



EITF Reaches Two Final Consensuses

The FASB's Emerging Issues Task Force (EITF) discussed three issues at its June 12, 2014, meeting and reached two final consensuses.

The final consensuses must be ratified by the FASB before they are issued and become authoritative. The FASB is scheduled to consider the consensuses at a July 2014 meeting.

Key Facts

Final consensuses were reached on the following issues.

- Accounting for the Effect of a Federal Housing Administration Guarantee (Issue 13-F)
- Measuring the Financial Assets and Financial Liabilities of a Consolidated Collateralized Financing Entity (Issue 12-G)

The EITF also discussed the following issue.

- Determining Whether the Host Contract in a Hybrid Financial Instrument Issued in the Form of a Share Is More Akin to Debt or to Equity (Issue 13-G)

Key Impacts

- **Government Guaranteed Residential Mortgage Loans.** The final consensus provides guidance for classifying certain foreclosed government guaranteed mortgage loans as a receivable.
- **Consolidated Collateralized Financing Entities.** A final consensus was reached on an alternative fair value measurement approach for consolidated collateralized financing entities (CFEs). The approach would permit the parent company of a consolidated CFE to measure the CFE's financial assets and financial liabilities based on the fair value of whichever has the more observable inputs.

Contents

Final Consensuses.....	2
Other Issue Discussed.....	4
Future EITF Agenda	6

Final Consensuses

Accounting for the Effect of a Federal Housing Administration Guarantee (Issue 13-F)

The EITF reached a final consensus to require creditors to classify certain foreclosed government guaranteed mortgage loans as a receivable from the guarantor that is measured at the amount expected to be recovered under the guarantee, without treating the guarantee as a separate unit of account. No additional disclosures would be required by the final consensus.

The final consensus would be effective for public business entities for annual and interim periods in fiscal years beginning after December 15, 2014. The effective date for other entities would be for annual periods in fiscal years ending after December 15, 2015, and interim periods in fiscal years thereafter.

The consensus includes a modified retrospective transition requiring a cumulative-effect adjustment as of the beginning of the annual period of adoption or a prospective transition. The transition method must be consistent with that applied by the entity for ASU 2014-04, *Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure*, (Issue 13-E). An entity may adopt the guidance early, but only if the entity has already adopted ASU 2014-04.

Background and Observations. Government mortgage guarantee programs provide creditors with protection against losses resulting from homeowner default. At foreclosure, the creditor generally takes title to the property and may convey the property to the government agency under the guarantee. The creditor also performs certain steps to submit a claim to the guarantor.

Under previous guidance, there was diversity in practice related to the creditor's balance sheet classification of certain foreclosed mortgage loans that have a government guarantee. A final consensus was reached to classify as a receivable upon foreclosure loans that meet the following criteria:

- The loan has a government guarantee that is not separable from the loan;
- At foreclosure, the creditor has the intent and ability to convey the property to the guarantor and make a claim on the guarantee; and
- At foreclosure, the amount recoverable under the guarantee is fixed and determinable.

The exposure draft for this issue limited the scope of the guidance to loans with government guarantees for the full, unpaid balance of the loan principal and for which, at the time of the foreclosure, the creditor had the intent to make the claim on the guarantee and the ability to recover through the guarantee.

Due to the criteria in the exposure draft that the guarantee must cover the full unpaid loan balance, the previously proposed guidance primarily would have applied to the classification of Federal Housing Administration (FHA) residential loans. Based on comment letters received on the exposure draft, the EITF expanded the scope of the issue.

As a result of these scope changes, the guidance in the final consensus will cover not only residential loans, but also multi-family and commercial loans that meet the other criteria. The changes also remove the requirement in the

exposure draft that the government guarantee cover the full, unpaid principal balance. Other loan programs such as those administered by the Veterans' Administration (VA) and the U.S. Department of Agriculture (USDA) with partial guarantees also will be subject to the guidance if the individual loans otherwise qualify under the criteria. In situations where the full unpaid principal balance will not be recovered, the loan would be written down to the amount recoverable under the guarantee so that the carrying amount of the loan is expected to be recovered under the guarantee.

Next Steps. The FASB will consider ratification of this final consensus at a meeting in July.

Measuring the Financial Assets and Financial Liabilities of a Consolidated Collateralized Financing Entity (Issue 12-G)

The EITF reached a final consensus to allow an alternative fair value measurement approach for certain consolidated collateralized financing entities (CFEs). The approach would permit the parent of a consolidated CFE to measure the CFE's financial assets and liabilities based on either the fair value of the financial assets or financial liabilities, whichever has the more observable inputs.

If the fair value of the financial assets is determined to be more observable, then the financial liabilities would be measured based on the fair value of the financial assets. Similarly, if the fair value of the financial liabilities is determined to be more observable, then the financial assets would be measured based on the fair value of the financial liabilities. As a result, the income statement impact of consolidating the CFE would be equal to the changes in the fair value of the reporting entity's owned beneficial interests in the CFE. Beneficial interests related to compensation for services provided by the reporting entity to the CFE would be excluded.

The alternative measurement approach would be available for CFEs that hold only:

- Financial assets and liabilities that are measured at fair value through net income;
- Assets or liabilities that are incidental to the financial assets and liabilities measured at fair value where the carrying value approximates fair value (e.g., cash or receivables and payables related to the financial assets and liabilities); and
- Nonfinancial assets that are held temporarily as a result of default or an attempt to restructure by the debtor on an underlying debt instrument held as an asset.

