MINUTES

Financial Accounting Standards Board

To:	Board Members
From:	Accounting for Financial Instruments Team: Burnap (x283), Kubic (x296)
Subject:	Minutes of the July 15, 2009 Board Meeting: Accounting for Financial Instruments
Date:	October 1, 2009
cc:	FASB: Golden, Bielstein, Stoklosa, Lott, Proestakes, Posta, Laungani, Brickman, Ampofo, Sangiuolo, Worshek, Homant, Yang, Willis, Maroney, Malcolm, Trench, Wilkins, Burnap, Kubic, C. Smith, Chookaszian, Glotzer, Mechanick, Klimek, McGarity, Gabriele, Sutay, Intranet; IASB: Leisenring, Finden

The Board meeting minutes are provided for the information and convenience of constituents who want to follow the Board's deliberations. All of the conclusions reported are tentative and may be changed at future Board meetings. Decisions become final only after a formal written ballot to issue a final standard.

Topic: Accounting for Financial Instruments

Basis for Discussion: Memorandum No. 11, dated July 7, 2009

Length of Discussion: 9 a.m. to 12:15 p.m. and 1:15 to 3:00 p.m.

Attendance:

Board members present: FASB: Herz, Linsmeier, Seidman, Siegel, and Smith

IASB: Leisenring

Staff in charge of topic: Malcolm, Ampofo, and Sangiuolo

Other staff at Board table: Golden, Stoklosa, Homant, Laungani, Yang, Kubic, and Burnap

Summary of Decisions Reached:

The Board decided on a model to improve financial reporting for financial instruments.

The Board reached the following decisions:

1. The Board decided that all financial instruments will be measured on the balance sheet at fair value with changes in value recognized in net income or other comprehensive income with an optional exception for own debt in certain circumstances, which will be measured at amortized cost. For those financial instruments whose change in value is recognized in other comprehensive income, amortized cost will be displayed on the balance sheet in addition to a fair value adjustment to arrive at fair value.
2. The Board decided that changes in an instrument's value may be recognized in other comprehensive income on the basis of qualifying criteria related to an entity's management intent/business model and the cash flow variability of the instrument. The Board will provide additional guidance on how to apply those qualifying criteria. The Board decided that changes in value for derivatives, equity securities, and hybrid instruments containing embedded derivatives requiring bifurcation under FASB Accounting Standards Codification™ Topic 815 on derivatives and hedging (originally issued as FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities)* will be recognized in net income. The Board decided that for all financial instruments, interest and dividends will continue to be recognized in net income. Credit impairments, as well as realized gains and losses from sale and settlement, also will be recognized in net income. The classification of instruments will be determined at initial recognition of the instrument and will not be subsequently changed.
3. The Board decided to require one statement of financial performance with subtotals for net income and total comprehensive income. It also decided to continue to require earnings per share based on net income and not based on total comprehensive income.

Objective of Meeting:

The objective of this meeting was to deliberate measurement attributes of financial instruments, alternate measurement models, categorization of financial instruments, and issues related to specific types of instruments, reclassification, impairment, and presentation. The objective of the meeting was met.

Matters Discussed and Decisions Reached:

BACKGROUND

1. Mr. Herz discussed the history of the joint FASB-IASB project on recognition and measurement of financial instruments. He noted that in March 2008, the IASB issued the Discussion Paper, *Reducing Complexity in Reporting Financial Instruments,* which was closely followed by the FASB issuing an Invitation to Comment with the same title that included the IASB's Discussion Paper as an appendix. The FASB issued the Exposure Draft, *Accounting for Hedging Activities,* in June 2008. In December 2008, the Boards decided to add a comprehensive financial instruments project to the agenda. Given the financial crisis, both Boards have been asked by major constituencies to make short-term changes and clarify certain guidance pertaining to financial instruments in the last year. Both Boards had many public roundtable meetings on subjects related to accounting for financial instruments and the financial crisis. Additionally, the FASB issued two FASB Staff Positions in April to address impairment issues: FASB Staff Position FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments*, and 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*. The IASB has deliberated and issued an Exposure Document on the classification and measurement of financial instruments. The FASB has had a series of education sessions on different aspects of recognition and measurement of financial instruments. The FASB is trying to issue an Exposure Draft in the latter half of August. At the joint meeting next week, the Boards will discuss how to achieve the common goal of the project, which is to issue a common, high-quality standard on recognition and measurement of financial instruments. The Boards will likely share the comments that are received on each others' Exposure Drafts, hold joint public roundtable meetings, and have joint redeliberations to achieve a common, high-quality standard.

