MINUTES

Financial Accounting Standards Board

To: Board Members

From: Kubic (x296)

Subject: November 4, 2009 Board Meeting Minutes: Accounting for Financial Instruments

Date: March 10, 2010

cc: Leisenring, Golden, Bielstein, Stoklosa, Laungani, Lott, Proestakes, Mills, Wilkins, Maroney, Sangiuolo, Ampofo, H. Yang, K. Yang, Putnam, Kubic, Willis, C. Smith, Brickman, Homant, Chookaszian, Posta, Glotzer, Mechanick, Gabriele, Sutay, Finden, FASB Intranet, Klimek, McGarity

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 an Accounting Standards Update.

Topic:	Accounting for Financial Instruments: Initial Measurement
Basis for Discussion:	Board Memorandum No. 20
Length of Discussion:	9:30 to 10:05 a.m.
Attendance:	
Board members present:	FASB: Herz, Linsmeier, Seidman, Siegel, and L. Smith IASB: Leisenring
Staff in charge of topic:	Yang
Other staff at Board table:	Golden, Stoklosa, Sangiuolo, C. Smith, Wilkins, Burnap, Laungani, and Homant

Summary of Decisions Reached:

The Board's decided at the October 14, 2009 Board meeting to initially measure financial instruments with subsequent changes in fair value recognized in other comprehensive income (FV-OCI) at the transaction price. At today's Board meeting, the Board discussed how an entity would account for the difference, if any, between transaction price and fair value at initial measurement for those financial instruments in situations in which it is clear that the transaction price is different from fair value. The staff was asked to develop a principle to help identify when the transaction price would differ from fair value and, if so, how to calculate the initial value of the financial instrument at that date, similar to *FASB Accounting Standards Codification*™ Section 310-10-30 on initial measurement of receivables (originally issued as APB Opinion No. 21, *Interest on Receivables and Payables*). For example, if an entity issues a loan with a zero interest rate in a five percent market rate environment, it is clear that the transaction price differs from the fair value of the loan. In that situation, the entity would record the loan at an amount other than the transaction price with the loss recorded in other comprehensive income. If the entity decides that the transaction involves any other consideration, an expense may be recognized relating to the other element in the transaction.

Objective of Meeting:

The objective of the meeting was for the Board to decide how an entity should measure the financial instrument at inception if a transaction that gives rise to a financial instrument involves other considerations. The objective of the meeting was met.

Matters Discussed and Decisions Reached:

Issue 1: Additional Clarification of Initial Measurement

1. Ms. Yang stated that the Board decided at the October 14, 2009 Board meeting that an entity should initially measure a financial instrument with changes in fair value recognized in net income at fair value. A financial instrument measured at fair value with changes in fair value recognized in other comprehensive income and financial instruments measured at amortized cost would initially be measured at the transaction price. The staff researched fair value through other comprehensive

income instruments and the concern is that using the transaction price does not properly recognize the other considerations in which an instrument has an off-market rate as a result of other considerations. For a financial instrument measured at fair value with changes in fair value recognized in other comprehensive income, the difference between the transaction price and fair value upon the first remeasurement would be recognized in other comprehensive income. The other considerations would be buried in other comprehensive income rather than being recognized separately. The staff researched this issue under the current U.S. generally accepted accounting principles and concluded that the issue falls into the scope of Section 310-10-30 and Subtopic 835-30 on imputation of interest (originally issued as Opinion 21). The application of Subtopic 835-30 requires a discount or premium being recognized immediately if unstated rights or privileges are embedded in a transaction that exchanges notes[1] for cash. Zero interest or unreasonable interest is an indicator of unstated rights and privileges, which would trigger the application of Subtopic 835-30. When that Subtopic is applied, the discount or premium is recognized as a deduction or an addition to the value of the financial instrument with the corresponding offset recognized immediately as an expense, an adjustment to costs, or an adjustment to assets. This effectively measures the financial instrument at fair value on day one after netting the discount or premium. Additionally, under the model in this project, the premium or discount would be eliminated when the financial instrument would subsequently be measured at fair value on day two.

2. Under Subtopic 835-30, if a financial instrument has zero interest or has an unreasonable interest rate, an entity would need to analyze whether the off-market arrangement is attributable to other items. If the answer is yes, the entity is required to discount all future cash flows using prevailing market rates to arrive at a present value. The difference between a present value and the face amount would be recognized separately as a discount or premium. For balance sheet presentation purposes, the face value would be recognized on the face or in the notes with a

[1] *Notes* as defined in paragraph 835-30-15-2 (originally issued as paragraph 2 of Opinion 21) is interchangeable with *financial instruments* except for items included in paragraph 835-30-15-3 (originally issued as paragraph 3 of Opinion 21) as further discussed in these minutes.

separate presentation for the premium or discount showing as a deduction or addition to the face amount. For income statement presentation purposes, the interest would be calculated on the prevailing market rate. The other consideration would be recognized either as an expense or asset or a reduction of sale.

