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SPECIAL REPORT:

CLASSIFICATION AND MEASUREMENT OF FINANCIAL INSTRUMENTS

For years, the FASB has had a project underway to change the guidance on the classification and measurement of financial instruments. The objective of the project is to improve the usefulness of information provided to users of financial statements. The way financial instruments are classified on the balance sheet determines how the instruments are measured initially and going forward. It became apparent during the financial meltdown in 2008 that the rules on the recognition of gains and more importantly losses and impairment charges on certain instruments, such as loans, was not providing the information the market wanted and needed.

The FASB began discussing changes to the guidance on the accounting for financial instruments as early as 2007. The FASB's project gained heightened attention after markets experienced a financial crisis in 2008 and 2009. Over the course of the project, the FASB has explored various ways to categorize and account for financial instruments going forward. The FASB is expected to issue a final standard on the classification and measurement of financial instruments in the fourth quarter of 2015. The final standard will be the culmination of the work that the FASB has conducted for nearly a decade.

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Users, preparers, regulators and standard setters often have differing views on the best way to classify and measure financial instruments. Two measurement bases often used to account for financial instruments are amortized cost and fair value.

During its project on the classification and measurement of financial instruments, the FASB has debated:

- Whether to measure instruments at amortized cost, fair value or on some other basis
- When each measurement basis is appropriate

Observation: Some constituents feel strongly that financial instruments must be measured at fair value. Supporters of fair value assert that this measurement basis provides timely information about the liquidity, performance and market perception of an instrument.

Other constituents contend that financial instruments must be measured at amortized cost. Supporters of amortized cost think that this measurement basis minimizes volatility on the balance sheet and income statement and is a more relevant measurement basis for securities held until maturity or for the purpose of collecting their cash flows (principal and interest).

Each measurement basis also has downsides. Opponents of fair value do not like the large degree of judgment required to estimate fair value and the volatility that results from measuring instruments at fair value. Opponents of amortized cost argue that it does not give adequate information about the liquidity, performance and market perception of an instrument.

Revising the rules on the classification and measurement of financial instruments has taken considerable time. The FASB has sought feedback from constituents on a regular basis and has tried to consider the interaction of this project with the FASB's other ongoing projects. The FASB hoped to reach a converged standard with the IASB but ultimately was unable to do so.

After several Exposure Drafts regarding the classification and measurement of financial instruments, the FASB charted a new course in which it decided to make targeted improvements to existing GAAP.

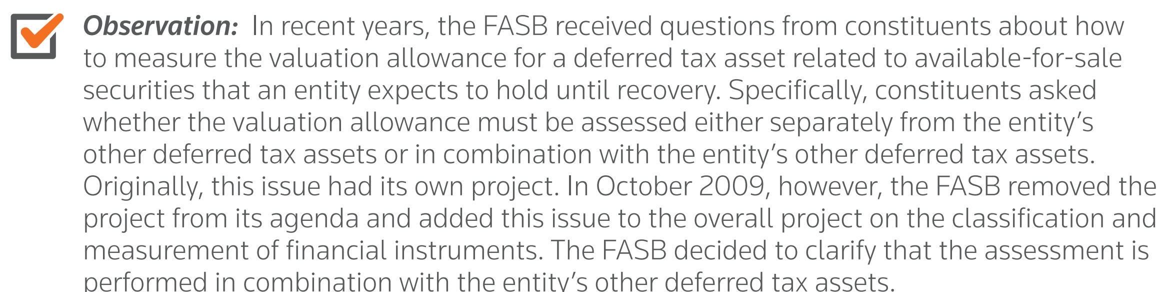
Overview of the FASB's Original Proposal

The FASB has come a long way in terms of thinking through the best way to classify and measure financial instruments going forward. The following table summarizes the rules in the FASB's original proposal (Proposed ASU No. 1810-100). This summary is provided as a reference only; the FASB rejected this approach when it decided to make only targeted improvements to existing GAAP. The summary, however, demonstrates some of the alternatives considered by the board before it ultimately settled on making targeted improvements.

AREA	ORIGINAL PROPOSAL (PROPOSED ASU NO. 1810-100)
Classification of financial assets	Financial assets would have been classified into one of three categories: • Fair value, with changes in fair value recognized in net income • Fair value, with changes in fair value recognized in other comprehensive income • Amortized cost Although these three categories sound similar to the existing categories of trading, available-for-sale and held-to-maturity, the criteria used to select the proper classification would have been different. An entity would have determined the proper classification based on both the characteristics of the financial instrument and the entity's business strategy for the instrument.
Classification of financial liabilities	Financial liabilities would have been classified into one of two categories: • Fair value, with changes in fair value recognized in other comprehensive income • Amortized cost
Reclassifications	Reclassifications would not have been permitted. This would have been a change to existing guidance that allows reclassifications.
Fair value option	The existing fair value option would have been eliminated and replaced with a fair value option that would have been allowed for a much smaller subset of financial instruments.

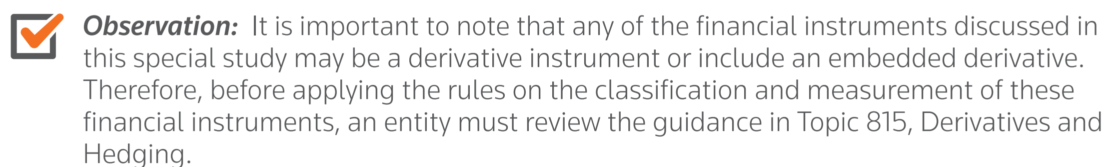
The following table lists the expected improvements in the final standard that the FASB expects to issue shortly. The FASB expects that these improvements will simplify the accounting for financial instruments.

AREA	EXPECTED IMPROVEMENTS
Financial assets	Investments in equity securities must be measured at fair value with changes in fair value recognized in earnings, except as follows: • An investment that qualifies for the equity method is measured in accordance with the equity method. • An investment that does not have a readily determinable fair value generally is eligible for a practicability exception. An entity can elect whether to apply the practicability exception. Under the practicability exception, the investment is measured at cost, minus impairment and plus or minus changes in the price that are observable in orderly transactions for the same (or a similar) investment. An investment that uses the practicability exception is subject to a one-step impairment model. The practicability exception cannot be used by broker-dealers or investment companies or for investments for which an entity estimates fair value based on net asset value.
Financial liabilities	If a financial liability is measured at fair value under the fair value option, an entity must determine which portion of the change in the fair value relates to changes in the entity's own credit risk. The change in the fair value due to changes in the entity's own credit risk is recognized in other comprehensive income. The rest of the change in the fair value is recognized in earnings.
Valuation allowance for a deferred tax asset related to available-for-sale securities	An entity determines whether the valuation allowance for this deferred tax asset is adequate in combination with evaluating the entity's other deferred tax assets.
Presentation and disclosure	As with any new standard, the presentation and disclosure requirements have been revised to reflect the other targeted improvements.



