FINANCIAL ACCOUNTING STANDARDS BOARD

Board Meeting Handout
Current Expected Credit Losses
April 3, 2019

Meeting Purpose

1. The purpose of this decision-making meeting is to discuss an Agenda Request that was submitted to the FASB on November 5, 2018, as well as a follow-up letter on January 9, 2019 that was submitted to the FASB by a group of financial institutions (hereafter referred to as the Proposal). Board members also will discuss stakeholders' feedback relating to credit-quality disclosures.

Questions for the Board

1. Does the Board believe that the Proposal submitted by a group of regional banks on November 5, 2018, and their follow-up letter, which was submitted on January 9, 2019, will result in incremental improvements to the accounting for expected credit losses? If so, does the Board want to add a project to its technical agenda to explore modifying the accounting for expected credit losses by requiring entities to bifurcate expected credit losses as recommended in the Proposal?

Credit-Quality Vintage Disclosures

2. Does the Board believe that the intent of what is required as it relates to credit-quality disclosures in paragraphs 326-20-50-4 through 50-9 and what is illustrated in Example 15 paragraph 326-20-55-79 is unclear and, therefore, entities should apply the guidance as currently stated in paragraphs 326-20-50-4 through 50-9 when preparing credit-quality disclosures and not what is illustrated in Example 15?

Issue 1—Alternative Presentation of the Provision for Expected Credit Losses

Background

2. On November 5, 2018, a group of 20 U.S.-based regional banks and an industry trade group submitted the Proposal to the FASB. The Proposal recommended an alternative approach

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to presenting the provision for expected credit losses in the financial statements. In summary, the Proposal sought to bifurcate expected credit losses for performing loans by presenting the first 12 months of expected credit losses in the net income as a provision expense while presenting credit losses expected to occur beyond the first 12 months in other comprehensive income. For impaired loans, an entity would record the full amount of expected credit losses in the income statement as a provision expense. Impairment is characterized in the Proposal as, when based on current information and events, a creditor determines that it is probable that it will be unable to collect all amounts due from a borrower in accordance with the original contractual terms.

Feedback Received on the Proposal

3. The staff conducted outreach calls with 28 stakeholders (19 signers, 4 large banks, 2 credit unions, and 3 nonfinancial institutions) during the month of January to gain a better understanding of the views surrounding the Proposal. At the conclusion of those outreach calls, the Board held a public roundtable at which the perspectives of a diverse set of stakeholders, representing 23 different organizations, including 4 large financial institutions, 4 mid-sized financial institutions (representing those who submitted the Proposal), 3 small financial institutions, 4 investment firms/investor associations, 3 audit firms, and 5 regulatory agencies were heard. The public roundtable feedback was consistent with the feedback shared by stakeholders during the outreach calls. A summary of the roundtable feedback can be found here.

Issue 2—Credit-Quality Vintage Disclosures

Background

4. Before the Credit Losses Transition Resource Group (TRG) meeting on November 1, 2018, a stakeholder submitted a technical inquiry about the amendments in Accounting Standards Update No. 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments,* regarding the credit-quality information disclosure requirements in paragraphs 326-20-50-4 through 50-9 and the illustration of those disclosure requirements in Example 15 (paragraph 326-20-55-79). Paragraphs 326-20-50-5 through 50-6 require public business entities to disclose in the footnotes to the financial statements the amortized cost basis of financial assets by class of financing receivable, credit-quality indicator, and year of origination to meet the disclosure objective in paragraph 326-20-50-4. Example 15 illustrates how an entity might meet the disclosure requirements in the implementation guidance. In addition to providing amortized cost basis by origination year, the illustration also provides a line item for gross writeoffs and recoveries for each origination year.

5. Specifically, the stakeholder asked whether gross writeoffs and gross recoveries by origination year and class of financing receivable are required to be included in the credit-quality disclosure as portrayed in Example 15. The stakeholder noted that disclosing that information is not required by the guidance in paragraphs 326-20-50-4 through 50-9.

6. During the November Credit Losses TRG meeting, the staff informed the TRG members that on the basis of the research performed, the staff believes that the Board intended to require the disclosure of gross writeoffs and gross recoveries by origination year for each class of financing receivable type as portrayed in Example 15. Specifically, the staff supported the belief that the Board intended to provide financial statements users with insight into management's estimate of the allowance for credit losses and how the individual components of the allowance are changing each period. The staff stated that omitting the information needed to track management's estimates would significantly decrease the confirmatory value of the financial information provided in the credit-quality information disclosures.

