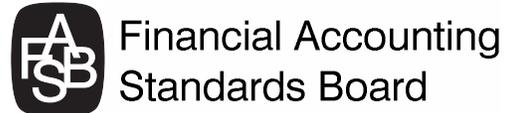


MINUTES



To: Board Members
From: Fair Value Option Team
(Cowan x233)
Subject: Minutes of the August 16, 2006 Board Meeting: Fair Value Option
Date: August 31, 2006
cc: Bielstein, Smith, MacDonald, Leisenring, Fair Value Option Team, Fair Value Measurements Team, Gabriele, Polley, Swift, Sutay, FASB Intranet

The Board meeting minutes are provided for the information and convenience of constituents who want to follow the Board's deliberations. All of the conclusions reported are tentative and may be changed at future Board meetings. Decisions become final only after a formal written ballot to issue a final Statement or Interpretation.

Topic: Fair Value Option Phase 1 Scope Redeliberations

Basis for Discussion: Board Memorandum No. 20 dated July 28, 2006

Length of Discussion: 9:20 a.m. to 10:30 a.m.

Attendance:

Board members present: Batavick, Crooch, Herz, Linsmeier, Seidman, and Trott

Board member absent: Young

Staff in charge of topic: Barker

Other staff at Board table: L. Smith, Lott, Wilkins (Phone), and Cowan

Outside participants: None

Summary of Decisions Reached:

The Board redeliberated the scope of Phase 1 of the project. The Board decided that:

1. Equity method investments will remain in the scope of Phase 1; no eligibility criteria will be imposed for those investments; an entity will be required to apply the fair value option, if elected, to all of its financial investments (equity and debt) in an investee, rather than on a contract-by-contract basis; and an entity may irrevocably elect the fair value option upon obtaining the ability to exercise significant influence.
2. Investments in equity securities that do not have a readily determinable fair value will remain in the scope of Phase 1 and no eligibility criteria will be imposed for those investments.
3. Insurance and reinsurance contracts that meet the definition of a financial instrument will remain in the scope of Phase 1, and the scope of Phase 1 will be expanded beyond insurance and reinsurance contracts that are financial instruments to also include insurance contracts that do not prohibit settlement of the insurer's obligation by payment to a third-party provider of goods or services rather than by payment to the insured or other claimant.
4. Warranty rights and obligations that meet the definition of a financial instrument will remain in the scope of Phase 1, and the scope of Phase 1 will be expanded beyond warranty rights and obligations that are financial instruments to also include warranty rights and obligations that do not prohibit settlement of the warranty obligation by payment to a third-party provider of goods or services rather than by payment to the claimant.
5. Unconditional purchase obligations that are recorded as financial liabilities on the purchaser's statement of financial position as discussed in paragraph 10 of FASB Statement No. 47, *Disclosure of Long-Term Obligations*, will remain in the scope of Phase 1.
6. Otherwise unrecognized firm commitments that satisfy the definition of a firm commitment in FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and involve only financial instruments will remain in the scope of Phase 1.
7. Written loan commitments not accounted for under Statement 133 will no longer be excluded from the scope of Phase 1.
8. Demand deposit accounts will be considered in Phase 2 of the project and will be defined as financial liabilities of financial institutions with demand features in a manner consistent with the IASB.

9. The following items, which are excluded from the scope of FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, will also be excluded from the scope of Phase 1:
 - a. Interests that would otherwise be consolidated
 - b. Financial assets and financial liabilities recognized under lease contracts as defined in FASB Statement No. 13, *Accounting for Leases*
 - c. Employers' and plans' financial obligations for pension benefits, other postretirement benefits (including health care and life insurance benefits), postemployment benefits, employee stock option and stock purchase plans, and other forms of deferred compensation arrangements as defined in FASB Statements No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, No. 87, *Employers' Accounting for Pensions*, No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, No. 112, *Employers' Accounting for Postemployment Benefits*, No. 123 (revised December 2004), *Share-Based Payment*, No. 43, *Accounting for Compensated Absences*, and No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*, and APB Opinion No. 12, *Omnibus Opinion—1967*.
10. No additional reference to the exclusion of income tax assets and liabilities will be made in the standards section of the final Statement.

Objectives of Meeting:

The objective of the meeting was for the Board to redeliberate certain scope issues related to Phase 1 of the FVO project. The objective of the meeting was met.

