No. 2013-06
14 February 2013

To the Point
FASB — proposed guidance

FASB proposes new classification and measurement model

The proposal would create a new comprehensive framework for classifying and measuring financial instruments within its scope.

What you need to know

- The FASB proposed for all entities a new classification and measurement model for financial instruments that would better converge some areas of US GAAP with IFRS 9.
- Financial assets would be classified and measured based on the instrument's cash flow characteristics and an entity's business model for managing the instrument.
- More financial assets would be measured at fair value through net income than under current practice, including many equity investments. Financial liabilities would generally be measured at amortized cost, with certain limited exceptions.
- The fair value option would be available only in limited circumstances.
- Comments are due by 15 May 2013.

Overview

The Financial Accounting Standards Board (FASB) today proposed a sweeping new classification and measurement model for financial instruments[1] that would apply to all entities across industries, with certain exceptions. Key changes from current US GAAP would include:

- Debt instruments (including loans) would first be evaluated under a new cash flow characteristics test. Instruments that pass that test would be classified and measured at amortized cost (AC), fair value through other comprehensive income (FV-OCI) or fair value through net income (FV-NI) based on a business model assessment.
- Reclassifications would be required only when an entity's business model for managing its financial assets changes.

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- Equity investments with readily determinable fair values would be measured at FV-NI.
- Equity method investments would be measured at FV-NI if they are held for sale. Impairment would be triggered when it is more likely than not that the investment's fair value is less than its carrying value.
- Today's embedded derivative bifurcation requirements for hybrid financial assets would be eliminated. Hybrid financial liabilities would generally follow today's bifurcation and separation requirements.
- Nonrecourse liabilities that are settled with cash flows only from financial assets would be measured on the same basis as the related financial assets, which would permit liabilities to be measured at FV-OCI.
- The fair value option for financial assets and financial liabilities would be available only in limited situations.

The proposal reflects feedback the FASB received on its May 2010 exposure draft[2] that would have required most financial instruments to be measured at fair value. Many constituents said that wouldn't be appropriate for instruments that entities hold for the collection (or payment) of contractual cash flows.

All financial instruments, including debt and equity securities, loans and receivables, would be classified and measured under a single model.

The FASB began redeliberations on its own, but later decided to jointly redeliberate selected issues with the International Accounting Standards Board (IASB) (collectively, the Boards). While the Boards started in different places, the current FASB proposal is generally more consistent with IFRS 9.[3] To further promote convergence, the IASB has proposed limited amendments to IFRS 9.[4]

Financial assets

Cash flow characteristics and business model assessments

An entity would determine, at initial recognition, whether the contractual terms of an individual financial asset give rise on specified dates to cash flows that are solely payments of principal and interest (P&I). Principal would refer to the amount transferred by the holder at initial recognition. Interest would be consideration for the time value of money and for the credit risk associated with the principal outstanding (which may also include a premium for liquidity risk). Assets with cash flows that are not solely P&I (e.g., equity securities, certain debt instruments with leverage features) would be measured at FV-NI.

An asset with cash flows that are solely P&I would be classified and subsequently measured based on the business model in which it will be managed. Assets held in a business model for the purpose of collecting contractual cash flows would be subsequently measured at AC. Assets held in a business model for both holding to collect cash flows and selling assets would be subsequently measured at FV-OCI. Assets that aren't managed under either business model would be classified and subsequently measured in the residual category, which would be FV-NI.

Selling financial assets due to a significant deterioration in the issuer's creditworthiness would be consistent with the classification objective of AC if the sale would maximize the investor's collection of cash flows. In all other cases, sales of assets with the classification objective of AC would be expected to result only from events that are isolated, nonrecurring and unusual and could not have been reasonably anticipated.

An entity would reclassify a financial asset if the business model changes, which the FASB expects to occur very infrequently. A reclassification would be accounted for prospectively and would be recognized on the last day of the reporting period in which the business model changes.

How we see it

Common debt features that are not bifurcated under current practice (e.g., certain prepayment options) could result in an instrument being measured at FV-NI under the proposal. In addition, while carrying forward much of the current held-to-maturity guidance, the proposal does not include an explicit tainting notion for sales from the "hold-to-collect" category.

Equity investments

Equity investments that do not result in consolidation and are not accounted for under the equity method would be measured at FV-NI. However, entities other than broker-dealers and investment companies would generally be able to elect to measure equity investments without a readily determinable fair value at cost less impairment, adjusted for observable price changes for identical or similar investments from the same issuer.

Unrealized gains and losses on investments in equity securities would no longer be permitted to be recognized in other comprehensive income.

At initial qualification, equity method investments for which entities have identified both the potential exit strategies and the timing of the exit would be measured at FV-NI. Today's unconditional fair value option would be eliminated for equity method investments. Equity method investments would be considered impaired if it is more likely than not that the investment's fair value is less than its carrying value.

