FASB Emerging Issues Task Force

Issue No. 12-G

Title: Accounting for the Difference between the Fair Value of the Assets and the Fair Value of the Liabilities of a Consolidated Collateralized Financing Entity

Document: Issue Summary No. 1, Supplement No. 2(R)*

Date prepared: May 29, 2013

FASB Staff: Brown (ext. 471) / McKinney (ext. 359)

EITF Liaison: Jackson Day

Dates previously discussed: September 11, 2012; March 14, 2013

Previously distributed EITF materials: Issue Summary No. 1, dated August 27, 2012; Issue Summary No. 1, Supplement No. 1, dated February 26, 2013

Background

1. The objective of this Issue is to resolve the diversity in practice in the accounting by a reporting entity for the difference between the fair value of the financial assets and the fair value of the financial liabilities of a consolidated collateralized financing entity (CFE) so that a reporting entity recognizes in its consolidated income statement only amounts related to its own beneficial interest in a CFE.

2. At the March 14, 2013 EITF meeting, the Task Force affirmed without significant modifications its consensus-for-exposure as a final consensus that a reporting entity that measures the financial assets and financial liabilities of a consolidated collateralized financing entity (CFE) at fair value should be required to determine the fair value of the CFE's financial assets and financial liabilities consistently with how market participants would price the reporting entity's net risk exposure related to the financial assets and financial liabilities at the

*** The alternative views presented in this Issue Summary Supplement are for purposes of discussion by the EITF. No individual views are to be presumed to be acceptable or unacceptable applications of Generally Accepted Accounting Principles until the Task Force makes such a determination, exposes it for public comment, and it is ratified by the Board.**

measurement date. Beneficial interests that represent compensation for services (such as management fees) and the fair value of nonfinancial assets that are being held temporarily by a CFE as a result of default by the debtor on the underlying debt instruments held as assets by the CFE or in an effort to restructure the debt instruments held as assets by the CFE should be excluded when determining the fair value of the net risk exposure and should be measured in accordance with other applicable U.S. GAAP. The Task Force noted that a net risk exposure would typically exist when the reporting entity has an interest in the consolidated CFE other than an interest relating solely to a beneficial interest that represents compensation for services. Subsequent changes to the net risk exposure would be attributed to the reporting entity on the consolidated statement of comprehensive income.

3. In arriving at its consensus, the Task Force clarified that reporting entities should present the financial assets and financial liabilities on a gross basis by allocating the net risk exposure to the individual financial assets and financial liabilities. A reporting entity should measure and recognize the more observable fair value of either the financial assets or the financial liabilities, excluding any amounts relating to beneficial interests that represent compensation for services or nonfinancial assets that are being held temporarily as a result of default by the debtor on the underlying debt instruments held as assets by the CFE or in an effort to restructure the debt instruments held as assets by the CFE.

4. The Task Force decided to limit the scope of the proposed Update to reporting entities that consolidate a CFE and account for all eligible financial assets and financial liabilities of the CFE at fair value. In reaching its consensus, the Task Force clarified that the scope of the proposed Update applies to all reporting entities that consolidate a variable interest entity meeting the definition of a CFE, including those that retain beneficial interests in the CFE.

5. The Task Force also affirmed without significant modifications its consensus-for-exposure as a final consensus that the amendments in the proposed Update should be applied prospectively by all reporting entities. In addition, the Task Force agreed that reporting entities that previously elected to measure all eligible financial assets and financial liabilities of the consolidated CFE at fair value may apply the amendments retrospectively to all relevant prior periods beginning in

the fiscal year in which the amendments in Accounting Standards Codification Update No. 2009-17, *Consolidations (Topic 810): Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities*, were initially adopted.

6. The Task Force agreed to allow reporting entities that consolidate a CFE to elect at the date of adoption of the amendments in the proposed Update to measure all eligible financial assets and financial liabilities of the CFE at fair value (the "fair value option") in accordance with Topic 825, Financial Instruments. Reporting entities electing the fair value option at the date of adoption should only apply the amendments in the proposed Update prospectively.

