MINUTES

Financial Accounting Standards Board

To: Board Members

From: Fair Value Option Team
(Murphy, ext. 208)

Subject: Minutes of the December 7, 2005 Fair Value Option Board Meeting

Date: December 22, 2005

cc: Bielstein, Smith, Petrone, Leisenring, Fair Value Option Team, Fair Value Measurements Team, Gabriele, Carney, Polley, Swift, 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: Final Issues to Be Resolved before Drafting the Preballot Draft of the Phase 1 Fair Value Option Exposure Draft

Basis for Discussion: Board Memorandum No. 12 dated November 22, 2005

Length of Discussion: 10:20 a.m. to 11:40 a.m.

Attendance:

Board members present: *FASB*: Batavick, Crooch, Herz, Schipper, Seidman, Trott, and Young
IASB: Leisenring

Staff in charge of topic: Wilkins

Other staff at Board table: Barker, Cronin, Gerard, Lott, Murphy, L. Smith

Outside participants: None

<u>Summary of Decisions Reached</u>:

The Board discussed a number of issues regarding the fair value option project and decided:

1. Cash receipts and cash payments related to financial assets and financial liabilities for which the fair value option has been elected should not be required to be classified as operating activities in the statement of cash flows. In addition, FASB Statement No. 95, *Statement of Cash Flows,* as amended by FASB Statements No. 102, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale,* and No. 145, *Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections,* should be amended to remove the requirement that cash receipts and cash payments resulting from purchases and sales of securities classified as trading securities under FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities,* be classified as operating activities. The cash receipts and cash payments for those financial assets and financial liabilities should be classified pursuant to Statement 95 (as amended) based on the nature and purpose for which the related financial assets and financial liabilities were acquired or incurred.
2. Cash receipts and cash payments related to investments in life settlement contracts (both those reported at fair value and under the investment method) should not be required to be reported as investing activities in the statement of cash flows. Rather, those cash receipts and cash payments should be classified pursuant to Statement 95 (as amended) based on the nature and purpose for which the related financial assets and financial liabilities were acquired or incurred. (This decision will be reflected in the forthcoming FSP on life settlement contracts, not in the fair value option Exposure Draft.)
3. Both written loan commitments that would otherwise not be recognized at inception under existing GAAP and financial liabilities for demand deposit

accounts should be excluded from the scope of the fair value option election in phase 1 of the project. Rather, those items should be included for consideration in Phase 2 of the project.

4. Entities should be required to disclose how interest and dividends are reported and measured with respect to financial assets and financial liabilities for which the fair value option has been elected.
5. For only those financial assets and financial liabilities that are reported at fair value pursuant to the fair value option election, fair value carrying amounts should not be aggregated with non-fair-value carrying amounts of similar financial assets or similar financial liabilities in the balance sheet.
6. The following disclosures should be required to compensate for the lack of comparability created by the fair value option election:
    a. For an entity that is reporting any financial liabilities at fair value due to electing the fair value option, the qualitative reasons for significant changes in those liabilities' fair values included in current period earnings.
    b. Where gains and losses are reported in the income statement arising from the changes in the fair value of financial assets and financial liabilities for which the fair value option has been elected. This requirement for quantitative information by line item would apply for each period for which an income statement is presented.
    c. The difference between the carrying amount of any financial liabilities reported at fair value due to election of the fair value option and the aggregate principal amount the entity would be contractually required to pay at maturity to the holders of the obligations (or through the maturity date for any debts whose principal amounts are payable in installments).
7. The following disclosures should not be required by the Exposure Draft:
    a. Additional disclosures with respect to the amount of the fair value changes that are unrealized at the reporting date

