior Vice President, Financial Standards, at gyungmann@nareit.com or 1-202-739-9432, or Christopher Drula, NAREIT's Vice President, Financial Standards, at cdrula@nareit.com or 1-202-739-9442.

Respectfully submitted,

George Yungmann
Senior Vice President, Financial Standards
NAREIT

Christopher T. Drula
Vice President, Financial Standards
NAREIT

REIT Wise®

March 31- April 2
2015

NAREIT's Law, Accounting
& Finance Conference

JW Marriott Desert Ridge Resort & Spa
Phoenix, AZ

Concurrent Session 1:
Financial Instruments Developments

April 1, 2014 2:45pm – 4:00pm

Presenters

Moderator:
Andrew Corsini, Partner, KPMG LLP

Panelists:
Steven Broadwater, SVP & CAO, Simon Property Group, Inc.
Daniel Gentzel, Managing Director, Chatham Financial
Serena Wolfe, Partner, EY
Stephen Yarad, CFO, MFA Financial, Inc.

FASB's Financial Instruments project

Classification and Measurement

Building a better working world

Classification and measurement

Background

- FASB issued a revised ED on classification and measurement in February 2013
    - FASB and IASB jointly deliberated selected aspects of their classification and measurement models
    - FASB's proposal and IASB's amendments to IFRS 9 would require entities to classify and measure their financial assets by applying a cash flow characteristics test and a business model test
- Redeliberations
    - FASB decided not to pursue the February 2013 proposed model and instead make only targeted amendments to existing US GAAP
- The FASB has not yet decided on an effective date
- Final standard is expected by the end of Q2 2015

Classification and measurement

Proposed changes to existing US GAAP

- Investments in equity securities (not accounted for under the equity method) would be measured at FV-NI
  - Practicability exception for investments in equity securities without readily determinable fair values
    - Measurement would be at cost less impairment, adjusted for observable price changes for an identical or similar investment of the same issuer
- Changes in instrument-specific credit risk for financial liabilities (that are measured under the fair value option) would be recognized in OCI
- Valuation allowances on deferred tax assets related to debt securities classified and measured at FV-OCI would be evaluated in combination with an entity's other deferred tax assets

Classification and measurement

Proposed changes to existing US GAAP (cont'd)

- 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
- Exception to measure the fair value of loans receivable for disclosure purposes on an entry price notion would be eliminated
- Transition
  - 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.

Classification and measurement

Existing US GAAP would be retained

- Classification and measurement models for loans and debt securities
- Accounting for equity method investments
- Guidance for bifurcating embedded derivatives from hybrid financial instruments
- Guidance for financial liabilities not measured under the FVO
- Unconditional fair value option
- Classification and measurement of lender loan commitments
- Accounting for unrealized foreign currency gains and losses on available-for-sale debt securities
- Balance sheet presentation

What does this mean for REITs?

- Proposed model is substantially consistent with current US GAAP
- REITs with large equity security holdings will experience increased income (and FFO) volatility
- REITs that have elected FVO for assets and liabilities will no longer have ‘symmetry’ in the income statement

Financial Instruments - Hedging

Topics for discussion

- Project background
- Potential changes and the impact on REITs
- Timing

Financial Instruments - Hedging

Project background

- 2008 Exposure Draft
- 2010 Proposed ASU
- IFRS 9
- Current project

Financial Instruments - Hedging

Potential changes and the impact on REITs

- FASB conducting research in certain areas
  - Risks permitted to be hedged
  - Effectiveness threshold
  - Effectiveness assessment
  - Ineffectiveness measurement
  - Presentation and disclosure
  - Hedge relationship documentation
  - Voluntary dedesignation

Financial Instruments - Hedging

Potential changes and the impact on REITs

- Risks permitted to be hedged
  - Currently permitted risks
    - Benchmark interest rate (i.e. US Treasury, LIBOR, & Fed Funds)
    - Foreign currency
    - Credit
    - Overall changes

Financial Instruments - Hedging

Potential changes and the impact on REITs

- Risks permitted to be hedged (continued)
  - Potential changes to permitted risks
    - Financial and non-financial component hedging
    - Changes to benchmark interest rate definition
    - Introduction of “contractually specified” concept
    - Separately identifiable & reliably measureable unlikely to be included
  - Impact
    - Expansion of risks permitted to be hedged
    - Not quite as expansive as the IASB model in IFRS 9
    - Easier to hedge SIFMA, Prime, and commodity exposures

Financial Instruments - Hedging

Potential changes and the impact on REITs

- Effectiveness threshold
  - Current threshold – highly effective (80%-125% offset)
  - Potential changes to threshold
    - Non-financial risk – may become reasonably effective or stay at highly effective (depending on outcome of component hedging decision)
    - Financial risk – may continue to be highly effective
  - Impact
    - Minor impact on interest rate hedging
    - Commodity hedging relationships become more likely to qualify
      - Significant ineffectiveness could still exist depending on nonfinancial risk exposure permitted to be hedged

Financial Instruments - Hedging

Potential changes and the impact on REITs

- Effectiveness assessment
  - Currently perform at inception and ongoing basis (at least quarterly)
  - Potential changes
    - Short-cut and critical terms match methods may go away
    - Quantitative assessment at inception & qualitative assessment thereafter
    - Quantitative assessment necessary if changes to critical terms of hedging relationship occur
  - Impact
    - Effectiveness assessments should become easier to administer over time, except in situations where critical terms are likely to change (e.g. forward hedging of debt issuances)
    - Ineffectiveness still needs to be measured in each hedging relationship

