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Heads Up

In This Issue:

While the boards' paths toward completing this project have diverged, they continue to make efforts to reconcile their differences and work toward convergence.

Extreme Makeover: FI Edition

Update on FASB's Project on Accounting for Financial Instruments

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Introduction

It's been almost a year since the FASB released its much-anticipated exposure draft (ED) on accounting for financial instruments.[1] And as expected, feedback on the ED has been extensive, causing the FASB to reexamine certain aspects of the original proposal. This reevaluation, coupled with the boards' April 21, 2011, joint progress report on their convergence efforts, has left constituents wondering what conclusions the FASB will ultimately reach on its financial instruments project. While the boards' paths toward completing this project have diverged,[2] they continue to make efforts to reconcile their differences and work toward convergence.

This *Heads Up* provides an update on recent progress in the financial instruments project, in particular (1) the FASB's tentative decisions on its classification and measurement model, (2) joint FASB/IASB decisions on impairment of financial assets, (3) feedback on the IASB's hedge accounting ED, and (4) an update on the boards' joint ED on offsetting of financial assets and financial liabilities.[3]

In addition, this *Heads Up* contains the following appendixes:

- Appendix A outlines the classification and measurement approaches (1) in the FASB's original ED and IFRS 9[4] and (2) according to the tentative decisions reached during the FASB's redeliberations.
- Appendix B summarizes the supplementary document's proposed impairment model and the boards' tentative decisions on this model to date.
- Appendix C compares the hedge accounting model in the FASB's original ED with that in the IASB's hedge accounting ED (this comparison includes the IASB's redeliberations).

[1] FASB Proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities.*

[2] These paths include (1) the FASB's original ED; (2) the boards' January 31, 2011, joint supplementary document on impairment; and (3) the IASB's December 2010 ED, *Hedge Accounting*.

[3] FASB Proposed Accounting Standards Update, *Offsetting*.

[4] IFRS 9, *Financial Instruments.*

Classification and Measurement

Although the FASB has not yet completed its redeliberations of the classification and measurement of financial instruments, it has made significant progress, including several key tentative decisions[5] on various aspects of the classification and measurement model.

Classification Categories

The FASB has tentatively agreed on the following three principal classification and measurement categories for financial instruments, thereby eliminating the remeasurement category for core deposit liabilities proposed in the original ED: (1) amortized cost, (2) fair value through other comprehensive income (FV-OCI), and (3) fair value through net income (FV-NI). The FASB has concluded that there will be no default category. That is, in contrast to the original ED, FV-NI is not identified as the default category for instruments. Instead, financial instruments are classified into one of the three categories on the basis of an evaluation of the criteria that apply to each category (see "Classification Criteria" below).

Editor's Note: The three categories are similar to those in IFRS 9 (amortized cost, fair value through profit or loss (FVTPL), and FV-OCI); however, IFRS 9 differs from the FASB's tentative decisions regarding the criteria that apply to each of the three categories.

Classification Criteria

The FASB has tentatively decided that in determining the classification and measurement category for financial instruments, an entity should evaluate both the instrument's cash flow characteristics and its business strategy for entering into such an instrument. The Board has tentatively defined the cash flow characteristics criterion as follows (reprinted from the FASB's May 4, 2011, Action Alert):

The cash flow characteristics criterion is largely consistent with the FASB's original ED.

> It is a *debt instrument* held or issued with all of the following characteristics:
>
> 1. It is not a financial derivative instrument subject to the guidance in [ASC 815[6]].
> 2. There is an amount transferred to the debtor (issuer) at inception that will be returned to the creditor (investor) at maturity or other settlement, which is the principal amount of the contract adjusted by any discount or premium at acquisition.
> 3. The debt instrument cannot contractually be prepaid or otherwise settled in such a way that the investor would not recover substantially all of its initial investment, other than through its own choice.

Editor's Note: The cash flow characteristics criterion is largely consistent with the FASB's original ED. However, the Board tentatively amended the criterion (1) to clarify that derivative instruments accounted for under ASC 815 do not meet the criterion and (2) for other minor changes. The Board also noted that trade receivables and trade payables would generally meet the cash flow characteristics criterion (discussed below).

Although an entity would assess the cash flow characteristics of each instrument individually, it would assess the business strategy at a higher level of aggregation and would not be prevented from classifying identical or similar financial instruments differently if they relate to different business activities. Financial instruments that do not meet the cash flow characteristics criterion would be classified and measured at FV-NI. Those that do meet the cash flow characteristics criterion would be classified and measured on the basis of an entity's business strategy. The FASB has tentatively decided on the following revisions to the business strategy criterion that applies to each of the three categories:

[5] As of the FASB's May 4, 2011, board meeting.

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

Amortized Cost

For financial instruments to be classified and measured at amortized cost, the business activity must meet all of the following conditions (reprinted from the FASB's April 6, 2011, Action Alert):

1. Financial instruments issued or acquired for which an entity's business strategy, at origination or acquisition of the instrument, is to manage the instruments through customer financing (lending or borrowing) activities. These activities primarily focus on the collection of substantially all of the contractual cash flows from the borrower or payment of contractual cash flows to the lender.
2. Financial instruments for which the holder of the instrument has the ability to manage credit risk by negotiating any potential adjustment of contractual cash flows with the counterparty in the event of a potential credit loss. Sales or settlements would be limited to circumstances that would minimize losses due to deteriorating credit.
3. Financial instruments that are not held for sale (assets) or transfer (liabilities) at acquisition or issuance.

