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The mixed feedback poses a potential challenge to the FASB as it seeks to improve the classification and measurement of financial instruments under U.S. GAAP while still achieving convergence with IFRS 9.

Mixed Messages

Stakeholders Divided on FASB Classification and Measurement Proposal

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Introduction

On May 15, 2013, the comment period ended on the FASB's [proposed ASU](#)¹ on the recognition, classification, measurement, and presentation of financial instruments.² The proposal, which affects all entities that hold financial assets or owe financial liabilities, generated approximately 150 comment letter responses. In addition to reviewing these responses, the FASB staff performed targeted outreach, speaking with preparers, auditors, regulators, and financial statement users to gather further input on the proposal.

The opinions expressed by respondents reveal disparate views among the various stakeholders. The mixed feedback poses a potential challenge to the FASB as it seeks to improve the classification and measurement of financial instruments under U.S. GAAP while still achieving convergence with IFRS 9.³

This *Heads Up* discusses themes in the feedback on the FASB's proposed ASU. The [Appendix](#) to this *Heads Up* summarizes the feedback received by the IASB in response to its limited proposals to amend IFRS 9.

Observations Related to the Proposed Model

Overview of Proposed Model

Under the proposed model, entities would be required to classify a financial asset, on the basis of the asset's contractual cash flow characteristics and the business model in which the asset is managed along with similar assets, into one of three categories: (1) amortized cost, (2) fair value through other comprehensive income (FV-OCI), or (3) fair value through net income (FV-NI). Financial liabilities would be accounted for at amortized cost with certain exceptions.

The proposal's objectives include (1) reducing complexity, (2) improving the quality and quantity of decision-useful information by aligning the classification and measurement of financial assets with the manner in which an entity expects to benefit from a financial asset's cash flows or to pay cash flows to settle a financial liability, and (3) converging the classification and measurement guidance under U.S. GAAP and IFRSs.

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. See also Deloitte's April 16, 2013, *Heads Up* for information about the FASB's subsequent [exposure draft](#) containing consequential amendments related to the proposed ASU on the recognition and measurement of financial instruments.

³ IFRS 9, *Financial Instruments*, as would be amended by the IASB's ED/2012/4, *Classification and Measurement: Limited Amendments to IFRS 9*.

Themes in the feedback included:

- Support among respondents, including both users and preparers of financial statements, for the proposed ASU's stated objectives, tempered by the view of many that the proposed ASU does not fully meet those objectives. For example, some suggested that the proposed ASU would merely replace existing accounting complexity with new accounting complexity (e.g., the proposed ASU would eliminate the embedded derivative requirements for financial assets but introduce new cash flow characteristics criteria) and would not result in full convergence with IFRSs.
- Support among many preparers for the introduction of a business model assessment for classifying financial assets. However, many would prefer that this assessment be the primary or sole basis for classification. Further, many suggested eliminating the proposed contractual cash flow characteristics assessment.
- Strong support among users (in contrast to preparers) for the dual-assessment model.

The Contractual Cash Flow Characteristics Assessment

The Proposed Assessment

Under the FASB's proposed model, a financial asset would qualify for a category other than FV-NI if the asset's contractual cash flows give rise to solely payments of principal and interest (SPPI). In determining whether an asset's contractual cash flows are SPPI, an entity would need to assess certain features as follows:

- For terms that create leverage or an interest rate reset mismatch, the entity would compare the cash flows of its financial asset with those of a benchmark instrument that has the same terms except for the feature being evaluated.
- For prepayment and extension options, the entity would (1) determine whether the cash flows related to these features would be solely principal and interest if exercised and (2) assess whether the features are contingent on the occurrence of future events for any reason other than to provide certain protections to the holder or issuer.
- For contingent features that modify the timing or amount of cash flows, the entity would ignore the probability of the occurrence of such features. However, the proposed guidance further states that the entity would disregard such contingent features if they would affect the financial asset's cash flows "only on the occurrence of an event that is extremely rare, highly abnormal, and very unlikely to occur."
- For beneficial interests in securitized financial assets, the entity would, among other things, "look through" to the contractual cash flows of underlying assets and consider the credit risk of the beneficial interests held relative to the credit risk of the underlying pool of securitized financial assets.

