Financial Accounting Standards Board

Board Meeting Handout

Financial Instrument: Improvements to Recognition and Measurement
Decision Making Meeting
July 15, 2009

INTRODUCTION

1. At the March 2009 joint Board meeting, the FASB and IASB determined that the objective of this project is to replace the respective financial instruments standards with a common standard that will significantly improve the decision usefulness of financial instrument reporting for users of financial statements. The Boards believed that simplification of the accounting requirements for financial instruments should be an outcome of this improvement and tentatively agreed that although the project objective is comprehensive, the project should be completed expeditiously.
2. The Boards intend the project to:
   - Reconsider the recognition and measurement of financial instruments
   - Address issues related to impairment of financial instruments and hedge accounting
   - Increase convergence in accounting for financial instruments.
3. Since May 2009, there have been five public education sessions to prepare the Board to make decisions regarding potential measurement attributes, categorization characteristics, and impairment. The following is a list of topics presented at the public education sessions:
   - Fair Value Measurement for Financial Instruments
   - Fair Value-Other Comprehensive Income Approach for Financial Instruments
   - Current Value Measurement Method for Financial Instruments
   - Amortized Cost and Impairment of Financial Assets
   - Categorization of Financial Instruments.
4. In recent history, the Board has received a significant amount of input and recommendations regarding fair value accounting for financial instruments, for example,

in the global roundtable meetings held late in 2008, during the discussions of the Financial Crisis Advisory Group,[1] from other advisory groups to the FASB such as ITAC and FASAC, through recommendations made by the G20 Working Group,[2] the Department of Treasury[3], and a host of others in articles and comment letters, and so forth). Much of the feedback has been provided in the context of the current economic environment, during a period of relatively unprecedented decreases in the fair value of financial assets (and financial liabilities).

5. Leading up to today's meeting, the staff consulted with an informal constituent resource group that consisted of users, preparers, auditors, and a valuation firm to receive feedback and develop recommendations. In addition, the Board has received ongoing comments about how to measure, recognize, and impair financial instruments through the issuance of various financial instrument and fair value guidance.

6. Given that this is a joint project with the IASB, the Boards will discuss the decisions reached by the respective Boards at the July 24, 2009 joint meeting in London.

7. At this decision-making meeting, the Board will discuss the issues listed below concerning the recognition and measurement of financial instruments. At a later date, the Board will decide which financial instruments to scope into the project, disclosures, and the effective date and transition requirements. At this meeting, the Board will deliberate the following issues as outlined in this handout:

- Issue 1: Measurement Attributes
- Issue 2: Alternate Measurement Models
- Issue 3: Categorization of Financial Instruments
    - Issue 3(A): Management Intent/Business Model
    - Issue 3(B): Cash Flow Variability
    - Issue 3(C): Market Activity
- Issue 4: Issues Related to Specific Types of Instruments
    - Issue 4(A): Liabilities, Including Own Debt
    - Issue 4(B): Private Equity Interests

[1] The Financial Crisis Advisory Group is preparing to issue its Report in July 2009.
[2] *Enhancing Sounds Regulation and Strengthening Transparency*; G20 Working Group 1
[3] *Financial Regulatory Reform; A New Foundation: Rebuilding Financial Supervision and Regulation*, Department of Treasury

- Issue 4(C): Deposit Liabilities

- Issue 5: Follow-on Issues for the Fair Value-OCI Model
  - Issue 5(A): Reclassification (recycling)
  - Issue 5(B): Presentation and Earnings per Share
- Issue 6: Impairment
- Issue 7: Reclassification.

BACKGROUND

Fair Value Measurement Method

8. Under a fair value measurement method, a financial instrument would initially be recognized as a financial asset or financial liability at its initial fair value and would subsequently be measured at fair value at each reporting date. Realized and unrealized changes in fair value would be reported in earnings in the period in which they occur. Fair value is based on the concept of exit price and the measurement framework of FASB Statement No. 157, *Fair Value Measurements.*

9. Supporters of fair value measurement note that it provides users with the most realistic depiction of the market's assessment of the present value of net future cash flows, discounted to reflect both current interest rates and the market's assessment of the risks that the cash flows will not occur. Fair value measurement provides information to enable investors to perform real-time assessments of management's decisions about the allocation of resources. A fair value model does not depend on management intent, realization, or other actions of the company for timing and measurement of gains and losses in value. As such, it removes the accounting consequences of actions from the decision-making process of both investors and management.