Editor's Note: The new business strategy criteria for the amortized cost category represent a significant change from the FASB's original ED. Although the Board has yet to fully redeliberate the impact of the classification and measurement criteria on financial liabilities, we believe, on the basis of the tentative decisions to date, that "plain vanilla" debt instruments, including loan assets, core deposit liabilities, and an entity's debt obligations, often would qualify for amortized cost measurement.

The new business strategy criteria for the amortized cost category represent a significant change from the FASB's original ED.

Fair Value Through Other Comprehensive Income

For financial instruments to be classified and measured at FV-OCI, the business activity must meet all of the following conditions (reprinted from the FASB's April 6, 2011, Action Alert):

1. Financial assets issued or acquired in a business activity for which an entity's business strategy, at origination or acquisition of the instruments, is to invest the cash of the entity *either* to:
   a. Maximize total return by collecting contractual cash flows or selling the instrument
   b. Manage the interest rate or liquidity risk of the entity by either holding or selling the instrument.
2. Financial assets that are not held for sale at acquisition or issuance.

Editor's Note: Unlike the original ED, the FASB's tentative decisions would limit the FV-OCI category to financial assets; the category would no longer be elective. Further, under the FASB's tentative decisions, only debt instruments that meet the business strategy criterion and cash flow characteristics criterion would be classified in FV-OCI. This proposal differs from IFRS 9, under which the FV-OCI classification is limited to nontrading equity instruments for which an entity has made an irrevocable election at initial recognition.

Fair Value Through Net Income

For financial instruments to be classified and measured at FV-NI, the business activity must meet either of the following conditions (reprinted from the FASB's April 6, 2011, Action Alert):

1. Financial instruments that are held for sale (assets) or transfer (liabilities) at acquisition
2. Financial instruments that are actively managed and monitored internally on a fair value basis but do not qualify for the FV-OCI category.

Editor's Note: In a significant change from the FASB's original ED, FV-NI is no longer the default category and is instead limited to financial instruments in an entity's held-for-trading and held-for-sale activities.

Reclassification and Sales

The FASB has tentatively decided that (1) reclassification between classification categories will not be permitted even if there is a change in an entity's business strategy and (2) subsequent sales of financial assets in the amortized cost category will not "taint" the classification of other financial assets in that category. In addition, the FASB has tentatively decided that financial assets classified and measured at amortized cost at initial recognition that are subsequently identified for sale would be measured at amortized cost subject to an impairment approach. The Board plans to develop this approach as part of the impairment component of the financial instruments project; however, the Board noted that such assets would be marked down to fair value if fair value is lower than amortized cost. The adjustment necessary to report such a financial asset at fair value (when fair value is lower than amortized cost) would be recognized in earnings.

Editor's Note: The FASB plans to further develop the impairment approach at future meetings, which will address impairment not only of financial assets classified as amortized cost but also of those classified as FV-OCI. In addition, the Board plans to deliberate and develop alternative disclosures (including rollfoward disclosures) that would convey the amount and nature of, and reasons for, subsequent sales of financial assets that are initially classified and measured at amortized cost and subsequently identified for sale.

The FASB's tentative decision differs from the requirements in IFRS 9, under which a financial asset must be reclassified upon a change in the entity's business model; however, such reclassification is expected to be infrequent.

The FASB has tentatively agreed to reaffirm its previous consensus that marketable equity securities should be measured at FV-NI.

Recycling

The FASB has reaffirmed its previous decision that gains and losses on financial assets classified as FV-OCI would be recognized in net income (i.e., "recycled") when such gains and losses are realized from sales or settlements or an asset is impaired.

Editor's Note: The FASB's tentative decision on recycling differs from the requirements in IFRS 9, which prohibits recycling of gains and losses from FV-OCI into net income even if they are subsequently realized through sale or settlement.

Equity Securities

The FASB has tentatively agreed to reaffirm its previous consensus that **marketable** equity securities should be measured at FV-NI. In addition, the FASB has tentatively decided that **nonmarketable** equity securities should also be measured at FV-NI; however, nonpublic entities would be provided a practicability exception under certain circumstances.

The Board also tentatively concluded that when the practicability exception is used, a nonmarketable equity security would be (1) measured at cost less any other-than-temporary impairments and (2) adjusted for any observable changes in the price of the instrument.

Editor's Note: Although the Board has tentatively agreed to limit the practicability exception to nonpublic entities, the Board has instructed the staff to explore other potential circumstances in which the exception should be made available (e.g., for public entities) and, conversely, whether the scope should be further refined (e.g., by limiting the exception to nonfinancial, nonpublic entities). The Board has also instructed the staff to further develop the concept of an observable change in the price of an instrument as well as the impairment model to use when the exception is applied.

The Board's tentative decisions regarding equity securities, including the use of a practicability exception for nonpublic entities, do not apply to entities subject to specialized industry accounting guidance, such as broker-dealers, investment companies, sponsors of defined benefit plans, and insurance companies. The Board will address specialized industry accounting at a later date. In addition, the Board has yet to redeliberate its proposal in the original ED to limit the scope of equity method accounting.

The FASB's tentative decision on equity securities differs from IFRS 9, which permits an entity to irrevocably elect, at initial recognition, to classify and measure equity securities at FV-OCI. In addition, IFRS 9 indicates that, in limited circumstances, cost may be an appropriate estimate of fair value for unquoted equity instruments.