Assets transferred to a CFE by the parent would continue to be measured using the parent's measurement method (e.g., fair value or amortized cost) before the transfer. As a result, a CFE would not qualify for this measurement approach if assets measured by the parent at amortized cost or at fair value through other comprehensive income were transferred to the consolidated CFE. Entities would be able to elect the alternative measurement approach on an individual CFE-by-CFE basis upon initial consolidation of the CFE or at transition.

The proposed guidance will require a modified retrospective application to all existing CFEs or retrospective application to all relevant periods beginning with the annual period in which the amendments in ASU 2009-17, *Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities*, were initially adopted.

The effective date for public business entities will be for annual and interim periods in fiscal years beginning after December 15, 2015. The effective date for other entities will be for annual periods in fiscal years ending after December 15, 2016, and interim periods in fiscal years thereafter.

Background and Observations. A CFE is an entity that holds financial assets such as asset-backed securities and issues beneficial interests to investors. These beneficial interests are usually debt instruments that are considered financial liabilities under U.S. GAAP. Because a CFE generally has little or no equity, it is typically a variable interest entity (VIE) under U.S. GAAP and subject to the consolidation requirements that apply to an entity not controlled through voting equity interests. Consequently, an entity may be the primary beneficiary of, and therefore required to consolidate, a CFE for which it is the asset manager, even if it owns no equity or beneficial interests in the CFE. An asset manager may be the primary beneficiary of a CFE that is a VIE because it has the power to direct the activities that most significantly affect the CFE's economic performance by making decisions about the CFE's investment portfolio. An asset manager also may have the right to receive benefits that could potentially be significant to the CFE through a subordinated management fee.

Many reporting entities that are required to consolidate a CFE elect the fair value option for all of the CFE's eligible financial assets and financial liabilities. While a CFE's assets are the sole source of repayment for its beneficial interests (i.e., its liabilities) and its beneficial interests are entitled to receive all of the cash flows from the CFE's assets after payment of management fees and other expenses, fair value differences between a CFE's assets and its beneficial interests may arise. Fair value differences may be caused by different liquidity discounts and duration mismatches between the CFE's assets and its beneficial interests.

There is diversity in the accounting for differences between the fair value of a consolidated CFE's assets and liabilities. Some primary beneficiaries record the difference in fair value as a gain or loss in the consolidated income statement. Others record the gain or loss in appropriated retained earnings.

Next Steps. The FASB will consider ratification of the final consensus at a meeting in July.

Other Issue Discussed

Determining Whether the Host Contract in a Hybrid Financial Instrument Issued in the Form of a Share Is More Akin to Debt or to Equity (Issue 13-G)

The EITF discussed three alternatives for providing guidance about the significance placed on various types of terms and features within an instrument when evaluating whether the host contract is more akin to debt or equity under the whole-instrument approach.

Alternative A. Provides additional implementation guidance to assist entities in evaluating the relative weighting to apply to the specific terms and features.

Alternative B. Establishes a rebuttable presumption that a fixed-price, noncontingent redemption option held by the investor leads to a determination that the host contract is debt-like.

Alternative C. Provides no additional implementation guidance.

The EITF determined that additional implementation guidance should be provided in Alternative A. The EITF observed that the implementation guidance included in the issue summary provided useful information, however it did not provide sufficient information to allow entities to weight the features in combination with other features. The EITF requested that the FASB staff expand the guidance.

Background and Observations. An entity that issues or invests in a hybrid financial instrument (a contract that embodies one or more embedded derivatives and a host contract) is required to bifurcate embedded derivatives from the host contract and account for the features as a derivative if certain criteria are met. For example, one criterion is whether the host and embedded features are clearly and closely related. When an entity issues a hybrid financial instrument in the form of a share (e.g., preferred share), the determination to bifurcate its embedded derivative features will depend, in part, on whether the host contract is more akin to debt or equity. There is diversity in practice about the approaches used to evaluate the nature of the host contract. The determination of whether the host contract is debt or equity may differ depending on the approach used. At a previous meeting the EITF discussed these approaches to evaluate the host contract.

- **Whole-instrument Approach.** Considers all of the instrument's terms and features, weighing each feature based on the relevant facts in one host evaluation.
- **Chameleon Approach.** Excludes the embedded derivative feature being evaluated for bifurcation. A separate host evaluation is performed for each feature and therefore the host could be equity in one evaluation and debt in another.
- **Pure-host Approach.** Excludes all embedded derivative features.

At the March 2014 meeting, the EITF reaffirmed its previous consensus-for-exposure that would require the consideration of all terms and features of an instrument (whole-instrument approach) when performing an evaluation to determine whether the host contract is more akin to debt or equity for hybrid financial instruments issued in the form of a share.

The EITF observed that diversity may still exist under the whole-instrument approach because the evaluation of the nature of the host instrument depends on the perceived significance of all terms and features. In response to this potential diversity, the EITF requested that the FASB staff perform additional analysis and research on whether potential guidelines could be developed that would lead to increased consistency relating to the significance placed on various types of terms and features within an instrument.

Next Steps. The issue will be discussed at a future meeting.

Future EITF Agenda

In addition to the issues discussed at the June meeting, Issue 12-F, Recognition of New Accounting Basis (Pushdown) in Certain Circumstances, is also on the EITF's agenda for discussion at future meetings.

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