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FASB FLASH REPORT

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FASB Issues Targeted Improvements to Financial Instruments Standards

The FASB issued ASU 2019-04[1] to clarify and improve guidance within the recently issued standards on credit losses, hedging, and recognition and measurement of financial instruments. The new ASU is available **here,** and the amendments have various effective dates and transition guidance.

BACKGROUND

Since 2016, the FASB has issued the following standards related to financial instruments:

- ASU 2016-01, *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*
- ASU 2016-13, *Financial Instruments— Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*
- ASU 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*

Since issuance of the standards, the FASB has identified through stakeholder feedback certain areas that need clarification and correction, resulting in changes similar to those issued under its ongoing Codification Improvements project. The FASB also established the Transition Resource Group (TRG) for Credit Losses early in 2016 to solicit, analyze, and discuss implementation issues that could arise when organizations implement ASU 2016-13.

1 Codification Improvements to Topic 326, Financial Instruments—Credit Losses, Topic 815, Derivatives and Hedging, and Topic 825, Financial Instruments

MAIN PROVISIONS

The amendments are organized into five topical areas, each of which has multiple issues. BDO has summarized the improvements below. Certain topical issues have been excluded as they simply correct or clarify cross-references.

1. Codification Improvements Resulting from the June 11, 2018 and November 1, 2018 Credit Losses TRG Meetings

What was the issue?	Summary of Improvements
Issue 1A: Accrued Interest Because 'accrued interest' is included in the definition of 'amortized cost basis,' an entity would be required to consider accrued interest amounts in determining the allowance for credit losses on the corresponding loan. Further, any write off of accrued interest amounts would be through the allowance for credit losses. Many financial reporting systems do not track accrued interest amounts on an individual loan basis, therefore including such interest in the amortized cost basis would be burdensome and costly to implement.	The amendments to ASC 326-20 allow an entity to measure the allowance for credit losses on accrued interest receivable balances separately from other components of the amortized cost basis. The amendments also provide several accounting policy elections regarding measurement, presentation, and disclosure of accrued interest and write off of accrued interest.
Issue 1B: Transfers between Classifications or Categories for Loans and Debt Securities Stakeholders questioned how to account for the allowance for credit losses or valuation allowance when transferring loans and debt securities between classifications.	The amendments require that an entity reverse through earnings any allowance for credit losses or valuation allowance previously measured on a loan or debt security, reclassify and transfer the loan or debt security to the new classification or category, and apply the applicable measurement guidance in accordance with the new classification or category.
Issue 1C: Recoveries Stakeholders noted that the guidance could be interpreted to prohibit consideration of recoveries of financial assets and trade receivables previously written off in the estimation of expected credit losses. Further, it is unclear how to account for an amount expected to be collected greater than the amortized cost basis.	The amendments clarify that an entity should include recoveries when estimating the allowance for credit losses. However, expected recoveries of amounts previously written off and expected to be written off to be included in the valuation account should not exceed the aggregate of amounts previously written off and expected to be written off. Similarly, an allowance for credit losses that is added to the amortized cost basis of collateral-dependent financial assets should not exceed amounts previously written off.

BDO Observation

Based on discussion with the FASB staff we expect further codification improvements clarifying how expected recoveries might be considered and measured for purchased credit deteriorated (PCD) assets.

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2. Other Codification Improvements to Update 2016-13

What was the issue?	Summary of Improvements
Issue 2C: Reinsurance Recoverables Stakeholders asked whether reinsurance recoverables measured on a net present value basis in accordance with ASC 944[2] are within the scope of ASC 326-20, considering those recoverables are not measured at amortized cost basis.	The amendment clarifies that all reinsurance recoverables within the scope of ASC 944 are also within the scope of ASC 326-20, regardless of the measurement basis of those recoverables.
Issue 2D: Projections of Interest Rate Environments for Variable-Rate Financial Instruments Stakeholders questioned the prohibition of using projections of future interest rate environments in estimating expected future cash flows and determining the effective interest rate with which to discount those cash flows for variable-rate financial instruments.	The amendments provide flexibility by removing the prohibition of using projections of future interest rate environments when using a discounted cash flow method to measure expected credit losses on variable-rate financial instruments. If projections of future interest rate environments are used in estimating cash flows, the same assumptions should be used in determining the effective interest rate (EIR) for discounting those cash flows. Further, the EIR also should be adjusted for changes in the timing of expected cash flows resulting from expected prepayments.
Issue 2E: Effect of Prepayments on Effective Interest Rate (EIR) Stakeholders asked whether expected prepayments that are required to be considered in estimating expected cash flows also may be considered in determining the EIR used to discount those expected cash flows in a discounted cash flow method.	The amendments permit an accounting policy election to adjust the EIR for the consideration of timing (and changes in timing) of expected prepayments. However, adjustments to the EIR for subsequent changes in expected prepayments is not permitted if the financial asset is restructured in a troubled debt restructuring.
Issue 2F: Consideration of Estimated Costs to Sell - Foreclosure Is Probable Stakeholders asked whether it is required to consider estimated costs to sell collateral when using the fair value of collateral to estimate expected credit losses on a financial asset because foreclosure is probable.	The amendments clarify that an entity should consider the estimated costs to sell if it intends to sell rather than operate the collateral when the entity determines that foreclosure is probable. The amendments also clarify that when an entity adjusts the fair value of collateral for the estimated costs to sell, the estimated costs to sell should be undiscounted if the entity intends to sell rather than operate the collateral.

