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Heads Up

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Under the proposal, which affects all entities that hold financial assets or owe financial liabilities, a mixed measurement attribute approach would be applied to classification and measurement.

A Proposal on Valentine's Day
FASB Issues Proposed ASU on Classifying and Measuring Financial Instruments

by Magnus Orrell and Jason Nye, Deloitte & Touche LLP

Introduction

Today the FASB released for public comment a proposed ASU[1] on the recognition, classification, measurement, and presentation of financial instruments.[2] Comments are due by May 15, 2013. Under the proposal, which affects all entities that hold financial assets or owe financial liabilities, a mixed measurement attribute approach would be applied to classification and measurement. This *Heads Up* provides an overview of the proposed ASU, and the appendix discusses key issues in a question-and-answer format.

Editor's Note: In light of the global financial crisis and a desire to improve and converge financial reporting standards, the FASB added a project on the accounting for financial instruments to its agenda in December 2008. In May 2010, the FASB issued a proposed ASU that would have expanded the scope of fair value accounting to encompass most financial assets and financial liabilities (see Deloitte's May 28, 2010, *Heads Up*). However, most respondents favored a mixed measurement attribute model (see Deloitte's November 5, 2010, *Heads Up*). In response, the FASB substantially revised its original proposal to incorporate greater use of amortized cost measurement and, in January 2012, began joint deliberations with the IASB to converge key aspects of their respective approaches to classifying and measuring financial instruments (see Deloitte's September 24, 2012, *Heads Up*). Although important differences between U.S. GAAP and IFRSs remain, today's proposed ASU would result in greater convergence between the two models for classifying and measuring financial instruments.[3] See Q&A 7 in the appendix of this *Heads Up* for a comparison of key aspects of the two models.

[1] FASB Proposed Accounting Standards Update, *Recognition and Measurement of Financial Assets and Financial Liabilities.*

[2] Separately, the FASB recently released a proposed ASU on the accounting for credit losses on financial assets (see Deloitte's December 21, 2012, *Heads Up*).

[3] In November 2012, the IASB released an exposure draft proposing limited amendments to its requirements for classifying and measuring financial instruments under IFRS 9 (2010), *Financial Instruments.* Comments are due by March 28, 2013.

Proposed Classification and Measurement Approach

Scope

The proposal applies to all entities and to most financial instruments (e.g., receivables, payables, loans, debt securities, and equity investments). Financial instruments that are exempted from the scope of the proposed ASU include instruments classified in stockholders' equity, stock compensation arrangements, pension plan assets and obligations, lease receivables and payables, financial guarantee contracts, and derivative instruments under ASC 815.[4]

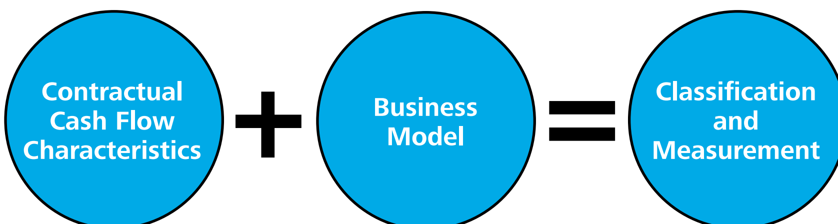
Classification of Financial Assets

The classification and measurement of financial assets depends on their contractual cash flow characteristics and the business model in which they are managed. Under the proposal, there are three principal classification and measurement categories:

- Fair value for which all changes in fair value are recognized in net income (FV-NI).
- Fair value with qualifying changes in fair value recognized in other comprehensive income (FV-OCI).[5]
- Amortized cost.

The classification and measurement of financial assets depends on their contractual cash flow characteristics and the business model in which they are managed.

The proposed ASU eliminates the guidance on embedded derivatives in hybrid financial assets and instead requires the entire instrument to be classified on the basis of the contractual cash flow characteristics criterion and the entity's business model for managing the asset. The existence of an embedded feature in a financial asset may affect the outcome of the cash flow characteristics assessment.



Contractual Cash Flow Characteristics Assessment

Under the contractual cash flow characteristics criterion, an entity assesses whether the contractual terms of a financial asset "give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding [("SPPI")]."[6] In the proposed ASU, principal is defined as "the amount transferred by the holder at initial recognition," while interest is defined as "consideration for the time value of money and for the credit risk associated with the principal amount outstanding during a particular period of time, which may include a premium for liquidity risk."

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

[5] For the FV-OCI category, the following are recognized in net income rather than OCI: interest income or expense, credit losses, changes in fair value attributable to foreign currency exchange rates, fair value hedging adjustments, and realized gains or losses from sales or settlements.

[6] The proposed ASU contains guidance on how to apply the SPPI test to financial instruments with more complex features, such as contractually linked interests and instruments with contingent cash flows or prepayment, term extension, put, call, leverage, or interest mismatch features. See Q&As 4.1 through 4.3 in the appendix for more information.

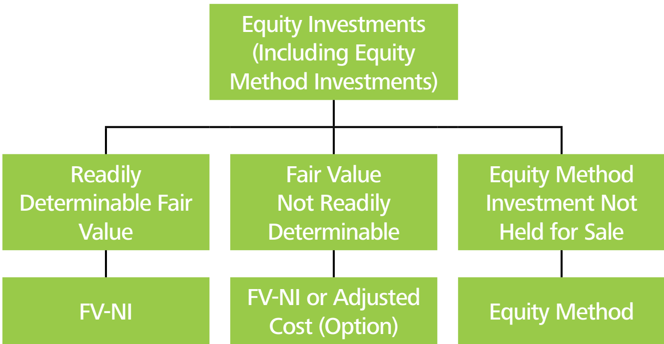
Examples of Assets That Fail to Meet the SPPI Criterion	Examples of Assets That Generally Meet the SPPI Criterion
• Investments in convertible bonds. • Investments in bonds indexed to the debtor's net income or an equity index. • Investments in inverse floaters. • Investments in equity securities or other ownership interests.	• Investments in unleveraged inflation-linked bonds indexed to inflation of the currency in which the bond is denominated. • Investments in variable-rate debt instruments with a choose-your-rate option where the reset period always matches the period covered by the interest rate. • Investments in variable-rate bonds with a cap on the interest rate. • Collateralized full recourse loan receivables.