Many preparers recommended eliminating the proposed contractual cash flow characteristics assessment altogether. Generally, these preparers proposed retaining the existing guidance in U.S. GAAP under which an entity determines whether a hybrid financial asset contains an embedded derivative that must be bifurcated and accounted for separately at fair value, with changes recognized in earnings. These respondents observed that current U.S. GAAP is well understood, even if complex, and that a lack of sufficient implementation guidance on the contractual cash flow characteristics assessment could lead to diversity in practice and greater complexity.

Many preparers recommended eliminating the proposed contractual cash flow characteristics assessment altogether.

Many respondents were concerned about the application guidance on beneficial interests in securitized financial assets. They expressed general disagreement with the FASB's proposed "look-through" guidance on the basis that it would be difficult to apply in practice.

In addition, many preparers expressed concern that the contractual cash flow characteristics assessment could force entities to use fair value accounting for hybrid financial assets with de minimis or otherwise immaterial features that fail the cash flow characteristics assessment. Preparers also noted that there might be an increased restatement risk as a result of an entity's accidentally overlooking nonsubstantive features that fail the assessment. Further, respondents expressed concern about applying the contractual cash flow characteristics test to purchased credit-impaired (PCI) assets because the proposed definition of "principal amount" might force many PCI assets to be accounted for at FV-NI.⁴

Many respondents were also concerned about the application guidance on beneficial interests in securitized financial assets. They expressed general disagreement with the FASB's proposed "look-through" guidance on the basis that it would be difficult to apply in practice. For example, they believed that it would be too complex and difficult to look through multiple resecuritization vehicles to identify the assets that ultimately give rise to the beneficial interests' cash flows and to gather sufficient information about those assets, including their purchase price.

Some respondents also disagreed with the proposed provision stating that for beneficial interests to pass the contractual cash flows assessment, such interests must have credit risk equal to, or less than, the average credit risk of the underlying pool. These respondents observed that as a result of this criterion, there could be fewer beneficial interests that qualify for amortized cost or FV-OCI under the proposed ASU than there would be under existing GAAP.

Several respondents indicated that if the FASB retains the contractual cash flow characteristics assessment, it should improve the assessment by:

- Changing "solely payments of principal and interest" to "primarily (or substantially) payments of principal and interest."
- Modifying the definition of "principal" to emphasize the amount lent or borrowed (although some respondents recommended not providing a definition on the grounds that the term is well understood in practice).
- Modifying the definition of "interest" to include not only the time value of money, compensation for credit risk, and liquidity premiums but also profit margins, funding costs, and servicing costs.
- Defining "time value of money."
- Ensuring that features unrelated to credit risk, leverage, or interest rate resets that are either likely to have only a small effect on cash flows or unlikely to arise in the future do not drive the classification outcome.
- Providing application guidance on the treatment of specific instruments, including:
 - Credit cards with below-market introductory rates.
 - Loans indexed to a bank's prime rate.
 - Auction-rate securities.
 - Debt-like equity instruments.
 - Loan participations.
 - Revenue bonds.
 - Adjustable-rate mortgages.

⁴ The proposed ASU defines principal as "the amount transferred by the holder at initial recognition." Loans or debt securities that are acquired at a discount and prepayable at par, for example, may fail the contractual cash flow characteristics assessment because the amount prepaid in settlement of the obligation would differ from the unpaid portion of the amount transferred at acquisition plus interest.

The Business Model Assessment

Assessing the Business Model

The proposed ASU identifies three business models in which financial assets may be held and managed:

1. *Amortized cost* — A “hold to collect” business model whose objective is to hold financial assets to collect contractual cash flows.
2. *FV-OCI* — A “hold and sell” business model whose objective is (1) to hold financial assets to collect contractual cash flows and (2) to sell the financial assets. That is, the entity has not determined whether it expects to hold its assets or to sell them.
3. *FV-NI* — A business model whose objective is inconsistent with that described in (1) and (2) above.

Respondents generally supported requiring entities to assess the business model in which they manage financial assets when they are determining how an asset should be classified. In fact, many respondents advocated using the business model assessment as the primary or sole basis for classifying financial assets.