   b. A roll-forward presentation of the debt balances from period to period that would incorporate the effect of fair value changes and currency changes
   c. For entities that have elected the fair value option for its liabilities, circumstances that have contributed to the deterioration of the reporting entity's creditworthiness but have not yet caused loss recognition in the financial statements.
8. For entities that elect the fair value option for some of its current available-for-sale securities in conjunction with the initial adoption of the fair value option Statement, the amount of the effect of that reclassification into the trading category should be disclosed and reported consistent with the transition provisions of the fair value option Statement (and not under Statement 115's reporting provisions for transfers between categories).
9. Adoption of the Statement should be required as of the beginning of each reporting entity's first fiscal year that begins after December 15, 2006, with earlier adoption permitted as of the beginning of an entity's earlier fiscal year that begins after issuance of the Statement (provided the entity has not yet issued financial statements for any interim period of that fiscal year).
10. Retrospective application of the Statement should not be required or permitted.
11. The impact of the initial adoption of the Statement should be accounted for as a cumulative-effect adjustment for retained earnings.
12. The comment period for the fair value option phase 1 Exposure Draft should be 75 days.

The Board directed the staff to prepare a draft of the Exposure Draft for vote by written ballot for phase 1 of this project.

<u>Objectives of Meeting</u>:

The objective of the meeting was for the Board to resolve several remaining issues pertaining to the fair value option (FVO) project, thus enabling the staff to prepare a preballot draft of the Phase 1 FVO Exposure Draft.

<u>Matters Discussed and Decisions Reached</u>:

The Effect of the FVO Election on Cash Flow Reporting Categories

1. Mr. Wilkins said that FASB Statement No. 145, *Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections,* made a technical correction to paragraph 8 of Statement 102 to add the following: "Cash receipts and cash payments resulting from purchases and sales of securities classified as trading securities as discussed in FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities,* shall be classified as operating cash flows." He noted that this decision could possibly be viewed as establishing a requirement that anything for which the FVO was elected would be subject to the same cash flow reporting requirement. Mr. Wilkins said that the staff recommends that the cash receipts and cash payments related to financial assets and financial liabilities for which the FVO has been elected should not be required to be classified as operating cash flows. All Board members agreed with that recommendation. Additionally, he said that the staff recommends that in determining the appropriate reporting under Statement 95 (as amended), the definitions of investing activities and financing activities should be applied to the nature and purpose for which the related financial assets and financial liabilities were acquired or incurred. All Board members agreed with those staff recommendations.

2. Ms. Seidman said that those decisions could create an inconsistency with one of the Board's decisions in its project on life settlement contracts. In that project, she noted that the Board prescribed that cash flows related to investments in life settlement contracts be classified as investing activities in the statement of cash flows. However, given the staff's analysis for this meeting on the effect of the FVO on cash flow reporting categories, and to be consistent with

the Board's decision to apply the definitions of investing activities and financing activities to the nature and purpose for which the related financial assets and financial liabilities were acquired or incurred, she recommended that the Board not require cash receipts and cash payments related to investments in life settlement contracts (both those reported at fair value and under the investment method) to be reported as investing activities in the statement of cash flows. Rather, those cash receipts and cash payments should be classified pursuant to Statement 95 (as amended) based on the nature and purpose for which the related financial assets and financial liabilities were acquired or incurred, which would be consistent with the Board's decisions in the FVO project. All Board members agreed with that suggestion.

Applying the FVO to Certain Financial Instruments Whose Fair Value Involves Nonfinancial Components

3. Mr. Wilkins recalled that the Board determined at its November 22, 2005 meeting that the FVO election should be available at the inception of financial forward contracts for such contracts that would otherwise not be recognized at inception under existing GAAP because they would be either financial assets or financial liabilities. He noted that consistent with that decision, the staff believes that option contracts involving only financial instruments, such as nonderivative loan commitments, that would otherwise not be recognized at inception under existing GAAP should also be permitted the FVO election. However, he noted that the possibility of permitting the application of the FVO election to loan commitments raises another scope issue that the staff would like the Board to consider whether Phase 1 of the FVO project should permit application of the FVO to financial instruments whose fair value involves nonfinancial components. Two types of financial instruments for which the effect of the nonfinancial components can be especially profound, and which the staff wishes the Board to consider, are written loan commitments and a financial institution's demand deposit accounts (that is, checking accounts). Mr. Wilkins said that the staff recommends that (a) written loan commitments that would otherwise not be recognized at inception under existing GAAP and (b) financial liabilities for

demand deposit accounts be excluded from the scope of the FVO election in Phase 1 and included for consideration in Phase 2 of the project.

