FEBRUARY 14, 2013

# In Focus

## Proposed Accounting Standards Update—*Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*

### Overview

Since 2005, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) have been working together to improve and simplify reporting for financial instruments. The global economic crisis of 2008 further highlighted the need to improve the existing accounting model for financial instruments, whose gaps and inconsistencies were exacerbated in an increasingly complex economic environment.

### Why Is the FASB Issuing this Exposure Draft?

The proposed Accounting Standards Update would improve financial reporting for financial instruments by developing a consistent, comprehensive framework for classifying those instruments. That framework would link the measurement of financial assets to the way in which the company expects to benefit from the cash flows embedded in those assets, while the measurement of financial liabilities would be consistent with how the entity expects to settle those liabilities. Additionally, the proposal would improve the clarity and organization of much of the guidance on financial instruments, which in turn improves its accessibility and understandability. Furthermore, the proposed guidance would improve convergence of U.S. Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS) by reducing key differences in accounting for financial instruments.

### What Are the Main Proposals?

The FASB's proposed Update focuses on creating a comprehensive framework for the classification and measurement of financial instruments within its scope.

Under the proposal, the classification and measurement of a financial asset would be based on the asset's cash flow characteristics and the entity's business model for managing the asset rather than on its legal form, that is, whether the asset is a loan or a security. Based on this assessment, financial assets would be classified into one of three categories:

- **Amortized cost**—financial assets with solely payments of principal and interest that are held for the collection of contractual cash flows
- **Fair value through other comprehensive income (OCI)**—financial assets with solely payments of principal and interest that are both held for the collection of contractual cash flows and for sale
- **Fair value through net income**—financial assets that do not qualify for measurement at either amortized cost or fair value through other comprehensive income.

All equity investments (excluding those accounted for under the equity method of accounting) would be measured at fair value with changes in fair value recognized in net income, because such investments do not have payments of principal and interest. An entity may elect a practicability exception to measure equity investments based on any observable price changes in orderly transactions for the identical or a similar investment of the same issuer. The proposed guidance would also provide a one-step impairment model for equity investments measured using the practicability exception.

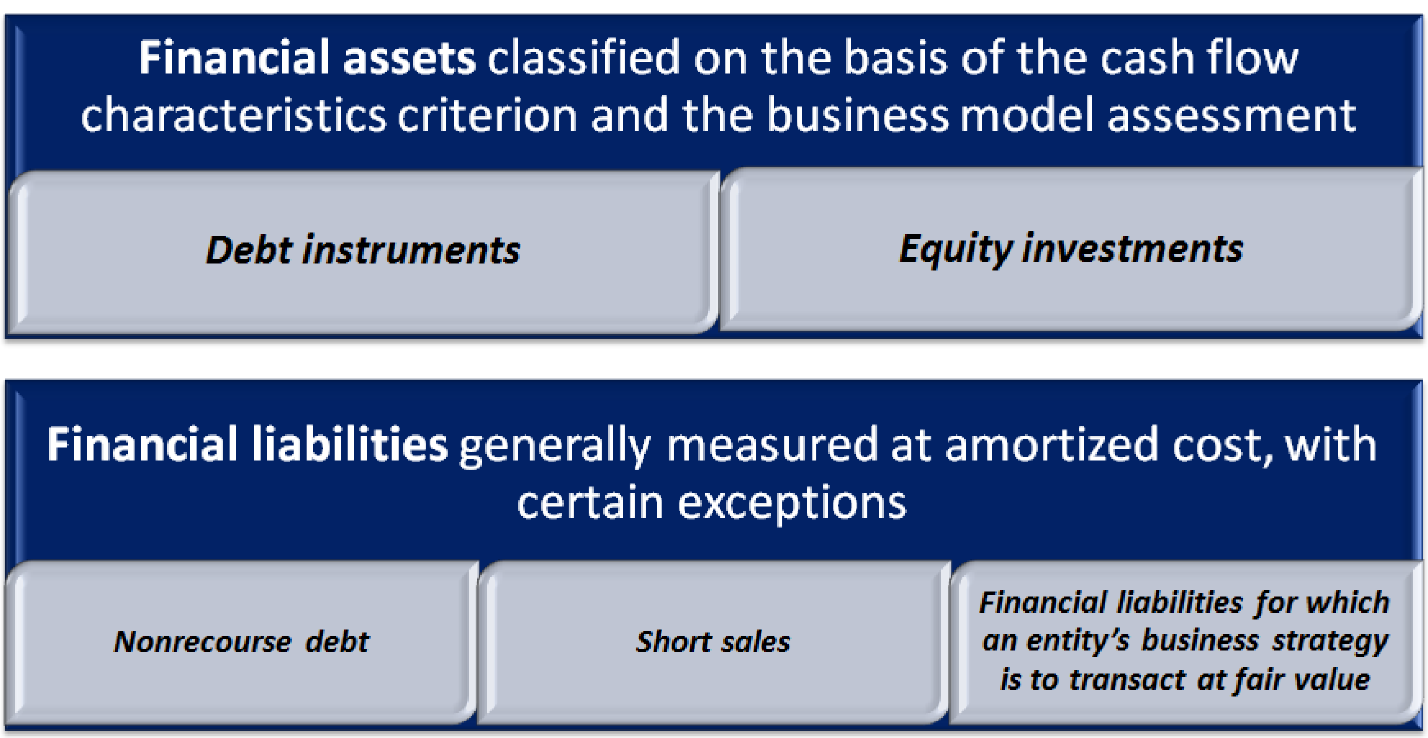
The proposal also would require financial liabilities generally to be carried at amortized cost, unless the entity's business strategy is subsequently to transact at fair value, or the obligation results from a short sale. The proposal would retain the embedded derivative requirements for hybrid financial liabilities under existing U.S. GAAP.