7. At its March 28, 2013 meeting, the Board ratified the consensus reached by the Task Force on this Issue. During the ballot process for the proposed Update, some Board members expressed a concern that using the term "net risk exposure" to describe a reporting entity's interest in a CFE would create unnecessary complexity. In addition, they were concerned that the guidance to separately measure net risk exposure and allocate that measurement to financial assets and liabilities is unclear and may result in follow-up questions from the constituents. The FASB staff revised the language in the proposed Update as discussed in paragraph 8 below, however some Task Force members questioned whether the revised language in the proposed Update remained consistent with the decisions reached by the Task Force at its September 11 2012 and March 14, 2013 meetings. Separately, as discussed further in paragraph 10 below, some Task Force members also expressed concerns about the consequences of applying the guidance in the proposed Update when the fair value of the financial liabilities is the more observable measure and the reporting entity holds nonfinancial assets.

Accounting Issues and Alternatives

Issue 1: Whether the requirement to separately measure the fair value of a reporting entity's net risk exposure at the measurement date should be removed.

8. The amendments originally presented in the exposure draft of the proposed Update required reporting entities that consolidate a CFE to measure the financial assets and financial liabilities of the CFE using the measurement guidance in Topic 820, Fair Value Measurement, that applies

to financial assets and financial liabilities with offsetting positions in market risks or counterparty credit risk, and which states that a reporting entity "shall measure the fair value of the group of financial assets and financial liabilities consistently with how market participants would price the net risk exposure at the measurement date." At the March 14, 2013 meeting, the Task Force decided that the guidance in the proposed Update should be contained within Topic 810, Consolidation, to simplify the amendment language. In the pre-ballot and ballot drafts of the proposed Update that were considered by the Board, the FASB staff retained the guidance that the measurement of a reporting entity's net risk exposure would determine the amount of the remaining financial liabilities or financial assets. However, based on the feedback received during the review process, the amendments in the proposed Update have been revised to no longer require reporting entities to separately measure the net risk exposure, but, instead, to require reporting entities to use the more observable fair values of either the financial assets or the financial liabilities to determine the value of the corresponding liabilities or assets as follows (additions since exposure are underscored and deletions are ~~struck through~~):

> **Initial Measurement**
> **810-10-30-2A** When a reporting entity becomes the primary beneficiary of a VIE that is a **collateralized financing entity** and the financial assets and financial liabilities of the collateralized financing entity are measured at fair value in its statement of financial position, the reporting entity shall initially measure the more observable fair value of either the financial assets or the financial liabilities, excluding amounts accrued for any beneficial interests that represent compensation for services, of the collateralized financing entity at the measurement date. Beneficial interests in the collateralized financing entity owned by the reporting entity that represent compensation for services (such as management fees) shall be measured in accordance with other applicable U.S. GAAP. ~~of the collateralized financing entity using the measurement guidance in paragraphs 820-10-35-18D and 820-10-35-18F, provided that the requirement in paragraph 820-10-35-18E(c) is met. To use the measurement guidance in paragraph 820-10-35-18D, the reporting entity shall not consider the requirements in paragraphs 820-10-35-18J through 35-18K, which require a reporting entity to ensure that the market risk (or risks) to which the reporting entity is exposed within a group of financial assets and liabilities is substantially the same and that the duration of the reporting entity's exposure to a particular market risk (or risks) is substantially the same.~~
>
> **Subsequent Measurement**
> **810-10-35-6** A reporting entity that consolidates a VIE that is a **collateralized financing entity** and measures the financial assets and financial liabilities of the

collateralized financing entity at fair value shall subsequently measure the more observable fair value of either the financial assets and financial liabilities of the collateralized financing entity excluding amounts accrued for any beneficial interests that represent compensation for services of the collateralized financing entity at the measurement date. Beneficial interests in the collateralized financing entity owned by the reporting entity that represent compensation for services (such as management fees) shall be measured in accordance with other applicable U.S. GAAP. ~~using the measurement guidance in paragraphs 820-10-35-18D and 820-10-35-18F, provided that the requirement in paragraph 820-10-35-18E(c) is met. To use the measurement guidance in paragraph 820-10-35-18D, the reporting entity shall not consider the requirements in paragraphs 820-10-35-18J through 35-18K, which require a reporting entity to ensure that the market risk (or risks) to which the reporting entity is exposed within a group of financial assets and liabilities is substantially the same and that the duration of the reporting entity's exposure to a particular market risk (or risks) is substantially the same.~~

Question 1:* *Does the Task Force agree with removing the requirement to separately measure the fair value of a reporting entity's net risk exposure at the measurement date?