Hybrid Financial Instruments

The FASB tentatively decided to retain the bifurcation requirements in ASC 815-15 for embedded derivatives in hybrid financial instruments.

The FASB tentatively decided to retain the bifurcation requirements in ASC 815-15 for embedded derivatives in hybrid financial instruments. Therefore, in a manner consistent with current GAAP, an embedded feature that meets the bifurcation requirements in ASC 815-15 would need to be bifurcated and accounted for separately as a derivative instrument. This represents a significant change from the original ED, under which an entity would have measured a hybrid financial instrument with such an embedded feature at fair value. In other words, under the original ED, an embedded derivative feature would not have been separated; instead, the presence of an embedded derivative feature could have caused the entire hybrid financial instrument to be measured at FV-NI.

Editor's Note: During the redeliberations, the Board noted that this decision is an "interim decision" since the FASB is working on further developing its overall classification and measurement model. Furthermore, the Board indicated that it may explore an alternative model for hybrid instruments at a later date when it meets with the IASB to discuss convergence on the financial instruments project.

Under IFRS 9, the embedded derivative guidance is eliminated for hybrid financial assets within its scope; however, IFRS 9 retains the embedded derivative guidance for hybrid financial liabilities.

Certain Convertible Debt Instruments

The Board reached a tentative decision on how an issuer should account for certain convertible debt instruments in which the conversion feature (1) qualifies for the scope exception in ASC 815-10-15-74(a) (formerly paragraph 11(a) of Statement 133[7]) and (2) meets the requirements in ASC 470-20-25-10 through 25-16 related to a nonbeneficial conversion feature. The Board concluded that such instruments should be measured at amortized cost in their entirety.

[7] FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities.*

Editor's Note: The Board's tentative decision is limited to convertible debt instruments that meet the two conditions above; such instruments would continue to be accounted for under current U.S. GAAP. Specifically, these instruments include convertible instruments (1) that do not contain embedded derivative instruments because they meet the scope exception in ASC 815-15 (i.e., they are indexed to an entity's own stock and classified in shareholders' equity) and (2) for which no portion of the proceeds (from issuance) is allocated to the conversion feature. The Board directed the staff to determine how the business strategy criterion should be amended to reflect the accounting for such instruments. Note also that issued convertible debt instruments that do not meet the conditions above would also continue to be accounted for under current U.S. GAAP. The Board concluded that it would not change the issuer's accounting for convertible debt instruments at this time since the Board has a separate joint project (currently on hold) on financial instruments with characteristics of equity.

Next Steps

Although the FASB continues to make steady progress on its classification and measurement model for financial instruments, it still needs to redeliberate many aspects of this model, including the scope of the final standard, classification and measurement of financial liabilities, the fair value option for financial assets and financial liabilities, accounting for loan commitments, equity method accounting, presentation and disclosures, and specialized industry accounting. The FASB expects to complete these redeliberations over the next few months, after which it plans to discuss its new model with the IASB. The IASB has indicated that it will issue for public comment an invitation to comment on any proposal issued by the FASB. For its part, the FASB has indicated that it plans to issue for public comment, in the second half of 2011, proposed ASC amendments resulting from the new classification and measurement model.

The boards tentatively decided that the calculation of amortized cost for a financial asset would not include a reduction for the credit impairment allowance.

Impairment of Financial Assets

On January 31, 2011, the boards jointly issued a supplementary document[8] for comment as a follow-up to the FASB's original ED and the IASB's November 2009 ED on credit impairment.[9] The supplementary document would replace the incurred loss impairment models under U.S. GAAP and IFRSs with an expected loss impairment model. However, the supplementary document only focuses on when and how credit impairment should be recognized; it does not address other aspects of the accounting for impairment of financial assets. Subsequently, the boards have discussed other impairment-related issues and have reached tentative decisions[10] on some of them. The paragraphs below summarize these decisions as well as the boards' outreach activities and comment letter feedback received thus far in connection with the impairment of financial assets.

Amortized Cost Measurement

The boards tentatively decided that the calculation of amortized cost for a financial asset would not include a reduction for the credit impairment allowance.

Editor's Note: This is a significant change from the boards' respective EDs on impairment. Under the earlier proposals, an entity determining interest revenue would have applied the effective interest rate to an amortized cost balance that is reduced for credit impairment. However, constituents' feedback indicated that linking the calculation of interest income to an amortized cost balance that is reduced for credit impairment would be operationally challenging and would limit a financial statement user's ability to analyze net interest margin and credit losses separately.

[8] For more information about the proposals in the supplementary document, see Deloitte's February 8, 2011, *Heads Up*.

[9] IASB Exposure Draft, *Financial Instruments: Amortised Cost and Impairment*.

[10] As of the FASB/IASB April 14, 2011, joint board meeting.

Estimating Expected Losses

The supplementary document describes the information an entity should consider in estimating expected losses but does not provide guidance on which method the entity should use in making these estimates. Subsequently, the boards tentatively decided that an expected value approach should be used to estimate expected losses (i.e., a probability-weighted-average approach) but acknowledged that other reasonable methods of approximating expected values would be permitted. Such methods would incorporate use of information about loss rates, probability of default, loss given default, and exposure at default.

Discounting a Loss Estimate

The boards tentatively decided that the measurement of expected losses should reflect the effect of discounting. They noted that the final impairment guidance will indicate that different techniques can be used to measure the amount of discounted expected losses and that the unit of account does not need to be an individual loan. This is a change from the supplementary document, which permitted either a discounted or an undiscounted expected loss calculation under the time-proportional approach.