Financial Instruments - Hedging

Potential changes and the impact on REITs

- Ineffectiveness measurement
  - Currently
    - Fair value hedges – all ineffectiveness recognized
    - Cash flow hedges – cumulative overhedged amount recognized
  - Potential changes
    - Fair value hedges – no changes expected
    - Cash flow hedges – over and under hedged amounts recognized
  - Impact
    - Recognize ineffectiveness on <u>over and under</u> hedged amounts

Financial Instruments - Hedging

Potential changes and the impact on REITs

- Presentation and disclosure
  - Expanded disclosure
  - Rollforward of hedging activity
  - Impact
    - Greater transparency of where hedging related amounts are presented in financial statements

Financial Instruments - Hedging

Potential changes and the impact on REITs

- Hedging relationship documentation
  - Considering simplified/relaxed requirements
  - Could be less punitive than current practice
  - Impact
    - Possibly more time to complete documentation
    - Goal to “get it right” rather than “receive the death penalty”

Financial Instruments - Hedging

Potential changes and the impact on REITs

- Voluntary dedesignation
  - Voluntary dedesignation is currently permitted
  - Proposal could prohibit voluntary dedesignation
  - Impact
    - Less flexibility to manage hedge portfolio

Financial Instruments - Hedging

Timing

- Next steps in the current project
  - Continue research efforts
  - Prepare and expose amendments
  - Issue ASU
  - Effective ASU

FASB's Financial Instruments project

Credit loss model

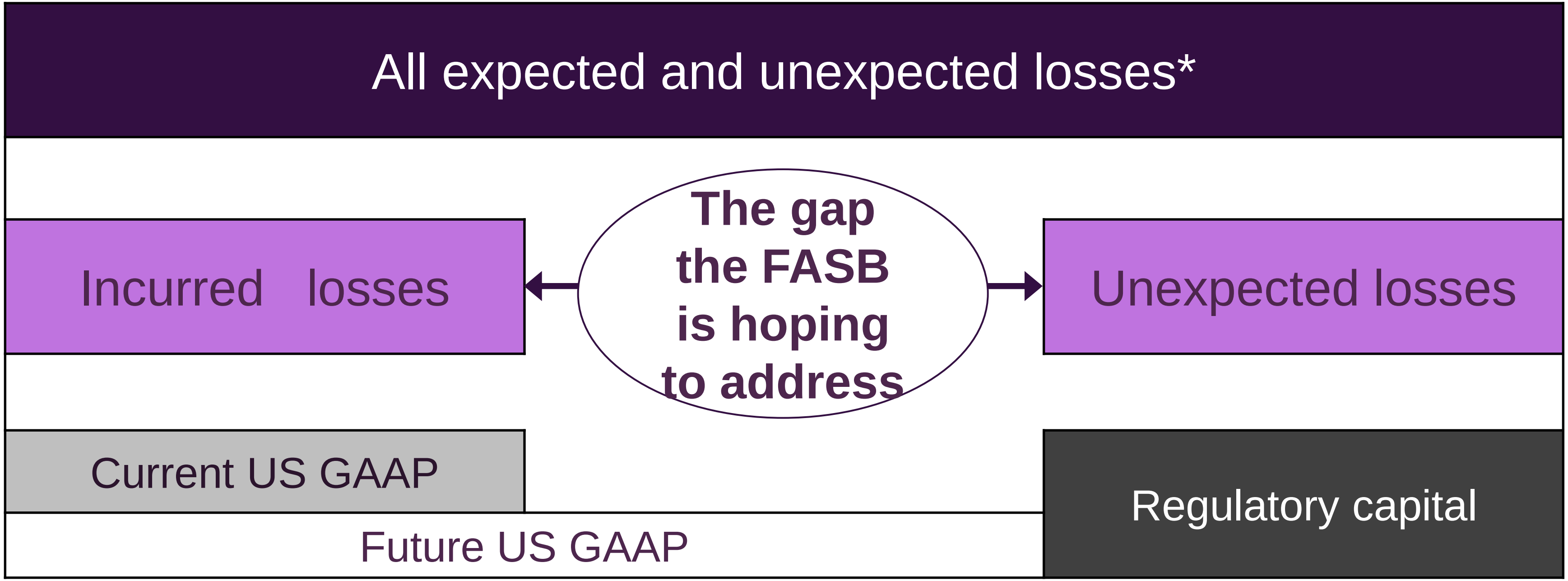
Building a better
working world

FASB's Current expected credit loss model

Background

- Financial Crisis Advisory Group organized by FASB and IASB in October 2008
  - Consider how improvements in financial reporting could help enhance investors' confidence in financial markets
- Primary weaknesses identified
  - Delayed recognition of losses associated with loans and other financial instruments
  - Complexity of multiple impairment approaches
- Recommended that the Boards explore an alternative to the incurred loss model that would use forward-looking information

Expected credit losses
The concept



*This diagram is **not** drawn to scale.