10. Adopting a fair value measurement model for all financial instruments would significantly reduce existing complexity in the accounting for financial instruments under GAAP. Applying a fair value measurement model to financial instruments could have the following benefits:

a. A single measurement attribute would exist, which would facilitate comparisons between entities, between accounting periods for the same entity, and between similar instruments held by the same entity.

b. Recognition of other-than-temporary impairment would not be needed because impairment would be inherent in the recognition of fair value changes of a financial asset.

c. The need for fair value hedge accounting for financial instruments would be eliminated because cash instruments and derivatives hedging them would be consistently measured at fair value and would achieve a natural or "economic" hedge (assuming changes in value for both are reported in the same location within the financial statements).

d. Bifurcation of hybrid financial instruments, with different measurement attributes applied to the components, would be obviated if the entire instrument was measured at fair value.

e. The disparity between measurement of derivatives that are in or out of the scope of Statement 133 would be eliminated.

f. The practice of structuring certain transactions to avoid a certain accounting method (accounting arbitrage) would be curtailed (discussed below in the section relating to neutrality).

11. Concerns have also been expressed about measurement of financial instruments at fair value, with changes in fair value recognized in net income. Those concerns include the procyclical effects of fair value accounting, concerns about volatility of earnings, and concerns about the measurement of an entity's own debt reflecting its credit standing. In addition, fair value measurement of financial instruments presents challenges when there are no market prices available, for example, because the instrument is unique or highly unusual or because transactions occur but price information is not disclosed by market participants. Similarly, when observable prices are available but significant adjustments need to be made to observable inputs, fair values are determined using a valuation technique based primarily on management's internal assumptions. In such cases, a hypothetical exit price must be constructed using Level 2 or Level 3 inputs to valuation techniques. Some believe that Level 3 estimates incorporate a degree of subjectivity that is so significant that fair value measures at this level are not sufficiently reliable.

Fair Value–OCI Approach

12. Under a fair value through other comprehensive income approach ("Fair Value-OCI"), all financial instruments would be presented on the face of the balance sheet at cost/amortized cost with a line item for the accumulated fair value adjustment to arrive at the fair value of the financial instruments as of the reporting date. The accumulated fair value adjustment would be the amount needed to adjust the cost/amortized cost basis to arrive at the fair value for that financial instrument category, as depicted below:

Cost/Amortized Cost	*xx*
Accumulated FV Adjustment	*xx or (xx)*
Fair Value	*xx*

13. The following summarizes some of the basic features of the Fair Value-OCI model:

- Initial and subsequent measurement of fair value would be based on the definition of fair value and measurement framework in Statement 157.
- Dividend and interest income (including amortization/accretion of premium/discount arising upon acquisition) would continue to be recognized in earnings
- Changes in fair value (exclusive of dividend and interest income) would be recognized in other comprehensive income in the period in which the change occurs for certain financial instruments
- Other comprehensive income and its components would be more prominently displayed; for example, on the face of the statement of financial performance, net of tax and below net income (*presentation will be decided separately*).

14. The Fair Value-OCI model acknowledges the strengths of both sides of the fair value accounting debate. The model potentially provides information about both of the following:

- Management's expectations/intentions about how and when the entity will realize the cash flows associated with the entity's financial instruments

- The current changes in value of an entity's financial instruments, which may affect management's intentions.

Current Value Measurement Method

15. The current value measurement method is based on the notion of calculating a value for a financial asset or financial liability based on the present value of expected future cash flows of the financial asset or financial liability. The value calculated by this method is not based on an exchange price but instead is based on the cash flows in the instrument that an entity would realize through the collection or payment of the cash flows with the counterparty to the instrument. The purpose of this method is to provide an alternative to fair value for certain instruments in certain situations and not to replace fair value in all situations.

Amortized Cost Measurement Method

16. The term *amortized cost* has not been consistently defined in U.S .GAAP. AICPA Statement of Position 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer,* defines *amortized cost* as the sum of the initial investment *less* cash collected *less* write-downs *plus* yield accreted to date. Paragraph 19 of FASB Staff Position FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments*, refers to the amortized cost basis as including adjustments made to the cost of an investment for accretion, amortization, collection of cash, previous other-than-temporary impairments recognized in earnings, and fair value hedge accounting adjustments.