In addition, because the boards tentatively decided that the measurement of expected credit losses should reflect the effect of discounting, they also tentatively decided that they did not need to consider the inclusion of a nonaccrual principle in an impairment model at this time.

The boards tentatively concluded that the interest recognition model for purchased assets is based on whether an entity classifies these assets as "good book" or "bad book" assets.

Accounting for Purchased Debt

The boards tentatively decided that the basis used to recognize revenue for purchased "good book" assets would be the same as that for originated assets — that is, the effective interest rate would be determined on the basis of the contractual cash flows of the asset. However, for purchased "bad book" assets, the boards tentatively decided on a different interest recognition approach in which the cash flows expected to be received as of the purchase date, rather than the contractual cash flows, would be used to determine the effective interest rate. The boards indicated that they will revisit this decision on the basis of the feedback received on the supplementary document.

Editor's Note: The boards tentatively concluded that the interest recognition model for purchased assets is based on whether an entity classifies these assets as "good book" or "bad book" assets. The supplementary document indicates that the determination of whether a financial asset is managed in a "good book" or a "bad book" depends on the degree of uncertainty about the collectibility of the cash flows of the asset. However, for entities purchasing distressed debt, this evaluation may not be so clear. The boards indicated that they will revisit this topic when they review constituents' feedback on the differentiation between "good book" and "bad book" assets.

Defined Terms

The boards tentatively decided to define a write-off as "a direct reduction of the amortized cost of a financial asset resulting from uncollectibility." In addition, the boards tentatively decided that an asset would be considered uncollectible if an entity has no reasonable expectation of recovering it. Therefore, an asset would be partially or fully written off in the period in which the entity determines that no reasonable expectation of recovery exists.

Editor's Note: Although the definitions of "write-off" in the boards' respective EDs were largely similar, the IASB's definition stated that the entity would have "ceased any further enforcement activities." This additional language extended the period in which a balance could be written off. Respondents to the IASB's ED noted that a loss should be written off when it is incurred, regardless of whether the legal means of recovery have expired.

Presentation

The boards tentatively decided that the accretion (i.e., unwinding) of the discount in impairment losses should be included in the impairment losses financial statement line item. At a later date, the boards plan to discuss what additional disclosures should be provided about the effect of accretion on impairment losses.

Summary of Outreach Activities and Comment Letters Received

During the supplementary document's comment letter period, the FASB and IASB staffs reached out to financial statement users (e.g., buy- and sell-side analysts, regulators, and investor or analyst industry groups). Although these users generally supported the boards' objective of developing a single, converged impairment model that applies to all financial instruments, they were concerned about the lack of comparability that could result from the proposal to recognize, for assets in the "good book," an impairment allowance for the "higher of" the credit losses expected to be incurred under a time-proportional approach and those expected to be incurred within the foreseeable future. Users commented that this was a particular concern when an entity's recognition of the impairment allowance periodically changes from one approach to the other. In addition, users expressed concerns about the comparability of entities' determination of (1) the foreseeable future period and (2) when to transfer assets from the "good book" to the "bad book." Users believed that a standardized trigger for transfers from the "good book" to the "bad book" would help increase comparability.

Generally, comment letter respondents thought that the 60-day comment period was insufficient to allow proper testing of the proposals and also requested that the entire impairment model be exposed for comment.

Generally, comment letter respondents thought that the 60-day comment period was insufficient to allow proper testing of the proposals and also requested that the entire impairment model be exposed for comment.

Many U.S. respondents preferred determining the "good book" allowance on the basis of credit losses expected to occur in the foreseeable future; however, many international respondents preferred to determine this allowance by using only a time apportionment of expected lifetime credit losses. Further, many respondents suggested their own variations on the supplementary document's proposals. Respondents also expressed concern that in certain cases, regulators might override entities' use of allowable judgment under the proposals. These respondents pointed out that while, in such circumstances, a converged model would exist, its application could vary significantly from jurisdiction to jurisdiction.

Next Steps

The boards expect to issue a final standard on impairment in the second half of 2011. However, this timing depends on whether the boards decide to expose another draft standard, which at this point is not certain.

Hedge Accounting

In February 2011, the FASB issued a discussion paper (DP)[11] to obtain feedback on the IASB's hedge accounting ED. Comments on the DP were due by April 25, 2011. The FASB intends to consider the feedback received on the IASB's proposal during its redeliberations of the hedge accounting component of the financial instruments project.

The IASB has already begun redeliberating its hedge accounting ED, on which comments were due by March 9, 2011. During the exposure period, the IASB reached out to entities in all major geographical regions. The feedback received from comment letters and during outreach activities indicates that constituents generally support the overall hedging proposal. For example, constituents strongly supported (1) the proposed objective of hedge accounting, which aligns hedge accounting with an entity's risk management activities; (2) the proposed elimination of the 80 percent to 125 percent bright-line hedge effectiveness threshold to qualify for hedge accounting; and (3) permitting risk components of nonfinancial items to be hedgeable items. Constituents also noted that they would need additional implementation guidance to apply the proposal and requested that macro hedging be addressed because it will be an important part of the final standard on hedge accounting. The paragraphs below highlight some of the more significant comments received by the IASB on its hedge accounting ED.

