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## Reporting for Financial Instruments – FASB and IASB Perspectives

### *Introduction*

In early August, Conning published an *Asset Management Viewpoint* on the convergence of FASB/IASB accounting standards which focused on the late May FASB exposure draft on "Accounting for Financial Instruments."

Specifically, the FASB released for comment Topic 825 (Financial Instruments) and Topic 815 (Derivatives and Hedging) – comments are due to the FASB by September 30, 2010. After comments have been received, FASB will hold a series of roundtable discussions with industry and will issue a final ASU (Accounting Standard Update) on both Topics in 2011.

In this follow-up article, we will examine the FASB Topic 825 proposal in more detail and lay out key questions that we believe will be addressed before the draft is adopted. We will also look at Topic 815 later in the article.

Our approach here is to lay out the elements of Topic 825 and then to drill into them. We have a particular interest in several key elements of the current reporting procedure – if adopted as written, these changes could affect an insurance company's investment portfolio. Along the way we will provide perspective on how the IASB sees similar issues.

### *Critical Changes to the New Reporting Procedures*

- The FASB endorses a methodology where all investments would be reported at Fair Market Value (FMV). Depending on the type of investment or the business strategy, the changes in FMV would be reported in Net Income or in Other Comprehensive Income (OCI). Amortized cost is no longer an approved method for the valuation of securities on the balance sheet.
- The IASB would allow for two methods of reporting, either at FMV, with changes being reported in Net Income, or, at amortized cost. Reporting of securities at FMV with changes in value being reported in unrealized gain/loss (OCI) would no longer be an approved methodology.
- Both regulatory bodies would allow companies to establish impairment reserves which could increase or decrease depending on economic conditions. The primary difference between the two would be that the FASB approach prohibits companies from using future expectations while the IASB endorses it.

It appears to us (as well as to other U.S. interests) that the IASB standards are more reasonable than those proposed by the FASB.

Adoption of these changes as written may also force some insurance companies to categorize a significant portion of their bond portfolio as "trading like" because they will not be able to demonstrate that their business model is to hold their securities for a significant portion of the bond's life. This may result in insurance companies segregating their portfolios into two categories, a "Trading" category of assets that could be sold as market or other conditions warrant, and a "Held for a Significant Period of Time" category. Expected to be finalized in 2011, this re-categorization could have significant implications for insurers.

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Let's look at the individual elements within the FASB proposal:

1) Fair Market Value vs Amortized Cost - The FASB proposal does away with amortized cost altogether, moving strongly to a comprehensive FMV basis. Under the proposed FASB guidance, all stocks and bonds will be measured at FMV.

2) Reporting Changes in Fair Market Value – Net Income or Other Comprehensive Income (OCI) - The "default" approach for stocks and bonds would be to report changes in FMV through Net Income vs OCI.

3) The change in accounting classifications for securities based on business strategy - the "Held to Maturity" (amortized cost) classification option would be eliminated for most asset types (as is the case today for securities in a "Trading" portfolio). In fact, for common and perpetual preferred stocks, this will be the only choice – all gains and losses will immediately be recognized in income (excluding those reported using the equity method).

4) Changes in impairment methodology in the context of OCI.

Item 1 above is straightforward and reflects recent FASB thinking. However, there are exceptions to Item 2 above with respect to bonds and redeemable preferred stock. For these securities, there is another category, i.e., reporting changes in FMV through OCI. However, to qualify for OCI, the securities need to meet all criteria listed in paragraph 21 of the FASB exposure draft as follows:

**Criterion 1:** It is a debt instrument held with all of the following characteristics:

a) There is an amount transferred to the issuer at inception that will be returned to the investor at maturity or other settlement date, which is the principal amount of the contract adjusted by any original issue discount or premium.

b) 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.

c) The debt instrument cannot be contractually 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.

**Criterion 2:** The entity's business strategy for the instrument is to collect or pay the related contractual cash flows rather than sell the financial asset or settle the financial liability with a third party. The possibility that a debt instrument may be settled with the counterparty before the stated maturity date (that is, the instrument may be prepaid) because of the exercise of an embedded call or put option would not prevent an entity from have a business strategy to collect or pay the instrument's contractual cash flows.

**Criterion 3:** It is not a hybrid instrument for which the guidance on derivatives and hedging would otherwise have required the embedded derivative to be accounted for separately from the host contract. The entire change in fair value of a hybrid instrument for which those criteria would have required separate accounting for the embedded derivative shall be recognized in net income.

## *The Devil's in the Details – Discussion of Criteria*

**Criterion 1** ("debt instrument with …characteristics") – Most bonds and structured notes would meet this requirement, so this does not represent a major change. However, item 1c, "investor would not recover substantially all of its initial investment" means that debt securities such as interest-only (IOs) and debt purchased at a significant premium (threshold for significant premium still to be determined) would not meet this requirement and would be precluded from reporting through OCI. Instead, these instruments would be categorized as "trading" assets (changes in FMV would be reported in net income.)

