MINUTES

Financial Accounting Standards Board

To:	Board Members
From:	Fair Value Option Team (Cowan ext. 233)
Subject:	Minutes of the September 6, 2006 Board Meeting: Fair Value Option
Date:	September 15, 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 Redeliberations

Basis for Discussion: Board Memorandum No. 21 dated August 23, 2006

Length of Discussion: 10:20 a.m. to 12:00 p.m.

Attendance:

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

Board member absent: Crooch (left after vote on the optionality of the FVO)

Staff in charge of topic: Wilkins

Other staff at Board table: L. Smith, Lott, Barker, and Cowan

Outside participants: None

Summary of Decisions Reached:

The Board redeliberated (1) election of the fair value option (FVO) and related documentation, (2) recognition, measurement, and presentation issues, and (3) certain disclosure issues of Phase 1 of the FVO project. The Board decided:

Election of the FVO and Related Documentation Issues

1. The FVO should continue to be an optional accounting treatment elected on a contract-by-contract basis.
2. The FVO shall not be available for a portion of an item that is within the scope of Phase 1 of the FVO project.
3. The election of the FVO must be made at initial recognition or a new basis event and that the basis for conclusions of the final Statement should clarify that if an entity is required to initially recognize an instrument at the trade date rather than the settlement date, the FVO should also be elected at the trade date (which would be the date that the contract is initially recognized).
4. No eligibility criteria should be imposed.
5. Not to provide specific documentation guidance, however, an enterprise should designate its election of the FVO at the time of initial recognition or a new basis event.

Recognition, Measurement, and Presentation Issues

6. Changes in fair value for items accounted for pursuant to the FVO should be recognized in earnings as they occur.
7. To reaffirm the decision not to permit entities to elect (outside of the hedge accounting outlined in Statement 133) to recognize in earnings the change in an asset's or liability's fair value attributable to only certain selected risks (rather than the total change in fair value).
8. Not to exclude the effect of changes in an entity's creditworthiness from earnings in reporting liabilities at fair value.
9. Not to provide specific presentation guidance for the effects of fair value measurements on earnings, but rather address the need for understanding the effects of changes in fair values of items for which the FVO has been elected through disclosures.
10. To continue to require that an entity provide separate presentation or parenthetical disclosure on the face of the statement of financial position for fair value and non-fair-value carrying amounts.
11. Not to amend FASB Statement No. 95, *Statement of Cash Flows*, as part of the FVO project, to permit changing the cash flow classification of

financial assets and liabilities based on management's intent at the reporting date.

Certain Disclosure Issues

12. Not to modify the disclosure requirement in paragraph 12(a) of the FVO Exposure Draft which requires 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 obligation at maturity (or through the maturity date for any debts whose principal amounts are payable in installments), if any, be disclosed.

13. To modify the disclosure requirement in paragraph 12(b) of the FVO Exposure Draft to include (a) a requirement to disclose the method and significant assumptions used to estimate fair value and (b) the encouragement to disclose quantitative information about the market risk of instruments that is consistent with the way the entity manages or adjusts those risks, for items whose fair value measurements, in their entirety, fall within level 3 of the fair value hierarchy defined in the fair value measurements Statement. With respect to this disclosure, the Board decided not to require sensitivity analysis or a specific requirement to provide information about model validation procedures.

14. To add clarifying language to the disclosure requirement in paragraph 12(b) of the FVO Exposure Draft to state that the entity is required to disclose sufficient information about changes in fair value for those items for which the FVO has been elected rather than disclosure of the effect on earnings resulting from election of the FVO.

15. Not to modify the disclosure requirement in paragraph 12(c) of the FVO Exposure Draft since it is already sufficiently clear that it applies to all gains and losses (not just unrealized ones), but to include additional background in the basis for conclusions of the final FVO Statement on the Board's decisions regarding separate disclosures of only unrealized gains and losses.

16. To revise the disclosure in paragraph 12(d) of the FVO Exposure Draft and the basis for conclusions in the final FVO Statement to clarify that the FVO does not address methods for recognizing and measuring the amount of interest and dividend income.