The credit impairment journey

Nov 2009
ED
Lifetime losses built into effective interest rate
IASB

May 2010
ED
Lifetime expected losses on origination
FASB

Jan 2011
SD
Good book and bad book
FASB & IASB

Apr 2011
'Three-bucket' expected loss model
FASB & IASB

Dec 2012
ED
Current expected credit loss (CECL) model
FASB

Mar 2013
ED
Expected credit loss model
IASB

Q2 2014
IFRS 9
IFRS issues final standard
IASB

H2 2015
ASU
FASB to issue final CECL standard
FASB

Scope

- Entities would apply the proposal to financial assets including:

Debt instruments recognized at amortized cost

(Loans, held-to-maturity debt securities, trade and reinsurance receivables)

Lease receivables recognized by lessors

Loan commitments

Proposal

CECL Model

(to replace ASC 310-10, 310-30, 320-10, & 450-20)

Available-for-sale debt securities

Proposal

Retain current US GAAP

(with modifications to ASC 320-10)

Available-for-sale debt securities

- Today's other-than-temporary impairment (OTTI) model would continue to be applied to available-for-sale (AFS) debt securities with some modifications:
  - An allowance would be used to recognize the credit portion of an OTTI, so an entity would recognize reversals of those losses immediately upon improvement in credit quality
  - When assessing OTTI, an entity would no longer consider:
    - The length of time that the fair value of the AFS debt security has been less than its amortized cost basis
    - Recoveries or additional declines in the fair value of the AFS debt security after the balance sheet date

Current expected credit loss model
As proposed (December 2012 ED)

- An estimate of all **contractual cash flows** not expected to be collected would include the following elements:

At least two possible outcomes, one of which reflects a credit loss

Information about past events

Information about current conditions

Reasonable and supportable forecasts

Time value of money

Current expected credit loss model
What has changed during redeliberations?

- An estimate of all **contractual cash flows** not expected to be collected would include the following elements:

The risk of loss, even if that risk is remote

Information about past events

Information about current conditions

Reasonable and supportable forecasts

Time value of money

FASB removed the multiple outcomes approach;
a probability-weighted analysis of scenarios not required

Current expected credit loss model
What has changed during redeliberations?

- An estimate of all **contractual cash flows** not expected to be collected would include the following elements:

The risk of loss, even if that risk is remote

Information about past events

Information about current conditions

Reasonable and supportable forecasts

Time value of money

For periods beyond which the entity is able to obtain reasonable and supportable forecasts, the entity would revert to its unadjusted historical credit loss experience

Current expected credit loss model
What has changed during redeliberations?

- An estimate of all **contractual cash flows** not expected to be collected would include the following elements:

The risk of loss, even if that risk is remote

Information about past events

Information about current conditions

Reasonable and supportable forecasts

Time value of money

Acceptable methods and models include: discounted cash flow, loss rate, probability of default and loss given default, provision matrices

Current expected credit loss model
Other clarifications

- Unit of measurement: measure credit losses on a collective (pool) basis when similar risk characteristics exist
  - Measure credit losses on an individual financial asset basis only when that asset does not share similar risk characteristics with other financial assets of the entity

- Collateral-based practical expedients for subsequent measurement of expected losses include:
  - For a collateral-dependent financial asset, measure CECL allowance as the difference between the collateral’s fair value (adjusted for selling costs, when applicable) and the amortized cost basis of the asset
  - For a financial asset in which the borrower must continually adjust the amount of collateral securing the financial asset, limit the CECL allowance to the difference between the collateral’s fair value (adjusted for selling costs) and the amortized cost basis of the asset

Current expected credit loss model
Other clarifications (continued)

- All contractual cash flows should be considered
    - The full contractual term of the financial asset, adjusted for expected prepayments
    - Expected extensions, renewals and modifications would not be considered unless the entity reasonably expects to execute a troubled debt restructuring with the borrower
- For the funded portion of loan commitments, expected credit losses should be estimated in the same manner as for other loans
    - Expected credit losses for unfunded loan commitments should reflect the full contractual period over which the entity is exposed to credit risk via a present legal obligation to extend credit, unless unconditionally cancellable by the issuer
- Areas for which FASB decided to retain current US GAAP
    - Write off when the financial asset is deemed uncollectible (also applicable to AFS debt securities)
    - Nonaccrual practices

Current expected credit loss model
Practical considerations

- Lenders would need to develop estimation techniques that aim to faithfully estimate lifetime expected credit losses

- Unit of measurement
  - FASB's proposal was drafted with a pooled view, however, a bank would be permitted to measure credit losses on an individual financial asset basis only when that asset does not share similar risk characteristics with other financial assets of the entity
  - Measuring credit losses for individual loans
    - Use of fair value would not be permitted as a practical expedient
    - Requirement to use collateral when foreclosure is probable would be removed
    - Proposal would change definition of collateral-dependent
      - A financial asset for which the repayment is expected to be provided primarily or substantially through the operation (by the lender) or sale of the collateral, based on an entity's assessment as of the reporting date

Current expected credit loss model
Practical considerations (continued)

- Unit of measurement
  - Measurement of credit losses for pools of loans
    - Are companies considering the need for new or different modelling techniques or approaches to achieve the lifetime loss objective?
    - If not, what changes to current modelling techniques may be needed to capture the movement from incurred to lifetime expected losses
    - Commercial versus consumer loans
      - Different product lines for consumer loans (residential vs. credit cards)
    - Modelling assumptions
      - Policy elections
      - Estimation judgments
  - Measurement of credit losses for unfunded loan commitments