Financial Assets That Fail to Meet the SPPI Criterion

Generally, financial assets that fail to meet the SPPI criterion are classified and measured at FV-NI. Examples include investments in equity securities and debt instruments with commodity-indexed payments. There is a practicability exception for equity investments that do not have a readily determinable fair value.[7] An entity is permitted to measure an equity investment without a readily determinable fair value at its cost minus impairment, if any, plus or minus changes resulting from observable price changes in orderly transactions for identical or similar investments of the same issuer ("adjusted cost"). Such an investment is considered impaired if it is more likely than not that the fair value is less than its carrying amount. If an impairment exists, the investment is written down to its fair value.

The proposed ASU retains the equity method of accounting for equity investees over which the entity has significant influence but limits its scope.

The proposed ASU retains the equity method of accounting for equity investees over which the entity has significant influence but limits its scope. If an investor holds an equity investment that otherwise would have qualified for the equity method for sale when it first qualified for the equity method, that investment must be accounted for at FV-NI or, if the practicability exception is available and applied, at adjusted cost rather than using the equity method. An equity method investment is considered to be held for sale if the investor has identified potential exit strategies and defined the time at which it expects to exit the investment when it first recognized the investment. An entity is not permitted to account for an equity method investment that is not held for sale at FV-NI. The impairment requirements for equity method investments are similar to those applicable to equity investments for which the entity has applied the practicability exception to account for the investment at adjusted cost.



[7] This practicability exception is not available for equity investments that qualify for the net asset value practical expedient under ASC 820-10-35-59. The exception is also not available to broker-dealers or investment companies.

Financial Assets That Meet the SPPI Criterion

Business Model Assessment

To determine the appropriate accounting for financial assets that meet the SPPI criterion (many loans, receivables, and debt securities), an entity assesses the business model in which they are managed. The entity considers factors such as how performance is evaluated by key management personnel and the frequency and volume of sales and the reason for those sales. The proposed ASU identifies three distinct business models in which an asset may be held and managed:

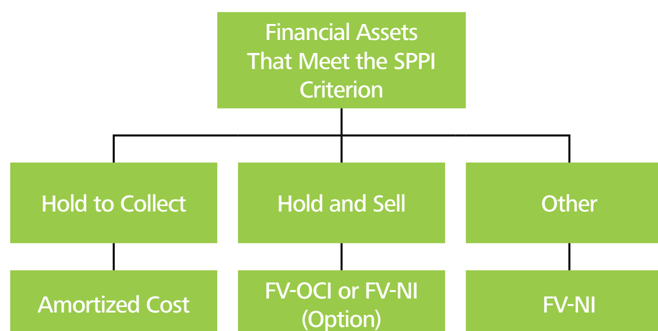
1. A business model that has the objective of holding the assets to collect contractual cash flows ("hold to collect").
2. A business model that has the objective of both holding financial assets to collect contractual cash flows and selling financial assets ("hold and sell"). In other words, the entity has not determined whether it expects to hold or sell the assets.
3. A business model with an objective that is not consistent with (1) or (2) above.

Financial assets that meet the SPPI criterion and are held in a hold-to-collect business model are accounted for at amortized cost. Managing assets to generate interest income is an example of a business activity that is consistent with the hold-to-collect business model.[8] Other than to manage credit risk, sales under such a business model should be very infrequent.

Financial assets that meet the SPPI criterion and are held in a hold-and-sell business model are accounted for at FV-OCI or, optionally, at FV-NI. An example is an entity's portfolio of financial assets that is rebalanced frequently to match the duration of its liabilities.[9]

Financial assets that meet the SPPI criterion and are held in a hold-to-collect business model are accounted for at amortized cost.

Financial assets that are held in a business model that is neither hold to collect nor hold and sell are accounted for at FV-NI. Thus, a portfolio of financial assets that are held for sale would be classified in this category.



Reclassifications

If an entity changes its business model (e.g., it shuts down a held-to-collect business and actively markets it for sale), the entity is required to prospectively reclassify related financial assets as of the last day of the reporting period during which the change occurs. The proposed ASU does not permit reclassifications for reasons other than a change in business model. Thus, a financial asset that an entity decides to sell would not be reclassified as long as the decision was not accompanied by a change in business model.[10] The proposed ASU notes that reclassifications are expected to occur very infrequently.

[8] See Q&As 5.2 and 5.3 in the appendix for examples of other activities that are consistent with the hold-to-collect business model.

[9] When FV-OCI financial assets have unrealized losses, a valuation allowance on deferred tax assets is evaluated separately from other deferred tax assets (rather than being combined and analyzed together).

[10] If an entity identifies an amortized-cost-classified financial asset as held for sale, the asset continues to be accounted for at amortized cost (less an allowance for expected credit losses) but is presented as a separate line item on the statement of financial position. However, if the instrument's fair value is less than its amortized cost (less an allowance for expected credit losses), impairment is measured as the entire difference between the asset's fair value and its net carrying amount.

Financial Liabilities

Financial liabilities are measured at amortized cost, with the following exceptions:

- Short sale obligations are accounted for at FV-NI.
- Financial liabilities for which the entity has a business strategy to subsequently transact at fair value (e.g., transfer the liability to a third party) are accounted for at FV-NI.
- Nonrecourse financial liabilities that are contractually required to be settled with only the cash flows from related financial assets are accounted for on the same basis as the related financial asset (i.e., amortized cost, FV-OCI, or FV-NI).