4. All Board members except Ms. Seidman agreed with the staff's recommendation. Most Board members agreeing with the staff cited that a scope exclusion for these two items would allow the project to move forward in the most expedient way.

5. Ms. Seidman said that she disagreed with the staff's recommendation to exclude both (a) written loan commitments that would otherwise not be recognized at inception under existing GAAP and (b) financial liabilities for demand deposit accounts from the scope fo the FVO election in Phase 1 of the project. In regard to loan commitments, she said that she does not find the staff's rationale, which is related to there being a nonfinancial component embedded in a loan commitment, to be persuasive because servicing is inherent in every set of contractual cash flows. She said that if loan commitments were to be excluded on that basis, then it follows that everything requiring servicing should be excluded, and that is not the Board's intent. Additionally, there is no strong conceptual reason why the Board should treat this small subset of loan commitments different from those that are already accounted for at fair value under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. In regard to demand deposit accounts, she noted that excluding them from the scope of Phase 1 of the FVO project could possibly leave significant holes in certain entities' balance sheets where demand deposit accounts that have an observable fair value, which is different from their withdrawal amount, are measured at the withdrawal amount. Ms. Seidman suggested two possible ways to proceed with the issue: (a) defer the inclusion of demand deposit accounts in the FVO project until Phase 2 or (b) include demand deposit accounts in Phase 1 of the FVO project and ask questions such as (i) is there an immediate need for the FVO for demand deposit accounts or should the staff perform a more thorough analysis of demand deposit accounts outside the FVO project, (ii) are there concerns about the unit of account (that is, is the decision on the unit of account to date in the FVO project (item-by-item)

appropriate for demand deposit accounts, and (iii) are any special disclosures required. She expressed that her preference is to include demand deposit accounts within the scope of Phase 1 of the FVO project and ask questions.

6. Mr Herz said that his thinking on this issue is similar to that of Ms. Seidman's. However, he said that he does not object to the staff's recommendation. He suggested that questions about (a) written loan commitments that would otherwise not be recognized at inception under existing GAAP and (b) financial liabilities for demand deposit accounts be included in the Phase 1 FVO Exposure Draft, despite the exclusion of those items from the scope of that document, to indicate that the Board considered those items for inclusion in Phase 1 and to solicit constituent input about those items. All Board members agreed with that suggestion.

Determining Reported Interest for Receivables and Payables under the FVO Election

7. Mr. Wilkins stated that the next issue is whether any guidance should be provided about how reported interest should be determined for receivables and payables reported at fair value under the FVO. He said that the staff believes that it is inappropriate to burden the FVO project with the resolution of this issue. Consequently, the staff recommends that the FVO standard merely impose a requirement for entities to disclose how interest and dividends are reported and measured with respect to financial assets and financial liabilities for which the FVO has been elected. Mr. Wilkins said that the staff's recommendation would be similar to the approach taken by Statement 115, which stated in paragraph 14 that "this Statement does not affect the methods used for recognizing and measuring the amount of dividend and interest income." Additionally, the FVO standard would not require a change in the methods used for recognizing and measuring the amount of dividend and interest income. All Board members agreed with the staff's recommendation.

General Disclosures Related to Changes in Fair Value

Handout Item 4(a)

8. Mr. Wilkins said that because the FVO can be elected on an item-by-item basis, it is possible that the carrying amount for a single line item on the balance sheet could be a composite of a fair value measurement attribute and another measurement attribute. He said that the staff believes it is unnecessary to prohibit such composite amounts by requiring a separate line item for each subsequent measurement attribute used. Instead, the staff recommends that for each line item in the balance sheet, the FVO standard require disclosure in the notes of the carrying amounts for each of the subsequent measurement attributes used when the carrying amount reported is a composite of a fair value measurement attribute and at least one other measurement attribute. That requirement would apply for each date for which a balance sheet is presented.