17. To require an entity that is reporting a financial liability at fair value pursuant to the FVO that has experienced a significant change in creditworthiness during the reporting period to disclose an approximation of the amount of change attributable to its creditworthiness that is included in current period earnings. In connection with this decision, the Board also decided not to provide (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.

Objectives of Meeting:

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

Matters Discussed and Decisions Reached:

ELECTION OF THE FVO AND RELATED DOCUMENTATION ISSUES

The Optionality of the FVO

1. Mr. Wilkins asked that the Board reaffirm whether or not the FVO should remain an option. Mr. Trott stated that he supported the optionality of the election since it was a better option for preparers to communicate with users of the financial statements. He also noted that he supported requiring fair value measurement for all financial instruments. Ms. Seidman also supported the optionality of the election. She explained that the Board has expressed its intention to go toward full fair value measurement for financial instruments, but that the majority of the Board was not ready to require that. Ms. Seidman stated that the FVO was a good interim step. Mr. Batavick agreed with Ms. Seidman's point and reiterated the point made by Mr. Trott that preparers could use the FVO to improve their reporting.

2. Mr. Linsmeier stated that he preferred to account for all financial instruments at fair value, but that he understood that such an alternative was not currently possible. Mr. Linsmeier stated that the Board's interim steps to full fair value measurement for all financial instruments should communicate the underlying risk of the entity. To do so, Mr. Linsmeier asserted that the FVO should require a class-by-class election rather than a contract-by-contract election. He explained that the contract-by-contract election allows a company to mask the true volatility of their business, thus making the risk of the company less transparent. Additionally, Mr. Linsmeier stated that the contract-by-contract election requires a

definition of contract in each area. He stated that defining the term *contract* in so many different contexts may prove extremely difficult. Because of that difficulty and to better portray the economics of companies, Mr. Linsmeier supported election of the FVO by class, if the FVO remains an option rather than a requirement to report all financial instruments at fair value.

3. Mr. Young stated that he was concerned with the optionality that the FVO provides, especially since the Board does not have any empirical evidence that an optional accounting treatment is useful in furthering fair value reporting. Mr. Young further explained that optional accounting is difficult for users of the financial statements to understand. The Board decided to maintain the optionality of the FVO by a vote of 5 (LFS, GMC, RHH, GJB, and EWT) to 2 (TJL and DMY).

Required Contract-by-Contract Election

4. Mr. Wilkins opened the Board's discussion of the requirement to elect the FVO on a contract-by-contract basis, stating that the staff recommended not to modify that requirement. He further explained that the staff did not recommend providing definitional guidance on the term *contract*, but provided the Board with examples of the application of the contract-by-contract election to securities and loans. Lastly, Mr. Wilkins stated that the staff recommended that the final FVO Statement (a) indicate that the determination of fair value must be consistent with the guidance in the forthcoming FVM Statement, (b) acknowledge in the basis for conclusions that, in determining the fair value of an individual financial instrument, the FVM Statement does not preclude an entity from measuring it as part of a portfolio rather than strictly on a standalone basis, and (c) indicate that the contract-by-contract election of the FVO does not limit the entity in determining the appropriate unit of account for measuring the financial assets and financial liabilities for which the FVO has been elected.

5. The Board decided to retain the contract-by-contract election of the FVO by a vote of 4 (RHH, EWT, LFS, and GJB) to 2 (TJL, DMY). The Board requested that the staff develop additional guidance for defining contract-by-contract for

discussion at a future meeting. Ms. Seidman expressed concern regarding overly prescriptive guidance on such an election for some instruments while not addressing others. She noted the staff's examples of securities and loans and the contract-by-contract election applicable to those instruments. Ms. Seidman stated that she preferred that the Board not provide prescriptive guidance on any class of instruments. Ms. Seidman also stated that she did not want to discuss unit of account issues for measurement as part of the FVO redeliberations since doing so could result in a conflict with the fair value measurements (FVM) Statement. Instead, she preferred to address those issues in the FVM Statement. Specifically, Ms. Seidman preferred not to include items (b) and (c) above, as noted by Mr. Wilkins.

