Hot Topic
Update on major accounting and auditing activities

FASB proposes more fair value for financial instruments and new performance statement

What you need to know
- Most financial assets will be measured at fair value, with changes recognized either through net income or other comprehensive income (OCI)
- Impairment rules aligned for loans and securities, and "probable" threshold removed
- A single performance statement will be required, with equal prominence for net income and OCI
- Other presentation and disclosure requirements will significantly increase
- Qualifying for hedge accounting will be simplified, but the fundamental fair value, cash flow and net investment hedging models remain unchanged
- The proposed update does not converge with IFRS

Background
Yesterday, the Financial Accounting Standards Board (FASB) released its highly-anticipated Proposed Update on the accounting for financial instruments.¹ If adopted as proposed, the accounting for financial instruments will change significantly because:
- More financial instruments will be measured at fair value
- The accounting for loans and securities will be more aligned, and both would be measured at fair value
- Hedge accounting will be simplified
- Core deposit liabilities will be recognized using a present value measurement

While these changes will affect the financial statements of many companies, they likely will have the greatest impact on financial institutions.

Scope
The scope of the Proposed Update includes all financial instruments, with limited exceptions in areas such as leases, insurance contracts and obligations for pension benefits.

The Proposed Update includes a four-year limited scope exception for non-public entities with consolidated total assets less than US$1 billion. The deferral applies only to qualifying loans, loan commitments and core deposit liabilities, and allows those instruments to be measured using existing US GAAP during the deferral. All other aspects of the Proposed Update would have to be applied, including additional fair value disclosures for the instruments subject to the deferral.

The equity method of accounting will continue to apply when the investor has significant influence over the investee, but only if the investment is considered "related to" the investor’s consolidated businesses. Further, the fair value option will no longer be available when an investment is otherwise within the scope of equity-method accounting. Investments not within the scope of equity-method accounting will be accounted for at fair value, with changes in fair value recognized in net income.

¹ Proposed Accounting Standards Update, Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities

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Classification and measurement

Most financial instruments will be reported on the balance sheet at fair value, with limited exceptions for short-term receivables and payables, certain other investments and an entity’s own debt. For those financial instruments measured at fair value, the default accounting is to recognize changes in fair value in net income. However, if an entity elects, and the following criteria are met, changes in fair value would be recognized in OCI:

- The instrument is a debt instrument held or issued with the following characteristics:
  - There is an amount that is transferred at inception and returned at maturity or other settlement, which is the principal amount.
  - The contractual terms identify any additional cash flows (e.g., interest) to be paid to the creditor.
  - The instrument cannot contractually be prepaid or otherwise settled in such a way that the investor would not recover substantially all of its initial investment, other than through its own choice.
  - The entity’s business strategy is to collect or pay the related contractual cash flows rather than to sell or settle the financial instruments with a third party.
  - The instrument does not contain an embedded derivative that is not clearly and closely related to the host instrument (see the Hybrid instruments section that follows).

In applying the second criterion, an entity’s business strategy for a financial instrument would need to be evaluated based on how it manages its financial instruments, rather than based on the intent for an individual financial instrument. For this purpose, an entity’s strategy should be to hold instruments in a portfolio designated as held for collection or payment of contractual cash flows for a significant portion of their contractual term. The following would be recognized in net income for financial instruments for which changes in fair value are recognized in OCI:

- Interest income and expense.
- Realized gains and losses.
- Credit-related impairments.
- The change in fair value related to the hedged risk of a financial instrument in a fair value hedge.

How we see it

The Proposed Update expands the use of fair value as a measurement attribute to almost all financial instruments within its scope, most notably to loans and equity securities of non-public entities. This is a significant change from current practice (especially for financial institutions), which requires loans not held for sale (and not at fair value under the fair value option) to be measured at amortized cost. An entity may elect to measure its own debt at amortized cost if the above criteria to recognize changes in fair value through OCI are met and measuring the debt at fair value would create or exacerbate a measurement attribute mismatch of recognized assets or liabilities. The Proposed Update includes guidance on determining when a measurement of a financial liability at fair value would create or exacerbate a “measurement attribute mismatch.”

Also, certain types of investments that can only be redeemed with the issuer at a maximum of the amount contributed (i.e., par) must be measured at the redemption value (e.g., Federal Reserve stock and Federal Home Loan Bank stock).

Initial measurement

Financial instruments will be initially measured at:

- Fair value, for those instruments subsequently measured at fair value with changes in fair value recognized in net income.
- Transaction price, for those instruments subsequently measured at fair value with changes in fair value recognized in OCI and for those financial liabilities for which the amortized cost option is elected.