Unlike financial assets, embedded derivatives in financial liabilities are separately accounted for at FV-NI if they are required to be separated under ASC 815-15 unless an entity elects to account for the hybrid financial liability in its entirety at FV-NI.

The issuer of a loan commitment, revolving line of credit, or commercial letter of credit would account for the commitment in the same manner as the underlying loan to be made under the commitment (i.e., amortized cost, FV-OCI, or FV-NI) provided the probability of exercise is not remote.[11]

Fair Value Option

On initial recognition of a financial asset or financial liability, an entity may elect to account for certain financial assets and financial liabilities at FV-NI even if they would otherwise have been accounted for at amortized cost or FV-OCI. This option is available when:[12]

- Financial assets are held and managed in a hold-and-sell business model.
- 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.
- A hybrid financial liability contains an embedded derivative that significantly modifies its cash flows provided it is clear with little or no analysis that separation of the embedded derivative is not precluded.

If an entity has elected the fair value option for a financial liability, any changes in fair value attributable to instrument-specific credit risk are recognized in OCI rather than in net income.

If an entity has elected the fair value option for a financial liability, any changes in fair value attributable to instrument-specific credit risk are recognized in OCI rather than in net income.

Presentation

On the face of the statement of financial position, an entity is required to present the following:

- Financial assets and financial liabilities separately, grouped by measurement category.
- A separate line item for hold-to-collect financial assets that have been identified for sale.
- Parenthetical fair value information for all financial assets and financial liabilities accounted for at amortized cost except for receivables and payables due in less than a year and demand deposit liabilities. This requirement does not apply to nonpublic entities.
- Parenthetical amortized cost information for its own outstanding debt instruments accounted for at FV-NI.

[11] If the probability of exercise is remote, any commitment fee received is recognized over the commitment period under ASC 310-20.

[12] 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.

Effective Date and Transition

The FASB has not yet determined an effective date for the final guidance. An entity would make a cumulative-effect adjustment to the statement of financial position as of the beginning of the first reporting period for which the guidance is effective. The amendments cannot be early adopted, except for the presentation in OCI of fair value changes attributable to instrument-specific credit risk for hybrid financial liabilities for which the fair value option is available and applied.

Editor's Note: Watch for upcoming Deloitte *Heads Up* newsletters with additional analysis and insights related to the proposal. Also, join us on February 20, 2013, for a *Dbriefs* webcast on the status of the financial instruments project.

Appendix — Q&As

1. The FASB's Objectives

Question 1.1

What are the FASB's objectives in this project?

Answer

The FASB intends for the proposal to result in "more decision-useful information about an entity's involvement in financial instruments, while reducing the complexity in accounting for those instruments." The guidance is intended to link "the measurement of financial assets to the way in which an entity expects to benefit from the cash flows embedded in those assets." That is, the proposed ASU would link measurement of a financial instrument to both the cash flow characteristics of the instrument and the entity's business model for managing financial instruments. In contrast, current U.S. GAAP emphasizes an instrument's legal form (e.g., whether the instrument is a debt security or a loan receivable) and management's intentions.

The FASB also seeks to improve the clarity and organization of the guidance on classification and measurement to make it easier to understand and apply. The proposal reduces complexity by (1) aligning the classification of investments in debt securities and loan receivables, (2) limiting the scope of the fair value option,[13] and (3) eliminating the bifurcation of hybrid financial assets.

In addition, to increase convergence between the FASB's guidance and IFRS 9, the FASB and IASB jointly deliberated key aspects of their respective models.

2. Impact of the Proposed ASU

Question 2.1

What types of entities and industries will be affected by the FASB's proposal?

Answer

Virtually all entities hold financial assets or owe financial liabilities and, thus, would be affected by the proposal. Entities in the financial services industry, such as banks and insurance companies, are expected to be affected the most, since typically the majority of their assets and liabilities are financial assets and liabilities. Entities in industries for which the FASB is proposing to retain specialized industry guidance will not necessarily have to change all aspects of their accounting for financial instruments (e.g., investment companies will continue to apply the specialized industry guidance in ASC 946).

Question 2.2

What types of financial instruments will be affected, and in what category would an entity generally classify these instruments under the FASB's proposal?

Answer

The proposal addresses the accounting for a broad range of financial assets and financial liabilities, including investments in debt and equity securities, loans, trade receivables, trade payables, and issued debt financing.

The table below illustrates likely classifications of common types of financial instruments under current U.S. GAAP and the FASB's proposed guidance. Note that an entity's classifications may differ on the basis of facts and circumstances (such as an entity's business model).

Instrument[14]	Current U.S. GAAP	FASB's Proposed ASU
Investments in marketable[15] equity securities that are held for trading and for which the investor does not have significant influence over the investee	FV-NI	FV-NI
Investments in marketable equity securities that are not held for trading and for which the investor does not have significant influence over the investee	FV-OCI or, optionally, FV-NI	FV-NI

[13] Replacing the unconditional fair value option with one that can be applied only in limited circumstances reduces the number of accounting choices entities can use to account for similar instruments. This is expected to improve comparability.

[14] The terminology in this column is based on current U.S. GAAP (e.g., equity securities may be classified as "trading securities" under ASC 320, but the proposed ASU does not contain a similar designation).

[15] A marketable security is one that has a readily determinable fair value whereas a nonmarketable security does not have a readily determinable fair value.