Issue 2: How measurement consequences when the fair value of the financial liabilities is more observable and the reporting entity holds nonfinancial assets should be addressed.

9. As a result of discussions during the March 14, 2013 meeting, and based on feedback received during the fatal flaw review process, the proposed Update was revised to require reporting entities to use the more observable fair values of either the financial assets or the financial liabilities to determine the value of the corresponding liabilities or assets. The following paragraphs have been included in the proposed Update ~~also have been revised~~ to ~~include~~ provide further details about how to apply the measurement guidance ~~(additions since exposure are underscored)~~:

Initial Measurement

810-10-30-2B If the fair value of the financial assets is more observable, the financial liabilities of the collateralized financing entity shall be recorded as the sum of (1) the fair value of the financial assets held by the collateralized financing entity and (2) the carrying value of any nonfinancial assets held by the collateralized financing entity less (3) the amount of fair value of financial assets and carrying value of nonfinancial assets that relates to the beneficial interest owned by the reporting entity and (4) the carrying value of any beneficial interests that represent compensation for services.

810-10-30-2C If the fair value of the financial liabilities, excluding amounts accrued for any beneficial interests that represent compensation for services is more observable, the financial assets of the collateralized financing entity shall be recorded equal to the fair value of the financial liabilities less the carrying value of any non-financial assets held by the collateralized financing entity.

Subsequent Measurement

810-10-35-6A If the fair value of the financial assets is more observable, the financial liabilities excluding amounts accrued for any beneficial interests that represent compensation for services, of the collateralized financing entity shall be recorded as the sum of (1) fair value of the financial assets held by the collateralized financing entity and (2) the carrying value of any non-financial assets held by the collateralized financing entity less (3) the amount of fair value of financial assets and carrying value of nonfinancial assets that relates to the beneficial interest owned by the reporting entity and (4) the carrying value of any beneficial interests that represent compensation for services.

810-10-35-6B If the fair value of the financial liabilities, excluding amounts accrued for any beneficial interests that represent compensation for services is more observable, the financial assets of the collateralized financing entity shall be recorded equal to the fair value of the financial liabilities excluding amounts accrued for any beneficial interests that represent compensation for services less the carrying value of any non- financial assets held by the collateralized financing entity.

10. Some Task Force members expressed concern that when a reporting entity uses the fair value of the financial liabilities to determine the value of the financial assets, the resulting value of the financial assets includes an amount relating to any nonfinancial assets held by the collateralized financing entity because of the following:

a. The fair value of the financial liabilities inherently would consider the fair value of any nonfinancial assets held, because the nonfinancial assets would be used to settle the financial liabilities.
b. Under the guidance in the proposed Update, the reporting entity would continue to measure the value of the nonfinancial assets using existing U.S. GAAP, which may not be a fair value measurement.

View A: No changes should be made to the proposed Update.

11. Proponents of View A believe that any amounts relating to the change in fair value of the nonfinancial assets would not be material because (a) the amount of nonfinancial assets is expected to be small compared to the amount of financial assets and (b) the definition of a CFE specifies that a CFE may hold nonfinancial assets temporarily.

12. Opponents of View A believe that the proposed Update should not permit reporting entities to recognize the fair value of the nonfinancial assets inherently through the calculation of the value of the financial assets or otherwise, because this guidance was not intended to change existing U.S. GAAP guidance relating to the measurement of nonfinancial assets. Additionally, opponents believe that the accounting in instances in which the fair value of the financial liabilities is more observable should not consider different factors than the accounting in instances in which the fair value of the financial assets is more observable.

