



Proposed Changes to Accounting for Financial Instruments and Hedging Activities

Entities accounting for financial instruments would face significant changes under a new FASB proposed Accounting Standards Update (ASU) that would require using a more consistent accounting model for the classification and measurement of most financial assets and liabilities and impairment of financial assets.¹ Although most financial instruments would be measured at fair value on the statement of financial position, information about the amortized cost of certain instruments would also be presented in the financial statements when an entity's business strategy involves holding the financial instruments for collection or payment of contractual cash flows. The proposal would remove the current probability threshold and revise the incurred-loss model for recognizing impairment thus accelerating the recognition of credit losses.

The proposed ASU also would change hedge accounting to resolve major practice issues and would require additional disclosures.

The effective date of the proposed guidance will be established when the final ASU is issued. However, the effective date of certain aspects of the measurement guidance for nonpublic entities with less than \$1 billion in total consolidated assets would be deferred for four years after the initial effective date.

The FASB's proposal is intended to improve comparability across entities while giving financial statement users more relevant and reliable information that they can use to evaluate an entity's performance. The FASB and IASB intend to jointly discuss the feedback received on the proposed ASU issued by the FASB and the IFRS existing requirements and proposals related to the accounting for financial instruments.² The goal of the discussions is to advance convergence of the accounting standards by continuing to work toward reducing significant differences between U.S. GAAP and IFRS.

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¹ FASB Proposed Accounting Standards Update, Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities, available at www.fasb.org.

² International Financial Reporting Standard No. 9, Financial Instruments; IASB Exposure Draft, Financial Instruments: Amortized Cost and Impairment; and IASB Exposure Draft, Fair Value Option for Financial Liabilities; all available at www.iasb.org.

Comments on the proposal are due by September 30, 2010. The FASB will hold public roundtable meetings for interested parties in October 2010 to obtain feedback about the proposed guidance. Organizations wishing to participate in a public roundtable meeting should contact the FASB.

Scope

All assets and liabilities that meet the definition of a financial instrument are included in the proposal's scope unless explicitly excluded.³ Certain financial instruments, including lease assets and liabilities and an employer's obligation under pension and other compensation arrangements and the related assets, are excluded from the scope of this guidance. (See the section on *Instruments Excluded from Scope of the Proposed ASU* for additional information.)

Classification and Measurement Guidance

At initial recognition, all financial instruments within the proposal's scope (except those for which specific measurement guidance applies, such as core-deposit liabilities and certain short-term receivables and payables), would be classified as either:

- Fair value, with changes in fair value recognized in net income (FVTNI);⁴
- Fair value, with qualifying changes in fair value recognized in other comprehensive income (FVTOCI); or
- Amortized cost.

Financial instruments (except those for which specific measurement guidance applies) would be classified as FVTNI, unless certain conditions are met and the entity elects to classify a financial asset or liability as FVTOCI or a financial liability as amortized cost. This proposal represents a significant departure from current GAAP, which in many circumstances state that a financial instrument's measurement is primarily dictated by an entity's classification based on its intent for the specific financial instrument (e.g., trading, available-for-sale, or amortized cost). It is expected that more financial instruments would be measured at fair value with subsequent changes recognized in net income under the proposed guidance than under current GAAP.

Financial Instruments for Which Changes in Fair Value Are Recognized in Net Income (FVTNI). FVTNI is the default classification under the proposal. Financial instruments classified as FVTNI would be initially measured at fair value and, in subsequent periods, all changes in fair value would be recognized in net income. Any difference between the fair value and the transaction price of a FVTNI financial instrument would be recognized in net income at initial recognition. Similarly, transaction costs and fees would be included in net income.

³ A financial instrument is cash, evidence of an ownership interest in an entity, or a contract that both (1) imposes on one entity a contractual obligation either to deliver cash or another financial instrument to another entity or exchange other financial instruments on potentially unfavorable terms with the second entity and (2) conveys to that second entity a contractual right either to receive cash or another financial instrument from the first entity or to exchange other financial instruments on potentially favorable terms with the first entity.

⁴ The term 'fair value' used throughout this document refers to fair value as defined by ASC Topic 820, *Fair Value Measurements*, available at www.fasb.org.

Unless certain conditions are met, financial instruments (except those for which specific measurement guidance applies) would be classified as FVTNI. This would result in the following financial instruments, among others, being classified as FVTNI:

- Derivative instruments, except for derivatives designated as the hedging instrument in a cash-flow hedge or a hedge of a net investment in a foreign operation.
- Hybrid financial instruments (including short-term instruments) with embedded derivatives that would otherwise be separately accounted for as derivative instruments under existing guidance.⁵ and
- Equity instruments, except for investments in equity securities that are accounted for using the equity method of accounting, that result in consolidation of an entity, or that meet the criteria to be measured at redemption value because they are not held for capital appreciation and can be redeemed with the issuer only for a specified amount (e.g., investments in Federal Home Loan Bank or Federal Reserve Bank stock). The section on *Measurement Guidance for Specific Financial Instruments* discusses the proposed changes to the application of the equity method of accounting.

Financial Instruments for Which Qualifying Changes in Fair Value Are Recognized in Other Comprehensive Income (FVTOCI). At initial recognition, an entity would have the option to irrevocably classify a financial instrument (except those for which specific measurement guidance applies) that meets the following criteria as FVTOCI:

1. It is a debt instrument held or issued with the following characteristics:
 - There is an amount transferred to the issuer at inception that will be returned to the investor at maturity or other settlement, which is the principal amount of the contract adjusted by any original issue discount or premium;
 - The contractual terms of the debt instrument identify any additional contractual cash flows to be paid to the investor either periodically or at the end of the instrument's term; and
 - The debt instrument cannot contractually be prepaid or otherwise settled in a way that the investor would not recover substantially all of its initial investment, other than through its own choice.
2. The entity's business strategy for the instrument is to collect or pay the related contractual cash flows rather than to sell or settle the financial instrument with a third party.
3. It is not a hybrid financial instrument for which current GAAP would otherwise have required the embedded derivative to be accounted for separately from the host contract.⁶

⁵ FASB ASC Subtopic 815-15, Derivatives and Hedging – Embedded Derivatives, available at www.fasb.org.