Instrument	Current U.S. GAAP	FASB's Proposed ASU
Nonmarketable equity investments for which the investor does not have significant influence over the investee	Cost or, optionally, FV-NI	FV-NI or, optionally, adjusted cost[16]
Equity investments that are not held for sale at inception and for which the investor has significant influence over the investee	Equity method (i.e., at cost with adjustments for proportionate earnings or losses) or, optionally, FV-NI	Equity method
Equity investments that are held for sale at inception and for which the investor has significant influence over the investee	Equity method or, optionally, FV-NI	FV-NI or, optionally, adjusted cost[16]
Investments in debt securities held for trading	FV-NI	FV-NI
Investments in debt securities that are neither held for trading nor held to maturity	FV-OCI or, optionally, FV-NI	FV-OCI or, optionally, FV-NI
Investments in debt securities for which the investor has the intention and ability to hold to maturity	Amortized cost or, optionally, FV-NI	Amortized cost
Loans and receivables held for sale	Lower of cost or fair value or, optionally, FV-NI	FV-NI
Loans and receivables held for investment in a held-to-collect business model	Amortized cost or, optionally, FV-NI	Amortized cost
Issued debt securities	Amortized cost or, optionally, FV-NI	Amortized cost
Hybrid financial assets	Bifurcate embedded derivative if certain conditions are met or, optionally, FV-NI for the hybrid in its entirety	FV-NI (i.e., without bifurcation), provided that the feature results in cash flows that are not solely principal and interest
Hybrid financial liabilities	Bifurcate embedded derivative if certain conditions are met or, optionally, FV-NI for the hybrid in its entirety	Bifurcate embedded derivative if certain conditions are met; FV-NI option generally available for hybrid in its entirety

3. Classification and Measurement of Financial Assets

Under the proposed ASU, an entity classifies a financial asset by assessing the contractual cash flows of the instrument and the business model in which the instrument is managed. Both assessments are performed at initial recognition. Hybrid financial assets would be classified in their entirety and would not be bifurcated.

Editor's Note: In its Basis for Conclusions for the proposed ASU, the FASB notes that an entity would first assess the contractual cash flow characteristics of the instrument and then assess the business model in which the asset is managed. Although the sequence of assessing the criteria is not expected to result in different outcomes, assessing the cash flow characteristics criterion before the business model may result in unnecessary work if, for example, an entity knows that the business model in which an asset will be managed would not permit a classification other than FV-NI.

Question 3.1

Does the proposed ASU require entities to account for all financial assets at FV-NI?

Answer

No. The FASB proposes a mixed-attribute model under which financial assets are accounted for at FV-NI, FV-OCI, or amortized cost on the basis of their cash flow characteristics and the business model in which they are managed. Equity investments are accounted for at FV-NI unless (1) they result in consolidation, (2) the equity method of accounting applies, or (3) the investment does not have a readily determinable fair value and the entity has elected to apply a practicability exception.

[16] Entities holding nonmarketable equity interests may measure such investments at cost adjusted for impairment and observable price changes in identical or similar instruments from the same issuer.

Question 3.2

When is a financial asset accounted for at something other than FV-NI?

Answer

The proposed ASU states that a "financial asset is classified at something other than [FV-NI] if it meets the contractual cash flow characteristics criterion and is managed within a business model" for which related objectives are consistent with subsequent measurement at amortized cost or FV-OCI. See Q&As 4.1, 4.2, and 5.1 through 5.5 for more information.

Question 3.3

Does the level of market activity for an asset (i.e., the liquidity of the market for the asset and the extent to which market transactions in the asset are occurring) affect its classification?

Answer

In classifying financial assets other than equity investments, an entity would not necessarily consider the level of market activity. From a practical perspective, however, the level of market activity may influence the frequency and volume of the entity's sales. An entity must consider whether its business activities for managing financial instruments are consistent with the "hold-to-collect" or "hold-and-sell" business model assessments (i.e., amortized cost or FV-OCI classifications, respectively). An entity should consider, among other things, the "frequency and volume of sales in prior periods, why sales have occurred in the past, and expectations about the sales activity in the future."

The proposal contains an elective practicability exception from FV-NI for equity investments that do not have a readily determinable fair value (e.g., because price quotations on a securities exchange are not available).

Question 3.4

Does the FASB propose any changes to the fair value option for financial instruments that is available under existing U.S. GAAP?

Answer

Yes. The existing unconditional fair value option for financial instruments within the proposal's scope would be replaced with a conditional option. The proposal states that under this option, an entity may irrevocably elect to account for the following instruments at FV-NI:

- [A] group of financial assets and financial liabilities for which both of the following conditions are met:
  a. The entity manages the net exposure relating to the financial assets and financial liabilities (which may be derivative instruments subject to Topic 815) on a fair value basis.
  b. The entity provides information on a net exposure basis to its management.
- [A] hybrid financial liability provided that neither of the following conditions exists:
  a. The embedded derivative or derivatives do not significantly modify the cash flows that otherwise would be required by the contract
  b. It is clear with little or no analysis when a similar hybrid instrument is first considered that separation of the embedded derivative or derivatives is prohibited.

In addition, an entity may irrevocably elect to account for an instrument that qualifies for the FV-OCI classification at FV-NI.

Changes in the fair value of a financial liability for which the fair value option has been elected are presented separately in OCI rather than in net income to the extent that they result from a change in instrument-specific credit risk. Cumulative gains and losses recognized in OCI that are associated with changes in instrument-specific credit risk are recognized in net income upon the settlement of the liability.

Question 3.5

How would an entity classify and measure investments in equity instruments?

Answer

The proposed ASU notes that an "entity shall subsequently measure an equity investment [(e.g., investments in ownership interests in an entity, including equity securities)] at [FV-NI] unless":

1. The investment must be accounted for under the equity method of accounting.
2. The investment results in consolidation of the investee.
3. The investment does not have a readily determinable fair value and is accounted for under a practicability exception.

Practicability Exception

The exception noted in (3) above only applies to equity investments without a readily determinable fair value that do not qualify for the practical expedient to estimate fair value by using net asset value per share (or its equivalent) under ASC 820. Under the exception, an entity may measure its equity investment at cost less impairment, plus or minus changes resulting from observable price changes in orderly transactions for the identical investment or a similar investment of the same issuer.