2. Ms. Malcolm stated that at the March 2009 Board meeting, the Boards jointly decided that the objective of the project was to create a common, high-quality standard that will significantly improve the decision usefulness of financial instrument reporting for users of financial statements. The staff has issued eight memos and had five public education sessions since the meeting in March. The Boards intend the project to (a) reconsider the recognition and measurement of financial instruments, (b) address issues related to impairment of financial instruments and hedge accounting, and (c) increase convergence in accounting for financial instruments. The Boards agreed to consider three potential measurement bases for measuring financial instruments, which include fair value as defined in Topic 820 on fair value measurements and disclosures (originally issued as FASB Statement No 157, *Fair Value Measurements),* amortized cost with impairment, and an alternate measurement basis known as the current value method. Ms. Malcolm stated that the staff has received much input from users, preparers, and auditors, which it used in developing its views regarding measurement methods in this project.

3. Ms. Malcolm stated that information about the current value method was presented at the May 5, 2009 education session and that the method is based on the present value of future cash flows of a financial asset or liability. The current value method uses market assumptions about future cash flows and current rates. Current value is not based on an exchange price. 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. The staff believes that current value and fair value should not be materially different in rational liquid markets.

4. Ms. Malcolm stated that the staff informed the Board about the other two measurement attributes at the June 3 and June 24, 2009 education sessions. Ms. Malcolm summarized a few of the key advantages. Supporters of fair value accounting think that it improves transparency of financial reporting, feeds recognition of risk, and appropriately reflects the volatility of asset valuations in earnings. 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's intent, realization, or other actions of the entity 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. Many also believe that fair value promotes short-term decision making, amplifies risk-taking behavior in economic expansion, and amplifies deleveraging and credit constrictions in economic contractions, which results in increased volatility in the system that is not inherent in the system itself without fair value accounting. Many also expressed concern about neutrality and reliability of fair value accounting if there are no market prices available.

5. Ms. Malcolm stated that with regard to the use of amortized cost with impairment, preparers normally favor the use of amortized cost if an entity intends to hold the financial instrument and realize the benefit of the instrument through the collection of 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, creates incentives to take short-term actions that are not in the best long-term interest of the entity, or both. One of the drawbacks of using an amortized cost measurement method is that the use of amortized cost reflects an historical transaction cost that some believe 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. The use of amortized cost will require the application of an impairment model to reflect gains and losses on a timely basis. The staff analyzed several alternatives for the Board's consideration

when selecting an impairment model. The incurred loss model has received criticism for delaying the recognition of economic losses. The staff also analyzed expected losses and the fair-value-based model.

6. Regarding the categorization of financial instruments, Ms. Malcolm outlined three criteria for the Board to consider when making decisions. The first criterion is the entity's business model or management's intended use of the financial instrument. A *business model* is how an entity achieves its business purpose. In a top-down approach to management's intent; management decides how to use the entity's assets and liabilities within the business model to achieve its business purpose. *Management's 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. 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.

7. Ms. Malcolm stated that the second criterion is the cash flow variability of the financial instrument. *Cash flow variability* refers to the sensitivity of the cash flows underlying a financial instrument to changes in economic inputs, such as interest rates or equity prices over 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. In addition, the greater the variability of the contractual cash flows, the less information that is provided by the amortized cost model as a measurement basis in the balance sheet and income statement.

8. Ms. Malcolm stated that the third criterion is the level of market activity. The staff defined *active* and *inactive markets* for the purposes of this analysis. The term *active market* is defined as a market in which transactions for the asset or liability occur with sufficient frequency and volume to provide pricing information on an ongoing basis. An *inactive market* is a market 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.

9. Ms. Malcolm changed the topic to presentation and introduced a dual presentation method called the fair value-other comprehensive income (FV-OCI) model. Ms. Malcolm outlined some of the basic characteristics of the approach. 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. In addition, 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. Initial and subsequent measurement of fair value would be based on the definition of fair value and measurement framework in Topic 820. Dividend and interest income (including amortization/accretion of premium/discount arising upon acquisition) would continue to be recognized in earnings. Changes in fair value (excluding dividend and interest income) would be recognized in other comprehensive income in the period in which the change occurs for certain financial instruments that would be determined by the categorization model determined by the Board. The staff believes a selection of the FV-OCI model is an acknowledgement of the strengths of the arguments in favor of both fair value and amortized cost. It provides information on management's expectations and intentions for a financial instrument and how the entity expects to realize the cash flows associated with the instrument. The election of the FV-OCI model would display both attributes at the same time with equal prominence.