[11] FASB Discussion Paper, *Selected Issues About Hedge Accounting.*

Objective of Hedge Accounting

A majority of the respondents expressed strong support for the proposed principle, which aligns the hedge accounting requirements with an entity's risk management activities. However, respondents also had several concerns, including the following:

- There were requests to expand the objective of hedge accounting from risk management activities that affect profit and loss to include risk management strategies that affect other comprehensive income.
- The term "risk management" is not defined in the proposal, which could lead to diversity in practice.

Hedged Items

Most respondents strongly support the proposal to permit designation of (1) risk components (financial and nonfinancial) as hedged risks, (2) aggregate exposures (i.e., synthetic exposures), and (3) layer components as hedged items, since to do so would better reflect entities' different risk management strategies. However, many respondents raised the following issues:

- Entities need more implementation guidance on non-contractually-specified risk components of nonfinancial items, since such guidance would help them identify a risk component.
- There is a need for additional clarification and implementation guidance on designating aggregate exposures.
- Respondents generally disagreed with the proposal to disallow designation of a layer component that includes a prepayment option.

Most respondents support the elimination of the 80 percent to 125 percent effectiveness threshold to qualify for hedge accounting.

Time Value of Options

Most respondents support the need to address the accounting for the time value of options and generally agree that this time value is a cost associated with a hedging relationship. However, many respondents believe that the accounting proposed for the time value of options significantly adds to the complexity of hedge accounting.

Hedge Effectiveness

Most respondents support the elimination of the 80 percent to 125 percent effectiveness threshold to qualify for hedge accounting. Respondents' feedback on hedge effectiveness included the following:

- Some requested more implementation guidance on the new principles-based approach for assessing hedge effectiveness.
- Some believe that the proposed effectiveness requirements are not stringent enough to prevent inappropriate hedges from qualifying for hedge accounting. Others suggested that the final guidance should introduce the notion of "reasonable" effectiveness without stipulating a numerical threshold.

Rebalancing

Respondents expressed mixed views regarding rebalancing of a hedging relationship. Generally, respondents support rebalancing because it reflects an entity's risk management strategy; however, some were concerned that requiring rebalancing might result in an accounting exercise rather than reflect risk management. Similarly, some believe that rebalancing should be optional rather than mandatory.

Discontinuation

Most respondents agree that hedge accounting should be discontinued prospectively when a hedging relationship ceases to meet the hedge accounting criteria. However, many believe that an entity's decision to discontinue hedge accounting should not be limited to situations in which the hedge ceases to meet these criteria but rather that it should be elective.

Fair Value Hedge Mechanics

Most respondents disagree with the proposal to defer changes in the fair value of the hedged item and the hedging instrument in other comprehensive income, since they believe there is no conceptual basis for such deferral. In addition, most respondents do not agree with reporting changes in fair value of the hedged item as a separate line item on the balance sheet.

> **Editor's Note:** For more information about the IASB's proposed hedge accounting model, see Deloitte's December 22, 2010, *Heads Up*.

Next Steps

The FASB has not yet indicated a specific timeline for when it plans to start redeliberating the hedge accounting component of the financial instruments project. However, the FASB has indicated that it expects to participate in and consider the feedback on the IASB's hedge accounting ED when it continues its redeliberations.

Offsetting of Financial Assets and Financial Liabilities

In January 2011, the FASB and IASB issued their joint ED on offsetting financial assets and financial liabilities. Comments on the offsetting ED were due by April 28, 2011. The boards held roundtables on the offsetting ED on May 3, May 6, and May 9, in London, Singapore, and Norwalk, respectively, to seek feedback from constituents. The boards plan to jointly redeliberate the comments received; their goal is to issue a final converged standard in the second half of 2011.

> **Editor's Note:** For details on the proposed offsetting criteria, see Deloitte's February 2, 2011, *Heads Up*.

Appendix A — Classification and Measurement

The following table summarizes similarities and differences between the FASB's original ED, IFRS 9, and the FASB's redeliberations of the classification and measurement of financial assets and financial liabilities (which includes a summary of tentative decisions reached by the FASB through May 4, 2011, as part of its redeliberations of the classification and measurement of financial instruments):