**Criterion 2** – This could be a difficult hurdle. The auditor perspective (based on insurance company feedback) is that most insurance companies feel they meet the Item 2 requirement because most hold their debt with the intention to collect the cash flows. Further, the number of insurers that actively trade their bond portfolios is not significant.

However, auditors are not as confident. Paragraph 22 includes further clarity on what the FASB intends for a qualifying business strategy, i.e., *"The entity's business strategy shall be to hold the instruments for a significant portion of the contractual terms."*

It is unclear what is meant by the term "significant." Is it 8 out of 10 years? Is a portfolio turnover ratio of 10% sufficient? The audit world is pointing out that if there were a large unexpected loss, insurers would need to sell assets to meet this obligation, thus negating the business strategy to hold for a significant portion of the debt terms. Certainly, a U.S. Treasury, surrogate or liquidity portfolio would not meet this "significant" holding period threshold. Therefore, it will be critical to see what sort of future clarification is provided and how industry and audit practices are instituted. The early indications suggest that more debt securities are likely to be treated as "Trading" assets.

**Criterion 3** – Any securities being reported today using Hybrid rules that require bifurcation will no longer require bifurcation (e.g., convertible bonds). Instead, the entire security would be reported as one instrument with all changes in value being recorded in net income.

If a portfolio/security meets all requirements in items 1-3 above, then the company can make an **irrevocable** election to report those debt securities at FMV with changes flowing through unrealized gain/loss and reported in OCI.

We see a problem with the "irrevocable" nature of this election. A company would be stuck with its decision to report changes in unrealized gain/loss through OCI, regardless of future business strategies or organizational changes. The potential exists for future negative impacts that are unforeseen at present.

A further interesting aspect of the FASB draft relates to financial liabilities. Some financial liabilities may continue to be reported at amortized cost. However, if 50% or more of the Balance Sheet is reported at FMV then this election is prohibited and financial liabilities also must be reported at FMV.

And finally, while stocks and bonds will be reported at FMV on the balance sheet, there would also be a requirement to disclose (in parenthetical form) the associated amortized cost.

## *Item 4 – Impairments – What is FASB's Current View?*

One might have expected that with the movement towards convergence, we might be seeing more principles-based guidelines. However, in respect to impairments, this is not the case. The new impairment model would apply only to those securities qualifying for the OCI method of reporting of changes in FMV. The reasoning is that there is no need to impair a security reported at FMV because market value changes have already been reported in net income.

Credit impairments should be recognized each reporting period when the entity no longer expects to collect all the contractual cash flows. The good news is that companies would no longer be required to take an impairment for declines in FX rates, interest rates or slower/later cash flows. Credit impairments would be determined on all available information relating to the economic conditions from either the past or the present (no forecasting into the future).

For example, if you held a variable rate note, you should not discount the projected cash flows using the forward yield curve – instead you should use today's existing rate, even though this rate may be an aberration. Depending on conditions in the financial markets, this methodology could lead to exasperating swings, i.e., larger impairment losses in time periods of financial turmoil, which would then be reversed as the market recovers. This point has been made in several of the comment letters sent to the FASB. Under the proposed guidance, impairments could even be reversed!

An additional change from today's practice has to do with the issue of "tainting." Although tainting would not come into play with the sale of an individual security, it may become an issue at the business strategy level. This gets back to the auditors' concern relating to holding instruments for a significant period and selling assets due to unexpected losses.

**Impairment Allowance for Individual Securities:** If a company determines there is a credit impairment based on an unfavorable change in cash flows, it should increase or establish an allowance for credit losses on that security and also establish a contra-asset account (this goes back to the days of impairment reserves). If subsequently, there is a favorable change, these entries should be reversed, up to the point of the original impairment. If the change is so favorable that a company will recover more than the amount of the impairment, the additional amount should be included as an improvement in the yield on the investment and amortized over the remaining life of the security.

**Impairment Allowance for a Pool of securities:** The FASB viewpoint is that impairment analysis also should be done on a group of assets. They have stated that these groups (or pools) should share common characteristics such as:

- Internal or External credit score or rating
- Risk rating or classification
- Financial asset type
- Collateral type
- Size
- Term
- Industry

Guidance on impairment of a pool of securities can be found in paragraph 58 of the draft proposal, *"In determining the amount of the impairment…an entity shall consider historical loss experience for financial assets that have those characteristics."* This statement raises several questions that we believe the industry will need to consider, such as:

- Will it be acceptable for insurers to post an impairment reserve based on the overall quality rating of their portfolio using Moody's or S& P historical loss ratios?
- How "similar" will these pools need to be?
- Can a company calculate its reserve based on a large-scale macro bond basis?