⁶ FASB ASC Subtopic 815-15, Derivatives and Hedging – Embedded Derivatives, available at www.fasb.org.

When considering whether the second criterion would be met, an entity would evaluate its business strategy based on how it manages its financial instruments rather than its intent for an individual instrument. In order to classify a financial instrument as FVTOCI, an entity's business strategy must involve holding instruments for a significant portion of their contractual terms. Financial instruments that are prepayable due to the exercise of an embedded call or put option would not prevent an entity from having a business strategy to collect or pay the instrument's contractual cash flows. Additionally, a change in an entity's business strategy would impact the classification of financial instruments acquired or issued after the change but would not impact the classification of previously recognized financial instruments.

The proposal would eliminate the *tainting* concept included in current GAAP. For example, if an entity's business strategy was holding debt securities to collect contractual cash flows and it had classified these instruments as FVTOCI, the sale of an individual security prior to maturity would not affect the FVTOCI classification of other debt securities. However, if the entity sells a large number of these instruments significantly before their maturity, that may indicate that its business strategy has changed, which would impact the classification of similar instruments acquired or issued in the future.

Financial instruments classified as FVTOCI would be initially measured at the transaction price, unless there is reliable evidence that indicates that there is a significant difference between the transaction price and the fair value at initial measurement. If there is reliable evidence that a significant difference exists, the instrument would be initially measured at fair value. Refer to the section on *Measurement Guidance When Transaction Price Is Significantly Different from Fair Value* for additional information. Certain loan origination fees, net of direct origination costs, would be initially recognized in other comprehensive income (OCI) and amortized to net income as an adjustment of yield over the life of the instruments. All other transaction fees and costs would be recognized immediately in net income.

All subsequent changes in fair value would be recognized in OCI, except for current period interest income or expense (including amortization or accretion of premiums and discounts and certain deferred loan origination fees and costs), credit losses (or reversal of prior-period credit losses), and the change in fair value attributable to the hedged risk if the financial instrument is designated as the hedged item in a qualifying fair value hedging relationship. Instead, all of these amounts would be recognized in net income. Unrealized gains and losses recognized in OCI would be recycled to net income when they are realized through sales or settlements.

Financial Liabilities Measured at Amortized Cost. At initial recognition, entities would be allowed to irrevocably elect to classify financial liabilities (except those for which specific measurement guidance applies) as amortized cost if:

1. The financial liability meets the FVTOCI criteria and
2. Measuring the financial liability at fair value would create or exacerbate a measurement attribute mismatch of recognized assets and liabilities.

This election was included in the proposal to address concerns raised about the impact on comprehensive income if a financial liability is measured at fair value and the associated asset is not remeasured at fair value (i.e., asset-liability matching). When considering whether the second criterion would be met, an entity would be able to establish that the measurement of a financial liability at fair value would create or exacerbate a measurement attribute mismatch only if one of the following criteria is met:

- The financial liability is contractually linked to an asset not measured at fair value. A financial liability that is collateralized by an asset, or is contractually required to be settled on the derecognition of an asset, is contractually linked to that asset;
- The financial liability is issued by and recorded in, or evaluated by the chief operating decision maker as part of, an operating segment for which less than 50 percent of its recognized assets (both financial and nonfinancial assets) are subsequently measured at fair value; or
- The financial liability does not meet either of those two criteria but is the liability of a consolidated entity for which less than 50 percent of the consolidated entity's recognized assets are subsequently measured at fair value.

Recognized assets refer to those recognized under GAAP (less assets that are contractually linked to a financial liability) at the end of the immediate prior reporting period, plus assets that were acquired by issuing the financial liability. For purposes of applying these quantitative thresholds, cash (excluding cash equivalents) is not considered to be measured at fair value. Financial entities may not meet the measurement attribute mismatch criterion unless a financial liability is contractually linked to an asset not measured at fair value because in many circumstances more than 50 percent of the assets in an operating segment or consolidated entity would be measured at fair value (either through net income or OCI).

Financial liabilities classified as amortized cost would be initially measured at the transaction price, unless there is reliable evidence that indicates that there is a significant difference between the transaction price and the fair value at initial measurement. If there is reliable evidence that a significant difference exists, the liability would be initially measured at fair value. The following section contains additional information.

Measurement Guidance When Transaction Price Is Significantly Different from Fair Value. At initial recognition of a financial instrument that is classified as FVTOCI, and core-deposit liabilities or other financial liabilities, if there is reliable evidence that indicates that there is a significant difference between the transaction price and the fair value at initial measurement, the entity would measure the financial instrument at fair value and account for the other transaction elements under other GAAP. Differences between the transaction price and fair value due to loan origination fees, net of direct origination costs, or because the market in which the transaction occurs is different from the market in which the reporting entity would sell the asset or transfer the liability, would not be considered when evaluating the significance of the difference between the transaction price and fair value. If an entity cannot identify

another element or determine the value of the other elements in the transaction, the difference between the transaction price and fair value would be recognized in net income in the period of acquisition or occurrence.

Hybrid Financial Instruments. Embedded derivative features in hybrid financial instruments would no longer be bifurcated and accounted for separately as derivative instruments. However, the measurement of a hybrid financial instrument in its entirety (inclusive of embedded derivatives) would depend on whether the embedded derivative would otherwise be required to be separately accounted for as a derivative instrument.⁷ If it would be separated, the entire hybrid financial instrument would be classified as FVTNI. If it would not be separated under existing guidance, an entity could classify the entire hybrid financial instrument as FVTOCI or amortized cost, if the related conditions are met.

Although embedded derivative features in hybrid financial instruments would no longer be bifurcated and accounted for separately, embedded derivative features in hybrid nonfinancial instruments would continue to be evaluated for bifurcation and separate accounting as derivative instruments.

Measurement Guidance for Specific Financial Instruments

The proposed measurement guidance for some financial instruments would differ from the general proposed measurement guidance.