17. Preparers have generally favored the use of amortized cost in situations in which an entity intends to hold the financial instrument and realize the benefits of the instrument through collection of contractual cash flows. Many argue that the volatility in the income statement for short-term market changes that may never be realized by an entity is misleading and/or creates incentives to take short-term actions that are not in the best long-term interest of the entity.

18. One of the drawbacks of using an amortized cost measurement method is that the use of amortized cost reflects a historical transaction cost that is not relevant for current point-in-time investment decisions. Another drawback is that currently an entity can change its intent and realize the short-term changes in value, thus potentially using amortized cost in this situation to delay the recognition of economic gains and losses. An entity could sell assets that are performing well and hold on to underperforming assets if it wants to make its results of operations look better.

19. The use of amortized cost relies on complex impairment models. Estimating impairment losses and using valuation accounts is complicated and subjective and could create opportunities to smooth the recognition of income.

Categorization Criteria

20. The Board has decided to consider possible ways to categorize financial instruments for the purpose of selecting a measurement attribute, with the objective of determining when to depart from a "base" fair value measurement model. The three criteria considered are: business model, cash flow variability, and market activity.

Criterion 1: The entity's business model or management's intended use of the financial instrument

21. A *business model* is how an entity achieves its business purpose. In a top-down approach to management intent, management decides how to use the entity's assets and liabilities within the business model to achieve its business purpose. Management intent is an application of the business model to individual financial instruments. Both terms refer to management's intended manner of realizing the value of the financial instrument or intended means for settlement of financial instruments.

22. At a high level, management determines how to use assets and liabilities by deciding whether to sell assets and transfer liabilities or whether to settle them through the receipt or delivery of the contractual cash flows based on the terms of the agreement with the counterparty. Management's intent related to the use of the entity's assets and

liabilities provides management's view of the utility of those financial instruments in attaining the overall business purpose of the entity.

Criterion 2: Cash flow variability of the financial instrument

23. Cash flow variability refers to the sensitivity of the cash flows underlying a financial instrument to changes in economic inputs, such as interest rates, equity prices, and so forth, over some period of time. Cash flow variability is important because the greater the variability of the cash flows over time, the greater the risk premium required to compensate the holder for the uncertainty associated with the financial instrument and vice versa.

24. A categorization model based on the variability of cash flows could be most simply based on the contractual nature of the cash flows. Using this model, financial instruments could be categorized as having either contractually known cash flows versus having cash flows that are unknown, or variable. Financial instruments with *contractually known cash flows* would be defined as having both of the following characteristics:

- Predetermined *amount* of contractual cash flows
- Known *timing* of all the cash flows.

25. Instruments that have *unknown* or *variable cash flows* may not have either or both of the above characteristics. For such instruments, cash flows will need to be estimated using valuation techniques.

Criterion 3: Market activity

26. For the purposes of this analysis, the following definitions of active and inactive markets are used:

- *Active markets*: Markets in which transactions for the asset or liability occur with sufficient frequency and volume to provide pricing information on an ongoing basis (Statement 157, paragraph 24)
- *Inactive markets*: Markets characterized by a significant decrease in the volume and level of activity for the asset or liability when compared with

normal market activity for the asset or liability (or similar assets or liabilities) and transactions are not orderly (that is, distressed or forced). (Based on FASB Staff Position FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly*).

27. In normal functioning markets there is a continuum of market activity/liquidity for different assets and liabilities. A highly liquid market is one in which market participants can rapidly execute large volume transactions with a small effect on prices (at a low cost). The degree of liquidity is determined by all of the following factors:

- The type of asset or liability
- The size of the position relative to trading volume and turnover
- The liquidation horizon.

ISSUES FOR DISCUSSION

ISSUE 1: MEASUREMENT ATTRIBUTES

28. Measurement attribute refers to the measure of the financial instrument for recognition in the balance sheet (that is, it does not focus on presentation or classification of changes in the measure). The Board is considering three measurement attributes: fair value, current value, and amortized cost (with impairment). This issue addresses which measurement attribute(s) the Board wishes to consider as an alternative to fair value. This is being presented as the first decision point to narrow down the number of possible measurement attributes for financial instruments that will be considered as part of the issues that follow.

