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Ready, set, change: Upcoming transformations to financial instrument accounting

At a glance

FASB and IASB advances could shake up existing financial instrument accounting framework

Extensive changes to fair value, impairment, and interest income recognition could impact companies' systems, processes, and shareholder communications

Act now: Provide comments during the standard-setting process and then prepare for compliance by assessing the gaps in your reporting infrastructure

PricewaterhouseCoopers

At the wheel

Preparing for the future of automotive finance

As the economy begins its slow recovery, automotive finance companies now face a new business landscape. To help navigate this challenging and sometimes unfamiliar road, PricewaterhouseCoopers is publishing a series of papers that will explore important topics affecting the industry now and in the future.

In our latest paper "Ready, set, change: Upcoming transformations to financial instrument accounting", we discuss the accounting changes currently under consideration by the FASB and IASB. Both Boards' models would essentially rewrite the entire financial instrument accounting framework, and would require many automotive finance companies to make significant changes to their accounting processes, systems, and reporting.

The FASB's comment period is still open and it is welcoming comments during the standard-setting process. Companies have an important opportunity to influence the final nature of the standard by providing input on the proposed changes. In addition, auto finance companies should begin thinking about the implications of the upcoming standard, including its impact on systems, business performance measures, and shareholder communications.

For more information, please contact any of the individuals listed at the back of the publication.

Marking a milestone (or to some a tombstone) in the pursuit of accounting standard convergence, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) (the Boards) have each published separate proposals that would radically change how companies must account for financial instruments. Both of these proposals create additional accounting issues that may be perceived as more divergent than convergent.

FASB and IASB proposals would substantially change how companies account for financial instruments

Accelerated in part by the global financial crisis, the Boards' recommendations are intended to improve the usefulness of financial statements by providing a more timely and accurate representation of an organization's financial instruments. The FASB proposal is open for comments through September 30, 2010, while the IASB has published IAS 9.

The Boards' approaches essentially rewrite the entire financial instrument accounting framework, and would require organizations to make significant changes to their accounting processes, systems, and reporting. Most notably, both Boards would greatly increase reporting of fair value for most financial instruments on the face of the balance sheet. The FASB's approach is more comprehensive in that it requires companies to report the fair value of all financial instruments comprised of consumer and commercial loans, while the IASB's allows companies to carry these instruments at amortized cost under specific circumstances. Other changes would affect how companies calculate and record impairment, recognize interest income, and achieve hedge accounting.

The FASB's proposed rules apply to entities with assets greater than $1 billion, and would take effect in 2013. Nonpublic entities with less than $1 billion in total consolidated assets would receive a four-year deferral for some requirements.

Although the FASB must still address comments before finalizing any changes, both Boards' models represent a substantial shift with far-reaching impact. Additionally, both Boards need to more closely harmonize their models' divergent approaches. These modifications are likely to result in additional complex accounting adjustments for businesses. With such sweeping changes on the horizon, companies should start thinking about their accounting infrastructures now to begin preparing for the future of accounting for financial instruments.

This discussion is limited to some of the more complex areas of the proposed standard. However, anyone with hold-to-maturity financial instruments, hedge accounting structures, convertible debt, or equity method investments will be impacted. For information on the impact for non-financial services companies, please see PricewaterhouseCoopers' DataLine 2010-34.

FASB and IASB eye big changes to fair value measurement, impairment, and interest income recognition

As written, the Boards' approaches contain changes to almost all aspects of financial instrument accounting, including the use of fair value measurement, impairment, and interest income recognition. The FASB's proposal also includes changes to hedge accounting in the United States. Despite the Boards' stated goal of converging their current standards, their frameworks differ significantly in many areas. However, once adopted, a final standard will replace most of the current guidance for financial instruments.

A closer look at the changes and what they mean to you

Fair value measurement

Currently, companies carry loans at amortized cost and disclose fair value in the footnotes of financial statements. The FASB's proposal would require companies to report the fair value of almost all financial instruments on the balance sheet, including loans held by banks. When an instrument's fair value changes, the default setting will require the recognition of the change in net income. If a company's business strategy is to hold the financial instruments or loans to maturity, then the proposal permits an irrevocable election to recognize the fair value changes in Other Comprehensive Income (OCI).