7. On the basis of feedback by certain stakeholders who asked the Board to clarify whether gross writeoffs and gross recoveries are required to be presented within the vintage disclosure table, the staff believes that the intent of what is required as it relates to credit-quality disclosures and what is illustrated in Example 15 is unclear. In keeping with the long-standing tradition, the staff believes that entities should apply the requirements as they are stated in the guidance and not in Example 15.

FINANCIAL ACCOUNTING STANDARDS BOARD

Board Meeting Handout

Distinguishing Liabilities from Equity (Including Convertible Debt)

April 3, 2019

Meeting Purpose

1. At the September 20, 2017 meeting, the Board added a project to its agenda to improve the understandability and operability of the guidance and reduce the complexity (without loss of information for users) of the liabilities and equity guidance. The project's scope includes guidance on indexation and settlement (in the context of the derivative scope exception for contracts in entity's own equity), convertible instruments, disclosures, and earnings per share (EPS).

2. At Board meetings in June 2018 and February 2019, the Board conducted initial deliberations and made the majority of the decisions on the project. The April 3, 2019 Board meeting is a decision-making meeting for the Board to decide on consequential amendments, technical corrections, and transition.

Questions for the Board
Convertible Instruments
1. Does the Board want to clarify the difference between convertible debt and share-settled debt?
2. Does the Board want to clarify the scope of the Codification guidance on convertible debt in Subtopic 470-20, Debt—Debt with Conversion and Other Options, and on convertible preferred shares in Topic 505, Equity?
3. Does the Board agree with the staff recommendations on technical corrections to remove the word *conventional* from the term *conventional convertible debt* used in Subtopic 815-40, Derivatives and Hedging—Contracts in Entity's Own Equity, and to amend paragraph 470-20-25-2 by clarifying that Topic 480, Distinguishing Liabilities from Equity, and Topic 815, Derivatives and Hedging, should be considered for the classification of the detachable stock purchase warrant?
Derivatives Scope Exception for Contracts in Entity's Own Equity
4. Does the Board agree with the staff recommendation to expand the scope of the subsequent measurement guidance in paragraph 815-40-35-4 (which requires fair value measurement) to include instruments that failed the indexation criterion under

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Section 815-40-15, Derivatives and Hedging—Contracts in Entity's Own Equity—Scope and Scope Exceptions?

5. Does the Board agree with the staff recommendations on technical corrections to modify the disclosure requirement about settlement alternatives, delete the embedded features table (and related paragraphs), and to retain the disclosure requirements about temporary equity?

6. Does the Board agree with the staff recommendation to (a) clarify that the reassessment requirement of the derivatives scope exception applies both to freestanding instruments and embedded features (similar to the scope as written in paragraph 815-40-15-5) and (b) add a cross-reference in Section 815-40-35, Derivatives and Hedging—Contracts in Entity's Own Equity—Subsequent Measurement, to the guidance in paragraph 815-15-35-4 on the accounting for embedded features upon a change in assessment of the derivatives scope exception?

Other Consequential Amendments

7. Does the Board agree with the staff recommendation that equity-classified convertible preferred shares should be added to the scope of the down rounds EPS adjustment?

8. Does the Board agree with the staff recommendation to allow entities that have not yet adopted Accounting Standards Update No. 2017-11, *Earnings per Share (Topic 260); Distinguishing Liabilities from Equity (Topic 480); Derivatives and Hedging (Topic 815): (Part I) Accounting for Certain Financing Instruments with Down Round Features, (Part II) Replacement of the Indefinite Deferral for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests with a Scope Exception,* to early adopt the convertible instruments amendments for convertible instruments that include a down round feature?

9. Does the Board agree with the staff recommendation to exclude stock-based compensation arrangements from its tentative decision about the effect of share versus cash settlement in the diluted EPS calculation?

10. Does the Board agree with the staff recommendation to align the post-vesting classification of convertible instrument awards with other financial instrument awards under Topic 718, Compensation—Stock Compensation?

Transition

11. What transition approach does the Board prefer for the derivatives scope exception and convertible instruments amendments (modified retrospective, full retrospective or modified retrospective with an option for full retrospective)?