Staff Recommendation

29. The staff recommends that if the Board wishes to maintain a measurement attribute for financial instrument other than fair value, that it consider only amortized cost. The staff recommends that the Board not undertake a project to further define *current*

value for use in this project. The staff believes that to implement the current value measure, the Board would need to develop a robust definition for consistent application, similar to the exercise undertaken in defining *fair value* in Statement 157. The staff has held discussions with FASB and IASB Board members regarding current value in addition to asking users, preparers, auditors, and others about the operationality and usefulness of a current value measurement method. Although there was some support for current value, a majority of the input received was that current value was not sufficiently defined and there was confusion regarding what it was meant to represent. Overall, there was little support for its use as an alternate to either fair value or amortized cost. Accordingly, the staff views the usefulness of current value as an alternate to fair value or amortized cost to be limited.

Question for the Board

30. *When considering alternatives to a fair value measurement attribute for financial instruments, does the Board wish to consider current value, amortized cost, or both?*

ISSUE 2: ALTERNATIVE MEASUREMENT MODELS

31. This issue focuses on the primary model for recognition and measurement of financial instruments. This issue does not consider any possible exceptions to the model, as issues related to specific types of financial instruments are outlined in Issue 4. The alternatives listed below have been identified for possible combinations of recognition and measurement models for financial instruments. Once the Board reaches a decision on the combination of recognition and measurement models that should be required or permitted for financial instruments, a second step is to identify the criteria that will determine which model should be required or permitted for categories of financial instruments.

Alternatives

32. **Alternative 1: Require a single recognition and measurement method for all financial instruments based on fair value.** Under this alternative, all financial instruments are required to be measured at fair value, with changes in fair value recognized in net income in the period of the change.

33. **Alternative 2: Require or permit two recognition and measurement method for financial instruments**. This alternative can be further described as follows:

a. Alternative 2(a): Fair value with changes recognized in net income and Fair Value-OCI (this alternative results in all financial instruments measured at fair value with a difference in recognition and presentation of fair value changes).

b. Alternative 2(b): Fair value with changes in fair value recognized in net income and amortized cost (this alternative results in a mixed-attribute accounting model for financial instruments).

34. **Alternative 3: Require or permit three recognition and measurement method for financial instruments**: Under this alternative, the three recognition and measurement models are fair value with changes recognized in net income; Fair Value-OCI; and amortized cost.

Staff Recommendation

35. The staff recommends Alternative 2(a).

Question for the Board

36. *In addition to certain financial instruments at fair value through net income, does the Board wish to require or permit the Fair Value-OCI model or a mixed-attribute accounting model that would include some financial instruments at fair value (with changes in fair value recognized entirely in net income or in net income and other comprehensive income) and some financial instruments at amortized cost?*

ISSUE 3: CATEGORIZATION OF FINANCIAL INSTRUMENTS

37. This issue applies within the context of a model that would permit or require two or three recognition and measurement methods for financial instruments (Issue 3, Alternative 2 or 3). The following three criteria are being considered as possible criteria for determining which recognition and measurement method should apply for financial instruments.

- Management's intent with regard to the use of the instrument
- Cash flow variability of the instrument

- Whether the market for the financial instrument is active.

38. Before determining which criteria should be used to determine the recognition and measurement methods that apply to financial instruments, a threshold issue exists. That issue is whether a fair value measurement attribute, with changes in fair value recognized in net income, is the presumptive or "default" measurement attribute for financial instruments. If so, and multiple recognition and measurement methods will be permitted, then purpose of the categorization criteria is to determine under what circumstances it is appropriate to depart from that model.

Staff Recommendation

39. The staff believes that a fair value measurement attribute with changes in fair value recorded in net income be the default measurement attribute for financial instruments.

Question for the Board

40. *Does the Board believe that a fair value measurement attribute with changes in fair value recorded in net income should be the default measurement model?*

ISSUE 3(A): MANAGEMENT INTENT/ BUSINESS MODEL

41. The alternatives below focus on possible ways to define a criterion based on management intent for the purpose of determining whether a financial instrument should be eligible for a recognition and measurement method other than fair value with changes recognized in net income.

Alternatives

42. **Alternative 1: Instruments that the entity intends to hold to maturity**. This alternative is based on Statement 115, which provides guidance on the term *held-to-maturity* and requires a very high level of certainty for an entity to apply held-to-maturity accounting for the debt securities within its scope. Statement 115 also has a tainting requirement that significantly reduces an entity's ability to use the category.