The FASB proposal contains an exception for a company's own debt. If marking that debt to market will increase volatility without any offset, businesses can record it using amortized cost. For example, if a company issued a bond that was collateralized by its property plant and equipment, marking the bond to market would increase reported volatility, and the company could elect to record the bond using amortized cost.

Conversely, IAS 9 states that companies must record most financial instruments at fair value and recognize any value changes in net income. However, it differs from the FASB proposal when a company's business strategy is to hold the financial instruments or loans to maturity with the intent of earning the interest income. In this case, a business could record these items at amortized cost. This is not an option under the FASB proposal.

Although the two approaches differ in their application of fair value measurements, many banking institutions that currently record financial instruments at amortized cost will be significantly affected by either Board's fair value changes.

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The FASB would recognize impairment based on an expected loss model that factors in historic events and current conditions. The IASB would recognize impairment based on expected losses over the instrument's life (past, present, and future).

Impairment

Impairment measures become relevant for any financial assets that are measured at fair value through OCI. In this case, the FASB's proposal would change the way companies account for credit losses by moving from an incurred loss model to an expected loss model. Under their proposal, the expected loss model no longer allows businesses to wait until a loss is *probable* to recognize a credit impairment. Instead, companies would recognize a credit impairment in net income when they do not *expect* to receive the entire contractual loan amount due (both principal and interest).

To determine whether a credit impairment exists, preparers would analyze historic events and current conditions to ascertain whether they expect to receive all of the contractual cash flows. However, the FASB proposal does not permit companies to factor expected future conditions into the expected loss model. For example, if an analysis of the current and historic environment indicates an instrument's loan-to-value (LTV) ratio is 90 percent, and the ratio is expected to increase to 100 percent because of deteriorating market conditions, the forecasted LTV ratio of 100 percent would not be permitted in the loss model.

The FASB's proposal allows two methods to measure impairment under the expected loss model:

- Pooled basis: The pooled method for calculating impairment would be as follows:

  Balance x Probability of Default x Loss Given Default

- Individual basis: The method to calculate impairment on individual assets would be calculated as follows:

  Present Value of the Cash Flows Adjusted for Incurred Losses

Notably, the FASB impairment model allows preparers to consider the value of the collateral supporting the impaired asset and the determination of the allowance.

If an entity determines that an impairment does not exist under the individual basis method, it must also determine whether an impairment would exist if assessed on a pooled basis. Under the individual basis method, companies must take into consideration the timing of the cash flow they expect to collect. In other words, any delay in when the cash flow is expected to be received must be factored in when measuring impairment. Additionally, the proposal would result in an impairment recognition in the first reporting period for financial instruments, essentially requiring companies to recognize the loss during the first reporting period after origination (day one). Based on this change, it is expected that the initial impairment amounts will be larger and will be recognized sooner than they are now.

In contrast, IAS 9 requires companies to recognize losses over the life of the instrument. It allows companies to consider past, present, and future events when forecasting losses, whereas the FASB would allow only past and present events. For example, the IASB would permit companies to include an expected change in an instrument's LTV ratio, such as a change from 90 percent to 100 percent, when calculating expected losses.

Unlike the FASB's proposal to book expected losses on day one, the IASB model calls for businesses to book these losses over time as an adjustment to the effective interest rate. For example, if a loan's coupon is 5 percent, there are no fees, and the loan is originated at par, then the coupon rate would be 5 percent. But because companies would have to forecast a loss, they will likely need to record an effective interest rate that will be less than 5 percent. In this example, the coupon rate of 5 percent might be recorded at 4.25 percent to represent the losses and to build up the loss reserve over time.

Interest income recognition

Currently, both Boards' existing income recognition models are similar and follow the same general pattern:

Stated interest rate multiplied by the loan balance

Plus or minus the amortization of initial fees, costs, premiums, and discounts

Less portfolio-level and specific loss impairments

Accrual stops based on loan delinquency

In an attempt to address concerns that the current model allows the recognition of too much interest income, the FASB would require recognition of interest income on the net loan balance. The FASB proposal bases income recognition on the effective interest rate (EIR) that is determined based on day-one balances, prior to any impairment. Interest income will be EIR multiplied by the amortized balance adjusted for impairment. Interest accrual will be discontinued when the overall yield on the financial instrument becomes negative.