The proposed guidance would eliminate the fair value option under existing U.S. GAAP for investments accounted for under the equity method of accounting held by business entities. The proposed guidance would require that when an equity investment first qualifies for the equity method, the entity would consider specified indicators to determine whether it holds the investment for sale. If the investment is held for sale, the entity would measure it at fair value with all changes in fair value recognized in net income.

The proposed guidance would replace the unconditional fair value option under existing U.S. GAAP that permits an entity to elect to measure many financial instruments at fair value, with all changes in fair value recognized in net income, with a limited number of conditional fair value options. For a financial liability measured at fair value with all changes in fair value recognized in net income under the conditional fair value option, an entity would be required to present separately in other comprehensive income the portion of the total change in the fair value of the liability that results from a change in the instrument-specific credit risk. The proposed guidance would retain the separate, portfolio-wide option for not-for-profit entities, other than health care entities, to account for their equity method investments at fair value.

For financial assets and financial liabilities measured at amortized cost, public companies would be required to disclose their fair values parenthetically on the face of the balance sheet (except for receivables and payables due in less than a year and demand deposit liabilities). Nonpublic entities would not be required to disclose such fair value information either parenthetically or in the notes.

The proposed accounting for expected credit losses on debt instruments carried at amortized cost or fair value through OCI is addressed in the FASB's proposed Accounting Standards Update on credit losses, which was issued in December 2012. Stakeholders are encouraged to consider both of these proposals concurrently.



## How Would the Board's Proposals Improve Financial Reporting?

Under existing U.S. GAAP, an entity classifies its debt securities as trading (measured at fair value with all changes in fair value recognized in net income), available for sale (measured at fair value with qualifying changes in fair value recognized in other comprehensive income), or held to maturity (measured at amortized cost). However, loans are classified as either held for sale (measured at lower of cost or fair value) or held for investment (measured at amortized cost) using different criteria. Impairment is measured under separate standards.

Current U.S. GAAP requires investments in equity securities that have readily determinable fair values to be classified as either trading or available for sale and prescribes the cost method for equity securities without a readily determinable fair value. The equity method of accounting is required if the investor exerts significant influence over the investee.

Under the proposed guidance, an entity would classify its financial assets by applying the contractual cash flow characteristics criterion and a business model criterion. The business model assessment would require an organization to classify and measure a financial asset that meets the contractual cash flow characteristics criterion on the basis of how it would manage that financial asset together with other financial assets within a distinct business model.