Observation: In recent years, the FASB received questions from constituents about how to measure the valuation allowance for a deferred tax asset related to available-for-sale securities that an entity expects to hold until recovery. Specifically, constituents asked whether the valuation allowance must be assessed either separately from the entity's other deferred tax assets or in combination with the entity's other deferred tax assets. Originally, this issue had its own project. In October 2009, however, the FASB removed the project from its agenda and added this issue to the overall project on the classification and measurement of financial instruments. The FASB decided to clarify that the assessment is performed in combination with the entity's other deferred tax assets.

The remainder of this special study takes a look at the existing rules on the classification and measurement of investments, loans, receivables and debt obligations. It also points out some of the primary differences with IFRS and gives a status of the FASB's other ongoing projects for financial instruments.



Observation: It is important to note that any of the financial instruments discussed in this special study may be a derivative instrument or include an embedded derivative. Therefore, before applying the rules on the classification and measurement of these financial instruments, an entity must review the guidance in Topic 815, Derivatives and Hedging.

CLASSIFICATION AND MEASUREMENT OF INVESTMENTS

Rules on the classification and measurement of investments are located in the following Topics:

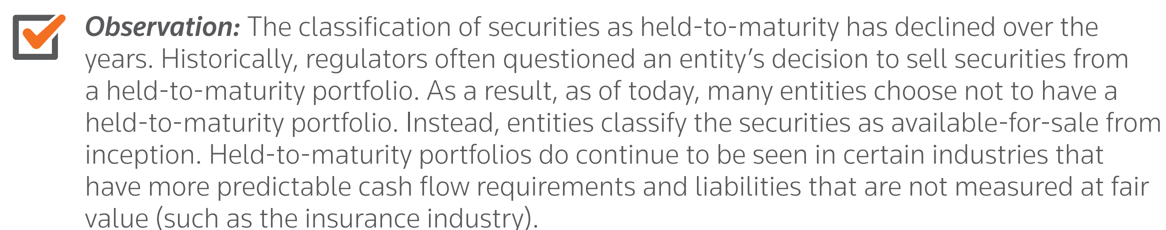
- Topic 320, Investments — Debt and Equity Investments
- Topic 323, Investments — Equity Method and Joint Ventures
- Topic 325, Investments — Other

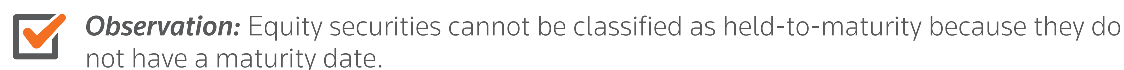
Generally, an entity must classify an investment in a debt or equity security into one of the following three categories:

- Trading
- Available for sale
- Held to maturity

An entity must determine the proper category for a security at the time of acquisition. The following table provides a summary of the accounting rules for each of these three categories.

	HELD TO MATURITY	TRADING	AVAILABLE FOR SALE
When does a security fall into this category?	The entity has both the ability and the positive intent to hold the security until maturity.	The entity generally expects to sell the security in hours or days (although the holding period may be longer).	The security does not qualify as held-to-maturity or trading.
How is the security measured?	Held-to-maturity securities are measured at amortized cost.	Trading securities are measured at fair value, with changes in fair value recognized in net income.	Available-for-sale securities are measured at fair value, with changes in fair value recognized in other comprehensive income.
How are dividends and interest income reflected?	Dividends and interest are included in earnings.	Dividends and interest are included in earnings.	Dividends and interest are included in earnings.


Observation: The classification of securities as held-to-maturity has declined over the years. Historically, regulators often questioned an entity's decision to sell securities from a held-to-maturity portfolio. As a result, as of today, many entities choose not to have a held-to-maturity portfolio. Instead, entities classify the securities as available-for-sale from inception. Held-to-maturity portfolios do continue to be seen in certain industries that have more predictable cash flow requirements and liabilities that are not measured at fair value (such as the insurance industry).


Observation: Equity securities cannot be classified as held-to-maturity because they do not have a maturity date.

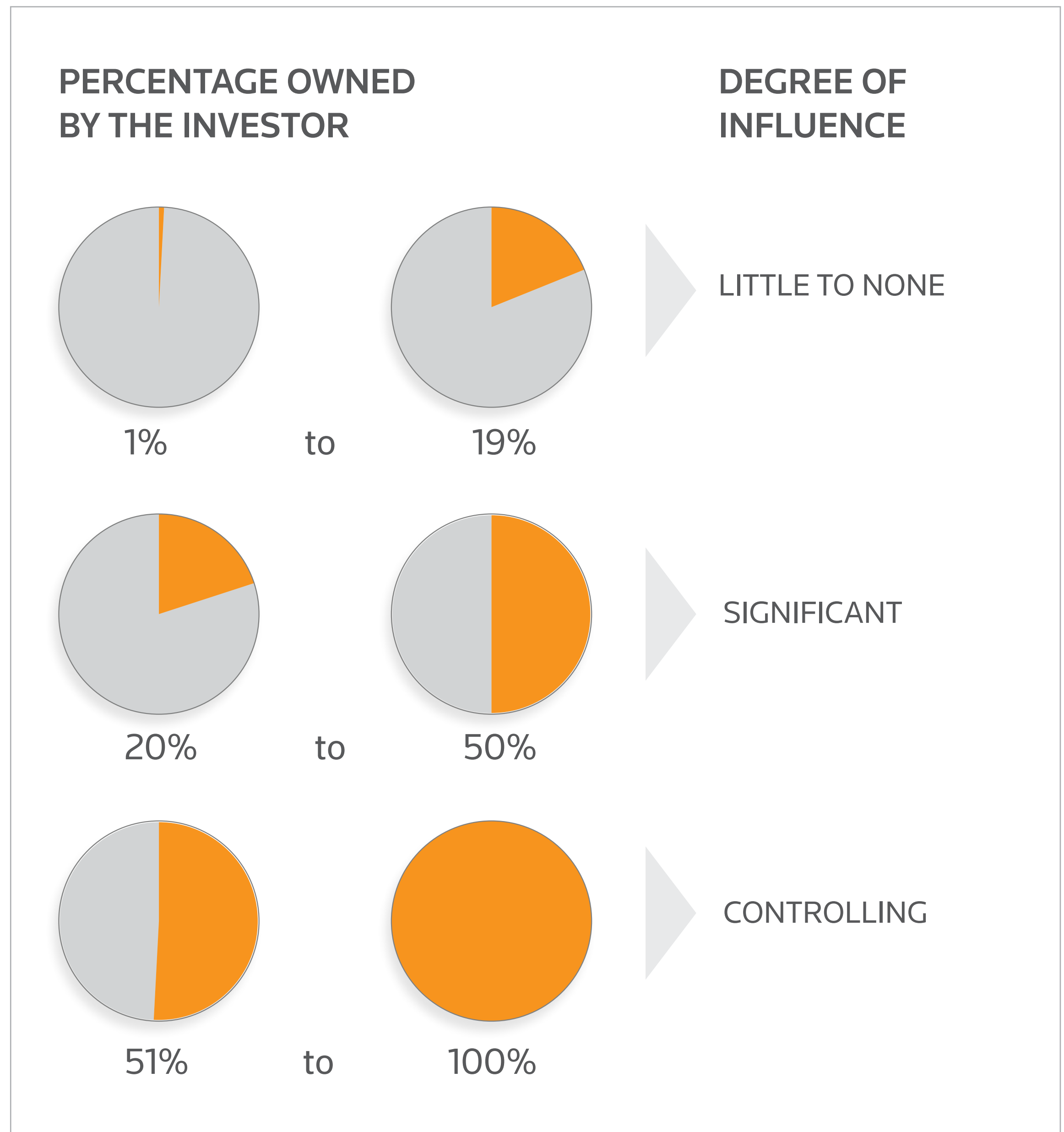
Investments that are classified as held-to-maturity, available-for-sale or trading are investments for which the entity has little or no influence over the investee.