Loan Commitments and Standby Letters of Credit. The accounting by issuers of loan commitments and standby letters of credit would be significantly changed by the proposal. Currently, only the issuers of loan commitments related to mortgage loans that would be held for sale are required to record the commitment in the financial statements (i.e., as a derivative instrument that is measured at fair value with changes in fair value recognized in net income). Issuers of other types of loan commitments do not record the commitment in the financial statements. Issuers of standby letters of credit currently record a value in the financial statements related to the guarantee (stand-ready portion) and an additional amount to reflect probable losses.

The proposal would require issuers of loan commitments and standby letters of credit to classify those instruments in the same way that they would classify the underlying loan, if funded. For example, if a loan, if funded, would meet the conditions to be classified as FVTOCI, the related loan commitment would be classified as FVTOCI. However, the issuer of a revolving line of credit issued under a credit-card arrangement would not apply this measurement guidance because that line of credit is excluded from the scope of the proposal.

Core-Deposit Liabilities. The proposal establishes separate measurement guidance for core-deposit liabilities, which are deposits without a contractual maturity that management believes are a stable source of funds (excludes transient and surge balances). Core-deposit liabilities primarily relate to banking entities and include deposits without a stated maturity made by customers in a bank's general market area. Core-deposit liabilities would be measured at the present value of the average core-deposit amount during the reporting period discounted over the implied

⁷ FASB ASC Subtopic 815-15, Derivatives and Hedging – Embedded Derivatives, available at www.fasb.org.

maturity of the deposits (the remeasurement amount). The discount rate would be the difference between the alternative funds rate and the all-in-cost-to-service rate, which includes the net direct costs to service core deposits, including the interest paid on the deposits and the expense of maintaining a branch network, less the fee income earned on the deposit accounts. Because this calculation is based on average deposits over an implied maturity, future deposits would be considered in the valuation, which would result in the inclusion of an intangible asset in the remeasurement amount.

Changes in the remeasurement amount would be recognized in net income unless the core deposit meets the FVTOCI criteria and an entity elects to recognize qualifying changes in OCI. Regardless of this election, all changes in the remeasurement amount related to current period interest accruals and realized gains and losses would be recognized in current period net income.

If there is reliable evidence that indicates that there is a significant difference between the transaction price and the fair value at initial measurement, the deposits would be initially measured at fair value. Refer to the section on *Measurement Guidance When Transaction Price Is Significantly Different from Fair Value* for additional information.

Short-Term Receivables and Payables. Receivables and payables that arise in the normal course of business whose customary terms do not exceed one year and that meet the FVTOCI criteria would be measured at amortized cost (plus or minus any fair-value hedging adjustments). This exception would not apply to short-term lending arrangements (such as credit-card receivables) or investments in short-term debt securities, which must follow the general proposed measurement guidance.

Investments That Can Be Redeemed Only for a Specified Amount. Investments such as those in Federal Home Loan Bank System or Federal Reserve Bank stock (or similar structures) that are not held for capital appreciation and can be redeemed with the issuer only for a specified amount would be subsequently measured at redemption value if the investment meets all of the following characteristics:

- It has no readily determinable fair value because ownership is restricted and it lacks a market;
- It cannot be redeemed for an amount greater than the entity's initial investment;
- It is not held for capital appreciation, but rather to obtain other benefits such as access to liquidity or assistance with operations; and
- It must be held for the holder to engage in transactions or participate in activities with the issuing entity.

Guidance for Broker/Dealers and Investment Companies. The proposal provides specific measurement guidance for broker/dealers in securities and investment companies that currently apply specialized accounting practices. Broker/dealers in securities would be required to apply the proposal's measurement guidance to their financial liabilities (which would allow qualifying changes in fair value to be recognized in OCI if the FVTOCI criteria are met) and measure all financial assets at fair value

with changes in fair value recognized in net income. Investment companies would be required to measure their financial assets and liabilities at fair value with changes in fair value recognized in the net increase (decrease) in net assets for the period.

Deferred Tax Assets. Entities would be required to evaluate the need for a valuation allowance on a deferred tax asset related to a financial instrument for which qualifying changes in fair value are recognized in OCI in combination with the entity's other deferred tax assets. This approach would not permit segregating the evaluation of an entity's deferred tax assets related to specific assets or liabilities. This may result in a change for some entities as there has been diversity in practice related to the evaluation of the recoverability of deferred tax assets associated with debt securities.

Equity Method Investments. Although entities would generally be required to classify investments in equity securities as FVTNI, the proposal specifies that equity investments in which an entity has both significant influence over the investee and the investee's operations are related to those of the entity's consolidated operations would be accounted for under the equity method of accounting.⁸ The second condition is incremental to the current criteria to apply the equity method of accounting. When determining whether an investee's operations are related to its consolidated operations, an entity would consider the following factors (no single factor necessarily carries more weight than the others):

1. A significant portion of the operations of the investee involve the sale of the entity's products or services including providing product financing and access to markets that otherwise would be inaccessible or more difficult to access;
2. A significant portion of the operations of the investee expand the entity's ability to purchase inputs for its products or services;
3. The operations of the entity and the investee are similar;
4. The investee's management personnel are current or former managers of the entity;
5. The entity and investee have common employees or employees that transfer between the investor and investee;
6. The entity or investee provides significant management services to the other entity;
7. There are significant intra-entity transactions between the entity and the investee that are relevant to the consolidated operations of the entity.

Additionally, in a change from current GAAP, the proposal would not allow an entity to elect the fair value option for investments in equity securities that qualify for the equity method of accounting.

Financial Statement Presentation

The proposal would make significant changes to the current financial statement presentation requirements for financial instruments.

⁸ FASB ASC Topic 323, Investments—Equity Method and Joint Ventures, available at www.fasb.org.

Statement of Financial Position. Financial assets and liabilities would be displayed separately in the statement of financial position depending on whether changes in their fair value are recognized in net income or qualifying changes in their fair value are recognized in OCI. For financial instruments that are classified as FVTNI, entities would be required to present the fair value of all financial instruments and the amortized cost of an entity's own outstanding debt instruments. For financial instruments that are classified as FVTOCI, entities would be required to present separately:

- Amortized cost;
- Allowance for credit losses on financial assets;
- Accumulated amount needed to reconcile amortized cost less allowance for credit losses to fair value; and
- Fair value.

