New Developments Summary

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Codification improvements to financial instruments

ASU 2020-03 clarifies accounting and disclosure for financial instruments

Contents

ASU 2020-03, *Codification Improvements to Financial Instruments*, clarifies the accounting and disclosure guidance in various Codification Topics for financial instruments. In particular, the amendments

- Clarify certain disclosure requirements, including fair value option disclosures
- Add cross-references in U.S. GAAP to clarify certain guidance
- Make clear the applicability of the portfolio exception in ASC 820, *Fair Value Measurement,* to nonfinancial items
- Clarify the determination of the contractual life of a net investment in leases in estimating expected credit losses under ASC 326, *Financial Instruments – Credit Losses*
- Explain the interaction between the guidance in ASC 860-20, *Transfers and Servicing: Sales of Financial Assets*, and ASC 326.

A. Disclosures

The amendments in ASU 2020-03 clarify the FASB's intent for several areas of disclosure that are required for financial instruments.

Fair value option disclosures

ASU 2016-01, *Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*, provided disclosure relief for entities that are not public business entities (PBEs) by removing the requirement to disclose the fair value of financial instruments measured at amortized cost in ASC 825, *Financial Instruments*.

The amendments in ASU 2020-03, however, clarify that the disclosure requirements in ASC 825-10-50-24 through 50-32 apply to *all* entities that elect the fair value option under ASC 825, including non-PBEs.

Disclosures for depository and lending institutions

ASU 2020-03 also addresses the interaction between certain disclosure requirements in ASC 320, *Investments – Debt and Equity Securities*, and ASC 942, *Financial Services – Depository and Lending*. The amendments in ASU 2020-03 clarify that the disclosure requirements in ASC 320-10-50-3 and in 50-5 through 50-5C also apply to the industry guidance in ASC 942-320-50-3 and 50-3A applicable to depository and lending institutions.

In particular, the amendments to ASC 942-320-50-3 and 50-3A state that entities may separately disclose securities that are not due at a single maturity date, such as mortgage-backed securities, rather than allocating these securities over the maturity groupings otherwise required by these paragraphs. However, an entity may still choose to allocate such securities over several maturity groupings, but is required to disclose the basis for such allocation under the amendments.

B. Cross-references

The amendments in ASU 2020-03 enhance the understandability of certain areas of U.S. GAAP by inserting cross-references to relevant guidance in other Codification Topics.

Costs for modifications to line-of-credit and revolving debt arrangements

The amendments in ASU 2020-03 modify the guidance in ASC 470-50-40-17 through 40-18 and in 40-21 to clarify the accounting for fees directly related to exchanges or modifications of debt instruments between a debtor and creditor and a debtor and third parties.

Specifically, the amendments to paragraphs 470-50-40-17 through 40-18 provide guidance on accounting for fees between debtors and creditors and debtors and third parties for debt arrangements other than line-of-credit and revolving debt arrangements. Following the amendments in ASU 2020-03, those paragraphs now include a cross-reference to paragraph 470-50-40-21 for relevant guidance on line-of-credit and revolving credit arrangements.

Disclosures for investments accounted for under the NAV practical expedient

The amendments in ASU 2020-03 clarify that the disclosure guidance in ASC 820-10-50-2 does not apply to investments accounted for under the net asset value (NAV) per share practical expedient in accordance with ASC 820-10-35-59.

C. Applicability of the portfolio exception in ASC 820 to nonfinancial items

Paragraphs ASC 820-10-35-18D through 35-18H provide an exception to the general guidance in ASC 820 with regard to the unit of account for determining fair value. In general, ASC 820 requires entities to determine the unit of account pursuant to other guidance governing the recognition and measurement of an asset or a liability that is measured at fair value. However, the guidance in ASC 820-10-35-18D through 18H provides a "portfolio exception" to these general principles when measuring financial instruments with offsetting risks if certain criteria are met.

The amendments in ASU 2020-03 clarify that the portfolio exception applies not only to financial assets and financial liabilities, but also to nonfinancial items accounted for as derivatives under ASC 815, *Derivatives and Hedging*.

D. Determining contractual term of net investment in leases under ASC 326

The guidance on credit losses in ASC 326-20, *Measured at Amortized Cost,* which includes the current expected credit losses (CECL) model, requires entities to estimate expected credit losses over the contractual life of financial assets. Generally, the contractual term may not be modified for expected extensions, though it can be shortened for expected prepayments.

However, under the leasing guidance in ASC 842, a lessor with an option to extend a lease would include the time period beyond the option's exercise dates in the lease term. When a lessee has an option to extend a lease, the time period beyond the option's exercise dates is included in the lease term if it is reasonably certain that the lessee will exercise the option to extend the lease. As a result, the contractual term of a net investment in a lease determined under the CECL model could be different than the lease term for the same lease determined under ASC 842.

The amendments in ASU 2020-03 clarify that the contractual term used to measure expected credit losses on a net investment in a lease under the CECL model is equal to the lease term determined under ASC 842.

E. Interaction of ASC 326 and ASC 860

Prior to the amendments in ASU 2020-03, the guidance in ASC 860-20-25-13 prohibited an entity from recognizing a loan loss allowance upon rerecognition of a previously sold and derecognized financial asset.