An entity also no longer would be able to classify an equity investment with a readily determinable fair value as available for sale, and the cost method of accounting would be eliminated. The proposed guidance would provide a practicability exception for an equity investment without a readily determinable fair value that does not qualify for the practical expedient to estimate fair value in accordance with the net asset value per share expedient in Topic 820, "Fair Value Measurement". In addition, the proposed guidance also would eliminate the other-than-temporary impairment model for equity investments accounted for under the cost method and those subject to the equity method of accounting under existing U.S. GAAP and replace it with a one-step impairment model based on assessment of qualitative factors to determine when it is more likely than not that the fair value of the equity investment is below its carrying amount.

The proposed guidance would reduce alternative accounting methods, thereby improving comparability, by replacing the existing unconditional fair value option for financial instruments within the scope of this proposed guidance with limited fair value options.

Hybrid financial assets (that do not give rise to cash flows that are solely payments of principal and interest on the principal amount outstanding) no longer would be eligible for separate accounting for the derivative and nonderivative components and would be measured in their entirety at fair value with all changes in fair value recognized in net income. That provision would simplify the accounting for those instruments by eliminating the bifurcation and separate accounting requirement for hybrid financial assets.

The proposed guidance also would eliminate the need for bifurcation and separate accounting for hybrid nonfinancial assets by requiring the hybrid contract to be measured at fair value (with changes in fair value recognized in net income) if the hybrid nonfinancial asset contains an embedded derivative that would have required bifurcation and separate accounting under Subtopic 815-15, Derivatives and Hedging—Embedded Derivatives.

Under current U.S. GAAP, changes in the fair value of a financial liability designated under the fair value option that result from a change in the instrument-specific credit risk are included in net income. The proposed guidance would require the portion of a change in the fair value of a financial liability resulting from a change in instrument-specific credit risk to be recognized in other comprehensive income and presented separately. That proposed amendment would improve the relevance of the information about financial liabilities measured at fair value.

## Project History

In May 2010, the FASB issued its first Exposure Draft on financial instruments, which proposed a much greater use of fair value measurement for financial assets and liabilities than exists in U.S. GAAP. The feedback that the FASB received on that proposal indicated that the vast majority of investors, reporting entities, and other stakeholders did not think that fair value was the most appropriate primary measurement attribute for some financial instruments, particularly, loans, deposits, and financial liabilities that the entity does not have the ability to trade. Based on the 2010 feedback, in this proposed Update, the Board decided to require amortized cost as a measurement attribute for assets held for collection of cash flows, because the value is realized over the holding period of the asset. Assets that might be sold to manage interest rate risk or liquidity risk would not qualify for cost measurement. In addition, the Board also decided that financial liabilities generally would be measured at amortized cost unless certain conditions are met.

## How Does this Proposal Fit Into the Goal of Convergence?

In January 2012, the FASB and the IASB jointly decided to redeliberate selected aspects of their classification and measurement models in an attempt to reduce differences in several important areas. In November 2012, the IASB issued its proposed amendments to IFRS 9, *Financial Instruments,* which, like the FASB's proposed Update, would require an entity to classify and subsequently measure financial assets based on the results of cash flow characteristics and business model assessments. A brief comparison of the proposals is included in this proposed Update.

## When Would the Proposed Amendments Be Effective?

The Board will establish the effective date of the proposed requirements, including any appropriate deferral for some or all nonpublic entities, when it issues the final amendments. An entity would apply the proposed guidance by means of 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. It may early adopt the presentation guidance related to the presentation of changes in instrument-specific credit risk for hybrid financial liabilities that will qualify for the fair value option upon issuance of the amendments in the final Update.

## What Are the Next Steps in the Process?

Stakeholders are encouraged to review and provide feedback on the proposed Update by May 15, 2013. (The document is available at www.fasb.org.) The FASB also plans to issue, in a separate exposure document, consequential amendments to the various FASB Accounting Standards Codification Topics that will be impacted by this proposed Update. The FASB will consider the comments received on its proposal, as well as the comments received by the IASB on its proposal, prior to finalizing the standard.

**For more information about the project, please visit the FASB's website at www.fasb.org.**

Financial Accounting Standards Board
401 Merritt 7, PO Box 5116
Norwalk, Connecticut 06856-5116
T: 203.847.0700 | F: 203.849.9714