10. Before moving on to the first issue, Ms. Malcolm noted that in addition to the feedback received for the current financial instruments project, the Board has received ongoing input regarding how to measure financial instruments. Ms. Malcolm said that some of the sources of the feedback included:

a. The discussions at the global roundtable meetings held late in 2008
b. The discussions of The Financial Crisis Advisory Group and the FASB's other advisory groups, such as the Investors Technical Advisory Committee and the Financial Accounting Standards Advisory Council
c. Recommendations made by the G20 Working Group and the Department of Treasury
d. Articles and comment letters.

Much of the feedback was 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.

ISSUE 1: MEASUREMENT ATTRIBUTES

11. Ms. Malcolm stated that the first topic for discussion relates to whether any of the three measurement attributes should not be considered for use in the project. The staff believes that to implement the current value measurement, the Board would need to develop a robust definition for consistent application, similar to the exercise undertaken in defining *fair value* in Topic 820. The staff 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.

Staff Recommendation

12. The staff thinks the usefulness of current value as an alternate to fair value or amortized cost is limited and, therefore, recommends that current value not be used as a measurement attribute in this project.

Board Vote

13. The Board decided not to pursue the development of a current value measurement attribute. All Board members agreed.

Board Comments

14. Mr. Smith agreed with the staff that a current value measurement attribute would be difficult and confusing to define in such a short period of time. Using the FV-OCI model would increase the decision usefulness of financial reporting. Mr. Siegel stated that there are some benefits of a current value measurement attribute, but that it would introduce more complexities because it would be a new attribute. He would not want to consider current value at that point in time.

15. Ms. Seidman and Mr. Linsmeier also agreed with the staff. Ms. Seidman noted that the insurance team is developing a current value type of measurement that would apply to arrangements with specific attributes. Therefore, she thinks a new measurement attribute does not need to be developed. She stated that the current value attribute might be a possible approach to impairment. Mr. Linsmeier noted that if the current value attribute is not being considered, the best alternative would be to have the FV-OCI model so that both the fair value and amortized cost of financial instruments would be presented.

16. Mr. Herz stated that he encourages the staff to examine current value because some constituents have asserted concepts like *intrinsic* and *fundamental value* that may be different from *fair value*. While market or exit prices should be used for instruments in which an active market exists, it may not be the best indicator of value in other situations. In cases in which an instrument is not actively being traded but is being held for collection to better match asset and liability cash flows, there is a question of whether exit prices fully indicate the cash flows. There are many markets that are dislocated and it is not clear that trying to derive a hypothetical exit value is more representative than a value notion based on discounting expected future cash flows using current interest rates. Given the lack

of support from other Board members, he agreed that it was time to move on from current value.

ISSUE 2: ALTERNATIVE MEASUREMENT MODELS

17. Ms. Malcolm spoke about the primary model for recognition and measurement of financial instruments. She stated that once the Board reaches a decision on the combination of recognition and measurement models that should be required or permitted for financial instruments, the second step would be to identify the criteria that will determine which model should be required or permitted for categories of financial instruments.

18. She outlined three alternatives for recognizing and measuring financial instruments. The first alternative would require a single recognition and measurement attribute for all financial instruments based on fair value. Under this alternative, all financial instruments would be required to be measured at fair value, with changes in fair value recognized in net income in the period of the change (FV-NI model). The second alternative also would require a single recognition and measurement attribute for financial instruments based on fair value. However, this alternative would recognize some changes in fair value in net income and some changes recognized in fair value in other comprehensive income. This alternative also would require display of the amortized cost amount on the face of the statement of financial position. The third alternative would require two recognition attributes for financial instruments, fair value, and amortized cost. This alternative would result in a mixed-attribute accounting model for financial instruments. For instruments that would be measured at fair value under this alternative, all changes in fair value could be recognized in net income or some changes could be recognized in net income and other changes could be recognized in other comprehensive income. The version of this alternative that would allow some changes in fair value to be recognized in other comprehensive income would be similar to the current model for accounting for financial instruments.