An equity investment that is accounted for under the exception described above "is impaired if it is more likely than not that the fair value of the investment is less than its carrying value." An entity must perform this assessment each reporting period by qualitatively considering certain impairment indicators, including:

a. A significant deterioration in the earnings performance, credit rating, asset quality, or business prospects of the investee

b. A significant adverse change in the regulatory, economic, or technological environment of the investee

c. A significant adverse change in the general market condition of either the geographic area or the industry in which the investee operates

d. A bona fide offer to purchase, an offer by the investee to sell, or a completed auction process for the same or similar investment for an amount less than the cost of that investment

e. Factors that raise significant concerns about the investee's ability to continue as a going concern, such as negative cash flows from operations, working capital deficiencies, or noncompliance with statutory capital requirements or debt covenants.

Equity Method of Accounting

Equity investments that give the investor significant influence over the investee are accounted for under the equity method of accounting unless the investment is held for sale at the moment significant influence is established. The proposed ASU states that an equity investment is held for sale if both of the following indicators are present:

- The investor has identified potential exit strategies even though it may not yet have determined the specific method of exiting the investment.
- The investor has defined the time at which it expects to exit the investment, which may be either an expected date or range of dates or a time defined by specified facts or circumstances, such as achieving specified milestones or the stated investment objectives of the investor.

If an equity investment that otherwise would qualify for the equity method of accounting is held for sale, it is accounted for at FV-NI or by using the practicability exception.

4. Assessing the Cash Flow Characteristics of Financial Assets

A financial asset satisfies the contractual cash flow characteristics criterion if the contractual terms "give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding [SPPI]." Principal is defined as the "amount transferred by the holder at initial recognition," while interest is defined as "consideration for the time value of money and for the credit risk associated with the principal amount outstanding during a particular period of time, which may include a premium for liquidity risk."

Further, if "the contractual cash flows include payments that are unrelated to principal, the time value of money, and the credit risk, the contractual cash flows do not represent [SPPI]." In such case, the instrument must be accounted for at FV-NI.

Editor's Note: The principal amount is defined as the amount transferred at initial recognition rather than the principal amount defined in the contract or the amount originally funded to the debtor. These definitions of principal and interest potentially could disqualify many purchased prepayable debt instruments from meeting the SPPI criterion. For example, if a loan is prepayable at its contractual principal amount by the borrower and is purchased at a significant discount to par (e.g., because it is credit impaired), it may be argued that the lender potentially could realize a return that is significantly higher than the compensation would be for the time value of money and the credit risk on the principal amount outstanding.

Question 4.1

How does an entity assess contractual terms that change the timing or amount of cash flows, including changes in cash flows contingent upon the occurrence of a particular event or change in circumstances?

Answer

A contractual term may give rise to contingent cash flows (i.e., changes in the timing or amount of cash flows) that are SPPI. A contingent term that results in cash flows that are not SPPI would cause an asset to fail to meet the SPPI criterion regardless of the probability of the contingent event occurring unless the contingent event is extremely rare, highly abnormal, and very unlikely to occur.

Prepayment and extension options may change the timing or amount of cash flows. The proposed ASU provides implementation guidance on prepayment terms or extension options.

- Prepayment provisions give rise to cash flows that are SPPI if both of the following conditions are met:
  a. The provision is not contingent on future events, other than to protect . . .
     1. The holder against the credit deterioration of the issuer (for example, defaults, credit downgrades, or loan covenant violations) or a change in control of the issuer [or]
     2. The holder or issuer against changes in relevant taxation or law.
  b. The prepayment amount substantially represents unpaid amounts of principal and interest on the principal amount outstanding, which may include reasonable additional compensation for the early termination of the contract.
- Extension options give rise to cash flows that are SPPI if both of the following conditions are met:
  a. The provision is not contingent on future events, other than to protect . . .
     1. The holder against the credit deterioration of the issuer (for example, defaults, credit downgrades, or loan covenant violations) or a change in control of the issuer [or]
     2. The holder or issuer against changes in relevant taxation or law.
  b. The terms of the contractual provision result in contractual cash flows during the extension period that are [SPPI].

Question 4.2

Background

The proposed ASU states that "[c]ash flows that are interest always have a close relation to the amount advanced to the debtor (that is, the funded amount) because interest is consideration for the time value of money and for the credit risk associated with the issuer of the instrument and with the instrument itself." Contractual terms that create leverage or that require interest rates to reset for a period that does not match the period covered by the interest rate would "modify" the relationship between principal and the time value of money and credit risk associated with the principal amount outstanding.

Question

Under the proposed ASU, how does an entity assess terms that "modify" the relationship between principal and interest (i.e., leveraged interest and interest mismatch features)?

Answer

The general principle is that a contractual term that modifies the economic relationship between principal and interest causes an asset to fail to meet the SPPI criterion if it could result in cash flows that are more than insignificantly different from the cash flows of a comparable financial asset (i.e., a benchmark instrument) that excludes the modifying term.

Terms That Create Leverage

The proposal notes that "[m]ore than insignificant leverage increases the variability of the contractual cash flows so that they do not have the economic characteristics of interest." An example of a term that creates leverage is an interest rate equal to LIBOR multiplied by two.

Interest Rate Reset

Some variable-rate debt instruments have an interest rate reset period that is different from the time period covered by the rate (e.g., a constant maturity bond or a loan that pays one-month LIBOR reset only every third month). Because of the mismatch between the tenor of the interest rate and the reset period, such terms are considered to modify the economic relationship between principal and interest.

Assessing the Modifying Term

An "entity is required to assess the modification to the economic relationship to determine whether the contractual cash flows represent [SPPI]." An entity assesses the modification by comparing the cash flows of the instrument in question to the cash flows of a benchmark instrument. The benchmark instrument is a "contract of the same credit quality and with the same contractual terms, except for the contractual [provision] under evaluation." If the cash flows are more than insignificantly different, the instrument fails to meet the SPPI criterion.