9. Mr. Trott disagreed with the staff's recommendation. He noted that he would prefer a requirement that the balance sheet and income statement have separate displays for these items because there is little understandability from the aggregation of two or more amounts with different measurement bases.

10. Mssrs. Crooch and Young agreed with Mr. Trott in not supporting the staff's recommendation. Mr. Young added that he believes this requirement, as well as the rest of the staff's proposed disclosures, are ideal candidates for field testing with users and preparers.

11. Mr. Batavick agreed with the staff's recommendation. While he noted that the separate display supported by Mr. Trott would provide the best transparency for those items, he does not believe that this project should address this particular issue; he believes that the Board will eventually address this issue in the performance reporting project. He noted that he was comfortable with not requiring this disclosure so long as companies were not precluded from presenting disaggregated amounts.

12. Ms. Seidman agreed with the staff's recommendation. She noted that the disclosure requirements in the fair value measurement Statement will provide a comprehensive snapshot of the effect on earnings of all items at fair value (both

required and elected). She said that she is not convinced that it is worthwhile to repeat this information on the faces of the balance sheet and income statement. However, she indicated that she would change her vote to support separate line item disclosure on the face of the balance sheet for items with a fair value subsequent measurement attribute if users indicated that this would be more informative for them.

13. Ms. Schipper agreed with the staff's recommendation because she said there is no principle that directs when amounts should be disaggregated. Further, the Board does not have any basis to determine whether that disaggregation should occur on the faces of the balance sheet and income statement. Thus, in the absence of any reason to put in on the faces of those statements, she would prefer it in the notes because that is where most disaggregation is found.

14. Mr. Herz also agreed with Mr. Trott in not supporting the staff's recommendation. He said that this information is significant enough to be broken out on the faces of the balance sheet and income statement because it is important to understand what amounts have different measurement bases. Nonetheless, the Board decided that for only those financial assets and financial liabilities that are reported at fair value pursuant to the FVO election, fair value carrying amounts should not be aggregated with non-fair-value carrying amounts of similar financial assets or similar financial liabilities in the balance sheet.

Handout Item 4(b)

15. Mr. Wilkins said that the fair value measurement final Statement will likely require disclosure of the total gains or losses for the period relating to each major category of assets and liabilities remeasured at fair value during the period, even if those assets and liabilities are not still held at the reporting date. Because that Statement will require recognition of the fair value changes in earnings without specifying how those gains and losses are reported, the staff proposes requiring disclosure of where in the income statement those gains and losses (arising from the changes in the fair value) are reported. That requirement would apply for each period for which an income statement is presented.

16. Mr. Smith said that the Board members' responses to Handout Item 4(a) indicated their preference that changes in fair value that flow through the income statement could not be combined with the change in fair value of any other income statement item that is not a result of a change in fair value. For example, a change in fair value could not be aggregated with interest income. However, the Board's responses also suggested that one is not precluded from measuring an item at fair value and requiring the total change in fair value of that item to flow through the change in fair value of the line regardless of whether that change in fair value is attributable to interest. In other words, segregating the change in fair value on the face of the income statement does not preclude an entity from not recognizing interest income.

17. In that regard, Mr. Herz said that, at a minimum, he would prefer to have the changes in fair value of different items for which the fair value option was elected in one line on the face of the income statement. This line item would then be disaggregated in the footnotes. Board members agreed with that suggestion whereby requiring disclosure in the footnotes of where gains and losses are reported in the income statement arising from the changes in the fair value of financial assets and financial liabilities for which the FVO has been elected. This requirement would apply for each period for which an income statement is presented.

Handout Item 4(c)

18. Mr. Wilkins said that the staff recommends that the FVO Statement should not require any additional disclosures with respect to the amount of fair value changes that are unrealized at the reporting date because requirements to disclose that information will be included in the fair value measurement final Statement to the extent warranted. All Board members except Mr. Young agreed with that recommendation. Mr. Young expressed his concern that it will be difficult to ascertain how much of the amount reported at fair value is required (under the fair value measurement Statement) and how much is elected (under the FVO Statement).