43. **Alternative 2: Instruments for which the entity asserts its intention to hold for collection or payment of the contractual cash flows *and* it is more likely than not that management will not be required to sell or repurchase the financial instrument before its contractual maturity or termination date**. The assessment of whether

management will be required to sell or settle the instrument retains the principle underlying the held-to-maturity requirement but may provide more flexibility in its application to individual securities.

44. **Alternative 3: Instruments that the entity does not intend to sell *and* it is more likely than not that management will not be required to sell or repurchase the financial instrument before its contractual maturity or termination date.** This alternative is based on the determination that an entity will not sell a financial instrument, aligning with the concept for financial assets in FSP FAS 115-2 and FAS 124-2.

45. **Alternative 4: Instruments that the entity manages on a contractual-yield basis**. A financial asset or liability is managed on a contractual-yield basis only if it is managed, and its performance evaluated, on the basis of contractual cash flows that it generates when it is held (including any adjustment or consideration for prepayment provisions), rather than the fair value realized before maturity. An instrument for which information is not provided on that basis to the entity's key management personnel is not managed on a contractual-yield basis. Whether a financial asset or financial liability is managed on a contractual-yield basis depends on an entity's business model, not on management's intentions for an individual instrument. A business model does not apply to an individual financial asset or financial liability in isolation. Accordingly, a business model need not be determined at the reporting entity level. One reporting entity may have different businesses with different business models. The IASB's Exposure Draft, *Financial Instruments: Classification and Measurement,* permits instruments that the entity manages on a contractual-yield basis to be eligible for an alternate measurement (in the IASB's model, the alternate measurement to fair value with changes reported in earnings is amortized cost).

Staff Recommendation

46. The staff recommends Alternative 2. With respect to Alternative 1, the staff believes that the level of certainty that has been required in the past regarding management's intent is inconsistent with the manner in which most entities manage their assets and liabilities, because it requires a positive assertion of how management will settle an individual asset or liability. Generally, most entities do not build their business

model at the individual security level up, but apply the business model from the top on down. On the other hand, the principles underlying the held-to-maturity category are valuable. It must be likely that those interim changes will not be realized to conclude that interim changes in fair value are not relevant to a user. The staff notes that Alternative 3 would permit more financial instruments to be eligible for a measurement basis other than fair value through net income.

Question for the Board

47. *Does the Board wish to specify management intent as one criterion for eligibility for the alternate measurement basis? If so, which alternative presented does the Board wish to require?*

ISSUE 3(B): CASH FLOW VARIABILITY

48. Cash flow variability relates to the characteristics of the instrument itself. This characteristic focuses on the permissible level of variability within an instrument such that it can be eligible for a recognition and measurement method other than fair value with changes reported in net income. The alternatives below focus on possible ways to define a level of cash flow variability for the purpose of determining whether a financial instrument should be eligible for a recognition and measurement method other than fair value with changes recognized in net income

Alternatives

49. **Alternative 1: Financial instruments other than (a) derivatives or (b) instruments that represent evidence of an ownership interest in another entity.** FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, defines derivatives and requires that they be recorded on the balance sheet at fair value. Financial instruments that meet the definition of a derivative are characterized by significant variability in fair values and net cash flows. Similarly, equity instruments typically do not have a principal amount or contractually stated cash flows; therefore, a measurement other than fair value does not provide much predictive value to users.

50. **Alternative 2: Financial instruments other than (a) derivatives or (b) those that have a stated maturity date that contractually cannot be prepaid or otherwise**

settled in such a way that the holder of the instrument would not recover substantially all of its initial investment. Specifying that in order to be eligible for an alternate measurement, the financial instrument must have a stated maturity date and contractually cannot be prepaid or otherwise settled in such a way that the holder of the instrument would not recover substantially all of its initial investment would reduce the types of instruments eligible for an alternate measurement significantly compared with Alternative 1. It would ensure that instruments such as interest only strips and many collateralized debt obligations that provide credit coverage to senior tranches were not eligible for an alternate measurement alternative. It is relatively easy to understand and apply and, as it is taken from FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, and FASB Statement No. 140, *Transfers and Servicing of Financial Assets*, is already applied in practice.

