Accounting Committee Meeting

Wednesday, March 30th
3pm – 4:30pm
Marriott Marquis, Washington DC

Moderator:
Chris Drula, VP-Financial Standards, NAREIT

Panelists:
Glenn Cohen, EVP-CFO & Treasurer, Kimco Realty Corp.
Keri Shea, SVP-Finance & Treasurer, AvalonBay Communities, Inc.
Stephen Theriot, CFO, Vornado Realty Trust

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ACCOUNTING COMMITTEE MEETING
(Open to all REITWise® Registrants)
Marriott Marquis Washington, DC
Room TBD
Washington, D.C.
Wednesday, March 30, 2016
3:00 p.m. – 4:30 p.m.

Co-Chairs:

Glenn G. Cohen, EVP – CFO & Treasurer, Kimco Realty Corporation
Keri A. Shea, SVP, Finance & Treasurer, AvalonBay Communities, Inc.
Stephen W. Theriot, CFO, Vornado Realty Trust

NAREIT Staff Liaisons:

George Yungmann, SVP Financial Standards
Christopher T. Drula, VP Financial Standards

I. Update on SASB Standard Setting
Tom Riesenberg, Consultant to SASB

II. State of Real Estate Non-GAAP Reporting
- NAREIT Funds from Operations (FFO)
- Net Operating Income (NOI)

III. FASB *Financial Performance Reporting* Research Project
Kirk Rogers, Partner, Grant Thornton LLP

IV. FASB *Financial Instruments – Recognition and Measurement* Standard
Chris Merchant, Partner, PwC

V. FASB *Financial Instruments – Credit Losses* Standard
Daniel Goerlich, Director, PwC

Note: This meeting may qualify for 1.5 hours of continuing professional education credits, depending on the state. For CLE or CPE credit information, please contact Afia Nyarko at 202-739-9433 or anyarko@nareit.com.

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Accounting Journal Entry

Financial Instruments — FASB Makes Tentative Decisions About Purchased Credit-Impaired Assets

April 23, 2015 — At its meeting yesterday, the FASB discussed (1) the definition of a purchased credit-impaired (PCI) asset and (2) assets acquired in a business combination. Specifically, the Board tentatively decided to revise the definition of a PCI asset[1] such that an entity would be required to apply the gross-up approach[2] to an asset for which there has been a "more than insignificant" deterioration in credit quality since origination. In addition, the Board reaffirmed the proposed ASU's[3] requirement under which an entity would use the gross-up approach to account for PCI assets acquired in a business combination.

Editor's Note: The Board chose to revise the definition of a PCI asset partially in response to continued stakeholder feedback suggesting that if an entity were to recognize expected credit losses in its income statement upon purchase of any asset, regardless of the level of credit deterioration in the asset's credit quality since origination, the entity would be "double-counting" expected credit losses on that asset because those losses were already contemplated in the purchase price. Although the Board decided not to require an entity to apply the gross-up approach to all acquired assets, stakeholders are likely to support the change to the definition of a PCI asset because an entity is likely to apply the gross-up approach to more assets than it would have under the proposed ASU's requirements. The Board also indicated at the meeting that the final standard will include implementation guidance to help entities assess whether there has been a "more than insignificant" deterioration in a purchased asset's credit quality since origination.

The Board tentatively decided to require an entity to apply the gross-up approach to assets acquired in a business combination that are determined to be PCI assets because the Board believes that in the measurement of expected credit losses, there is no inherent difference between PCI assets acquired in a business combination and those acquired outside of one. Consequently, an entity would continue to account for non-PCI assets acquired in a business combination in accordance with existing U.S. GAAP. That is, for non-PCI assets acquired in a business combination, an entity would measure the assets at fair value upon acquisition and would be prohibited from recognizing a separate valuation allowance for those assets.

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1 The proposed ASU defines PCI assets as "[a]cquired individual assets (or acquired groups of financial assets with shared risk characteristics at the date of acquisition) that have experienced a significant deterioration in credit quality since origination."

2 Under the gross-up approach, an entity would recognize its initial expectation of credit losses on PCI assets as an allowance for expected credit losses with an adjustment that increases the cost basis of the asset. As a result of applying this approach, the entity avoids immediately recognizing expected credit losses in its income statement upon acquiring the asset. For more information about the gross-up approach, see Deloitte's March 13, 2015, *Heads Up*.

3 FASB Proposed Accounting Standards Update, *Financial Instruments — Credit Losses*.

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January 12, 2016
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Heads Up

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Targeted Therapy
FASB Amends Guidance on Classification and Measurement of Financial Instruments

by Jamie Davis and Shahid Shah, Deloitte & Touche LLP

Introduction

On January 5, 2016, the FASB issued ASU 2016-01,[1] which amends the guidance in U.S. GAAP on the classification and measurement of financial instruments. Although the ASU retains many current requirements, it significantly revises an entity's accounting related to (1) the classification and measurement of investments in equity securities and (2) the presentation of certain fair value changes for financial liabilities measured at fair value. The ASU also amends certain disclosure requirements associated with the fair value of financial instruments.

This *Heads Up* provides a comprehensive summary of the FASB's changes to its classification and measurement model for financial instruments. In addition, the appendix to this *Heads Up* compares the classification and measurement models under current U.S. GAAP, the ASU, and IFRS 9 (2014).[2]

Editor's Note: Although the FASB and IASB had been working to converge their respective classification and measurement models (see the FASB's February 2013 exposure draft), after performing stakeholder outreach and a cost-benefit analysis, the FASB ultimately decided to make only limited changes to existing U.S. GAAP. Consequently, the ASU's amendments do not achieve convergence with IFRSs. The IASB's final guidance on this topic was issued in July 2014 in the form of amendments to IFRS 9 (see Deloitte's August 8, 2014, *Heads Up* for more information about the amendments to IFRS 9 (2014)).

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

Key changes as a result of the ASU are discussed below.

Classification and Measurement of Equity Investments

The ASU requires entities to carry all investments in equity securities, including other ownership interests such as partnerships, unincorporated joint ventures, and limited liability companies, at fair value through net income (FVTNI). This requirement does not apply to investments that qualify for the equity method

[1] FASB Accounting Standards Update No. 2016-01, *Recognition and Measurement of Financial Assets and Financial Liabilities*.
[2] IFRS 9, *Financial Instruments* (revised 2014).

of accounting or to those that result in consolidation of the investee or for which the entity has elected the practicability exception to fair value measurement (as discussed below).

Editor's Note: Under current U.S. GAAP, marketable equity securities other than (1) equity method investments (those for which the investor has significant influence over the investee) or (2) those that result in consolidation of the investee are classified as either held for trading or available for sale (AFS). For AFS equity securities, any amounts in accumulated other comprehensive income (OCI) are recycled to net income upon sale or an other-than-temporary impairment. Investments in nonmarketable equity securities other than equity method investments or those that result in consolidation of the investee are measured at cost (less impairment) unless the fair value option has been elected. Because equity securities would no longer be accounted for as AFS securities or by using the cost method, entities that hold such equity investments could see significant volatility in earnings. For instance, this new requirement would significantly affect certain types of mutual funds (e.g., bond funds and fixed-income funds) that are currently accounted for as AFS securities. According to ASC 320-10-55-9,[3] a mutual fund is considered an equity security even if it invests only in U.S. government debt securities. Consequently, investments in bond funds and fixed-income mutual funds are considered equity securities and must be accounted for at FVTNI under the ASU.

For investments in equity securities without a readily determinable fair value that do not qualify for the net asset value (NAV) practical expedient in ASC 820-10-35-59, an entity is permitted to elect a practicability exception to fair value measurement, under which the investment will be measured at cost, less impairment, plus or minus observable price changes (in orderly transactions) of an identical or similar investment of the same issuer. The ASU clarifies that when identifying observable price changes, an entity should consider relevant transactions "that are known or can reasonably be known" and that an entity is not required to spend undue cost and effort to identify such transactions. The ASU also indicates that an entity should consider a security's rights and obligations, such as voting rights, distribution rights and preferences, and conversion features, when evaluating whether the security issued by the same issuer is similar to the equity security held by the entity.

The practicability exception is not available to (1) reporting entities that are investment companies, (2) broker-dealers in securities, or (3) postretirement benefit plans.

Editor's Note: Entities that elect the practicability exception would still need to assess the equity investment for impairment (see discussion below).

Furthermore, investments in Federal Home Loan Bank (FHLB) and Federal Reserve Bank (FRB) stock issued to member financial institutions are not subject to this guidance. Instead, FHLB and FRB stock would continue to be accounted for at cost less impairment under ASC 942-325-35-3. The ASU's impairment guidance on equity investments for which fair value is not readily determinable also does not apply to FHLB or FRB stock.

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

Impairment Assessment of Equity Investments Without Readily Determinable Fair Values That Are Measured by Using the Practicability Exception

In an effort to simplify the impairment model for equity securities for which an entity has elected the practicability exception, the FASB eliminated the requirement in U.S. GAAP to assess whether an impairment of such an investment is other than temporary. Under the new guidance, as of each reporting period, an entity will qualitatively consider the following indicators (from ASC 321-10-35-3, which was added by the ASU) to determine whether the investment is impaired:

> a. A significant deterioration in the earnings performance, credit rating, asset quality, or business prospects of the investee
>
> b. A significant adverse change in the regulatory, economic, or technological environment of the investee
>
> c. A significant adverse change in the general market condition of either the geographical area or the industry in which the investee operates
>
> d. A bona fide offer to purchase, an offer by the investee to sell, or a completed auction process for the same or similar investment for an amount less than the carrying amount of that investment
>
> e. Factors that raise significant concerns about the investee's ability to continue as a going concern, such as negative cash flows from operations, working capital deficiencies, or noncompliance with statutory capital requirements or debt covenants.

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

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

The ASU establishes an incremental recognition and disclosure requirement related to the presentation of fair value changes of financial liabilities for which the fair value option has been elected. Under this guidance, an entity would be required to separately present in OCI the portion of the total fair value change attributable to instrument-specific credit risk as opposed to reflecting the entire amount in earnings. For derivative liabilities, however, any changes in fair value attributable to instrument-specific credit risk would continue to be presented in net income, which is consistent with current U.S. GAAP. This new requirement to separately present in OCI the portion of the total fair value change attributable to instrument-specific credit risk does not apply to financial liabilities of consolidated collateralized financing entities that are measured in accordance with ASC 810-10-30-10 through 30-15 and ASC 810-10-35-6 through 35-8.

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

Any accumulated gains or losses reflected in OCI as a result of this provision would be recognized through earnings once the financial liability is derecognized.

Editor's Note: During the financial crisis of 2008, many stakeholders expressed concerns about the counterintuitive impact on earnings of recording changes in the fair value of financial liabilities when such changes are related to an entity's own debt for which the fair value option had been elected.

Under U.S. GAAP today, for financial liabilities measured at fair value, an entity would recognize a gain in earnings when there is an increase in instrument-specific credit risk or a loss when there is a decrease in instrument-specific credit risk. The new guidance aims to eliminate this counterintuitive result by requiring entities to present in OCI changes in fair value that result from changes in an entity's own credit risk.

As discussed in more detail below in the Effective Date and Early Adoption section, entities are permitted to early adopt this provision of the ASU for financial statements that have not yet been issued.

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

The new guidance eliminates the diversity in practice related to the evaluation of the need for a valuation allowance for deferred tax assets (DTAs) related to debt securities that are classified as AFS. Under current U.S. GAAP, entities may perform this evaluation either separately from their other DTAs or in combination with them. The new guidance clarifies that an entity should "evaluate the need for a valuation allowance on a [DTA] related to [AFS] securities in combination with the entity's other [DTAs]."

Editor's Note: When a financial instrument is measured at fair value, the tax basis of that instrument is not usually affected. This causes a temporary difference between the tax basis and financial reporting basis of an investment, thereby creating a DTA or DTL pursuant to ASC 740. Historically, some entities have evaluated the need for a valuation allowance on DTAs associated with AFS debt securities separately from other DTAs. The revised guidance clarifies that such separate evaluation is not permitted.

Disclosure Requirements

Summarized below are some of the ASU's notable changes related to disclosures.

Amendments to Disclosures in ASC 825

For financial instruments not recognized at fair value in the statement of financial position, the ASU specifies that:

- Entities that do not meet the definition of a public business entity (PBE) are no longer required to provide the disclosures[4] in ASC 825-10-50 about fair value.
- PBEs are no longer required to disclose the information in ASC 825-10-50-10(b) and (c) related to (1) the methods and significant assumptions they used to estimate fair value or (2) a description of the changes in the methods and significant assumptions they used to estimate fair value.

[4] Before ASU 2016-01's amendments, ASC 825-10-50-10 states that "a reporting entity shall disclose all of the following:

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

However, the ASU retains the current requirements in U.S. GAAP for PBEs to provide fair value information about (1) financial instruments not recognized at fair value in the statement of financial position either in the body of the financial statement or in accompanying notes and (2) the level of the fair value measurement hierarchy in which financial instruments are classified (i.e., Level 1, Level 2, or Level 3).

Editor's Note: The option permitting entities to omit ASC 825-10-50 fair value disclosures if it is not "practicable to estimate fair value" has been eliminated.

The ASU also clarifies U.S. GAAP by eliminating the guidance in ASC 825 that had been interpreted to permit an "entry" price notion for estimating the fair value of loans for disclosure purposes. The amendments instead require a PBE to disclose the fair value, in accordance with the "exit" price notion in ASC 820, of financial assets and financial liabilities measured at amortized cost, except for (1) receivables and payables due within one year or less; (2) equity investments for which the practicability exception is applied; and (3) deposit liabilities with no defined or contractual maturities.

Editor's Note: Practitioners may have interpreted the current illustrative guidance in ASC 825-10-55-3 to allow entities to disclose the fair value of loans on the basis of an "entry" price notion. The ASU's requirement to disclose fair value on the basis of an "exit" price notion may represent a major shift for some entities that have continued to disclose the fair value of loans on the basis of entry price. The new guidance was intended to achieve greater consistency and comparability related to fair value measurements for financial statement users.

The ASU also requires all entities to disclose either on the balance sheet or in the notes to the financial statements all financial assets and financial liabilities grouped by (1) measurement category (i.e., amortized cost or fair value — net income or OCI) and (2) form of financial asset (i.e., securities and loans/receivables).

Equity Investments Without Readily Determinable Fair Values

The new guidance requires entities that have elected the practicability exception to fair value measurement (discussed above) to disclose (1) the carrying amount of investments without readily determinable fair values, (2) the amount of the adjustment (either upward or downward) made to the carrying amount due to observable price changes, (3) any impairment charge during the reporting period, and (4) additional information to help users understand the information the entity considered in determining the quantitative information disclosed in items (1) through (3).

Effective Date and Early Adoption

For PBEs, the new standard is effective for fiscal years and interim periods within those fiscal years beginning after December 15, 2017. For all other entities, including not-for-profit entities and employee benefit plans within the scope of ASC 960 through ASC 965 on plan accounting, the effective date is in line with the recommendation of the private-company decision-making framework — that is, the guidance is effective for fiscal years beginning one year after the effective date for PBEs (i.e., December 15, 2018) and interim reporting periods within fiscal years beginning two years after the PBE effective date (i.e., December 15, 2019).

Early adoption is permitted for all entities whose financial statements have not yet been issued or have not been made available for issuance with respect to the following changes made to ASC 825:

- For financial liabilities measured under the fair value option, fair value changes resulting from a change in instrument-specific credit risk would be presented separately in other comprehensive income.
- The fair value disclosure requirements for financial instruments not recognized at fair value would be eliminated for non-PBEs.

Early adoption of other provisions is not permitted for PBEs. Non-PBEs are permitted to early adopt the new standard when it becomes effective for PBEs (i.e., fiscal years beginning after December 15, 2017, including interim periods therein).

To adopt the amendments, entities will be required to make a cumulative-effect adjustment to beginning retained earnings as of the beginning of the fiscal year in which the guidance is effective, with the exception of the following:

- Guidance (including disclosure requirements) on equity securities without readily determinable fair values will be applied prospectively to all equity investments that exist as of the date of adoption.
- Guidance consistent with ASC 820 on using the exit price notion to measure the fair value of financial instruments for disclosure purposes will be applied prospectively. If information is no longer comparable as a result of adopting the guidance, entities will be required to disclose that fact.

Appendix — Comparison of Classification and Measurement Models

The table below compares the classification and measurement models under current U.S. GAAP, the ASU, and IFRS 9 (2014).

Subject	Current U.S. GAAP	ASU 2016-01	IFRS 9 (2014)
Classification and measurement categories for financial assets other than equity investments	Under ASC 320, three categories are used to classify and measure investments in securities: • Trading (FVTNI). • AFS (FVTOCI). • Held to maturity (amortized cost). Under ASC 310, two categories are used to classify and measure loans: • Held for investment (amortized cost). • Held for sale (lower of cost or fair value).	No changes.	Three categories are used: • Amortized cost. • Fair value through other comprehensive income (FVTOCI). • Fair value through profit or loss (FVTPL).
Classification and measurement categories for equity investments	Under ASC 320, marketable equity securities other than equity method investments (those for which the investor has significant influence over the investee) or those that result in consolidation of the investee are classified as either held for trading (FVTNI) or AFS (FVTOCI). For AFS equity securities, any amounts in accumulated OCI are recycled to net income upon sale or when the security becomes other than temporarily impaired. Investments in nonmarketable equity securities other than equity method investments are measured at cost (less impairment) unless the fair value option has been elected.	Under ASC 321, entities will carry all investments in equity securities that do not qualify for equity method accounting or result in consolidation of the investee at FVTNI. For equity investments that do not have a readily determinable fair value, entities are permitted to elect a practicability exception and measure the investment at cost less impairment plus or minus observable price changes (in orderly transactions). The exception would not be available to investment companies, broker-dealers, defined benefit plans, and investors in equity investments that apply the NAV practical expedient under ASC 820-10-35-59.	Equity investments other than equity method investments or those that result in consolidation of the investee are accounted for at FVTPL with an option to irrevocably designate equity investments that are not held for trading at FVTOCI at initial recognition. For FVTOCI equity investments, any amounts in accumulated OCI are not transferred to profit or loss, even if the investment is sold or impaired. In limited circumstances, "cost may be an appropriate estimate of fair value."
Classification and measurement categories for financial liabilities	Nonderivative financial liabilities (primarily an entity's own debt) are accounted for at amortized cost unless the fair value option is elected. Derivative financial liabilities and short-sale obligations are measured at fair value.	No changes, except for the presentation of certain fair value changes for fair value option liabilities (see below).	Financial liabilities are carried at amortized cost, except for derivative and trading liabilities and those designated under the fair value option (see below).
Method for classifying financial assets	For securities, the classification depends on whether the entity holds the security for trading or has the intent and ability to hold it to maturity. For loans, the classification depends on whether the entity intends to hold the loan to maturity or for the foreseeable future.	No changes.	The classification is based on both the entity's business model for managing the financial assets and the contractual cash flow characteristics of the financial asset.
Criteria for carrying financial assets at amortized cost	The following financial assets are carried at amortized cost: • Debt securities that the entity has the positive intent and ability to hold to maturity. • Loans that the entity has the intent and ability to hold to maturity or for the foreseeable future.	No changes.	Financial assets are carried at amortized cost if they satisfy both of the following criteria: • They meet the cash flow characteristics criterion (i.e., solely payments of principal and interest). • They are held in a business model whose objective is to hold assets for the collection of contractual cash.