Disclosures Related to Financial Liabilities Reported at Fair Value

Handout Items 4(d) and 4(e)

19. In regard to Handout Item 4(d), Mr. Wilkins said that the staff recommends that the Board require disclosure of the difference between the carrying amount of the financial liability (that is, reported at fair value due to either election of the FVO or application of Statement 133 to derivative liabilities) and the amount the entity would be contractually required to pay at maturity to the holder of the obligation. That disclosure would provide information to the users of the financial statements about the amounts that would be owed by the entity to its creditors in the event of its liquidation. He noted that the staff's recommended disclosure is the same as the IASB's disclosure of "the difference between the carrying amount of the financial liability and the amount the entity would be contractually required to pay at maturity to the holder of the obligation" (Cf. IAS 32, par. 94(h)(ii)) and, thus, is consistent with the FVO project's convergence objective. That requirement would apply for each date for which a balance sheet is presented.

20. In regard to Handout Item 4(e), Mr. Wilkins said that the staff recommends that the Board require an entity that is reporting a financial liability at fair value and has experienced a significant change in creditworthiness (whether an improvement or deterioration) during the reporting period to disclose an approximation of the amount of change attributable to its creditworthiness that is included in current period earnings. The staff believes that, in the interest of simplicity, the Board should not stipulate (a) guidance regarding when a change in a debtor's creditworthiness is considered significant or (b) detailed computational guidance regarding how to determine the approximation of the amount of the liabilities' fair value change attributable to the change in creditworthiness. Furthermore, he said that the staff believes the suggested disclosure should be required for entities that are reporting liabilities (including derivatives) at fair value, not just entities that have elected the FVO for a financial liability. If the amount of liabilities that are reported at fair value is very small, the staff believes the Statement's materiality box is sufficient to indicate that

disclosure of immaterial effects of a significant change in the debtor's creditworthiness is not required.

21. Mr. Trott agreed with the staff's recommendation for Handout Item 4(d), but he disagreed with staff's recommendation for Handout Item 4(e). That is, Mr. Trott supported disclosure of the reasons for the difference between the contractual cash flows and the fair value of an item, but he did not support disclosure of a close approximation of the amount of change attributable to creditworthiness. Mr. Smith clarified that Mr. Trott's suggested requirements addressed two concerns: First, constituents are uncomfortable with the anomaly that a reduction in an entity's own creditworthiness can create an effect on the income statement. And, second, it is difficult to isolate and quantify the change in fair value attributable to a change in an entity's own creditworthiness. He said that Mr. Trott's proposal has the benefit of addressing both these concerns because it does not require the quantification of something that constituents have indicated that it is difficult to quantify.

22. Mr. Batavick suggested that there be qualitative disclosures about what is happening with these items so that it is apparent what caused the change in fair value. Mr. Crooch agreed with Mr. Batavick's suggestion.

23. Ms. Seidman agreed with staff's recommendation for Handout Item 4(d). She said that she would prefer to incorporate the disclosure into existing GAAP requirements if a clear reference could be found that would be broad enough (that is, it would be consistent with the scope of this FVO Statement and include any financial liability). However, she would not be opposed to setting a new requirement if a clear reference could not be found. Furthermore, if a refererence was found, she expressed her support for separate disclosures for the items being carried at fair value versus the items that are not because differences potentially exist for all of them. Ms. Seidman also indicated that she is unsure whether she wants to include derivative liabilities in the scope of that requirement because she does not know how to operationalize it for those items. She said that her instinct would be to take them out and leave the requirement to

debt instruments. In regard to Handout Item 4(e), she agreed with the staff's recommendation to require that disclosure. She said that that disclosure would provide important information to users so that they could understand where there has been a change in creditworthiness and whether it is likely to have been concurrently offset by other recognized items in the income statement. Additionally, she said that users can then reference the balance sheet and ascertain what types of items are measured at fair value so as to make their own judgments about whether to factor in the gain or loss related to changes in an entity's own creditworthiness.

