

Straight away

IFRS bulletin from PricewaterhouseCoopers

FASB's different proposals for financial instrument accounting may impact IFRS requirements

What is the issue?

The FASB has published significantly different proposals from the IASB on financial instrument accounting. In its proposed Accounting Standards Update, 'Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities', published on 26 May 2010, the FASB sets out its comprehensive approach to financial instruments accounting. This includes classification and measurement, impairment and revisions to hedge accounting. It also proposes extensive new presentation and disclosure requirements.

The more significant difference relates to the classification and measurement approach for financial assets under IFRS 9, 'Financial instruments,' which requires amortised cost measurement for certain financial instruments; versus a proposed fair value through 'other comprehensive income' (OCI) approach under US GAAP. The IASB has also proposed different impairment and interest recognition models, and is still to finalise its hedge accounting proposal.

The IASB and FASB projects on financial instruments are running concurrently, so the FASB proposals have the potential to impact the IASB's deliberations on financial instrument impairment and hedge accounting. The IASB has requested that constituents from the IFRS community respond directly to the FASB.

The key provisions

Classification and measurement

The FASB proposes that most financial instruments should be measured at fair value, except for core deposit liabilities of financial institutions, which would be valued using a new remeasurement methodology. Trade receivables and payables may be recognised at amortised cost if certain criteria are met. All changes in fair value would be recognised in net income unless an instrument qualifies and the entity elects to recognise those fair value changes in OCI. The determination of whether an instrument qualifies for OCI treatment focuses on an entity's business strategy and the instrument's characteristics.

Many debt instruments may qualify for OCI treatment, including most held-to-maturity securities, certain loans that are held for investment and core deposit liabilities. However, all equity investments not accounted for under the equity method would be measured at fair value and would not be eligible for OCI treatment. The type of equity investments that qualify for the equity method would also be reduced. Hybrid financial instruments (excluding any equity component), which are currently separated into their component parts for accounting purposes, would be recorded in their entirety at fair value through net income.

An entity could measure its own debt at amortised cost if fair value measurement would create or increase a measurement mismatch between the recognised assets and liabilities. If an entity's own debt is measured at fair value, any significant changes in fair value attributable to changes in the entity's own credit standing would have to be presented separately on the face of the financial statements.

Impairment and interest income recognition

Financial assets for which OCI treatment or amortised cost is elected would be subject to a single credit impairment model. A credit impairment would be recognised in net income when an entity does not expect to collect all of the contractually promised cash flows. An entity would no longer wait for a probable event before recognising a loss; instead, it would need to consider the impact of past events and existing conditions on the collectability of contractual cash flows over the remaining life of the asset(s) without regard to the probability threshold. An entity would determine its best estimate of the amount of credit impairment at the end of each reporting period.

Financial assets with similar risk characteristics could be assessed collectively for impairment, with the amount of credit impairment calculated by applying a loss rate to the group. Alternatively, they could be assessed individually. If assessed individually, the amount of credit impairment would initially be determined as the difference between the amortised cost and the present value of the cash flows expected to be collected. The impairment amount could also be based on the value of the underlying collateral for collateral-dependent assets.

A single interest income recognition approach would be required for financial assets. The amount of interest income recorded would be impacted by any credit impairment recognised on the financial asset.

Hedge accounting

Hedge accounting would be available for financial instruments where OCI or amortised cost treatment has been elected. The risks that are eligible for hedge accounting would remain unchanged. However, it would be easier to qualify for hedge accounting because a hedging relationship would only need to be reasonably effective (no longer highly effective).

The ability to assume no hedge ineffectiveness by using the shortcut and critical terms match methods would be eliminated, but the current onerous effectiveness assessment requirements would be significantly reduced.

Other proposed changes include prohibiting the discretionary de-designation of hedging relationships, and requiring the recognition in net income of the ineffectiveness associated with both over- and under-hedges for all cash flow hedging relationships.

Am I affected?

The proposal will affect entities applying US GAAP across all industries that hold or issue financial instruments and that apply hedge accounting. Financial institutions (especially retail and commercial banks) are likely to be most significantly impacted by these changes.

What do I need to do?

The comment letter period ends on 30 September 2010; a final standard is expected in the first half of 2011. The FASB will host a live webcast on 30 June 2010. It also plans to host public roundtables later this year to obtain further input. Management should consider if they wish to comment on the FASB's proposals.

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