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In Focus

FASB Proposal on Liquidity Risk and Interest Rate Risk Disclosures

Overview

The Financial Accounting Standards Board (FASB), on June 27, 2012, issued for public comment a proposed Accounting Standards Update (ASU) intended to improve financial reporting about certain risks inherent in financial instruments and how they contribute to broader risks to which the reporting organization is exposed. Stakeholders are asked to review and provide input by September 25, 2012.

The Update addresses many stakeholders' concerns about how organizations disclose their exposures to these risks. Specifically, the ASU proposes new disclosures related to liquidity risk and interest rate risk, two risks that were prominent during the recent financial crisis and that continue to be relevant to reporting organizations on an ongoing basis. In response to consistent feedback from users of financial statements, the proposal would require expanded and standardized disclosures.

Highlights

The proposed liquidity risk disclosures are intended to provide information about the risk that the reporting organization will encounter difficulty when meeting its financial obligations, and would apply to all public, private and not-for-profit organizations. However, the nature of the disclosures will depend on whether the reporting organization is considered a financial institution, as defined by the proposed Update.

The proposed interest rate risk disclosures are intended to provide information about the exposure of a financial institution's financial assets and financial liabilities to fluctuations in market interest rates, and would apply only to financial institutions.

Why did the Boards undertake a project on liquidity risk and interest rate risk disclosures?

In May 2010, the FASB issued the proposed ASU, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities—Financial Instruments (Topic 825) and Derivatives and Hedging (Topic 815),* which reconsidered, among other things, the classification and measurement model for financial instruments.

Comments received from stakeholders on that proposal indicated that no single measurement attribute would fully convey complete information about a financial instrument's risks and the broader risks to which an organization is exposed. Users of financial statements consistently asked for expanded and standardized information about these risks.

Accordingly, the Board decided to publish this Update to propose enhanced disclosures about exposure to interest rate risk and liquidity risk. The FASB previously issued enhanced disclosure requirements about credit risk (ASU, *Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*). The FASB's redeliberations of the May 2010 proposed Update on the accounting for financial instruments are ongoing.

What are the main proposals?

The new guidance is intended to help users of financial statements obtain more decision-useful information about organizations' exposures to liquidity risk and interest rate risk and the ways in which those risks are managed—further enabling them to make well-informed capital allocation decisions.

The proposed amendments would provide guidance that the Board believes is incremental to that provided under current U.S. GAAP and other financial disclosure requirements, such as the SEC's MD&A requirements. The proposal also prescribes certain information and formats, so that the information is presented in a comparable manner across organizations. The FASB proposes the following disclosure requirements, depending on the characteristics of the reporting organization:

Liquidity Risk Disclosures

The proposed liquidity risk disclosures are intended to provide information about the risk that the reporting organization will encounter difficulty meeting its financial obligations.

- For a financial institution, the proposed amendments in this Update would require disclosure of the carrying amounts of classes of financial assets and financial liabilities in a table, segregated by their expected maturities, including off-balance sheet financial commitments and obligations. The amendments in this proposed Update also would require a financial institution to disclose its available liquid funds in a table, which would include any unencumbered cash and highly liquid assets and any available borrowings such as loan commitments, unpledged securities, and lines of credit.
- For a financial institution that is a depository institution, the proposed amendments in this Update would require an organization to disclose information about its time deposit liabilities. Specifically, a depository institution would have to provide disclosure of the cost of funding in a table from the issuance of time deposits and acquisition of brokered deposits during the previous four fiscal quarters.
- An organization that is not a financial institution would be required to disclose its expected cash flow obligations in a table, segregated by their expected maturities, without being required to include the reporting organization's financial assets in that table. Similar to a financial institution, an organization that is not a financial institution would also be required to disclose its available liquid funds in a table.
- All reporting organizations would be required to provide additional quantitative or narrative disclosure of the organization's exposure to liquidity risk, including discussion about significant changes in the amounts and timing in the quantitative tables and how the reporting organization managed those changes during the current period.

Interest Rate Risk Disclosures

The proposed interest rate risk disclosures are intended to provide information about the exposure of a financial institution's financial assets and financial liabilities to fluctuations in market interest rates. An organization that is not a financial institution would not be required to provide any of the interest rate risk disclosures in this proposed Update.

The amendments in this proposed Update would require a financial institution to disclose the carrying amounts of classes of financial assets and financial liabilities segregated by their yield maturity, according to time intervals based on the contractual repricing of the financial instruments. Such a disclosure also would include the weighted average contractual yield by class of financial instrument and time interval as well as the duration for each class of financial instrument.

