FINANCIAL ACCOUNTING STANDARDS BOARD

Board Meeting Handout

Accounting for Financial Instruments: Classification and Measurement

April 4, 2014

Fair Value Option—Overall

Background

1. At its December 18, 2013 meeting, the Board tentatively decided that it would not continue to pursue the solely payments of principal and interest model for assessing the contractual cash flow characteristics of financial assets. In addition, the Board decided to retain the embedded derivative bifurcation requirements for hybrid financial assets in current U.S. generally accepted accounting principles (GAAP).

2. In light of the Board's tentative decision to retain the embedded derivative bifurcation requirements in current U.S. GAAP for hybrid financial assets, at its February 26, 2014 meeting the Board tentatively decided to extend the conditional fair value option (FVO) for hybrid financial liabilities in the FASB's proposed Accounting Standards Update, *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*, to hybrid financial assets. That is, the Board decided to allow an FVO for hybrid financial instruments (both assets and liabilities) when an entity has determined that the instruments contain embedded derivative features requiring bifurcation and separate accounting.

3. At that meeting the staff noted that while the extension of the conditional FVO in the proposed Update to hybrid financial assets was a direct result of the Board's decision to retain bifurcation for hybrid financial assets, the staff also intended to more broadly present to the Board the feedback received on the FVO guidance in the proposed Update.

FVO under the FASB's Proposed Update (as Amended by the Board's Tentative Decisions at the February 26, 2014 Meeting)

4. The proposed Update would eliminate the unconditional FVO in existing U.S. GAAP and, instead, permit an entity to elect to measure all of the following at fair value through net income:

   a. A group of financial assets and financial liabilities if the entity both:

      i. Manages the net exposure relating to those financial assets and financial liabilities (which may be derivative instruments) on a fair value basis

      ii. Provides information on a net exposure basis to the reporting entity's management.

   b. Hybrid financial instruments that the entity has determined contain an embedded derivative feature requiring bifurcation and separate accounting in accordance with paragraph 815-15-25-1

   c. Financial assets that meet the contractual cash flow characteristics criterion and are managed within a business model that has the objective of both holding financial assets to collect contractual cash flows and selling financial assets (that is, fair value through other comprehensive income)

   d. Nonfinancial hybrid liabilities if an entity determines that the hybrid nonfinancial liabilities contain an embedded derivative subject to bifurcation and separate accounting in accordance with Subtopic 815-15, Derivatives and Hedging—Embedded Derivatives.

5. Similar to existing U.S. GAAP, the FVO election under the proposed Update would be irrevocable and made at initial recognition of the eligible financial instruments.

6. In addition, the proposed Update would retain the guidance on accounting for "other investments" in Section 958-325-35, Not-for-Profit Entities—Investments—Other—Subsequent Measurement, which would permit not-for-profit entities (other than health care entities) to continue to elect a portfolio-wide FVO for "other investments," including equity method investments.

Alternatives

7. Based on an analysis of the feedback received, the staff has developed the following three alternatives for the Board's consideration:

   a. **Alternative A:** Retain the FVO in current U.S. GAAP provided for in Topic 825, Financial Instruments, and paragraph 815-15-25-4.

   b. **Alternative B:** Retain the conditional FVO in the proposed Update (as amended by the Board's tentative decisions that were made at the February 26, 2014 meeting).

   c. **Alternative C:** Amend the conditional FVO in the proposed Update (as amended by the Board's decisions at the February 26, 2014 meeting) to include an FVO when it would eliminate or significantly reduce a measurement or recognition inconsistency (often referred to as an accounting mismatch).

Questions for the Board
1. Which alternative does the Board prefer with respect to providing an FVO? 2. If the Board chooses Alternative B or Alternative C, does the Board agree with the staff's recommendation to eliminate paragraph 825-30-15-4 of the proposed Update in its entirety (paragraph 4(c) of this handout)?

FASB FINANCIAL ACCOUNTING STANDARDS BOARD

Board Meeting Handout

Investment Companies: Disclosures about Investments in Another Investment Company

April 4, 2014

PURPOSE OF THIS MEETING

1. The purpose of this meeting is to discuss concerns raised by external reviewers on a draft of the proposed FASB Accounting Standards Update, *Financial Services—Investment Companies (Topic 946): Disclosures about Investments in Other Investment Companies*. This meeting will focus on concerns raised that question the Board's tentative disclosure requirements. Specifically, the following issues will be discussed at this meeting:

   a. **Issue 1:** The concerns raised by external reviewers and the path forward

   b. **Issue 2:** Potential revisions to disclosures about returns and expenses from an investee fund

   c. **Issue 3:** Disclosure about the risks inherent in the assets and liabilities of an investee fund

   d. **Issue 4:** The need for a practicability exception.