Entities would be required to present separately for its core-deposit liabilities:

- Amortized cost of the deposits (amount due on demand);
- Amount needed to adjust amortized cost to the deposits' remeasurement amount; and
- Remeasurement amount of the core deposits.

Entities also would be required to present separately amounts included in accumulated other comprehensive income (and allocated to noncontrolling interests, if applicable) related to the qualifying changes in fair value or qualifying changes in the remeasurement amount for financial instruments for which those changes are recognized in OCI.

Statement of Comprehensive Income. Entities would be required to provide a single statement of comprehensive income.⁹ This statement would report total comprehensive income, subtotals for net income and other comprehensive income, and basic and diluted earnings per share calculated based on net income. The statement of comprehensive income, at a minimum, would require separate presentation within net income of an aggregate amount for realized and unrealized gains and losses on financial instruments classified as FVTNI.

For financial instruments classified as FVTOCI, an entity would present in separate line items in its statement of comprehensive income:

- Current period interest income and expense, including amortization and accretion;
- Credit impairment for the current period on financial assets; and
- Realized gains or losses.

For foreign-currency-denominated financial instruments classified as FVTOCI, entities would not be permitted to separately recognize in net income a transaction gain or loss due to changes in exchange rates.

⁹ The guidance in Proposed Accounting Standards Update—Comprehensive Income (Topic 220): Statement of Comprehensive Income, available at www.fasb.org, would require an entity to present one statement of comprehensive income.

Financial liabilities within the amortized cost category would require separate presentation of current period interest (including amortization and accretion) and realized gains and losses on settlements in the statement of comprehensive income.

Fair value measurements of an entity's financial liabilities, whether classified as FVTNI or FVTOCI, include changes due to the entity's own credit risk. Entities would need to present the amount of significant changes in fair value due to changes in the entity's credit standing on the face of the statement of comprehensive income, separated between liabilities classified as FVTNI and FVTOCI. This amount would not include changes in fair value due to general changes in the price of credit. The proposal does not prescribe a method for determining the change in fair value attributable to a change in an entity's credit standing excluding the change in the price of credit; however, the proposal solicits constituent feedback on two potential methods for determining that change.

If an entity elects to record changes in the remeasurement amount of core-deposit liabilities in OCI, the statement of comprehensive income would include, at a minimum, separate presentation within net income of current period interest expense. Core-deposit liabilities whose changes are recognized in net income would require, at a minimum, separate presentation of an aggregate amount of unrealized gains or losses.

Impairment Recognition and Measurement

The proposal establishes a single impairment model that would be applied to all financial assets such as debt securities and loans and would replace the various impairment models applied to different types of financial assets under current GAAP. The proposed model would apply to financial assets classified as FVTOCI, short-term receivables measured at their amortized cost, and equity instruments that are measured at their redemption value because they can be redeemed only for a specified amount. The proposed model is similar in some respects to the existing incurred-loss model, in which no impairment is recognized until a loss is incurred and the recognition and measurement of credit impairment is based on an entity's expectations surrounding collectability of cash flows. However, unlike current GAAP, determining whether a credit loss exists would not include considering whether it is probable that a loss has been incurred.

If conditions indicate that an entity does not expect to collect all amounts originally expected on origination or acquisition, a credit impairment would be recognized regardless of whether the loss is probable. This would result in credit impairments being recognized earlier than under current GAAP, which requires a loss to be probable. Credit impairments would be recorded as part of the allowance for credit losses for the financial asset and would be reflected in net income.

Evaluating Financial Assets for Credit Impairment. At the end of each reporting period, entities would be required to evaluate their financial assets classified as FVTOCI, short-term receivables measured at their amortized cost, and equity instruments that are measured at their redemption value for credit losses. For originated and most acquired financial assets, credit impairment would be recognized when the entity does not expect to collect all interest and principal payments due

according to the contractual terms of the financial asset. For financial assets acquired at an amount that includes a discount related to credit quality, credit impairment would be recognized when the entity does not expect to collect all amounts originally expected to be collected on acquisition.

Similar to current GAAP, entities would continue to consider both the amount and timing of cash flows expected to be collected. If an entity's expectation of the amount of cash flows originally expected to be collected decreases, a financial asset would be considered impaired. However, an insignificant delay or shortfall in the amount of cash flows expected would not cause the financial asset to be considered impaired.

When determining whether a credit impairment exists, entities would consider all relevant information about past events and existing conditions and their effect on the collectability of cash flows attributable to the financial asset at the reporting date. Entities would need to consider both economic conditions and factors specific to the issuer of the financial asset and the effect of these conditions and factors when developing estimates of cash flows expected to be collected over the remaining life of the financial asset. Entities would assume that the economic conditions existing at the end of the reporting period would remain unchanged for the remaining life of the financial asset and forecasts of future events or economic conditions that do not exist at that time would not be considered. To determine whether credit impairment has occurred, entities would be expected to consider, at a minimum, all of the following:

- The financial condition of the borrower or issuer of a financial asset;
- Expectations (based on past events and existing conditions) about potential default by the borrower or issuer of a financial asset;
- Failure of the borrower or issuer of a financial asset to make scheduled principal or interest payments;
- Credit rating changes related to the borrower or the issuer of a debt security;
- Level of delinquencies, bankruptcies, charge-offs, and recoveries and changes in those levels compared with previous experience;
- Remaining payment terms of the financial asset and any credit-related modifications of terms;
- The fair value of any underlying collateral;
- Current environmental factors such as geographic and economic data;
- Effects of credit concentrations; and
- The payment structure of the financial asset and the likelihood of the borrower or issuer of a financial asset satisfying the payment terms.

However, changes in cash flows expected to be collected that relate to the following factors would not create credit impairment:

- For foreign-currency-denominated financial assets, changes in foreign exchange rates used to remeasure financial assets;¹⁰

¹⁰ FASB ASC Subtopic 830-20, Foreign Currency Matters — Foreign Currency Transactions, available at www.fasb.org.

