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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.

[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.

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.

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.

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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