- Data needs and availability

Current expected credit loss model
Purchased credit impaired financial assets

- Current guidance for so-called purchased credit-impaired (PCI) financial assets (SOP 03-3) would be replaced with a “gross up” model
  - Recognize a CECL allowance for expected credit losses on PCI assets
  - Initial cost basis of the asset would equal the sum of (1) the purchase price and (2) the estimate of expected credit losses as of the date of acquisition
  - Subsequent accounting for PCI assets would be the same as other originated loans
- Example:

Assume Company A acquires a debt instrument with the following characteristics:

- Par amount of $100,000
- Purchase price of $80,000 (the instrument has experienced significant deterioration in credit quality since origination)
- Expected credit loss embedded in the $20,000 discount to par is determined to be $15,000

<u>Journal entry at purchase:</u>

Debt instrument (par amount)	100,000	
Debt instrument (noncredit discount)		5,000
Allowance for expected credit losses		15,000
Cash		80,000

- Non-credit discount of $5,000 would be accreted into interest income over the life of the instrument under ASC 310-20
- Allowance would be remeasured each reporting period

What does this mean for REITs?

- Significant impacts expected, particularly for MREITs and Equity REITs that invest in structured products
- Accounts Receivable and Lease Receivables would be in scope therefore proposed changes could be a ‘sleeper’ issue for Equity REITs
  - Change in reserves unlikely to be material but could have significant process and controls implications
- Many implementation issues remain
  - Little additional guidance provided during redeliberations
  - How to apply to high credit quality debt securities i.e. Treasuries vs. Agencies
  - Proposed accounting for purchased credit impaired financial assets could create volatility in comparison to current GAAP

Current expected credit loss model
The path forward

- Significant matters to be discussed at future meetings:
    - Transition (expect to be discussed in March 2015)
    - Effective date (to be discussed once a staff draft of the final standard has been prepared)
- We anticipate the FASB will reach final decisions in the first half of 2015 and issue a final standard in the second half of 2015

NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

May 15, 2013

Ms. Susan Cosper
Technical Director
File Reference No. 2013-220
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, Connecticut 06856-5116
director@fasb.org

Delivered Electronically

Re: File Reference No. 2013-220, Financial Instruments – Overall (Subtopic 825-10): *Recognition and Measurement of Financial Assets and Financial Liabilities*

Dear Ms. Cosper:

This letter is submitted by the National Association of Real Estate Investment Trusts® (NAREIT) in response to the Proposed Accounting Standards Update (Proposed ASU or the Proposal) from the Financial Accounting Standards Board (FASB or the Board) on Financial Instruments – Overall (Subtopic 825-10): *Recognition and Measurement of Financial Assets and Financial Liabilities*.

NAREIT is the worldwide representative voice for real estate investment trusts (REITs) and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other businesses throughout the world that own, operate, and finance income-producing real estate, as well as those firms and individuals who advise, study, and service those businesses.

REITs are generally deemed to operate as either Equity REITs or Mortgage REITs. Our members that operate as Equity REITs acquire, develop, lease, and operate income-producing real estate. Our members that operate as Mortgage REITs finance housing and commercial real estate, by originating mortgages or by purchasing whole loans or mortgage backed securities in the secondary market.

A useful way to look at the REIT industry is to consider an index of stock exchange-listed companies like the FTSE NAREIT U.S. Real Estate Index, which covers both Equity REITs and Mortgage REITs. This Index contained 172 companies representing an equity market capitalization of $603.4 billion at 2012 year end. Of these companies, 139 were Equity REITs representing 90.2% of total U.S. listed

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REIT equity market capitalization (amounting to $544.4 billion)[1]. The remainder, as of December 31, 2012, was 33 publicly traded Mortgage REITs with a combined equity market capitalization of $59 billion.

NAREIT's Recommendation

NAREIT recommends that the FASB continue with its approach in the Proposal to provide companies with the ability to recognize and measure financial assets and financial liabilities based on a business model assessment. NAREIT commends the Board for working with the International Accounting Standards Board (IASB) (collectively, the Boards) in developing a mixed attribute model for the recognition and measurement of financial assets (*i.e.*, amortized cost, fair value through other comprehensive income, and fair value through net income) and financial liabilities (*i.e.*, amortized cost and fair value through net income). NAREIT has supported a mixed attribute model for financial instruments previously. For example, NAREIT recommended that the Board develop a mixed attribute model in its September 30, 2010 submission[2] regarding the FASB's Proposal on Financial Instruments (Topic 825) and Derivatives and Hedging (Topic 815): *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities.*

In NAREIT's view, a mixed attribute model would be consistent with the business models of companies that own and operate real estate, as well as companies that finance transactions involving real estate. These companies typically hold or issue financial assets and financial liabilities for collection or payment of contractual cash flows for principal and interest. We believe that the amortized cost method more accurately reflects this business strategy, rather than measuring these financial instruments at fair value implying that the intention is to trade financial instruments. In addition, for companies that hold mortgage backed securities for collection or payment of contractual cash flows for principal and interest or for sale, we believe that the fair value through other comprehensive income method appropriately reflects this business strategy. For financial instruments held for trading purposes, we agree with the Board that fair value through net income is a more appropriate method.