Subject	FASB's Original ED	IFRS 9	FASB's Redeliberations
Categories of financial assets and financial liabilities	Effectively, six categories of **financial assets** and **financial liabilities**: 1. FV-NI (default category). 2. FV-OCI (elective for qualifying debt instruments). 3. Amortized cost (elective for qualifying liabilities and short-term payables and receivables). 4. Redemption value (required for certain redeemable investments). 5. Remeasurement approach for core deposits through net income (default category for core demand deposit liabilities). 6. Remeasurement approach for core deposits through OCI (elective for qualifying core demand deposit liabilities).	Effectively, three categories of **financial assets**: 1. FVTPL. 2. Amortized cost (required for certain debt instruments). 3. FV-OCI (elective for equity investments). Effectively, three categories of **financial liabilities**: 1. FVTPL (required for trading and derivative liabilities). 2. Fair value, with changes attributable to an entity's own credit risk recognized in OCI and other changes recognized in profit or loss (also required for financial liabilities elected under the fair value option). 3. Amortized cost (required for certain debt instruments).	Effectively, three categories of **financial instruments**: 1. FV-NI (required for financial instruments held for sale (assets) or transfer (liabilities) or for financial instruments actively managed and monitored on a fair value basis). 2. FV-OCI (financial assets (1) for which an entity's business activity is "investing" and (2) that are not held for sale). 3. Amortized cost (financial instruments in lending and customer financing activities that meet certain criteria; see below). Note that the FASB has not yet redeliberated the redemption value category for certain redeemable instruments.
Criteria for amortized cost measurement	An entity has the option to elect to carry the following financial instruments at amortized cost: 1. Short-term receivables and payables (other than short-term lending arrangements, such as credit card receivables) arising in the normal course of business, and due in customary terms not exceeding one year, that meet the criteria for classification as FV-OCI (see below). 2. Financial liabilities that meet the criteria for classification as FV-OCI (see below), provided that measuring the financial liability at fair value would create or exacerbate an accounting mismatch.	A **financial asset** must be carried at amortized cost if it meets **both** of the following criteria: 1. *Business model* — The objective of the entity's business model is to hold assets to collect the contractual cash flows. 2. *Cash flow characteristics* — The asset's contractual cash flows represent payment of principal and interest. A **financial liability** must be carried at amortized cost if it is not held for trading and the entity has not elected the fair value option.	A financial instrument is carried at amortized cost if it meets the **cash flow characteristics criterion** (as discussed below) and the **business activity** meets all of the following conditions: 1. "Financial instruments issued or acquired for which an entity's business strategy, at origination or acquisition of the instrument, is to manage the instruments through customer financing (lending or borrowing) activities." 2. "Financial instruments for which the holder of the instrument has the ability to manage credit risk." 3. "Financial instruments that are not held for sale (assets) or transfer (liabilities) at acquisition or issuance." In its May 4, 2011, Action Alert, the FASB states that the cash flow characteristics criterion for financial instruments is as follows: "It is a *debt instrument* held or issued with all of the following characteristics: 1. It is not a financial derivative instrument subject to the guidance in [ASC 815].

Subject	FASB's Original ED	IFRS 9	FASB's Redeliberations
Criteria for amortized cost measurement (continued)			2. There is an amount transferred to the debtor (issuer) at inception that will be returned to the creditor (investor) at maturity or other settlement, which is the principal amount of the contract adjusted by any discount or premium at acquisition. 3. The debt instrument cannot contractually be prepaid or otherwise settled in such a way that the investor would not recover substantially all of its initial investment, other than through its own choice."
Criteria for FV-OCI classification	An entity has the option to classify a **financial asset** or **financial liability** as FV-OCI if it meets all of the following criteria: • *Cash flow characteristics* — A "debt instrument held or issued with all of the following characteristics: 1. There is an amount transferred to the debtor (issuer) at inception that will be returned to the creditor (investor) at maturity or other settlement, which is the principal amount of the contract adjusted by any original issue discount or premium. 2. The contractual terms of the debt instrument identify any additional contractual cash flows to be paid to the creditor (investor) either periodically or at the end of the instrument's term. 3. The debt instrument cannot contractually be prepaid or otherwise settled in such a way that the investor would not recover substantially all of its initial investment, other than through its own choice." • *Business strategy* — "[B]usiness strategy for the instrument is to collect or pay the related contractual cash flows rather than to sell the financial asset or settle the financial liability with a third party." • *No embedded derivative required to be separated* — It is a not a hybrid instrument for which an embedded derivative is required to be separated under existing U.S. GAAP. For instruments in this category, current-period interest accruals, credit losses, and realized gains or losses are recognized in earnings.	Upon initial recognition, an entity has the option to irrevocably elect to classify an **equity investment** as FV-OCI. For this category, both unrealized and realized gains and losses are recorded in OCI; dividend income is recorded in profit or loss unless the dividend clearly represents a recovery of part of the cost of the investment.	A financial asset is carried at FV-OCI if it meets the **cash flow characteristics criterion** (see above) and the **business activity** meets all of the following conditions: 1. Business strategy is to invest the cash of the entity to either (1) "[m]aximize total return by collecting contractual cash flows or selling the instrument" or (2) "[m]anage the interest rate or liquidity risk of the entity by either holding or selling the instrument." 2. "Financial assets that are not held for sale at acquisition or issuance."