Staff Recommendation

19. Ms. Malcolm noted that the staff recommends the second alternative, which would require all financial instruments to be measured at fair value, with changes reflected in net income and other comprehensive income.

Board Vote

20. The Board voted to elect the second alternative, which would require a single recognition attribute with a display of the amortized cost amount of the statement of financial position. Ms. Seidman voted for the third alternative.

Board Comments

21. Mr. Linsmeier stated that he agrees with the staff's recommendation. He noted that the Board had received much input concerning the best information for financial instruments. For financial instruments held for trading purposes, there is not much debate about whether the FV-NI model portrays the economics. For other types of instruments, there is much debate concerning measurement attributes and whether amortized cost or fair value is the best attribute. Mr. Linsmeier believes the FV-OCI model is useful because it addresses the concerns of both users and preparers. It provides information to enable investors to make real-time assessments of risk, and it provides preparers with the ability to continue to report information about how they manage certain instruments in net income. He suggested that the market will be the judge as to which numbers are preferable and presenting both sets of information will be a step forward for financial instrument reporting.

22. Ms. Seidman stated that there are three important dimensions to consider when thinking about measurement of financial instruments—the business activity of an entity, the variability of the cash flows of the instruments, and the marketability of the instrument. She thinks that an instrument that is traded or held for sale by the entity and has highly variably cash flows should be measured at fair value through net income. However, when an entity intends to hold an instrument with fixed cash flows and the instrument is not marketable, the instrument should be recognized at amortized cost. She noted that in between these two extremes is a grey zone and it is difficult and subjective to create a standard that prioritizes the dimensions

consistently. She stated that her vision is to have instruments on the balance sheet at an amount that reflects what an entity expects to realize. She expressed concern about measuring deposits and an entity's own debt at fair value, as well as the creation of new asset-liability mismatch issues. She prefers to have the criteria in the model properly categorize instruments as opposed to having exceptions to the model. For these reasons, she said that she supports the third alternative. She suggested that the cost bucket only include debt instruments with predictable cash flows that are not marketable and are held by the entity as part of a long-term business strategy. Similar debt instruments that are marketable would be reported at fair value through other comprehensive income. However, she emphasized the need for continuing fair value disclosure and a more robust impairment model.

23. Mr. Smith stated that he agrees with Ms. Seidman's rationale, but also agrees with Mr. Linsmeier that many people think the most useful information available to investors is fair value information. He noted how financial reporting played a role in past financial crises, such as the savings and loan crisis and the Japanese financial crisis. Presenting amortized cost as well as the reconciliation to fair value on the balance sheet will provide useful information to users as well as information about an entity's strategy for managing the financial instruments. He acknowledged that while he agrees with the staff's recommended model, he may consider some exceptions to the model.

24. Mr. Siegel acknowledged that fair value measurement for all financial instruments is highly contentious. He noted that the objective of the project is to provide the most relevant information to users and stated that he supports the second alternative in which some of the changes in fair value are recognized in net income and other changes are recognized in other comprehensive income. He stated that he prefers to have comprehensive income and net income presented with the same level of prominence on the income statement.

25. Mr. Herz stated that he supports the second alternative and that he may consider some exceptions due to operationality and cost-benefit considerations. He prefers the second alternative to the third alternative because amortized cost does not provide enough meaningful information, such as information related to changes in stocks. Mr. Herz stated that he thinks financial reporting starts with basic macroeconomic considerations about wealth and income. Economic models might depict things that are sold based on current wealth (measures of value) but noted that sometimes an exit price may not be the best measurement. Changes in wealth (value) have two economic components—the *flows* for the period and the change in the measure of the *stocks*. In accounting terms, *stocks* are unrealized changes in value associated with changes in factors such as interest rates and foreign exchange rate items and *flows* are the current period cash flow accruals. Mr. Herz stated that, ideally, he would like to separate flows from the changes in the value of stocks instead of deciding which changes in value should be recognized in net income and which should be recognized in other comprehensive income. He emphasized that the fundamental issue should be the change in stocks and flows; however, more time and due process would be required. He noted that the division between recognizing some fair value changes in net income and some in other comprehensive income under the FV-OCI model approximates the separation. Mr. Herz also stated that he may be open to accepting amortized cost in certain circumstances, such as when asset-liability mismatches are exacerbated, when there are operational impediments, and when the costs do not outweigh the benefits.