While NAREIT supports the FASB's mixed attribute model, we recommend the following enhancements to the Proposal:

- **Synchronize embedded derivatives guidance for financial assets with financial liabilities**

- **Eliminate the assessment for cash flows based solely on principal and interest**

- **Converge the Proposal's impairment guidance with the FASB and IASB respective Credit Impairment models in allowing for the reversal of previously recorded impairment charges**

[1] http://returns.reit.com/reitwatch/rw1301.pdf at page 20.
[2] http://www.reit.com/~/media/Files/Policy/NAREITFinancialInstrumentsLetter1810-100.ashx

- **Clearly articulate the threshold for sales and the consequence of selling financial assets that are classified in the amortized cost category**

- **Ensure that interim disclosures are not a mere repeat of the annual disclosures unless there is a material change**

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NAREIT contends that the Proposal, as written, creates asymmetry between financial assets and financial liabilities. While financial liabilities would continue to be evaluated for bifurcation of embedded derivatives, the corresponding embedded derivative guidance for financial assets would no longer exist. As a result, the *mere existence* of an embedded derivative in a financial asset, even if of quite limited magnitude, would cause the entire financial instrument to be subject to the cash flow characteristics and business model assessment to determine its classification and measurement. In NAREIT's view, this could result in different accounting treatment for economically similar arrangements.

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NAREIT recommends that the FASB retain existing embedded derivatives guidance for financial assets, which would create symmetry with financial liabilities. NAREIT does not believe that the current embedded derivative guidance for financial assets is broken. Currently, an embedded derivative is bifurcated and accounted for separately if it is not clearly and closely related to the host contract. Preparers account for the host contract separately from the embedded derivative, which is measured at fair value with changes in value recognized in net income. In this manner, changes in fair value are isolated to the embedded derivative only, as opposed to the entire financial asset as required by the Proposal.

Eliminate the assessment for cash flows based solely on principal and interest

NAREIT believes that the criteria to classify financial instruments at amortized cost are too restrictive. For example, many financial instruments that currently are held for the collection of cash flows and are therefore measured at amortized cost would be precluded from such classification under the Proposal. Additionally, financial assets with early redemption features could fail the assessment of cash flows based solely on principal and interest when acquired at a premium or discount. Another example is an investment in subordinated tranches of a mortgage securitization. In NAREIT's view, current U.S. GAAP that requires an embedded derivatives assessment more faithfully presents the underlying economics of the transaction. Therefore, NAREIT recommends that the FASB eliminate the assessment for cash flows based solely on principal and interest from the Proposal, and maintain existing embedded derivatives guidance for financial assets.

NAREIT also notes that the proposed cash flow test would *add* to complexity because the embedded derivative bifurcation rules would still be needed for financial liabilities. And no doubt, the proposed new test would lead to more questions and interpretation.

Converge the Proposal's impairment guidance with the FASB and IASB respective Credit Impairment models that allow for the reversal of previously recorded impairment charges

NAREIT understands that the Proposal would eliminate current impairment guidance on other-than-temporary-impairments (OTTI) for equity investments not measured at fair value through net income. The new impairment model would be based on a qualitative assessment (*i.e.,* more likely than not) as to whether the carrying amount of the investment exceeds fair value.

While we welcome the simplified approach to recording impairment charges, we are concerned that the Proposal would only allow preparers to record downward adjustments and not reverse those losses in situations where the fair value of investments subsequently increases. With the benefit of hindsight, we could observe whether market downturns are sustained. To the extent that markets stabilize, we believe that an accounting model that allows for reversals of previously recorded impairment write-downs would more accurately reflect the financial position of a company. In our view, this symmetric accounting model would provide the best information to users of financial statements.

Further, NAREIT observes that the proposed impairment model is divergent from the models proposed by the FASB and the IASB in their respective Credit Impairment models. NAREIT notes that both the FASB and IASB Credit Impairment proposals allow for the reversal of previously recorded allowance for credit losses. In our view, providing companies with the ability to reverse previously recorded impairment write-downs would serve as an opportunity for the FASB to synthesize impairment guidance within U.S. GAAP with respect to financial instruments and achieve convergence with the IASB at the same time.

Clearly articulate the threshold for sales and the consequence of selling financial assets that are classified in the amortized cost category

NAREIT understands that the Proposal would eliminate the concept of "tainting" from U.S. GAAP that occurs when a company sells financial instruments that are classified as held to maturity. Under the Proposal, the FASB indicates that such sales should be rare and infrequent. However, the Proposal does not articulate how many times such sales could occur. Nor does the Proposal indicate what the consequences are of executing sales from the amortized cost category. In order to reduce the possibility for improper sales from the amortized cost category, and work towards reducing situations whereby some companies might try to "game the system," NAREIT recommends that the FASB clearly articulate a threshold for sales (and the consequence of selling beyond this threshold) of financial assets that are classified in the amortized cost category.