2. Issues 2–4 are only relevant if the Board decides to revise the tentative disclosure requirements under Issue 1.

ISSUE 1: CONCERNS RAISED AND THE PATH FORWARD

3. Some external reviewers raised concerns that the tentative disclosure requirements do not meet the objective of the project and that they would result in limited benefits for users of investment company financial statements. The concerns raised relate to the following two issues:

   a. Lack of disclosure about the assets and liabilities, or leverage, of an investee fund

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b. Disclosure of ratios for returns and expenses of an investee fund would provide more useful information rather than dollar amounts of income, management, and incentive fees.

4. The staff has identified the following three alternatives for the Board to consider as the path forward on the project in light of the concerns raised by external reviewers:

a. **Alternative A:** Do not revise the tentative disclosure requirements.

b. **Alternative B:** Revise specific disclosure requirements.

c. **Alternative C:** Remove the project from the Board's technical agenda.

Question for the Board
1. How does the Board wish to proceed in light of concerns raised by external reviewers regarding the tentative disclosure requirements?

ISSUE 2: RETURNS AND EXPENSES FROM AN INVESTEE FUND

5. External reviewers commented that disclosure of an investee fund's total return and expense ratios would be more relevant and would better achieve the Board's objective for this project than disclosure of the dollar amounts of income, management fees, and incentive fees. Reviewers provided the following reasons for their recommendation:

a. Disclosure of total return and expense ratios are currently required for investment companies under Topic 946 and, as such, those concepts are well understood (and used by) investors.

b. Dollar amounts could be confusing for investments not held for the entire period.

c. Requiring disclosure of the dollar amounts of management fees and incentive fees ignores other expenses that could be material expenses for investment companies.

d. Incentive fees are a major expense for investment companies not regulated under the Investment Company Act of 1940 but are not relevant for regulated investment companies.

6. The staff has identified the following two alternatives for the Board to consider regarding disclosures about returns and expenses of an investee fund:

a. **Alternative A:** Continue to require disclosure of the dollar amount of income and expenses from an investee fund, but revise the expense disclosure to require disclosure of the dollar amount of ***all*** expenses from an investee fund, not just management and incentive fees.

b. **Alternative B:** Require disclosure of an investee fund's total return and expense ratios rather than dollar amounts of income and expenses.

Question for the Board
2. How does the Board believe the return and expense disclosures for investee funds should be revised?

ISSUE 3: RISKS INHERENT IN THE ASSETS AND LIABILITIES OF AN INVESTEE FUND

7. Some external reviewers commented that the tentative disclosure requirements do not meet the project's objective of providing information about the risks of investing in other investment companies without disclosure about the assets and liabilities, or leverage, of the investee fund. They stated that such disclosures would provide transparency into the relationship between the risks inherent in the portfolio of an investee fund and the total return and expenses of the investee fund.

8. The staff has identified the following three alternatives for the Board to consider regarding a disclosure about the assets and liabilities of an investee fund:

a. **Alternative A:** Require disclosure of the total fair value of long positions, the total fair value of short positions, and net assets for an investee fund.

b. **Alternative B:** Require disclosure of a “total assets to net assets multiple” for an investee fund, calculated by dividing an investee fund’s total assets by its net assets.

c. **Alternative C:** Do not require disclosure of assets and liabilities of an investee fund.

Question for the Board
3. Which alternative related to a reporting investment company’s requirement to disclose information about the assets and liabilities of an investee fund does the Board prefer?

ISSUE 4: PRACTICABILITY EXCEPTION

9. If the Board decides to require disclosure of total return, expense ratio, and assets and liabilities under Issues 2 and 3, this issue discusses whether a practicability exception is necessary to address operationality concerns previously raised by constituents. A practicability exception would allow a reporting investment company to include a statement that the necessary information about its investment in the investee fund could not be obtained.

Question for the Board
4. Does the Board believe that a practicability exception is necessary for disclosures about investee funds?

FASB FINANCIAL ACCOUNTING STANDARDS BOARD

Board Meeting Handout

Disclosure Framework

April 4, 2014

Purpose of This Meeting

1. The purpose of this meeting is to discuss field study results and the additional work planned based on what the staff learned through the field study.

Field Study Background

2. As part of the entity's decision process component of the disclosure framework project, the FASB conducted a field study to better understand the use of discretion in notes to financial statements. The staff provided volunteer field study participants with one of the follow discretion criteria:

   (a) **Materiality Criterion:** Apply paragraph 105-10-05-6 as follows with an additional sentence in italics: "The provisions of the Codification need not be applied to immaterial items. *When considering provisions of the Codification that require disclosures, the materiality of each disclosure requirement should be considered individually and in combination with other disclosures*." The instructions also included Supreme Court descriptions of materiality and guidance issued by the Securities and Exchange Commission (SEC) of qualitative factors to be considered when making a materiality assessment.