Initial measurement

Instruments that would be subsequently measured at FV-NI would initially be measured at fair value. Instruments that would be subsequently measured at AC or FV-OCI would initially be measured at transaction price. Investment companies would continue to initially measure financial instruments at transaction price.

Financial liabilities

Financial liabilities would generally be measured initially at their transaction price and subsequently at AC unless an entity's business strategy when it incurs the liability is to transact at fair value or the liability results from a short sale. Those liabilities would be recorded at FV-NI.

If financial assets will be used to settle nonrecourse financial liabilities, the financial liabilities would be measured consistently with the associated financial assets. This guidance would be applied, for example, to consolidated securitizations and asset-backed financing structures.

Hybrid instruments

The proposal would eliminate today's embedded derivative bifurcation requirements for hybrid financial assets. Hybrid financial assets that have cash flows that are not solely P&I would be classified and measured in their entirety at FV-NI. Hybrid nonfinancial assets would be classified and measured in their entirety at FV-NI if the nonfinancial embedded derivative would have required bifurcation under ASC 815.[5] The current bifurcation and separation guidance for both hybrid financial and hybrid nonfinancial liabilities would be retained.

Fair value option

Today's unconditional fair value option would instead be limited to:

- Groups of financial assets and financial liabilities (which may include derivatives) if the entity manages its net exposure at fair value and provides information to management on that basis
- Hybrid financial and hybrid nonfinancial liabilities, with limited exceptions
- Financial assets that qualify for the FV-OCI business model

When the conditional fair value option is applied to a financial liability, the portion of the change in fair value that results from a change in the instrument-specific credit risk (e.g., portion of the change that exceeds the change in a base market risk, such as the US Treasury rate) would be presented separately in OCI.

Presentation and disclosure

The proposal would expand today's presentation and disclosure requirements. All entities would have to present financial assets and financial liabilities separately on the balance sheet by measurement category. Only public entities would have to present the fair value of financial assets and financial liabilities (except for receivables or payables due in less than a year and demand deposit liabilities) measured at AC parenthetically on the face of the balance sheet. Nonpublic entities would be exempted from both parenthetical and footnote disclosures of fair value for instruments measured at AC.

Effective date and transition

The FASB hasn't yet set an effective date. At the beginning of the period in which the guidance becomes effective, an entity would record a cumulative-effect adjustment to retained earnings. Entities would be permitted to early adopt only the proposed presentation requirements related to changes in instrument-specific credit risk for hybrid financial liabilities that would qualify for the fair value option under the proposal. Comments are due by 15 May 2013.

Endnotes:

[1] FASB Proposed Accounting Standards Update, *Financial Instruments—Overall (Subtopic 825-10).*

[2] FASB Proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*.

[3] IFRS 9, *Financial Instruments.*

[4] IASB Exposure Draft, *Classification and Measurement: Limited Amendments to IFRS 9 (Proposed amendments to IFRS 9 (2010)), November 2012.*

[5] ASC 815, *Derivatives and Hedging.*

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SCORE No. BB2498

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Appendix: Other key changes to current US GAAP

The following table highlights other key changes to US GAAP based on the proposal.

Topic	FASB proposal
Evaluation of legal form of debt instruments	Under current US GAAP, debt securities and loans follow different measurement models. Under the proposal, the measurement of debt instruments would no longer depend on their legal form.
FV-OCI measurement category	FV-NI would replace FV-OCI as the residual measurement category for debt instruments.
Cost method of accounting	The cost method of accounting for equity securities without a readily determinable fair value would be eliminated. However, a practicability exception would be provided for an equity investment without a readily determinable fair value, with limited exceptions.
Other-than-temporary impairment model for certain equity investments	The other-than-temporary impairment model for equity investments not measured at FV-NI and equity method investments would be eliminated and replaced with a one-step impairment model that would be based on an assessment of qualitative factors to determine whether it is more likely than not that the fair value of the investment is below its carrying amount.
Unrealized foreign currency (FX) gains or losses on FX denominated instruments measured at FV-OCI	The entire change in the fair value of an available-for-sale debt security that is denominated in a foreign currency is now recognized in OCI. Under the proposal, the portion of the fair value change attributable to a transaction gain or loss would be recognized in earnings.
Valuation allowance on deferred tax assets related to financial instruments measured at FV-OCI	Under current US GAAP, the evaluation of the need for a valuation allowance on a deferred tax asset related to financial instruments for which qualifying changes in fair value are recognized through OCI can be performed either separately or together with the evaluation of an entity's other deferred tax assets. Under the proposal, an entity would be required to perform a separate evaluation without considering its other deferred tax assets.