

## Heads Up

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The issues and concerns raised in the feedback indicate the areas the FASB is likely to focus on in finalizing new accounting requirements for financial instruments.

## Report Card: A, F, or Incomplete? Constituents Share Views on the FASB's AFI Project

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Now that over a month has elapsed since comments were due on the [proposed financial instruments ASU](#),<sup>1</sup> and because the FASB decided recently to decelerate three other projects,<sup>2</sup> many constituents may wonder about the future of accounting for financial instruments (AFI). Given the far-reaching nature of the changes that the FASB has proposed to the accounting for loans, debt and equity securities, private equity investments, and financial liabilities, it should come as no surprise that the proposed ASU has generated an unprecedented amount of reaction. The FASB has received over 2,800 public comment letters and has collected feedback from 28 investor questionnaires, 8 field visits with preparers, 5 public roundtable meetings, and face-to-face meetings and calls with more than 100 individual constituents.

While the FASB has not yet analyzed all this information in detail, it discussed at its October 27 meeting the key themes of the feedback it received on its proposed classification and measurement model for financial instruments. And in a joint meeting with the IASB on October 21, it discussed feedback on its credit impairment proposals related to financial instruments. The issues and concerns raised in the feedback indicate the areas the FASB is likely to focus on in finalizing new accounting requirements for financial instruments. This *Heads Up* summarizes that feedback and discusses the FASB's expected next steps. In addition, Appendixes [A](#), [B](#), and [C](#) outline the proposed ASU's provisions related to classification and measurement, the impairment model, and hedge accounting, respectively, as well as the prevailing views from respondents' feedback received to date.

**Editor's Note:** The issues and concerns raised by constituents may make it challenging for the FASB to be able to finalize its project on the accounting for financial instruments by its expected completion date of June 2011. As yet, however, no changes have been made to the project's timeline. See Deloitte's [May 28, 2010, Heads Up](#) for information about the project and an overview and analysis of the proposed ASU's key provisions.

<sup>1</sup> Proposed FASB Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*.

<sup>2</sup> During their joint meeting last month, the IASB and the FASB decided that in light of the boards' schedules, they would defer further deliberations on the following projects: reporting entity (conceptual framework, phase D); financial statement presentation; and financial instruments with characteristics of equity (liabilities and equity). Both boards concluded that all three projects deserve more attention than the boards' capacity currently allows.

One of the proposed ASU's more contentious topics is the requirement for loans (e.g., the lending portfolios of banks) to be carried at fair value in the financial statements.

## Key Themes in Respondents' Feedback

In their comments on the proposed ASU, most respondents indicated their support for the FASB's efforts to reduce complexity in the accounting for financial instruments and to provide investors with more useful, transparent, and relevant information about an entity's financial assets and financial liabilities. However, a large majority of respondents stated their opposition to many of the key aspects of the proposal, in particular, expansion of fair value accounting to loans and financial liabilities. Further, many are concerned about the lack of convergence between the proposed ASU and the IASB's approach to the accounting for financial instruments.

### Classification and Measurement

One of the proposed ASU's more contentious topics is the requirement for loans (e.g., the lending portfolios of banks) to be carried at fair value in the financial statements. Few respondents support the FASB's proposal that fair value should be the primary measurement attribute for loans that are intended to be held to collect the contractual cash flows. Many constituents are concerned that requiring loans to be carried at fair value would increase the subjectivity of financial statements. While many acknowledge that fair value provides relevant supplemental information to financial statement users, many believe that amortized cost is a better starting point for financial analysis when supplemented by information about asset quality and risk exposures.

**Editor's Note:** In light of the concerns raised about fair value accounting for loans, we anticipate that the FASB will explore whether amortized cost should be retained as a measurement attribute that could be applied to loans not held for sale. For instance, the FASB may explore whether to develop an approach similar to IFRS 9, *Financial Instruments*, under which debt instruments (both loans and debt securities) that meet certain business strategy and cash flow characteristics criteria are accounted for at amortized cost. Alternatively, the FASB may consider whether to limit such an amortized cost category to debt instruments that are deemed relatively less liquid (e.g., it may limit amortized cost measurement to loans and debt securities for which the relevant market is inactive but require liquid debt securities to be measured at fair value with changes in fair value recognized in either net income or other comprehensive income depending on the business purpose and cash flow characteristics of the instruments).