Other methods that may be used to account for an investment are the cost method, the equity method and consolidation. These other methods are used in the following circumstances:

- An entity uses the cost method if an investment does not have a readily determinable fair value and the entity has little or no influence over the investee
- An entity uses the equity method if the entity has significant influence over the investee
- An entity uses consolidation if the entity has a controlling influence over the investee

An entity also may be eligible to measure a security at fair value using the fair value option.

One factor that an entity considers to determine its degree of influence over an investee is its ownership percentage. The following figure shows how an investor's ownership percentage generally affects it degree of influence over an investee.



Observation: The ownership levels provided in the figure are not bright lines. An investor must use its judgment and consider the facts and circumstances to determine the level of influence that it has over the investee. For instance, an investor with a 10 percent ownership interest in an investee still may determine that it has the ability to exercise significant influence over the investee.

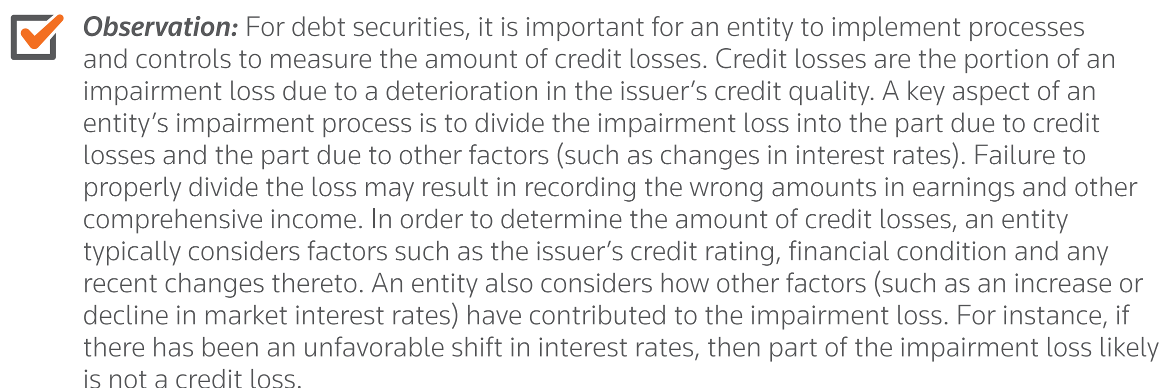
> The SEC generally believes that a limited partner should account for an investment in a limited partnership using the equity method unless the partner has such a small interest in the partnership that the partner essentially has no influence over the partnership's operating and financial policies. The SEC usually considers a limited partner to have some influence over the partnership's policies if the partner has an interest of more than three to five percent. Therefore, the SEC may view an interest of more than three to five percent as an interest that should be accounted for using the equity method.

Other factors that an entity might consider to determine its degree of influence are:

- Whether the entity has a seat on the board of directors of the investee
- Whether the entity participates in the operating and financial decisions of the investee
- Whether there are significant intercompany transactions between the entity and the investee
- Whether the entity has relinquished substantial rights as a shareholder (such as a standstill agreement)
- Whether the entity has access to financial information about the investee that is not available to other shareholders
- The amount of the entity's holdings in relation to the holdings of other shareholders
- Whether there is a dependency between the investee and the entity for technology or other reasons

Impairment. An entity must review its securities for impairment on a regular basis. A security is impaired if its fair value is less than its cost basis. Once an entity determines that a security is impaired, the entity then must evaluate if the impairment is other-than-temporary.
An other-than-temporary impairment is accounted for as follows:

- For equity securities, other-than-temporary impairments are recognized in earnings for the current period
- For debt securities, other-than-temporary impairments due to credit losses are recognized in earnings for the current period, while the portion of the impairment due to other factors is recognized in other comprehensive income



Observation: For debt securities, it is important for an entity to implement processes and controls to measure the amount of credit losses. Credit losses are the portion of an impairment loss due to a deterioration in the issuer's credit quality. A key aspect of an entity's impairment process is to divide the impairment loss into the part due to credit losses and the part due to other factors (such as changes in interest rates). Failure to properly divide the loss may result in recording the wrong amounts in earnings and other comprehensive income. In order to determine the amount of credit losses, an entity typically considers factors such as the issuer's credit rating, financial condition and any recent changes thereto. An entity also considers how other factors (such as an increase or decline in market interest rates) have contributed to the impairment loss. For instance, if there has been an unfavorable shift in interest rates, then part of the impairment loss likely is not a credit loss.

Reclassifications. At each reporting date, an entity must reassess a security's classification and make changes as appropriate. If an entity determines that it must reclassify a security from one category to another, the transfer must be accounted for at fair value and the entity must determine the proper treatment for the unrealized holding gain or loss on the date of the transfer. The accounting for the unrealized holding gain or loss depends on the category of the security before and after the transfer.

Reclassifications from the held-to-maturity category and to or from the trading category are expected to be rare.

The reclassification of a security from the held-to-maturity category can call into question the classification of the other securities in the entity's held-to-maturity portfolio. If the reclassification taints the entity's assertion that it has the intent and ability to hold other

securities until maturity, the entity must reclassify its entire held-to-maturity portfolio to the available-for-sale category.

CLASSIFICATION AND MEASUREMENT OF LOANS AND RECEIVABLES

Rules on the classification and measurement of loans and receivables are found in Topic 310, Receivables.