View B: CFEs that hold nonfinancial assets should be eliminated from the scope of the proposed Update.

13. At the March 14, 2013 meeting, the Task Force decided that the scope of the proposed Update should include CFEs that hold nonfinancial assets temporarily as a result of default by the debtor on the underlying debt instruments held as assets by the CFE or in an effort to restructure the debt instruments held as assets by the CFE. The Task Force discussed that excluding CFEs that hold financial assets temporarily may cause CFEs to be periodically included and excluded from the scope of the proposed Update.

14. Proponents of this view, however, believe that a CFE receives nonfinancial assets only in limited circumstances and that this does not frequently occur. Excluding from the scope CFEs that hold nonfinancial assets would decrease the complexity in the application of this guidance and would eliminate the inconsistency between the accounting in instances in which the fair value of the financial liabilities is more observable and the accounting in instances in which the fair value of the financial assets is more observable.

View C: Reporting entities should be required to use the fair value of the financial assets to determine the value of the financial liabilities.

15. Proponents of View C note that this approach would be consistent with the guidance in the proposed Accounting Standards Update, *Financial Instruments—Overall (Subtopic 825): Recognition and Measurement of Financial Assets and Financial Liabilities*, which states that if the contractual terms of a nonrecourse financial liability require an entity to settle the entire liability with only the cash flows from the related financial assets, the entity shall measure the nonrecourse financial liability on the same measurement basis as the related financial assets. Proponents of this view believe that requiring reporting entities to use the fair value of the financial assets would decrease the complexity of the measurement guidance and would prevent diversity in practice that may arise when measuring the fair value of the financial liabilities.

Staff recommendation

16. The FASB staff recommends View C. As noted above, excluding CFEs that hold non-financial assets temporarily may cause CFEs to be periodically included and excluded from the scope of the proposed Update. That would create additional issues that would need to be researched and resolved and would increase the complexity for certain reporting entities applying the guidance in the proposed Update. Requiring reporting entities to use the fair value of the financial assets to determine the value of the financial liabilities would decrease the complexity of the amendments in the proposed Update while remaining consistent with the Task Force's original decision to include CFEs that hold nonfinancial assets temporarily.

17. If the Task Force reaches a conclusion on View C, the FASB staff recommends the following guidance should be provided in Topic 810:

> **Initial Measurement**
> **810-10-30-2A** When a reporting entity becomes the primary beneficiary of a VIE that is a **collateralized financing entity**, and the financial assets and financial liabilities of the collateralized financing entity are measured at fair value in its statement of financial position, the reporting entity shall measure the financial liabilities of the collateralized financing entity as the sum of (1) fair value of the financial assets held by the collateralized financing entity and (2) the carrying

> value of any nonfinancial assets held by the collateralized financing entity less (3) the amount of fair value of financial assets and carrying value of nonfinancial assets that relates to the beneficial interest owned by the reporting entity and (4) the carrying value of any beneficial interests that represent compensation for services.
>
> **Subsequent Measurement**
> **810-10-35-6** A reporting entity that consolidates a VIE that is a **collateralized financing entity** and measures the financial assets and financial liabilities of the collateralized financing entity at fair value shall subsequently record the financial liabilities excluding amounts accrued for any beneficial interests that represent compensation for services, of the collateralized financing entity as the sum of (1) fair value of the financial assets held by the collateralized financing entity and (2) the carrying value of any non-financial assets held by the collateralized financing entity less (3) the amount of fair value of financial assets and carrying value of nonfinancial assets that relates to the beneficial interest owned by the reporting entity and (4) the carrying value of any beneficial interests that represent compensation for services. Beneficial interests in the collateralized financing entity owned by the reporting entity that represent compensation for services (such as management fees) shall be measured in accordance with other applicable U.S. GAAP.
>
> **810-10-35-6A** Changes in the value of the beneficial interest owned by the reporting entity shall be recognized in the consolidated income statement of the reporting entity.