Another contentious topic in the proposed ASU is the view that fair value should be the default measurement attribute for financial liabilities. Few support this position, and many are concerned that measuring financial liabilities at fair value for which an entity's business model is to pay contractual cash flows rather than to trade results in the recognition of gains when an entity's creditworthiness deteriorates even though such gains are unlikely to be realized. For the same reason, some respondents believe that an entity should continue to have the ability to bifurcate an embedded derivative from a host financial liability contract rather than having to account for the entire hybrid financial liability at fair value through net income. The proposed ASU would eliminate the bifurcation of embedded derivatives in hybrid financial instruments and instead require hybrid financial instruments to be accounted for in their entirety at fair value through net income when they contain an embedded derivative that, under existing U.S. GAAP, would have been bifurcated and accounted for separately at fair value through net income.

**Editor's Note:** In finalizing new accounting requirements for financial liabilities, the FASB is likely to consider whether amortized cost should be retained as the default measurement attribute for nontrading financial liabilities as well as a requirement to separate certain embedded derivatives from their host contracts in a manner similar to current U.S. GAAP.

A majority of users support the FASB's proposal to require marketable equity securities to be accounted for at fair value through net income.

Virtually all respondents oppose the proposed ASU's guidance under which entities would measure core deposit liabilities by using a remeasurement approach involving the present value of the average core deposit amount over its implied maturity. Many are concerned (1) about the subjectivity of this approach and (2) that the resulting measurement represents neither the amount payable on demand nor the fair value of core deposits.

**Editor's Note:** We believe that on that basis of the feedback received, the FASB is highly unlikely to proceed with its proposed remeasurement approach for core deposit liabilities.

Many users of financial statements indicated they believe that the fair value option should not be provided for financial liabilities. However, others noted that the fair value option should only be available when certain eligibility criteria are met (e.g., when the measurement of a financial liability at amortized cost would result in a measurement attribute mismatch).

**Editor's Note:** The FASB is expected to discuss whether the fair value option should continue to be available for financial liabilities that would otherwise be accounted for at amortized cost and whether the fair value option should be subject to specified eligibility criteria (e.g., an accounting mismatch would be created if the liability is carried at amortized cost). If the FASB decides to maintain the fair value option for financial liabilities, it may consider whether changes in fair value attributable to own credit risk should be recognized in other comprehensive income rather than in net income. The IASB recently amended IFRS 9 to require such an approach for financial liabilities to which the fair value option has been applied.

A majority of users support the FASB's proposal to require marketable equity securities to be accounted for at fair value through net income. These respondents believe that fair value accurately depicts an entity's economic position because an entity would have to sell a marketable equity security to realize a change in value. Other respondents believe that an entity should be permitted to recognize changes in fair value of equity securities in other comprehensive income if the securities are held for the long term. Views are mixed on the accounting for nonmarketable equity investments that entities account for under current U.S. GAAP by using the cost method of accounting but would be required to account for under the proposed ASU at fair value through net income. Some believe that the cost method of accounting should be retained for such investments because of the subjectivity of related fair value estimates.

The proposed ASU would narrow the scope of the equity method of accounting to investments in investees that have operations that are related to the investor's consolidated operations. For investments in investees that are currently accounted for under the equity method and that have operations that are not related to the investor's consolidated operations, most nonusers of financial statements generally do not support the use of fair value and note that entities typically hold such investments for long-term, strategic purposes. Conversely, feedback received from financial statement users generally supports the use of fair value for such investments.

Many constituents agree that transaction price is the most appropriate initial measurement approach for financial instruments that are accounted for at either (1) fair value with certain changes in fair value recognized in other comprehensive income or (2) amortized cost. However, views are mixed on whether transaction price or fair value is appropriate for financial instruments accounted for at fair value with changes in fair value recognized in net income.

Regarding transaction costs, investment companies generally do not support treating such costs as operating expenses (rather than as part of the unrealized gain or loss on the instrument) for financial instruments accounted for at fair value through net income. In their view, such costs are a part of the basis for obtaining a financial instrument, and treating such costs as operating expenses would distort key financial metrics used for investment companies (e.g., expense ratios) and would be operationally challenging.

Almost all respondents expressed concern about the proposed standard's guidance on how to recognize interest income.

## Credit Impairment and Interest Recognition

Most respondents support the proposal to establish a single impairment model for both loans and debt securities (including both purchased and originated assets) rather than the multiple models present under existing U.S. GAAP. Further, most respondents support the elimination of a probability threshold in determining whether an impairment loss should be recognized.