Election for a Portion of a Financial Asset or Financial Liability

6. Mr. Cowan noted that the staff had received comment letters and comments at the roundtable meeting requesting that the Board permit election of the FVO for a portion of a financial instrument. He stated that the staff recommended that the Board reject those requests since they would not meet two of the primary objectives of the FVO. That is, allowing election of the FVO for a portion of a financial instrument would neither (a) result in reporting that financial instrument at fair value nor (b) be convergent with the IASB's FVO. The Board unanimously agreed with the staff's recommendation.

Timing of the Election of the Fair Value Option—Delayed Election

7. Mr. Cowan explained that some respondents to the FVO Exposure Draft recommended that the Board also permit the election of the FVO when (a) the legal form and substance of a financial instrument changes and (b) an enterprise changes its risk management strategy. Mr. Cowan also noted that one constituent requested clarification of whether the FVO election should be made at the trade date or the settlement date. He stated that the staff recommended that the election of the FVO must be made at initial recognition or a new basis event and that the basis for conclusions of the final Statement should clarify that if an entity is required to initially recognize an instrument at the trade date rather

than the settlement date, the FVO should also be elected at the trade date (which would be the date that the contract is initially recognized).

8. The Board agreed to the staff's recommendation unanimously. Mr. Batavick stated that he would rather see the clarification on election at the trade date or the settlement date in the standards section rather than the basis for conclusions. Ms. Seidman also stated that the staff should use care in drafting the clarification to make sure that the wording does not provide flexibility regarding when the election of the FVO takes place. Mr. Young stated that he was concerned that the FVO did not provide any wash sale provision. He explained that without such a provision, the irrevocability of the FVO election and the need to elect the FVO at initial recognition or a new basis event is undermined.

Need for Qualifying Criteria for the FVO Election

9. Mr. Cowan explained that the staff did not receive information regarding the need for qualifying criteria for the FVO election that was not already considered by the Board in its initial deliberations. He stated that the staff believes the objectives of the FVO, as explained in paragraph 1 of the FVO Exposure Draft, are better met by not imposing any eligibility requirements and therefore the staff recommended that no eligibility criteria be imposed in the final FVO Statement.

10. Mr. Trott, Mr. Batavick, and Ms. Seidman agreed with the staff's recommendation. Ms. Seidman stated that certain disclosures may be able to mitigate some of the concerns of not having eligibility requirements, such as a disclosure stating the reasons for electing the FVO and reasons for not electing the FVO for similar financial instruments. Mr. Herz also agreed with the staff's recommendation, but noted that he may change his mind if the disclosures do not provide information that allows users of the financial statements to understand how the FVO is elected and why it is elected.

11. Mr. Young and Mr. Linsmeier disagreed with the staff's recommendation. Mr. Linsmeier stated that if the FVO is an elective accounting treatment it should only be permitted when an entity uses it to better reflect the volatility inherent in its

operations (for example, when there is a mixed attribute issue). Mr. Linsmeier stated that he was still concerned that the elective nature of the FVO on a contract-by-contract basis would allow companies to hide the true risk or volatility of their operations by selective election.

Documentation Requirements for the FVO Election

12. Mr. Cowan stated that most respondents to the FVO Exposure Draft that commented on documentation requirements disagreed with the Board's decision to require concurrent documentation. Mr. Cowan explained that those respondents provided two primary reasons for their objection to the documentation requirement: (a) documentation should be an area handled by internal controls and with auditors and (b) the requirement for concurrent documentation takes away two primary advantages of the FVO, which are flexibility and ease of use. Mr. Cowan stated the staff recommended that the documentation requirements be modified to require documentation within a reasonable amount of time after election of the FVO (which is still required at initial recognition or a new basis event) but no later than the end of the month in which the item is initially recognized or the new basis event occurs.

13. All Board members present disagreed with the staff's recommendation. Mr. Batavick stated that he preferred not to provide documentation guidance at all since that could be handled by a company's internal controls and verified by its auditors. Ms. Seidman, Mr. Herz, Mr. Linsmeier, and Mr. Young also agreed. Ms. Seidman suggested the final FVO Statement state that an entity must designate the election of the FVO at initial recognition or the new basis event. She stated that she did not want to recreate the documentation issues of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

RECOGNITION, MEASUREMNT, AND PRESENTATION ISSUES

Recognizing Changes in Fair Value in Earnings

14. Mr. Wilkins asked the Board to reaffirm its decision to recognize changes in the fair value of items for which the FVO is elected in earnings. The Board

unanimously agreed that such changes in fair value should be included in earnings in the period they occur.