Subject	Current U.S. GAAP	ASU 2016-01	IFRS 9 (2014)
Criteria for measuring financial assets other than equity investments at FVTOCI	The following financial assets other than equity investments are measured at FVTOCI: • Investments in debt securities that are not classified as either trading or held to maturity. • Loans not classified as held for trading if the investor is contractually at risk of not recovering substantially all of its initially recorded investment.	No changes.	Financial assets other than equity investments are measured at FVTOCI if they satisfy both of the following criteria: • They meet the cash flow characteristics criterion. • They are held in a business model in which assets are managed both to collect contractual cash flows and for sale.
Criteria for measuring financial assets other than equity investments at FVTNI (or FVTPL)	The following financial assets other than equity investments are measured at FVTNI: • Debt securities bought and held principally for trading. • Loans bought and held principally for trading if the investor is contractually at risk of not recovering substantially all of its initially recorded investment. • Financial assets elected under the fair value option (see below).	No changes.	The following financial assets other than equity investments are measured at FVTPL: • Financial assets that fail to qualify for either amortized cost or FVTOCI. • Financial assets designated under the fair value option (see below).
Criteria for measuring financial assets at the lower of cost or fair value	Loans held for sale.	No changes.	Not applicable.
Unrealized foreign currency gains and losses on financial assets accounted for at FVTOCI	For AFS debt securities, unrealized foreign currency gains and losses are deferred in OCI in a manner similar to how other unrealized gains and losses are deferred.	No changes.	Unrealized foreign currency gains and losses on nonequity investments accounted for at FVTOCI are recognized in profit or loss.
Hybrid financial assets	Embedded derivatives in hybrid financial assets are bifurcated and accounted for separately at FVTNI when certain conditions are met.	No changes.	Measured and classified in their entirety in accordance with their contractual cash flow characteristics and the business model under which they are managed. Bifurcation of embedded derivatives in hybrid financial assets is prohibited.
Fair value option — qualifying conditions	For financial instruments within the scope of the guidance, qualifying conditions need not be met before the fair value option may be elected.	No changes.	The fair value option may be elected only if qualifying conditions are met. For a financial asset, the option may be elected if exercising it would eliminate or significantly reduce an accounting mismatch. For a financial liability, the option may be elected if either of the following applies: • Exercising the option would eliminate or significantly reduce an accounting mismatch. • A "group of financial liabilities or [a group of] financial assets and financial liabilities is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity's key management personnel." In addition, the fair value option may be elected for a hybrid financial liability unless either of the following applies: • The embedded derivative or derivatives do not "significantly modify the cash flows that otherwise would be required by the contract." • "[I]t is clear with little or no analysis when a similar hybrid instrument is first considered that separation of the embedded derivative(s) is prohibited."

Subject	Current U.S. GAAP	ASU 2016-01	IFRS 9 (2014)
Presentation of fair value changes attributable to instrument-specific credit risk for financial liabilities designated under the fair value option	There are no similar requirements under current U.S. GAAP.	The portion of the total fair value change caused by a change in instrument-specific credit risk is recognized in OCI. Any accumulated amount remaining in OCI is reclassified to earnings when the liability is extinguished.	The portion of the total fair value change caused by a change in the liability's credit risk is recognized in OCI unless such treatment would create or enlarge an accounting mismatch in profit or loss. This amount is not subsequently transferred to profit or loss.
Reclassification of financial assets other than equity investments	Reclassification is permitted in certain circumstances. Transfers from the held-to-maturity category and transfers into or out of the trading category are expected to be rare.	No changes.	Reclassification is required if the business model changes and would be recorded as of the first day of the period after the period in which the business model changes.

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Heads Up

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We've Been Expecting You

FASB Finalizing Credit Impairment Guidance

by Abhinetri Velanand, Anthony Mosco, and Stephen McKinney, Deloitte & Touche LLP

The FASB is currently finalizing amendments to its guidance on the impairment of financial instruments. The proposed amendments would introduce a new impairment model[1] based on expected losses rather than incurred losses. Under this current expected credit loss (CECL) model, an entity would recognize as an allowance its estimate of the contractual cash flows not *expected* to be collected. The FASB believes that the CECL model will result in more timely recognition of credit losses and will reduce the complexity of U.S. GAAP by decreasing the number of credit impairment models used to account for debt instruments.[2]

This *Heads Up* provides a comprehensive summary of the FASB's proposed changes to the credit impairment guidance under current U.S. GAAP, which are reflected in the Board's December 2012 proposed ASU[3] and subsequent tentative decisions.[4] In addition, this newsletter contains several appendixes. Appendix A compares the impairment models under current U.S. GAAP, the FASB's tentative approach, and the IASB's recently amended IFRS 9, respectively. Appendix B gives an overview of the existing impairment models under U.S. GAAP for loans and debt securities. Appendix C and Appendix D provide illustrative examples of how an entity might apply the CECL model to purchased credit-impaired (PCI) assets and trade receivables, respectively.

Editor's Note: Although the FASB has completed nearly all significant redeliberations and its staff has begun drafting a final ASU, the Board has yet to discuss the effective date of its proposed amendments to the current guidance on accounting for credit losses. A final standard is likely to be issued in the second half of this year.

The CECL Model

Scope

The CECL model would apply to most[5] debt instruments (other than those measured at fair value through net income (FVTNI)), trade receivables, lease receivables, reinsurance receivables that result from

[1] Although impairment began as a joint FASB and IASB project, constituent feedback on the boards' "dual-measurement" approach led the FASB to develop its own impairment model. The IASB, however, continued to develop the dual-measurement approach and issued final impairment guidance based on it as part of the July 2014 amendments to IFRS 9. For more information about the IASB's impairment model, see Deloitte's August 8, 2014, *Heads Up*.

[2] Note that the proposed CECL model would replace or amend several existing U.S. GAAP impairment models. See Appendix B for a tabular summary of those models.

[3] FASB Proposed Accounting Standards Update, *Financial Instruments — Credit Losses*.

[4] Decisions are as of the FASB's March 11, 2015, meeting. Although the Board has nearly completed its deliberations in the project, the guidance in the final ASU may differ from that in the tentative decisions as a result of changes made during the finalization process.

[5] The CECL model would not apply to the following debt instruments:
- Loans made to participants by defined contribution employee benefit plans.
- Policy loan receivables of an insurance entity.
- Pledge receivables (promises to give) of a not-for-profit entity.
- Loans and receivables between entities under common control.

insurance transactions, financial guarantee contracts,[6] and loan commitments. However, available-for-sale (AFS) debt securities would be excluded from the model's scope and would continue to be assessed for impairment under ASC 320[7] (the FASB has proposed limited changes to the impairment model for AFS debt securities, as discussed below).

Recognition of Expected Credit Losses

Unlike the incurred loss models in existing U.S. GAAP, the CECL model does not specify a threshold for the recognition of an impairment allowance. Rather, an entity would recognize an impairment allowance equal to the current estimate of expected credit losses (i.e., all contractual cash flows that the entity does not expect to collect) for financial assets as of the end of the reporting period. Credit impairment would be recognized as an allowance — or contra-asset — rather than as a direct write-down of the amortized cost basis of a financial asset. However, the carrying amount of a financial asset that is deemed uncollectible would be written off in a manner consistent with existing U.S. GAAP.

Editor's Note: Because the CECL model does not have a minimum threshold for recognition of impairment losses, entities will need to measure expected credit losses on assets that have a low risk of loss (e.g., investment-grade held-to-maturity (HTM) debt securities). However, the FASB tentatively decided that an "entity would not be required to recognize a loss on a financial asset in which the risk of nonpayment is greater than zero [but] the amount of loss would be zero."[8] U.S. Treasury securities and certain highly rated debt securities may be assets the FASB contemplated when it tentatively decided to allow an entity to recognize zero credit losses on an asset, but the Board decided not to specify the exact types of assets. Nevertheless, the requirement to measure expected credit losses on financial assets whose risk of loss is low is likely to result in additional costs and complexity.

Measurement of Expected Credit Losses

Under the proposed amendments, an entity's estimate of expected credit losses represents all contractual cash flows that the entity does not expect to collect over the contractual life of the financial asset. When determining the contractual life of a financial asset, the entity would consider expected prepayments but would not be allowed to consider expected extensions unless it "reasonably expects that it will execute a troubled debt restructuring with the borrower."[9]

The entity would consider all available relevant information in making the estimate, including information about past events, current conditions, and reasonable and supportable forecasts and their implications for expected credit losses. That is, while the entity would be able to use historical charge-off rates as a starting point in determining expected credit losses, it would have to evaluate how conditions that existed during the historical charge-off period differ from its current expectations and accordingly revise its estimate of expected credit losses. However, the entity would not be required to forecast conditions over the contractual life of the asset. Rather, for the period beyond the period for which the entity can make reasonable and supportable forecasts, the entity would revert to an unadjusted historical credit loss experience.

Editor's Note: Measuring expected credit losses will most likely be a significant challenge for all entities, particularly financial institutions. As a result of moving to an expected loss model, entities could incur one-time and recurring costs when estimating expected credit losses, some of which may be related to system changes and data collection. While the costs associated with implementing the CECL model will vary by entity, nearly all entities will incur some costs when using forward-looking information to estimate expected credit losses over the contractual life of an asset.

[6] The CECL model would not apply to financial guarantee contracts that are accounted for as insurance or measured at FVTNI.

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

[8] Quoted text is from the FASB's summary of tentative Board decisions reached at the joint meeting of the FASB and IASB on September 17, 2013.

[9] Quoted text is from the FASB's summary of tentative Board decisions reached at its September 3, 2014, meeting.

Unit of Account

The CECL model would not prescribe a unit of account (e.g., an individual asset or a group of financial assets) in the measurement of expected credit losses. However, an entity would be required to evaluate financial assets within the scope of the model on a collective (i.e., pool) basis when similar risk characteristics are shared. If a financial asset does not share similar risk characteristics with the entity's other financial assets, the entity would evaluate the financial asset individually. If the financial asset is individually evaluated for expected credit losses, the entity would not be allowed to ignore available external information such as credit ratings and other credit loss statistics.

Editor's Note: The FASB's tentative decisions would require an entity to collectively measure expected credit losses on financial assets that share similar risk characteristics (including HTM securities). While the concept of pooling and collective evaluation currently exists in U.S. GAAP for certain loans, the FASB has not specifically defined "similar risk characteristics." As a result, it remains to be seen whether the FASB expects an aggregation based on "similar risk characteristics" to be consistent with the existing practice of pooling PCI assets on the basis of "common risk characteristics." Entities may need to make changes to systems and processes to capture loss data at more granular levels depending on the expectations of market participants such as standard setters, regulators, and auditors.

Practical Expedients for Measuring Expected Credit Losses

The FASB tentatively decided to permit entities to use practical expedients when measuring expected credit losses for two types of financial assets:

- *Collateral-dependent financial assets* — In a manner consistent with existing U.S. GAAP, an entity would be allowed to measure its estimate of expected credit losses for collateral-dependent financial assets as the difference between the financial asset's amortized cost and the collateral's fair value (adjusted for selling costs, when applicable).
- *Financial assets for which the borrower must continually adjust the amount of securing collateral (e.g., certain repurchase agreements and securities lending arrangements)* — The estimate of expected credit losses would be measured consistently with how it is measured for other financial assets within the scope of the CECL model but would be limited to the difference between the amortized cost basis of the asset and the collateral's fair value (adjusted for selling costs, when applicable).

Write-Offs

Under the proposed ASU, an entity would write off a financial asset if it determines that it has no reasonable expectation of future recovery. However, in light of stakeholders' concerns that the proposed requirement could conflict with regulatory guidance and may result in entities' recognizing write-offs significantly later than under current practice, the FASB tentatively agreed to retain the write-off requirements in existing U.S. GAAP. That is, an entity would write off the carrying amount of a financial asset when the asset is deemed uncollectible. The Board also tentatively decided that this write-off guidance would apply to AFS debt securities.

AFS Debt Securities

Under the proposed ASU, the CECL model would have applied to AFS debt securities. However, during redeliberations, the FASB tentatively decided not to include AFS debt securities within the scope of the CECL model. Instead, the impairment of AFS debt securities would continue to be accounted for under ASC 320. However, the FASB tentatively decided to revise ASC 320 by:

- Requiring an entity to use an allowance approach (vs. permanently writing down the security's cost basis).
- Removing the requirement that an entity must consider the length of time fair value has been less than amortized cost when assessing whether a security is other-than-temporarily impaired.
- Removing the requirement that an entity must consider recoveries in fair value after the balance sheet date when assessing whether a credit loss exists.

Editor's Note: The Board did not revise (1) step 1 of the existing other-than-temporary impairment model (i.e., an "investment is impaired if the fair value of the investment is less than its cost") and (2) the requirement under ASC 320 that entities recognize the impairment amount only related to credit in net income and the noncredit impairment amount in other comprehensive income (OCI). However, the FASB did tentatively decide that entities would use an allowance approach when recognizing credit losses (as opposed to a permanent write-down of the AFS security's cost basis). As a result, in both of the following instances, an entity would reverse credit losses through current-period earnings on an AFS debt security:

- If the fair value of the debt security exceeds its amortized cost in a period after a credit loss had been recognized through earnings (because fair value was less than amortized cost), the entity would reverse the *entire* credit loss previously recognized and recognize a corresponding adjustment to its allowance for credit losses.
- If the fair value of the debt security does not exceed its amortized cost in a period after a credit loss had been recognized through earnings (because fair value was less than amortized cost) but the credit quality of the debt security improves in the current period, the entity would reverse the credit loss previously recognized only in an amount that would reflect the improved credit quality of the debt security.

The FASB's tentative decisions to revise the impairment model in ASC 320 could result in earlier recognition of impairment.

PCI Assets

For PCI assets as defined[10] in the proposed ASU, an entity would measure expected credit losses consistently with how it measures expected credit losses for originated and purchased non-credit-impaired assets. Upon acquiring a PCI asset, the entity would recognize as its allowance for expected credit losses the amount of *contractual* cash flows not expected to be collected as an adjustment that increases the cost basis of the asset (the "gross-up" approach). After initial recognition of the PCI asset and its related allowance, the entity would continue to apply the CECL model to the asset — that is, any changes in the entity's estimate of cash flows that it expects to collect (favorable or unfavorable) would be recognized immediately in the income statement. Consequently, any subsequent changes to the entity's estimate of expected credit losses — whether unfavorable or favorable — would be recorded as impairment expense (or reduction of expense) during the period of change. Interest income recognition would be based on the purchase price plus the initial allowance accreting to the contractual cash flows. See Appendix C for an illustrative example on how to apply the proposed guidance to PCI assets.

Editor's Note: Under the current accounting for PCI assets, an entity recognizes unfavorable changes in cash flows as an immediate credit impairment but treats favorable changes in cash flows that are in excess of the allowance as prospective yield adjustments. The CECL model's proposed approach to PCI assets eliminates this asymmetrical treatment in cash flow changes. However, in a manner consistent with current practice, the CECL model precludes an entity from recognizing as interest income the discount embedded in the purchase price that is attributable to expected credit losses as of the date of acquisition.

An acquired asset is currently considered credit-impaired when it is probable that the investor would be unable to collect all contractual cash flows as a result of deterioration in the asset's credit quality since origination. Under the FASB's tentative approach, a PCI asset is an acquired asset that has experienced significant deterioration in credit quality since origination. Consequently, entities will most likely need to use more judgment than they do under current U.S. GAAP in determining whether an acquired asset has experienced significant credit deterioration.

[10] The proposed ASU defines PCI assets as "[a]cquired individual assets (or acquired groups of financial assets with shared risk characteristics at the date of acquisition) that have experienced a significant deterioration in credit quality since origination."

Certain Beneficial Interests Within the Scope of ASC 325-40

The FASB tentatively decided that an impairment allowance for "purchased or retained beneficial interests for which there is a significant difference between contractual and expected cash flows" should be measured in the same manner as PCI assets under the CECL model. Therefore, at initial recognition, a beneficial interest holder would present an impairment allowance equal to the estimate of expected credit losses (i.e., the estimate of *contractual* cash flows not expected to be collected). In addition, the FASB indicated that "changes in expected cash flows due to factors other than credit should be accreted into interest income over the life of the asset (that is, the difference between contractual and expected cash flows attributable to credit would not be included in interest income)."[11]

Editor's Note: Under the CECL model, an entity would be required to determine the contractual cash flows of beneficial interests in securitized transactions. However, there may be certain structures in which the beneficial interests do not have contractual cash flows (e.g., when a beneficial interest holder receives only residual cash flows of a securitization structure). In these situations, an entity may need to use a proxy for the contractual cash flows of the beneficial interest (e.g., the gross contractual cash flows of the underlying debt instrument).

