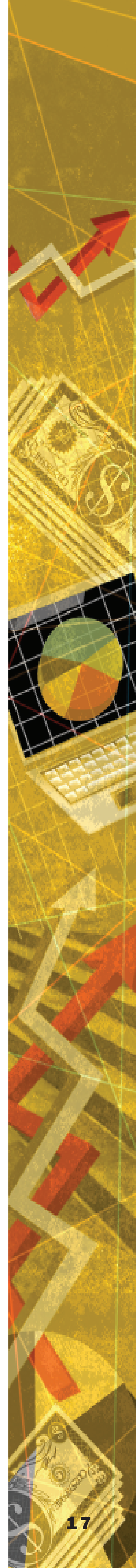
Bruce Pounder, CMA, CFM, Editor



Accounting for Financial Instruments: Post-Crisis Changes, Part 2

As the IASB and the FASB overhaul their accounting standards for financial instruments, observers wonder whether IFRS and U.S. GAAP will converge or diverge in this area.

This column is the second of two that describe recent and forthcoming changes to financial-instrument accounting standards —changes that carry significant implications for preparers, auditors, and users of financial statements. Last month, I focused on how the International Accounting Standards Board (IASB) is changing International Financial Reporting Standards (IFRS). This month, I'll focus on how the U.S. Financial Accounting Standards Board (FASB) is changing U.S. Generally Accepted Accounting Principles (GAAP).

Different Approaches, Different Timetables

In contrast to the IASB's three-phase approach to replacing International Accounting Standard (IAS) 39, "Financial Instruments: Recognition and Measurement," the FASB is taking a "one-shot" approach to revising Accounting Standards Codification (ASC) Topics 825, *Financial Instruments*, and 815, *Derivatives and Hedging*. And while the IASB has already issued the first part of its revised financial-instruments standard as well as an exposure draft (ED) of an additional revision, the FASB hasn't issued any final or proposed Accounting Standards Updates (ASUs) in conjunction with the financial-instruments project. But the FASB hasn't been idle and is quickly catching up to the IASB.

In the first quarter of this year, the FASB will issue an ED of a proposed ASU that will include all changes the FASB believes should be made to its financial-instruments accounting standards. The single ED will cover every aspect of financial-instruments accounting that the IASB will eventually cover, including recognition, measurement, impairment, and hedge accounting. Both Boards expect to complete their work on financial-instruments standards by the end of 2010.

Focus on Fair Value

Although the FASB hasn't yet issued its ED on financial-instruments accounting, the Board has been very open regarding its deliberations on the issues involved. As a result of these deliberations, the FASB has made and disclosed several tentative decisions, only some of which are aligned with the final and proposed guidance that the IASB has issued.

For example, both Boards agree that some financial instruments should be measured at fair value and others should be measured at amortized cost. But they haven't yet reached agreement on criteria for determining which of those two measurement attributes a reporting entity should apply to a particular financial instrument.

For its part, the FASB has tentatively decided that nearly all financial instruments should be measured at fair value. Amortized cost could be used as a measurement attribute only in limited circumstances and only if an entity's management elects to use it instead of fair value. One situation in which management would have the option to use amortized cost is in measuring a liability arising from the reporting entity's "own debt"—i.e., debt instruments that the entity has issued for financing purposes.

Recognition of Changes in Fair Value

Both the FASB and the IASB agree that, for financial instruments measured at fair value, in some cases changes in fair value should be recognized in Net Income (NI), while, in other cases, changes in fair value should be recognized in Other Comprehensive Income (OCI). But, again, the Boards currently diverge in their thinking on the criteria for applying one treatment vs. the other.

The FASB has tentatively decided that changes in the fair value of financial instruments measured at fair value should be recognized in NI by default; changes in fair value would be recognized in OCI only in limited circumstances. In particular, OCI recognition would apply to any debt instrument that has a principal amount and that, according to the reporting entity's business strategy, is held for collection (or payment) of contractual cash flows rather than being sold (or otherwise transferred) to a third party.

Classification

The overall effect of the FASB's tentative approach is that each financial instrument would fall into one of three classifications:

1. Fair value with changes recognized in NI (FV-NI),
2. Fair value with changes recognized in OCI (FV-OCI), or
3. Amortized cost.

Financial instruments would be displayed separately on the face of the statement of financial position based on these categories. Reclassification wouldn't be permitted.

The FASB's approach would result in nearly all financial assets, including traditional loans and straightforward debt instruments, being classified as FV-NI. The approach is also likely to result in a much higher proportion of financial assets being measured at fair value than would be measured at fair value under IFRS 9, "Financial Instruments," which the IASB issued recently.

The implications of the FASB's approach for financial liabilities are more difficult to predict. They depend significantly on management's inclination to measure entities' own debt at fair value vs. amortized cost—a choice that managers often wrestle with today under current U.S. GAAP.

Bruce Pounder will present *International Financial Reporting Standards: Legal Implications for State Boards of Accountancy* at NASBA's 15th Annual Conference for State Board Legal Counsel in Nashville, Tenn., March 21–23, 2010. For more information, visit www.nasba.org.

Impairment

The FASB's tentative approach to the impairment of financial instruments is that instruments classified in the FV-OCI category —and *only* those instruments— would be subject to a periodic assessment to determine if impairment losses should be recognized. An impairment loss would be recognized and measured based on the present value of management's current estimate of the contractual cash flows that aren't expected to be collected from an instrument. Current-period impairments would be recognized in NI, and cumulative losses would be presented on the balance sheet as separate line items.

Both the FASB and the IASB are considering shifting from an "incurred loss" impairment model (as currently embodied in U.S. GAAP and IFRS) to an "expected loss" model that incorporates expectations about future credit losses over the life of a financial asset. Last month's column discussed the broad implications of such a shift.

Given the current differences in the FASB's and IASB's thinking about future financial-instruments accounting standards, as well as the importance of getting the changes "right" in the wake of the global financial crisis, many observers consider 2010 to be a "make or break" year for the Boards' efforts to converge U.S. GAAP and IFRS at the standard level. If there's one thing we can be sure of from a standards-setting perspective, it's that the year will end very differently from the way it began. **SF**

Bruce Pounder, CMA, CFM, DipIFR (ACCA), is president of Leveraged Logic, a provider of consulting and educational services to financial professionals. He is chair of IMA's Small Business Financial and Regulatory Affairs Committee and the liaison from that Committee to IMA's Financial Reporting Committee. You can reach Bruce at BPounder@LeveragedLogic.com.