If a note is exchanged for cash alone, the note is measured initially at the amount of the cash exchanged.

If a note is exchanged for property, goods or services, the initial measurement of the note usually is equal to the present value of the consideration. In any of the following cases, however, the initial measurement is either the fair value of the consideration or the fair value of the note, whichever is more apparent:

- There is no stated interest rate
- The stated interest rate is not reasonable
- The face amount of the note differs materially from the fair value of either the consideration or the note on the date of the transaction

An entity also may be eligible to measure a loan or receivable at fair value using the fair value option described in Topic 825, Financial Instruments.

If a note is exchanged for cash alone, the note is measured initially at the amount of the cash exchanged.

Accounting for Interest Income. An entity generally is required to recognize interest income on a loan using the interest method. The interest method is described in Subtopic 835-30, Interest — Imputation of Interest. Under the interest method, the difference between the present value and face amount of a note is considered a discount or premium. An entity amortizes the discount or premium over the life of the note in a way that results in a constant rate of interest.

Illustration: An entity sells office furniture to a customer in exchange for a $15,000 note receivable that is payable in equal installments of $5,000 over a three year period. The note does not specify an interest rate. The entity usually sells the office furniture at a cash price of $12,435. Therefore, the implied interest is $2,565.

The $2,565 of interest must be amortized into income over the period of the loan using the interest method.

First, the entity determines the present value factor as follows:

Present value factor = Fair value of office furniture / Periodic cash receipt

= $12,435 / $5,000

= 2.4870

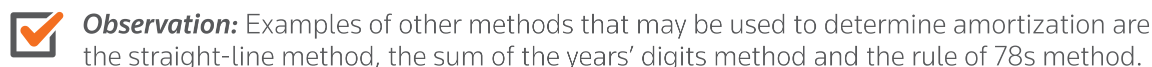
Using a table that shows the present value of an ordinary annuity, the factor of 2.4870 is equal to approximately a 10 percent interest rate over three years.

The entity calculates amortization on the note using the interest method, as shown in the following amortization schedule.

YEAR	CASH FLOW	AMORTIZATION (AT 10 PERCENT)	REDUCTION IN NOTE VALUE	NOTE VALUE
0				$12,435
1	$5,000	$1,243	$3,757	8,678
2	5,000	867	4,133	4,545
3	5,000	455	4,545	0
Total		**$2,565**	**$12,435**	

Once an entity determines the constant rate of interest, the rate does not change unless the terms of the loan are modified.

An entity is permitted to use another method of amortization (other than the interest method) only if the other method achieves results that are not materially different from the results that would be achieved using the interest method.



Observation: Examples of other methods that may be used to determine amortization are the straight-line method, the sum of the years' digits method and the rule of 78s method.

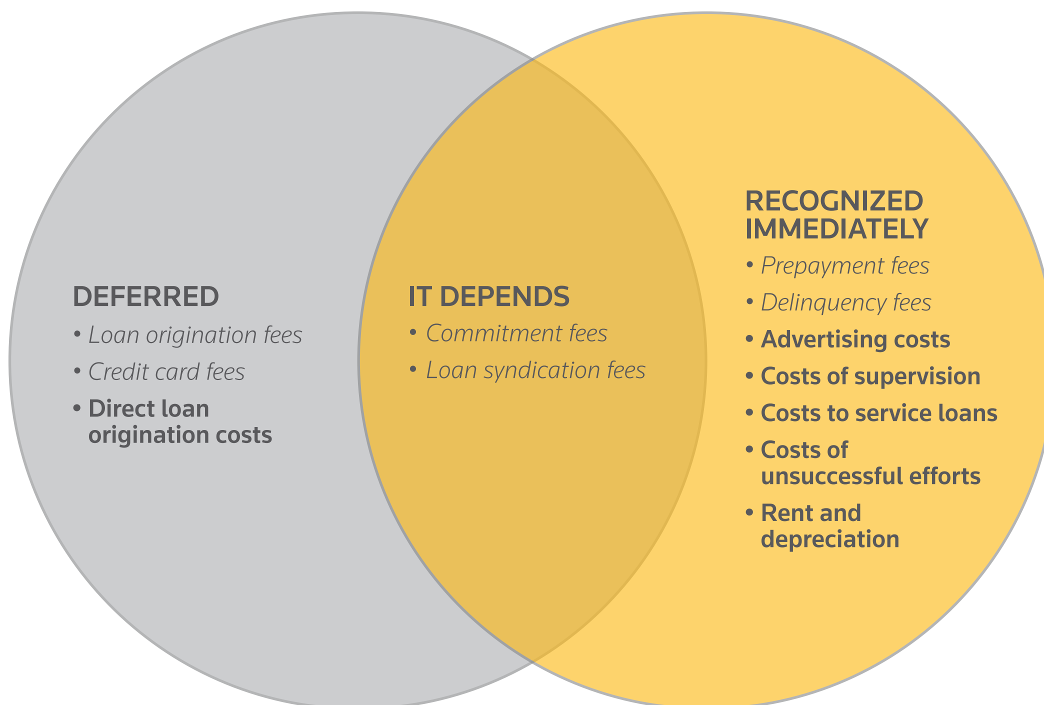
An entity cannot assume that the results of applying one of these other methods are similar to the results attained by applying the interest method. If an entity wants to use one of these other methods, the entity must perform an analysis to show that the results of using the other method are not materially different from the results achieved under the interest method.

Accounting for Fees and Costs. An entity may receive various fees related to lending activities (such as commitment fees or prepayment fees). Likewise, an entity may incur numerous costs.

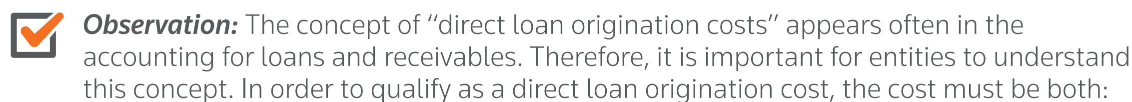
It is important for an entity to determine whether it is necessary to recognize the fees and costs immediately in income or defer the amounts and recognize them over the period of the loan as an adjustment to interest income.

Fees that are deferred ultimately result in an increase to interest income. Costs that are deferred result in a decrease to interest income.

The following figure shows some common fees (*italics*) and costs (**bold**) and whether they generally are deferred or recognized immediately in income.



There are exceptions to these general rules. For example, special rules apply to a loan involved in a troubled debt restructuring. If a loan is involved in a troubled debt restructuring, an entity must record fees received as a reduction of the recorded investment in the loan and any related costs (including direct loan origination costs) must be expensed as incurred.