Modified Financial Assets

In a manner consistent with the proposed ASU, the FASB decided not to comprehensively reconsider the accounting for modifications during redeliberations (e.g., when a modification results in derecognition or what constitutes a troubled debt restructuring (TDR)). However, the Board affirmed its previous decision that the CECL model would apply to modified debt instruments.

For non-TDR modifications that do not result in derecognition, an entity would measure expected credit losses on the basis of the cash flows expected after the modification, discounted at the post-modification effective interest rate. However, as stated in the proposed ASU, when an entity executes a TDR, "the cost basis of the modified asset shall be adjusted . . . so that the effective interest rate on the modified asset continues to be the original effective rate, given the new series of contractual cash flows. The basis adjustment . . . would be determined as the amortized cost basis before modification less the present value of the new series of contractual cash flows (discounted at the original effective interest rate)." The basis adjustment that reflects a *decrease* in cash flows post-modification would be recognized as a credit loss with a corresponding reduction to the amortized cost basis of the instrument. The basis adjustment that reflects an *increase* in cash flows post-modification would be recognized as an increase to the instrument's amortized cost basis with a corresponding increase in the allowance for expected credit losses.

Loan Commitments

Off-balance-sheet arrangements such as commitments to extend credit, guarantees, and standby letters of credit that are not considered derivatives under the guidance in ASC 815 are subject to credit risk and are therefore within the scope of the CECL model. In a manner consistent with the proposed ASU, the FASB tentatively decided that the estimate of expected credit losses on the *funded* portion of a loan commitment should be determined similarly to how the estimate is determined for other loans. For an *unfunded* portion of a loan commitment, the Board tentatively decided to retain the guidance in the proposed ASU that would require an entity to "estimate [expected] credit losses over the full contractual period over which the entity is exposed to credit risk [under an unconditional] present legal obligation to extend credit." Such an estimate would take into account both the likelihood that funding will occur and the expected credit losses on commitments to be funded.

Editor's Note: An entity's estimate of expected credit losses on unfunded loan commitments (e.g., credit card receivables) will most likely depend on (1) whether the entity has the unconditional ability to cancel the commitment to extend credit and, if so, (2) the time it takes for the cancellation to become effective.

[11] Quoted text is from the FASB's summary of tentative Board decisions reached at its June 11, 2014, meeting.

Disclosures

Many of the disclosures that would be required under the proposed ASU are similar to those already required under U.S. GAAP as a result of ASU 2010-20.[12] Accordingly, entities would be required to disclose information related to:

- Credit quality.[13]
- Allowance for expected credit losses.
- Policy for determining write-offs.
- Past-due status.
- PCI assets.
- Collateralized financial assets.

In addition, the FASB affirmed the provision in the proposed ASU that would require an entity to provide a rollforward of its allowance for expected credit losses for assets measured at amortized cost and AFS debt securities. However, in a change from the proposed ASU, an entity would not be required to provide rollforward disclosures of the amortized cost balances of its debt instruments. Instead, an entity would be required to disclose credit-quality indicators for each asset class, disaggregated by vintage, for a period not to exceed five years (although upon transition, the entity would be required to provide this disclosure only for the current and prior-year amortized cost balances). The disclosure would be required for annual and interim periods and would not be required for an entity's revolving lines of credit.

Editor's Note: The FASB's decision not to require the amortized cost rollforward disclosure is in response to the concerns raised by financial statement preparers about the operational challenges in providing such information. The FASB believes that disclosing credit-quality information disaggregated by asset class and by vintage would be operationally easier for financial statement preparers and would provide financial statement users with information similar to that provided in a rollforward of the amortized cost balance. Because the FASB's tentative decision to require this new disclosure has not been exposed for public comment, the Board directed its staff to conduct significant outreach activities to obtain feedback from financial statement users, preparers, and other stakeholders on the proposed requirement.

Transition

Approach

For most debt instruments, the amendments would require entities to record 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 (modified retrospective approach). However, the Board tentatively decided on the following instrument-specific transition provisions:

- *Other-than-temporarily impaired debt securities* — An entity would be required to apply (1) the CECL model prospectively to HTM debt securities and (2) the changes to ASC 320 prospectively to AFS debt securities. As a result, previous write-downs of a debt security's amortized cost basis would not be reversed; rather, only changes in the estimate of expected cash flows of the debt security occurring on or after the effective date of the guidance would be reflected as an allowance for credit losses. Upon adoption of the new guidance, any impairment previously recognized in OCI would be accounted for as a prospective adjustment to the accretable yield of the debt instrument.
- *PCI assets* — An entity would be required to apply the changes to PCI assets prospectively. That is, the change in the definition of a PCI asset would apply only to assets acquired on or after the effective date of the guidance. For debt instruments accounted for under ASC 310-30, an entity would apply the gross-up approach as of the transition date (i.e., establish an allowance for expected credit losses with a corresponding adjustment to the debt instrument's cost basis).

[12] FASB Accounting Standards Update No. 2010-20, *Disclosures About the Credit Quality of Financing Receivables and the Allowance for Credit Losses.*

[13] Short-term trade receivables resulting from revenue transactions within the scope of ASC 605 are excluded from these disclosure requirements.

In addition, any post-adoption changes in the entity's estimate of cash flows that it expects to collect (favorable or unfavorable) would be recognized immediately in the income statement as impairment expense (or reduction of expense). Accordingly, the yield on a PCI asset as of the date of adoption would be "locked" and would not be affected by subsequent changes in the entity's estimate of expected credit losses.

- *Certain beneficial interests within the scope of ASC 325-40* — Entities holding such interests would need to comply with the same transition requirements as those that apply to PCI assets.

Disclosures

The FASB tentatively decided to retain the following transition disclosure guidance in ASC 825-15-65-1(d) and 65-1(e) of the proposed ASU:

d. An entity shall provide the following disclosures in the period that the entity adopts [the new guidance]:

   1. The nature of the change in accounting principle, including an explanation of the newly adopted accounting principle.
   2. The method of applying the change.
   3. The effect of the adoption on any line item in the statement of financial position, if material, as of the beginning of the first period for which the guidance is effective. Presentation of the effect on financial statement subtotals is not required.
   4. The cumulative effect of the change on retained earnings or other components of equity in the statement of financial position as of the beginning of the first period for which the guidance is effective.

e. An entity that issues interim financial statements shall provide the disclosures in item (d) in each interim financial statement of the year of change and the annual financial statement of the period of the change.

Next Steps

An effective date for the final guidance has not yet been proposed but will be determined at a future FASB meeting. The FASB directed its staff to prepare a draft of the final ASU for distribution to stakeholders (including financial statement users, preparers, and auditors) to obtain feedback on the proposed amendments ("fatal flaw review").

Appendix A — Comparison of Impairment Models

The table below compares the impairment models under current U.S. GAAP, the FASB's tentative approach, and IFRS 9 (2014), respectively.

Subject	Current U.S. GAAP	FASB's Tentative Approach	IFRS 9 (2014)
Scope	Applicable to: • Large groups of smaller-balance, homogeneous loans that are collectively evaluated for impairment. • Loans identified for individual evaluation. • Loans acquired with deteriorated credit quality. • Debt securities (including beneficial interests in securitized financial assets).	Applicable to: • Most debt instruments (other than those measured at FVTNI). • Lease receivables. • Reinsurance receivables from insurance transactions. • Financial guarantee contracts. • Loan commitments. AFS debt securities are excluded.	Applicable to: • Financial assets measured at amortized cost. • Financial assets mandatorily measured at fair value through OCI. • Loan commitments when there is a present obligation to extend credit (except for those measured at fair value through profit or loss (FVTPL) under IFRS 9 (2014)). • Financial guarantee contracts to which IFRS 9 applies (except for those measured at FVTPL). • Lease receivables within the scope of IAS 17.[1] • Contract assets within the scope of IFRS 15.[2]
Recognition threshold	Depending on the nature of the financial asset, credit losses must be either probable or other-than-temporary before recognition.	None. Impairment is based on expected (rather than incurred) credit losses.	None. Impairment is based on expected (rather than incurred) credit losses.
Measurement	Varies depending on the nature of the financial asset and unit of account. Approaches used in practice include: • Fair value measurement. • Present value of expected cash flows. • Fair value of underlying collateral.	Single-measurement approach: current expected credit losses (i.e., all contractual cash flows that the entity does not expect to collect).	Dual-measurement approach: • For assets in the first category, 12-month expected credit losses. • For assets in the second category, lifetime expected credit losses.
Transfer criteria between measurement categories	Not applicable under existing U.S. GAAP models.	Not applicable under CECL model. Only one measurement category.	Transfer to lifetime expected credit losses when there has been significant deterioration in credit quality since initial recognition unless credit risk is low. Transfer back to 12-month expected credit losses when transfer criteria are no longer satisfied.
Trade receivables	No specific guidance or applicable simplified approach.	No specific guidance or applicable simplified approach.	For trade receivables with a significant financing component, the three-bucket impairment model or a simplified model with an allowance of lifetime expected losses could be used.
PCI assets	Credit impairment is recognized when, on the basis of current information and events, it is probable that an investor will be unable to collect (1) all cash flows expected at acquisition plus (2) additional cash flows expected to be collected that arise from changes in post-acquisition estimates. Significant increases in the estimate of expected cash flows expected to be collected at acquisition are recognized as prospective yield adjustments.	The allowance for PCI assets is the current expected credit losses. Interest income recognition is based on purchase price plus the initial allowance accreting to the contractual cash flows. The non-credit-related discount or premium that results from acquiring a pool of PCI assets is allocated to each individual financial asset.	The allowance for PCI assets is based on the cumulative change (from the original expectation at acquisition) in lifetime expected credit losses. Interest income recognition is based on applying the credit-adjusted effective interest rate to the amortized cost of the financial asset (rather than contractual cash flows).

[1] IAS 17, *Leases*.

[2] IFRS 15, *Revenue From Contracts With Customers*.

Subject	Current U.S. GAAP	FASB's Tentative Approach	IFRS 9 (2014)
Nonaccrual accounting	No applicable guidance.	No applicable guidance.	IFRSs do not permit nonaccrual of interest. However, for assets that have become credit-impaired, interest income is based on the net carrying amount of the credit-impaired financial asset.
Write-offs	An entity writes off a financial asset in the period in which the financial asset is deemed *uncollectible*.	Same as under current U.S. GAAP.	An entity writes off the carrying amount of a financial asset if it ultimately determines that it has no reasonable expectation of future recovery.

Appendix B — Impairment Models Under U.S. GAAP

The table below highlights several impairment models under current U.S. GAAP for loans and debt securities.

Impairment Models for Loans and Debt Securities		
Guidance	**Scope**	**Measurement Objective**
ASC 450-20	Large groups of smaller-balance, homogeneous loans that are collectively evaluated for impairment.	All probable and reasonably estimable losses.
ASC 310-10-35	Loans that are identified for individual evaluation.	If it is probable that all of the contractual cash flows will not be collected, the difference between the carrying amount and the present value of the expected future cash flows discounted at the original effective interest rate. Certain practical expedients exist.
ASC 310-30	Loans acquired with deteriorated credit quality.	See ASC 310-10-35 or ASC 450-20, as applicable (as discussed in ASC 310-30-35-10). Or, for a loan accounted for as a debt security, see ASC 320-10-35 (as discussed in ASC 310-30-35-8). Recoveries (i.e., reversals of impairments) are not permitted for a loan accounted for as a debt security.
ASC 320-10-35 ASC 325-40-15	Debt securities (including beneficial interests in securitized financial assets).	If the investor intends to sell a debt security or it is more likely than not the investor will be required to sell the security before recovery of its amortized cost basis, impairment is deemed to be other than temporary and the difference between the amortized cost and fair value of the security is recognized in earnings. However if (1) the investor does not intend to sell, (2) it is not more likely than not that the investor will be required to sell the security before recovery, and (3) the investor does not expect to recover the entire cost basis of the security, the security is other than temporarily impaired and only the credit-related component of the impairment loss is recognized in earnings, and the noncredit portion is recorded in OCI. Credit losses might be measured in accordance with ASC 310-10-35, ASC 325-40, or ASC 310-30 depending on the circumstances. Recoveries are not permitted for debt securities.

Appendix C — Application of the CECL Model to PCI Assets

The example below, which is reproduced from ASC 825-15-55-40 through 55-42 of the proposed ASU, illustrates the application of the proposed guidance to PCI assets.

> Entity E is a bank that records [PCI] assets in its existing systems by recognizing the amortized cost of the asset, at acquisition, as equal to the sum of the purchase price and the associated expected credit loss at the date of acquisition. The difference between amortized cost and the par amount of the debt is recognized as a noncredit discount or premium. By doing so, the asset is accreted from this amortized cost to the contractual cash flows without ever recognizing as interest income the purchase discount attributable to expected credit losses at acquisition.
>
> Assume that Entity E pays $750,000 for a debt instrument with a par amount of $1,000,000. The instrument is classified at amortized cost. At the time of purchase, the expected credit loss embedded in the purchase price is $175,000. At that date of acquisition, the statement of financial position would reflect a financial asset carrying value of $925,000 (that is, par less the non-credit-related discount) and an associated allowance for expected credit losses of $175,000. The acquisition-date journal entry is as follows.

Loan — par amount	$	1,000,000		
Loan — noncredit discount			$	75,000
Allowance for credit losses				175,000
Cash				750,000

> Subsequently, the $75,000 noncredit discount would be accreted into interest income over the life of the debt instrument . . . . The $175,000 allowance for expected credit losses would be updated in subsequent periods . . . , with changes in the allowance for expected credit losses reflected immediately in the statement of financial performance as a provision for credit losses.

Appendix D — Application of the CECL Model to Trade Receivables

The CECL model would apply to trade receivables that result from revenue transactions within the scope of ASC 605 (or ASC 606, if adopted). The example below, which is reproduced from ASC 825-15-55-37 and 55-38 of the proposed ASU, illustrates how an entity would apply the proposed guidance to trade receivables by using a provision matrix.

> Entity D manufactures and sells toys to a broad range of customers, primarily retail toy stores. Customers typically are provided payment terms of 90 days with a 2 percent discount if paid within 60 days. The entity has tracked historical loss experience for its trade receivables over the past five years and calculated the following historical loss experience:
>
> a. 0.3 percent for receivables that are current
>
> b. 8 percent for receivables that are 1–30 days past due
>
> c. 26 percent for receivables that are 31–60 days past due
>
> d. 58 percent for receivables that are 61–90 days past due
>
> e. 82 percent for receivables that are more than 90 days past due.
>
> Entity D believes that this historical loss experience is consistent with what will be experienced for financial assets held at the reporting date because the composition of the receivables at the reporting date is consistent with that used in developing the historical statistics (that is, the shared risk characteristics of its customers has not changed significantly over time) and the economic conditions in which the historical statistics were calculated generally are consistent with the economic conditions expected over the remaining lives of the receivables.
>
> At the reporting date, Entity D develops the following provision matrix to estimate current expected credit losses.

Past-Due Status	Carrying Value	Loss Rate	Expected Credit Loss Estimate
Current	$ 5,984,698	0.3%	$ 17,954
1–30 days past due	8,272	8%	662
31–60 days past due	2,882	26%	749
61–90 days past due	842	58%	488
More than 90 days past due	1,100	82%	902
	$ 5,997,794		$ 20,755

Editor's Note: The proposed ASU's example highlights that application of the CECL model to trade receivables through the use of a provision matrix may not differ significantly from an entity's current methods for determining the allowance for doubtful accounts. However, the example illustrates that moving to an expected loss model would require entities to consider the following when using a provision matrix to estimate credit losses on trade receivables:

- Under the CECL model, an entity would be required to consider whether expected credit losses should be recognized for trade receivables that are considered "current" (i.e., not past due). In the example above, a loss rate of 0.3 percent is applied to the trade receivables that are classified as current.
- When using historical loss rates in a provision matrix, an entity would be required to consider whether and, if so, how the historical loss rates differ from what is currently expected over the life of the trade receivables (on the basis of current conditions and reasonable and supportable forecasts about the future).

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No. 2016-01
7 January 2016

To the Point

FASB —final guidance

FASB makes targeted amendments to guidance on classifying and measuring financial instruments

Entities will have to measure many equity investments at fair value and recognize changes in fair value in net income unless they qualify for the new practicability exception.

What you need to know

- The FASB issued final guidance that will require entities to measure equity investments that do not result in consolidation and are not accounted for under the equity method at fair value and recognize any changes in fair value in net income unless the investments qualify for the new practicability exception.
- The standard doesn't change the guidance for classifying and measuring investments in debt securities and loans.
- Entities will have to record changes in instrument-specific credit risk for financial liabilities measured under the fair value option in other comprehensive income.
- Entities that are not public business entities (PBEs) will no longer have to disclose the fair value of financial instruments measured at amortized cost.
- The guidance is effective for calendar-year PBEs beginning in 2018. For all other calendar-year entities, it is effective for annual periods beginning in 2019 and interim periods beginning in 2020. Non-PBEs can adopt the standard at the same time as PBEs, and both PBEs and non-PBEs can early adopt certain provisions.

Overview

The Financial Accounting Standards Board (FASB) issued final guidance[1] that will change how entities measure certain equity investments and present changes in the fair value of financial liabilities measured under the fair value option (FVO) that are attributable to their own credit.

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The new guidance also changes certain disclosure requirements and other aspects of current US GAAP. It does not change the guidance for classifying and measuring investments in debt securities and loans.

Under the new guidance, entities will have to measure many equity investments at fair value and recognize any changes in fair value in net income unless the investments qualify for the new practicability exception. For financial liabilities measured using the FVO in Accounting Standards Codification (ASC) 825, *Financial Instruments*, entities will need to present any change in fair value caused by a change in instrument-specific credit risk (own credit risk) separately in other comprehensive income (OCI).