Matters Discussed and Decisions Reached:

1. Ms. Barker explained that the objective of the meeting was to discuss the comments received regarding the Exposure Draft of the proposed FVO Statement. She stated that the staff received 80 comment letters. Those letters came from preparers, accounting firms, users, trade associations, academic associations, and government regulators.
2. In response to a question from Mr. Linsmeier about the objectives of the project and several recommendations by the staff to expand the scope beyond financial instruments, Ms. Barker explained that the objective was to keep the

FVO document as simple as possible while encouraging the use of fair value. Mr. Trott added that part of the scope expansions were for accounting expediency and ease of implementation in areas where it is difficult to determine whether an item is a financial instrument. Ms. Seidman stated that this approach should be followed uniformly wherever it is expedient to do so. Mr. Wilkins also noted that the staff's recommendations were intended to avoid reexposure.

Items Excluded from Statement 107 and Included in the Scope of the Proposed FVO Statement

Equity Method Investments

3. Mr. Batavick agreed with the staff's recommendations that equity method investments will remain in the scope of Phase 1; no eligibility criteria will be imposed for those investments; an entity will be required to apply the fair value option, if elected, to all of its financial investments (equity and debt) in an investee, rather than on a contract-by-contract basis; and an entity may irrevocably elect the fair value option upon obtaining the ability to exercise significant influence. He stated that he agreed with the clarification that the staff provided and noted that some of the concerns about discontinuing equity method accounting when the FVO is elected can be addressed through disclosure, which the Board will redeliberate at a future meeting. Messrs. Herz, Crooch, Trott, and Linsmeier also agreed with the staff's recommendations.

4. Ms. Seidman also agreed with the staff's recommendations and stated that her concerns about the potential for abuse with regard to equity method investments were addressed by the staff's recommendations. She also stated that she believed that the wording in the final Statement should be broad in order to clarify that all interests in the equity method investee should be accounted for pursuant to the FVO (for example, guarantees). She noted that this could be handled in drafting the final Statement.

5. Mr. Herz shared prepared comments from Mr. Young that stated that he believed reporting certain equity method investments at fair value (for example, strategic investments) is misleading and therefore recommended that equity

method investment be excluded from the scope of Phase 1. (Please note that votes by Mr. Young reflected in these minutes were provided to the staff before the meeting.) He stated that if the Board did vote to include such investments within the scope of Phase 1 that he recommended preserving the disclosure requirements of APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*. The Board agreed with the staff's recommendation by a vote of 6 (GMC, EWT, TJL, LFS, RHH, GJB) to 1 (DMY).

Investments in Equity Securities That Do Not Have Readily Determinable Fair Values

6. The Board unanimously agreed with the staff's recommendations to include these investments in the scope of Phase 1 and not to impose any eligibility requirements on these securities. The Board noted that there may be unique disclosures needed for investments in equity securities that do not have a readily determinable fair value (for example, why an enterprise elected the FVO for such securities) but that disclosures would be discussed at a future Board meeting.

Insurance and Reinsurance Contracts

7. Mr. Linsmeier stated that he agreed with the staff's recommendations to include insurance and reinsurance contracts that meet the definition of a financial instrument in the scope of Phase 1, and that the scope of Phase 1 should be expanded beyond insurance and reinsurance contracts that are financial instruments to also include insurance contracts that do not prohibit settlement of the insurer's obligation by payment to a third-party provider of goods or services rather than by payment to the insured or other claimant. However, he stated it should be clear that the FVO is for financial instruments and certain other items. Mr. Linsmeier stated that he still believes the FVO should be elected by classes of assets and liabilities to better reflect the economics of an enterprise. Mr. Crooch and Mr. Trott also agreed with the staff's recommendations.

8. Ms. Seidman agreed with the staff's recommendation to include insurance and reinsurance contracts that meet the definition of financial instruments in the

scope of Phase 1, but she disagreed with the staff's recommendation to expand the scope to certain other insurance and reinsurance contracts. She explained that this is a new notion that has not been fully explored and that she believes adds complexity and inconsistency. She further noted that it makes it difficult to understand why commodities cannot be included within Phase 1. Ms. Seidman recommended solving the issue by stating that any contract that allows settlement with a nonfinancial item is not included in the scope of Phase 1. Mr. Batavick stated that he understood Ms. Seidman's point, but that the expediency effect of the staff's recommended scope expansion in this area and the possibility of further convergence led him to agree with both of the staff's recommendations.

9. Mr. Herz stated that he wouldn't object to the staff's recommendations, but noted that he was concerned about convergence and the possibility of changing this provision in the future based on the outcome of the current comprehensive project addressing insurance accounting. Mr. Young did not agree with the staff's recommended scope expansion for insurance and reinsurance contracts. He stated that he believed the insurance project would deal with this issue. The Board agreed to the staff's recommendations by a vote of 5 (GMC, EWT, TJL, GJB, and RHH) to 2 (LFS and DMY).