Question 4.3

What conditions must be met for a beneficial interest in a securitized financial asset to meet the contractual cash flows characteristics criterion?

Answer

As stated in the proposed ASU,

> A beneficial interest in a securitized financial asset gives rise to contractual cash flows that are solely payments of principal and interest on the principal amount outstanding if all of the following conditions are met:
>
> a. The contractual terms of the beneficial interest being assessed for classification (without looking through to the underlying pool of financial instruments) give rise to cash flows that are [SPPI] (for example, the interest rate on the beneficial interest is not linked to a commodity index). A tranche is deemed to satisfy this condition if it otherwise would have payments that are solely principal and interest but is prevented from meeting this requirement solely because it is prepayable if a prepayment occurs in the underlying pool.
>
> b. The underlying pool of financial instruments has the following cash flow characteristics:
>
> 1. The underlying pool is required to contain one or more instruments that have contractual cash flows that are solely payments of principal and interest on the principal amount outstanding.
> 2. The underlying pool also may include instruments that do either of the following:
>
> i. Reduce the cash flow variability of the instruments in (b)(1) and, when combined with the instruments in (b)(1), result in cash flows that are solely payments of principal and interest on the principal amount outstanding (for example, an interest rate cap or floor or a contract that reduces the credit risk on some or all of the instruments in (b)(1))
>
> ii. Align the cash flows of the tranches of beneficial interests with the cash flows of the pool of underlying instruments in (b)(1) to address differences in and only in any of the following:
>
> 01. Whether the interest rate is fixed or floating
>
> 02. The currency in which the cash flows are denominated including inflation in that currency
>
> 03. The timing of the cash flows.
>
> An entity must look through until it can identify the underlying pool of instruments that are creating, rather than passing through, the cash flows. This is the underlying pool of financial instruments that (b) refers to.
>
> c. The exposure to credit risk in the underlying pool of financial instruments that are inherent in the tranche of beneficial interest is equal to or lower than the exposure to credit risk of the underlying pool of financial instruments. For example, this condition would be met if the underlying pool of instruments were to lose 50 percent as a result of credit losses and under all circumstances the tranche would lose 50 percent or less.

5. Business Model Assessment

Financial assets that meet the SPPI criterion and that are "managed together with other financial assets within a distinct business model . . . that has the objective of holding the assets to collect contractual cash flows" are accounted for at amortized cost. If an "asset is held and managed within a business model that has the . . . objective of both holding financial assets to collect contractual cash flows and selling financial assets," it is accounted for at FV-OCI. A financial asset that does meet the SPPI criterion but is not managed in a business model consistent with amortized cost or FV-OCI is accounted for at FV-NI. Further, the proposed ASU states:

> The entity's business model for managing financial assets is evidenced by the way the business is managed, including how its performance is evaluated by the entity's key management personnel. . . . The determination of the business model for managing financial assets is not driven by a single factor; rather all objective evidence that is relevant to assessing the entity's business model should be considered, including the following:
>
> a. How the performance of the business is reported to the entity's key management personnel
>
> b. How management is compensated, for example, whether the compensation is based on fair value of the assets managed
>
> c. The frequency and volume of sales in prior periods, why sales have occurred in the past, and expectations about the sales activity in the future.

Question 5.1

Does management intent affect the business model assessment?

Answer

No, not in the same way management's intentions drive the classification and measurement of investments in debt and equity securities under current U.S. GAAP. Today, a security is classified as trading, and therefore accounted for at FV-NI, if management acquires it with the **intent** of selling it within hours or days, or longer in certain cases. A security is classified as held to maturity, and therefore accounted for at amortized cost, if management has the positive **intent** and ability to hold the security to maturity.

In contrast, management's intentions do not directly affect classification under the proposed ASU. Instead, an entity classifies and

measures a financial instrument by considering the instrument's cash flow characteristics and how that asset is managed along with other financial assets in a distinct business model. However, management's intentions with respect to a particular type of financial asset may be incorporated into its policies and procedures, and therefore inform the business model's performance and activities, including the frequency and volume of sales. That is, management's intentions with respect to a single instrument will not directly affect classification under the proposed ASU. However, management's intentions may influence or be incorporated into the objective evidence relevant to assessing an entity's business model.

Question 5.2

What are examples of business activities that are consistent with a hold-to-collect business model?

Answer

Examples of activities that may be consistent with a hold-to-collect business model include:

- "A business activity that entails managing financial assets to generate interest income via collection of interest and principal over the life of the instrument."
- A "focus on managing the credit risk of the assets to maximize the collection of contractual cash flows."

However, sales of financial assets "that result from managing the credit exposure" may not be consistent with the hold-to-collect business model (see Q&A 5.3).

Question 5.3

What types of sales could be consistent with a hold-to-collect business model?

Answer

Under the proposed ASU, "[s]ales of financial assets as a result of a significant deterioration in the issuer's creditworthiness" could be consistent with a hold-to-collect business model. In addition, sales that result from the following events or circumstances could be consistent with a hold-to-collect business model:

> a. A change in tax law that eliminates or reduces the tax-exempt status of interest on debt instruments
>
> b. A major business combination or major disposition that results in an entity's reassessment of its business model and subsequent realignment of the assets managed within that business model
>
> c. A change in statutory or regulatory requirements that significantly modifies either what constitutes a permissible investment or the maximum level of investments in certain kinds of debt instruments
>
> d. A significant increase by a regulator in the industry's capital requirements that causes the entity to sell financial assets to meet regulatory requirements
>
> e. A significant increase in the risk weights of debt instruments used for regulatory risk-based capital purposes.
>
> Sales that result from events other than a significant deterioration in the issuer's creditworthiness that are isolated, nonrecurring, unusual for the entity, and result from events that could not have been reasonably anticipated would not be inconsistent with the objective of amortized cost classification.

Also, sales that occur close to maturity and for which proceeds approximate the remaining contractual cash flows may be consistent with the hold-to-collect business model.