51. **Alternative 3: Financial instruments other than loans with basic loan features.** The IASB chose the "basic loan features" criterion in its Exposure Draft. It limits the types of instruments that are eligible for an alternative measurement basis to ones that are considered common in practice and relatively vanilla.

52. **Alternative 4: No variability of cash flow overlay.**

Staff Recommendation

53. The staff recommends Alternative 2. The staff believes that, because Alternative 1 is limited to two types of financial instruments, it may not capture instruments whose fair value and cash flows may vary widely. Regarding Alternative 3, the staff observes that it may difficult to define *basic loan features* in practice and, therefore, there may be diversity in its interpretation and application.

Questions for the Board

54. *Does the Board wish to specify cash flow variability as one criterion for eligibility for the alternate measurement basis? If so, which alternative presented does the Board wish to require?*

ISSUE 3(C): MARKET ACTIVITY

55. The alternatives below focus on possible ways to define a level of market activity for financial instruments for the purpose of determining whether a financial instrument should be eligible for a recognition and measurement method other than fair value with changes recognized in net income.

Alternatives

56. **Alternative 1: Financial instruments that are not characterized by an active market should be eligible for an alternate measurement basis.** An active market is one in which an instrument can be valued using Level 1 or Level 2. An inactive market would result in a Level 3 measurement.

57. **Alternative 2: Financial instruments that are not characterized by an active market should not be eligible for an alternate measurement basis.** That is, the level of market activity should not be used as a criterion for determining categorization of financial instruments.

Staff Recommendation

58. The staff recommends Alternative 2. In the staff's outreach efforts, most users did not think that the level of market activity should be a criterion used in determining a measurement basis for financial instruments. However, the users were not always consistent in their views. For example, one noted that fair value information was not readily available for loans and cited the reliability of fair value measurements for loans as a reason not to apply a fair value measurement. On the other hand, several users stated that "toxic" assets (many of which are not actively traded and must currently be valued using Level 3 inputs) should be accounted for at fair value.

59. Those that cite market activity as a reason to differentiate between measurement alternatives often do so because of concerns about the reliability of fair values calculated when there is little or no market activity to use as an input to the calculation. However, amortized cost may be considered more reliable but less relevant. Adequate disclosures regarding inputs to fair value measurements may address concerns about the reliability of management's estimates.

Question for the Board

60. *Does the Board wish to specify market activity as one criterion for eligibility for the alternate measurement basis?*

ISSUE 4: ISSUES RELATED TO SPECIFIC TYPES OF INSTRUMENTS

ISSUE 4(A): LIABILITIES INCLUDING OWN DEBT

61. The discussion throughout the categorization section presumed application for both financial assets and liabilities. Based on discussions at education sessions, the staff believes the Board will wish to separately confirm its categorization decisions as it relates to liabilities.

Asset-Liability Mismatch and Duration Matching

62. If an entity's financial assets are measured at fair value but not their liabilities, then the model that results will not promote identification of duration or other mismatches. Measuring only the loans at fair value would provide information regarding how the loans react to changes in interest rates but would not provide information about how well or how poorly management has hedged that exposure with its liabilities. The asset-liability mismatch argument has also been used as an argument against recording liabilities, particularly long-term debt, at fair value. Most established entities have significant unrecognized assets, such as internally developed intangible assets. Changes in the value of an entity's long-term liabilities because of changes in its own credit will often reflect changes in the value of those assets that the entity has not recognized or that are not financial assets and, therefore, are not reported at fair value (for example, recognized intangible assets and productive assets).

Procyclicality

63. If the model selected by the Board will result in most or all financial assets being recorded at fair value (either through net income or through other comprehensive income), this could result in significantly higher volatility than the current model. In this scenario, measuring debt at fair value has a counter-cyclical effect and dampens the volatility resulting from valuing financial assets at fair value.

Alternatives

64. **Alternative 1:** Make no adjustment to the model for financial liabilities.

65. **Alternative 1(a):** Make no adjustment to the model for financial liabilities but provide an "amortized cost" option for entities who believe that fair-valuing its own debt will create accounting mismatches.

66. **Alternative 2:** Exclude long-term debt from the model.

