**MINUTES**

| | |
|---|---|
| **To:** | FASB Board Members |
| **From:** | Accounting for Financial Instruments Team |
| **Subject:** | October 12, 2010 Roundtable Minutes: Accounting for Financial Instruments |
| **Date:** | March 14, 2010 |

<ins>Topic</ins>: Proposed Accounting Standards Update: *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities—Financial Instruments (Topic 825) and Derivatives and Hedging (Topic 815)*

<ins>Length of Discussion</ins>: 9:00 a.m. to 12:00 p.m.

<ins>Attendance</ins>:

*Outside Participants*

| | |
|---|---|
| George Beckwith | National Gypsum |
| Gillian Emmons | NACUBO/Boston University |
| Sydney Garmong | Crowe Horwath LLP |
| Martha Garner | PricewaterhouseCoopers |
| Jack Hartings | Independent Community Bankers of America |
| Conrad Hewitt | Individual |
| Mary Ann Lawrence | KeyBank |
| Troy Lewis | Heritage Bank |
| Philip Santarelli | AICPA Technical Issues Committee/ ParenteBeard LLC |
| Monica Sonnier | FTN Financial |
| Bob Storch | FDIC |
| Diane Viacava | Moody's Investor Services |
| David Volk | Castle Creek Capital |
| Scott Waite | CUNA / Palteco Credit Union |

*FASB and IASB Participants*

| | |
|---|---|
| Leslie Seidman | FASB Acting Chairperson |
| Russ Golden | FASB Board Member |
| Tom Linsmeier | FASB Board Member |
| Marc Siegel | FASB Board Member |
| Larry Smith | FASB Board Member |
| John Smith | IASB Board Member |
| Jeff Mechanick | FASB Assistant Director |
| Kevin Stoklosa | FASB Assistant Director |
| Pat Donoghue | FASB Project Manager |
| Upaasna Laungani | FASB Project Manager |
| Chris Roberge | FASB Project Manager |
| Ben Couch | FASB Practice Fellow |
| Tracy Farr | FASB Postgraduate Technical Assistant |

## Classification and Measurement

### Debt Securities

Participants generally supported classification driven by the business intent for these instruments, which would result in debt securities measured at cost if they are held for the collection of cash flows. Community banks who invest in debt securities generally do so with the intent to hold the securities for the collection of the cash flows. However, one of the motivations for investing in debt securities is to provide liquid investments that can be adjusted to manage asset and liability mismatches because there is little market for the community bank loans that make up the majority of their portfolios. Management does not intend to sell the debt securities unless market conditions dictate a need to do so. Some participants suggested that the liquidity and marketability of the debt securities should be factors in the classification of these assets. They also added that this would likely lead to a model with three classification categories. However, participants noted that there are tainting and reclassification issues associated with the current available-for sale-classification and are unsure how this would be solved with a similar classification category. A participant from the IASB noted that specific accounting rules for debt securities would make it difficult to have a convergent standard because the IASB does not have a definition of a *debt security*.

**Loan Assets**

Participants were opposed to measuring loan assets at fair value because they reasoned that cash flow is a more important metric to analyze these instruments and they are not managed on a fair value basis. Some participants noted that for the majority of loan assets at community banks and credit unions, there is no willing buyer, and attempting to measure a fair value for these assets would be difficult and would not provide reliable information.

**Equity Securities**

Participants generally agreed that equity securities held for trading or other short-term gain should be measured at fair value with changes in fair value recognized in net income.

Participants generally supported measuring private equity or nonmarketable securities at cost with an impairment model. These participants noted that it is often too costly and difficult to determine the fair value of these investments and are unsure if users find fair value useful. They noted that smaller entities would incur significant expense to measure the fair value of non-liquid equity securities and, as a result, may have to use their own estimates that may not be reliable. In some cases, smaller entities may prepare financial statements that are audited with an exception for level three type equity securities, similar to the situation for illiquid debt securities. A representative of the health care sector noted that not-for-profit entities have similar concerns about being able to value investments in service providers that are not likely to have a market value because they are not intended to be traded.

Those who supported measuring equity securities at cost or fair value with fair value changes recognized in other comprehensive income generally stated that the current impairment model for equity securities is sufficient.