Under the proposed ASU, initially expected losses would be recognized on a portfolio of assets in net income in the reporting period that those assets were purchased or originated. Views are mixed on this aspect of the proposal. Some favor this outcome, whereas others prefer the IASB's proposed approach, under which entities would use a systematic and rational method to allocate such initially expected losses over the life of the related assets (although not necessarily by adjusting the effective interest rate, as proposed by the IASB).

Most respondents oppose the proposed ASU's prohibition against forecasting future events or economic conditions that did not exist as of the reporting date in the recognition and measurement of credit impairment. Many believe that it is appropriate to consider reasonable and supportable assumptions about future conditions and events within a predictable forecasting period.

Almost all respondents expressed concern about the proposed ASU's guidance on how to recognize interest income. For example, many felt that computing interest income on the basis of the amortized cost net of the allowance would reduce transparency about interest receipts and impairments and result in operational challenges because information systems typically do not compute interest income on the basis of the principal balance net of the allowance.

## Hedge Accounting

Respondents are mixed in their views on the proposed changes to hedge accounting. Most respondents support lowering the hedge effectiveness threshold from "highly" effective to "reasonably" effective, with some requesting implementation guidance on how an entity would apply the reasonably effective threshold. Respondents generally support permitting bifurcation by risk for financial items; however, some requested that the ability to designate hedges of risk components be expanded to include components of nonfinancial items.

The majority of respondents do not support eliminating the ability to voluntarily dedesignate a hedging relationship. In addition, many called for the FASB to work jointly with the IASB to develop revised hedge accounting requirements.

## Next Steps

Beginning in December, on the basis of the feedback it received (discussed above), the FASB plans to redeliberate the following aspects of the classification and measurement proposals:

- Initial measurement:
  - Whether there should be symmetry between classification categories (i.e., whether transaction price or fair value should be the initial measurement for all classification categories).
  - The effect of significant differences between fair value and transaction price.
  - The treatment of transaction costs (e.g., whether they should be expensed or capitalized).
- Subsequent measurement:
  - Classification and measurement categories.

- The subsequent classification and measurement of loans, debt securities, equity investments, core deposit liabilities, other financial liabilities, and hybrid financial instruments.
- The fair value option.
- The proposed criteria for equity method accounting.

The FASB staff indicated that it may take issues related to financial assets to the Board before addressing those related to financial liabilities.

Furthermore, the FASB indicated that its redeliberations on the classification and measurement aspects of the project initially will not be conducted jointly with the IASB. Rather, the FASB will first develop its proposed model for the classification and measurement of financial assets and financial liabilities and then discuss the proposed model with the IASB in a joint meeting addressing convergence.

The FASB and the IASB will jointly discuss the proposals on credit impairment and interest income recognition, beginning with a series of joint meetings in mid-November. Among other items, the boards plan to discuss:

- The information considered in the impairment determination, including whether to consider forecasts of future conditions or events in determining credit losses.
- The approach for determining the amount of the credit losses to be recognized (e.g., whether to reflect losses expected over the life of a financial asset or only those expected to occur in a specified time horizon).
- The timing of recognition of credit losses (e.g., whether to recognize the initial estimate of credit losses immediately or over the life of the financial asset).
- Whether interest income on impaired financial assets should reflect contractual yields or credit-risk adjusted yields (i.e., whether an estimate of credit losses should be integrated into the calculation of interest income from a financial asset).

**Editor's Note:** The FASB is expected to begin addressing the hedge accounting provisions of the proposed ASU in the first quarter of 2011.

## Appendix A — Classification and Measurement

The following table summarizes (1) the proposed ASU's provisions on the classification and measurement of financial assets and financial liabilities and (2) the prevailing views from respondents' feedback received to date.