Subject	FASB's Original ED	IFRS 9	FASB's Redeliberations
Criteria for FV-NI classification	Default measurement attribute for financial assets and financial liabilities.	• Financial assets that do not meet the amortized cost criteria or for which FV-OCI classification is not elected at initial recognition. • Financial assets and financial liabilities for which the fair value option is elected (see below).	A financial instrument is carried at FV-NI if the **business activity** meets either of the following conditions (or fails the cash flow characteristics criterion): 1. "Financial instruments that are held for sale (assets) or transfer (liabilities) at acquisition." 2. "Financial instruments that are actively managed and monitored internally on a fair value basis but do not qualify for the FV-OCI category."
Reclassification of accumulated OCI to net income	Amounts in accumulated OCI are recycled to net income upon sale, settlement, or impairment.	Amounts in accumulated OCI are permanently deferred in equity.	Same as the proposed ASU (i.e., amounts in accumulated OCI are recycled to net income upon sale, settlement, or impairment).
Equity investments	Carried at fair value, with changes in fair value recognized in earnings, except for certain redeemable investments that are carried at redemption value, with changes in the redemption value recognized in earnings.	Carried at fair value, with changes in fair value recognized in profit or loss, except for investments that an entity irrevocably elects to classify as FV-OCI on initial recognition.	Equity instruments (both marketable and nonmarketable) are classified as FV-NI. However, for nonmarketable equity securities, a practicability exception would be available for nonpublic entities only. Under the practicability exception, a nonmarketable equity security would be measured at cost less any other-than-temporary impairments and would be adjusted for any observable changes in price.
Embedded derivatives in hybrid financial contracts	Hybrid financial contracts with an embedded derivative, which currently must be bifurcated under ASC 815, would instead be measured in their entirety at fair value, with changes in fair value recognized in earnings. No embedded derivative would be bifurcated from a hybrid financial asset or liability (except for hybrid financial instruments that are outside the proposed ASU's scope). An entity is permitted to classify as FV-OCI hybrid financial contracts that meet the FV-OCI classification criteria and that contain an embedded derivative that does not require bifurcation under ASC 815.	The embedded derivative guidance is eliminated for hybrid **financial assets** (except for hybrid financial assets that are outside the scope of IFRS 9). That is, embedded derivatives would never be bifurcated from such assets. The embedded derivative guidance is retained for hybrid **financial liabilities**. That is, embedded derivatives would continue to be bifurcated from such liabilities if they meet the criteria for bifurcation.	An entity is required to bifurcate an embedded derivative from a hybrid financial instrument if it meets the bifurcation criteria in ASC 815-15.
Fair value option	No explicit fair value option.	Retained for **financial assets** but only available when a fair value designation eliminates or significantly reduces an accounting mismatch; irrevocable election at initial recognition. Retained for **financial liabilities** and available when a fair value designation eliminates or significantly reduces an accounting mismatch or an entity manages and evaluates a group of instruments on a fair value basis or the liability contains certain types of embedded derivatives. Changes in total fair value are recognized in profit or loss, with an entry to reclassify changes attributable to changes in an entity's own credit from earnings to OCI. Recycling of amounts initially recognized in OCI is prohibited.	Not yet redeliberated.

Subject	FASB's Original ED	IFRS 9	FASB's Redeliberations
Reclassification	Not permitted.	Required for a **financial asset** if the business model changes; however, changes in the business model are expected to be infrequent.	Not permitted. (Note that at future meetings, the FASB plans to discuss the presentation and disclosure requirements for financial assets classified as amortized cost that the entity subsequently sells.)

Appendix B — Impairment of Financial Assets

The following table summarizes (1) the key provisions of the boards' supplementary document on impairment of financial assets and (2) tentative decisions on this matter made by the boards since the supplementary document was published:[12]

Subject	FASB/IASB Supplementary Document	Subsequent Tentative Decisions to Date[13]
Scope	*FASB* — Loans and debt instruments managed on an "open" portfolio basis, provided that they are not measured at fair value with changes in value recognized in net income. *IASB* — Financial assets measured at amortized cost and managed on an open-portfolio basis, except for certain short-term trade receivables.	Not yet redeliberated.
Probability threshold for recognition of impairment	None.	Not yet redeliberated.
Whether an entity should consider future events when making loss estimates	Yes. Estimates of expected credit losses are based on all available information, including "reasonable and supportable forecasts of future events and economic conditions."	Not yet redeliberated.
Measurement of impairment	Measurement of impairment differs depending on whether assets are managed in a "good book" or a "bad book." *Bad book assets* — The impairment allowance equals the total of remaining lifetime expected credit losses. *Good book assets* — The impairment allowance equals the higher of (1) a portion of the remaining lifetime expected credit losses calculated by using a time-proportional ratio (i.e., the assets' weighted-average age to weighted-average life) or (2) a floor equal to all credit losses expected to occur within the foreseeable future (no less than 12 months).	Expected losses used in the "good book"/"bad book" model proposed in the supplementary document would be estimated on the basis of an objective of using an expected value approach (i.e., a probability-weighted-average approach). Reasonable methods of approximating expected values would be permitted. The measurement of expected losses should reflect the effect of discounting.
Discount accretion	Not addressed.	The accretion (i.e., unwinding) of the discount in the measurement of expected losses should be presented in the impairment losses financial statement line item.
Purchased debt instruments	Not addressed.	Entities would recognize interest income on purchased "good book" and "bad book" assets by using an effective interest rate that is determined on the basis of contractual cash flows and expected cash flows, respectively.
Effective interest rate	The IASB has decided "to 'decouple' the computation of the effective interest rate from the consideration of credit losses" for "open" portfolios.	Not yet redeliberated.
Interest recognition	Not addressed.	Interest income is calculated by applying the effective interest rate to an amortized cost basis that is not reduced for any related allowance for credit impairments.
Definition of write-off	Not addressed.	A write-off is a direct reduction of the amortized cost basis. An asset would be considered uncollectible if the entity has no reasonable expectation of recovering it. As a result, an asset would be partially or fully written off in the period in which the entity determines that no reasonable expectation of recovery exists.
Nonaccrual	Not addressed.	Because impairment is measured on a discounted basis, the boards concluded that they did not need to consider a nonaccrual principle.

[12] For more information about the FASB's and IASB's original impairment proposals, see Deloitte's May 28, 2010, *Heads Up*.
[13] As of April 14, 2011.

Appendix C — Hedge Accounting

The following table summarizes similarities and differences between the hedging model under the FASB's original ED and the hedging model under the IASB's ED on hedge accounting. The table also includes an update on the IASB's recent redeliberations of its hedging ED (through the IASB's April 27, 2011, board meeting).