For those financial instruments subsequently measured at fair value with changes in fair value recognized in OCI, transaction costs would be recognized in OCI and amortized or accreted to net income as a yield adjustment over the life of the related financial instrument.

Reclassifications

The decision to classify eligible financial instruments at fair value with changes recognized in OCI or at amortized cost must be made at the initial recognition of the instrument. Subsequent reclassifications are not permitted.

Hybrid instruments

In a significant step toward simplification, embedded derivatives will no longer be bifurcated from hybrid financial instruments. Any hybrid financial instrument for which the embedded derivative is not clearly and closely related to the host contract (and would be bifurcated under current US GAAP) will be measured at fair value in its entirety with changes in fair value recognized in net income. If the hybrid financial instrument’s embedded derivative is clearly and closely related to the host contract and would not
require bifurcation under current requirements, then it is eligible to be classified at fair value with changes in fair value recognized in OCI or measured at amortized cost (own debt only), if the respective criteria are met.

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<td>The removal of the requirement to separately account for derivatives embedded in hybrid financial instruments only applies to hybrid financial instruments within the scope of the Proposed Update. As a result, derivatives embedded in insurance contracts and leases may still require bifurcation pursuant to ASC 815, if those embedded derivatives are not clearly and closely related to the host contract.</td>
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Deposit liabilities
The Proposed Update defines core deposit liabilities as “deposits without a contractual maturity that management considers to be a stable source of funds.” Historically, the intangible asset resulting from the low cost source of funds represented by core deposits has not been recognized outside of an asset acquisition or a business combination. However, the Proposed Update provides that financial institutions will measure all core deposits at the present value of the average deposit balance over the “implied maturity” of the deposits (i.e., period the deposits are expected to remain outstanding). The average expected balance would be discounted at a rate equal to the difference between (a) the alternative funds rate and (b) the all-in-cost-to-service rate over the implied maturity. This approach would generally result in the liabilities being measured at an amount that is less than that at which they could be currently settled, effectively recognizing a portion of the core deposit intangible asset within the liability balance.

Changes in the value of core deposit liabilities will be recognized in net income or OCI. The election to recognize changes in the value of core deposit liabilities in OCI would be made at the date of adoption and could not be subsequently changed.

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<td>Core deposit liabilities would not be measured at fair value as defined in ASC 820, as the measurement is not based on an exit price but, rather, is based on entity-specific costs to service. Although an intangible asset is implicitly recognized because future deposits are considered, it is a measure of an inexpensive source of funds rather than a measure of the entire customer relationship. The proposed measurement does, however, highlight interest sensitivity in the deposits. Because loans will be measured at fair value, the FASB believes users will have better information on how interest rates affect both the assets and the liabilities used to fund those assets.</td>
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Presentation
In order to provide more prominence to OCI, the FASB also issued a separate Proposed Update that requires the display of the components of OCI below net income in a continuous statement that reports results of operations. This would remove the alternative presentation models currently available under ASC 220, whereby comprehensive income and its components may be displayed in a separate statement or in a statement of changes in equity. Earnings per share would continue to be based on net income and not total comprehensive income. Also, existing guidance related to items that must be presented in OCI will not change. As a result, the presentation of adjustments to certain foreign currency translation items, as well as adjustments to certain pension or other postretirement benefit items, will not change.

The Proposed Update on financial instruments also includes a number of requirements about how an entity would present financial instruments in the basic financial statements. For example, for financial instruments (excluding core deposit liabilities) whose fair value changes are recognized in OCI, an entity would be required to present as separate line items in the balance sheet, the amortized cost and the amounts needed to adjust amortized cost to arrive at fair value. An entity would also be required to present separately on the face of the performance statement interest accruals, realized gains or losses and, if applicable, credit impairment.

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<td>The Proposed Update on financial instruments requires more information about financial instruments to be presented on the face of the financial statements. Those companies that choose to provide a balance sheet and income statement with their press release will need to decide whether the additional information required to be presented on the face of the financial statements will be included in the balance sheets and income statements provided with the press release. If so, modifications may need to be made to accounting processes so that the required information is gathered timely.</td>
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2 ASC 815, Derivatives and Hedging

3 ASC 820, Fair Value Measurements and Disclosures

4 Proposed Accounting Standards Update, Comprehensive Income (Topic 220)

5 ASC 220, Comprehensive Income
Impairment
An entity is required to determine if credit losses exist for financial instruments whose changes in fair value are recognized in OCI, short-term receivables measured at amortized cost and certain other investments that must be measured at their redemption value. The FASB modified the existing incurred loss model in an attempt to allow earlier recognition of credit losses.