With two methods to determine impairments (individual and pool), a strange potential outcome becomes possible – as you realize an impairment loss on a specific security, you may also be able to book a release of the pooled or grouped impairment reserve. Because these are offsetting entries, the net result is a zero impact to the income statement.

**Impairment Rule-based Guideline – Measuring Interest Income on Debt Instruments Held:** This may be one of the most challenging changes included in the draft proposal, leading us to ask if the FASB may have become overly prescriptive here. From Paragraph 80:

*"The method of recognizing interest income on the basis of a financial asset's amortized cost balance, net of any allowance for credit losses, results in a difference between the amount of interest contractually due...and the amount of interest accrued for the financial asset. The difference between the amount of the accrued interest receivable, based on the amount of interest contractually due, and the amount of the interest accrued shall be recognized as an increase in the allowance for credit losses."*

| | Today's Entry | | Future Entry | |
|---|---|---|---|---|
| | Debit | Credit | Debit | Credit |
| **Cash Received** | 100 | | 100 | |
| **Interest Received** | | 100 | | 100 |
| **Impairment Reserve** | | | | 5 |
| **Income Received** | | | 5 | |

While the intention appears good – establishing a reserve for future potential losses – we have a number of questions:

- This method would force companies to track a portion of all interest received into an impairment reserve.
- This all-time information will need to be tracked somewhere at a lot level in order to be offset against future losses.
- Could companies be forced to manually track this information on excel spreadsheets?
- How will investment software vendors handle this?

Another issue associated with this methodology would result when companies record a portion of the interest received, not as income, but as an impairment reserve, creating a book/tax difference.

We feel it might make more sense to simply allow companies to establish a book yield which is based on the Net Realizable Value (as is the case for structured securities today). Instead of establishing a cash-based reserve, a company could establish an accrual-based reserve – both reserves impact the income statement.

## *FASB Topic 815 – A Word about Hedging*

Under the draft proposal for Topic 815, to qualify for hedge accounting, companies would need to perform a qualitative or quantitative assessment at the inception date to demonstrate that there is an expected correlation between the hedging instrument and the hedged item. The proposal reduces the threshold to qualify for on-going hedge accounting from 80%-125% (highly effective) to 50% (reasonably effective). In addition, the requirement to perform on-going tests to prove hedge effectiveness has been reduced and will be required only in circumstances that would suggest the hedging relationship is no longer reasonably effective. Finally, the "shortcut method" and "critical terms match" would be eliminated – companies will no longer be able to assume perfect effectiveness for any hedging relationship. In fact, assuming perfect effectiveness would no longer be necessary since the threshold for effectiveness has been reduced to "reasonably effective."

## *FASB vs. IASB – Where are the Critical Differences on Reporting for Financial Instruments?*

**Reporting of Debt Securities at FMV:** The IASB will release their financial instrument guidance (Classification and Measurement, Impairment & Hedge Accounting) in stages over the next year. Classification and Measurement (IFRS 9) already has been released. Like the FASB proposal, the IASB model also endorses two different categories of reporting, but the IASB categories differ from the FASB model. The default category is similar to FASB, i.e., reporting of debt securities at FMV with changes flowing through net income. However, there is a significant difference in the reporting for debt securities in the other category - amortized cost. To qualify for amortized cost reporting, companies would need to meet standards similar to FASB standards in terms of a business strategy/model. As a general rule of thumb, if an instrument qualifies for OCI treatment under FASB, that instrument is likely to qualify for amortized cost under IASB.

**Equities not Held for Trading Purposes:** Another IASB difference exists for equities in situations where the company claims the equities are not held for trading purposes. Under the proposed FASB rules, there is no option for equities; all changes in FMV are reported in net income. Under IASB, companies electing the "Not Held for Trading Purposes" option will report changes in FMV in OCI but with a twist. For these securities, IASB rules do not permit reclassification from unrealized to realized – there would be no realized gains/losses on sale of these securities. The amount, which under current rules would be reported as a realized gain/loss, will instead remain an unrealized gain/loss indefinitely.

**Impairments:** A crucial difference exists when it comes to impairments. Under the IASB model companies are allowed to determine if an impairment exists based upon existing and future economic events or conditions (FASB does not allow impairments to be determined on future expected conditions).

**Hedge Accounting:** Because the IASB has not yet issued guidance on hedge accounting, it is too early to tell if how closely their guidance will mirror the FASB proposal.

The clear differences between FASB and IASB guidance on the Reporting for Financial Instruments lead us to believe the goal of 100% convergence between these two rules-making bodies is unlikely over the short term. Additional recommendations by both organizations are expected to be released over the coming months – we will keep you posted on emerging developments and critical discussion items around these and other proposed regulatory changes as they progress.

To see a listing of the comment letters on the FASB initiative click here: FASB Comment Letters

We would welcome your thoughts and feedback – email us at: Comment_IAR@conning.com.