12. Does the Board agree with the staff's analysis of how the transition method would be applied and the consequences of applying the transition method to various instruments? Would the Board like to allow for any transition expedients (as described) at this time to address the potential consequences described in Issue 1? If so, which expedients would the Board like to allow?

13. As a practical expedient, does the Board want to require entities to assess probability for indexation and settlement as of the date of adoption?

14. Does the Board want to require full retrospective transition for the amendments to EPS guidance on cash versus share settlement, and does the Board want to require entities to apply the if-converted method as of the date of adoption for the amendments to the EPS guidance on convertible instruments? If in Question 11 the Board decides to allow an option for full retrospective transition, would the Board also like to require entities that take that option to apply the if-converted method retrospectively? If not, what does the Board recommend?

15. Does the Board agree with the staff recommendation to require the disclosures in Topic 250, Accounting Changes and Error Corrections (except for disclosures in paragraph 250-10-50-1(b)(2), which would be required only for entities that elect full retrospective transition, and paragraph 250-10-50-3) and to require disclosure about the use of transition expedients (if provided)?

Convertible Instruments

3. During outreach, practitioners raised a number of practice issues with convertible instruments. Those issues were either caused by (a) the complexity in the existing guidance that, therefore, is overlooked or inappropriately applied or (b) a lack of relevant guidance. Many of the issues that had been raised will be resolved by removing the beneficial conversion feature (BCF) and cash conversion models. However, certain issues would continue to exist under the Board's tentative decision to accounted for convertible instruments under the model for traditional convertible debt or traditional convertible preferred shares except for the ones with conversion feature accounted for as a derivative.

4. The following issues are identified for the Board's consideration:

a. **Issue 1: Convertible Debt versus Share-Settled Debt**—There are struggles in practice to distinguish a share-settlement redemption feature from a conversion feature for the debt that could be converted to a variable number of shares. As a result, a share-settled redemption feature may be mischaracterized and incorrectly accounted for as a conversion feature. Share-settled debt is discussed but not defined in GAAP, and the current definition of *convertible securities* does not provide clear guidance for those securities.

b. **Issue 2: Scope of Codification Guidance on Convertible Debt and Convertible Preferred Shares**—Stakeholders often struggle to navigate the existing guidance on convertible instruments that are covered in different Topics (such as Topics 470, 505, and 815) and, therefore, overlook or misapply relevant guidance, resulting in incorrect accounting outcomes for classification and/or measurement.

c. **Issue 3: Technical Corrections:**

    i. **Issue 3A: Conventional convertible debt**—The term *conventional convertible debt instrument* is used in Subtopic 815-40 only for a simplified assessment of the settlement criterion. The Board's tentative decisions on convertible instruments would not affect how convertible instruments would be analyzed under the guidance in Topic 815. However, in practice, the term *conventional convertible debt* is sometimes used interchangeably with traditional convertible debt, causing confusion and misinterpretation of guidance.

    ii. **Issue 3B: Debt with detachable stock purchase warrant**—Subtopic 470-20 requires that detachable warrants issued with debt instruments be accounted for as paid-in capital. However, this guidance conflicts with Subtopic 480-10, Distinguishing Liabilities from Equity—Overall, or 815-40 that may require entities to classify the warrants as liabilities.

Derivatives Scope Exception on Contracts in Entity's Own Equity

5. Throughout the course of this project at both the pre-agenda research and the initial deliberation phases, practitioners raised issues regarding incomplete guidance or inconsistent guidance. The following issues are identified for the Board's consideration:

    a. **Issue 1**: **Subsequent Measurement Guidance**—Subtopic 815-40 provides classification guidance for an instrument that does not meet the indexation criterion (classify as a liability). However, it does not provide subsequent measurement guidance for instruments that do not meet the indexation criterion and do not meet the definition of a derivative (for example, whether to measure at cost or fair value). However, paragraph 815-40-35-4 requires instruments that do not meet the definition of a derivative and met the indexation criterion but did not meet the settlement criterion to be measured at fair value. Practitioners generally have applied the subsequent measurement guidance in paragraph 815-40-35-4 (fair value) for those instruments but observed that this is an area of confusion that has created diversity in practice (with some entities measuring those instruments at cost).