   (b) **Entity-Specific Relevance Criterion:** The second criterion tested was labeled entity-specific relevance and was based on the approach described in Chapter 4 of the Invitation to Comment (ITC), *Disclosure Framework.* Entity-specific relevance centers on a model intended to help an entity determine if a disclosure is relevant in their particular facts and circumstances based on the users' assessment of cash flow prospects.

3. The field study was not a statistical sample but was designed to provide insights on the following:

   a. The change in the effectiveness of the notes after applying the discretion criteria.

   b. The effectiveness of the discretion criteria in removing disclosures that are not decision useful to the users of the entity's financial statements.

   c. How the criteria were understood in practice.

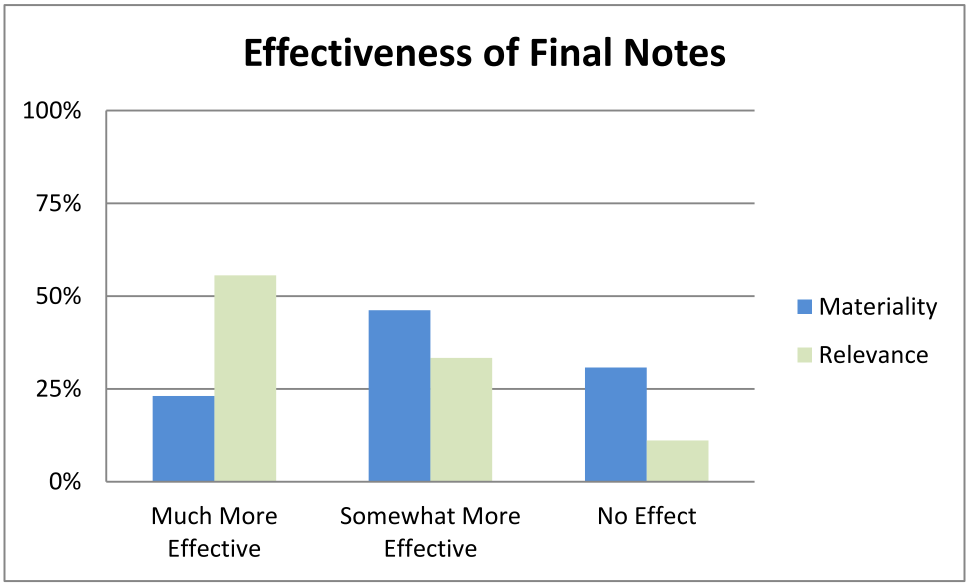
4. Twenty-three entities submitted field study results. The participants were fairly evenly split between business entities and not-for-profit entities. The size of the entities varied significantly based on financial metrics. However, most business entities had annual revenue in excess of $5 billion and most not-for-profit entities had assets in excess of $100 million.

5. After receiving field study results, the staff asked all participants to complete a questionnaire. After reviewing both the results and responses to questionnaire, the staff conducted follow-up calls or site visits with most of the participants. The staff then conducted additional outreach calls with a number of participants and their auditors. In total, the staff conducted 28 outreach calls and site visits with participants, participants' auditors, national audit firm representatives, a securities attorney and a regulator.

Field Study Results

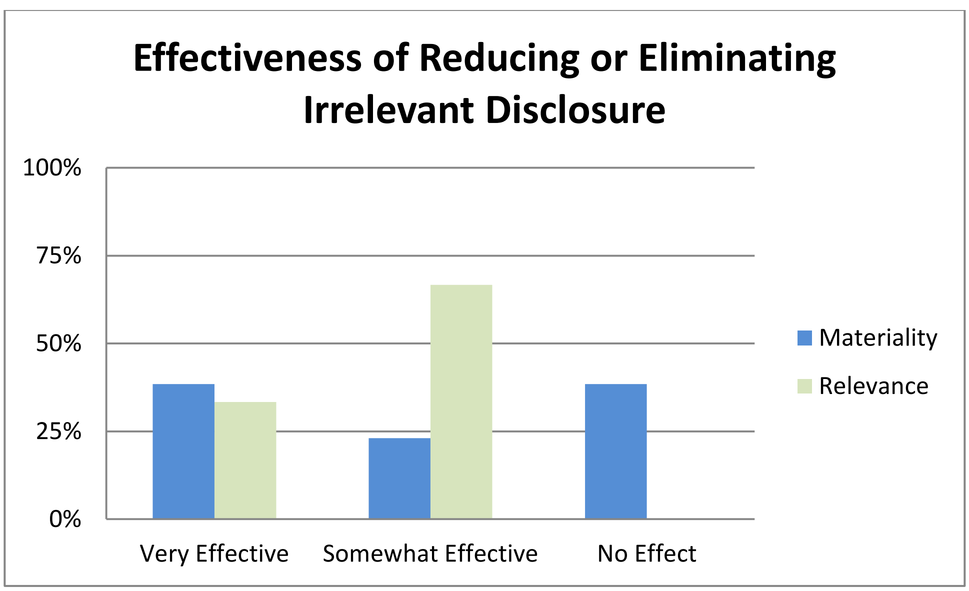
6. On average, more information was removed by entity-specific relevance participants than by materiality participants. Comparatively, a much higher variance in the amount of removals was seen amongst materiality participants' results, largely because of the number of materiality participants that made no changes to the notes. Those participants said they already consider materiality in the financial statement preparation process. Questionnaire responses and follow-up outreach conversations with participants provided further context to participant results.