24. Mr. Young agreed with the staff's recommendation for Handout Item 4(d). He also agreed with staff's recommendation for Handout Item 4(e), but suggested that the word *significant* be removed so that any change in creditworthiness that passes the materiality test be required to be disaggregated. Mr. Wilkins clarified that Mr. Young did not want the threshold in Handout Item 4(e) to be a significant change in creditworthiness, but that the effect of a change in creditworthiness is material.

25. Ms. Schipper agreed with the staff's recommendation for Handout Item 4(d). She disagreed with the staff's recommendation for Handout Item 4(e). She said that while it is possible to prescribe a calculation for that amount, it would lack understandability. Also, she did not necessarily support Mr. Trott's suggestion because she believes that information is already included in the management's discussion and analysis (MD&A) section of the financial statements.

26. Mr. Herz summarized the discussion on Handout Item 4(e). He noted that two Board members supported the staff's recommendation and two Board members did not support the staff's recommendation. Furthermore, two Board members each proposed their own modifications of the recommendation: Mr. Trott's suggestion was based on qualitatively discussing at the reporting date the causes of the differences between the disclosure of the contractual amount and the carrying amount (which is shown as the fair value), and Mr. Batavick's suggestion was based on the discussion of the qualitative factors that led to the

change in fair value rather than the difference at a point in time between the contractual amount and end amount of fair value. Ms. Schipper and Mr. Herz also supported Mr. Batavick's suggestion.

27. Mr. Smith said that when a comparative balance sheet is presented, to the extent that the difference is attributed to the interest rate in one year and changes in an entity's own creditworthiness the next year, the result is Mr. Batavick's desired disclosure because the difference due to changes in an entity's own creditworthiness is isolated and is the only change for which commentary is provided. Mr. Wilkins clarified that this disclosure would relate to a change in the fair value of only those items for which the fair value election has been elected and that it would not relate to the change in fair value of items required to be measured at fair value under other GAAP.

28. In regard to Handout Item 4(d), the Board decided that the difference between the carrying amount of any financial liabilities reported at fair value due to election of the FVO and the aggregate principal amount the entity would be contractually required to pay to the holders of the obligations at maturity (or through the maturity date for any debts whose principal amounts are payable in installments) should be disclosed. Also, in regard to Handout Item 4e, the Board decided that for an entity that is reporting any financial liabilities at fair value due to electing the FVO, the qualitative reasons for significant changes in those liabilities' fair values included in current period earnings should be disclosed.

Handout Items 4(f) and 4(g)

29. Mr. Wilkins said that at the meeting of the Creditworthiness Resource Group in September 2005, several Resource Group members made suggestions to include and exclude certain disclosures. In regard to those suggestions, the staff recommends not requiring (a) a roll-forward presentation of the debt balances from period to period that would incorporate the effect of fair value changes and currency changes and (b) for entities that have elected the FVO for their liabilities, disclosure of the circumstances that have contributed to the deterioration of the reporting entity's creditworthiness but have not yet caused

loss recognition in the financial statements. All Board members agreed with those recommendations.

Effective Date and Transition

30. Mr. Wilkins said that the staff recommends that the effective date and transition guidance be consistent with the Board's tentative decisions reached on the servicing rights and hybrid financial instruments projects. In making this recommendation, the staff notes that the proposed effective dates for the servicing rights and hybrid financial instruments final Statements are the same—as of the beginning of fiscal years beginning after September 15, 2005, which provides constituents approximately six months between issuance of the Statement and the earliest required effective date. Because the final FVO Statement is currently projected to be issued in June 2006, the staff recommends the same approximate six-month implementation time frame, yielding an effective date based on December 15, 2006. Accordingly, Mr. Wilkins said that the staff recommends that the adoption of the FVO Statement be required as of the beginning of each reporting entity's first fiscal year that begins after December 15, 2006, with earlier adoption permitted as of the beginning of an entity's earlier fiscal year that begins after issuance of the FVO Statement (provided the entity has not yet issued financial statements for any interim period). All Board members agreed with that recommendation.