- For financial assets that are contractually prepayable, changes in expected prepayments; and
- For financial assets with contractual interest rates that vary based on subsequent changes in an index or rate (e.g., prime rate or LIBOR), changes in the index or rate.

Entities may also consider the fair value of the financial asset when evaluating whether credit impairment exists. However, an entity would not be permitted to assert that a financial asset is not credit impaired simply because its fair value is greater than its amortized cost.

At the end of each reporting period, entities would be required to recognize a credit impairment in net income for the amount the entity does not expect to collect related to all contractual amounts due for originated assets and all amounts originally expected to be collected for purchased financial assets. Entities would also be required to establish or increase the allowance for credit losses related to the financial asset (presented as a contra-asset account) by an equal amount.

Changes in circumstances may result in different expectations of impairment each period, and the financial statement recognition of these changes may differ depending on the nature of the financial asset. For all financial assets other than those acquired at a discount related to credit quality, subsequent changes in expected cash flows would change the amount of credit impairment recognized in the period. If credit impairment has been recorded on a financial asset and subsequent information indicates an improvement in expected cash flows, previously recorded credit impairments would be reversed and recorded in net income (up to the previously recognized allowance) and a corresponding decrease in the allowance for credit losses would be recognized.

For financial assets acquired at an amount that includes a discount related to credit quality, subsequent increases in expected cash flows would first reduce any previously recognized allowance for credit losses, and to the extent the revised expected cash flows exceed the amount of any previous allowance, the entity would prospectively adjust the effective interest rate used to recognize interest income. Subsequent decreases in expected cash flows would first reduce any previous prospective adjustments to the effective interest rate, and a credit impairment would be recognized to the extent the decrease in expected cash flows would reduce the effective interest rate below the original effective interest rate.

Financial Assets Evaluated on a Pool Basis. Evaluation of credit impairment for pools of similar assets is appropriate when the group of assets, based on their shared characteristics, may have some credit impairment even though the impairment cannot be associated with a specific financial asset. To evaluate impairment collectively for a pool of financial assets, entities would aggregate financial assets based on their similar risk characteristics, including factors such as credit scores or ratings, risk ratings, type of financial asset, collateral type, size, interest rate, terms, geographical location, industry of the borrower or issuer, or other factors. The amount of credit impairment recognized would be based on a historical loss rate for financial assets that have characteristics of the assets in the pool. Loss rates would be adjusted for

all information relevant to the collectability of the financial assets, including the effect of past events and existing economic factors and conditions. Loss rates reflect cash flows not expected to be collected over the life of the assets in the pool. If an entity has insufficient data to develop its own loss rates for a group of financial assets, it may be appropriate to use the historical loss rates of other entities if the attributes of the financial assets are similar to those being evaluated by the entity. Entities would choose a historical time period appropriate for the specific financial assets in the pool to determine a historical loss rate.

If a loan that was modified or restructured in a troubled-debt restructuring was previously included in a pool of assets evaluated for impairment on a collective basis, it would be removed from the pool and be subsequently measured for impairment on an individual basis.

Financial Assets Evaluated Individually. The proposal would permit entities to individually evaluate financial assets for impairment; however, it does not specify how an entity should identify financial assets that should be individually evaluated for collectability. When a financial asset is individually determined to be impaired, the proposal would require using a present-value technique that considers past events and existing economic conditions to estimate the present value of cash flows expected to be collected and discounts those cash flows at the financial asset's effective interest rate to measure the amount of credit impairment.

An entity would apply the present-value technique on an asset-by-asset basis to financial assets that are individually considered impaired and have risk characteristics that are unique to an individual borrower or issuer. However, if a financial asset that is individually considered to be impaired shares similar risk characteristics with other impaired financial assets, an entity may aggregate those financial assets for purposes of measuring credit impairment. In that circumstance, an entity would use a present-value technique that includes historical statistics related to financial assets with similar characteristics to measure credit impairment.

In certain circumstances, an entity may measure impairment for an individually impaired collateral-dependent financial asset based on the fair value of the collateral rather than using the present-value technique. Whenever foreclosure is expected to occur, an entity would be required to measure impairment based on the fair value of the collateral. Similar to current GAAP, if the fair value of the collateral exceeds the amortized cost of the financial asset, no credit impairment would be recorded and an entity would be precluded from including the financial asset in a pool of assets for which impairment is measured on a collective-pool basis.

For a financial asset that was determined not to be impaired on an individual basis, an entity would have to evaluate whether credit impairment exists within a group of financial instruments with similar characteristics. For example, an entity has a portfolio of commercial real estate loans that are assessed individually for credit impairment and it concludes that it expects to collect all interest and principal payments due according to the contractual terms of the financial assets, and thus none of the loans are individually impaired. At that point, the entity would be required to consider whether historical loss experience or other factors indicate that credit impairment

exists within its commercial real estate loan portfolio, and if so, recognize credit impairment in net income for the group of similar types of loans. The amount of credit impairment recognized would be based on a historical loss rate for financial assets within that group, not on a present-value technique.

Interest Income Recognition

Significant changes to interest income recognition on financial assets classified as FVTOCI would occur as entities would recognize interest income by applying the financial asset's effective interest rate to its amortized cost, net of any allowance for credit losses.

Because interest income would be accrued based on the financial asset's amortized cost less any allowance for credit losses, an excess may result between the contractual interest collected by an entity and the amount of interest income recognized. This difference would be recorded as an increase to the allowance for credit losses. However, if at any time, an entity determines that the allowance for credit losses exceeds its best estimate of credit impairment related to its financial assets, the allowance for credit losses would be adjusted and a reversal of credit impairment expense would be reflected in net income. Interest income would not be adjusted.

The effective interest rate would include premium amortization, discount accretion, and amortization of deferred loan fees and costs. For variable-rate financial assets, the effective interest rate would be based on the index or rate as it changes over the life of the asset. The effective interest rate would be based on the contractual cash flows over the life of the asset. Entities would not be permitted to project future changes in the variable rate when determining the effective interest rate.

