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In This Issue:

- Background
- Recent Decisions
- Next Steps
- Other Key Issues

At its meeting on January 29, 2014, the FASB tentatively decided to abandon the business model assessment that it had developed with the IASB.

Back to Square One

FASB Abandons Converged Approach to Classification and Measurement

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The FASB is no longer pursuing a converged approach to the classification and measurement of financial instruments. At its meeting on January 29, 2014, the FASB tentatively decided to abandon the approach that it had developed with the IASB for assessing the business model in which financial assets are managed. This decision, combined with the Board's previous decision in December 2013 to abandon the contractual cash flow characteristics test that it had developed with the IASB, represents a significant change in the direction of the FASB's classification and measurement project.

This *Heads Up* discusses the FASB's recent decisions and anticipated next steps related to its classification and measurement project.

Background

On February 14, 2013, in an effort to improve and increase convergence of the FASB's and IASB's respective accounting standards for financial instruments, the FASB released for public comment a proposed ASU[1] on the recognition, classification, measurement, and presentation of financial instruments.[2] Under that proposal, the classification and measurement of financial assets would have been determined on the basis of the assets' contractual cash flow characteristics (i.e., whether their contractual cash flows are solely payments of principal and interest under the so-called SPPI test) and the business model in which the assets are managed. An entity would have been required to classify financial assets as (1) amortized cost, (2) fair value through other comprehensive income, or (3) fair value through net income. The proposal would have eliminated the requirement to analyze embedded features in hybrid financial assets for bifurcation; instead, an entity would have been required to classify a hybrid financial asset in its entirety on the basis of the asset's contractual cash flow characteristics and the entity's business model for managing the asset.

In the second half of 2013, in response to comments on the proposal, the FASB and IASB made several tentative decisions aimed at clarifying the SPPI and business model tests. In particular, the boards focused their discussions on clarifying the meaning of principal and interest and how de minimis and nonsubstantive features would be considered when entities applied the SPPI test. While some differences between the U.S. GAAP and IFRS approaches would have remained, the FASB's proposal would have resulted in greater convergence of those standards for classifying and measuring financial instruments.

[1] FASB Proposed Accounting Standards Update, *Recognition and Measurement of Financial Assets and Financial Liabilities*.
[2] See Deloitte's February 14, 2013, *Heads Up* for more information about the proposed ASU.

Recent Decisions

In December 2013, in a radical departure from the original FASB-IASB proposal, the FASB tentatively decided not to move forward with the boards' jointly developed SPPI test, noting that the test would be swapping known complexity (i.e., the bifurcation guidance in ASC 815-15[3]) for unknown complexity (i.e., SPPI). In light of this decision, the FASB also decided to retain the bifurcation requirements under current U.S. GAAP for embedded derivatives in hybrid financial assets.

The following month, the FASB tentatively decided not to proceed with the business model test. In addition, it directed its staff to further analyze, and consider targeted improvements of, current requirements related to the classification and measurement of loan receivables and investments in securities under U.S. GAAP.

In light of its tentative decision not to move forward with the boards' jointly developed SPPI test, the FASB also decided to retain the bifurcation requirements under current U.S. GAAP for embedded derivatives in hybrid financial assets.

Editor's Note: Under U.S. GAAP, several models are used to classify and measure financial instruments:

- ASC 310 contains guidance on accounting for loans and trade receivables, under which loans are classified and measured as either held for investment (amortized cost) or held for sale (cost or fair value, whichever is lower).
- ASC 320 addresses the classification and measurement of investments in debt and marketable equity securities. Under this guidance, entities classify and measure investments in securities as either trading (fair value through net income), available for sale (fair value through other comprehensive income), or held to maturity (amortized cost).
- ASC 323 governs accounting for equity method investments (unless the fair value option is elected) and investments in nonmarketable equity securities.
- ASC 325-40 delineates special accounting requirements related to beneficial interests in securitized financial assets.

Because some stakeholders view loans and debt securities as economically similar instruments that should not be subject to different accounting models solely because of their legal form, an objective of the FASB's February 2013 proposal was to replace the various classification and measurement models under current guidance with a single approach.

Next Steps

The Board's recent decisions may lead to one of the following outcomes:

- The Board develops a single classification and measurement model for both loans (including trade receivables) and investments in debt securities. Such a model would most likely be based on the existing guidance in ASC 320 on investments in securities.
- The Board retains the separate accounting guidance under U.S. GAAP for classifying and measuring investments in debt securities and loans. This alternative would result in limited changes, if any, to the current accounting models.

In either case, the Board is expected to consider (1) potential refinements to the tainting guidance in ASC 320 on investments in held-to-maturity securities and (2) the extent to which reclassification between the classification and measurement categories should be permitted or required.

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

It remains to be seen whether the proposed CECL model will govern impairment accounting for both loans and securities if the Board decides to go down the path of retaining two separate classification and measurement models for loans and securities, respectively.

Editor's Note: Like classification and measurement, impairment of debt instruments is governed by various models[4] under U.S. GAAP. The FASB's proposed current expected credit loss (CECL) model is based on a concept of expected credit losses and would apply regardless of the form of the asset (e.g., loan or debt security). It remains to be seen whether the proposed CECL model will govern impairment accounting for both loans and securities if the Board decides to go down the path of retaining two separate classification and measurement models for loans and securities, respectively.

Other Key Issues

Thus far, the FASB's redeliberations have been predominantly focused on the classification and measurement of financial assets. The Board has not yet deliberated other aspects of its proposed ASU, such as classification and measurement of financial liabilities, equity investments, and recognition of instrument-specific credit risk on financial liabilities for which a fair value option has been elected. Under the proposed ASU:

- Financial liabilities would be accounted for at amortized cost, with certain exceptions.
- Equity investments would be accounted for at fair value through net income 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.
- Instrument-specific credit risk on financial liabilities for which a fair value option has been elected would be recognized in other comprehensive income rather than in net income.

It remains to be seen what course of action the FASB will take on these other key issues.

[4] Impairments related to debt instruments are accounted for by applying the models in ASC 310-30 (formerly SOP 03-3), ASC 310-40 (formerly FAS 114), ASC 320-10-35 (formerly FSP FAS 115-2), ASC 325-40 (formerly EITF 99-20), and ASC 450-20 (formerly FAS 5), respectively.

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