The calculation for the FASB model is as follows:

Unpaid principal balance
+/- origination fees/costs/premiums/discounts

= Historical accounting basis

Historical accounting basis
-Credit/impairment allowance

= Accounting basis for interest income

Accounting basis x effective yield = interest Income

In contrast, IAS 9 requires companies to determine their interest income based on an EIR that discounts expected cash flows, including credit losses. Revisions would be based on changes in expected cash flows discounted by the original EIR. Thus, the EIR becomes less than the contractual cash flows, creating the reserve that is released over time or when expectations change.

The calculation for the IASB model is as follows:

Adjust the EIR for expected losses
The accounting basis times adjusted EIR = interest income

The FASB proposes basing income recognition on the effective interest rate that is determined based on day-one balances, prior to any impairment. IAS 9 requires companies to determine their interest income based on an EIR that discounts expected cash flows, including credit losses.

Even partial adoption of the Boards' models will result in significant operational challenges for most organizations.

Operational implications of the proposed changes: What companies need to consider now

Although the final standard is still forthcoming, even partial adoption of the Boards' models will result in significant operational challenges for most organizations. These challenges include:

Fair value

The models will require companies to mark to market almost all financial instruments—a change that will create a considerable operational burden for accounting departments and require a fundamental change in accounting infrastructure.

If implemented, it would mark the first time that fluctuations in held-to-maturity loan values would appear on the balance sheet. If offsets are elected on the income statements, this will significantly impact companies' reported financial position. The increase in fair value measurements and changes in fair value appearing in net income will result in more net income volatility for many organizations. Similarly, OCI volatility could increase as new valuation offsets are captured in OCI. This will fundamentally change how financial statement users will need to evaluate a company's financial performance, especially when the company is a financial institution.

Because the models could have a significant impact on balance sheets, especially those of financial institutions, organizations should prepare for a substantial increase in the precision and scrutiny necessary to comply with the changes. For instance, companies will need to project their contractual cash flows and identify or assign a discount rate that accurately reflects the risk and the amount that a third party would be willing to pay for it—all at the loan level.

Finally, most companies originally designed their systems to accommodate fair value disclosure requirements, not to handle the level of detail that will be required going forward. These valuation systems and approaches are not usually set up to provide valuation information in time for the typical earnings release; yet one of the FASB's overarching objectives is to synchronize the timing of earnings with valuation measures. The requirement to identify differences between day-one fair value and transaction price will also be difficult for institutions that factor customer relationship values into the rates they charge.

Interest income recognition

Companies will need to capture new data, including the effective interest rate as defined by each of the standards. Additionally, organizations will have to develop methodology to calculate the current yield on a loan-by-loan basis. IAS 9 requires preparers to forecast the amount and timing of future cash flows. Either Board's model brings potential operational, systematic, and procedural challenges related to interest income recognition.

Impairment measurement

The FASB proposal for impairment measurement replaces the current incurred loss model with an expected loss model, recognizing an impairment when an entity does not anticipate receiving all expected cash flows in the time specified by the contract. The FASB's model requires the use of historical and current information; companies would not be able to forecast expected losses based on changes to future market conditions.

While pooling is used under the FASB's model, it is difficult to see how this will work in practice given the requirements of the income recognition model without an allocation to the loan or transaction level. If companies use a pooling method, it could likely be simplified by identifying similar assets for the pooling and accounting process.

The IASB model measures impairment on expected losses over time as an adjustment to the EIR. The difference between the interest cash received and the EIR is what will build the reserve over time. This method does not result in day-one profit/loss recognition. It would include historical and current market information, as well as expected changes in the market environment, requiring preparers to establish processes to forecast future cash flows.