The proposal provides specific interest income recognition guidance for financial assets acquired at an amount that includes a discount related to credit quality. If an allowance for credit losses for these assets had previously been established after acquisition, subsequent increases in expected cash flows would first be recognized in net income as a reversal of credit impairment expense to the extent of the previously recognized allowance. To the extent that no allowance for credit losses has been established or the increase in expected cash flows exceeds the amount of any previously established allowance for credit losses, the effective interest rate of the asset would be adjusted prospectively resulting in more interest income being recognized in the future. Subsequent decreases in expected cash flows would first reduce the effective interest rate based on the revised cash flows expected to be collected, but not to a rate below the original effective rate. Any additional decreases in expected cash flows would result in additional credit impairment.

Entities would be required to cease accruing interest income on a financial asset when a negative yield on future cash flows is expected. In this circumstance, they would use the cost-recovery method.

Hedge Accounting

The proposal would amend requirements for assessing hedge effectiveness, dedesignating hedging relationships, and measuring and reporting ineffectiveness in a cash

flow hedge. The changes are intended to resolve major practice issues and simplify and improve accounting and reporting related to hedging activities.

This guidance would apply to all instruments (both financial and nonfinancial) currently within the scope of existing authoritative literature on derivatives and all other items or transactions eligible for hedge accounting under that guidance.¹¹ The proposed changes to hedge accounting are primarily based on decisions exposed by the FASB in June 2008, except that entities would be able to designate specific risks in financial items currently eligible as the hedged risk in a hedging relationship.¹²

Hedge Effectiveness. The proposal would simplify the requirements for assessing hedge effectiveness and lower the threshold for qualifying as an effective hedge. Entities would have to make at least a qualitative assessment of effectiveness at the inception of a hedging relationship. A reassessment would be required only if changes in circumstances suggest that the hedging relationship may no longer be reasonably effective. This is a significant change from current guidance that requires a quarterly reassessment of effectiveness.

A relationship would qualify for hedge accounting under the proposed qualitative assessment if an economic relationship exists between the hedging instrument and the hedged item or forecasted transaction and the change in the hedging instrument's fair value would be *reasonably effective* in offsetting changes in the hedged item's fair value or the variability in the hedged cash flows attributable to the risk being hedged. The demonstration of offsetting changes in fair value or cash flows would have to include an assessment of the credit risk related to the payments owed to the entity under the derivative's provisions, as well as the entity's own nonperformance risk.

The reasonably effective threshold for determining whether a hedging relationship qualifies for hedge accounting would replace the *highly effective* threshold that has been interpreted to be within 80 to 125 percent effective. The proposal gives no quantitative guidance about what constitutes reasonable effectiveness. Instead, it says that reporting entities should disclose the sources of volatility associated with the fair value of the hedged item or the cash flows of the forecasted transaction for the risk being hedged and the factors that support a conclusion that the hedging instrument would be reasonably effective in offsetting changes in the hedged item's fair value or the variability in the hedged cash flows over the life of the hedging relationship. Although a qualitative assessment is permitted, a quantitative assessment may be necessary to demonstrate that the hedging relationship will be reasonably effective.

Entities would not be able to assume at inception that any hedging relationship is perfectly effective or that there would never be any ineffectiveness to be recognized in net income. This prohibition would significantly change the current practice of assuming perfect effectiveness by using hedging relationships that qualify for the shortcut or critical-terms-match methods.

¹¹ FASB ASC Topic 815, *Derivatives and Hedging*, available at www.fasb.org.

¹² FASB Proposed Statement, *Accounting for Hedging Activities, an amendment of FASB Statement No. 133, June 6, 2008*, available at www.fasb.org.

Entities that enter into cash-flow-hedging relationships to hedge the variability in cash flows related to a group of transactions within a specific time period (e.g., a cash-flow-hedging relationship to hedge forecasted purchases of oil that occur ratably over the month) would be able to *assess effectiveness* using a method that includes a derivative that settles within a reasonable period of time of the cash flows related to the hedged transactions. The time period is reasonable if there is no more than a minimal difference between the forward rate on the actual derivative and the forward rate on a derivative or derivatives that would exactly offset the changes in the forecasted transactions' cash flows.

Dedesignation of Hedging Relationship. Entities would no longer be permitted to discontinue hedge accounting by electing to dedesignate an effective hedging relationship. They would be permitted to discontinue hedge accounting only if the relationship no longer qualifies for hedge accounting or the hedging instrument expires or is sold, terminated, or exercised.

However, the proposal would allow a hedging instrument to be effectively terminated for accounting purposes if the entity enters into an offsetting derivative instrument and concurrently documents that the offsetting derivative is expected to fully offset future changes in the cash flows of the original derivative and is intended to terminate the original hedging instrument. Neither the terminated derivative nor the offsetting derivative would be permitted to be designated as the hedging instrument in a new hedging relationship.

This change would practically prohibit hedge accounting for strategies where the hedging relationships are dedesignated and redesignated on a daily or weekly basis and the hedging derivative's term is longer than a day or week.

Measuring and Reporting Ineffectiveness in Cash-Flow Hedging Relationships.

Entities would be required to calculate the ineffectiveness of a cash-flow hedge by comparing the change in fair value of the derivative designated as the hedging instrument and the present value of the cumulative change in expected future cash flows on the hedged transaction. The present value of the cumulative change in expected future cash flows on the hedged transaction could be determined by analyzing the changes in fair value of a derivative instrument that would mature on the date of the forecasted transaction, be priced at market, and provide cash flows that would exactly offset the hedged cash flows. The balance of accumulated other comprehensive income would reflect the cumulative change in the expected future cash flows on the hedged transaction from inception less amounts previously reclassified from accumulated other comprehensive income into net income. This modification would require entities to recognize ineffectiveness for both overhedges and underhedges in contrast to current GAAP that results in ineffectiveness only when the change in fair value of the derivative exceeds the change in expected cash flows of the hedged transaction (overhedge).