Observation: The concept of "direct loan origination costs" appears often in the accounting for loans and receivables. Therefore, it is important for entities to understand this concept. In order to qualify as a direct loan origination cost, the cost must be both:

- Directly related to originating the loan
- Incremental to originating the loan (in other words, the cost would not otherwise be incurred if the loan were not originated)

Direct loan origination costs may include costs associated with the following activities performed by the lender:

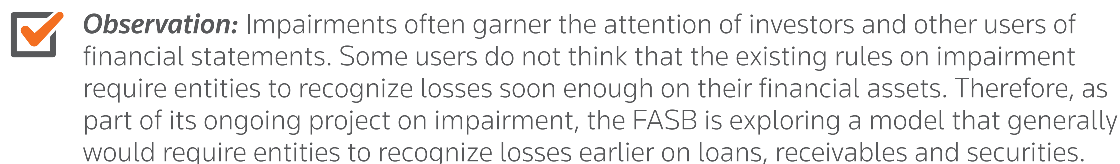
- Assessing the creditworthiness of the borrower or guarantor
- Evaluating loan collateral
- Negotiating the terms of the loan
- Drafting and processing the loan documents
- Closing the loan transaction

For a given loan, an entity may have both fees and costs that are eligible for deferral. For instance, the entity might have both loan origination fees and direct loan origination costs. If so, the entity offsets the fees and costs against each other and defers only the net amount.

Impairment. Rules on the recognition of impairment losses for loans and receivables are included in both Topic 310 and Subtopic 450-20, Contingencies — Loss Contingencies. An impairment is recognized when both:

- It is probable that a loss has been incurred
- The amount of the loss can be estimated reasonably

In order to determine if a loss has been incurred, an entity considers past events and conditions at the balance sheet date. The entity does not speculate about future events that might result in additional losses.



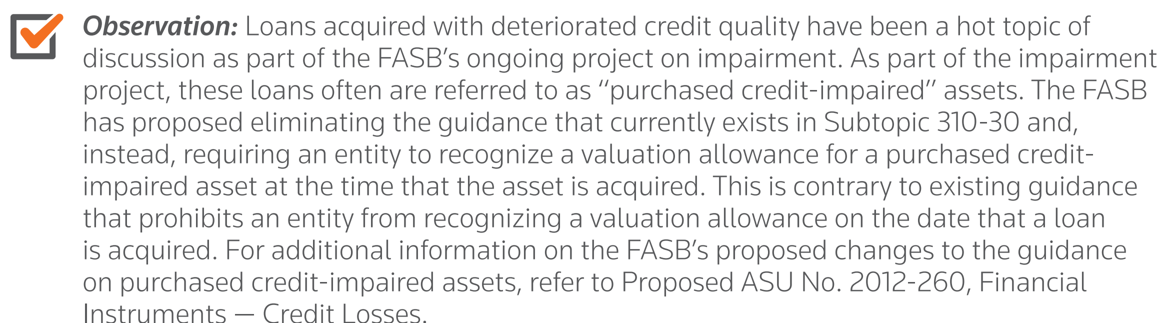
Observation: Impairments often garner the attention of investors and other users of financial statements. Some users do not think that the existing rules on impairment require entities to recognize losses soon enough on their financial assets. Therefore, as part of its ongoing project on impairment, the FASB is exploring a model that generally would require entities to recognize losses earlier on loans, receivables and securities.

Due to the heightened attention on impairments, it is important for entities to maintain robust documentation of their impairment analysis. In particular, the SEC may request support for an entity's impairment decisions. For instance, the SEC may ask for documentation to uphold an entity's conclusion not to recognize an impairment loss in a particular period. An entity must keep in mind that the SEC has the benefit of hindsight when asking questions. Documenting one's judgment at a point in time is therefore crucial.

The amount of the impairment loss recognized is the entity's best estimate of the loss. If the entity estimates a range of losses and no amount in the range is a better estimate than any other amount, the entity recognizes the minimum loss in the range.

An entity must support its impairments with a well-documented analysis that is applied consistently from one reporting period to the next.

If an entity acquires a loan with deteriorated credit quality, the entity must follow the accounting guidance in Subtopic 310-30, Receivables — Loans and Debt Securities Acquired with Deteriorated Credit Quality.



Observation: Loans acquired with deteriorated credit quality have been a hot topic of discussion as part of the FASB's ongoing project on impairment. As part of the impairment project, these loans often are referred to as "purchased credit-impaired" assets. The FASB has proposed eliminating the guidance that currently exists in Subtopic 310-30 and, instead, requiring an entity to recognize a valuation allowance for a purchased credit-impaired asset at the time that the asset is acquired. This is contrary to existing guidance that prohibits an entity from recognizing a valuation allowance on the date that a loan is acquired. For additional information on the FASB's proposed changes to the guidance on purchased credit-impaired assets, refer to Proposed ASU No. 2012-260, Financial Instruments — Credit Losses.

Modifications. The terms of a loan may be modified in various ways. For instance, an entity may modify the timing or amount of the interest and principal payments. The terms of a loan may be revised as part of either a refinancing or a restructuring.

If the terms of a loan are modified, an entity first must determine whether the modification constitutes a troubled debt restructuring. A troubled debt restructuring has occurred if both:

- The debtor is experiencing financial difficulty
- The creditor has granted a concession to the debtor (such as by reducing or deferring amounts due to satisfy the loan)

Observation: A troubled debt restructuring essentially lowers the debtor's total cost of borrowing. As a result, the creditor receives a lower return on the loan.

The Codification provides rules on the accounting for a troubled debt restructuring in various scenarios (such as when the creditor receives assets as either full or partial settlement of the loan). A common thread in accounting for each type of troubled debt restructuring is that the creditor recognizes a loss.

If a modification is not considered a troubled debt restructuring, the creditor must determine the proper accounting for any prepayment penalties and unamortized net fees or costs. Specifically, the creditor must determine if these amounts must be recognized immediately in interest income on the date of the modification or deferred and recognized over time. If the terms of the refinanced or restructured loan are the same or better for the lender as compared to comparable loans, these amounts are recognized immediately in interest income. If the terms are worse for the lender, these amounts are deferred. If only minor changes are made to the terms of the loan, the entity accounts for the modification as if the terms were worse for the lender.

CLASSIFICATION AND MEASUREMENT OF DEBT OBLIGATIONS

Rules on the classification and measurement of debt obligations are found in Topic 470, Debt.

A debt obligation generally is measured at amortized cost; any discount or premium is amortized using the interest method. An entity also may be eligible to measure the debt obligation at fair value using the fair value option.

Observation: The FASB is expected to make a targeted improvement to the accounting for liabilities that are measured at fair value using the fair value option.

Under current guidance, the entire change in the fair value of the liability is recognized in earnings. This, however, has unforeseen consequences.