7. As part of the questionnaire, when asked the degree to which application of the criterion changed the effectiveness of the notes to the financial statements, participants responded as follows:

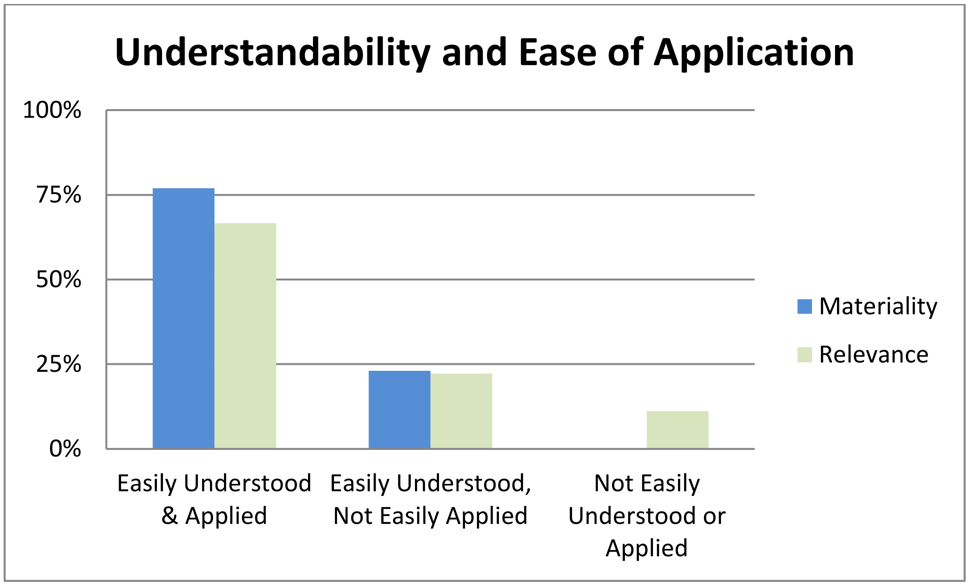


Those participants who responded that there was no effect had either made no changes to the notes or had concluded that removal of immaterial information does not change the effectiveness of the notes.

8. When asked how effective the application of the criterion was in reducing or eliminating irrelevant disclosure, participants responded as follows:



9. When asked to rate the understandability and ease of application of their assigned criterion, participants responded as follows:



10. Participants were also provided the criterion to which they were not assigned and were asked if they thought application of that alternate criterion would have significantly changed their results. While most responded that it would not have significantly changed their results, a few materiality participants noted that application of entity-specific relevance would have made a significant difference.

11. In order to understand the costs of applying the criteria in practice, the staff asked participants whether they would make the field study changes to their notes if the discretion criterion was codified. The staff also asked participants what, if any, obstacles they foresaw in making those changes to their notes. Both materiality and entity-specific relevance participants generally said they would attempt to make the field study changes in practice if their discretion criterion was codified.

12. The following costs were identified by participants:

    (a) Auditor objections

    (b) Auditor communication of disclosure omissions to the audit committee

    (c) SEC comment letters

    (d) Time required to make and adequately document judgments

(e) Changes to internal controls

(f) Education process to complete the exercise.

Auditor Input

13. Auditors were asked whether they would be able to audit the participant's results using the assigned criterion and what, if any, obstacles they foresaw in practice. Auditors did not express concern that the information that had been removed was decision useful. However, they did express concern about their ability to obtain sufficient audit documentation for certain judgments based on the entity-specific relevance criterion.

Next Steps

14. The staff will discuss the additional work planned based on what was learned through the field study.