3. Ms. Yang stated that the staff would like the Board to reconsider its decisions regarding initial measurement in light of Subtopic 835-30 by making some modification to the existing wording for financial instruments that are in the FV-OCI category. She noted that the staff has developed three alternatives for the Board's consideration:

    a. Alternative 1 follows the requirements of Subtopic 815-30 by establishing an account for discounts and premiums on day one. On Day 2 when the instrument is remeasured, the premium or discount would be written off to other comprehensive income similar to all other subsequent changes in fair value.

    b. Alternative 2 requires that no separate discount or premium be established. The calculated present value would become the new basis of the financial instrument. This approach is similar to fair value on initial measurement.

    c. Alternative 3 requires that FV-OCI instruments be initially measured at fair value. Any initial premiums or discounts would be recognized in other comprehensive income. The staff believes this is a simpler approach. If other consideration is involved, the entity will have to decide what the proper accounting treatment is for the other items, which could result in an expense. Subtopic 835-30 would still apply for financial instruments measured at amortized cost.

Issue 1 Board Vote

1. The Board decided to develop a principle to help identify when the transaction price would differ from fair value and, if so, how to calculate the initial value of the financial instrument at that date, similar to Section 310-10-30. No Board members objected.

Issue 1 Board Comments

4. Mr. Siegel stated that under Alternative 3, it was unclear how to account for the nonfinancial component in a multiple-element arrangement. Mr. Golden clarified that the proposed guidance only relates to how to account for financial instruments. It assumes that the financial and nonfinancial components have been separated.

5. Mr. Herz expressed similar concerns as Mr. Siegel. He noted that an originated loan with an off-market rate would be accounted for under Subtopic 835-30. This would require the imputation of an interest rate and the recognition of a discount at origination. The discount would be accreted over time by using the imputed interest rate to accrue income. Mr. Herz stated that a key objective in this project is to have minimal effect on the income statement and net interest margin. He stated it was unclear how Alternative 3 would affect interest income, and he noted that under any solution he would want to see interest accrued at the imputed rate, similar to the method used today. Mr. Stoklosa noted that all three models would result in an effective interest rate that reflected the discount, similar to the accounting under Subtopic 835-30 today.

6. Mr. Leisenring expressed concerns that the principles from Subtopic 835-30 are not being correctly applied by some financial institutions. He noted that in the public discussions during deliberations of FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, major accounting firms stated that banks were able to lend at zero percent, yet did not have to apply Opinion 21 and did not impute an interest rate. He stated that if such practices exist today, then a nonfinancial component should be recognized. Messrs. Herz and Leisenring agreed that any final language should be clarified so that it is evident that if a financial institution is lending at zero, then there is a nonfinancial component to that loan that should be separately accounted for under relevant U.S. generally accepted accounting principles (GAAP).

7. Mr. Linsmeier expressed concern that under the proposed alternatives, the discount related to the nonfinancial component would flow through other comprehensive income. Mr. Leisenring expressed a similar concern and noted that it was confusing because in the example, the financing entity issuing the loan did not record an expense but showed a receivable from the parent corporation. Then, the parent corporation recorded an expense and a payable. It was noted that in consolidation, the receivable and payable would offset, and the net effect of the sales discount would be a reduction to net income for the sales expense. Thus, the discount related to the sales expense would not be deferred in other comprehensive income. It was noted that any final guidance should clearly illustrate how the nonfinancial discount would affect net income.

8. Ms. Seidman expressed concern with the interaction between Alternative 3 and Subtopic 835-30. Ms. Seidman noted that the wording in Subtopic 835-30, which is similar to the entry price language in appendix A of Statement 107, suggests an allocation based upon an entry price calculation. She noted that an entry price calculation is not fair value based on an exit price notion, but rather an approximation of fair value. However, she noted that the subsequent amendments to Topic 820 on fair value measurements and disclosures (originally issued as FASB Statement No. 157, *Fair Value Measurements)* state that the allocation under Subtopic 835-30 results in a value that could be considered fair value. She stated that the amendments were made to reduce complexity so that preparers did not have to determine if there was a difference between the amount allocated to the financial component and its fair value. She expressed concerns that the wording in Alternative 3 would require an entity to identify if there was a difference between the transaction price and the amount allocated to the financial instrument (based on an allocation using an entry price notion), and then to determine if there was a difference between the amount allocated to the instrument and a fair value based on an exit price notion, which would significantly increase complexity.

9. Ms. Sangiuolo agreed with Ms. Seidman that Subtopic 835-30 is more consistent with an entry price calculation than a pure exit price fair value. However, she noted that Alternatives 2 and 3 are very comparable; under either alternative, the nonfinancial component would be measured using Subtopic 835-30.

10. Mr. Herz stated the key difference between Alternatives 2 and 3 is the calculation of the amount that should be compared to the transaction price. He noted that under Alternative 2, an entry price would be calculated and compared to the transaction price and that under Alternative 3, an exit price would be calculated and compared to the transaction price. He stated that he believes the transaction price should be compared to the amount the instrument would have been originated for in an arm's-length transaction, which would be an entry price. He believes any difference should be taken as an adjustment to the effective interest rate, similar to current U.S. GAAP.