ISSUE 3: CATEGORIZATION OF FINANCIAL INSTRUMENTS

26. Ms. Malcolm stated that the Board will need to decide whether a fair value measurement attribute with changes in fair value recognized in net income should be the presumptive or "default" measurement attribute for financial instruments before deciding which criteria should be used to make the distinction between which instruments' changes in fair value should be recognized in net income and which instruments' changes in fair value should be recognized in other comprehensive income. If the Board were to decide that a fair value measurement attribute with changes in fair value recognized in net income should be the

presumptive measurement attribute for financial instruments, the purpose of the categorization criteria would be to determine under which circumstances it would be appropriate to depart from that model and record changes in fair value in other comprehensive income.

Staff Recommendation

27. Ms. Malcolm stated that the staff recommends that a fair value measurement attribute with changes in fair value recognized in net income be the default measurement attribute for financial instruments.

Board Vote

28. The Board voted to have a fair value measurement attribute with changes in fair value recognized in net income as the default measurement attribute for financial instruments. All Board members agreed.

Board Comments

29. Mr. Linsmeier asked if the staff's recommendation means that an instrument has to either be classified as trading or be a derivative to have the changes in fair value recognized in net income, or if an entity has to make assertions about a financial instrument for it not to be required to recognize the changes in value in net income. He also asked if an entity would have the option to recognize the changes in fair value in net income regardless of management's intent for the instrument. Mr. Stoklosa clarified that the recommendation is that an entity has to make assertions about a financial instrument for it not to be required to recognize the changes in value in net income. Not making such an assertion would result in changes being recognized in net income.

30. Mr. Smith stated that management's intent would be similar to a de facto fair value option because how management deploys the asset within the business would determine where the changes in value are recognized. If an entity buys an asset and does not indicate that the item is not being held for collection, then the default would be to recognize the changes in value in net income. Mr. Leisenring asked if asserting that an instrument is being held for trading would force an entity to, in

fact, trade the instrument. Mr. Golden clarified that the default method would require an entity to recognize changes in fair value in net income; however, there may be times in which changes in value would not be recognized in net income depending on the Board's decisions. Under the staff's recommendation, an entity would have to choose whether it wants to go through the rigor to prove that it does not have to recognize the changes in fair value in net income.

31. Ms. Seidman stated that some of the feedback regarding FSP FAS 115-2 and FAS 124-2 is that some auditors have told preparers that if they do not assert that an instrument will not be sold, then the auditors expect the preparers to sell the instrument in the next quarter or so. She stated that her intention was not to have a tainting notion of this nature. Mr. Golden stated that the required assertions will depend on the decisions the Board makes regarding the other characteristics and the rigor they decide to impose on the application of management's intent.

32. Mr. Herz asked about the scope of the model and if it would apply to pension plan accounting, investment company accounting, and/or broker-dealer accounting. Mr. Golden stated that he thinks that pension plan accounting, investment company accounting, and broker-dealer accounting would not be changed, but the issues will need to be further considered. He stated that he hopes that when the accounting already prescribes the use of fair value, an entity would not have to use something other than fair value. Mr. Seidman stated that if the model starts with fair value through net income as the default measurement method, a list of characteristics could be provided that would allow an instrument not to be valued at fair value through net income.

33. Mr. Smith asked for further clarification about why an entity that buys a financial instrument with the positive intent and ability to hold the instrument for collection would not be required to recognize the changes in value in other comprehensive income. It was further clarified that if an entity wanted to recognize the changes in value in net income, it would not make the assertion that it had the intent to hold the instrument. Mr. Linsmeier clarified that the decision that needs to be made is

whether the model should require a positive assertion not to recognize changes in fair value through earnings. Ms. Malcolm stated that within the management's intent concept there is inherent optionality in how management intends to use the assets. As such, an entity should be required to positively assert that it has the intent and ability to hold the instrument for collection of cash flows to be able to recognize the changes in value in other comprehensive income.