b. **Issue 2: Technical Corrections:**

   i. **Issue 2A—Disclosures about settlement alternatives**—Paragraph 815-40-50-5(d) requires an entity to disclose a contract's current fair value for each settlement alternative (denominated, as relevant, in monetary amounts or quantities of shares) and how changes in the price of the issuer's equity instruments affect those settlement amounts. This wording is confusing because fair value is an amount, as defined by the Master Glossary and, therefore, fair value cannot be a quantity of shares. It seems that the intent of the requirement in this paragraph is to obtain the same type of information that must be disclosed for financial instruments subject to the guidance in Section 480-10-25, Distinguishing Liabilities from Equity—Overall—Recognition, in which paragraph 480-10-50-2 requires an entity to disclose the amount that would be paid or the number of shares that would be issued and their fair value and how changes in the fair value of the issuer's equity shares would affect those settlement amounts.

   ii. **Issue 2B—Disclosures about contracts classified in temporary equity**—Paragraph 480-10-S99-3A-3(b) explicitly states that equity-classified freestanding derivative instruments are not subject to the temporary equity requirements in SEC Accounting Series Release No. 268, *Presentation in Financial Statements of Redeemable Preferred Stocks*. However, paragraph 815-40-50-5(e) requires an entity to provide certain disclosures if an instrument that is within the scope of Subtopic 815-40 is classified as temporary equity. Practitioners have told the staff that there are no freestanding contracts within the scope of Subtopic 815-40 that would be classified as temporary equity; however, the Board's tentative decisions to modify the derivatives scope exception may affect the scope of contracts under the disclosure in the future.

   iii. **Issue 2C—Table for embedded written put options and embedded forward purchase contracts**—Paragraph 815-40-55-11 includes a table that illustrates how Subtopic 815-40 applies to embedded written put options and embedded forward purchase contracts. This table was originally included in EITF Issue No. 00-19, "Accounting for Derivative Financial instruments Indexed to, and Potentially Settled in, a Company's Own Stock," to apply to freestanding written put options and forward purchase contracts. This table as applicable to freestanding written put options and forward purchase contracts is included in paragraph 480-10-55-63. Subtopic 815-40 does not apply to hybrid contracts or embedded features except when an entity is analyzing whether an embedded feature must be bifurcated as an embedded derivative under paragraph 815-15-25-1(c). Therefore, Subtopic 815-40 does not provide classification or measurement guidance for hybrid contracts or embedded features. As such, the information in the table could be considered misleading.

c. **Issue 3: Reassessment of embedded features under Subtopic 815-40**—Paragraphs 815-40-35-8 through 35-13 provide guidance for the reassessment and reclassification of a contract under the derivatives scope exception. The guidance in paragraphs 815-40-35-8 through 35-13 was written specifically for freestanding instruments. However, through discussions with practitioners, the staff has noted that this reassessment guidance is applied in practice to both freestanding instruments and embedded features because no explicit guidance exists for reassessment of embedded features. Additionally, practitioners noted that it is common for entities to analogize to the guidance for an embedded conversion option that no longer meets bifurcation criteria under paragraph 815-15-35-4 (which requires reclassification of the feature to equity).

Other Consequential Amendments

6. In July 2017, the Board issued Accounting Standards Update No. 2017-11, *Earnings Per Share (Topic 260); Distinguishing Liabilities from Equity (Topic 480); Derivatives and Hedging (Topic 815): (Part 1) Accounting for Certain Financial Instruments with Down Round Features, (Part II) Replacement of the Indefinite Deferral for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests with a Scope Exception*. A down round feature is a provision in an equity-linked financial instrument (or embedded feature), such as a warrant or a conversion option, that provides a downward adjustment of the current exercise price on the basis of the price of future equity offerings. Down round features are most common in warrants, convertible preferred shares, and convertible debt instruments issued by private companies and development-stage public companies. Under GAAP in place before the issuance of Update 2017-11, the existence of a down round feature caused an instrument, or feature, to fail the indexation aspect of the derivatives scope exception.