Staff Recommendation

67. The staff recommends Alternative 2. That is, the staff recommends that the Board exclude long-term debt liabilities from the Fair Value-OCI model and allow them to be measured at amortized cost. The staff acknowledges that creating an exception for long-term debt liabilities increases the complexity of the overall model and retains a mixed-attribute model. Also, the staff believes that almost all of the arguments in favor of providing fair value for assets are true for liabilities as well. However, feedback received from a variety of sources shows that there continues to be widespread lack of understanding or support for measuring liabilities at fair value. The staff believes that it would require additional research demonstrating that the effect of marking own credit would not more than offset the effect of carrying an entity's financial assets and/or recognition of internally developed intangible assets to address the accounting mismatch concern expressed above.

Question for the Board

68. *Does the Board wish to modify the model for financial liabilities?*

ISSUE 4(B): PRIVATE EQUITY INTERESTS

69. It has been suggested that equity interests in privately held entities should not be measured at fair value if management does not intend to trade the instrument for an extended period. This may be the case for strategic investments, for example. There is an argument that in the absence of an active market, it is more difficult to reliably estimate the fair value of an equity instrument when compared with a debt instrument because of the lack (in many cases) of contractual cash flows. Others have noted that there may be

difficulty, particularly for equity investments that do not rise to the level of significant influence, to obtain the information required to estimate the fair value on a routine basis.

Alternatives

70. **Alternative 1: Create an exception to the model for private equity instruments**.

71. **Alternative 2: Do not create an exception to the model for private equity investments.**

Staff Recommendation

72. The staff recommends Alternative 2. The staff is sympathetic to discussions regarding cost and the difficulty of periodic fair value calculations when an entity does not intend to trade an instrument in the short term. However, it appears difficult to argue for an exception for equity instruments without any contractual cash flows and not for other instruments that have more predictable cash flows associated with them. Additionally, the staff believes that exceptions to the model will create structuring opportunities and could have other unintended consequences.

Question for the Board

73. *Does the Board wish to create an exception to the model for private equity instruments?*

ISSUE 4(C): DEPOSIT LIABILITIES

74. An issue that has been identified for further consideration relates to deposit liabilities. The value of a demand deposit includes three components, which are not traded separately in the marketplace:

a. *The demand deposit agreement.* A demand deposit agreement establishes the terms under which the two parties will conduct business. The agreement does not explicitly create contractual obligations to accept deposits, but it specifies the terms of deposits that occur. The written contract does not establish rights and obligations that represent a financial instrument until a deposit is made, but it is possible that such rights and obligations are created by an implied contract.

b. *The depository institution's obligation to pay the depositor.* The amount owed by a depository institution to a depositor as a result of accepting deposits is a financial instrument.

a. *Other benefits of the demand deposit relationship*. The other benefits of the relationship, which are noncontractual, represent an asset (or assets) of the depository institution. The asset is not a financial instrument.

75. Generally, all three components are factors in the prices for demand deposit relationships; that is, the three are traded as a unit for a single price. Accordingly, the value of demand deposits of a financial institution incorporates the institution's long-term relationships with depositors, commonly known as core deposit intangible assets, which are separate intangible assets, not financial instruments. Using an exit price notion, the fair value of a deposit would include the premium that would be received for the core deposit intangible component of the instrument in a hypothetical sale transaction. To determine this value, entities would need to consider observable transactions that exist in the form of branch acquisitions that occur in the marketplace.

76. Given questions surrounding the fair value measurement of deposit liabilities, the Board and staff plan to conduct further research in this area.

ISSUE 5: FOLLOW-ON ISSUES FOR FAIR VALUE-OCI MODEL

ISSUE 5(A): RECLASSIFICATION (RECYCLING)

77. A key issue in the Fair Value-OCI model is whether, and if so, when changes in fair value recorded in other comprehensive income should be reclassified (recycled) into net income.

78. The majority of resource group participants stated that the credit portion of impairments should be presented separately, most suggesting within net income, similar to the recognition of impairment on available-for-sale and held-to-maturity investments after adoption of FSP FAS 115-2 and FAS 124-2. The *measurement* of impairments will be discussed below, after the section titled "Categorization."

Alternatives

79. **Alternative 1: Recognize credit-related impairments in net income**.

80. **Alternative 2: Recognize both credit-related impairments in net income and other realized gains and losses in net income**.

81. **Alternative 3: Do not recycle any realized gains and losses in net income**.