ISSUE 3(A): MANAGEMENT INTENT/BUSINESS MODEL

34. Ms. Malcolm stated that the alternatives presented by the staff are based on the assumption that changes in value recognized in net income is the default category, and that the criteria decided on in Issue 3 will allow an entity not to recognize the changes in value in net income. Ms. Malcolm stated that the staff thinks it would be helpful for the Board to think about which types of value changes should be recognized in net income and which should be recognized in other comprehensive income when making categorization decisions. For example, other comprehensive income could be a place to recognize a change in value for those items with values that an entity can reasonably expect to reverse. Other changes in value that are not expected to reverse would be recognized in net income. Another approach is to recognize fair value changes that management expects not to realize through trading activities in other comprehensive income. This approach would be consistent with instruments currently classified as *available for sale* under Topic 320 on investments, debt, and equity securities (originally issued as FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*).

35. Ms. Malcolm outlined four possible alternatives for determining whether changes in fair value should be eligible to be reported in other comprehensive income.

    a. **Alternative 1:** Instruments that the entity intends to hold to maturity. This alternative is based on Topic 320, 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. Topic 320 also has a tainting requirement that significantly reduces an entity's ability to use the category.

b. **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. It requires a probability assessment of an entity's ability to hold the instrument for payment or collection of contractual cash flows and sets the threshold at *more likely than not*.

c. **Alternative 3:** Instruments that the entity intends not 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. 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.

d. **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. 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

36. Ms. Malcolm stated that 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 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.

Board Vote

37. The Board decided that the fair value changes in a portfolio of debt instruments can be recognized in other comprehensive income if the entity asserts that the predominant activity of the portfolio is to hold the instruments for a significant portion of the term of the portfolio, and selling instruments within such a portfolio is not the expected business activity. All Board members agreed.

Board Comments

38. Mr. Golden clarified that the difference between alternatives 1 and 2 is that there is less rigor regarding the tainting notion. In alternative 2, an entity would still have to positively state its intent to hold, but would have the opportunity to explain the circumstances. Mr. Smith stated that he understands alternative 1 to consider both intent and ability and alternative 2 to have more emphasis on intent and less consideration given to the probability to hold (ability).

39. Mr. Leisenring stated that all the alternatives with respect to intent are not operational and that they all implicitly have some level of tainting in that expectations do not always translate into reality. If the Board is going to have the default measurement attribute be fair value through net income, he recommended dropping management's intent because the decisions imply that it is the characteristics of the instrument and its marketability that dictate which instrument's changes in value is prohibited from being recognized in other comprehensive income. He stated that he believes that classification based on intent is not operational or necessary. Ms. Seidman stated that the she does not understand how the ability to freely choose to recognize changes in value in net income bears on the decisions. Her experience is that not many entities elect to put all financial instruments at fair value under Topic 320, so the decisions are being

made to create the line for instruments that qualify not to be at fair value through net income. Mr. Leisenring stated that under an intent-based model, there will always be tainting concerns that reduce operationality.

40. Mr. Smith clarified Mr. Leisenring's point by stating that it is unnecessary to introduce the operational concerns relating to intent when it is the characteristics of the instrument that seem to be more important as to whether an instrument can meet some of the criteria not to have the changes in value recognized in net income. By electing to recognize changes in fair value outside of net income, a de facto intent model is created. Introducing intent into the model allows management to cherry-pick earnings. He noted that keeping the intent concept would be keeping something that has little meaning, particularly if there is not going to be a tainting notion.

41. Mr. Linsmeier stated that the cash flow criterion is not operational by itself. It is difficult to draw the line between which types of instruments can be recognized in net income and which types can be recognized in other comprehensive income if only cash flow is considered. Mr. Smith stated that an advantage of not including management's intent as a criterion is that the ability for an entity to cherry-pick which gains and losses to recognize on a quarterly basis will be eliminated because auditors will not allow an entity that is actively trading an instrument to put the changes in value of the instrument in other comprehensive income.

42. Mr. Herz asked why the staff prefers alternative 2 and not alternative 3. He also noted that the IASB chose alternative 4 and then asked why the staff did not choose alternative 4. Ms Malcolm stated that in developing the staff's recommendation, the majority of the staff believes that alternative 2 is more consistent with the notion of net income being the primary performance indicator. She also stated that the difference between alternatives 2 and 3 is that alternative 2 is closer to the held-to-maturity concept and the notion of any changes in value that are not expected to be realized would be recognized in other comprehensive income. Alternative 3 would allow for more instruments, such as equity instruments, to have changes in value

recognized in other comprehensive income, which would make total comprehensive income the primary performance indicator. Ms. Malcolm also stated that alternative 4 is somewhat ambiguous since the meaning of the phrase *managed on a contractual yield basis* is unclear. The staff prefers not to recommend something that has an ambiguous meaning. The language used in alternatives 2 and 3 is currently used in accounting literature. Mr. Golden stated that the positive intent to hold is substantially different from the intent not to sell. Mr. Linsmeier stated that he thinks alternative 4 would not be operational.