Warranty Obligations

10. Because the staff's recommendations for warranty obligations were so similar to the recommendations on insurance and reinsurance contracts, the Board voted the same on this issue. That is, the Board decided by a vote of 5 (GMC, EWT, TJL, GJB, and RHH) to 2 (LFS and DMY) to follow the staff's recommendations that warranty rights and obligations that meet the definition of a financial instrument should remain in the scope of Phase 1, and that the scope of Phase 1 should be expanded beyond warranty rights and obligations that are financial instruments to also include warranty rights and obligations that do not prohibit settlement of the warranty obligation by payment to a third-party provider of goods or services rather than by payment to the claimant.

Unconditional Purchase Obligations

11. The Board agreed with the staff's recommendation to continue to include unconditional purchase obligations that are recorded as financial liabilities on the purchaser's statement of financial position as discussed in paragraph 10 of FASB Statement No. 47, *Disclosure of Long-Term Obligations*, by a vote of 6 (RHH, GMC, GJB, EWT, TJL, and LFS) to 1 (DMY).

Otherwise Unrecognized Firm Commitments Involving Only Financial Instruments

12. By a vote of 6 (RHH, GMC, GJB, EWT, TJL, and LFS) to 1 (DMY) the Board agreed with the staff's recommendation that otherwise unrecognized firm commitments that meet the definition of a firm commitment in Statement 133 and involve only financial instruments should be included in the scope of Phase 1. Mr. Young recommended that if firm commitments were being included in the scope of Phase 1, the Statement 133 qualifying criterion should be dropped since it was meaningless to investors. He also reiterated his preference for a qualifying criterion that would require preparers to demonstrate an attribute mismatch before applying the FVO to firm commitments.

Written Loan Commitments

13. Ms. Barker introduced this topic by explaining that a majority of respondents to the Exposure Draft disagreed with the Board's conclusion to exclude written loan commitments that are not accounted for under Statement 133. She noted that these respondents disagreed with the Board for the following reasons:

- a. There is no substantive difference between those loan commitments currently in the scope of Statement 133 and those excluded from Statement 133's fair value accounting requirement
- b. Including written loan commitments would increase convergence with IFRS
- c. Loan commitments are valued using the same techniques that are used to value funded loans
- d. Much of bank lending exposure is in the form of unfunded commitments and the funded and unfunded portions of a credit facility are managed together when assessing credit risk

- e. Loan commitments are economically hedged on a portfolio basis, and a hedge accounting solution is often not viable.

14. Ms. Barker further explained that the staff originally excluded written loan commitments from Phase 1 because of potential conflicts with the SEC's guidance provided in SEC Staff Accounting Bulletin No. 105, *Application of Accounting Principles to Loan Commitments*. However, based on the staff's belief that the fair value measurements project will provide the appropriate framework for measuring and disclosing these loan commitments and based on constituent's responses, the staff recommends that written loan commitments not accounted for under Statement 133 should be included in the scope of Phase 1.

15. In response to a question from Mr. Herz, Mr. Wilkins stated that the FASB staff had not yet received an official position from the SEC on the apparent conflict of the fair value measurements project with SAB 105. Mr. Trott explained that the issue with loan commitments is what is being valued, which is also the issue with DDAs. Mr. Trott noted that SAB 105 focuses on the valuation of the liability portion of an exchange that is usually made in conjunction with a written loan commitment (and also a demand deposit). In many cases, the amount exchanged is not solely for the obligation, but also includes other items that would not meet the definition of a financial instrument, such as a customer relationship, which is not included in Phase 1 and in fact is rarely recorded except for when it is acquired in an exchange. Mr. Trott asked whether the Board should address the unit of account issue in these exchanges since loan commitments are made up of multiple components and some may be outside the scope of Phase 1. Mr. Trott stated that he disagreed with the staff's recommendation to include these loan commitments in the scope of Phase 1.

16. Mr. Lott asserted that the situation with loan commitments is not the same as DDAs since a DDA is clearly made up of two separable components: (a) a demand deposit liability and (b) a deposit agreement. It is easy to require that an enterprise measure the demand deposit liability. However, with a loan commitment it is not easy to separate the components. Mr. Lott recommended that, if the Board only wanted the liability portion of the commitment to be valued,

the proposed Statement should be clearer. He also noted that doing so, in his opinion, would measure the loan commitment at a value other than fair value since a component of the contract was not included.