Staff Recommendation

82. The Staff recommends Alternative 2. The majority of the staff recommends recording the credit portion of impairment separately within net income as it appears that both users and preparers would prefer it. These staff members also recommend that recycling of realized gains and losses with separate presentation be required. These staff members believe that the frequency with which instruments are sold or reacquired before collection or payment of principal will clearly be visible to users and over time will affect how users choose to use all of the fair value changes recorded in other comprehensive income.

83. Some staff members believe that separating credit impairments within a fair value measurement attribute adds unnecessary complexity to the financial statements. Those staff members recommend requiring disclosure of credit impairments in the footnotes. They also recommend no recycling of realized gains or losses. Those staff members believe that once it is determined that other comprehensive income is the appropriate place to report performance for certain financial instruments, there is no need to recycle through another section of a performance statement

Questions for the Board

84. *Does the Board wish to require recognition within net income of credit-related impairments in the Fair Value-OCI model?*

85. *Does the Board wish to require separate recognition within net income of other realized gains and losses?*

ISSUE 5(B) PRESENTATION AND EARNINGS PER SHARE

86. One component of the Fair Value-OCI model is that fair value changes recorded in other comprehensive income be reported prominently. A second aspect of presentation

related to this model is the possibility of presentation of two earnings per share figures—one related to net income and one related to comprehensive income.

Staff Recommendation

87. If the Board chooses to require the Fair Value-OCI model, the staff recommends that the Board require the display of the components of other comprehensive income below the total for net income in a statement that reports the results of operations. The staff recommends not requiring separate reporting of comprehensive earnings per share but continuing to report net income per share.

Questions for the Board

88. *Does the Board wish to require the display of the components of other comprehensive income below the total for net income in a statement that reports the results of operations? If not, what alternate presentation does the Board wish to adopt?*

89. *Does the Board wish to require the presentation of comprehensive earnings per share?*

ISSUE 6: IMPAIRMENT

Background

90. In either the Fair Value-OCI model or in a mixed-attribute model, amortized cost will be reflected on the balance sheet for some financial assets. Under the amortized cost model, and possibly under a Fair Value-OCI model (if recycling is required), a method for measuring the impairment of financial assets will be required. Three possible models for recognition of impairment are the incurred loss model, expected loss model, and the fair-value-based model. The models differ in terms of timing, triggers, and measurement of impairment.

Alternatives

91. **Alternative 1: Incurred Loss Model**. An incurred loss model is required under current GAAP.

92. **Alternative 2: Expected Loss Model**. The expected loss model measures the impairment amount based on predictions of shortfalls in future cash flows using economic

loss forecasting. The carrying amount of the financial asset is the discounted present value of the remaining future cash flows at some expected economic interest rate.

93. **Alternative 3: Fair-Value-Based Model**. Under this model, once an impairment trigger is met, impairment is calculated as the difference between the fair value of the impaired asset and its carrying value.

Staff Recommendation

94. The staff recommends an expected loss model but believes that additional work is required to create an expected loss model that is operational and can be applied in practice. Efforts in this area are ongoing by the staff.

Questions for the Board

95. *Does the Board wish to specify the impairment model for all financial assets?*

96. *Does the Board wish to specify a different impairment model for equity instruments and other financial assets (if applicable)?*

ISSUE 7: RECLASSIFICATION

97. If Board decides that more than one measurement attribute will be used for financial instruments, the assessment of the measurement attribute of a financial instrument could occur only upon initial recognition or could be a continuous reassessment. For example, if management intent is one criterion for measuring a financial asset at amortized cost and management intent changes, the issue is whether the financial instrument may be reclassified to a fair value category.

Alternatives

98. **Alternative 1: Permit reclassification of financial instruments.**

99. **Alternative 2: Preclude reclassification of financial instruments.**

Staff Recommendation

100. The staff recommends Alternative 2. Of the three criteria that the staff has presented to the Board for consideration within its categorization model, the two that are likely to change are management's intent and the level of market activity for the

instrument. Reclassification of instruments between categories would create significant accounting and interpretation complexity. The staff believes that if management's intent changes and a financial asset or liability is settled that the resulting gain or loss should be presented separately within the income statement, as described previously. The staff believes that a pattern of management's intent changing will influence how users of the financial statements utilize the fair value changes in other comprehensive income.

Question for the Board

101. *Does the Board wish to permit or preclude reclassifications?*