Question 2: Does the Task Force agree with the staff recommendation to require reporting entities to use the fair value of the financial assets to determine the value of the financial liabilities?

Issue 3: How a reporting entity should apply the transition guidance in the proposed Update.

18. The proposed Update requires prospective transition, with an option to apply the guidance in the proposed Update retrospectively only for reporting entities that previously elected to measure all eligible financial assets and financial liabilities of the CFE at fair value as follows:

> **810-10-65-4** The following represents the transition and effective date information related to Accounting Standards Update No. 2013-XX, *Consolidation (Topic 810): Accounting for the Difference between the Fair Value of the Assets*

and the Fair Value of the Liabilities of a Consolidated Collateralized Financing Entity:

a. The pending content that links to this paragraph shall be effective as follows:
   1. For fiscal years, and interim periods within those years, beginning after December 15, 2013.
   2. For **{add glossary link to 3rd definition}nonpublic entities{add glossary link to 3rd definition}**, for fiscal years beginning after December 15, 2014, and interim and annual periods thereafter.
b. The pending content that links to this paragraph shall be applied prospectively.
c. Reporting entities that previously elected to measure all eligible financial assets and financial liabilities of the consolidated **collateralized financing entity** at fair value may apply the amendments retrospectively to all relevant prior periods beginning in the fiscal year in which the amendments in Accounting Standards Update No. 2009-17, *Consolidations (Topic 810): Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities*, were initially adopted.
d. To apply the pending content that links to this paragraph, entities may elect at the date of adoption to measure all eligible financial assets and financial liabilities of the collateralized financing entity at fair value (the "fair value option") in accordance with Topic 825 on financial instruments. An entity electing the fair value option at the date of adoption shall not use the retrospective method of adoption.
e. Earlier application of the pending content that links to this paragraph is permitted.
f. An entity shall provide the disclosures in paragraphs 250-10-50-1 through 50-3 in the period the entity adopts the pending content that links to this paragraph.

19. To apply the guidance in the proposed Update prospectively, reporting entities that previously elected to measure all eligible financial assets and financial liabilities of the CFE at fair value would reclassify amounts recorded in equity to either the financial assets or the financial liabilities as of the beginning of the period of adoption. Reporting entities that elect at the date of adoption to measure all eligible financial assets and financial liabilities of the CFE at fair value would first reclassify amounts recorded in equity to either the financial assets or the financial liabilities and then recognize any remaining amounts in the consolidated income statement.

20. To apply the guidance in the proposed Update retrospectively, reporting entities that previously elected to measure all eligible financial assets and financial liabilities of the CFE at fair value would reclassify amounts previously recorded in equity to either the financial assets or the financial liabilities as of the beginning of the first annual period in which Update 2009-17 was initially adopted.

Question 3: Does the Task Force agree with the methods of applying the transition requirements in the proposed Update?

Issue 4: Whether the proposed Update should be reexposed.

21. The Task Force may wish to consider whether to reexpose this Issue based on the changes (which are discussed in this Issue Summary Supplement) to the proposed Update since the issuance of the exposure draft. According to the FASB staff analysis, reexposure is generally required when there has been a substantive change to the scope or to the primary recognition, measurement, or disclosure principles. The intention of a reexposure is to allow constituents to have an opportunity to raise issues or concerns not previously considered by the Task Force.

22. One factor to consider in evaluating reexposure is the extent to which decisions reached by the Task Force during its redeliberations of a proposed Update resulted in a substantive change to the guidance in the proposed Update on which respondents commented (individually and/or in the aggregate). On this Issue, amendments in the proposed Update were revised to no longer refer to the guidance in Topic 820 on the application to financial assets and financial liabilities with offsetting positions in market risks or counterparty credit risk and to no longer require reporting entities to separately measure the net risk exposure at the measurement date. In addition, depending on the decision reached by the Task Force in Issue 2 of this Issue Summary Supplement, the proposed guidance may no longer allow reporting entities to measure the financial liabilities of a collateralized financing entity.

Question 4: Does the Task Force believe that the proposed Update should be reexposed?