2 Financial Services— Insurance

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3. Codification Improvements to Update 2017-12 and Other Hedging Items

What was the Issue?	Summary of Improvements
Issue 3A: Partial-Term Fair Value Hedges of Interest Rate Risk Stakeholders asked whether a hedged item's assumed term may also be used to measure the change in fair value of a hedged item in a partial-term fair value hedge of risks other than solely interest rate risk. Stakeholders also asked whether multiple partial-term fair value hedging relationships of a single financial instrument can be outstanding at the same time.	The amendments clarify that an entity may measure the change in fair value of a hedged item using an assumed term only for hedges of interest rate risk or in a hedge of both interest rate risk and foreign exchange risk. Other related clarifications were made. Further, one or more separately designated partial-term fair value hedging relationships of a single financial instrument can be outstanding at the same time, and for forward-starting partial-term fair value hedges, the issuance of the hedged item is assumed to occur on the date in which the first hedged cash flow commences.
Issue 3B: Amortization of Fair Value Hedge Basis Adjustments Stakeholders asked whether the amortization of a fair value hedge basis adjustment is required for outstanding fair value hedging relationships. Stakeholders also requested clarification of the amortization period in a partial-term fair value hedging relationship.	The amendments clarify that an entity may, but is not required to, begin to amortize a fair value hedge basis adjustment before the fair value hedging relationship is discontinued. Further, if an entity elects to amortize the basis adjustment during an outstanding partial-term hedge, that basis adjustment should be fully amortized by the hedged item's assumed maturity date.
Issue 3C: Disclosure of Fair Value Hedge Basis Adjustments Stakeholders asked the Board to clarify whether hedged available-for-sale debt securities should be disclosed at amortized cost or fair value and whether basis adjustments related to foreign exchange risk should be disclosed.	The amendments clarify that available-for-sale debt securities should be disclosed at their amortized cost and that fair value hedge basis adjustments related to foreign exchange risk should be excluded from the required disclosures.
Issue 3D: Consideration of the Hedged Contractually Specified Interest Rate under the Hypothetical Derivative Method Stakeholders asked whether an entity should consider the contractually specified interest rate designated in the hedging relationship when applying the hypothetical derivative method.	The amendment clarifies that an entity should consider the hedged contractually specified interest rate when applying the hypothetical derivative method.
Issue 3E: Scope for Not-for-Profit Entities Stakeholders raised questions on the applicability to a not-for-profit entity that does not separately report earnings of the amortization approach for amounts excluded from the assessment of effectiveness under fair value hedge accounting.	The amendments clarify that a not-for-profit entity that does not separately report earnings may not elect the amortization approach for amounts excluded from the assessment of effectiveness for fair value hedging relationships.
Issue 3F: Hedge Accounting Provisions Applicable to Certain Private Companies and Not-for- Profit Entities Stakeholders asked about the applicability of certain hedge documentation guidance and timing relief to private companies that are not financial institutions and to not-for-profit entities.	The amendments clarify that a private company that is not a financial institution should document the analysis supporting a last-of-layer hedge designation concurrently with hedge inception. The amendments also clarify that not-for-profit entities (except those that have issued, or are a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market) may apply the same subsequent quarterly hedge effectiveness assessment timing relief allowed to certain private companies.

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What was the Issue?	Summary of Improvements
Issue 3G: First-Payments-Received Cash Flow Hedging Technique The amendments in ASU 2017-12 removed the implementation guidance and illustration on the application of the first-payments-received cash flow hedging technique to changes in overall cash flows on a group of variable interest payments. Stakeholders asked whether the technique is no longer is permitted.	The amendments clarify that the application of the first-payments-received cash flow hedging technique to changes in overall cash flows on a group of variable interest payments continues to be permitted.
Issue 3H: ASU 2017-12 Transition Guidance Stakeholders raised questions related to certain transition requirements in the ASU.	The amendments clarify that transition adjustments to amend the measurement methodology of the hedged item in a fair value hedge of interest rate risk should be made as of the date of initial application of ASU 2017-12, which may differ from the date of adoption if adopted in an interim period. The amendments also clarify several other aspects of the transition guidance in ASU 2017-12, including rebalancing of certain fair value hedges, transitioning from a quantitative method of assessing hedge effectiveness to a more simplified method and reclassifications of a debt security from held-to-maturity to available-for-sale.