Subject	FASB's Original ED	IASB's ED on Hedge Accounting	IASB's Redeliberations
Hedged Items			
Ability to designate as the hedged item an exposure that contains a freestanding derivative	Not permitted.	A combination of an exposure (e.g., a recognized nonderivative asset or liability) and a derivative could be designated jointly as a hedged item.	Not yet redeliberated.
Risk components	Retains the provision under current U.S. GAAP (ASC 815) that allows an entity to designate hedges of **financial** items for certain risks (e.g., benchmark interest rate risk, foreign currency risk, credit risk). Component hedging of **nonfinancial** items is not permitted (except for foreign currency risk in a cash flow hedge).	Aligns the requirements for eligible risk components for both financial and nonfinancial items. Risk components of any item would be eligible for hedge accounting provided that the risk component is (1) separately identifiable and (2) reliably measurable.	Not yet redeliberated.
Groups and net positions	Hedges of net positions not permitted.	Permits groups of individually eligible hedged items to be hedged collectively as a group, provided that the group of items is managed together for risk management purposes. Such groups may be net positions (certain conditions apply to cash flow hedges).	Not yet redeliberated.
Equity investments designated at FV-OCI	Equity investments are classified and measured at FV-NI in accordance with the FASB's tentative decisions.	Prohibits equity investments designated at FV-OCI (under IFRS 9) from qualifying as hedged items.	Permit equity investments designated at FV-OCI (under IFRS 9) to qualify as hedged items; ineffectiveness recognized in OCI.
Hedging Instruments			
Time value of financial options	No changes to ASC 815. If intrinsic value of the option is designated as a hedge, the time value is recognized in earnings. If option time value is included in the hedge, an entity can defer time value in OCI when certain conditions are met.	Proposes a two-step approach to accounting for the time value of options: *Step 1* — Defer in OCI the amount of the change in fair value of the time-value component (on the basis of a hypothetical option whose terms are matched to the hedged item). *Step 2* — Reclassify amounts from OCI to profit or loss or to the basis of the hedged item, depending on whether the hedged item is transaction-related or period-related.	Overall model for time value of options has not yet been redeliberated. However, the IASB has tentatively concluded that accounting for "zero cost" collars should be aligned with accounting for the time value of options.
Nonderivative financial instruments	Not permitted except for certain foreign currency hedges.	Permits nonderivative financial instruments classified as FVTPL to qualify as hedging instruments.	Not yet redeliberated.
Effectiveness Assessment			
Effectiveness threshold	Reasonably effective.	Hedging relationship must achieve "other-than-accidental offset" and meet the objective of hedge effectiveness assessment (i.e., minimize expected hedge ineffectiveness).	Not yet redeliberated.

Subject	FASB's Original ED	IASB's ED on Hedge Accounting	IASB's Redeliberations
Effectiveness Assessment (continued)			
Means of assessing effectiveness (quantitative versus qualitative)	Typically, only a qualitative assessment is required; however, a quantitative assessment may be necessary if the qualitative assessment is not conclusive.	No specific requirement for a quantitative assessment; a qualitative assessment may be sufficient in some cases.	Not yet redeliberated.
Frequency of hedge effectiveness assessments	Inception only, unless reassessment is warranted because of a change in circumstances.	An entity would need to determine that a hedging relationship meets the hedge effectiveness requirements at inception and then on an ongoing basis (at a minimum, in each reporting period or upon a significant change in circumstances).	Not yet redeliberated.
Ineffectiveness Measurement			
Determination of amounts recorded in accumulated OCI for cash flow hedges	Eliminates the "lower of test" in ASC 815. Recorded at the amount necessary to offset the present value of the cumulative change in expected future cash flows on the hedged transaction since hedge inception, less any amounts previously reclassified.	Retains the "lower of test" in IAS 39.[14]	Not yet redeliberated.
Cash Flow Hedge — Mechanics			
Basis adjustment	No changes to ASC 815 requirements. Amount is reclassified from OCI to earnings when the hedged transaction affects earnings.	Eliminates the option in IAS 39 that permits an entity either to adjust the basis of the hedged nonfinancial item (when the forecasted transaction is recognized) or to reclassify amounts from accumulated OCI to profit or loss, when the hedged items affect earnings. The entity would be required to apply a basis adjustment when the forecasted transaction is recognized.	Not yet redeliberated.
Fair Value Hedge — Mechanics			
Changes in fair value of hedged item — balance sheet impact	No changes to ASC 815. Changes in fair value of the hedged item are recorded as an adjustment to the carrying value of the hedged item.	Changes in fair value of the hedged item are reported in a separate line item on the balance sheet. Carrying value of the hedged item is not adjusted.	Changes in fair value of the hedged item are reported as an adjustment to the carrying value of the hedged item.
Changes in fair value of hedged item and hedging instrument — income statement impact	No changes to ASC 815. Changes in fair value of the hedged item and the hedging instrument are recorded in the income statement.	Changes in fair value of the hedged item and the hedging instrument are recorded in OCI, with any hedge ineffectiveness recognized in profit or loss.	Changes in fair value of the hedged item and the hedging instrument are recorded in profit or loss.
Dedesignation			
Voluntary dedesignation of a hedging relationship	An entity cannot voluntarily remove hedge designation after it has been established; however, the entity may enter into an offsetting derivative to effectively terminate the hedge.	An entity cannot voluntarily remove hedge designation after it has been established; however, partial dedesignation and rebalancing may be required.	Not yet redeliberated.

[14] IAS 39, *Financial Instruments: Recognition and Measurement.*

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