Specifically, the fair value of a liability is affected by the entity's credit risk. When the entity's credit improves, the fair value of the liability increases. When the entity's credit worsens, the fair value of the liability decreases. As a result, an improvement in the entity's credit results in an increase to the liability and the recognition of a loss. Likewise, a deterioration in the entity's credit leads to a decline in the liability and the recognition of a gain. Constituents criticize this accounting treatment because it does not make sense for an entity to record a gain as a result of a worsening of its own credit.

As a result, the FASB is considering revising the way that an entity records a change in the fair value of a liability that is accounted for under the fair value option. The portion of the change related to improvements or deteriorations in the entity's own credit would be recognized in other comprehensive income. The portion of the change related to other factors (such as movements in market interest rates) would be recognized in earnings.

An important aspect of reporting a debt obligation is determining whether to classify the obligation as current or noncurrent (long-term) on the balance sheet:

- An entity expects to liquidate a current liability using current assets or the creation of other current liabilities
- A long-term liability has a scheduled maturity date that is more than one year (or operating cycle, if applicable) from the balance sheet date

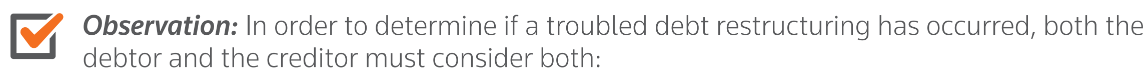
The appropriate classification for a debt obligation may change over time. Therefore, it is important for an entity to reconsider the classification of the obligation each reporting period. For instance, an entity may violate a debt covenant that relates to a long-term debt obligation. In this instance, the lender typically has a right to call the debt. As a result, the entity must consider whether it is necessary to reclassify the obligation to a current liability.

Debt can be issued with a variety of features (such as redemption and conversion features). The features may be relatively straightforward or very complex. It is critical for an entity to understand the terms of the debt to ensure that the proper accounting is applied. The following table summarizes the accounting considerations for some common debt features.

DEBT FEATURE	ACCOUNTING CONSIDERATIONS
Conversion feature	A conversion feature gives the holder of a debt instrument the option to convert the debt instrument into equity shares. A conversion feature may be considered an embedded derivative that is required to be accounted for separately from the host contract. Therefore, an entity first must determine if the feature is an embedded derivative. If the feature is an embedded derivative, the entity must follow the guidance in Topic 815. If the feature is not an embedded derivative, an entity must determine if the debt instrument can be settled in cash upon conversion. If the instrument can be settled in cash upon conversion, the instrument must be split into a liability component and an equity component, and each component must be accounted for separately. This is done as a two-step process: • First, the issuer must determine the carrying value of the liability component. This is done by determining the carrying value of a debt with similar terms and features that does not have a conversion option or an equity component. • Second, the carrying value of the equity component generally is determined as the difference between the carrying value of the liability component and the proceeds allocated to the convertible debt instrument. If the instrument cannot be settled in cash upon conversion, an entity must determine if the conversion feature is beneficial. A conversion feature is beneficial if the conversion price is lower than the current market price of the shares on the commitment date. This is also referred to as a "beneficial conversion feature." If a debt instrument has a beneficial conversion feature, the entity must separate the instrument into two parts for accounting purposes: • The conversion feature • The debt instrument The entity then allocates the proceeds from the debt issuance between the conversion feature and the debt instrument. The amount of the proceeds allocated to the conversion feature is equal to the intrinsic value of the conversion feature; this amount is recognized as a discount on the debt with a corresponding credit to additional paid in capital. The amount of the proceeds allocated to the debt instrument is recognized as debt. If a conversion feature is not beneficial, the entire proceeds from the debt issuance are recognized as debt. Convertible debt also may affect an entity's calculations of earnings per share.
Detachable warrants	A warrant gives the holder a right to buy shares of stock according to the terms of the instrument. If a debt instrument is issued with detachable warrants, an entity must separate the debt instrument into two parts for accounting purposes: • The detachable warrants • The debt instrument An entity must allocate the proceeds from the offering between the detachable warrants and the debt instrument. The amount of the proceeds allocated to each part depends on whether the warrants are classified as liabilities or equity. Therefore, it is important for an entity to determine how the warrants are classified. Detachable warrants also may affect an entity's calculations of earnings per share.
Redemption feature	A redemption feature allows the debt to be redeemed prior to its maturity date. Common redemption features are call options and put options. A redemption feature may be considered an embedded derivative that is required to be accounted for separately from the host contract. Therefore, an entity first must determine if the feature is an embedded derivative. A redemption feature may speed up the payment of a liability. Therefore, a redemption feature can affect the classification of the related liability as current or noncurrent on the balance sheet.

Some instruments may have characteristics of both debt and equity. In this circumstance, an entity must determine whether the instrument must be classified as either debt or equity. A common example of an instrument with both debt and equity characteristics is preferred stock. Even though stock generally is considered equity, preferred stock often has features that make it similar to debt. For instance, the preferred stock may require the issuer of the stock to redeem the stock at a fixed price on a designated date; the Codification generally requires such stock to be treated as a liability.

Modifications. If a debt is modified, an entity first must determine whether the modification constitutes a troubled debt restructuring.



Observation: In order to determine if a troubled debt restructuring has occurred, both the debtor and the creditor must consider both:

- If the debtor is experiencing financial difficulty
- If the creditor has granted a concession to the debtor

The evaluation of whether these conditions are satisfied, however, differs under Subtopic 470-60, Debt — Troubled Debt Restructurings by Debtors, and Subtopic 310-40, Receivables — Troubled Debt Restructurings by Creditors. Therefore, it is possible for a debtor and a creditor involved in the same transaction to reach different conclusions about whether a troubled debt restructuring has occurred. In particular, the parties might reach different conclusions if the carrying amount of the debt in the debtor's financial statements is different from the amount of the recorded investment in the creditor's financial statements.

If a modification is a troubled debt restructuring, the debtor must follow the rules in Subtopic 470-60. This Subtopic includes rules on the accounting for a troubled debt restructuring in various scenarios (such as when the debtor transfers assets as either full or partial settlement of the debt). A common thread in accounting for each type of troubled debt restructuring is that the debtor must determine if it has a gain on the restructuring.

If the modification is not a troubled debt restructuring, the debtor must establish whether the modification constitutes an extinguishment of the existing debt. A modification is considered an extinguishment if the new debt has substantially different terms from the existing (old) debt. The new debt has substantially different terms if the present value of cash flows under the new debt varies by ten percent or more from the present value of the remaining cash flows under the old debt. This is often referred to as the "ten-percent test."

Illustration: On January 1, 20X1, an entity borrows $10 million of debt from a bank. The debt matures in ten years and pays a fixed annual coupon of $600,000. Third party costs of $50,000 are deferred and amortized over the life of the debt.