Ensure that interim disclosures are not a mere repeat of the annual disclosures unless there is a material change

As NAREIT indicated in its November 30, 2012 submission[3] on the FASB's *Disclosure Framework* discussion paper, NAREIT has observed a growing trend in accounting pronouncements that requires companies to prepare the same types of disclosures at both interim and annual reporting dates. NAREIT questions whether detailed information can continue to be disclosed at interim periods given shorter quarterly SEC financial reporting deadlines (*i.e.,* 40 days for both large accelerated filers and accelerated filers, and 45 days for non-accelerated filers[4]) when compared with annual SEC financial reporting deadlines (*i.e.,* 60 days for large accelerated filers, 75 days for accelerated filers, and 90 days for non-accelerated filers[5]). According to APB 28: *Interim Financial Reporting*, each interim period is an integral part (as opposed to a discrete part) of the annual reporting period. Therefore, NAREIT suggests that the Board consider the approach that the SEC utilizes for changes in financial condition and quantitative and qualitative disclosures of market risks. The SEC requires these disclosures in annual reports. To the extent that there has been a material change since the date of the most recent annual report, the SEC requires disclosures in quarterly filings as well. By taking this approach, the SEC has effectively reduced unnecessary disclosure duplication. NAREIT believes that the FASB would achieve its objective by taking a similar approach.

Other Comments

NAREIT notes that in the FASB's consequential amendments document, hedge accounting for interest rate risk is not permitted for debt securities measured at amortized cost, but apparently is permitted for loans measured at amortized cost. NAREIT found this difficult to understand given that the Proposal overall treats securities and loans in the same manner. NAREIT believes hedge accounting should be permitted for both loans and securities which would be consistent with good treasury risk management practices (*e.g.,* see paragraph 825-10-55-73 in the Proposal).

NAREIT observes that the proposed held-for-sale criteria for equity method investments may be interpreted very broadly. We are concerned that this may result in certain investments being inappropriately reported at fair value through net income, which may be contrary to the Board's intention. For example, investments reported under the equity method of accounting (*e.g.,* investments in joint ventures, partnerships and limited liability companies) might be considered held-for-sale investments simply because (1) the underlying arrangements may contain explicit or implied end/termination dates or (2) management often considers a wide range of exit plans depending on future developments over a long time horizon. NAREIT does not believe this result would represent the most useful financial reporting and questions whether or not the Board intended this result.

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[3] http://www.reit.com/~/media/Files/Policy/Letter-to-FASB-on-Disclosure-Framework-11-30-12.ashx

[4] http://www.sec.gov/answers/form10q.htm

[5] http://www.sec.gov/answers/form10k.htm

In summary, we urge the FASB and the IASB to remain committed on their convergence efforts. As the Boards near the completion of the convergence projects, we implore the FASB and IASB to work together to reduce differences in their respective Financial Instruments models. This will benefit preparers, users, auditors, and regulators alike.

We thank the FASB for the opportunity to comment on the Proposal. If you would like to discuss our views in greater detail, please contact George Yungmann, NAREIT's Senior Vice President, Financial Standards, at gyungmann@nareit.com or 1-202-739-9432, or Christopher Drula, NAREIT's Vice President, Financial Standards, at cdrula@nareit.com or 1-202-739-9442.

Respectfully submitted,

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NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

May 31, 2013

Ms. Susan Cosper
Technical Director
File Reference No. 2012-260
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, Connecticut 06856-5116
director@fasb.org

Delivered Electronically

Re: File Reference No. 2012-260, *Financial Instruments – Credit Losses (Subtopic 825-15)*

Dear Ms. Cosper:

This letter is submitted by the National Association of Real Estate Investment Trusts® (NAREIT) in response to the Proposed Accounting Standards Update from the Financial Accounting Standards Board (FASB or the Board) on *Financial Instruments – Credit Losses (Subtopic 825-15)* (the Proposal).

NAREIT is the worldwide representative voice for real estate investment trusts (REITs) and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other businesses throughout the world that own, operate, and finance income-producing real estate, as well as those firms and individuals who advise, study, and service those businesses.

REITs are generally deemed to operate as either Equity REITs or Mortgage REITs. Our members that operate as Equity REITs acquire, develop, lease, and operate income-producing real estate. Our members that operate as Mortgage REITs finance housing and commercial real estate by originating mortgages or by purchasing whole loans or mortgage backed securities in the secondary market.

A useful way to look at the REIT industry is to consider an index of stock exchange-listed companies like the FTSE NAREIT U.S. Real Estate Index, which covers both Equity REITs and Mortgage REITs. This Index contained 172 companies representing an equity market capitalization of $603.4 billion at 2012 year end. Of these companies, 139 were Equity REITs representing 90.2% of total U.S. listed

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REIT equity market capitalization (amounting to $544.4 billion)[1]. The remainder, as of December 31, 2012, was 33 publicly traded Mortgage REITs with a combined equity market capitalization of $59 billion.

NAREIT's Recommendation

NAREIT concurs with the FASB's goal of developing a financial reporting model that more accurately reflects the timing and degree to which companies sustain credit losses on financial assets. However, with respect to the FASB's proposed current expected credit loss model (CECL), we believe that there are a number of areas that need improvement for the model to become operational for preparers and understandable for users, regulators, and auditors alike. Therefore, NAREIT proposes the following enhancements with regard to the CECL model:

- **Allow the credit loss allowance to be based on management's "best estimate" of expected credit losses – so, for example, an investor in an AA-rated bond or U.S. Treasury bond or Agency security would expect a best estimate of zero**

- **Clarify that the time horizon for the CECL model is based on the expected life (as opposed to the contractual life) of the financial asset**

- **Allow preparers to reverse previously recorded credit losses and require preparers to adjust the effective yield over the remaining life of the financial instrument to the extent that the expected cash flows exceeds the <u>originally</u> anticipated amount**

