

Heads Up

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Consider the Consequences FASB Proposes Consequential Amendments Related to Its Proposed ASU on the Recognition and Measurement of Financial Instruments

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Introduction

On April 12, 2013, the FASB released for public comment an [exposure draft](#) (ED)¹ containing consequential amendments related to its February 2013 [proposed ASU](#)² on the recognition and measurement of financial instruments. Issued as a companion document to the proposed ASU, the ED would (1) eliminate the existing options under U.S. GAAP to electively account for financial instruments in the form of guarantees, insurance contracts, warranties, loan commitments, and firm commitments at fair value through net income (FV-NI) and (2) amend or supersede various ASC topics related to the classification and measurement of financial instruments. Comments on both the ED and proposed ASU are due by May 15, 2013. This *Heads Up* provides an overview of the significant changes proposed in the ED.

Editor's Note: Entities may wish to comment on both the proposed ASU and the ED in a single letter. For an overview of the proposed ASU, see Deloitte's February 14, 2013, [Heads Up](#).

Fair Value Option

Under the proposed ASU, the unconditional fair value option for financial assets and financial liabilities in ASC 825³ would be replaced with a conditional fair value option that would be available when:⁴

- Financial assets are held and managed in a hold-and-sell business model (i.e., otherwise accounted for at fair value through other comprehensive income).
- An entity manages the net exposure for a group of financial assets and financial liabilities on a fair value basis and provides net exposure information to its management.

¹ FASB Proposed Accounting Standards Update, *Recognition and Measurement of Financial Assets and Financial Liabilities: Proposed Amendments to the FASB Accounting Standards Codification*.

² FASB Proposed Accounting Standards Update, *Recognition and Measurement of Financial Assets and Financial Liabilities*.

³ For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's "[Titles of Topics and Subtopics in the FASB Accounting Standards Codification](#)."

⁴ This option is also available for a nonfinancial hybrid liability that contains an embedded derivative that otherwise would require separate accounting under ASC 815-15.

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- A hybrid financial liability contains an embedded derivative that significantly modifies its cash flows as long as it is clear (with little or no analysis) that separation of the embedded derivative is not precluded.

However, the ED notes that for financial assets and financial liabilities outside the scope of the proposed ASU such as the following, a fair value option would no longer be available:

- a. Guarantees and other contingencies accounted for in accordance with [ASC] 460, Guarantees, or contingencies accounted for under [ASC] 450, Contingencies, that will not be within the scope of the forthcoming proposed [ASU] on insurance contracts. The effective date and transition provisions to eliminate the fair value option for these items would be consistent with the guidance in the proposed [ASU] on financial instruments.⁵
- b. Rights and obligations under an insurance contract and obligations under a warranty that currently are accounted for under [ASC] 944, Financial Services—Insurance, or would be accounted for in accordance with the forthcoming proposed [ASU] on insurance contracts. . . .
- c. Rights under a warranty that would be accounted for in accordance with the guidance in the forthcoming [ASU] on revenue recognition. . . .
- d. Written loan commitments accounted for in accordance with the proposed [ASU] on financial instruments. . . .
- e. Firm commitments that otherwise would not be recognized at inception and that involve only financial instruments. . . . The effective date and transition provisions for these items would be consistent with the guidance in the proposed [ASU] on financial instruments.⁶

The ED notes that for financial assets and financial liabilities outside the scope of the proposed ASU, a fair value option would no longer be available.

Entities would cease using the fair value option under ASC 825 for each of these instruments in accordance with the effective date and transition method for each related project. For example, public entities would no longer be able to apply the fair value option under ASC 825 to rights under a warranty accounted for in accordance with the forthcoming final standard on revenue recognition for fiscal and interim periods that begin on or after January 1, 2017.⁷ The revenue standard will permit entities to apply the new guidance retrospectively or by using a cumulative-effect approach.⁸ The FASB has not decided what the effective dates will be for its forthcoming standard on insurance contracts or for the proposed ASU.