4. Codification Improvements to Update 2016-01

What was the Issue?	Summary of Improvements
Issue 4B: Held-to-Maturity Debt Securities Fair Value Disclosures The disclosure guidance required that all entities disclose the fair value of held-to-maturity debt securities measured at amortized cost basis.	The amendments clarify the guidance to exempt entities other than public business entities from fair value disclosure requirements for financial instruments not measured at fair value on the balance sheet.
Issue 4C: Applicability of ASC 820 to the Measurement Alternative Stakeholders asked whether an entity is required to remeasure an equity security without readily determinable fair value accounted for under the measurement alternative at fair value in accordance with ASC 820 when the entity identifies an orderly transaction with an observable price change for the identical or similar investment of the same issuer. Stakeholders also asked whether entities are required to follow the disclosure requirements of ASC 820 for subsequent remeasurements of equity securities without readily determinable fair values measured in accordance with the measurement alternative.	The amendments specifically require that an entity remeasure an equity security without readily determinable fair value at fair value when an orderly transaction is identified for an identical or similar investment of the same issuer in accordance with ASC 820. That is, the amendments clarify that the measurement alternative is a nonrecurring fair value measurement. Additionally, the amendments clarify that an entity should follow the applicable disclosure requirements in ASC 820 for a nonrecurring fair value measurement.

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What was the Issue?	Summary of Improvements
Issue 4D: Remeasurement of Equity Securities at Historical Exchange Rates Stakeholders noted that the guidance requiring that certain accounts be remeasured at historical exchange rates was not amended. Specifically, stakeholders stated that equity securities within the scope of ASC 321 are no longer carried at cost but, instead, are measured at fair value with changes in fair value recognized in net income each period. However, stakeholders asked whether equity securities without readily determinable fair values measured in accordance with the measurement alternative should continue to be remeasured at historical exchange rates.	The amendments clarify that equity securities without readily determinable fair values accounted for under the measurement alternative are required to be remeasured at historical exchange rates. In addition, the amendments clarify that the rate used should be the historical exchange rate as of the later of the acquisition date or the most recent date on which the equity security was adjusted to fair value. The amendments are not intended to change items that should be remeasured at historical exchange rates.

5. Codification Improvements Resulting from the November 1, 2018 Credit Losses TRG Meeting

What was the Issue?	Summary of Improvements
Issue 5A: Vintage Disclosures— Line-of-Credit Arrangements Converted to Term Loans Stakeholders asked how an entity should disclose line-of-credit arrangements that convert to term loans within the vintage disclosure table.	The amendments require that an entity present the amortized cost basis of line-of-credit arrangements that are converted to term loans in a separate column as illustrated in Example 15.
Issue 5B: Contractual Extensions and Renewals Stakeholders asked whether an entity should consider contractual extension or renewal options in determining the contractual term of a financial asset, noting that the guidance appears to preclude an entity from considering those contractual extension or renewal options.	The amendments clarify that an entity should consider extension or renewal options (excluding those that are accounted for as derivatives in accordance with ASC 815) that are included in the original or modified contract at the reporting date and are not unconditionally cancellable by the entity.

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EFFECTIVE DATE AND TRANSITION REQUIREMENTS

Topics 1, 2, and 5: Codification Improvements to ASU 2016-13

For entities that have not yet adopted ASU 2016-13, the effective dates and transition requirements for these amendments are the same as those in ASU 2016-13.

For entities that have adopted ASU 2016-13, the relevant amendments of ASU 2019-04 are effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. Early adoption is permitted once ASU 2016-13 has been adopted. The amendments should be applied on a modified-retrospective basis through a cumulative-effect adjustment to opening retained earnings as of the date an entity adopted ASU 2016-13.

The transition adjustment includes those made by an entity due to developing or amending its accounting policy for determining when accrued interest receivables are deemed uncollectible and written off.

Topic 3: Codification Improvements to ASU 2017-12 and Other Hedging Items

For entities that have not yet adopted ASU 2017-12, the effective dates and transition requirements for the amendments to ASC 815 are the same as those in ASU 2017-12.

For entities that have adopted ASU 2017-12, the relevant amendments of ASU 2019-04 are effective as of the beginning of the first annual period beginning after the issuance of ASU 2019-04. Early adoption is permitted for those entities.

Entities that have already adopted ASU 2017-12 may elect either to retrospectively apply all the amendments in ASU 2019-04 as of the date the entity adopted ASU 2017-12 or to prospectively apply all amendments with certain exceptions for which there is specific transition guidance. These exceptions relate to modifications of measurement methodology of the hedged item in fair value hedges of interest rate risk, rebalancing of fair value hedging relationships and reclassification of debt securities upon adoption of the amendments.

Topic 4: Codification Improvements to ASU 2016-01

The amendments related to ASU 2016-01 are effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. Early adoption is permitted in any interim period as long as the entity has adopted all of the amendments in ASU 2016-01. The amendments should be applied on a modified-retrospective basis through a cumulative-effect adjustment to opening retained earnings as of the date an entity adopted ASU 2016-01.

The amendments related to equity securities without readily determinable fair values for which an entity elects the measurement alternative should be applied prospectively.

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