Respondents generally supported requiring entities to assess the business model in which they manage financial assets when they are determining how an asset should be classified. In fact, many respondents advocated using the business model assessment as the primary or sole basis for classifying financial assets. However, respondents expressed the following concerns:

- Differences between the proposed ASU’s application guidance on the business model assessment and the guidance in both IFRS 9 and the IASB’s proposed amendments in ED/2012/4 could lead to divergence in practice (although the underlying principles appear to be converged).
- The proposed ASU’s application guidance on sales out of an amortized cost business model may be too restrictive — some respondents prefer the related application guidance in IFRS 9 that permits (1) infrequent sales if the volume is not significant or (2) sales of a greater volume if they occur infrequently.
- The business model objective of the FV-OCI category is unclear — for example, some respondents noted uncertainty about the level of sales that would be permissible.
- There may not be a conceptual basis for the recognition of gains and losses in other comprehensive income (although respondents generally supported the FV-OCI category).

Some respondents requested clarification about the level at which the business model assessment should be performed (e.g., at a portfolio or business unit level or at the entity level) and about the interaction between such assessment and the proposed ASU’s requirement to reclassify financial assets when there is a change in business model.

Finally, some respondents observed that the proposed ASU is unclear about how an entity should classify and measure pools of financial assets it has acquired or issued when (1) the entity intends to hold a portion of the pool to collect contractual cash flows and to sell a portion of the pool and (2) the specific assets that will be held or sold are not identified at initial recognition. The proposed ASU would require entities to allocate portions of such pools to appropriate categories; however, it does not specify whether the portions would be allocated on a pro rata basis (i.e., portions of individual assets) or on the basis of whole instruments. This lack of clarity may complicate an entity’s impairment analysis for allocated, or proportionally allocated, debt instruments and for reclassifications as a result of a change in business model.

Other Comments

Financial Liabilities

With certain exceptions, respondents strongly agreed with the FASB's proposal to require entities to account for financial liabilities at amortized cost. However, many nonusers of financial statements advocated retaining the fair value option currently in U.S. GAAP, which would enable preparers to account for financial liabilities (and financial assets) at FV-NI with limited restrictions.

Accounting for Equity Investments

Although the FASB seeks to retain much of the guidance under existing GAAP on investments that qualify for the equity method of accounting, the Board proposes to eliminate the fair value option for such investments and to require entities to account for an equity investment at FV-NI when the investment is held for sale at the time that it would otherwise qualify for the equity method. Under the proposed ASU, equity-method investments that are held for sale would include those for which an entity has identified (1) potential exit strategies and (2) a date or range of dates when the entity would exit the investments. A majority of respondents disagreed with the proposed change, noting that such factors are too broad and would apply to investments that an entity may intend to hold for strategic purposes on a long-term basis.

A practicability exception in the proposed ASU would permit entities to account for equity investments without readily determinable fair values at cost adjusted for impairment and observable price changes from transactions in identical or similar equity interests of the same issuer. Most respondents supported this exception.

Views were mixed on the proposed impairment model for investments accounted for under the equity method and equity investments measured under the practicability exception. Some respondents supported the proposed single-step approach, which would require a qualitative assessment of impairment indicators that may trigger measurement and recognition of differences between the equity investment's carrying amount and fair value. Others, however, supported retaining the existing other-than-temporary impairment model or requiring subsequent reversals. Further, some observed that applying the single-step impairment model to equity-method investments could effectively result in measuring such investments at the lower of equity-method valuation or fair value.

Fair Value Option

Many preparers disagreed with the FASB's proposal to eliminate the fair value option currently in ASC 825,⁵ which, subject to limited conditions, can be applied to financial assets and financial liabilities. They noted that they preferred the current guidance to the FASB's proposed, more restrictive, fair value option. Other respondents suggested that the FASB align its fair value option criteria with those proposed by the IASB.

Presentation and Disclosure

Preparers and users were split on the proposed requirement to present parenthetically, on the face of the statement of financial position, fair value information for instruments at amortized cost. Users strongly supported this proposal, whereas most preparers did not.

However, preparers and users were generally aligned in supporting the proposed requirement to present separately, in other comprehensive income, changes in fair value attributable to changes in the entity's credit risk for financial liabilities accounted for at FV-NI under the fair value option. Some respondents even requested that the requirement apply to financial liabilities for which accounting at FV-NI is mandatory, not merely optional.

Views were mixed on the proposed impairment model for investments accounted for under the equity method and equity investments measured under the practicability exception.

⁵ FASB Accounting Standards Codification Topic 825, *Financial Instruments*.

The FASB and IASB plan to redeliberate topics related to their proposals for classifying and measuring financial instruments at upcoming joint meetings. In addition, each board will separately redeliberate matters specific to its proposals.