The new standard differs significantly from the model the FASB developed jointly with the International Accounting Standards Board (IASB) and from IFRS 9, *Financial Instruments*, which the IASB issued in July 2014. The FASB plans to issue a separate standard on credit losses later this quarter with requirements that will also differ from those in IFRS 9. Entities that invest in debt securities should monitor that project because the guidance will affect the measurement, presentation and disclosure of impairment related to these securities.

This publication summarizes the key provisions of the new guidance and includes a summary of changes in presentation and disclosure requirements in the appendix.

Summary of key amendments

Equity investments

The new guidance requires the fair value measurement of investments in equity securities and other ownership interests in an entity, including investments in partnerships, unincorporated joint ventures and limited liability companies (collectively, equity investments) that do not result in consolidation and are not accounted for under the equity method. Entities will have to measure these investments at the end of each reporting period and recognize changes in fair value in net income (FV-NI). Entities will no longer be able to recognize unrealized holding gains and losses on equity securities they classify today as available for sale (AFS) in OCI. They also will no longer be able to use the cost method of accounting for equity securities that do not have readily determinable fair values.

The guidance applies to all entities except those in certain industries that are required to account for substantially all of their investments at fair value with changes in fair value recognized in net income or in the change in net assets (e.g., broker-dealers in securities, investment companies, defined benefit pension and other postretirement plans). It also does not apply to (1) derivative instruments that are subject to the requirements of ASC 815, *Derivatives and Hedging*, (2) Federal Home Loan Bank and Federal Reserve Bank stock and (3) an exchange membership that has the characteristics of an ownership interest specified in ASC 940-340-25-1(b).

A practicability exception will be available for equity investments that do not have readily determinable fair values and do not qualify for the practical expedient to estimate fair value under ASC 820, *Fair Value Measurement* (i.e., the net asset value practical expedient). These investments may be measured at cost, less any impairment, plus or minus changes resulting from observable price changes in orderly transactions for an identical or similar investment of the same issuer. Entities will have to reassess at each reporting period whether an investment qualifies for this practicability exception.

To identify observable price changes, entities should consider relevant transactions that occurred on or before the balance sheet date that are known or can reasonably be known. To identify price changes that can be reasonably known, entities will be expected to make a reasonable effort (without expending undue cost and effort) to identify any observable

transactions. However, they will not be required to perform exhaustive searches. In addition, when determining whether an equity instrument issued by the same issuer is similar to the equity investment it holds, an entity should consider the different rights and obligations associated with the instruments. Differences in rights and obligations could include characteristics such as voting rights, distribution rights and preferences, and conversion features. Entities should adjust the observable price of the similar instrument for the different rights and obligations to determine the amount that should be recorded as an adjustment in the carrying value of the instrument being measured.

How we see it

An entity will have to exercise judgment and consider its facts and circumstances to determine whether an equity instrument issued by the same issuer is similar to the equity investment it holds and to apply the concepts of "undue cost and effort," and "reasonably known" under the new practicability exception.

For each reporting period, an entity that uses the practicability exception to measure an equity investment will be required to make a qualitative assessment of whether the investment is impaired. If an impairment exists, the entity will have to estimate the investment's fair value in accordance with ASC 820 and recognize an impairment loss in net income equal to the difference between the investment's carrying value and its fair value. The entity will no longer be able to consider whether the decline is other than temporary, as is required under current US GAAP. This single-step model for assessing impairment is expected to accelerate the recognition of losses in investments without readily determinable fair values.

The guidance 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 measured using the FVO in ASC 825, the change in fair value caused by a change in instrument-specific credit risk (own credit risk) will be presented separately in OCI. An entity may consider this amount to be the difference between the total change in fair value and the amount resulting from a change in a base market rate (e.g., a risk-free interest rate). This is a significant change from current US GAAP, which requires the instrument's entire change in fair value to be recognized through earnings. An entity may use another method that it believes results in a faithful measurement of the fair value change attributable to instrument-specific credit risk. However, it will have to apply the method consistently to each financial liability from period to period.

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

How we see it

The only own-credit relief the guidance provides is for financial liabilities measured using the FVO. The effect of an entity's own credit risk for other financial liabilities measured at FV-NI, including derivatives, will continue to be reported in net income, resulting in continued earnings volatility due to 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. Under the new guidance, entities will have to assess the realizability of a DTA related to an AFS debt security in combination with the entity's other DTAs.

How we see it

The new guidance eliminates one method that is currently acceptable for assessing the realizability of DTAs related to AFS debt securities. That is, an entity will no longer be able to consider its intent and ability to hold debt securities with unrealized losses until recovery, which may not be until maturity, akin to a tax planning strategy. Under this method, a valuation allowance currently wouldn't be necessary for DTAs on unrealized losses, even when there is significant negative evidence (e.g., recent cumulative losses) related to the realizability of other DTAs because the specific DTAs are expected to reverse as time passes.

Presentation and disclosure

The new guidance requires entities to present financial assets and financial liabilities separately, grouped by measurement category and form of financial asset in the statement of financial position or in the accompanying notes to the financial statements. Entities that are not PBEs will no longer have to disclose the fair value of financial instruments measured at amortized cost. PBEs will no longer have to disclose the method(s) and significant assumptions they use to estimate the fair value of financial instruments measured at amortized cost. In addition, PBEs will have to use the exit price notion when measuring the fair value of financial instruments measured at amortized cost for disclosure purposes.

Non-PBEs can early adopt a provision that eliminates the fair value disclosures for financial instruments not recognized at fair value.

Transition and effective date

The guidance is effective for PBEs for annual periods beginning after 15 December 2017, and interim periods therein. For all other entities, it is effective for annual periods beginning after 15 December 2018, and interim periods within annual periods beginning after 15 December 2019. Non-PBEs can early adopt the standard as of the effective date for PBEs. All entities can early adopt a provision requiring them to recognize the fair value change from own credit in OCI for financial liabilities measured using the FVO in ASC 825. Non-PBEs can early adopt a provision that eliminates the fair value disclosures for financial instruments not recognized at fair value. Both of these provisions can be early adopted for financial statements of annual or interim periods that have not yet been issued or made available for issuance, including those for periods in 2015.

An entity will record a cumulative-effect adjustment to beginning retained earnings as of the beginning of the first reporting period in which the guidance is adopted, with two exceptions. The amendments related to equity investments without readily determinable fair values (including disclosure requirements) will be effective prospectively. The requirement to use the exit price notion to measure the fair value of financial instruments for disclosure purposes will also be applied prospectively.

Endnote:

[1] Accounting Standards Update 2016-01, *Financial Instruments — Overall — Recognition and Measurement of Financial Assets and Financial Liabilities.*

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Appendix: Summary of key presentation and disclosure requirements

<table>
<tr><th>Instruments and features affected</th><th>Presentation and disclosure requirements</th></tr>
<tr><td>Financial assets and financial liabilities</td><td>Entities will separately present financial assets and financial liabilities by measurement category and form of financial asset (i.e., securities or loans and receivables) in the statement of financial position or in the notes to the financial statements.</td></tr>
<tr><td>Financial instruments, with certain exceptions (such as equity method investments, equity investments without readily determinable fair values, receivables and payables due in less than one year and demand deposit liabilities)</td><td>A PBE will be required to disclose, either in the body of the financial statements or in the accompanying notes, the fair value of financial instruments and the level of the fair value hierarchy within which the measurements are categorized in their entirety (i.e., Level 1, 2 or 3).
‣ A PBE won't be required to disclose:
  ‣ The methods and significant assumptions used to estimate the fair value of financial instruments consistent with the requirements of ASC 820-10-50-2(bbb).
  ‣ A description of the changes in the methods and significant assumptions used to estimate the fair value of financial instruments, if any, during the period.
Non-PBEs will no longer be required to disclose the fair value of financial instruments measured at amortized cost.</td></tr>
<tr><td>Fair value measurements only for disclosure purposes</td><td>The new guidance eliminates the exception in ASC 825 that allows entities to calculate fair values of certain financial instruments (e.g., loans) using an entry price notion rather than the exit price notion of ASC 820.</td></tr>
<tr><td>Equity investments without readily determinable fair values measured using the new practicability exception</td><td>An entity that applies the practicability exception for measuring equity investments without readily determinable fair values will disclose all of the following:
‣ The carrying amount of investments without readily determinable fair values
‣ The amount of impairments and downward adjustments, if any, both annual and cumulative
‣ The amount of upward adjustments, if any, both annual and cumulative
‣ As of the date of the most recent statement of financial position, additional information (in narrative form) that is sufficient to permit financial statement users to understand the quantitative disclosures and the information that the entity considered in reaching the carrying amounts and upward or downward adjustments resulting from observable price changes</td></tr>
<tr><td>Financial liabilities measured under the fair value option</td><td>Entities will disclose the following information about the effects of the instrument-specific credit risk and changes in it for financial liabilities measured under the FVO:
‣ The amount of change, during the period and cumulatively, of the fair value of the liability that is attributable to changes in the instrument-specific credit risk
‣ How the unrealized gains and losses attributable to changes in instrument-specific credit risk (and recorded in OCI) were determined
‣ If a liability is settled during the period, the amount, if any, recognized in OCI that was recognized in net income at settlement</td></tr>
<tr><td>Fair value option</td><td>In annual periods only, an entity will need to disclose the methods and significant assumptions used to estimate the fair value of items measured under the FVO, consistent with the requirements of ASC 820-10-50-2(bbb), except that an entity is not required to provide the quantitative disclosures about significant unobservable inputs used in measurements categorized in Level 3 of the fair value hierarchy.</td></tr>
</table>

No. 2015-83
12 November 2015

To the Point

FASB — proposed guidance

Preparing for the new credit impairment standard

Now that the FASB has set effective dates for the new credit impairment standard, entities should start planning for implementation.

What you need to know

- The FASB set effective dates for the new credit impairment standard starting in the first quarter of 2019 for calendar-year entities.
- Because implementing the new credit impairment standard will likely require significant effort, entities should begin planning now. The standard would require them to estimate and recognize an allowance for lifetime expected credit losses for loans, trade receivables, held-to-maturity debt securities and certain other financial assets measured at amortized cost.
- Implementing the new credit impairment standard will likely require changes in processes, systems and controls for financial institutions and other entities. Public companies also will need to consider disclosures they would have to make about the new standard and its effects.
- If they haven't yet done so, entities should establish a governance structure for implementation.

Overview

With more than three years before the first effective date of the new credit impairment standard, entities may think they have ample time to implement the standard the Financial Accounting Standards Board (FASB or Board) plans to issue in the first quarter of 2016. But financial institutions and other entities should be taking steps now to prepare for the potentially significant changes they would need to make.

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The first steps for management are developing a governance structure for implementation and performing a preliminary assessment of how much work will be necessary. Implementing the standard will likely require significant adjustments to processes, systems and controls, especially for financial institutions.

Entities should also develop plans to communicate with investors and other stakeholders, including making disclosures about the effects of new standards discussed in Securities and Exchange Commission (SEC) Staff Accounting Bulletin (SAB) Topic 11.M.[1]

Background

The new impairment standard would supersede today's guidance and would apply to all entities that hold financial assets that are not measured at fair value through net income. The guidance would address the recognition and measurement of credit losses on debt securities, trade receivables, loans, net investments in leases, off-balance sheet credit exposures, reinsurance receivables and other financial assets that represent the contractual right to receive cash.

For available-for-sale (AFS) debt securities, the FASB has decided to modify today's other-than-temporary impairment (OTTI) model to no longer require entities to consider certain factors when determining whether a credit loss should be recognized. The FASB also has decided to require entities to recognize credit losses through an allowance for credit impairment (rather than a direct reduction of a security's cost basis), thereby allowing for the reversal of credit impairments in later periods.

Now is the time for preparers to begin developing a plan to implement the credit impairment standard.

For all other affected financial assets, the FASB has decided to replace today's "incurred loss model" with an "expected credit loss model." This change would require entities to make more estimates of future losses, which would require more judgment.

Key considerations

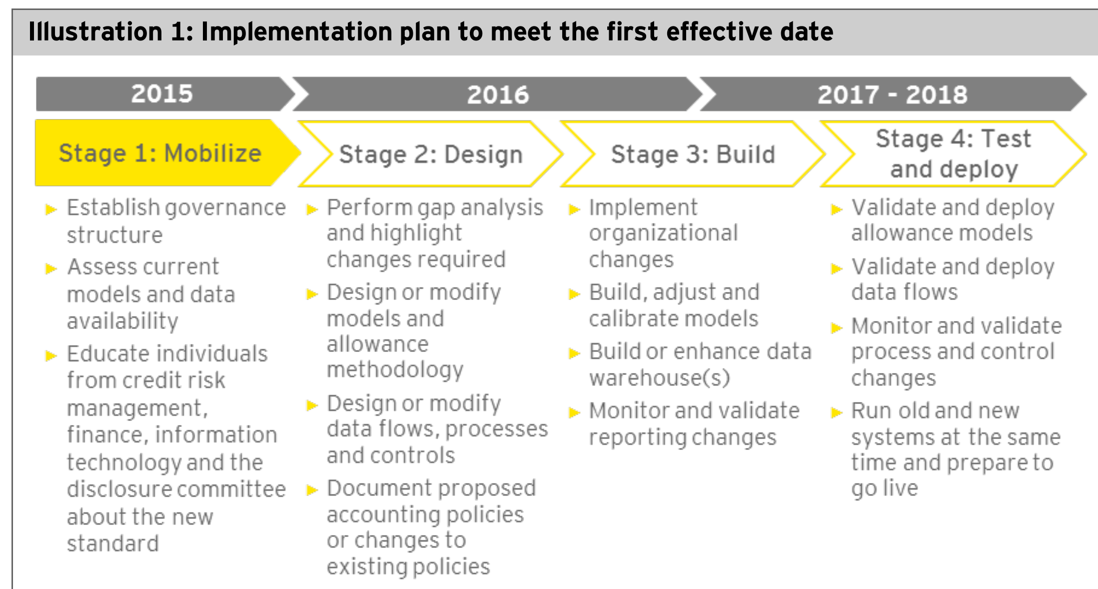
The FASB decided on the following effective dates for the credit impairment standard:

- For public business entities (PBEs) that meet the definition of an SEC filer, the standard would be effective for annual periods beginning after 15 December 2018, and interim periods therein. That means calendar-year SEC filers would begin applying it in the first quarter of 2019.
- For other PBEs, the standard would be effective for annual periods beginning after 15 December 2019, and interim periods therein. That means calendar-year PBEs that are not SEC filers would begin applying it in the first quarter of 2020.
- For all other entities, the standard would be effective for annual periods beginning after 15 December 2019, and interim periods within annual periods beginning after 15 December 2020. That means these entities that have calendar years would begin applying it in their annual financial statements for 2020 and in interim statements in 2021.

All entities would be allowed to adopt the guidance as of the effective date for PBEs that are SEC filers.

In making their decision on effective dates, the FASB discussed the difficulty of implementing several major new standards, including those involving classification and measurement of financial instruments, revenue recognition and accounting for leases, over the next several years.

While the effective dates of the impairment standard may seem distant, entities should take steps to prepare for implementation once it is issued. This graphic depicts the steps an entity might take to meet the first effective date.



A good place to start is putting in place a governance structure for implementation that brings together multiple disciplines. For example, a financial institution that expects to be significantly affected may consider a governance structure that includes individuals from accounting policy, credit risk management, information technology, treasury, finance, accounting controllership, investor relations, regulatory reporting, internal control and internal audit.

The next step is typically identifying key actions that need to be taken during the implementation phase. A preliminary assessment of the current state and future state required by the standard can be used to identify key actions that need to be taken to implement the new standard.

For example, entities will need to decide how to change their credit risk models to estimate lifetime expected credit losses. As a result, entities may need to:

- Compile additional historical loss data to transform today's historical loss estimate from an incurred loss to an estimate of lifetime losses
- Identify information (internal or external) that can be used to develop what the FASB is calling a "reasonable and supportable" forecast of the future
- Consider how to adjust their historical lifetime loss statistics for these reasonable and supportable forecasts, including developing the necessary processes and controls.

In addition, entities with trade receivables will need to think about changing their processes and documentation to meet the requirements of the standard, even though in many cases the standard won't significantly change their results.

Entities also will need to start planning for new disclosures because the standard is expected to require significantly more interim and annual disclosures than current US GAAP. Entities will need to assess whether they currently collect the information they will need to satisfy the new requirements or whether they will need to adjust their processes and controls or put new ones in place to gather the information and make sure it is accurate.

Implementing the standard also will be challenging because industry groups, regulators and implementation groups will be addressing questions that arise over time, and an entity's understanding of the new requirements will likely evolve. In addition to industry groups and banking regulators, we expect the staff of the SEC, the American Institute of Certified Public Accountants and the FASB's Transition Resource Group on Credit Impairment to all weigh in.

Questions to consider now

As entities develop their implementation plans, management should consider the following questions:

- What governance structure will be used to oversee and coordinate implementation? How will this effort be communicated and agreed to by the Board of Directors?
- What is the plan for a preliminary assessment of the standard's effect on the entity? When will it be complete?
- If the entity is an SEC registrant, what is the plan for making the disclosures under SAB Topic 11.M about the effect of a new accounting standard?
- What process has the entity put in place to monitor interpretations by the various organizations that are likely to interpret the standard?