- **Exclude trade receivables and lease receivables from the scope of the Proposal**

- **Ensure that interim disclosures are not a mere repeat of the annual disclosures unless there is a material change**

Allow the credit loss allowance to be based on management's "best estimate" of expected credit losses – so, for example, an investor in an AA-rated bond or U.S. Treasury bond or Agency security would expect a best estimate of zero

NAREIT understands that the Proposal would require companies to book a credit loss upon execution of the transaction based on multiple possible outcomes. The estimate would be neither a worst-case scenario nor a best-case scenario, but rather would be based on an entity's assessment of current conditions and reasonable and supportable forecasts about the future. As such, the Proposal would expressly prohibit companies from utilizing a "best estimate" or "most likely outcome" approach that may result in recognizing zero credit losses.

NAREIT does not believe that the Proposal, as written, would faithfully present the underlying economics of certain transactions. NAREIT questions the Proposal's outcome when the model is applied to securities that are measured at fair value with changes in value recognized in other comprehensive income. For example, preparers would be required to record an allowance for credit losses immediately upon purchasing an AA-rated bond, a U.S. Treasury bond, or an Agency

[1] http://returns.reit.com/reitwatch/rw1301.pdf at page 20.

mortgage-backed security and thus "expect" credit losses of something other than zero. The vast majority of companies have never incurred a credit loss with respect to these particular investments. Therefore, NAREIT questions why the Board would require management to book an allowance for credit losses for these types of financial instruments, regardless of how small, when management's long-standing history indicates that there has never been a credit loss incurred historically. Further, the purchase price already inherently reflects what little credit risk exists.

The results of the CECL model become further perplexing when considering the fact that a company would record ***no allowance for credit losses*** at the date of purchase if these financial instruments are measured at fair value, with changes in value recognized in net income.

In NAREIT's view, the Board could easily address this accounting anomaly in the Proposal by permitting management to utilize a "best estimate" of expected credit losses. The concept of "best estimates" has conceptual merits in current U.S. GAAP. For example, FASB Concepts Statement No.7, *Using Cash Flow Information and Present Value in Accounting Measures*, defines the term *best estimate* as follows:

> The single most-likely amount in a range of possible estimated amounts; in statistics, the estimated mode. In the past, accounting pronouncements have used the term *best estimate* in a variety of contexts that range in meaning from "unbiased" to "most likely[2]."

NAREIT believes that providing management with the ability to use a "best estimate" approach within the CECL model would more accurately report management's view of the financial position of a company to users of financial statements.

Clarify that the time horizon for the CECL model is based on the expected life (as opposed to the contractual life) of the financial asset

A literal reading of the Proposal suggests that the allowance for credit losses estimate would be based on the cash flows that management does not expect to collect over the *contractual* life of the financial instrument. NAREIT questions whether it was the Board's intention for management to use the entire contractual life in all instances. For example, based on information obtained from the Federal Housing Finance Agency, the historical assumption for the average life of a 30-year residential mortgage loan is approximately 10 years[3]. The shorter life is due to prepayments that result when homeowners either sell their homes to move, decide to refinance due to decreasing interest rates, or default on the mortgage loan. NAREIT does not believe that an allowance for credit losses that is based on the entire 30-year life of the mortgage loan would be an accurate estimate.

NAREIT recommends that the Board discontinue use of the phrase "contractual cash flows" and utilize the term "expected cash flows" in its place. This would permit management to take

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[2] http://www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175820900214&blobheader=application%2Fpdf&blobcol=urldata&blobtable=MungoBlobs at page CON7-5.

[3] http://www.fhfa.gov/webfiles/25006/MIRS_Feb_2013_final.pdf at page 2.

prepayments into consideration when estimating the expected life of a loan. NAREIT believes that making this change would dispel the confusion regarding whether the Board's intention was for preparers to estimate credit losses over the life-time contractual term of financial instruments that surfaced after the Proposal was issued. Subsequently, the Board attempted to address its intention in question 8 of the Proposed Accounting Standards Update, *Financial Instruments—Credit Losses (Subtopic 825-15)* Frequently Asked Questions document.

Allow preparers to reverse previously recorded credit losses and require preparers to adjust the effective yield over the remaining life of the financial instrument to the extent that the expected cash flows exceeds the originally anticipated amount

While we understand the impetus for the development of an expected credit loss model, we are concerned about any model that would only allow preparers to record downward adjustments and not reverse those credit losses in situations where the fair value of investments (*e.g.*, estimates of future cash flows) subsequently increases. With the benefit of hindsight, a preparer could observe whether market downturns later reverse. To the extent that market conditions stabilize, we believe that an accounting model that allows for reversals of previously recorded credit losses would more accurately reflect the financial position of a company. Thus, in that regard, we agree with the Proposal as an improvement over current practices for debt securities.

However, NAREIT believes that preparers should be able to adjust the effective yield over the remaining life of the financial instrument to the extent that the expected cash flows exceed the *originally* anticipated amount, unlike the Proposal that would record an immediate gain. In our view, the accounting model that we recommend would provide the best information to users of financial statements as well as address the uncertainty of estimates in a prudent manner.

