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AN ALERT FROM THE BDO NATIONAL ASSURANCE PRACTICE

BDO **FLASH** REPORT
FASB

▶SUBJECT:

FASB ISSUES ASU ON MEASURING THE FINANCIAL ASSETS AND FINANCIAL LIABILITIES OF A CONSOLIDATED COLLATERALIZED FINANCING ENTITY

▶SUMMARY:

The FASB recently issued ASU 2014-13[1] to address the measurement mismatch that often results from the difference between the fair value of the financial assets and financial liabilities of a consolidated collateralized financing entity (CFE). The ASU provides an option for measuring the financial assets and financial liabilities of a CFE to eliminate that difference. If an entity does not elect the measurement alternative, it should continue applying the measurement guidance in Topic 820[2] to assets and liabilities that are carried at fair value in the financial statements. The ASU is available here.

▶SCOPE, EFFECTIVE DATE AND TRANSITION:

ASU 2014-13 applies to reporting entities that are required to consolidate a CFE under the VIE consolidation guidance when the entity measures all financial assets and financial liabilities of the CFE at fair value, with changes in fair value recorded in earnings. It is effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2015. For entities other than public business entities, the amendments are effective for annual periods beginning after December 15, 2016, and interim and annual periods thereafter. Early adoption is permitted as of the beginning of an annual period. Entities may adopt using either a full or modified retrospective approach. The modified approach only impacts the annual period of adoption by recording a cumulative-effect adjustment to equity.

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[1] *Measuring the Financial Assets and the Financial Liabilities of a Consolidated Collateralized Financing Entity (a consensus of the FASB Emerging Issues Task Force)*
[2] *Fair Value Measurement*

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MAIN PROVISIONS:

Collateralized debt obligation (CDO) and collateralized loan obligation (CLO) entities are two common examples of a CFE. More specifically, the ASU defines a CFE as:

> A VIE that holds financial assets, issues beneficial interests in those financial assets, and has no more than nominal equity. The beneficial interests have contractual recourse only to the related assets of the CFE and are classified as financial liabilities. A CFE may hold nonfinancial assets temporarily as a result of default by the debtor on the underlying debt instruments held as assets by the CFE or in an effort to restructure the debt instruments held as assets by the CFE. A CFE also may hold other financial assets and financial liabilities that are incidental to the operations of the CFE and have carrying values that approximate fair value (for example, cash, broker receivables, or broker payables).

The ASU provides a measurement alternative to Topic 820 for financial assets and financial liabilities of a CFE. Under that optional alternative, a reporting entity should use the more observable of the fair value of the financial assets and the fair value of the financial liaibilities of a CFE to measure both. In other words, the fair value of one is used as a proxy for the fair value of the other.

The measurement alternative may only be applied when both of the following conditions exist:

a. All of the financial assets and the financial liabilities of the CFE are measured at fair value in the consolidated financial statements under other GAAP, other than financial assets and financial liabilities that are incidental to the operations of the CFE and have carrying values that approximate fair value (e.g., cash, broker receivables, or broker payables).

b. The changes in the fair values of those financial assets and financial liabilities are reflected in earnings.

The alternative approach is a practical accommodation based on the premise that the cash flows of those financial assets can be used *only* to pay the financial liabilities, and such liabilities can be settled *only* with the cash flows of those assets. As such, if the primary beneficiary of the CFE guarantees all or a portion of the CFE's beneficial interests, the measurement alternative would not be available. This is because the beneficial interest holders would have recourse to the primary beneficiary rather than being limited to those cash flows arising *only* from the CFE's financial assets.

The alternative is available upon initial consolidation of the CFE, and, if elected, should be consistently applied thereafter, unless the CFE subsequently fails to meet both scope requirements noted above. If the reporting entity subsequently fails to meet both scope requirements, or does not elect the measurement alternative upon initial consolidation, the alternative is not available after that point.

If the alternative is not elected, any difference between the CFE's financial assets and financial liabilities should be reflected in earnings and attributed to the reporting entity in the consolidated income statement.

DISCLOSURE AND IMPLEMENTATION GUIDANCE:

An entity that elects the measurement alternative should disclose, for the less observable of the fair value of the financial assets and financial liabilites, that the amount was measured on the basis of the more observable of the two. An entity that elects the measurement alternative should also disclose applicable information required by Topics 820 and 825.[3] The ASU includes implementation guidance with examples of application of the measurement alternative.

[3] *Financial Instruments*