Subject	FASB's Proposed ASU	Summary of Feedback
Categories of financial assets and financial liabilities	<p>Effectively, six categories of <b>financial assets</b> and <b>financial liabilities</b>:</p> <ol style="list-style-type: none"> <li>1. Fair value through net income (FV-NI; default category).</li> <li>2. Fair value through other comprehensive income (FV-OCI; elective for qualifying debt instruments).</li> <li>3. Amortized cost (elective for qualifying liabilities and short-term payables and receivables).</li> <li>4. Redemption value (required for certain redeemable investments).</li> <li>5. Remeasurement approach for core deposits through net income (default category for core demand deposit liabilities).</li> <li>6. Remeasurement approach for core deposits through OCI (elective for qualifying core demand deposit liabilities).</li> </ol>	<ul style="list-style-type: none"> <li>• Most respondents believe that amortized cost is the most relevant measurement attribute for loans, core deposits, and an entity's own debt. Many cited the subjectivity of fair value measurements and a potential inappropriate negative impact on regulatory capital as reasons why fair value was not preferable for these instruments.</li> <li>• Many investors recommend expanded disclosures over fair value measurement for loans and financial liabilities held for the collection of payment, including: <ul style="list-style-type: none"> <li>◦ Interest rate sensitivity and credit risk disclosures.</li> <li>◦ Fair value disclosures (based on an exit price notion).</li> </ul> </li> <li>• Most nonusers recommend a mixed attribute model based on an entity's business strategy, for example: <ul style="list-style-type: none"> <li>◦ Financial instruments held for collection or payment of cash flows should be measured at amortized cost.</li> <li>◦ Financial instruments held for trading should be measured at fair value through net income.</li> </ul> </li> <li>• Many respondents asked for clarification of the classification criteria, e.g., the extent of sales that are permissible under the business strategy criterion.</li> </ul>
Criteria for amortized cost measurement	<p>An entity has the option to elect to carry the following financial instruments at amortized cost:</p> <ol style="list-style-type: none"> <li>1. Short-term receivables and payables (other than short-term lending arrangements such as credit card receivables) arising in the normal course of business and due in customary terms not exceeding one year that meet the criteria for classification as FV-OCI (see below).</li> <li>2. Financial liabilities that meet the criteria for classification as FV-OCI (see below), provided that measuring the financial liability at fair value would create or exacerbate an accounting mismatch.</li> </ol>	
Criteria for FV-OCI classification	<p>An entity has the option to classify a <b>financial asset</b> or <b>financial liability</b> as FV-OCI if it meets all of the following criteria:</p> <ol style="list-style-type: none"> <li>1. <i>Cash flow characteristics</i> — A debt instrument that cannot contractually be prepaid or otherwise settled in such a way that the investor would not recover substantially all of its initially recorded investment, other than through its own choice.</li> <li>2. <i>Business strategy</i> — Business strategy for the instrument is to collect or pay the related contractual cash flows.</li> <li>3. <i>No embedded derivative required to be separated</i> — It is not a hybrid instrument for which an embedded derivative is required to be separated under existing U.S. GAAP.</li> </ol> <p>For instruments in this category, current-period interest accruals, credit losses, and realized gains or losses are recognized in earnings.</p>	
Equity investments (other than equity method investments)	<p>Carried at fair value, with changes in fair value recognized in earnings, except for certain redeemable investments that are carried at redemption value, with changes in the redemption value recognized in earnings.</p>	<ul style="list-style-type: none"> <li>• A majority of investors support the use of the FV-NI model for marketable equity securities.</li> <li>• Insurance companies believe that fair value changes for equity securities held long term should be recognized in OCI.</li> </ul>

Subject	FASB's Proposed ASU	Summary of Feedback
Equity method investments	Limits the scope of equity method of accounting to equity investments in which the (1) entity has significant influence over the investee and (2) operations of the investee are related to the investor's consolidated operations. Equity investments that do not meet these criteria are accounted for at fair value through net income.	<ul style="list-style-type: none"> <li>Most nonusers generally do not support measuring investments that do not meet the proposed criteria for the equity method of accounting at fair value. However, users generally do support the use of fair value for such investments.</li> </ul>
Embedded derivatives in hybrid financial contracts	<p>Hybrid financial contracts with an embedded derivative, which currently must be bifurcated under ASC 815,<sup>3</sup> would instead be measured in their entirety at fair value, with changes in fair value recognized in earnings. No embedded derivative would be bifurcated from a hybrid financial asset or liability (except for hybrid financial instruments that are outside the proposed ASU's scope).</p> <p>An entity is permitted to classify as FV-OCI hybrid financial contracts that meet the FV-OCI classification criteria and that contain an embedded derivative that does not require bifurcation under ASC 815.</p>	<ul style="list-style-type: none"> <li>Some respondents support continuing to allow entities the ability to bifurcate an embedded derivative from a host financial liability contract so that the host contract may be classified in accordance with the entity's business strategy.</li> </ul>
Fair value option	Because the proposed default measurement attribute for financial liabilities is fair value, the explicit fair value option was eliminated.	<ul style="list-style-type: none"> <li>Some respondents support the use of the fair value option in limited circumstances, such as when the measurement of a financial liability at amortized cost would result in a measurement attribute mismatch.</li> </ul>
Reclassification	Not permitted.	<ul style="list-style-type: none"> <li>Many respondents cited concerns about the inability to reclassify instruments after initial classification in circumstances in which an entity's business model changes.</li> </ul>

<sup>3</sup> FASB Accounting Standards Codification Topic 815, *Derivatives and Hedging*.