Endnote:

[1] Refer to SEC Staff Accounting Bulletin Topic 11.M, *Disclosure Of The Impact That Recently Issued Accounting Standards Will Have On The Financial Statements Of The Registrant When Adopted In a Future Period.*

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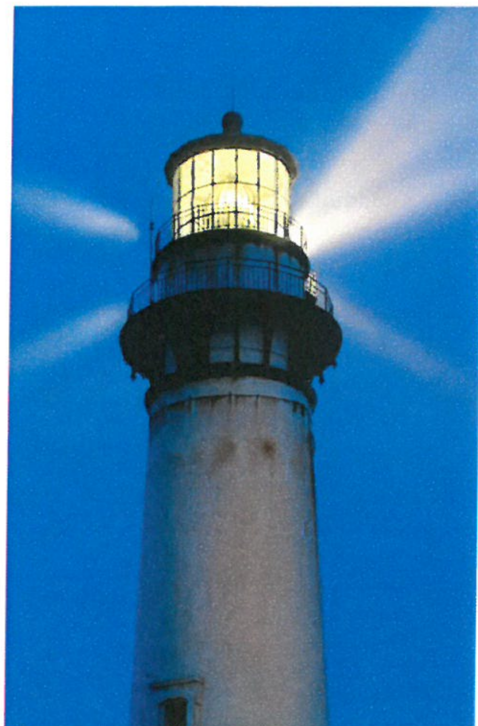
March 2015, No. 15-9



FASB Makes Impairment Transition and Disclosure Decisions

At two recent meetings, the FASB reached decisions on transition methods and disclosures for the proposed standard on financial instruments impairment (proposed ASU).[1] The FASB directed its staff to draft the final standard, and plans to discuss the effective date at a later meeting.

Key Facts

- The FASB provided the transition method for purchased-credit impaired (PCI) financial assets and other-than-temporarily impaired (OTTI) debt securities at the adoption date.
- The disclosure requirements for debt securities classified as available-for-sale (AFS) will be retained and updated for the proposed ASU's general credit risk disclosure principles.[2]
- A period-to-period rollforward of the amortized cost for financial assets measured at amortized cost and at fair value through other comprehensive income (FVOCI) will not be required.
- Disclosures of credit quality indicators for financing receivables will be disaggregated by the year of the asset's origination.

Key Impacts

- Entities may need to evaluate the new disclosure requirements, particularly credit quality indicators disaggregated by vintage year, and assess their impact on systems, processes, and controls.
- The transition method for OTTI debt securities and PCI financial assets is likely to be less burdensome for entities to implement than the original proposal.

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[1] FASB Proposed Accounting Standards Update, Financial Instruments – Credit Losses, December 20, 2012, available at www.fasb.org.

[2] FASB ASC Subtopic 320-10, Investments – Debt and Equity Securities, available at www.fasb.org.

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NDPPS 333954

Impairment Project Timeline

- 2010 – Exposure Draft
- December 2012 – Revised Exposure Draft
- April 2013 – Comment Period Ended
- 2013 to Present – Redeliberations
- 2015 – Final Standard Expected

Purchased-Credit Impaired Financial Assets

The Board decided that an entity will account for PCI financial assets upon transition as follows:

- All loans and debt securities acquired with deteriorated credit quality for which an entity applies Subtopic 310-30 (including by analogy) will be classified as PCI financial assets at the date of adoption.[3]
- Entities will not be permitted to perform further assessments at the adoption date to determine whether other previously acquired assets meet the new definition of PCI assets.
- Entities will be required to gross up the allowance for lifetime expected credit losses at the date of adoption with a corresponding adjustment to the carrying value of the assets.
- Interest income will be recognized based on the yield as of the adoption date.

The Board also decided that subsequent increases and decreases in lifetime expected credit losses will be recorded through the allowance for expected credit losses with a corresponding adjustment to the current-period provision for credit losses.

Background. The current PCI definition in Subtopic 310-30 is not the same as the proposed definition. Also, some entities have applied Subtopic 310-30 by analogy to other purchased loans. Respondents questioned whether loans purchased before the effective date of the proposed ASU would need to be reevaluated under the new PCI definition, and if so, whether the determination would be made as of the date of adoption or the date the assets were acquired.

Currently for PCI financial assets, the excess of expected cash flows at acquisition over the acquirer's initial investment in the assets is recognized as interest income on a level-yield basis over the remaining life of the assets. If there is a subsequent significant increase in estimated future cash flows, that change is recognized prospectively by increasing the yield. The Board decided entities will continue to recognize interest income on these assets based on their yield as of the adoption date.

OTTI Debt Securities

The Board decided that entities will adopt the provisions of the ASU related to OTTI debt securities prospectively as of the adoption date.

- Amounts previously recognized in accumulated other comprehensive income (AOCI) as of the date of adoption that relate to significant improvements in cash flows will continue to be accreted to interest income over the remaining life of the debt security on a level-yield basis.
- Any improvements in cash flows due to improving credit after the adoption date will be recorded through the provision for credit losses in the income statement.

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[3] FASB ASC Subtopic 310-30, Receivables – Loans and Debt Securities Acquired with Deteriorated Credit Quality, available at www.fasb.org.

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Background. At a previous meeting, the Board decided that debt securities classified as AFS would be excluded from the scope of the lifetime expected credit-loss model. Instead, the impairment amount would be recognized through an allowance account that would allow reversals of previously recognized credit losses. Under current U.S. GAAP, credit losses on debt securities are recognized in earnings through an adjustment to the amortized cost basis, and the amortized cost basis is not adjusted for improvements.

The proposed ASU would have required a cumulative-effect adjustment to the carrying amount of the debt securities at the adoption date with an offsetting adjustment to the opening balance of retained earnings or other appropriate components of equity. Respondents to the proposal requested additional guidance on transition for OTTI debt securities and specifically highlighted these two issues:

- Hindsight may be required to determine how much of the allowance initially recognized would have been written off.
- Accounting for a debt security that has had a significant improvement in cash flows following the initial impairment. Under current GAAP, subsequent improvements are recognized prospectively as an adjustment to yield.

Disclosures

An entity will be required to disclose a period-to-period rollforward of the allowance for expected credit losses for financial assets measured at amortized cost and at FVOCI. The Board decided not to require the amortized cost rollforward disclosures. However, entities will be required to disaggregate the credit quality indicators for all classes of financing receivables (excluding revolving lines of credit such as credit cards) that are disclosed under current GAAP by the year of the asset's origination (i.e., vintage year).[4] Some of the key requirements are:

- Disaggregation by vintage year will be for a specified minimum number of annual reporting periods, and any financing receivable originated prior to that will be disclosed in an aggregate column;
- Entities will apply current GAAP to determine if a loan refinancing or restructuring is a new loan or a loan modification;[5] and
- Revolving lines of credit will not be subject to the vintage year disclosure, but will still need to be disaggregated by credit quality indicators.

Background and Observations. The proposed ASU would have retained current U.S. GAAP requirements to disclose a rollforward of the allowance for credit losses and introduced an amortized cost rollforward of financial assets measured at amortized cost and FVOCI. Financial statement users generally supported this requirement while preparers believed implementation would be difficult.

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[4] A financing receivable is a defined as a financing arrangement that: (1) represents a contractual right to receive money either on demand or on fixed or determinable dates, and (2) is recognized as an asset in the entity's statement of financial position. Financing receivables include, but are not limited to, loans, trade accounts receivables, and notes receivable.

[5] ASC Paragraphs 310-20-35-9 through 35-12, available at www.fasb.org.

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Transition Disclosures

The Board affirmed the transition disclosure requirements included in the proposed ASU, which are listed below:

(a) The nature of the change in accounting principles, including an explanation of the newly adopted accounting principles.

(b) The method of applying the change.

(c) The effect of the adoption on any line item in the statement of financial position, if material, as of the beginning of the first period for which the guidance is effective. Presentation of the effect on financial statement subtotals is not required.

(d) The cumulative effect of the change on retained earnings or other components of equity in the statement of financial position as of the beginning of the first period for which the guidance is effective.

(e) An entity that issues interim financial statements must provide the disclosures in item (d) in each interim financial statement of the year of change and the annual financial statements of the period of change.

Next Steps

The Board directed the staff to draft the final standard. During the drafting process, the staff will perform outreach with preparers and users on the disclosure requirement to disaggregate credit quality disclosure by vintage year, any remaining issues identified, and the effective date. The Board will meet with the staff to discuss any remaining issues, the cost-benefit and complexity of the decisions reached to date, and the effective date.

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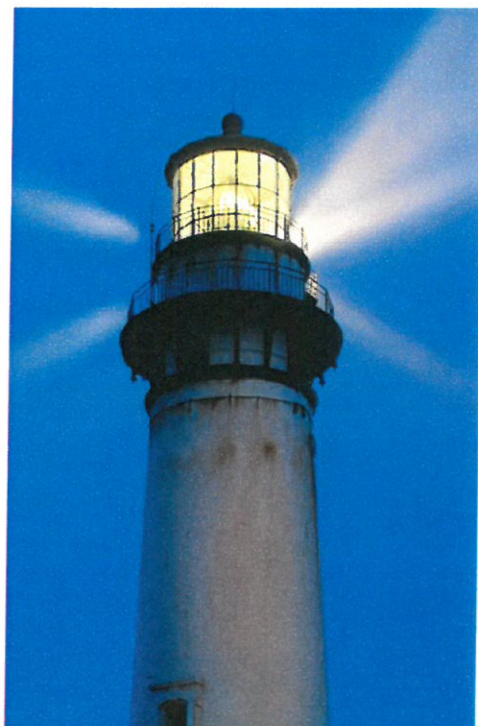

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FASB Nears Completion of Financial Instruments Standards

The FASB recently reached decisions on the financial instruments standards related to the accounting for troubled debt restructurings (TDRs), impairment of available-for-sale (AFS) debt securities, and the effective dates for the impairment and classification and measurement standards.[1]

The Board will meet before year end to discuss the remaining impairment issues and cost-benefit considerations, and intends to issue a final impairment standard in the first quarter of 2016. The Board plans to issue a final classification and measurement standard in 2015.

Key Facts

- Credit losses for loans classified as TDRs would be measured under the current expected credit loss (CECL) model.
- Impairment of debt securities classified as AFS would be limited to the difference between their amortized cost and fair value.
- Public business entities that are SEC filers would apply the ***impairment*** standard for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years.[2]
- Public business entities would apply the ***classification and measurement*** standard for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years.

Key Impacts

- Entities that previously had to segregate TDRs for subsequent measurement may not need to continue this practice.
- The effective dates for the new impairment guidance under U.S. GAAP and IFRS would be different.

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[1] The FASB met on November 11, 2015. FASB Proposed Accounting Standards Updates, Financial Instruments – Credit Losses, December 20, 2012; and Financial Instruments Overall: Recognition and Measurement of Financial Assets and Liabilities, February 14, 2013, both available at www.fasb.org.

[2] An SEC filer is defined as an entity that is required to file or furnish its financial statements with either (a) the SEC, or (b) with respect to an entity subject to Section 12(i) of the Securities Exchange Act of 1934, the appropriate agency. Financial statements for other non-SEC filers whose financial statements are included with another filer's SEC submission are not included in this definition.

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Impairment

External Review Draft

In August 2015, the FASB distributed an external review draft of the financial instruments impairment standard to a select group of stakeholders. The FASB staff received approximately 950 comments; the reviewers identified 147 comments as fatal flaws. The Board will discuss some of these issues in greater detail. For other comments, the staff said it would clarify the language in the final standard.

Effective Date

The Board decided that the impairment standard would be effective for:

- Public business entities that are SEC filers for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years;
- Public business entities that are *not* SEC filers for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years; and
- All other entities for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020.[3]

Early adoption would be permitted for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years.

KPMG Observations

The 2019 and 2020 effective dates might seem a long way off but already many companies are analyzing the implications of the standards. Entities may need to develop or revise accounting processes and internal controls, which would require applying significant judgments and developing new estimates. IT systems also may need to be modified to capture additional data to support the accounting and disclosure requirements.

Considerations for IFRS Convergence. Both U.S. GAAP and IFRS would have new impairment requirements that, while not converged, generally would result in an increase in the allowance for credit losses when compared with amounts recorded under current guidance. However, the mandatory effective dates of the respective standards are not the same.

For U.S. GAAP, the standard would be applied no earlier than fiscal years beginning after December 15, 2018. In contrast, the impairment guidance in IFRS 9, *Financial Instruments,* is effective for fiscal periods beginning on or after January 1, 2018.

[3] All other entities include not-for-profit entities, and employee benefit plans within the scope of ASC Topics 960, Defined Benefit Pension Plans; 962, Defined Contribution Pension Plans; and 965, Health and Welfare Benefit Plans, all available at www.fasb.org.

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Impairment Floor for AFS Debt Securities

The Board decided that the amount of impairment recognized for debt securities classified as AFS would be limited to a fair value floor. The impairment recognized would be the lesser of:

- The difference between the amortized cost basis and the fair value, and
- The credit loss amount.

Applying the Board's Decision on Recognizing Impairment on AFS Debt Securities			
Facts	**Scenario 1**	**Scenario 2**	**Scenario 3**
Amortized Cost	$100	$100	$100
Fair Value	98	92	107
Credit Loss Amount	5	5	5
Impairment Recognized Through Earnings	2	5	0

Background. The Board previously decided that debt securities classified as AFS would continue to use the current other-than-temporary impairment (OTTI) model. However, it decided to make targeted amendments to the model to address concerns about the timely recognition of credit losses.

As part of the external review process, the Board requested feedback from stakeholders about whether incorporating a fair value floor would further simplify the impairment model for AFS debt securities. Generally, stakeholders favored the fair value floor because the cost basis would not be lower than the price at which the entity could sell the debt securities.

KPMG Observations

Incorporating the fair value floor would not change the amount of impairment recognized for debt securities that entities intend to sell or are more likely than not to be required to sell before recovery of the amortized cost basis. In these cases, the impairment recognized in earnings would be equal to the difference between the fair value and the amortized cost basis.

Effect of Fair Value Floor. The Board's decision ensures that entities would not recognize an allowance for credit losses that reduces the carrying amount of a debt security below its fair value. Without the fair value floor, if the allowance for credit losses reduced the carrying amount below fair value,

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entities would record a simultaneous gain in other comprehensive income for the excess of the fair value over the net carrying amount.

Incorporating a fair value floor into the model for accounting for AFS debt securities would result in noncomparability with the allowance for credit losses recorded for financial instruments measured at amortized cost (e.g., held-to-maturity debt securities).

If the amount initially recognized as an allowance for credit losses was limited to the fair value floor, subsequent changes in fair value would require adjusting the allowance, even if those fair value changes were driven by non-credit factors, e.g., interest rates or liquidity.

Troubled Debt Restructurings

The Board decided that credit losses for loans classified as TDRs would be measured using the CECL model that would apply to all other financial assets measured at amortized cost. Therefore, entities would evaluate impairment of TDRs on a collective (pool) basis together with other loans that have similar risk characteristics. If TDRs do not share similar risk characteristics with other loans, impairment would be evaluated individually.

Consistent with current U.S. GAAP, credit losses would continue to be recognized through earnings using an allowance account that is updated each period.

Background. The Board had previously decided that the amortized cost basis of the asset would have been adjusted when impairment was recognized for TDRs. The new amortized cost basis would have been the present value of the post-modification contractual cash flows (discounted at the asset's original effective interest rate). Stakeholders raised concerns about the cost and complexity of the cost-basis adjustment, including determining the cumulative-effect transition adjustment required at the time of adoption for loans previously classified as TDRs.

KPMG Observations

Allowing TDRs to be measured using the CECL model gives entities more latitude to develop different methods to estimate and measure expected credit losses. The methods must be applied consistently and must reflect the key elements of the CECL model. This represents a change from current U.S. GAAP, which requires TDRs to be measured individually using a discounted cash-flow technique.

Because the same methods could be used to measure expected credit losses for TDRs and non-TDRs, entities that previously had to segregate TDRs for subsequent measurement may not need to continue to do so. However, for loan modifications that also are TDRs, consistent with current U.S. GAAP, creditors would continue to separately disclose both the

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impairment amounts related to TDRs and the recorded investment in the period in which the entity recognized impairment.[4]

The Board decided to provide more latitude to determine the methods that entities could use to measure impairment for TDRs. However, it is not clear whether the Board intended to permit measurement methods that would not recognize an impairment loss when the lender grants a concession through a reduction of the interest rate charged to the borrower.

Next Steps

The Board will meet again before year end to discuss cost-benefit considerations and an issue related to measuring expected credit losses for purchased assets with more-than-insignificant credit deterioration. The Board expects to issue the final impairment standard during the first quarter of 2016.

Classification and Measurement

External Review Draft

In August 2015, the FASB distributed an external review draft of the classification and measurement standard to a select group of stakeholders. The FASB received approximately 233 comments; the reviewers identified 36 comments as fatal flaws. The staff concluded there were no issues that the Board needed to discuss.

The Board decided not to align the effective date of the new classification and measurement standard with the effective date of the new impairment standard. Instead, the Board aligned the effective date of classification and measurement with the effective date of the revenue standard.

Effective Date

The Board decided the classification and measurement standard would be effective for:

- Public business entities for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years; and
- All other entities for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019.[5]

Early adoption would be permitted for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. When the standard is issued, entities could early adopt at the beginning of a fiscal year to separately present in other comprehensive income the portion of the change in fair value of the financial liability (for which the fair value option had been elected) that results from a change in the instrument-specific credit risk.

[4] FASB ASC paragraph 310-40-50-4, available at www.fasb.org.

[5] All other entities includes not-for-profit entities, and employee benefit plans within the scope of ASC Topics 960, Defined Benefit Pension Plans; 962, Defined Contribution Pension Plans; and 965, Health and Welfare Benefit Plans, all available at www.fasb.org.

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Next Steps

The Board concluded that the benefits of the new classification and measurement standard would outweigh the costs of application and directed the staff to draft a final standard for vote by written ballot. A final standard is expected to be issued by the end of 2015.

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NATIONAL ASSOCIATION OF
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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

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 originally 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.

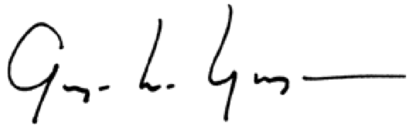
Respectfully submitted,

[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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NATIONAL ASSOCIATION OF
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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.