To calculate the fair value of the derivative that would mature on the date of the forecasted transaction, be priced at market, and provide cash flows that would exactly offset the hedged cash flows, an entity would be permitted to use the same credit-risk adjustment (or discount rate) that it uses in calculating the fair value of the

actual hedging derivative. This would result in no recorded ineffectiveness related to changes in credit risk of the parties to the hedging derivative.

An entity that uses purchased-option contracts as a hedging instrument in a cash-flow hedge to provide one-sided protection against the hedged risk (e.g., an entity that purchases a gold call option to protect against gold prices above \$1200) would be able to use either total changes in the option's cash flows or intrinsic value when measuring ineffectiveness using as a benchmark a purchased option derivative that would mature on the date of the forecasted transaction and provide cash flows that would exactly offset the one-sided change in the hedged cash flows. This guidance would allow an entity to continue to defer the changes in fair value of a purchased option associated with the time value component of the option.¹³

An entity that enters into a cash-flow-hedging relationship to hedge the variability in cash flows related to a group of transactions within a specific time period (e.g., a cash-flow-hedging relationship to hedge forecasted purchases of oil that occur ratably over the month) would be permitted to *measure ineffectiveness* by comparing the changes in the fair value of the actual derivative designated as the hedging instrument with the change in fair value of a derivative that would settle within a reasonable time period of the cash flows related to the hedged transactions. The time period is reasonable if there is no more than a minimal difference between the forward rate on the actual derivative and the forward rate on the derivative or derivatives that would exactly offset the changes in the forecasted transactions' cash flows.

Disclosures

The proposal would require entities to provide significant new disclosures related to financial instruments on both an annual and interim basis. These disclosures would require entities to provide considerable detail about financial instruments based on measurement category, as well as information related to the allowance for credit losses, hedge accounting, fair value, and equity method investments.

Effective Date

The effective date of the proposed guidance will be established when the final ASU is issued. Entities would not be allowed to early adopt the proposal.

The effective date of certain aspects of the measurement guidance for nonpublic entities with less than \$1 billion in total consolidated assets at the beginning of a fiscal year would be deferred for four years after the initial effective date. Although these entities would be required to apply the other proposed guidance related to classification and measurement, impairment, and hedge accounting during the deferral period, they would continue to apply current GAAP measurement requirements to loans (including accounts receivable with terms exceeding one year and notes receivable), loan commitments and core-deposit liabilities for which qualifying changes in fair value (or remeasurement amount) would be recognized in OCI. However, these entities would be required to disclose the fair value of loans subsequently remeasured at amortized cost using the exit price notion in GAAP.¹⁴

¹³ Statement 133 Implementation Issue No. G20, "Assessing and Measuring the Effectiveness of a Purchased Option Used in a Cash Flow Hedge," available at www.fasb.org.

¹⁴ FASB ASC Topic 820, Fair Value Measurements and Disclosures, available at www.fasb.org.

An entity would need to apply the transition guidance below in the first reporting period in which it no longer qualifies for the deferred effective date. Once an entity no longer qualifies for the deferral, it would not be eligible for the deferral in subsequent years.

Transition

An entity would apply the proposal through a cumulative-effect adjustment to the statement of financial position as of the end of the reporting period that immediately precedes the effective date. The statement of financial position for that reporting period should be restated in the first set of financial statements issued after the effective date. For example, a calendar-year-end entity for which the effective date is January 1, 20X4 would restate in its first quarter's financial report its statement of financial position as of December 31, 20X3.

An entity would determine the amount of the cumulative-effect adjustment as follows:¹⁵

- The cumulative effect of the change to the new accounting principle on periods that occurred before those presented would be reflected in the carrying amounts of assets and liabilities (including cost, changes in fair value, allowances, and fair value measurements) as of the end of the period prior to the effective date.
- An offsetting adjustment, if any, would be made to retained earnings (or other appropriate components of equity or net assets in the statement of financial position) as of the end of the period prior to the effective date.
- Financial statements for each individual prior period would not be adjusted, except that the prior-period statement of financial position would be restated in the first financial statements issued after the effective date.

An entity would be required to disclose the following information in the fiscal period in which the guidance is adopted (if that is an interim period, this information must also be included in the annual financial statements that include that interim period):

- The nature and reason for the change in accounting principle, including an explanation of the newly adopted accounting principle;
- The method of applying the adoption;
- The effect of the adoption on any line item in the statement of financial position as of the end of the reporting period that immediately precedes the effective date (presentation of the effect on financial statement subtotals is not required); and
- The cumulative effect of the change on retained earnings or other components of equity in the statement of financial position as of the reporting period that immediately precedes the effective date.

If the proposed guidance has no material effect in the adoption period but is reasonably certain to have a material effect in later periods, the disclosures would be provided whenever the financial statements of the adoption period are presented.

¹⁵ FASB ASC Topic 250, Accounting Changes and Error Corrections, available at www.fasb.org.

Instruments Excluded from Scope of the Proposed ASU

The following financial instruments would be excluded from the scope of the proposal. These instruments would continue to be accounted for under current GAAP.

1. An instrument held or issued by an entity that is classified in its entirety in the entity's stockholders' equity, such as ordinary common stock. (See ASC Topics 480 and 505).¹⁶
2. An equity component that has been bifurcated from a hybrid financial instrument and classified in an entity's stockholders' equity using the guidance on debt in ASC Topics 470 or 480, or other guidance that requires separate accounting for the components of a hybrid financial instrument (for example, a beneficial conversion feature that has been valued separately from convertible debt).¹⁷
3. An employer's or plan's obligation and the related assets, if any, that are within the scope of any of these ASC Topics:
 - a. ASC Topic 710 on compensation;¹⁸
 - b. ASC Topic 712 on nonretirement postemployment benefits;¹⁹
 - c. ASC Topic 715 on retirement benefits;²⁰
 - d. ASC Topic 718 on stock compensation;²¹
 - e. ASC Topic 960 on accounting by defined benefit pension plans;²²
 - f. ASC Topic 962 on accounting by defined contribution pension plans;²³ and
 - g. ASC Topic 965 on accounting by health and welfare benefit plans.²⁴
4. An insurance contract within the scope of ASC Topic 944 on financial services and insurance except:²⁵
 - a. A contract within the scope of the deposit method of accounting in ASC Subtopic 340-30 on insurance contracts that do not transfer insurance risk²⁶ and
 - b. An investment contract accounted for based on ASC paragraphs 944-825-25-1 through 25-2 on accounting for insurance entities.
5. An investment in the equity instruments of another entity that qualifies for the equity method of accounting based on ASC Topic 323 on the equity method and joint ventures.