The entity determines that the carrying amount of the debt is $9.95 million and the effective interest rate is 6.068153 percent. The amortization schedule for the loan is as follows:

YEAR	BEGINNING CARRYING AMOUNT	INTEREST PAYMENT	INTEREST EXPENSE	AMORTIZATION OF DISCOUNT	REMAINING DISCOUNT	ENDING CARRYING AMOUNT
1	$9,950,000	$600,000	$603,781	$(3,781)	$46,219	$9,953,781
2	9,953,781	600,000	604,011	(4,011)	42,208	9,957,792
3	9,957,792	600,000	604,254	(4,254)	37,954	9,962,046
4	9,962,046	600,000	604,512	(4,512)	33,442	9,966,558
5	9,966,558	600,000	604,786	(4,786)	28,656	**9,971,344**
6	9,971,344	600,000	605,076	(5,076)	23,579	9,976,421
7	9,976,421	600,000	605,384	(5,384)	18,195	9,981,805
8	9,981,805	600,000	605,711	(5,711)	12,484	9,987,516
9	9,987,516	600,000	606,058	(6,058)	6,426	9,993,574
10	9,993,574	600,000	606,425	(6,425)	-	10,000,000

On December 31, 20X5, the parties agree to modify the terms of a debt agreement to reduce the annual interest rate. The debtor pays the creditor a fee of $10,000 for making the modification. No other changes are made to the timing or amount of payments under the debt. At the time of the modification:

- There are five years remaining on the old debt
- The carrying amount of the old debt recorded in the debtor's financial statements is $9,971,344

The debtor determines that the modification is not a troubled debt restructuring because the debtor is not experiencing financial difficulty.

The debtor performs the ten-percent test to determine if the modification constitutes an extinguishment of the existing debt.

Under the old debt, the remaining cash flows are:

- A one-time payment of $10,000,000 for principal at the end of the five years remaining
- A $600,000 interest payment at the end of each of the five years left on the debt

The present value of these cash flows is determined based on the number of periods remaining (five) and the original effective interest rate (6.068153 percent) as follows:

Present Value of Principal Payment — Old Debt

$$\text{Present value of a single sum} = \frac{1}{(1+r)^n}$$

$$= \frac{1}{(1+0.06068153)^5}$$

$$= 0.7448605$$

Present value of principal payment = 0.7448605 * $10,000,000 = $7,448,605

Present Value of Interest Payments — Old Debt

$$\text{Present value of an ordinary annuity} = \frac{\left(1-\frac{1}{(1+r)^n}\right)}{r}$$

$$= \frac{\left(1-\frac{1}{(1+0.06068153)^5}\right)}{0.06068153}$$

$$= 4.2045653$$

Present value of interest payments = 4.2045653 * $600,000 = $2,522,739

Therefore, the present value of the expected cash payments under the old debt is $9,971,344 ($7,448,605 + $2,522,739). Note that this is also the carrying amount of the old debt as of December 31, 20X5.

Assume that, under the new debt, the remaining cash flows are:

- A one-time payment of $10,000,000 for principal at the end of the five years
- A $300,000 interest payment at the end of each of the five years left on the debt
- The $10,000 of fees paid immediately by the debtor to the creditor

The present value of these cash flows is determined based on the number of periods remaining (five) and the effective interest rate (6.068153 percent) on the old debt as follows:

Present Value of Principal Payment

Present value of principal payment = 0.7448605 * $10,000,000 = $7,448,605

Present Value of Interest Payments

Present value of interest payments = 4.2045653 * $300,000 = $1,261,370

Therefore, the present value of the expected cash payments under the new debt is $8,719,975 ($7,448,605 + $1,261,370 + $10,000).

The debtor compares the present value of the expected cash flows under the old debt and the new debt as follows:

Present value of expected cash flows — old debt	$9,971,344
Present value of expected cash flows — new debt	8,719,975
Difference	$1,251,369
Difference (%)	12.5%

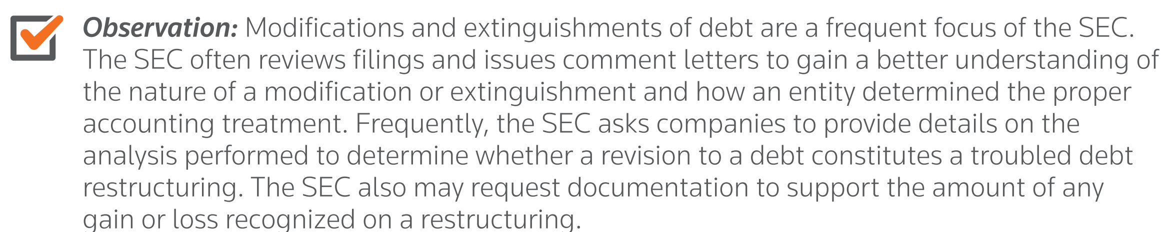
Since the difference is greater than 10 percent, this modification is substantial and the old debt is considered extinguished.

If a modification is considered an extinguishment:

- The debtor recognizes a gain or loss on the extinguishment of the old debt
- The debtor records the new debt on its books
- Fees paid or received as part of the modification are included in the calculation of the gain or loss on the extinguishment of the old debt

If a modification is not considered an extinguishment:

- No gain or loss is recognized
- The entity must calculate a new effective interest rate on the existing debt
- Fees paid or received as part of the modification are amortized over the remaining term of the modified debt instrument using the interest method



Observation: Modifications and extinguishments of debt are a frequent focus of the SEC. The SEC often reviews filings and issues comment letters to gain a better understanding of the nature of a modification or extinguishment and how an entity determined the proper accounting treatment. Frequently, the SEC asks companies to provide details on the analysis performed to determine whether a revision to a debt constitutes a troubled debt restructuring. The SEC also may request documentation to support the amount of any gain or loss recognized on a restructuring.

COMPARISON TO IFRS

Although at one time the FASB and the IASB hoped to issue a converged standard on the classification and measurement of financial instruments, convergence has not been achieved.

The IASB's rules for the classification and measurement of financial instruments are laid out in IFRS 9, Financial Instruments. The following table describes the basic rules in IFRS 9 and points out some of the primary differences with GAAP. This table is not an exhaustive list of the differences between IFRS 9 and GAAP (table continued on pages that follow).