Editor's Note: A change in statutory or regulatory requirements, an increase in regulated capital requirements, or an increase in risk weights used for regulatory risk-based capital purposes should apply to all entities subject to the regulator in question for the resultant sales to be consistent with the amortized cost business model.

Sales of financial assets "that result from managing the credit exposure because of concentrations of credit risk would not be consistent with the objective of amortized cost classification." In addition, "sales in response to changes in market interest rates, prepayment risk, or foreign exchange risk is inconsistent with the objective of an amortized cost business model."

Question 5.4

What are examples of business activities that are consistent with a hold-and-sell business model?

Answer

Examples of such activities include:

- A "business activity that entails managing exposure to interest rate risk or maintaining a certain yield profile by holding and selling financial assets in accordance with a stated risk management policy . . . . [Such] activity may entail less frequent buying and selling or rebalancing activities in stable interest rate, liquidity, and economic environments, whereas rapid or unexpected changes in market conditions may necessitate more frequent buying or selling or more significant rebalancing activities."
- Liquidity management under which an "entity may hold and sell financial assets (or rebalance the asset mix in the portfolio to achieve a better asset-liability profile) to meet an entity's liquidity needs."

Question 5.5

When would a financial asset that meets the SPPI criterion be accounted for at FV-NI?

Answer

The proposed ASU states that "[f]inancial assets [that meet the SPPI criterion but] that do not meet the business model for either amortized cost or [FV-OCI] classification would be [accounted for at FV-NI]. Holding financial assets for sale would not be consistent with the primary objective of amortized cost or [FV-OCI]."

6. Subsequent Sales and Reclassifications

An entity should "prospectively reclassify financial assets if, and only if, the business model within which the assets are held and managed changes. A change in the business model that requires reclassification of financial assets must be determined by an entity's senior management as a result of external or internal change, must be significant to the entity's operations, and must be demonstrable to external parties."

An entity should "reclassify the financial assets that are subject to a change in the business model as of the last day of the reporting period in which the change in the business model occurs."

Question 6.1

Should an entity reclassify an instrument accounted for at amortized cost when it decides to sell the instrument?

Answer

Generally, no. When an entity subsequently identifies a financial asset for sale that at recognition was classified in the amortized cost category,

> [T]he entity shall continue to classify and measure the financial asset at amortized cost (less allowance for expected credit losses) and shall recognize a related gain, if any, only when the sale is complete. If the fair value of the financial asset subsequently identified for sale is below the net carrying amount (including allowance for expected credit losses), an entity shall measure impairment . . . as the entire amount of the difference between the asset's net carrying amount and its fair value and include that impairment loss in net income.

Further, an entity is required to disclose detailed information about financial assets carried at amortized cost that it subsequently sold.

Editor's Note: If an entity subsequently identifies financial assets for sale that at recognition were classified in the amortized cost category, the entity's business model may have changed. If available evidence indicates that a change in business model has occurred, an entity should reclassify affected financial assets regardless of whether they are identified for sale.

Question 6.2

How should an entity classify and measure a pool of financial assets (e.g., a pool of originated loans) when management has not identified which instruments in the pool will be sold and which will be held for the collection of contractual cash flows?

Answer

As stated in the proposed ASU, the "entity should use its best estimates to determine the appropriate business model for the financial assets by classifying a percentage of the pool into one of the classification categories." An entity may manage "identical or similar financial assets through different business models."

Editor's Note: The proposed ASU notes that if, "at recognition, the entity has not yet determined whether it will hold the individual asset to collect contractual cash flows or sell the asset," the asset's business model is consistent with an FV-OCI classification. It is unclear how this guidance interacts with the guidance that requires an entity to allocate assets between the three classification categories when management has not identified which instruments in a pool will be sold and which will be held.

7. Comparison to IFRSs

Question 7

Will this project result in convergence with IFRSs?

Answer

In 2012, the boards deliberated key components of their respective approaches and decided to converge many aspects of their models. Nevertheless, differences between the two models remain. The table below outlines key similarities and differences between the FASB's proposed ASU and IFRS 9 (2010) as it would be amended by the IASB's November 2012 exposure draft (ED).[17]

Subject	IFRS 9 (2010) as Amended by the ED[18]	FASB's Proposed ASU
Classification and measurement categories for financial assets other than equity investments	• Amortized cost. • Fair value through other comprehensive income (FVTOCI). • Fair value through profit or loss (FVTPL).	• Amortized cost. • FV-OCI. • FV-NI.
Classification and measurement categories for financial liabilities	• Amortized cost. • FVTPL if the liability is a derivative, is acquired or incurred principally for the purpose of repurchasing it in the near term, or is part of a portfolio of financial instruments that are managed together and for which there is evidence of a recent actual pattern of profit taking. • Special guidance applies to a secured borrowing that results from an asset transfer that does not qualify for derecognition, a financial guarantee contract, or a commitment to provide a below-market loan.	• Amortized cost. • FV-NI if the liability is a derivative, a short sale, or will be subsequently transacted at fair value. • FV-NI or FV-OCI if the liability represents a nonrecourse liability settled with cash flows only from related financial assets that are accounted for at FV-NI or FV-OCI, respectively.
Classification and measurement categories for equity investments	• FVTPL with an option to irrevocably designate equity investments that are not held for trading at FVTOCI at initial recognition. Note that IFRS 9 (2010) indicates that in limited circumstances, "cost may be an appropriate estimate of fair value." • In accordance with IAS 28,[19] the equity method of accounting applies to equity investments that give the investor significant influence over the investee.[20]	• FV-NI. • Cost, adjusted for impairment, plus or minus changes resulting from observable price changes in orderly transactions for an identical or similar investment of the same issuer for equity investments that do not have a readily determinable fair value and do not qualify for the practical expedient in ASC 820 permitting investors to measure certain investments at net asset value per share. • Equity method of accounting applies to equity investments that give the investor significant influence over the investee except that such investments must be accounted for at FV-NI or at adjusted cost under the practicability exception if they are held for sale upon qualification for the equity method of accounting.