System changes

Because the models require capturing new data elements, companies should consider the system changes that would be necessary to comply with the forthcoming standard. Some of the key data elements and computations that could be impacted include:

- Data fields for EIR and impairment balances
- Contractual, forecasted, loan-level, and pooled cash flows will need to be available
- For income recognition, computations must be developed to know when the overall yield on the financial instrument becomes negative in order to discontinue interest accrual
- The loan balance for interest income recognition will be variable by period as original fees amortize and expected cash flows change

However, not all accounting systems are capable of addressing the guidance for many loan portfolios, such as expected cash flow projections and reserving at the loan level. With the new standard, organizations will need to decide whether to make significant system investments to address more complex accounting requirements or invest in human capital to develop workaround (non-systematic) analyses.

As US GAAP and IFRS accounting models evolve (though not necessarily converge), companies should strive for systems that are nimble enough to comply with multiple and changing accounting frameworks.

Historical simplifications may no longer be available

Because of the need to recognize income on an impairment-adjusted basis, the Boards' models could indirectly make FAS 91 amortization of origination costs and fees more difficult. As a result, pooling assets for amortization purposes may no longer be possible since each transaction would have its own characteristics that must be tracked. Individual loan information would become significantly more important in ascertaining negative return for the termination of interest accrual.

Additionally, the preparers would be required to create more detailed cash flow estimates, which may extend to the loan level. Cash flows will overlap with the return calculations, and curtailments may be a bigger issue. However, current servicing systems do not typically provide projected contractual cash flow information. And if loss projections are in the cash flows rather than reflected as an adjustment to the discount rate (per the IASB), the quality of the estimates will become more critical.

Address the upcoming substantial and wide-reaching accounting changes by focusing on the issue now

Although a single, converged standard is still under development, the Boards' models represent a fundamental shift in financial instrument accounting. The FASB's comment period is still open and it is welcoming comments during the standard-setting process. Companies have an important opportunity to influence the final nature of the standard by commenting on the proposed changes.

In addition to providing comments, companies should begin thinking about the implications of the upcoming standard, including the following areas (as well as the elements outlined in Figure 1):

Systems—Because system infrastructure will be vital to accommodate the changes, companies may have to either invest in a new system or fundamentally demonstrate that their current processes meet the new requirements. In any case, the system changes required by the new standard will not be a push-button transformation—they will require significant time and effort.

Business performance measures and communications—Preparers should consider how the new standard could impact the way they measure and manage their business performance, and how they communicate information to shareholders. With increased volatility in the reported balance sheet and income figures, management should be prepared to articulate the meaning behind this volatility. This will most likely require a significant re-engineering of shareholder communications.

Regulatory—Companies must be able to anticipate changes in the regulatory environment going forward. Much as changes in securitization accounting led to companies grossing up balance sheets due to greater consolidation, regulators will be looking at the impact of the new standard on capital ratios and any other key safety and soundness measures.

In addition to these potential changes, Figure 1 summarizes elements companies should consider as they work through the implications of the models.

Figure 1: Impact assessment across financial instruments topics

Accounting policy and disclosures	• Impact to financial statements due to change in classification and measurement • New accounting policy and disclosures to align with new accounting model	**External and internal reporting**	• Impact to SEC/regulatory/ segment reporting • Impact to source system, data warehouse, and controls
Valuation	• Increased use of fair value • New/additional valuation methodologies and processes	**Management accounting and compensation**	• Impact to financial metrics/KPIs • Impact to incentives and compensation • Link between external reporting and management accounting
Business strategy	• Revaluate optimal asset/liability instruments mix • Negotiate and structure new agreements/relationships and debt covenants	**Regulatory capital**	• Knock-on effect on regulatory capital resulting from fundamental changes in asset/liability classification and measurement

Other changes proposed by the FASB and IASB

Although this article focuses on the more complex issues included in the FASB and IASB models, financial statement preparers should also consider some of the other changes that the Boards address:

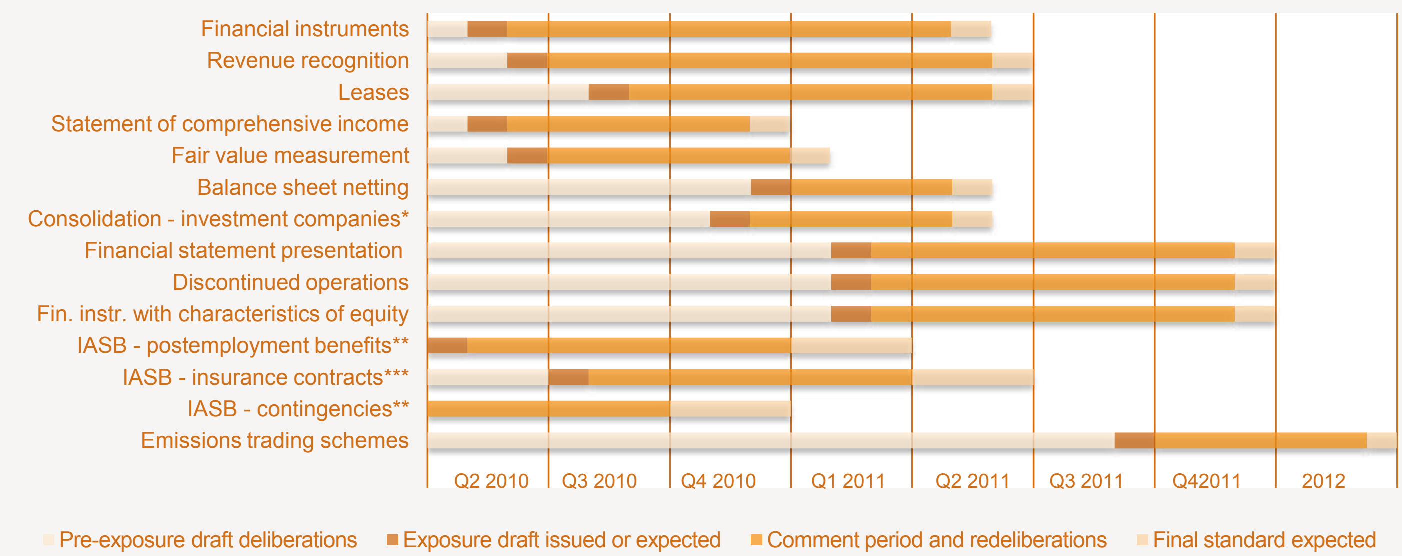
Hedge accounting:

- Short-cut and matched-terms hedge accounting will no longer be permitted.
- To get hedge accounting, the qualifying requirements move from quantitative assessments of "highly effective" to qualitative assessments of "reasonably effective."
- Hedges cannot be re-designated unless the hedging derivative is terminated. Active risk management strategies may be significantly limited.
- Cash flow hedging will include the results of both over- and under-hedges instead of the current model that only records over-hedges.

Other financial instruments:

- Items with embedded derivatives that require bifurcation will no longer be bifurcated; they will be measured at fair value through earnings.
- Convertible debt will be at fair value through earnings.
- Core deposits will be discounted (marked) using an interest rate that is a function of an alternative source of funding less the cost to service the deposits in order to discount them to a value reflective of their value to the business.
- Loan commitments will be carried at fair value.

Unprecedented scope and pace of pending change—US GAAP/IFRS



* The consolidation project has been divided into two projects: one focused on investment companies and one that is more comprehensive. The FASB will decide how it wants to proceed on a comprehensive project after it performs additional stakeholder outreach.

** These are IASB projects that have the potential to impact the views of the FASB as it evaluates existing U.S. GAAP in these areas.

*** IASB timeline. The FASB will decide, once the IASB issues its exposure draft, how best to proceed and plans to obtain stakeholder feedback on the IASB proposal.

How PricewaterhouseCoopers can assist

PricewaterhouseCoopers can help you address the upcoming changes in a number of ways. At this time, there are three key areas where clients will most likely need assistance:

1. **Education**—The Boards' models are complex and will require a significant investment to educate your team members, operating management, finance committees, and directors.
2. **Response**—Both standard-setters are thoughtfully considering the comments they have received or are still receiving from the marketplace and from financial statement preparers. We can assist by reviewing and commenting on your responses as you develop them.
3. **Assessment**—Significant changes are ahead and organizations will have to think through the potential system, process, and organizational issues these changes will bring. It is not too early to start assessing your infrastructure and identifying the key gaps you will need to close to achieve compliance.

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Feel free to contact one of our team members to see what we can do for you.

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