A change between the proposed impairment approach and the existing approach is the removal of the “probable” threshold for recognizing an incurred credit loss for all financial assets. Under the proposed approach, an entity would recognize a credit impairment when one or more events occur that indicate that the entity will be unable to collect all contractually promised cash flows and should not consider a probability threshold regarding the occurrence of the event(s) or the effect of specific conditions in determining whether a credit loss exists.

Another change from existing practice in the Proposed Update would provide that interest income be recognized by multiplying the amortized cost less cumulative credit impairments by the effective interest rate. This approach to interest income recognition would result in less interest income being recognized than under the existing model in circumstances in which credit impairments have been recognized.

How we see it
FSP 115-2 already removed the “probable” threshold for determining impairments on debt and equity securities. The Proposed Update includes one impairment model for all financial assets; thus, the removal of the “probable” threshold will primarily affect how credit losses on loans are determined.

Hedging
The FASB has decided to modify the existing hedge accounting model in ASC 815 based largely on changes that the FASB originally proposed in its 2008 exposure draft (ED). Proposed changes include:

- Replacing the notion of a “highly effective” relationship with one that is merely “reasonably effective,” thus lowering the bar on what constitutes a qualifying hedge
- Eliminating the short-cut method for interest rate swaps and the “critical terms match” concept for other derivatives that currently permit the assumption of no ineffectiveness in a hedge relationship, while mitigating the effect of this change somewhat by simultaneously acknowledging that qualitative assessments of what constitutes “reasonable effectiveness” are acceptable in many instances
- Replacing requirements that hedges be reassessed every quarter with requirements that hedges be reassessed qualitatively (or quantitatively, if necessary) only if circumstances suggest that the hedging relationship may no longer be reasonably effective
- Requiring that both “overhedges” and “underhedges” lead to the reporting of hedge ineffectiveness in earnings for cash flow hedges
- Prohibiting the de-designation of a hedge prior to the maturity of the derivative, unless the hedge fails to remain “reasonably effective” (hedge termination prior to maturity would only be accomplished by terminating the derivative with the counterparty)

Important provisions of ASC 815 that would not change include:

- Allowing hedges of certain individual risk components (i.e., bifurcation by risk) for hedged financial items

How we see it
Accounting for Hedging Activities

Effective date and transition
The Proposed Updates request comments by 30 September 2010. No effective dates have been proposed in either of the Proposed Updates as the FASB will determine the effective dates after the comment period ends and the final Accounting Standards Updates are issued.

With respect to the Proposed Update on financial instruments, the transition method will be a cumulative-effect adjustment to the balance sheet before the effective date (i.e., the prior-period balance sheet would be restated in the first financial statements issued after the effective date). Early adoption will not be permitted.

With respect to the Proposed Update on OCI, the FASB has proposed to require retrospective application of this guidance and to permit early adoption.

How we see it
Although the FASB does not provide an effective date, we believe the earliest these Proposed Updates will be effective is 1 January 2012. A more likely scenario is alignment with the effective date in IFRS 9 of 1 January 2013.
Convergence
Although described as an active-joint project, the International Accounting Standards Board (IASB) has been deliberating issues separately and has reached significantly different conclusions. In addition, the IASB’s project calls for separate EDs for each phase of the project (i.e., classification and measurement, impairment and hedge accounting). In that regard, the IASB finalized a classification and measurement standard for financial assets, issued an ED on classification and measurement of financial liabilities on 11 May 2010, and issued an ED on impairment in November 2009. The standard on classification and measurement of financial assets provided for significantly less measurement at fair value than the FASB’s Proposed Update.

The IASB plans to issue an ED on hedging sometime before 30 September 2010. Given the different conclusions reached by the respective Boards, it remains unclear what level of convergence will ultimately be achieved.

Looking ahead
Although the Proposed Update may simplify the accounting for financial instruments, it could increase volatility in net income and comprehensive income that will need to be understood and explained to users of financial statements. Also, accounting for additional instruments at fair value will increase the use of subjective estimates of fair value for many instruments that are not traded (e.g., loans and non-public equity securities).

All affected entities should carefully assess the impact of the proposed guidance and consider submitting comment letters to the FASB to provide feedback on the proposed standards. To assist you in this effort, we will be issuing a more detailed analysis of the Proposed Updates in the near future. We will also provide periodic updates as the FASB begins its redeliberations of the Proposed Updates.