[17] IASB ED/2012/4, *Classification and Measurement: Limited Amendments to IFRS 9.*
[18] Including amendments in ED/2012/4.
[19] IAS 28 (Revised 2011), *Investments in Associates and Joint Ventures.*
[20] Venture capital organizations, or mutual funds, unit trusts and similar entities including investment-linked insurance funds may apply a fair value option when accounting for equity investments that are otherwise required to be accounted for under the equity method of accounting.

Subject	IFRS 9 (2010) as Amended by the ED	FASB's Proposed ASU
Method of classifying financial assets	Based on both the entity's business model for managing the financial assets and the contractual cash flow characteristics of the financial asset.	Based on (1) the contractual cash flow characteristics of the financial asset and (2) the business model in which the financial asset is managed.
Contractual cash flow characteristics assessment	A financial asset may be classified at something other than FVTPL if the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding. Interest is consideration for the time value of money and for the credit risk associated with the principal amount outstanding during a particular period of time (SPPI criterion). Note that principal is not explicitly defined.	A financial asset may be classified at something other than FV-NI if the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding. Interest is consideration for the time value of money and for the credit risk associated with the principal amount outstanding during a particular period of time (SPPI criterion). Note that principal is defined as the amount transferred by the holder at initial recognition.
Amortized cost classification criteria for financial assets	• The asset meets the SPPI criterion. • The asset is held in a business model whose objective is to hold assets for the collection of contractual cash flows.	• The asset meets the SPPI criterion. • The asset is held and managed in a business model whose objective is to hold the assets for the collection of contractual cash flows. Note that the implementation guidance on the amortized cost classification in the FASB's proposed ASU differs from the guidance proposed under the amendments to IFRS 9 (2010).
Classification criteria for financial assets other than equity investments to be accounted for at FV-OCI	• The asset meets the SPPI criterion. • The asset is held in a business model in which assets are managed both in order to collect contractual cash flows and for sale.	• The asset meets the SPPI criterion. • The asset is held and managed in a business model that has the objective of both holding financial assets to collect contractual cash flows and selling financial assets. That is, at recognition, the entity has not yet determined whether it expects to hold the asset to collect contractual cash flows or sell the asset. Note that the implementation guidance on the FV-OCI classification in the FASB's proposed ASU differs from the guidance proposed under the amendments to IFRS 9 (2010).
Classification of financial assets other than equity investments at FV-NI (or FVTPL)	Any financial asset that is not measured at amortized cost or at FVTOCI.	A financial asset that fails to qualify for either amortized cost or FV-OCI.
Hybrid financial instruments	• An entity measures and classifies a hybrid financial asset in its entirety, taking into consideration the instrument's contractual cash flow characteristics and the business model in which the instrument is managed. • Embedded derivatives in hybrid financial liabilities are bifurcated and accounted for separately at FVTPL when certain conditions are met.	• An entity measures and classifies a hybrid financial asset in its entirety, taking into consideration the instrument's contractual cash flow characteristics and the business model in which the instrument is managed. • Embedded derivatives in hybrid financial liabilities are bifurcated and accounted for separately at FV-NI when certain conditions are met. Note that the conditions under which embedded derivatives in hybrid financial liabilities are bifurcated differ from those under IFRSs.

Subject	IFRS 9 (2010) as Amended by the ED	FASB's Proposed ASU
Fair value option	• An entity may account for financial assets at FVTPL that would otherwise be required to be accounted for at amortized cost or FVTOCI by using an irrevocable election at initial recognition if exercising such an option eliminates or significantly reduces an accounting mismatch. • An entity may account for financial liabilities at FVTPL that would otherwise be accounted for at amortized cost by using an irrevocable election at initial recognition if (1) exercising such an option eliminates or significantly reduces an accounting mismatch or (2) a group of financial liabilities or a group of financial assets and liabilities is managed and its performance is evaluated on a fair value basis in accordance with a documented management or investment strategy and information on that basis is provided to the entity's key management personnel. Note that this option is not available for financial assets. • An entity may account for hybrid financial liabilities at FVTPL in their entirety by using an irrevocable fair value option at initial recognition unless (1) the embedded derivative or derivatives do not significantly modify the cash flows that otherwise would be required by the contract or (2) it is clear with little or no analysis when a similar hybrid instrument is first considered that separation of the embedded derivative or derivatives is prohibited. • An entity may account for an equity investment at FVTOCI that is not held for trading by using an irrevocable election at initial recognition.	• An entity may account for a group of financial assets and financial liabilities at FV-NI by using an irrevocable fair value option at initial recognition if both (1) the entity manages the net exposure related to the financial assets and financial liabilities (which may be derivative instruments) on a fair value basis, and (2) the entity provides information on a net exposure basis to key management personnel. • An entity may account for hybrid financial liabilities at FV-NI in their entirety by using an irrevocable fair value option at initial recognition unless (1) the embedded derivative or derivatives do not significantly modify the cash flows that otherwise would be required by the contract or (2) it is clear with little or no analysis when a similar hybrid instrument is first considered that separation of the embedded derivative or derivatives is prohibited. • An entity may account for a financial asset that meets the contractual cash flow characteristics criterion and is managed in a FV-OCI business model at FV-NI by using an irrevocable fair value option at initial recognition. • An entity may account for a nonfinancial hybrid liability at FV-NI in its entirety by using a fair value option if the entity determines that the hybrid liability contains an embedded derivative subject to bifurcation and separate accounting in accordance with ASC 815-15.
Reclassifications of financial assets other than equity investments	• Required if the business model changes. • Recorded as of the first day of the period after the period in which the business model changes.	• Required if the business model changes. • Recorded as of the last day of the period in which the business model changes.

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