## Appendix B — Impairment Model

The following table summarizes (1) the proposed ASU's provisions on recognition and measurement of impairment of financial assets and (2) the prevailing views from respondents' feedback received to date.

Subject	FASB's Proposed ASU	Summary of Feedback
Scope	Financial assets classified as FV-OCI and short-term receivables accounted for at amortized cost.	<ul style="list-style-type: none"> <li>• Respondents generally support the elimination of the "probable" threshold to allow for more timely recognition of losses.</li> </ul>
Recognition of impairment	No probability threshold required for recognition of impairment. All information related to past events and existing conditions is considered.	<ul style="list-style-type: none"> <li>• Respondents expressed concerns about limiting management's expectations about losses to current conditions. Many recommend that the FASB allow forecasting for the foreseeable future, but some others expressed concerns about subjectivity when management is allowed to forecast for the entire life of an instrument.</li> </ul>
Measurement of impairment	An entity measures impairment of financial assets that are individually identified as impaired by using the present value of expected future cash flows, except that the entity may use the fair value of collateral as a practical expedient to measure impairment of collateral-dependent assets. An entity measures impairment of financial assets that are assessed as a group by using a historical loss rate that is adjusted for current conditions.	<ul style="list-style-type: none"> <li>• Some respondents do not support recognition of the entire expected impairment loss up front and recommend allocating the initial estimate of expected losses over the life of the instrument.</li> </ul>
Effective interest rate (EIR)	At initial recognition, the EIR is not adjusted for initially expected future credit losses, except in the case of purchased financial assets for which credit losses are expected at the time of purchase.	<ul style="list-style-type: none"> <li>• Most respondents believe that interest income recognition should be separated from credit impairment and prefer that it is calculated on the basis of the amortized cost without any adjustment for the allowance.</li> </ul>
Interest recognition	Entities calculate interest income by applying the EIR to the amortized cost basis, net of any related allowance for credit impairments.	<ul style="list-style-type: none"> <li>• Respondents prefer a single impairment model instead of distinct models for debt securities and loans.</li> </ul>
Ongoing reassessment	Ongoing reassessment is required. Changes in expected cash flows typically result in recoveries (gains) or losses.	<ul style="list-style-type: none"> <li>• Some respondents do not support the requirement to evaluate an instrument as part of a pool if it is considered not to be individually impaired.</li> </ul>



## Appendix C — Hedge Accounting

The following table summarizes (1) the proposed ASU’s provisions on hedge accounting and (2) the prevailing views from respondents’ feedback received to date.

Subject	FASB’s Proposed ASU	Summary of Feedback
Hedgeable risks	The proposed ASU retains the provision under current U.S. GAAP (ASC 815) that allows an entity to designate hedges of financial items for certain risks (e.g., benchmark interest rate risk, foreign currency risk, credit risk).	<ul style="list-style-type: none"> <li>• Respondents generally support the lower, “reasonably effective” threshold for hedge effectiveness, as well as the qualitative assessment for hedge effectiveness. However, many respondents noted a need for additional guidance on what is meant by “reasonably effective” (without setting a bright line).</li> <li>• Respondents expressed concern about the changes to the hedge dedesignation requirements.</li> <li>• Respondents support bifurcation-by-risk for financial items. Some advocate extending this approach to nonfinancial items.</li> <li>• Some respondents do not support the recognition of ineffectiveness in net income on underhedges in cash flow hedging relationships.</li> </ul>
Threshold for hedge accounting	Reasonably effective.	
Means of assessing effectiveness	Typically, only a qualitative assessment is required; however, a quantitative assessment may be necessary if the qualitative assessment is not conclusive.	
Frequency of hedge effectiveness assessments	Inception only, unless reassessment is warranted because of a change in circumstances.	
Assumption that a hedge is perfectly effective	Neither the shortcut method nor the critical-terms-match method is permitted.	
Determination of amounts recorded in OCI for cash flow hedges	Recorded at the amount necessary to offset the present value of the cumulative change in expected future cash flows on the hedged transaction since hedge inception.	
Dedesignating a hedging relationship	An entity cannot remove hedge designation after it has been established; however, the entity may enter into an offsetting derivative to effectively terminate the hedge.	

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