Exclude trade receivables and lease receivables from the scope of the Proposal

NAREIT fails to see the benefit of including trade receivable and lease receivables within the scope of the Proposal. NAREIT observes that the Board is inconsistent when it comes to defining whether a lease is a financial asset. For example, lease receivables are excluded from the scope of the project that deals with financial assets (*e.g.*, the Proposed Accounting Standards Update on *Financial Instruments: Recognition and Measurement*), while in projects such as this, the FASB includes lease receivables as financial assets within the scope of the Proposal. Further, we note that trade receivables are generally short term and present few accounting issues under current U.S. GAAP.

To avoid confusion and complexity, NAREIT recommends that the Board exclude these assets from the scope of the Proposal. NAREIT believes that the accounting treatment for credit losses with respect to these asset types is best suited for the chapters in the codification that address these asset types. For example, credit losses for leases should be included within the codification section that is dedicated to leases. In order to ensure that convergence is achieved, the FASB and IASB should include the accounting for credit losses for leases within the scope of the *Leases* Project.

In the event that the Board does not decide to follow our recommendation, NAREIT requests that the Board clearly articulate the types of leases that would be in scope of the Proposal (*e.g.*, both operating and finance lease receivables?). Depending on the Board's anticipated timing for the effective date, this scoping decision should contemplate both leases under current U.S. GAAP and leases that would exist under the proposed *Leases* standard.

Ensure that interim disclosures are not a mere repeat of the annual disclosures unless there is a material change

As NAREIT indicated in its November 30, 2012 submission[4] on the FASB's *Disclosure Framework* discussion paper and in its May 15, 2013 submission[5] on the FASB's *Financial Instruments: Recognition and Measurement* Proposal, NAREIT has observed a growing trend in accounting pronouncements that requires companies to prepare the same types of disclosures at both interim and annual reporting dates. NAREIT questions whether detailed information can continue to be disclosed at interim periods given shorter quarterly SEC financial reporting deadlines (*i.e.*, 40 days for both large accelerated filers and accelerated filers, and 45 days for non-accelerated filers[6]) when compared with annual SEC financial reporting deadlines (*i.e.*, 60 days for large accelerated filers, 75 days for accelerated filers, and 90 days for non-accelerated filers[7]). According to APB 28: *Interim Financial Reporting* (Accounting Standards Codification Topic 270), each interim period is an integral part (as opposed to a discrete part) of the annual reporting period.

NAREIT suggests that the Board consider the approach that the SEC utilizes for changes in financial condition and quantitative and qualitative disclosures of market risks. The SEC requires these disclosures in annual reports. To the extent that there has been a material change since the date of the most recent annual report, the SEC requires disclosures in quarterly filings as well. By taking this approach, the SEC has effectively reduced unnecessary disclosure duplication. NAREIT believes that the FASB would achieve its objective by taking a similar approach.

We urge the FASB and the IASB to work toward a converged solution. As the Boards near the completion of the convergence projects, we implore the FASB and IASB to work together to reduce differences in their respective Financial Instruments models. This will benefit preparers, users, auditors, and regulators alike.

We thank the FASB for the opportunity to comment on the Proposal. If you would like to discuss our views in greater detail, please contact George Yungmann, NAREIT's Senior Vice President, Financial Standards, at gyungmann@nareit.com or 1-202-739-9432, or Christopher Drula, NAREIT's Vice President, Financial Standards, at cdrula@nareit.com or 1-202-739-9442.

Respectfully submitted,

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[4] http://www.reit.com/~/media/Files/Policy/Letter-to-FASB-on-Disclosure-Framework-11-30-12.ashx

[5] http://www.reit.com/~/media/2013/NAREIT%20Comment%20Letter%20on%20FASB%20Recognition%20and%20Measurement%20Proposal.ashx

[6] http://www.sec.gov/answers/form10q.htm

[7] http://www.sec.gov/answers/form10k.htm

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SFO Alert (August 8, 2014)

August 8, 2014

FASB DECISIONS ON THE CLASSIFICATION AND MEASUREMENT FOR EQUITY INVESTMENTS

On July 30, the Financial Accounting Standards Board (FASB or Board) continued its redeliberations on the Accounting for Financial Instruments Classification and Measurement Project. At the meeting, the Board reaffirmed the guidance included in the February 2013 proposed Accounting Standards Update, Financial InstrumentsOverall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities (the Proposal) related to the classification and measurement of equity investments. This decision will be of interest to NAREIT member companies that hold equity investments.

The Board decided that all investments in equity securities would be measured at fair value through net income, except for the following:

- Investments in equity securities accounted for under the equity method of accounting (*e.g.*, investments in unconsolidated joint ventures); and,
- Investments in equity securities without readily determinable fair values for which the entity has elected to apply the practicality exception to carry them at cost, adjusted for both impairment and observable price changes.

Thus, the FASB would preclude recognizing changes in value for equity securities through other comprehensive income. While this represents a significant change to current practice for investments in equity securities, investments in debt securities will not be impacted by this decision. Under current U.S. GAAP companies are provided an option to classify equity securities as either:

- Trading (*i.e.*, equity securities are measured at fair value on the balance sheet, with changes in value recognized in earnings) or,
- Available-for-sale (*i.e.*, equity securities are measured at fair value on the balance sheet, with changes in value recognized in other comprehensive income).

The Board plans to finalize redeliberations on the Proposal in the coming months. The Board has not discussed an effective date for the Proposal.

CONTACT

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