31. Mr. Wilkins said that Statement 154 requires retrospective application for reporting a change in accounting principle unless it is impracticable to do so. He said that the staff believes that retrospective application of the FVO Statement is impracticable because assumptions about management's intention in prior periods in relation to specific instruments cannot be independently substantiated. Consequently, the staff recommends that retrospective application of the FVO Statement should not be required or permitted. All Board members agreed with that recommendation.

32. Mr. Wilkins said that to best achieve the objectives of the FVO project, the staff believes that, upon initial adoption, an entity should be permitted to elect the

FVO on an instrument-by-instrument basis for any existing financial assets and financial liabilities within the scope of the Statement. The staff recommends that the impact of the initial adoption of the Statement be accounted for as a cumulative-effect adjustment through retained earnings. All Board members agreed with that recommendation.

33. Mr. Wilkins said that because an entity may elect the FVO for each existing financial instrument as of the date of initial adoption, no specific guidance permitting a one-time reclassification of available-for-sale securities to the trading category would be required. That is, an entity will evaluate all existing financial instruments, including available-for-sale and held-to-maturity securities accounted for under Statement 115, as of the initial date of adoption to determine which instruments to account for under the FVO. He noted that the election of the FVO for current available-for-sale securities would result in their reclassification into the trading category, but the effect of that reclassification would be reported consistent with the transition provisions of the FVO Statement (and not under Statement 115's reporting provisions for transfers between categories). Ms. Seidman suggested that the amount of the effect of that reclassification into the trading category should also be disclosed. All Board members agreed with that suggestion.

Comment Period

34. Mr. Wilkins said that the staff plans to conclude the comment period, analysis of comment letters, and redeliberations while the Board composition is the same as it is now, which would be by the end of June, 2006. With that goal in mind, and given the timing pressures of companies' March 15 10K filing requirements, the staff recommends a 60-day comment period, ending approximately on March 27, 2005. Mr. Trott said that he would prefer a 75-day comment period because companies also have first quarter 10Q filing requirements, in addition to their 10K filing requirements. He noted that an additional 15 days should provide companies with enough extra time after their filing deadlines to formulate meaningful and appropriate responses to the

Exposure Draft. All Board members agreed with Mr. Trott's suggestions for a 75-day comment period.

35. The Board directed the staff to prepare a draft of the Exposure Draft for vote by written ballot for Phase 1 of this project.

<u>Follow-up Items</u>:

36. None

<u>General Announcements:</u>

37. None.

Financial Accounting Standards Board

Board Meeting Handout
Fair Value Option
December 7, 2005

The Board will discuss the following issues regarding the fair value option (FVO) project:

1. Should the cash receipts and cash payments related to financial assets and financial liabilities for which the FVO has been elected be required to be classified as operating cash flows in the Statement of Cash Flows?

The staff recommends that cash receipts and cash payments related to financial assets and financial liabilities for which the FVO has been elected should *not* be required to be classified as operating cash flows. The definitions of investing activities and financing activities should be applied to the nature and purpose for which the related financial assets and financial liabilities were acquired or incurred. Those definitions would not preclude the cash receipts and cash payments related to financial assets and financial liabilities from being reported as operating activities because *operating activities* is the default classification if neither investing activities nor financing activities is an appropriate classification.

The staff also recommends that FASB Statement No. 95, *Statement of Cash Flows,* as amended by FASB Statements No. 102, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale,* and No. 145, *Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections,* be amended to remove the requirement that cash receipts and cash payments resulting from purchases and sales of securities classified as trading securities under FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities,* be classified as operating cash flows. The staff notes that the classification of a security as trading is permitted even though the enterprise does not intend to sell it in the near term.

2. Should the FVO election be permitted for nonderivative loan commitments at the inception of the contract? Should the FVO election be permitted under phase one of the project for certain financial instruments whose fair value involves nonfinancial components?