Recognizing Changes in Fair Value Attributable Only to a Certain Risk

15. Mr. Wilkins stated that several constituents requested that the Board permit election of the FVO on a by-risk approach. He noted that the Board had previously rejected this approach, but asked the Board to reaffirm that decision. The Board unanimously agreed that the FVO project should not permit entities to elect (outside of the hedge accounting outlined in Statement 133) to recognize in earnings the change in an asset's or liability's fair value attributable to only certain selected risks (rather than the total change in fair value).

Special Treatment for the Changes in a Liability's Fair Value Attributable to Changes in a Debtor's Creditworthiness

16. Mr. Wilkins explained that several respondents to the FVO Exposure Draft did not agree with the Board's decision to include changes in a liability's fair value attributable to changes in a debtor's creditworthiness in earnings in the period they occur. He noted that this issue was discussed at length by the Board in its initial deliberations and that the staff did not believe any new information was presented in respondents' comments to the FVO Exposure Draft or through the roundtable meeting. Mr. Wilkins stated that the staff recommended that the Board not curtail the debtor's recognizing in earnings the effect of changes in its creditworthiness in reporting liabilities at fair value. The Board unanimously agreed with the staff's recommendation.

Aggregating Fair Value Changes in the Income Statement

17. Mr. Wilkins stated that the staff recommended that the Board not provide specific presentation guidance for the effects of the fair value measurements on earnings, but rather address the need for understanding the effects of changes in fair values of items for which the FVO has been elected through disclosures. The Board unanimously agreed with the staff's recommendation.

Distinguishing between Fair Value and Non-Fair-Value Carrying Amounts in the Statement of Financial Position

18. Mr. Wilkins stated that the staff recommended that the Board make no change to the requirement for separate presentation or parenthetical disclosure on the face of the statement of financial position. The Board unanimously agreed with the staff's recommendation.

Proposed Cash Flow Reporting Changes

19. Mr. Wilkins explained that some respondents to the FVO Exposure Draft requested that the Board amend FASB Statement No. 95, *Statement of Cash Flows,* to permit classification of cash flows based on management's intent at the reporting date. Mr. Wilkins stated that the staff believed that such an amendment was outside the scope of the FVO project. He stated that the staff recommended that the Board maintain the guidance regarding cash flow reporting in the FVO Exposure Draft without modification. The Board agreed unanimously with the staff's recommendation.

CERTAIN DISCLOSURE ISSUES

The Difference between the Liability's Fair Value Carrying Amount and the Aggregate Principal Amount

20. Ms. Barker stated that the staff recommended not amending the disclosure requirement in paragraph 12(a) of the FVO Exposure Draft regarding the difference between a liability's fair value carrying amount and the aggregate principal amount. She explained that the staff believed that existing disclosure requirements such as those contained in FASB Statement No. 47, *Disclosure of Long-Term Obligations,* would enable users of the financial statements to analyze an entity's cash obligations. The Board unanimously agreed with the staff's recommendation.

Information Sufficient to Understand the Effect of Subsequently Measuring at Fair Value under the FVO Election

21. Ms. Barker explained that some items that are not included within the scope of Statement 107, *Disclosures about Fair Value of Financial Instruments,* are included in the scope of the FVO Statement. Because of this, she explained that the staff recommended that the Statement 107 disclosures be incorporated into the FVO Statement, but only for fair value measurements that, in their entirety, fall within Level 3 of the fair value hierarchy defined in the FVM Statement. She stated that the staff also recommended revising the disclosure requirement in paragraph 12(b) of the FVO Exposure Draft to clarify that an entity is required to disclose information sufficient for users of the financial statements to understand changes in fair value for those items for which the FVO has been elected rather than disclosure of the effect on earnings resulting from election of the FVO. Ms. Barker further stated that the staff recommended not including specific requirements to perform sensitivity analysis or provide information regarding model validation procedures. The Board unanimously agreed with the staff's recommendations.

Quantitative Information Regarding Where Fair Value Changes Are Reported in the Income Statement

22. Ms. Barker explained that few constituents provided comments specifically on the disclosure requirement in paragraph 12(c) of the FVO Exposure Draft. She explained, however, that one respondent suggested requiring disclosure of the reasons for movements at each hierarchy level in both fair value changes and movements between levels.