¹⁶ FASB ASC Topic 480, Distinguishing Liabilities from Equity, and FASB ASC Topic 505, Equity, both available at www.fasb.org.

¹⁷ FASB ASC Topic 470, Debt, available at www.fasb.org.

¹⁸ FASB ASC Topic 710, Compensation—General, available at www.fasb.org.

¹⁹ FASB ASC Topic 712, Compensation—Nonretirement Postemployment Benefits, available at www.fasb.org.

²⁰ FASB ASC Topic 715, Compensation—Retirement Benefits, available at www.fasb.org.

²¹ FASB ASC Topic 718, Compensation—Stock Compensation, available at www.fasb.org.

²² FASB ASC Topic 960, Plan Accounting—Defined Benefit Pension Plans, available at www.fasb.org.

²³ FASB ASC Topic 962, Plan Accounting—Defined Contribution Pension Plans, available at www.fasb.org.

²⁴ FASB ASC Topic 965, Plan Accounting—Health and Welfare Benefit Plans, available at www.fasb.org.

²⁵ FASB ASC Topic 944, Financial Services—Insurance, available at www.fasb.org.

²⁶ FASB ASC Subtopic 340-30, Other Assets and Deferred Costs — Insurance Contracts That Do Not Transfer Insurance Risk, available at www.fasb.org.

6. An equity investment in a consolidated subsidiary.
7. A noncontrolling interest in a consolidated subsidiary.
8. An interest in a variable interest entity that the entity is required to consolidate based on ASC Subtopic 810-10.²⁷
9. A financial asset or financial liability pertaining to a lease that is within the scope of ASC Topic 840 on leases.²⁸
10. A loan commitment and a financial standby letter of credit held by a potential borrower.
11. A loan commitment related to a revolving line of credit under a credit-card arrangement.
12. The conditional obligation under a registration payment arrangement that would be accounted for separately from the financial instruments subject to the agreement based on ASC Subtopic 825-20 on registration payment arrangements.²⁹ However, a holder of a financial instrument that is subject to a registration payment arrangement is within the scope of this proposed guidance.
13. A contingent consideration arrangement that is not based on an observable market or an observable index. For example, a contingent consideration arrangement that is based on the future stock price of the acquirer that is observable in the market would be within the scope of the proposed guidance.
14. A not-for-profit entity's pledge receivable or payable resulting from a voluntary, nonreciprocal transfer.
15. The following financial guarantee contracts:
 - a. A contract that provides for payments that constitute a vendor rebate (by the guarantor) based either on the sales revenues of, or the number of units sold by the guaranteed party, or on the volume of purchases by the buyer;
 - b. A guarantee or an indemnification, the existence of which prevents the guarantor from being able either to account for a transaction as the sale of an asset or to recognize the profit from that sale transaction;
 - c. A guarantee or an indemnification of an entity's own future performance (e.g., a guarantee that the guarantor will not take a specified action);
 - d. A product warranty or other guarantee for which the underlying is related to the functional performance (and not the price) of nonfinancial assets that are owned by the guaranteed party;
 - e. A guarantee issued between a parent and its subsidiary or between entities under common control;

²⁷ FASB ASC Subtopic 810-10, Consolidation – Other, available at www.fasb.org.

²⁸ FASB ASC Topic 840, Leases, available at www.fasb.org.

²⁹ FASB ASC Subtopic 825-20, Financial Instruments – Registration Payment Arrangements, available at www.fasb.org.

- f. A parent's guarantee of its subsidiary's debt to a third party; and
 - g. A subsidiary's guarantee of debt owed to a third party by either its parent or another subsidiary of that parent.
16. Forward contracts that require physical settlement by repurchase of a fixed number of the issuer's equity shares in exchange for cash accounted for based on ASC paragraph 480-10-35-3.
17. The following instruments or transactions that are currently excluded from the scope of ASC Topic 815 on derivatives and hedging also are excluded from the scope of the proposed guidance:
- a. A forward contract related to a regular-way securities trade;
 - b. From the perspective of a transferor, a derivative that is an impediment to one party's use of sale accounting under ASC Topic 860 on transfers and servicing;³⁰
 - c. An investment contract that is subject to ASC Topic 960;
 - d. A contract that is not exchange-traded if the underlying is any of the following:
 - i. A climatic or geological variable;
 - ii. The price or value of a nonfinancial asset or liability of one of the parties to the contract provided that the asset is not readily convertible to cash; and
 - iii. Specified volumes of sales or service revenues of one of the parties to the contract.
 - e. A policyholder's investment in a life insurance contract that is accounted for under ASC Subtopic 325-30 on investments in insurance contracts;³¹ and
 - f. A contract between a potential acquirer and seller to enter into a business combination at a future date.

³⁰ FASB ASC Topic 860, Transfers and Servicing, available at www.fasb.org.

³¹ FASB ASC Subtopic 325-30, Investments—Other – Investments in Insurance Contracts, available at www.fasb.org.



A more comprehensive analysis of the provisions and potential impact of the proposal will be provided in a future Issues In-Depth publication. In addition, we encourage you to participate in our upcoming CFO Financial Forum Webcast on the proposal on Friday, June 4 from 1:00-3:00 p.m. Eastern time. **Click here** to register for the June 4 audio Webcast.

The descriptive and summary statements in this newsletter are not intended to be a substitute for the requirements of the proposed Accounting Standards Update or any other applicable or potential accounting literature or SEC regulations. Entities applying GAAP or filing with the SEC should apply the texts of the relevant laws, regulations, and accounting requirements, consider their particular circumstances, and consult their accounting and legal advisors.

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