## Fair Value Option

Many participants supported a fair value option for financial instruments without any restrictions. However, participants stated that entities should have a business reason for electing the fair value option for liabilities, for example, to eliminate a measurement mismatch between related assets and liabilities.  Some noted that a limitation should exist that the option for liabilities be permitted only to avoid an accounting measurement attribute mismatch.   Most of the participants supported a disclosure requirement of the reason an entity elected the option for both assets and liabilities. In the case of small entities, particularly for many credit unions, the cost of using fair value is prohibitively expensive.

## Presentation and Disclosure

Participants noted that current fair value disclosures are useful in distressed markets. However, some constituents noted that they attempt to back-out any assumptions made by management in fair value disclosures to make its own assessment of future cash flows. Users also commented that risk-focused disclosures about interest rate, duration, and liquidity would be more meaningful than fair value on the balance sheet. Participants noted that the use of fair value on the balance sheet can be misleading if the fair value is not objectively determinable.  They did not object to requiring disclosures about fair value if information about the basis for calculating the fair value can be provided side by side.  Participants also noted that fair value is most often determined by small entities using a discounted cash flow methodology rather than calculating an exit price.  Smaller entities simply do not have the resources to pay for a sophisticated fair value analysis and do not have the internal resources to produce that analysis themselves.  As a result, fair value calculated based on the requirements in Topic 820 on fair value measurements and disclosures (originally issued as FASB Statement No. 157, *Fair Value Measurements)* is likely to be less reliable than a cash flow methodology for smaller institutions that cannot afford to hire an outside valuation firm.  One user commented that fair values for liabilities are even less reliable than for assets because financial institutions often disagree about how to rate an entity's credit risk.

For interest rate risk, it may be better to permit a small entity to provide maturity analysis and a calculation of discounted cash flows in the footnotes rather than requiring fair value on the balance sheet because that analysis is one of management's fundamental tools used to manage the small financial institution.

***Impairment***

**Forecasting**

The majority of participants supported allowing entities to forecast future events when measuring impairment. Participants suggested requiring management to review the foreseeable future or to use objectively verifiable information. These participants stated that requiring a "freezing" of current economic conditions would not convey economic reality. Auditability of forward-looking information was not considered a problem to those who supported this, and many cited the need for auditors to consider management's judgment in other areas.

Some participants noted that they would support disclosure of the inputs and assumptions management used when measuring impairment.

**Timing and Amount of Recognition**

Views on the timing of impairment recognition were mixed. Some participants supported recognizing losses expected to occur over a two to three year period and others supported a method of spreading lifetime expected losses, with an incurred loss floor. Some participants were concerned that recognition of losses expected to occur too far in the future would result in a mismatch in the income statement. Some participants raised operational concerns about an approach that allocates losses over time. . A user of small entity financial statements stated that the Board should place a limit (such as one or two years) for how far out an entity should be able to forecast expected losses for purposes of calculating impairment and the reserve. Another alternative is to look over the average expected life of the portfolio of loans held by the entity. Some preparers noted that, in practice, financial entities are not using the incurred loss model but instead are using a model along the lines of an expected loss model. Also in practice, a loan is priced with the expected loss over the expected duration of the loan, which is similar to how the market prices are determined for debt securities such as mortgage backed securities in which the price is set based on the expected cash flows, net of the expected prepayments and defaults.

**Recognition of Interest Income**

None of the participants favored the proposed approach of recognizing interest income on the balance of a financial asset after adjustment for expected credit losses.

***Hedging***

**Short-Cut Method**

Many participants did not support the removal of the short-cut and critical-terms methods of determining effectiveness in qualifying for hedge accounting and measuring ineffectiveness throughout the hedging relationship. These participants were more concerned with the costs of the standard method rather than the difficulties associated with measuring ineffectiveness.  Some participants (especially from nonfinancial entities) noted that for “plain vanilla” derivatives like interest rate swaps, the elimination of the short-cut method would require small entities to incur unnecessary expense because it would require the calculation of an ineffectiveness amount.  It would be simpler and more cost effective to permit an exception for plain vanilla instruments and to require changes in the value of those instruments in net income rather than incurring expenses to record changes through other comprehensive income.

**Timing of Implementation**

One constituent thanked the Board for proposing a delayed effective date for small entities.  That constituent noted that it would reduce the transition cost for small institutions significantly because implementation would be delayed while some operation complexities are addressed and resolved by larger institutions and while systems are developed to implement the new standard at a lower cost.