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

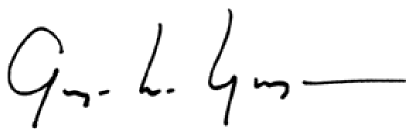
[4] http://www.sec.gov/answers/form10q.htm

[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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Dataline
A look at current financial reporting issues

No. 2013-01
January 16, 2013

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Credit losses on financial assets

An overview of the FASB's current expected credit loss model

Overview

At a glance

- Impairment is a major component of the FASB and IASB's (the boards') joint project to revisit most aspects of financial instruments accounting. In the aftermath of the recent financial crisis, the current incurred loss approach has been criticized for delaying the recognition of credit losses. As a result, many constituents believe revisions to the current impairment model are necessary.

- The FASB has completed redeliberations on its proposed impairment model, referred to as the "current expected credit loss" (CECL) model. In December 2012, the FASB issued for public comment its proposed Accounting Standards Update (ASU), *Financial Instruments—Credit Losses (Subtopic 825-15)*. The ASU proposes recognition of the full expected credit loss on financial instruments that fall within its scope. The comment period ends on April 30, 2013.

- The IASB has completed redeliberations on its proposed model, previously referred to as the "three bucket" model and now known as the "credit deterioration" model. The IASB's model differs from the FASB's model in several key areas, which are highlighted throughout this Dataline. The IASB is expected to issue its exposure draft in the first quarter of 2013.

The main details

.1 The development of a revised standard on the impairment of financial assets is one part of the boards' joint priority project to address various aspects of financial instruments accounting. This Dataline focuses only on the developments in impairment accounting. Refer to Dataline 2012-21, *Financial instruments classification and measurement — An update on the FASB's tentative approach to be exposed in Q1 2013*, for information on the classification and measurement portion of the financial instruments project.

.2 Various constituents have expressed the need for the accounting standard setters to address the perceived flaws in the current impairment model. For example:

1) In an April 2009 report reflecting on the causes of the global financial crisis, the Group of 20, consisting of the finance ministers and central bank governors of the major economies, made several recommendations. Among other things, the report recommended that accounting principles related to loan loss provisioning be improved to permit consideration of a "broader range of credit information."

2) The Financial Crisis Advisory Group, formed to advise the FASB and IASB, said in its final July 2009 report that the financial crisis exposed weaknesses in financial reporting that included "the delayed recognition of losses associated with loans, structured credit products, and other financial instruments by banks, insurance companies and other financial institutions." They recommended that the boards explore an approach that uses more forward-looking information, such as an expected loss model or fair value model.

3) The Basel Committee on Banking Supervision stated in an August 2009 report that the IASB's new financial instruments standard should "reflect the need for earlier recognition of loan losses to ensure robust provisions."

.3 Both the FASB's CECL model and the IASB's credit deterioration model seek to improve the decision usefulness of the reporting of credit losses by removing the perceived constraints to timely recognition, and allowing entities to consider a broader information set. Both models move away from the incurred loss model that exists in practice today and consider expected losses when determining the amount of credit losses that should be recognized each reporting period.

PwC observation:

Extensive system and process changes may be needed to apply both models and may require a considerable amount of lead time in order to be designed and implemented. Specifically, entities will need to develop the infrastructure to estimate losses over a longer time horizon. If there are concerns about the operationality and system requirements to implement the proposed model, constituents are encouraged to communicate those concerns through the comment letter process.

.4 This Dataline is focused on the FASB's CECL model but draws comparisons to the credit deterioration model throughout the document. In addition, refer to Appendix I of this Dataline for a side-by-side comparison of the boards' respective impairment approaches.

.5 As both boards move away from an incurred loss model and instead look to expected losses, it is likely that levels of allowance for credit losses will change. This could potentially impact regulatory capital requirements and various key financial metrics.

.6 The FASB has not yet determined an effective date for the proposed model. The FASB will discuss an effective date after considering feedback it receives during the comment period. The FASB has indicated that it will consider multiple potential effective dates, and may consider different effective dates for public versus non-public companies and regulated versus non-regulated entities.

PwC observation:

Given the FASB released its proposed CECL model in December 2012, it is unlikely it will issue a final standard before the later part of 2013. Therefore, an effective date earlier than 2015 appears unlikely.

Key elements of the CECL model

Objective

.7 The objective of recording an allowance for credit losses is to reflect the estimate of the amount of contractual cash flows not expected to be collected. The CECL model provides guidance on how an entity should recognize and measure expected credit losses. The CECL model is intended to simplify current practice by eliminating today's multiple impairment models. It also allows entities to consider a broader information set to determine the amount of credit losses expected to occur.

.8 For debt instruments, there are several different impairment models used today under US GAAP, including the following:

- ASC 310-30, *Receivables — Loans and Securities Acquired with Deteriorated Credit Quality* (formerly SOP 03-3)

- ASC 310-40, *Receivables — Troubled Debt Restructurings by Creditors* (formerly FAS 114)

- ASC 320-10-35, *Investments — Debt and Equity Securities — Recognition of an Other-Than-Temporary Impairment* (formerly FSP FAS 115-2)

- ASC 325-40, *Investments — Beneficial Interests in Securitized Financial Assets* (formerly EITF 99-20)

- ASC 450, *Contingencies* (formerly FAS 5)

The CECL model aims to replace the various impairment models that exist today with a single approach for all debt instruments.

PwC observation:

With respect to interest income recognition, the CECL model only speaks to how to recognize interest income on purchased credit impaired assets, and when to stop accruing interest income altogether. The proposed ASU does not address how a creditor should recognize interest income on the remainder of the portfolio. However, the proposed ASU is intended to supersede ASC 310-30 and ASC 325-40, which currently provide guidance on interest income recognition for certain instruments. We anticipate questions to arise regarding how interest income should be recognized under the CECL model.

Scope

.9 Both the CECL model and the credit deterioration model will apply to financial assets that are subject to losses related to credit risk and are *not* measured at fair value with changes in fair value recognized in net income. Said differently, both models will apply to financial assets that are subject to losses related to credit risk that are carried at amortized cost or fair value with changes in fair value recorded in other comprehensive income (FV-OCI).

.10 The scope of both models includes loans, debt securities, trade receivables, lease receivables, and loan commitments. At this stage, the FASB has also included reinsurance receivables that result from insurance transactions in the scope of its impairment model. The IASB recently made a decision to subject reinsurance receivables to insurance accounting, which under IFRS, results in an expected value measurement. Therefore, the proposed measurement of credit loss associated with a reinsurance

receivable will be the same under US GAAP and IFRS despite these arrangements being within the scope of two different areas of the accounting standards.

PwC observation:

Many have questioned whether or not financial guarantees are included in the scope of the FASB's proposed ASU. Many argue that financial guarantee contracts present many of the same credit considerations as loan commitments, which are included in the scope of the proposed guidance. However, others view financial guarantees as insurance contracts and believe they should be accounted for as such.

The FASB has made a tentative decision that the proposed insurance contracts standard should apply to financial guarantee contracts currently accounted for as insurance under existing US GAAP, such as mortgage insurance and financial guarantee contracts sold by insurance enterprises. The FASB has yet to decide whether guarantees issued by banks or other financial institutions will be included in the scope of the insurance standard. In its project on insurance contracts, the FASB has tentatively defined “insurance contracts” broadly. Therefore, absent a specific scope exclusion in the insurance contracts standard, financial guarantee contracts will likely meet the definition of an insurance contract.

The IASB has made a decision to include financial guarantee contracts in the scope of the impairment project. However, if an entity previously asserted explicitly that it regards financial guarantee contracts as insurance contracts and applied insurance accounting, the IASB will permit the entity to elect to continue applying insurance accounting.

Measurement

.11 The CECL model will require an entity to recognize an allowance for all expected credit losses on debt instruments. The FASB defines expected credit losses as "an estimate of all contractual cash flows not expected to be collected from a recognized financial asset (or group of financial assets) or commitment to extend credit." There will be no threshold to meet prior to recognizing a credit loss, and the allowance must reflect the time value of money. Refer to further discussion under “Information set to consider” below regarding consideration of the time value of money in applying the CECL model.

PwC observation:

The CECL model and the credit deterioration model both represent potentially significant changes from current practice, as both models move away from the incurred loss notion and instead focus on expected losses. While both models represent a change from current practice, there are several key differences between the two models.

Perhaps the most significant difference is that the CECL model does not contain a "trigger" to recognizing full expected credit losses, while the credit deterioration model only requires recognition of a full expected credit loss on those assets for which there has been a significant deterioration in credit or there is a probability of loss in the next twelve months.

.12 Both the CECL model and the credit deterioration model require that an entity’s estimate of expected credit losses reflect, at a minimum, two possible outcomes: an outcome in which a credit loss results and an outcome in which no credit loss results. An entity will be prohibited from estimating expected credit losses on the basis of the most likely outcome for an individual financial asset.

PwC observation:

Both the CECL model and the credit deterioration model require consideration of more than one possible scenario in estimating the allowance for credit losses. Because one scenario must reflect the possibility that a credit loss results, there will be some amount of allowance for every financial asset.

The CECL model does not contain a threshold to meet prior to recognizing a full expected credit loss. As all loans have some risk of loss, the CECL model will require day one loss recognition for the credit risk associated with newly originated loans. While application of the IASB's credit deterioration model will also result in day one losses, such losses will likely be smaller than under the CECL model. This is due to the fact that the IASB model only contemplates the probability of loss in the next twelve months for newly originated loans that have not experienced significant credit deterioration.

.13 Both the CECL model and the credit deterioration model apply to financial assets measured at amortized cost and FV-OCI. However, the CECL model contains a practical expedient for financial assets measured at FV-OCI. The practical expedient allows entities not to recognize credit losses when both of the following conditions are present:

- The fair value of the individual financial asset is greater than (or equal to) the amortized cost basis of the financial asset; and
- The expected credit losses on the individual financial asset are insignificant, which may be determined by considering the general expectation of the range of expected credit losses given the credit-quality indicator(s) for the asset as of the reporting date.

PwC observation:

Debt securities are expected to be one of the more common types of financial assets carried at FV-OCI. In many cases, entities hold large portfolios of debt securities with high credit quality, including U.S. Treasury and other highly rated securities. Often, credit losses will not be significant on an individual asset basis; therefore, these securities will likely meet the second criterion to qualify for the practical expedient.

However, the fair value of such securities is impacted by a variety of factors, including liquidity, interest rates, and credit. As a result, movement in market interest rates that result in a decrease in fair value could lead to these securities no longer qualifying for the practical expedient. Therefore, recognition of expected credit losses will be required even though there was no change in the credit risk of the securities. Although these credit losses may not be significant on an individual asset basis, they could potentially be significant across an entire portfolio.

.14 Consistent with current practice, the CECL model provides a practical expedient when estimating credit losses on collateral-dependent financial assets. The practical expedient allows entities to compare the fair value of the collateral to the amortized cost basis to determine the allowance for credit losses. If an entity elects to apply the practical expedient and repayment or satisfaction of the asset depends on the sale of the collateral, the fair value of the collateral is required to be adjusted to consider estimated costs to sell. If the repayment or satisfaction of the asset depends on the operation of the collateral, but not the sale, the fair value is not adjusted.

PwC observation:

The FASB expanded the current definition of a collateral-dependent financial asset. Under today's guidance, collateral dependent only applies to loans and is defined as "a loan for which repayment is expected to be provided solely by the underlying collateral."

The new definition of collateral-dependent financial asset is revised to "a financial asset for which 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."

Today, there is diversity in how entities apply the definition of a collateral-dependent financial asset. While the FASB expanded the scope and definition to accommodate additional financial instruments, they did not provide a significant amount of additional application guidance on collateral-dependent financial assets. Therefore, we expect that there will continue to be diversity in how entities apply the definition in practice.

.15 For loan commitments not measured at fair value through net income, the CECL model requires entities to estimate credit losses over the full contractual period over which the entity is exposed to credit risk via an unconditional legal obligation to extend credit. The estimate of credit losses on loan commitments will consider the likelihood of funding and the extent of credit losses expected to occur on such funded amounts.

Subsequent measurement

.16 At each reporting period, entities will recognize, as a provision for credit loss, the amount of credit loss (or reversal), required to adjust the allowance to reflect the updated expectation of contractual cash flows not expected to be collected.

.17 An entity will be required to write-off a financial asset (or portion thereof) in the period in which a determination is made that the entity has no reasonable expectation of future recovery.

PwC observation:

The guidance in the proposed ASU on write-offs represents a significant change from current practice. With respect to securities, there will no longer be a "write-down" of the cost basis to reflect other-than-temporary impairment. Rather, entities will record an allowance for credit losses, which could decrease in subsequent periods.

With respect to loans, current practice varies as to when a loan is written-off. Although practice is mixed, a level of consistency has been achieved in certain industries where a common approach has been established by regulators or others. For example, banks typically write-off a loan when it becomes 180 days past due.

The CECL model establishes a single approach to recognizing write-offs. That approach requires write-off when there is no reasonable expectation of recovery. While the CECL model attempts to bring consistency, we anticipate that regulators will continue to express a point of view about how to interpret the guidance, as a "no reasonable expectation of recovery" principle leaves room for interpretation. Additionally, the FASB will require entities to disclose their write-off policy.

Information set to consider

.18 Both the CECL model and the credit deterioration model require estimates of expected credit losses to be based on internally and externally available information considered relevant in making the estimate. This includes information about past events, current conditions, and reasonable and supportable forecasts. Entities will be able to consider both qualitative and quantitative factors specific to borrowers and the economic environment in which the reporting entity operates.

PwC observation:

One of the goals of both the CECL and the credit deterioration models is to allow entities to consider a broader information set when estimating the allowance for credit losses. During the financial crisis of 2008, entities were restricted by the incurred loss model. Despite having information available that suggested further credit losses would eventually occur, entities could only record credit losses when those losses had been incurred. In establishing the information set to consider, both boards were focused on ensuring that entities could consider all relevant information, including forecasts about macroeconomic and borrower-specific conditions.

.19 The CECL model recognizes the inherent judgment involved in estimating credit losses and also recognizes that the most appropriate method to do so will vary depending on the asset and the information available that is relevant to the process. Therefore, the CECL model does not mandate specific approaches or policy elections to determine an expected credit loss. The proposed ASU includes examples of various methodologies that could be used to estimate expected credit losses under the CECL model.

PwC observation:

The FASB has given constituents latitude to determine the most appropriate method to satisfy the principles of estimating an expected credit loss. This will represent a change from today's guidance, which requires entities to use discounted cash flow calculations in certain situations. No such mandates will exist in the CECL model.

.20 Both the CECL and credit deterioration models require the allowance to consider time value of money. However, the CECL model allows for that consideration to be either implicit or explicit. The FASB believes that an example of a method that considers time value of money explicitly is a discounted cash flow calculation, and examples of methods that consider time value of money implicitly are historical loss ratios and probabilities of default.

PwC observation:

The FASB spent considerable time discussing the need for the CECL model to consider time value of money. Constituents had expressed concern about whether incorporating the time value of money effectively required entities to use discounted cash flow calculations. The FASB believes that many commonly used methods for estimating credit losses; including probability of default/loss given default (PD/LGD) and historical loss rates, inherently capture the time value of money.

The FASB's conclusions are based on the premise that the amortized cost recorded on the balance sheet at a point in time reflects the present value of all expected future cash flows, discounted at the effective interest rate. If an entity has historically measured losses against the amortized cost basis, such historical loss information inherently captures the time value of money. Therefore, historical loss rates and loss given default rates that incorporate this information would satisfy the objectives of the model.

.21 The CECL model allows entities to consider how credit enhancements mitigate expected credit losses on financial assets when estimating the allowance for credit losses, provided such credit enhancements are not separate freestanding instruments. As a result, the estimate of expected credit losses on a financial asset should not be offset by a legally detachable and separately exercisable contract that may mitigate expected credit losses on the financial asset.

PwC observation:

The proposed ASU cites a purchased credit default swap as an example of a freestanding contract that cannot be considered when establishing an estimate of expected credit losses. While a credit default swap is clearly a freestanding contract, it is not clear whether other common credit enhancements would be considered freestanding contracts.

For example, standard representations and warranties, while not a "separately exercisable" contract, do not necessarily travel with a loan upon subsequent sale. As a result, it is unclear whether standard representations and warranties will be considered freestanding. Based on the wording in the proposed ASU, we anticipate questions to arise regarding how various types of credit enhancements like representations and warranties should or should not be factored into an entity's estimate of credit losses.

Interest income

.22 The CECL model only addresses two areas related to interest income recognition: (1) interest income recognition on purchased credit-impaired (PCI) financial assets, and (2) when to cease the accrual of interest income on financial assets. Otherwise, the CECL model does not address how a creditor should recognize, measure, or display interest income on financial assets.

.23 The CECL model defines PCI assets as "acquired individual financial assets (or acquired groups of financial assets with shared risk characteristics at the date of acquisition) that have experienced a significant deterioration in credit quality since origination, based on the assessment of the acquirer."

PwC observation:

The definition of purchased credit-impaired financial assets represents a change from current practice. Under ASC 310-30, purchased assets are deemed to be impaired (and therefore in the scope of that section) if there is evidence of credit deterioration since origination and it is probable, at acquisition, that the investor will be unable to collect all contractually required payments receivable.

The definition used in the CECL model eliminates the second criterion in existing guidance. As a result, there may be a change in the scope of assets that qualify as PCI under the proposed model.

.24 For PCI assets, the CECL model requires buyers to assess the discount embedded in the purchase price that is attributable to expected credit losses at the date of acquisition. This amount is not recognized as interest income.

PwC observation:

Under the CECL model, PCI assets will continue to be subject to specific guidance on day one. Upon acquisition, an entity will be required to record an allowance to represent the amount of contractual cash flows not expected to be collected. Each component of the original purchase price will be "grossed up" to reflect the day one allowance.

For example, assume an entity purchases an asset with a par value of $100 for $85. At the acquisition date, the entity estimates it will not collect $10 of the contractual cash flows. The $85 cost basis of the asset will be "grossed up" to $95 to reflect the $10 embedded allowance. The remaining $5 of purchase discount attributed to factors other than credit is accreted in interest income over the remaining life of the asset.