11. Mr. Linsmeier stated that there are two reasons the transaction price may not reflect fair value. First, there is an arrangement with a nonfinancial component (which would be accounted for under appropriate U.S. GAAP). Second, there could be a difference between the fair value and the transaction price that is not related to a nonfinancial component. He gave an example of a loan that was issued at a rate below market with no nonfinancial component. He asked how that discount would be accounted for under Alternative 3. Mr. Stoklosa noted that a discount not related to another component would be recorded in other comprehensive income.

12. Mr. Leisenring expressed the concern that it would not be operational to differentiate between the transaction price and the fair value of the loan. He noted that in practice it is extremely difficult to determine if a discount relates to a nonfinancial component. He gave an example in which the market rate was 9 percent and Entity A decides to issue a loan at 7 percent. He noted that it would be very hard to determine why Entity A issued the loan at 7 percent and if a discount should be recognized. He also stated it would be difficult to determine if the discount related to a nonfinancial component.

13. Ms. Seidman stated that when she initially voted for the initial measurement of FV-OCI instruments to be at transaction price, she was under the impression that the guidance in Subtopic 835-30 would remain to identify any nonfinancial component. She noted that under Subtopic 835-30, normal lending activities are scoped out to address the same concern that Mr. Leisenring just expressed. Thus, she supports Alternative 2. She believes there are valid reasons to have FV-OCI instruments initially measured at transaction price, such as the fact that FV-OCI instruments are also presented on the face of that balance sheet at amortized cost. Thus, Ms. Seidman does not support Alternative 3.

14. Ms. Seidman stated there would be operational problems with all three alternatives. Alternative 1 would create complexity because it would require a separate account for premiums or discounts be established on day one and then the account would be written off at the first reporting period. Alternative 2 would require initial measurement of FV-OCI items at transaction price except when the transaction is off market, in which case the instrument would be initially recorded at a calculated present value. She noted that this creates an exception to the principle for initial measurement, which creates complexity. Alternative 3 would require each entity to prove that a transaction price equals the fair value at origination, which would require an increase in work for preparers.

15. Mr. Stoklosa stated that he believes Alternatives 2 and 3 would result in similar accounting once it is determined there is a difference between fair value and the transaction price. He stated that the difference in the alternatives is how the decision was made that there is a difference between the fair value and transaction price. He stated that under Alternative 2, it would be assumed that the transaction price is fair value unless there is evidence to the contrary. Alternative 3 would assume that the transaction price is different from the fair value unless there is evidence that indicates that the fair value equals the transaction price.

16. Mr. Linsmeier stated that he would not object to Alternative 2, but he would not want the wording in Alternative 2 to refer to a present value calculation. Instead, the language should state that paragraphs 310-10-30-1 through 30-6 should be applied if other consideration is involved.

17. Mr. Herz stated that the final language would have to be carefully stated so that entities would have to analyze situations in which it is evident there is additional consideration in the transaction but entities would not be required to spend an unreasonable amount of time trying to determine if there is a difference between fair value and transaction price. Mr. Herz noted that earlier Mr. Leisenring stated that some financial institutions be excluded from of the scope of Subtopic 835-30 unless they issue an instrument with zero percent interest rate, by stating that their "customary lending activities" include lending at a below market rate. He stated that the final language should make it clear that if there is a market rate, and an entity originates a loan for significantly less than that market rate, then the entity should be required to determine the nonfinancial component.

18. Ms. Sangiuolo stated that the focus of Subtopic 835-30 is on non-customary lending arrangements and it is not intended to exclude all loans made by financial institutions. She suggested that the wording Subtopic 835-30 could be modified to state that the guidance applies to any non-customary lending arrangements, which would include loans originated at a rate above zero but less than the current market rate. Mr. Leisenring stated that such a clarification would be very useful. However, he stated that the clarification should not use the word "customary." He noted that certain financial institutions could state that it is "customary" for them to use off-market interest rates as a sales incentive in all loans, and thus, would not be required to determine the nonfinancial piece of the instrument.

19. Mr. Herz reiterated that the final language should address Mr. Leisenring's concerns. He stated it should be made clear that instruments issued at an off-market rate as a method of providing a sales incentive should be accounted for as two separate components (that is, having a financial component related to the lending arrangement and a nonfinancial component related to the sales incentive).

20. Mr. Linsmeier expressed support for Alternative 3 because he believes the initial measurement should be in line with the subsequent measurement. He stated that it could be confusing to have initial measurement at transaction price and subsequent measurement at fair value. He recommended slightly modifying the wording of Alternative 3 so that it states that transaction price can be considered equal to fair value if no other consideration is involved.

21. Mr. Smith stated that he prefers Alternative 3, but would not object to Alternative 2.

22. Ms. Seidman and Mr. Smith noted their support for Alternative 2.

Follow-up Items:

The staff was asked to draft the initial measurement principles for financial instruments.

General Announcements:

None