7. Because Update 2017-11 affected accounting for contracts in an entity’s own equity and accounting for convertible instruments, the staff identified the following potential issues for the Board’s consideration.

a. **Issue 1: Analysis of whether consequential amendments are needed to Topic 260, Earnings Per Share, related to convertible instruments**—The EPS guidance for instruments that include down round features is only applicable to freestanding equity-classified instruments and specifically excludes convertible instruments. As a result of the Board's tentative decision on eliminating the BCF model, equity-classified convertible preferred shares with down round features would not be reflected in basic EPS. Accordingly, without an amendment, a down round feature in a convertible preferred share would have no effect on the accounting for the instrument.

b. **Issue 2: Transition considerations for convertible instruments**—In transitioning to the new guidance in Update 2017-11, a convertible instrument with a down round feature would transition from derivative accounting to BCF accounting, if the down round meets the definition of a contingent BCF. Then, on the basis of the Board's tentative decisions reached to date for this project, the convertible instrument would transition from BCF accounting to traditional convertible debt accounting. Therefore, some entities would have a double change in the accounting of those instruments.

8. The staff also identified the following issues related to share-based payments consequential amendments:

a. **Issue 3: Share versus cash settlement for EPS**—The Board decided to amend the guidance on the diluted EPS calculation for instruments that may be cash settled or share settled. The Board decided that share settlement should be presumed for the diluted EPS calculation, and an entity could not overcome this presumption by asserting cash settlement. The affected paragraphs in the Codification about cash settlement versus share settlement also apply to stock-based compensation arrangements. Under current GAAP, a liability classified stock-based compensation would not be included in diluted EPS. Under the Board's tentative decision, those instruments would be included in diluted EPS. This would create inconsistency between the classification of the instrument and the diluted EPS treatment. An exception to the EPS guidance could be drafted to retain the current requirements for a liability-classified stock-based payment.

b. **Issue 4: Convertible instrument award granted to a nonemployee**—Accounting Standards Update No. 2018-07, *Compensation—Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting,* affected nonemployee share-based compensation. The amendments in that Update requires that all free-standing instrument awards, except for convertible instrument awards, remain subject to the guidance in Topic 718, Compensation—Stock Compensation, through the life of the instruments unless there are modifications, while convertible instruments are removed from Topic 718 and are subject to other areas of guidance (such as Subtopic 470-20) when fully vested. The different treatment for convertible instruments in that Update was not based on conceptual or economic factors, but rather deferred to the liability and equity project. No issues are identified in keeping convertible instruments under Topic 718 through the life of the instrument.

Transition

Issue 1: Transition Method for Derivatives Scope Exception and Convertible Instruments

9. The Board will discuss whether to require the new guidance be applied on a modified retrospective basis or retrospective basis. If the Board decides to require a modified retrospective method of transition, then the Board also will discuss whether to allow an option for full retrospective transition.

10. Under the modified retrospective approach, an entity would apply the proposed guidance to transactions outstanding as of the beginning of the year in which the standard is adopted. Transactions that were settled (or expired) during prior reporting periods would not be affected by the transition. The cumulative effect of the change would be recognized as an adjustment to the opening balance of retained earnings at the date of adoption.

11. Under the retrospective approach, an entity would apply the proposed guidance retrospectively to all instruments outstanding as of the beginning of the first comparative period. The cumulative effect of the change in guidance would be reflected in the carrying amounts of assets and liabilities as of the beginning of the first period presented. The offsetting adjustment would be made to the opening balance of retained earnings for the first period presented.

Issue 2: Transition Expedients for Derivatives Scope Exception, Likelihood Assessment

12. Application of the transition guidance would require an entity to retroactively identify whether the adjustment, or settlement, features were remote of occurring at contract inception. Then the entity would need to reassess for the period between contract inception of the contract and adoption of the amendments if a trigger had occurred and if reclassification would have been needed. The Board will discuss whether it would like to include a transition expedient that would require an entity to assess, *at the date of adoption*, whether the adjustment, or settlement, features are remote.

Issue 3: Transition for EPS

13. If the Board decides to require a modified retrospective transition for the recognition and measurement amendments for convertible instruments, the Board will discuss whether to

require full retrospective transition for the amendments to the diluted EPS calculation for contracts that could be settled in cash or shares.

14. The Board also will discuss whether the amendments to the EPS calculation for convertible instruments should be applied as of the date of adoption. That is, if an entity applies a modified retrospective method of transition, the date of adoption would be January 1 of the year of adoption. If an entity selects an option to apply full retrospective transition, the amendments would be applied as of January 1 of the first comparative period.

Issue 4: Transition Disclosures

15. The staff will ask the Board which transition disclosures it would like to require.