The credit deterioration model differs from the CECL model with respect to PCI assets. Under the credit deterioration model, there is no concept of "grossing up" the basis of the loan to reflect the embedded allowance. The IASB's model does not require an allowance to be recorded on day one, but instead limits the accrual of interest income to the expected cash flows as opposed to the contractual cash flows. This is consistent with current US GAAP treatment of PCI assets under ASC 310-30.

.25 On day two, the allowance for expected credit losses for PCI assets will follow the same approach as other debt instruments in the scope of the model. Changes in the allowance for expected credit losses will be recognized as an adjustment to the provision for credit losses in the current period.

PwC observation:

The CECL model attempts to address concerns raised about the complexity of today's accounting for purchased credit-impaired assets. Under today's guidance in ASC 310-30, deteriorations in expected cash flows on purchased credit impaired assets are reflected as additional provision expense, while improvements in cash flow expectations are generally reflected as prospective yield adjustments.

Under the CECL model, this "asymmetry" is eliminated. Any changes in expected cash flows, positive or negative, will be reflected through an adjustment of provision expense in the current period. As a result, if credit expectations significantly improve, gains could be recorded on assets for which the initial credit losses were never recorded in income due to the entity purchasing the asset at a discount.

.26 The CECL model requires entities to recognize contractual interest income unless it is not probable that the entity will collect all contractual cash flows. An entity will cease its accrual of interest income when it is not probable it will receive substantially all of the principal or substantially all of the interest.

.27 If it is not probable the entity will receive payment of substantially all of the principal, the entity will recognize all future cash receipts as a reduction in the carrying amount of the asset. When the carrying amount has been reduced to zero, additional payments are recognized as recoveries of amounts previously written off (that is, recorded as an adjustment to the allowance for expected credit losses) with any excess recognized as interest income.

.28 If it is probable the entity will receive payment of substantially all of the principal, but it is not probable the entity will receive substantially all of the interest, the entity will recognize interest income on the debt instrument when cash payments are received. Cash receipts that exceed the amount of interest income that would have been recognized had the asset not been placed on non-accrual status will be applied to reduce the carrying amount of the asset.

PwC observation:

Current practice varies in terms of when entities stop recognizing interest income, although in certain industries a consistent approach has evolved or has been established by regulators or others. For example, in the banking industry, interest is typically no longer recognized for loans that are more than 90 days past due. During its deliberations of this project, the FASB conducted outreach with various constituents, including the banking regulators. The FASB considered the banking regulators' feedback on current "non-accrual" practices in the banking industry when drafting the guidance in the proposed ASU. Therefore, constituents outside of the banking industry may see changes to their current practices.

Modifications

.29 For modifications that are not troubled debt restructurings (TDRs), there is no change to current guidance with respect to evaluating whether the modification results in a new loan or a continuation of the old loan. Creditors will be required to evaluate whether the modification is "more than minor" as outlined in ASC 310-20-35-9 (formerly EITF 01-7). If the modification is deemed more than minor, the loan is accounted for as a new loan and the effective interest rate is based on the terms of the new loan and current market conditions.

.30 The CECL model carries forward the definition of a TDR from current US GAAP. The FASB concluded that that the economic concession granted by the lender to the borrower in a TDR reflects the lender attempting to maximize its recovery of the original contractual cash flows. Therefore, a TDR will be viewed as a continuation of the original debt instrument and the effective interest rate will be the "pre-modification" effective interest rate.

.31 For TDRs, the CECL model will require an adjustment to the cost basis of the modified asset (with a corresponding adjustment to the allowance for expected credit losses) so that the effective interest rate on the modified asset continues to be the original effective interest rate, given the new series of cash flows. The basis adjustment will be calculated as the amortized cost basis before modification less the present value of the new series of contractual cash flows (discounted at the original effective interest rate).

Disclosures

.32 The ASU requires various disclosures. The proposed disclosures are summarized in Appendix II to this Dataline. The disclosures are intended to enable users of the financial statements to understand (1) the credit risk inherent in the portfolio and how management monitors the credit quality of the portfolio, (2) management's estimate of expected credit losses, and (3) changes in the estimate of expected credit losses that have taken place during the period. The ASU includes examples of the required disclosures.

.33 Several of the disclosures require entities to provide information either by portfolio segment or class of financial asset. Portfolio segment is defined in the ASU as "the level at which an entity develops and documents a systematic methodology to determine its allowance for expected credit losses." For example, this may be by type of receivable, industry, or risk. Class of financial asset is defined as "a group of financial assets

determined on the basis of all of the following: (1) measurement attribute, (2) risk characteristics of the financial asset, and (3) an entity's method for monitoring and assessing credit risk." For example, this may be by measurement attribute, product, and risk rating.

.34 Entities will be required to determine, in light of their specific facts and circumstances, how much detail they must provide to meet the objectives of the disclosures outlined in the ASU. An entity must strike a balance between obscuring important information as a result of too much aggregation and providing excessive detail that may not be beneficial to financial statement users.

Transition

.35 The FASB has not yet determined an effective date for the new guidance. However, once an effective date is established, the guidance will be effective for fiscal years, and interim periods within those fiscal years, beginning on or after the effective date.

.36 Entities will 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. For example, for calendar year-end companies with quarterly reporting requirements, if the effective date is determined to be January 1, 2015, a cumulative-effect adjustment will be recorded as of January 1, 2015, and the first reporting period that the guidance will be effective is the quarter ending March 31, 2015. Early adoption will not be permitted.

Questions

.37 PwC clients who have questions about this Dataline should contact their engagement partner. Engagement teams that have questions should contact a member of the Financial Instruments team in the National Professional Services Group (1-973-236-7803).

Appendix I — Comparison between the FASB's and IASB's models

Description	CECL model (FASB)	Credit deterioration model (IASB)
Scope	The CECL model will apply to loans, debt securities, loan commitments, trade receivables, reinsurance receivables, and lease receivables that are not measured at FV-NI.	Generally, the scope of the credit deterioration model is consistent with that of the CECL model. However, there are a few differences: • The credit deterioration model does not apply to reinsurance receivables. • Financial guarantee contracts are included in the scope of the credit deterioration model. If an entity has previously asserted explicitly that it regards financial guarantees contracts as insurance contracts and applied insurance accounting, it can elect to continue applying insurance accounting.
Information considered when estimating credit losses	The CECL model will require entities to consider all internally and externally available information relevant to the estimate. This includes information about past events, current conditions, and reasonable and supportable forecasts and their implications for expected credit losses.	Same
Definition of expected credit losses	The CECL model defines expected credit losses as an estimate of all contractual cash flows not expected to be collected from a recognized financial asset (or group of financial assets) or commitment to extend credit.	Same
Measurement objective for the allowance for credit losses	Under the CECL model, an entity recognizes an allowance for all expected credit losses for all debt instruments at each reporting date.	Under the credit deterioration model, recognition of full expected credit losses is required only when there has been a significant deterioration in credit or there is a probability of loss in the next twelve months.

Description	CECL model (FASB)	Credit deterioration model (IASB)
Recognition of changes in the allowance for credit losses	Under the CECL model, changes in the allowance for credit losses are recognized immediately in net income.	As a result of utilizing a dual measurement approach, the amount recognized through net income also includes (1) the effect of a change in the credit loss measurement objective from "12-months of expected losses" to "lifetime expected losses" for assets that have experienced significant credit deterioration and (2) the effect of a changes in the credit loss measurement objective from "lifetime expected losses" to "12-months of expected losses" for assets that have no longer experienced a significant deterioration in credit.
Purchased credit-impaired financial assets	Under the CECL model, purchased credit-impaired assets are subject to specific guidance on day one. The basis of the asset is "grossed up" to reflect the embedded allowance. The remaining portion of the original purchase discount not attributed to credit is accreted in interest income over the life of the asset.	The credit deterioration model does not have the concept of "grossing up" the basis of the loan to reflect the embedded allowance. Instead, the asset is recorded at its initial fair value and accreted to the level of cash flows expected to be collected.
Principles for measuring expected credit losses	Under the CECL model, the estimate of expected credit losses reflects the time value of money and, at a minimum, reflects both the possibility that a credit loss results and the possibility that no credit loss results. An entity is prohibited from estimating expected credit losses based solely on the most likely outcome.	Same
Principle for writing off financial assets	Under the CECL model, An entity will write-off a financial asset in the period in which it has no reasonable expectation of recovery.	Same

Appendix II – Disclosure requirements

	Required disclosure
Credit quality information	• Quantitative and qualitative information by class of financial asset about the credit quality, including (1) a description of the credit-quality indicator, (2) the amortized cost (by credit-quality indicator), and (3) for each credit-quality indicator, the date or range of dates in which the information was last updated • If an entity disclosures internal risk ratings, qualitative information on how those internal risk ratings relate to the likelihood of loss
Allowance for expected credit losses	• Information that enables financial statement users to understand (1) management's process for developing its allowance for expected credit losses, (2) the information that management has used in developing its current estimate of expected credit losses, and (3) the economic circumstances that caused changes to the allowance for expected credit losses • By portfolio segment, a description of the entity's accounting policies and methodology used to estimate the allowance for expected credit losses, including: (1) a description of how expected loss estimates are developed, (2) a description and discussion of the factors that influenced management's current estimate of expected credit losses, including past events, current conditions, and reasonable and supportable forecasts about the future, (3) a discussion of risk characteristics relevant to each portfolio segment, (4) a discussion of the changes in the factors that influenced management's current estimate of expected credit losses and the reasons for those changes (for example, changes in loss severity, change in portfolio composition, change in volume of assets whether purchased or originated, significant events or conditions that affect the current estimate but were not contemplated during the previous period), (5) identification of any changes to the entity's accounting policies or methodology from the prior period and the entity's rationale for the change, if applicable, (6) a discussion of any significant changes in estimation techniques used and reasons for the changes, if applicable, and (7) reasons for significant changes in the amount of write-offs, if applicable • For assets classified at amortized cost and FV-OCI, a roll forward of activity in the allowance for expected credit losses that includes: beginning balance in the allowance, current period provision for credit losses, write-offs charged against the allowance, recoveries of amounts previously written off, ending balance in the allowance • If an entity has utilized the practical expedient in paragraph 825-15-25-2 not to measure expected credit losses for certain financial assets classified at FV-OCI, the amortized cost balance of those assets at the portfolio segment level
Roll forward for certain debt instruments	• A roll forward, by portfolio segment, for a portfolio of debt instruments measured at FV-OCI or amortized cost that includes beginning amortized cost, originations, purchases, sales, repayments, write-offs, and ending amortized cost • The roll forward disclosures identified above do not apply to the following: (1) receivables that result from revenue transactions within the scope of Topic 605, (2) reinsurance receivables that result from insurance transactions within the scope of Topic 944, and (3) loan commitments that are not measured at fair value with changes in fair value recognized in net income.

<table>
<tr><th></th><th>Required disclosure</th></tr>
<tr><td>Reconciliation between fair value and amortized cost for debt instruments classified at FV-OCI</td><td>If not already presented on the balance sheet, a reconciliation of the difference between the fair value and amortized cost for assets measured at FV-OCI, including amortized cost, the allowance for expected credit losses, the accumulated amount needed to reconcile amortized cost less the allowance for expected credit losses to fair value, and fair value</td></tr>
<tr><td>Past due status</td><td>An aging analysis of the amortized cost for debt instruments that are past due as of the reporting date disaggregated at the portfolio segment level, and disclosure of when the entity considers a debt instrument to be past due</td></tr>
<tr><td>Non-accrual status</td><td>Disaggregated at the portfolio segment level:
The amortized cost of debt instruments on non-accrual status as of the beginning of the reporting period and the end of the reporting period
The amount of interest income recognized during the period on nonaccrual debt instruments in accordance with paragraph 825-15-25-10
The amortized cost of debt instruments that are 90 days or more past due, but not on nonaccrual status as of the reporting date
The amortized cost of debt instruments on nonaccrual status for which there are no related expected credit losses as of the reporting date because the debt instrument is a fully collateralized collateral-dependent financial asset</td></tr>
<tr><td>Purchased credit-impaired financial assets</td><td>To the extent an entity purchased credit-impaired financial assets during the period, a reconciliation of the difference between the purchase price of the assets and the par value of the assets, including: (1) the purchase price, (2) discount attributable to expected credit losses based on the buyer’s assessment, (3) the discount (or premium) attributable to other factors, and (4) the par value</td></tr>
<tr><td>Collateralized financial assets</td><td>By class of financial asset, a description of the type of collateral and the extent to which collateral secures an entity's financial assets
By class of financial asset, an explanation of significant changes in the extent to which collateral secures an entity's financial assets, whether because of a general deterioration or some other reason</td></tr>
<tr><td>Transition</td><td>In the period an entity adopts the ASU:
The nature of the change in accounting principle, including an explanation of the newly adopted accounting principle
The method of applying the change
The effect of the adoption on any line item in the statement of financial position, if material, as of the beginning of the first period for which the guidance is effective. Presentation of the effect on financial statement subtotals is not required.
The cumulative effect of the change on retained earnings or other components of equity in the statement of financial position as of the beginning of the first period for which the guidance is effective
An entity that issues interim financial statements will provide the disclosures above in each interim financial statement of the year of change and the annual financial statement of the period of the change.</td></tr>
</table>

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In brief
The latest news in financial reporting

No. US2016-01
January 7, 2016

Classification and measurement – FASB issues final standard

At a glance

The FASB has issued the classification and measurement standard. The standard principally affects accounting for equity investments and financial liabilities where the fair value option has been elected.

What happened?

On January 5, 2016, the FASB issued Accounting Standards Update 2016-01, *Financial Instruments–Overall: Recognition and Measurement of Financial Assets and Financial Liabilities* (the ASU). Changes to the current GAAP model primarily affects the accounting for equity investments, financial liabilities under the fair value option, and the presentation and disclosure requirements for financial instruments. In addition, the FASB clarified guidance related to the valuation allowance assessment when recognizing deferred tax assets resulting from unrealized losses on available-for-sale debt securities. The accounting for other financial instruments, such as loans, investments in debt securities, and financial liabilities is largely unchanged. The more significant amendments are summarized below.

Equity investments

All equity investments in unconsolidated entities (other than those accounted for using the equity method of accounting) will generally be measured at fair value through earnings. There will no longer be an available-for-sale classification (changes in fair value reported in other comprehensive income) for equity securities with readily determinable fair values.

For equity investments without readily determinable fair values, the cost method is also eliminated. However, entities (other than those following "specialized" accounting models, such as investment companies and broker-dealers) will be able to elect to record equity investments without readily determinable fair values at cost, less impairment, and plus or minus subsequent adjustments for observable price changes. Changes in the basis of these equity investments will be reported in current earnings. This election only applies to equity investments that do not qualify for the NAV practical expedient.

The impairment model for equity investments subject to this election is a single-step model (unlike today's two-step approach). Under the single-step model, an entity is required to perform a qualitative assessment each reporting period to identify impairment. When a qualitative assessment indicates an impairment exists, the entity would estimate the fair value of the investment and recognize in current earnings an impairment loss equal to the difference between the fair value and the carrying amount of the equity investment.

Financial liabilities and the fair value option

When the fair value option has been elected for financial liabilities, changes in fair value due to instrument-specific credit risk will be recognized separately in other comprehensive income. The accumulated gains and losses due to these changes will be reclassified from accumulated other comprehensive income to earnings if the financial liability is settled before maturity.

The ASU will allow, but not require, preparers to measure the change in fair value due to instrument-specific credit risk based on the portion of the total change in fair value that does not result from a change in a base market risk, such as a risk-free rate or a benchmark interest rate.

Disclosure

Entities that are not public business entities will no longer be required to disclose the fair value of financial instruments carried at amortized cost. While public business entities will continue to be required to make this disclosure, the ASU eliminates the requirement to disclose the methods and significant assumptions used to estimate the fair value.

Public business entities will be required to use the exit price when measuring the fair value of financial instruments measured at amortized cost for disclosure purposes. In addition, the new guidance requires financial assets and financial liabilities to be presented separately in the notes to the financial statements, grouped by measurement category (e.g., fair value, amortized cost, lower of cost or market) and form of financial asset (e.g., loans, securities).

Why is this important?

Certain financial institutions, such as retail and commercial banks and insurance companies, are likely to be most affected by the new guidance. Companies with large equity investment portfolios that are not currently being measured at fair value through net income may also be significantly impacted.

What's next?

The classification and measurement guidance will be effective for public business entities in fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. All other entities, including certain not-for-profit entities and employee benefit plans, will have an additional year, or may early adopt coincident with the public business entity effective date.

All entities can early adopt the provision to record fair value changes for financial liabilities under the fair value option resulting from instrument-specific credit risk in other comprehensive income. Entities that are not public business entities can early adopt the provision permitting the omission of fair value disclosures for financial instruments at amortized cost. Early adoption of these provisions can be elected for all financial statements of fiscal years and interim periods that have not yet been issued (for public business entities) or that have not yet been made available for issuance.

The classification and measurement guidance is the first ASU issued under the FASB's financial instruments project. The ASU for the new impairment guidance is expected in the first quarter of 2016. An exposure draft of the new hedging guidance is expected in the first half of 2016.

Questions?

PwC clients who have questions about this *In brief* should contact their engagement partner. Engagement teams who have questions should contact the Financial Instruments team in the National Professional Services Group (1-973-236-7803).

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No. US2015-36
November 18, 2015

FASB finalizes effective date for the proposed impairment standard

At a glance

The FASB has determined the effective date for the new impairment standard and made decisions on two other aspects: troubled debt restructurings and the available-for-sale credit loss model.

What happened?

On November 11, the FASB discussed the effective date for the proposed new impairment standard. Expected to be issued early next year, the impairment standard will be effective for:

- Public business entities (PBEs) that meet the definition of an SEC filer in fiscal years beginning after December 15, 2018 including interim periods within those fiscal years;
- PBEs that do not meet the definition of an SEC filer in fiscal years beginning after December 15, 2019 including interim periods within those fiscal years; and
- Non-PBEs (including certain not-for-profit entities and employee benefit plans) in fiscal years beginning after December 15, 2019 and interim periods within fiscal years beginning after December 15, 2020.