The proposed amendments also would require a financial institution to disclose an interest rate sensitivity table that presents the effects on net income and shareholders' equity of hypothetical, instantaneous shifts of interest rate curves as of the measurement date. The form and extent of the hypothetical shifts of interest rate curves would be prescribed by this proposed Update to promote consistency and comparability across reporting organizations.

Finally, the amendments would require a financial institution to provide additional quantitative or narrative disclosures of the organization's exposure to interest rate risk, including discussion about significant changes in the amounts and timing in the quantitative tables and how the reporting organization managed those changes during the current period.

Why don't the proposed interest rate risk disclosures apply to all organizations?

As a result of outreach to users of financial statements, the FASB decided not to require interest rate risk disclosures for organizations that are not financial institutions because the users of their financial statements indicated that managing the differences in repricing of interest earning assets and interest payments on financial liabilities and the difference in income that results was not a strategic imperative for these organizations. Therefore, they did not think interest rate risk disclosures would be essential nor would the benefits justify the costs.

How would the proposed provisions apply to private companies and not-for-profit organizations?

Private companies and not-for-profit organizations are required to provide liquidity risk disclosures only for annual reporting periods. A private financial institution is required to provide the interest rate risk disclosures only for annual reporting periods.

If an organization chooses to provide the disclosures related to liquidity risk or interest rate risk for an interim period, the organization must apply the time intervals prescribed in the proposed Update.

How would the proposed provisions apply to a consolidated organization that is not a financial institution, but has a reportable segment that meets the definition of a financial institution?

Many organizations that are not financial institutions have large finance subsidiaries or have a significant percentage of total assets in a subsidiary that is a financial institution.

The disclosures in this proposed Update apply to a reporting organization's reportable segments. However, reportable segments that are financial institutions may be combined with other reportable segments that are financial institutions for the purposes of providing the disclosures. Combining reportable segments that are not financial institutions also is permitted for the purposes of providing these disclosures.

How do the proposed provisions compare with International Financial Reporting Standards?

As part of the research and outreach for this project, the FASB reviewed risk disclosures currently required by various regulatory and accounting bodies and obtained feedback from users and preparers. As part of this analysis, the FASB considered disclosures about various risk factors that are currently required under International Financial Reporting Standards (IFRS). Ultimately, the amendments in this proposed Update bear many similarities to disclosures that are required by IFRS 7, *Financial Instruments: Disclosures,* with some differences:

Liquidity Risk Disclosures

- IFRS 7 requires that each organization disclose a maturity analysis of its financial liabilities segregated by time intervals based on the earliest period in which a reporting organization could be required to pay the liability.
- That maturity analysis is very similar to the analysis in this proposed Update for organizations that are not financial institutions, but key differences are that this proposed Update would prescribe the time intervals used to segregate the financial instruments under U.S. GAAP and that the segregation of the financial liabilities would be based on expected maturities. In contrast, under IFRS 7, an organization uses its own judgment to determine the appropriate number of time intervals and the segregation is based on the earliest possible settlement date.
- For financial institutions, the proposed amendments also require disclosure of financial assets segregated in time intervals by expected maturities.

Interest Rate Risk Disclosures

- Similar to IFRS 7, the amendments in this proposed Update would require a sensitivity analysis of net income and shareholders' equity to changes in interest rates. However, only financial institutions would be required to provide that disclosure.
- Unlike the analysis required by IFRS 7, in which the amounts by which interest rates change are based on an organization's judgment, this proposed Update would prescribe the amounts by which interest rates change when performing the sensitivity analysis.
- Reporting organizations are given the opportunity to use an alternative measure of sensitivity, such as value-at-risk, when complying with IFRS 7's requirement. No such alternative is included in this proposed Update.

When would the amendments be effective?

The FASB has acknowledged that companies will need sufficient lead time after the standard is approved to implement its provisions.

The FASB has not yet decided on an effective date, but plans to do so after seeking stakeholder comments.

What are the next steps in the process?

Stakeholders are requested to provide their written comments on the Proposed Accounting Standards Update by September 25, 2012.

Between now and the end of the comment period, the FASB will conduct additional outreach with preparers, users, and auditors of financial statements to continue to obtain input on the proposals. This will include educational speeches and webcasts, as well as field visits with preparers and auditors in targeted industries.

Outreach to users of financial statements will focus on obtaining feedback on how the proposals would affect their analysis of companies and other organizations.

The exposure draft can be accessed at http://www.www.fasb.org.

Further information, including a podcast and a press release, are available on the FASB website at www.fasb.org.

For more information about the project, please visit the FASB's website at www.fasb.org.

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