23. Ms. Barker also stated that a few respondents questioned whether paragraph 12(c) encompasses all gains and losses or only unrealized gains and losses. She noted that the Board discussed the need for disclosure of unrealized gains and losses in connection with the FVM Statement and believes that the disclosure requirements in the FVM Statement will address the comments received on this particular item.

24. Ms. Barker stated that the staff believed it is sufficiently clear the disclosure requirement in paragraph 12(c) applies to all gains and losses (not just unrealized ones) and that no changes are necessary. She stated that the staff also recommended providing additional background in the basis for conclusions on the Board's decisions regarding separate disclosures of only unrealized gains and losses. All of the Board members present agreed with the staff's recommendations. Mr. Herz was concerned about the interaction of the FVO Statement with FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* once both Statements are effective. He asked the staff to consider how an entity would determine what items require this disclosure pursuant to the FVO Statement versus the disclosures in Statement 115 regarding gains and losses associated with securities classified as trading securities.

A Description Indicating How Interest and Dividends Are Measured and Reported in the Income Statement

25. Ms. Barker stated that the disclosure requirement in paragraph 12(d) of the FVO Exposure Draft requires an entity to provide "a description indicating how interest and dividends are measured and reported in the income statement." Ms. Barker explained that in its original deliberations of this requirement, the Board determined that the FVO document should not affect how interest and dividends are measured and reported in the income statement.

26. She stated that, based on comments received, the staff recommended that the Board clarify that the FVO does not address methods for recognizing and measuring the amount of interest and dividend income. Ms. Barker noted that the staff believes that any change in recognizing and measuring interest and dividend income is beyond the scope of this project. The Board unanimously agreed with the staff's recommendation. Mr. Batavick stated that he preferred adding this in the standards section of the final Statement rather than in the basis for conclusions.

Qualitative Information Regarding Significant Changes in the Fair Value of Financial Liabilities

27. Ms. Barker stated that paragraph 13 of the FVO Exposure Draft requires an entity to disclose qualitative information about the reasons for changes in the fair values of its financial liabilities for which the FVO has been elected, if a significant change occurs in any period presented. She further stated that most respondents to this item requested quantitative disclosures similar to those required by International Accounting Standards. Ms. Barker noted that Deloitte suggested the Board clarify that an entity must disclose any significant change resulting from changes in the entity's own creditworthiness, prohibiting an entity from avoiding disclosure if offsetting changes, such as changes in interest rates, occur during the same period.

28. Ms. Barker explained that the IASB requires disclosure of the amount of change both during the period and cumulatively in the fair value of the financial liability that is attributable to changes in credit risk and that the IASB has granted some leeway in determining the amount of change in the liability's fair value that is attributable to changes in credit risk. It may be determined either

a. As the amount of change in its fair value that is not attributable to changes in market conditions that give rise to market risk as computed under an IASB-specified method or

b. By using an alternative method selected by the reporting entity because the entity believes the alternative method more faithfully represents the amount of change in its fair value that is attributable to changes in credit risk.

29. Ms. Barker stated that the staff recommended the Board require an entity that is reporting a financial liability at fair value and has experienced a significant change in creditworthiness during the reporting period to disclose an approximation of the amount of change attributable to its creditworthiness that is included in current period earnings. She further explained that the staff also

recommended that the Board 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. The Board agreed with the staff's recommendations by a vote of 4 (RHH, LFS, GJB, and DMY) to 2 (EWT and TJL).

Follow-up Items:

30. Mr. Herz asked that the staff consider and return to the Board with analyses of:

a. The interaction of the FVO project with Statement 115

b. The contract-by-contract election, specifically looking at the definition of a contract and whether it is more operational than a class-by-class election

c. The interrelationship of disclosures provided by the derivatives disclosures project, the FVM Statement, Statements 107 , 115, and 133, and FASB Statements No. 155, *Accounting for Certain Hybrid Financial Instruments* and No. 156, *Accounting for Servicing of Financial Assets,* so that the Board can understand whether there are redundancies or gaps in disclosures.

General Announcements:

None