Early application of the guidance will be permitted for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years.

Other provisions

At the same meeting, the FASB also discussed two issues: the accounting for Troubled Debt Restructuring (TDRs) by creditors and one aspect of the available-for-sale (AFS) securities credit loss model.

Troubled debt restructurings

The impairment standard will require use of the current expected credit loss (CECL) model for financial assets measured at amortized cost. The FASB decided that credit losses for TDRs should be measured using the same CECL model that will be applied to other financial assets measured at amortized cost. This would be a change from the current US GAAP model and the previous proposal, which, under certain circumstances, would require use of a discounted cashflow approach.

This represents a significant change from the proposed model and is responsive to feedback the FASB received during the external review process.

Available-for-sale securities

The Board deliberated and decided on the following:

- A fair value floor will be incorporated into the credit loss model for available-for-sale (AFS) debt securities. Specifically, credit losses on AFS debt securities will be limited to the difference between its amortized cost and fair value.
- Consistent with current guidance, an AFS debt security will be written down to fair value if it is more likely than not that an entity will be required to sell it prior to the fair value recovering to or above its amortized cost basis.
- The historical or implied volatility is not a required factor to consider when estimating whether a credit loss exists, however, an entity will not be prohibited from considering it.

Why is this important?

Companies with portfolios of financial assets subject to the scope of the proposed standard are likely to see an increase in credit reserves given the proposed standard's departure from the current US GAAP "incurred loss" concept. The proposed standard will likely require system and process changes to apply the new model and may require a considerable amount of time to implement. Specifically, entities will need to develop the infrastructure to estimate losses over a longer time horizon.

With the expected issuance of the standard in early 2016, companies that are SEC filers will have only three years before they begin reporting under the new guidance. With uncertainty as to the effective date now resolved, preparers can begin to develop a plan for an orderly and smooth transition.

What's next?

Another FASB meeting to discuss impairment is scheduled for November 23, 2015 and a final standard is expected to be issued in the first quarter of 2016.

Questions?

PwC clients who have questions about this *In brief* should contact their engagement partner. Engagement teams who have questions should contact the Financial Instruments team in the National Professional Services Group (973-236-7803).

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In depth

A look at current financial reporting issues

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New guidance on recognition and measurement to impact financial instruments

At a glance

The FASB issued the new recognition and measurement guidance on January 5, 2016. The changes to the current US GAAP financial instruments model primarily affect the accounting for equity investments, financial liabilities under the fair value option, and the presentation and disclosure requirements for financial instruments.

No significant changes were made to the recognition and measurement guidance for investments in loans and debt securities.

The standard is effective for public business entities for annual periods (and interim periods within those annual periods) beginning after December 15, 2017. All other entities will need to apply the standard for annual periods beginning after December 15, 2018, and for interim periods beginning after December 15, 2019.

Background

.1 On January 5, 2016, the FASB issued Accounting Standards Update 2016-01, *Financial Instruments–Overall: Recognition and Measurement of Financial Assets and Financial Liabilities* (the "ASU"). Once effective, the ASU will apply to the recognition and measurement of certain financial instruments for all entities.

.2 The recognition and measurement project started as a joint project with the IASB, with an objective of improving the decision usefulness of financial statements by simplifying and harmonizing the accounting for financial instruments. The recognition and measurement guidance is the first ASU issued under the FASB's financial instruments project. The ASU for the new impairment guidance is expected in the upcoming months. An exposure draft of the new hedging guidance is expected in the first half of 2016.

.3 The most recent exposure draft for the recognition and measurement project (issued in February 2013) proposed significant changes to current US GAAP guidance, including an accounting model that linked the measurement of an entity's financial assets to its cash flow characteristics and the manner in which the entity expected to benefit from the related cash flows. The measurement of financial liabilities also would have taken into account whether the entity expected to pay the contractual cash flows or to settle the liability at its fair value.

.4 The FASB noted that while the current accounting for the subsequent measurement of financial instruments is complex, stakeholders have learned how to navigate that complexity to obtain the information they need. The FASB also noted that the 2013 proposed ASU (which was more consistent with IFRS 9) would simply have replaced the

known complexities under current US GAAP with an unknown amount and type of complexity. As a result, the FASB discarded many of the proposals in the 2013 exposure draft and instead decided to make targeted improvements while retaining much of today's recognition and measurement model for financial instruments.

Key provisions

.5 The new guidance will impact the accounting for equity investments, financial liabilities under the fair value option, and the presentation and disclosure requirements for financial instruments. In addition, the FASB clarified the need for a valuation allowance on deferred tax assets resulting from unrealized losses on available-for-sale debt securities. The accounting for other financial instruments, such as loans, investments in debt securities, and financial liabilities not under the fair value option is largely unchanged.

Accounting for equity investments

.6 The ASU makes significant changes to the accounting for equity investments. The ASU's accounting model will apply to all types of equity investments, including equity instruments that meet the definition of a security (as provided under current US GAAP) and those that would not be considered securities (e.g., limited partnership interests). Equity investments included in the scope of the new guidance may include investments in the equity of investment companies that hold nothing but debt securities, as the ASU does not permit an investor to "look through" the investment to determine the appropriate recognition and measurement model.

.7 The guidance also applies to forwards and options to acquire and dispose of ownership interests that are not accounted for as derivative instruments under ASC 815, *Derivatives and Hedging*. For example, the ASU applies to a gross physically-settled forward contract to purchase equity shares that are not deemed to be readily convertible to cash.

Equity investments with readily determinable fair values

.8 All equity investments in unconsolidated entities (other than those accounted for using the equity method of accounting) will generally be measured at fair value through earnings. There will no longer be an available-for-sale classification (changes in fair value reported in other comprehensive income) for equity securities with readily determinable fair values.

.9 Equity securities have no maturity date, and therefore the primary way an entity realizes the value of their investment (aside from dividends) is through sale. As such, the FASB believes that "fair value through earnings" is the most appropriate measurement and recognition method for equity investments in unconsolidated entities not accounted for under the equity method.

PwC observation:

The FASB considered providing an exception to the fair value through earnings measurement model for equity securities deemed to be strategic investments, as entities may be able to realize the value from these types of investments by means other than sale or collecting dividends. Developing a definition of a strategic investment proved difficult, and the FASB concluded that providing an exception would add complexity to the accounting model that would not be worth the perceived benefits.

Equity investments without readily determinable fair values

.10 Under current US GAAP, an unconsolidated investment in an equity security without a readily determinable fair value that is not accounted for by the equity method is measured at cost, less any impairment determined to be other than temporary.

.11 The ASU generally eliminates the cost method for these investments. However, entities (other than those following "specialized" accounting models, such as investment companies and broker-dealers) will be able to elect to record equity investments without readily determinable fair values at cost, less impairment, adjusted for subsequent observable price changes. Entities that elect this measurement alternative will report changes in the carrying value of the equity investments in current earnings.

.12 If this measurement alternative is elected, changes in the carrying value of the equity investment will be required to be made whenever there are observable price changes in orderly transactions for the identical or similar investment of the same issuer. The implementation guidance notes that an entity should make a "reasonable effort" to identify price changes that are known or that can reasonably be known. The implementation guidance also indicates that in determining whether a security issued by the same issuer is similar, an entity should consider differences in the rights and obligations of the securities. Differences in rights and obligations may indicate that the security is not similar (and thus the observable price would not be used to adjust the carrying value of the equity investment held) or may indicate that the observable price should be adjusted to reflect such differences.

.13 The measurement alternative may be elected separately on an investment by investment basis for each equity investment without a readily determinable fair value. Once elected, it should be applied consistently as long as the investment meets the qualifying criteria. The standard requires that the entity reassess whether the investment continues to qualify for the measurement alternative each reporting period. If, for example, the investee subsequently undergoes an initial public offering such that there is now a readily determinable fair value, the measurement alternative would no longer be permitted, and the investment would be prospectively measured at fair value in accordance with ASC 820, *Fair Value Measurement*.

PwC observation:

The application of the measurement alternative will require new processes, controls, and procedures and will require the exercise of significant professional judgment. For example, entities will need to establish procedures to identify observable prices for the same or similar securities and to adopt policies for determining what types of securities would be considered similar for the purposes of determining whether an observable price of a different security should be utilized to adjust the basis of the security owned. Entities will also have to establish internal controls to ensure that each equity investment subject to the measurement alternative is evaluated each reporting period to ensure that it continues to meet the qualifying criteria (i.e., the equity security does not have a readily determinable fair value).

While there is no explicit requirement in the ASU for the preparation of contemporaneous documentation of the election of the measurement alternative, we believe entities should consider establishing procedures to evidence the election at the time an investment is made.

.14 If the election is not made, equity investments without readily determinable fair values should be reported at fair value in accordance with the provisions of ASC 820, with all subsequent changes in fair value recorded in earnings.

PwC observation:

Obtaining the necessary information to support a valuation prepared in accordance with ASC 820 for investments without readily determinable fair values can be time consuming and may require the assistance of third-party valuation professionals. Given the potential amount of time and expense involved with obtaining valuations for each equity investment for each reporting period, entities should carefully evaluate the costs and benefits associated with electing full fair value versus the measurement alternative.

Impairment model for equity investments without readily determinable fair values

.15 The ASU includes a new impairment model for equity investments without readily determinable fair values. The new model is a single-step, unlike today's two-step approach.

.16 Under the single-step model, an entity is required to perform a qualitative assessment each reporting period to identify impairment. When a qualitative assessment indicates that an impairment exists, the entity will need to estimate the fair value of the investment and recognize in current earnings an impairment loss equal to the difference between the fair value and the carrying amount of the equity investment.

.17 The single-step model is intended to reduce subjectivity, improve comparability, and increase representation faithfulness of the financial statements. In addition, the FASB looked to reduce the burden on preparers of financial statements by eliminating the need to forecast whether an equity investment will eventually recover value.

.18 The measurement alternative was established, in part, to provide entities with relief from having to get a valuation prepared each reporting period for equity investments without readily determinable fair values. The use of a qualitative impairment model is consistent with that objective. A quantitative impairment analysis does not need to be prepared, unless the qualitative assessment indicates that the fair value of the investment is less than its carrying value. The ASU provides a representative, but not all inclusive list of impairment indicators, which includes a "significant" deterioration or "significant" adverse change, or "significant" concerns about the investee's ability to continue as a going concern. The significance of these factors should be evaluated relative to the conditions that existed at the time of the investment's acquisition or last adjustment for either an impairment or an observable price. Considerable judgment will need to be applied in determining when an impairment indicator is significant enough to warrant preparation of a full quantitative valuation.

PwC observation:

The ASU does not include a threshold to be met in order for an equity investment to be evaluated for impairment (i.e., the model does not consider whether an impairment is "probable" or "more likely than not"). Rather, the qualitative assessment is used to identify the presence of significant impairment indicators. The presence of one or more indicators does not necessarily mean an equity investment is impaired. However, it does mean the entity is required to perform a valuation to determine whether an impairment exists (i.e., whether fair value is below the carrying value of the equity investment).

Financial liabilities and the fair value option

.19 The impact of changes in instrument-specific credit risk on liabilities for which the fair value option has been elected is reported in current earnings under current US GAAP. This resulted in gains when the entity's credit deteriorated and losses when it improved. While preparers and users understood the theory behind these counterintuitive outcomes, some questioned the value of this reporting given that such impacts may not be realizable. Many entities removed this amount from earnings in non-GAAP measures, because they believed the amount was not useful in analyzing an entity's financial performance.

.20 Under the ASU, when the fair value option has been elected for financial liabilities, changes in fair value due to instrument-specific credit risk will be recognized separately in other comprehensive income (OCI). This provision does not apply to financial liabilities required to be measured at fair value with changes in fair value recognized in current earnings. For example, this guidance would not apply to derivative instruments.

.21 The accumulated gains and losses due to changes in instrument-specific credit risk will be recycled from accumulated other comprehensive income and recognized in earnings if the financial liability is settled before maturity.

.22 In 2014, the FASB provided an alternative measurement for collateralized financing entities (CFEs) that eliminated the measurement difference that may exist when financial assets and financial liabilities of the CFE are measured independently at fair value. A requirement for CFEs to record changes in fair value due to instrument-specific credit risk in OCI would have generated a new measurement difference for these entities, as changes in credit risk related to financial assets would continue to impact earnings. As a result, the final ASU specifies that the guidance related to instrument-specific credit risk does not apply to financial liabilities of a CFE measured using the alternative measurement.

PwC observation:

During its deliberations, the Board also discussed other instances when preparers elected the fair value option on non-recourse liabilities to avoid a mismatch in recognition from the assets that support them. They noted that some entities do not disclose changes in instrument-specific credit risk for nonrecourse liabilities. The Board explains in the basis of conclusion that they did not intend to change how entities were identifying and measuring changes in instrument-specific credit risk from what is currently disclosed under US GAAP. While no guidance was formally included in the codification, we understand that the Board believes that entities can continue their current disclosure practices in this area both with respect to disclosure and what is included in OCI.

.23 The ASU allows, but does not require, preparers to measure the change in instrument-specific credit risk as the portion of the periodic change in fair value that is not due to changes in a base market rate, such as a risk-free interest rate. A reporting entity will be able to use an alternative method if it believes it to be a more faithful measurement of the change in credit risk for the entity. The selected methodology is a policy election and will need to be disclosed and consistently applied to each financial liability from period to period.

.24 No significant changes were made to the recognition and measurement of liabilities for which the fair value option has not been elected.

Loans and debt securities

.25 With the exception of those instruments for which the fair value option has been elected, the ASU does not make significant changes to the recognition and measurement guidance for investments in loans and debt securities.

PwC observation:

The FASB's project on credit losses will have a significant impact on how credit losses will be measured on loans and debt securities. That guidance is expected to be issued in the upcoming months.

Deferred tax assets

.26 Unrealized losses on available-for-sale debt securities are recognized in other comprehensive income and typically give rise to deferred tax assets. A valuation allowance is required to the extent it is more likely than not that a deferred tax asset is not realizable. Historically, entities applied one of two views. The need for a valuation allowance on a deferred tax asset related to available-for-sale securities was assessed either (1) in combination with the entity's other deferred tax assets, or (2) separately from other deferred tax assets and considered to be inherently recoverable so long as the related debt securities were expected to be held until they recovered in value (i.e., maturity, if necessary). The second view was supportable even if a valuation allowance was required on other deferred tax assets of a company.

.27 Although the latter approach was accepted by the SEC, the Board ultimately saw no conceptual basis for separately analyzing deferred tax assets for available-for-sale debt securities.

.28 The ASU requires that these deferred tax assets be evaluated for realizability in combination with other deferred tax assets of an entity. This approach is consistent with IFRS.

Presentation and disclosure

.29 The ASU makes targeted changes to the presentation requirements for financial instruments under current US GAAP. In addition to the change discussed above related to instrument-specific credit risk, the ASU requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (e.g., securities or loans and receivables) on the balance sheet or in the accompanying notes to the financial statements.

.30 With regard to disclosure, the ASU eliminates the requirement for entities that are not public business entities (PBEs) to present fair value information for financial assets and liabilities measured at amortized cost. PBEs will continue to be required to present this information either parenthetically on the face of the balance sheet or in the notes to the financial statements. PBEs do not need to provide fair value information for receivables and payables due within one year and demand deposit liabilities. The board concluded that the benefit to financial statement users of disclosing such information did not justify the likely cost for non-PBEs.

.31 PBEs will be required to determine fair value for financial assets and liabilities based on the exit price notion in ASC 820, *Fair Value Measurement*. This may represent a change in practice for some entities that had previously provided fair value information for loans carried at amortized cost using an entry price based on their interpretation of the illustrative examples in ASC 825, *Financial Instruments*.

.32 All entities will be required to disclose financial assets and financial liabilities separately, grouped by measurement category (e.g., fair value, amortized cost, lower of cost or market) and form of financial asset (e.g., loans, securities).

.33 For equity investments without readily determinable fair values measured under the measurement alternative, the ASU requires disclosures of:

- the carrying value of such investments;
- the total amount of adjustments resulting from impairment; and
- the total amount of adjustments for observable prices.

Transition

.34 In general, the new guidance will require modified retrospective application to all outstanding instruments, with a cumulative effect adjustment recorded to opening retained earnings as of the beginning of the first period in which the guidance becomes effective. However, changes to the accounting for equity securities without a readily determinable fair value will be applied prospectively.

PwC observation:

The ASU requires that the changes to the accounting for equity securities without readily determinable fair values to be applied prospectively. The Board made this decision. principally to eliminate the need for preparers to retrospectively identify impairments using the new single-step model and observable price changes for the same or similar instruments that may have occurred in prior periods for entities that elect to apply the measurement alternative.

This means that any impact from the adoption of this ASU on equity securities without readily determinable fair values will not be reported as part of the transition adjustment. Instead, these impacts will be recorded after the transition date and will impact that period's current earnings.

What's next?

.35 The new guidance will be effective for PBEs in fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. All other entities, including certain not-for-profit entities and employee benefit plans, will have an additional year, or may early adopt coincident with the PBE effective date. For these entities, the guidance will be effective in fiscal years beginning after December 15, 2018 and interim periods within fiscal years beginning after December 15, 2019.

.36 All entities can early adopt the provision to record fair value changes for financial liabilities under the fair value option resulting from instrument-specific credit risk in other comprehensive income. Entities that are not PBEs can early adopt the provision permitting the omission of fair value disclosures for financial instruments reported at amortized cost. Early adoption of these provisions can be elected for all financial statements of fiscal years and interim periods that have not yet been issued or that have not yet been made available for issuance.

Questions?

PwC clients who have questions about this *In depth* should contact their engagement partner. Engagement teams who have questions should contact the Financial Instruments team in the National Professional Services Group (1-973-236-7803).

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