AREA	RULES IN IFRS 9	DIFFERENCES WITH GAAP
Investments in debt instruments	Investments in debt instruments are classified into one of three categories: • Amortized cost • Fair value, with changes in fair value recognized in other comprehensive income • Fair value, with changes in fair value recognized in net income An entity determines the proper classification based on both the cash flow characteristics of the instrument and the entity's business model for the instrument. An investment in a debt instrument is measured at fair value, with changes in fair value recognized in net income, only if the asset does not qualify for one of the other two categories. In other words, the residual category is fair value, with changes in fair value recognized in net income. An entity also may be eligible to make an irrevocable election to measure a financial asset at fair value, with changes in fair value recognized in net income. For an investment measured at fair value, with changes in fair value recognized in other comprehensive income, the effects of changes in exchange rates are recorded in net income.	The criteria considered to determine the proper category (cash flow characteristics and business model) are different from GAAP. Also, under GAAP, the residual category for a debt security is available-for-sale (fair value, with changes in fair value recognized in other comprehensive income). For available-for-sale securities, the entire change in the fair value of the security, including any increase or decrease from changes in exchange rates, is recorded in other comprehensive income.

AREA	RULES IN IFRS 9	DIFFERENCES WITH GAAP
Investments in equity instruments	Investments in equity instruments are measured at fair value. The change in fair value is accounted for as follows: • The change generally is recognized in net income. • If the investment is not held for trading purposes, the entity can elect at the inception of the instrument to recognize the change in other comprehensive income. This election is irrevocable and made on an instrument-by-instrument basis. If an entity makes this election, changes in the fair value of the instrument cannot be transferred to net income at a later date. As a result, the entity cannot transfer the gain or loss to net income if the security is sold; also, the security is not evaluated for impairment. Dividends are included in income only when the following conditions are met: • The entity has a right to receive payment of the dividend • It is probable that the entity will receive the economic benefits of the dividend • The amount can be estimated reasonably	Under GAAP, if an investment in an equity security is measured at fair value, with changes in the fair value recognized in other comprehensive income: • The security must be evaluated for impairment • Any unrealized gain or loss is recognized in earnings at the time that the security is sold Dividends are included in income.
Loans	Loans and receivables are classified into one of three categories: • Amortized cost • Fair value, with changes in fair value recognized in other comprehensive income • Fair value, with changes in fair value recognized in net income An entity determines the proper classification based on both the cash flow characteristics of the instrument and the entity's business model for the instrument. A loan or receivable is measured at fair value, with changes in fair value recognized in net income, only if the asset does not qualify for one of the other two categories. In other words, the residual category is fair value, with changes in fair value recognized in net income.	The criteria considered to determine the proper category (cash flow characteristics and business model) are different from GAAP. Under GAAP, some loans and receivables meet the definition of a debt security and, therefore, are accounted for under the guidance for debt securities in Topic 320 instead of the guidance for loans and receivables under Topic 310.

(table continued on next page)

AREA	RULES IN IFRS 9	DIFFERENCES WITH GAAP
Financial liabilities	An entity must evaluate whether it is appropriate to classify an instrument as a liability or equity. Financial liabilities generally are measured at amortized cost. An entity also may be eligible to make an irrevocable election to measure the financial liability at fair value with changes in fair value recognized in net income. If a financial liability is measured at fair value, with changes in the fair value recognized in net income, an entity must record the portion of the change in fair value due to changes in the entity's own credit risk in other comprehensive income. Once an amount has been recognized in other comprehensive income, it is not transferred to net income at a later date. Therefore, if a financial liability is extinguished, any amount previously recognized in other comprehensive income (including an amount related to the entity's own credit risk) remains in other comprehensive income.	GAAP also requires an entity to evaluate whether an instrument must be classified as a liability or equity; the definition of a financial liability under GAAP, however, is more specific than the definition given under IFRS. As a result, entities may reach different conclusions under GAAP and IFRS about whether a specific instrument is a liability or equity. Similar to IFRS, if a financial liability is measured at fair value, with changes in the fair value recognized in net income, an entity must record the portion of the change in fair value due to changes in the entity's own credit risk in other comprehensive income. If the liability is extinguished, however, any unrealized gain or loss that has been recorded in other comprehensive income is transferred to net income.
Fair value option	An entity may make an irrevocable election to measure a financial asset at fair value with changes recognized in net income if the election eliminates or significantly reduces an accounting mismatch. The election must be made at the time that the asset is recognized initially. An entity may make an irrevocable election to measure a financial liability at fair value with changes recognized in net income if either: • The election eliminates or significantly reduces an accounting mismatch • The financial liability is part of a group of financial assets and liabilities that is managed based on its fair value, the entity has a documented strategy to manage the group based on its fair value and information about the group is reported to key management personnel based on its fair value • The financial liability includes an embedded derivative that significantly alters the cash flows of the contract and the entity otherwise would be able to separate the embedded derivative from the rest of the contract for accounting purposes	Although IFRS offers a fair value option, the conditions to elect the fair value option are slightly different than under GAAP.

Other Projects on Financial Instruments

The FASB has two other ongoing projects on the accounting for financial instruments:

- A project on impairment
- A project on hedge accounting

The status of each of these projects as of September 23, 2015, is provided in the table that follows:

PROJECT	STATUS
Impairment	One of the FASB's priorities for 2015 is to continue making progress on its project for impairment. The FASB is pursuing a new impairment model that will require entities to recognize expected losses on its financial assets. This approach contrasts with existing guidance that requires entities to recognize incurred losses. This will be a significant change for banks and other entities with loans and securities. As a result of recognizing impairments based on expected rather than incurred losses, entities generally will recognize losses sooner in their financial statements. Over the course of 2015, the FASB plans to deliberate the disclosures, transition and effective date for the new impairment model. The FASB expects to issue a final standard in the fourth quarter of 2015.
Hedge accounting	The FASB is in the initial deliberation stage of its project on hedge accounting. The FASB intends to make targeted improvements to the existing guidance on hedge accounting based on feedback from preparers, auditors and other users of financial statements. The FASB hopes that the targeted improvements will help produce financial results that are transparent and consistent. The FASB has indicated that it will consider opportunities to make GAAP consistent with the rules in IFRS 9, Financial Instruments.

FINANCIAL INSTRUMENTS RESEARCH TOOLS

CHECKPOINT CATALYST: US GAAP

Checkpoint Catalyst: US GAAP is the next generation of online research that gives practical insight and expertise on accounting topics that are complex, undergoing changes or challenging to apply, including Financial Instruments — Classification and Measurement.

Checkpoint Catalyst: US GAAP approaches online research from a fresh new perspective. Content is always delivered in the appropriate context, along with powerful insight into related issues, so you'll never miss an important detail. Jumpstart your research with source materials, diagrams, interactive tools and featured developments that come together in context with the analysis — giving you actionable next steps and helping you get to outcomes faster.

Topic 10500, Financial Instruments — Classification and Measurement, covers a wide range of topics including classification and measurement of common instruments such as loans, receivables, securities and financial liabilities, as well as specialty topics like cost method and equity method investments, embedded derivatives, the fair value option and troubled debt restructurings.

Visit **tax.thomsonreuters.com/Checkpoint-Catalyst-US-GAAP** to learn more.

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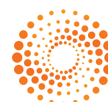

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