The staff recommends that the Board reject stipulating that, in applying the FVO election under Phase 1, the determination of fair value exclude the effect of nonfinancial components. The staff believes that prohibition would be inappropriate in this project since it addresses how to determine fair value, which is beyond the scope of the FVO project. Furthermore, such a prohibition could be considered inconsistent with the final Statement on the fair value measurement project. Rather, the staff suggests that the Board focus on the two currently known problematic financial instruments for which nonfinancial components can significantly affect fair value: nonderivative loan commitments and demand deposit accounts. The staff recommends that the following be excluded from the scope of the FVO election in Phase 1 and included for consideration in Phase 2 of the project:

a. Written loan commitments that would otherwise not be recognized at inception under existing GAAP

b. Financial liabilities for demand deposit accounts.

3. What guidance, if any, should be provided about how reported interest is determined for receivables and payables reported at fair value under the FVO?

The staff recommends that the FVO Statement merely impose a requirement for entities to disclose how interest and dividends are reported and measured with respect to financial assets and financial liabilities for which the FVO has been elected. The staff's recommendation would be similar to the approach taken by Statement 115, which stated in paragraph 14 that "This Statement does not affect the methods used for recognizing and measuring the amount of dividend and interest income." The FVO Statement would not require a change in the methods used for recognizing and measuring the amount of dividend and interest income.

4. What disclosures should be required to compensate for the lack of comparability created by the FVO?

The staff recommends the following regarding the disclosure requirements for entities electing the FVO:

a. For each line item in the balance sheet, entities should disclose in the notes to the financial statements the carrying amounts for each of the subsequent measurement attributes used when the carrying amount reported is a composite of a fair value measurement attribute and at least one other measurement attribute. That requirement would apply for each date for which a balance sheet is presented. Balance sheet presentation of a separate line item for each subsequent measurement attribute used would not be required.

b. Entities should disclose where in the income statement gains and losses arising from the changes in the fair value are reported. That requirement would apply for each period for which an income statement is presented.

c. The FVO Statement should not require any additional disclosures with respect to the amount of fair value changes that are unrealized at the reporting date. Requirements to disclose that information will be included in the fair value measurement final Statement to the extent warranted.

d. Entities should disclose the difference between the carrying amount of the financial liability (that is, reported at fair value either due to election of the FVO or application of Statement 133 to derivative liabilities) and the amount the entity would be contractually required to pay at maturity to the holder of the obligation.

e. An entity that is reporting a financial liability at fair value and has experienced a significant change in creditworthiness (whether an improvement or deterioration) during the reporting period is required to disclose an approximation of the amount of change attributable to its creditworthiness that is included in current period earnings. The staff believes that, in the interest of simplicity, the Board should not stipulate (1) guidance regarding when a change in a debtor's creditworthiness is considered significant nor (2) detailed computational guidance regarding how to determine the approximation of the amount of the liability's fair value change attributable to the change in creditworthiness. If the amount of liabilities that are reported at fair value is very small, the staff believes the Statement's materiality box is sufficient to indicate that disclosure of immaterial effects of a significant change in the debtor's creditworthiness is not required.

f. A roll forward presentation of the debt balances from period to period that would incorporate the effect of fair value changes and currency changes should not be required by the FVO project.

g. For entities that have elected the FVO for its liabilities, the disclosure of circumstances that have contributed to the deterioration of the reporting entity's creditworthiness but have not yet caused loss recognition in the financial statements should not be required by the FVO project.

5. What effective date and transition provisions are warranted?

The staff recommends that adoption of the FVO Statement be required as of the beginning of each reporting entity's first fiscal year that begins after December 15, 2006, with earlier adoption permitted as of the beginning of an entity's earlier fiscal year that begins after issuance of the FVO Statement (provided the entity has not yet issued financial statements for any interim period of that fiscal year).

Furthermore, retrospective application of the FVO Statement should not be required or permitted. The impact of the initial adoption of the Statement should be accounted for as a cumulative effect adjustment for retained earnings.

6. What should be the length of the comment period?

The staff recommends that the comment period for the Phase 1 Exposure Draft be about 60 days. That Exposure Draft is tentatively expected to be released for comment in late January 2006.