17. Ms. Seidman agreed with Mr. Lott's points. She stated that servicing is embedded in every financial asset and historically the Board has not viewed that embedded servicing as something that would preclude an item from being a financial instrument. Ms. Seidman also stated that any conceptual hurdles that the Board had with loan commitments have implicitly been overcome by including loan commitments within the scope of Statement 133. Ms. Seidman also stated that it was not clear why the staff was only recommending that written loan commitments be included in the scope as opposed to a broader set of loan commitments not accounted for under Statement 133 (for example, purchased and held loan commitments). Mr. Wilkins noted that loan commitments not mentioned in the specific scope exception for written loan commitments in the Exposure Draft would already be included in the scope of Phase 1 to the extent that they were financial instruments. Ms. Seidman agreed with the inclusion of written loan commitments not accounted for under Statement 133 in the scope of Phase 1.

18. Mr. Linsmeier also agreed with the inclusion of these items in the scope of Phase 1, but expressed concern in any decision that would lead to an amount being measured that is different than the fair value of the entire contract, which could happen in the case of a written loan commitment if the Board requires only the liability portion to be measured as opposed to the entire contract. Mr. Batavick also stated that he agreed with the staff's recommendation. Mr. Smith clarified that the Board was voting to include any loan commitment which a party is obligated to fund whether it was written, acquired, or assumed. Mr. Crooch agreed with Mr. Trott and therefore disagreed with including these loan commitments in the scope of Phase 1. Mr. Young also disagreed with the staff's recommendation while Mr. Herz agreed with the staff's recommendation.

19. The Board decided to include written loan commitments that are not accounted for under Statement 133 in the scope of Phase 1 by a vote of 4 (GJB, TJL, RHH, and LFS) to 3 (EWT, GMC, and DMY).

Financial Liabilities for Demand Deposits

20. Mr. Trott and Mr. Crooch stated that they viewed DDAs as similar to loan commitments and therefore voted to exclude DDAs from the scope of Phase 1. Mr. Batavick agreed with the staff's recommendation because it was consistent with the Board's initial decision to exclude DDAs because of mixed views and further research required in this area. Ms. Seidman, Mr. Herz, and Mr. Young also agreed with the staff's recommendation to exclude DDAs from the scope of Phase 1.

21. Ms. Seidman noted that she recommended addressing DDAs in Phase 2. Mr. Herz also noted that he was concerned about potential inconsistency in excluding DDAs from the scope of Phase 1; however, he also noted that there is enough uncertainty around this area to warrant further work.

22. Mr. Linsmeier disagreed with the staff's recommendation, remaining consistent with his reasoning for including loan commitments. Mr. Linsmeier expressed concern that the Board may be creating a circumstance with this decision that would not allow primary financial institutions who want to measure all of their financial instruments fair value to depict the economic volatility of their businesses.

23. The Board agreed by a vote of 6 (LFS, GJB, RHH, GMC, DMY, and EWT) to 1 (TJL) with the staff's recommendation to consider DDAs in Phase 2 and to define DDAs as financial liabilities of financial institutions with demand features in a manner consistent with the IASB.

Items Excluded from Statement 107 and the Proposed FVO Statement

Interests That Would Otherwise Be Consolidated

24. The Board unanimously agreed with the staff's recommendation that the final Statement be clarified to make sure that all interests that would otherwise be consolidated are excluded from the scope of the fair value option project.

Pensions, Other Postretirement Benefits, and Certain Compensation Arrangements

25. The Board unanimously agreed with the staff's recommendation that employers' and plans' financial obligations for pension benefits, other postretirement benefits (including health care and life insurance benefits), postemployment benefits, employee stock option and stock purchase plans, and other forms of deferred compensation arrangements as defined in FASB Statements No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, No. 87, *Employers' Accounting for Pensions*, No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, No. 112, *Employers' Accounting for Postemployment Benefits*, No. 123 (revised December 2004), *Share-Based Payment*, No. 43, *Accounting for Compensated Absences*, and No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*, and APB Opinion No. 12, *Omnibus Opinion—1967*, should be excluded from the scope of the fair value option project.

Financial Assets and Liabilities under Lease Contracts

26. The Board agreed with the staff's recommendation by a vote of 6 (RHH, GMC, GJB, LFS, DMY, TJL) to 1 (EWT) to exclude both financial assets and liabilities under lease contracts as defined in Statement 13 from the scope of Phase 1. Mr. Trott stated that from the lessee's standpoint capitalized lease obligations should be included in the scope of Phase 1. Ms. Seidman stated that she had mixed feelings in this area, but that she agreed with the staff's recommendation since the Board is addressing lease accounting in an ongoing

project and because there was not significant demand noted in the comment letters for the FVO in this area.

Other—Income Tax Assets and Liabilities

27. The Board unanimously decided not to include any additional references to income tax assets and liabilities in the standard section of the final Statement since the basis for conclusions is already clear that income tax assets and liabilities are not included in the scope of the FVO since they do not meet the definition of a financial asset or liability.

Follow-up Items:

None.

General Announcements:

None.