Respondents expressed concerns about many of the other proposed presentation and disclosure requirements. For example, several respondents observed that the statement of financial position may be cluttered if entities are required to present financial instruments separately by classification category. In addition, as described in a FASB [agenda paper](#), a few respondents noted that the contemplated disclosure requirements were “voluminous [and] operationally burdensome, and would not provide incremental benefit to the users of the financial statements.”

Next Steps

At a joint meeting of the FASB and IASB on July 23, 2013, staff members announced that the boards plan to redeliberate topics related to their proposals for classifying and measuring financial instruments at upcoming joint meetings as follows:

Topics to Be Redeliberated	Planned Meeting Date
Contractual cash flows characteristics assessment	
Objective of the amortized cost measurement	September 2013
The “SPPI condition”	
Definitions of “principal” and “interest”	
Application of the SPPI condition to features such as contingent, prepayment, and de minimis features	
Business model assessment	
Whether to retain three classification and measurement categories	September 2013
How to articulate the business model objectives	
Application guidance	
Fair value option	Fourth quarter 2013
Related issues	Fourth quarter 2013

In addition, each board will separately redeliberate matters specific to its proposals. The IASB plans to separately redeliberate only its limited proposed amendments to IFRS 9; its staff projects that the IASB will complete the process by the end of 2013. The FASB will separately redeliberate other aspects of its more comprehensive proposals; it expects to issue a final ASU in the first quarter of 2014.

Appendix — Summary of Feedback From Comment Letters and Outreach Related to the IASB’s Proposed Amendments to IFRS 9

In November 2012, the IASB released ED/2012/4, which proposes amendments to IFRS 9 that are intended to (1) incorporate the tentative decisions made as part of the IASB’s project on insurance contracts, (2) address certain questions related to the application of classification and measurement requirements in IFRS 9, and (3) reduce key differences between the requirements in IFRS 9 and those in the FASB’s model.

The most significant of the proposed amendments is the introduction of FV-OCI, a new measurement category for debt-instrument financial assets. Other proposed amendments include (1) new and modified application guidance on the cash flow characteristics assessment and (2) amended language characterizing FV-NI as a residual category required for all assets not held within a business model that is consistent with either the amortized cost or FV-OCI classification.

The IASB received approximately 170 comment letters related to its proposed amendments. In addition, the IASB staff performed considerable outreach to gain a better understanding of users’ perspectives. Some themes emerging from the comment letters and outreach feedback are discussed below.

New FV-OCI Category

A majority of respondents agreed that certain debt-instrument financial assets should be classified in FV-OCI. However, respondents that agreed with the IASB’s proposal to introduce this new category were split on what criteria should require its use. Although some agreed with the IASB’s proposed business model objective to hold and sell financial assets, others proposed alternative approaches, such as making FV-OCI the residual category.

Application Guidance on the Contractual Cash Flow Characteristics Assessment

Most respondents agreed that financial instruments with terms that modify the relationship between interest and principal should still pass the contractual cash flow characteristics assessment in certain circumstances. In fact, many respondents suggested that the IASB’s proposed application guidance, including the new benchmark assessment for terms that create leverage or an interest reset mismatch, would result in more appropriate outcomes. However, many also expressed concern that as a result of the new guidance, some financial assets might fail the assessment even when the amortized cost or FV-OCI classification seems most appropriate.

FV-OCI or FV-NI as the Residual Category

Some respondents expressed a preference for making FV-OCI the residual category. A number of respondents also noted that more financial assets will be accounted for at FV-NI if FV-NI is the residual category, particularly when there is uncertainty related to the application guidance on the amortized-cost business model. However, there did not appear to be broad support for, or disapproval of, the IASB’s proposal to make FV-NI the residual category.⁶

Editor’s Note: At its July 24, 2013, meeting, the IASB tentatively voted to eliminate IFRS 9’s current mandatory effective date of January 1, 2015. The Board plans to establish a new effective date after completing other phases of its project to replace IAS 39⁷ — i.e., those related to (1) amending the guidance in IFRS 9 on classification and measurement and (2) finalizing its guidance on the impairment of financial assets.

⁶ For more information, see the IASB’s [Agenda Paper 6A](#) for the week beginning May 20, 2013, and the IASB’s [Agenda Paper 6A](#) for the week beginning June 17, 2013.

⁷ IAS 39, *Financial Instruments, Recognition and Measurement*.

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