Editor’s Note: Replacing the unconditional fair value option with one that can be applied only in limited circumstances reduces the number of accounting choices for similar instruments and is expected to improve comparability. Improving comparability is one of the stated objectives in the proposed ASU. The ED does not propose eliminating the fair value option under ASC 860-10-35 for servicing assets and servicing liabilities.

Consequential Amendments

Superseded Guidance

The ED proposes superseding all of the guidance related to investments in debt and equity securities within the scope of ASC 320. The ED also proposes superseding the guidance on the deposit method of accounting for insurance contracts that do not transfer insurance risk in ASC 340-30 and the guidance on the cost method of accounting in ASC 325-20 since the financial instruments currently included within the scope of these subtopics would be subject to the new guidance under ASC 825-10.

⁵ The FASB currently plans to issue an ED on insurance contracts in the second quarter of 2013.

⁶ In the ED, the Board also clarifies that “physically settled forward and purchased option contracts (with no intrinsic value at inception) to purchase or sell loans that do not meet the definition of *derivative instrument* would follow the same accounting as the underlying loan in accordance with [ASC] 825-10, as amended by the proposed [ASU] on financial instruments.”

⁷ See Deloitte’s March 5, 2013, *Heads Up* for more information about the forthcoming revenue recognition standard.

⁸ Under the cumulative-effect approach, an entity would make an adjustment to the opening balance of retained earnings for the income-statement effect of remeasuring affected instruments in the year of initial adoption without restating prior periods.

In hedges of interest rate risk, hedge accounting treatment would be precluded for debt securities classified at amortized cost but not for loans and receivables accounted for at amortized cost.

The ED would also supersede or amend other classification and measurement guidance related to financial assets and financial liabilities under U.S. GAAP. Further, the FASB asks respondents to the ED to indicate whether “all guidance related to financial instruments [i.e., not just the guidance on classification and measurement] . . . should be consolidated into a single Topic.”

Other Consequential Amendments

The accounting for hybrid nonfinancial assets and liabilities would change. In the ED, the FASB notes that an entity would evaluate whether a hybrid nonfinancial asset or liability meets the criteria for separation into a host contract and an embedded derivative under ASC 815-15. If the entity determines that a hybrid nonfinancial asset would have required bifurcation into a financial host contract and a derivative and the contract is not a hybrid lease or hybrid insurance contract, the entire contract would be initially measured at fair value and subsequently accounted for at FV-NI. If an entity determines that a nonfinancial hybrid liability would have required bifurcation under ASC 815-15, the entity would have an option to account for it at FV-NI.

Entities are precluded under current U.S. GAAP from designating held-to-maturity debt securities as hedged items in hedges of interest rate risk. Because the proposed ASU would eliminate the held-to-maturity classification for debt securities, the ED proposes precluding debt securities accounted for at amortized cost from being designated as hedged items in such hedges. However, entities would still be able to designate financial assets accounted for at amortized cost that are not securities as hedged items in hedges of interest rate risk.

Editor’s Note: In justifying its prohibition under current U.S. GAAP of hedge accounting for a hedge of interest rate risk in a held-to-maturity debt security while permitting it for hedges of other financial assets accounted for at amortized cost, the FASB noted that “held-to-maturity debt securities receive special accounting . . . as a result of an asserted intent to hold them to maturity.”⁹ Under the proposed ASU, debt securities and other financial assets are no longer differentiated in the determination of whether they qualify to be accounted for at amortized cost. Therefore, some may find it surprising that, in hedges of interest rate risk, hedge accounting treatment would be precluded for debt securities classified at amortized cost but not for loans and receivables accounted for at amortized cost.

Next Steps

The ED’s effective date and transition provisions, other than the elimination of the unconditional fair value option under ASC 825, would be aligned with those of the proposed ASU. Entities would be required to apply the guidance by using a cumulative-effect approach to the statement of financial position as of the beginning of the first reporting period in which the guidance is effective.

⁹ Paragraph 429 of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (superseded).

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