The amendments in ASU 2020-03 clarify that when an entity rerecognizes a previously sold and derecognized financial asset, upon regaining control of that financial asset, an allowance for credit losses (ACL) should be recorded if that financial asset is within the scope of ASC 326. If the rerecognized financial asset is not a purchased financial asset with credit deterioration (a PCD asset), the entity would recognize an ACL, with a corresponding charge to credit loss expense, as of the reporting date. If, however, the rerecognized financial asset is a PCD asset, an ACL is recognized, with a corresponding increase to the amortized cost basis of the asset, as of the recognition date.

Grant Thornton insights: Rerecognizing financial assets subject to contingent ROAPs

A contingent removal-of-accounts provision (ROAP) is a stipulation in an agreement to transfer financial assets that gives the transferor a unilateral right to repurchase certain transferred financial assets if certain contingent events either occur or fail to occur. A contingent ROAP that is not currently exercisable would not prevent the transferor from derecognizing financial assets if the triggering event or events is outside of the transferor's control. Additionally, ROAPs typically specify the repurchase price that the transferor would pay to exercise the ROAP, which is most commonly either at fair value or at par.

A common scenario that results in the rerecognition of a previously transferred financial asset is when a contingent ROAP is triggered and the transferor regains control over a previously transferred financial asset. ASC 860-20-25-11 states that a transferor should rerecognize a previously transferred financial asset when a contingent ROAP is triggered, regardless of whether the ROAP is exercised, if the ROAP provides the transferor with a unilateral right to cause the transferee to return the financial asset and a more-than-trivial benefit to the transferor. Concluding that a currently exercisable ROAP does not provide a more-than-trivial benefit would be rare.

For example, a transferor might sell loans to a transferee subject to a provision that allows the transferor to repurchase any transferred financial assets at par that are more than 90 days past due. If a transferred loan is more than 90 days past due, the transferor would obtain a unilateral right to cause the transferee to return that loan that would generally convey a more-than-trivial benefit to the transferor. As a result, the transferred loan would fail to meet the criteria in ASC 860-10-40-5(c) and would be rerecognized by the transferor as of the date when the contingent ROAP was triggered.

ASC 860-20-25-8 through 25-13 provides guidance on how to account for a rerecognized financial asset. Generally, that guidance requires the transferor to account for the financial asset as a purchase of the rerecognized asset from the former transferee in exchange for liabilities assumed. Accordingly, when a contingent ROAP is triggered, the transferor initially recognizes the rerecognized asset at fair value, with a corresponding liability to the transferee. Pursuant to the amendments in ASU 2020-03, an ACL is also recognized if the rerecognized financial asset is accounted for under ASC 326.

Finally, the transferor may recognize a gain or loss when the ROAP is exercised if the ROAP is not accounted for as a derivative under ASC 815 and is not at the money.

Rerecognizing financial assets subject to contingent ROAPs

Scenario 1 – Reacquisition of non-PCD financial asset with ROAP at par

Entity A previously sold a whole financial asset to Entity B, subject to a contingent ROAP that is triggered if the financial asset is either more than 90 days past due or otherwise in default. Upon the initial transfer of the financial asset to Entity B, Entity A determines that the contingent ROAP should not be accounted for as a derivative under ASC 815. On 3/31/X1, the contingent ROAP is triggered and Entity A rerecognizes the previously transferred financial asset. Entity A has determined that the financial asset is not a PCD asset.

On 3/31/X1:

- The par amount of the financial asset is $10,000.
- The fair value of the financial asset is $9,500.
- The estimate of the ACL on the financial asset is $500.

The ROAP's terms allow Entity A to repurchase the financial asset at par from Entity B.

Assuming that 3/31/X1 is also a financial reporting date for Entity A, it would record the following journal entries when the financial asset is rerecognized:

Recording the loan and liability		
Loan	$10,000	
Discount		$500
Secured financing		$9,500
Recording the ACL		
Credit loss expense	$500	
ACL		$500

If Entity A exercises the ROAP, it would recognize a loss of $500 for the difference between the exercise price of the ROAP (par, or $10,000) and the fair value of the loan ($9,500). Upon exercise, Entity A would pay Entity B $10,000 and satisfy the secured financing liability to Entity B.

Scenario 2 – Reacquisition of PCD financial asset with ROAP at par

Assume the same facts as those in Scenario 1. However, in this scenario, Entity A has determined that the financial asset is a PCD asset.

On 3/31/X1:

- The par amount of the financial asset is $10,000.
- The fair value of the financial asset is $8,500.

- The estimate of the ACL on the financial asset is $1,000.

The ROAP's terms allow Entity A to repurchase the financial asset at par from Entity B.

Assuming that 3/31/X1 is also a financial reporting date for Entity A, it would record the following journal entries when it rerecognizes the financial asset:

Acquisition journal entry - Scenario 2		
Loan	$10,000	
ACL		$1,000
Discount		$500
Secured financing		$8,500

If Entity A exercises the ROAP, it would recognize a loss of $1,500 for the difference between the exercise price in the ROAP (par, or $10,000) and the fair value of the loan ($8,500). Upon exercise, Entity A would pay Entity B $10,000 and satisfy the secured financing liability to Entity B.

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