43. Ms. Seidman stated there should be a difference in where the changes in value are recognized if an entity is trading the instrument versus if an entity is using the instrument as part of long-term asset-liability management activities and is unexpectedly forced to sell the instrument. She stated that these are different activities.

44. Mr. Smith gave the scenario of a bank that originates loans. Historical trends indicate that, in total, half of the loans will be securitized and the other half will be held for collection. When the loans are originated, the bank does not know which loans will be securitized and which will be held (no specific identification). How would the loans be accounted for under alternatives 2 and 3? Ms. Seidman stated that historically loans are classified as *held for sale* if the loans might be securitized.

45. Mr. Linsmeier stated that the current classification of securities is based on a bottom-up approach and that the business model approach to classification requires thinking about securities in a top-down approach, as portfolios or groups of securities. He expressed the hope that if the business model approach is used to classify instruments, that it is written in such a way that it makes it clear that the Board is changing the focus from how individual instruments are used in a business to how portfolios or classes of instruments are used in a business. He clarified that the top-down approach was not intended to say that every type of a certain loan should be accounted for in a certain way, but that the top-down approach should lead to having groups of financial instruments separated such that when a group of

assets is indicated as being held for collection, then the changes in value are recognized in other comprehensive income.

46. Mr. Linsmeier stated that the largest difference between alternatives 2 and 3 has to do with equity securities. Mr. Leisenring stated that alternative 3 would allow an entity to do most anything. Effectively, an entity could always assert that it has no intention to sell the securities, but the entity will sell them if certain events occur.

47. Mr. Linsmeier stated that alternative 2 might result in value changes that may reverse being recognized in other comprehensive income, and value changes that are realized being recognized in net income. Alternative 3 is more of a flows and changes in stocks split between net income and other comprehensive income.

48. Mr. Herz stated that he prefers alternative 3 because it better reflects the changes in stocks (remeasurements). Alternative 2 would force almost all instruments to recognize value changes in net income, including instruments in which there is no realization of value changes.

49. Mr. Smith stated that he prefers alternative 2. He stated that he could not support alternative 3 if impairments were not going to be recognized in net income.

50. Mr. Siegel stated that alternative 3 seems less appealing because an entity could assert that it intends not to sell an asset until it is beneficial to do so. Alternative 2 is more appealing because an entity must assert that it intends to hold the asset to not recognize value changes in net income,

51. Mr. Linsmeier stated that if alternative 3 is selected, there can be no recycling or impairment. If the model is going to include provisions for impairment and recycling, he prefers alternative 2.

52. Mr. Smith and Ms. Seidman stated that they would not support alternative 3 without provisions for recycling and impairment

53. Mr. Herz stated that he prefers alternative 3. He stated that he does not like alternative 2 because it contains the tainting notion.

54. Mr. Smith stated that the world considers net income the most important indicator of performance and that this project should not change what investors use to evaluate performance. He wondered why the concerns about impairment and recycling could not be addressed with presentation and disclosure if alternative 3 were selected.

55. Mr. Linsmeier noted that he prefers alternative 3 because he would like flow information that has a multiple greater than one to be recognized in net income and changes in stocks (remeasurements) to be recognized in other comprehensive income. He does not want to reclassify or impair items in other comprehensive income because the multiple will not have a consistent meaning.

56. Mr. Stoklosa noted that if impairments and recycling were required under alternative 3, it would be the same as alternative 2.

57. Mr. Siegel stated that if an entity has the intention of ever selling the instrument, the changes in value should be recognized in net income.

58. Ms. Seidman stated that both alternatives 2 and 3 are being thought of within the context of individual loans and securities and suggested that this mindset is what leads to tainting concepts. When instruments are considered on a portfolio basis, how an entity is using instruments within the broader entity can be considered.

59. Mr. Golden stated that alternative 3 was in the context of an entity not being sure of how the asset would be utilized within the entity. An entity would not have to assert that it intends to hold the asset until collection to be able to recognize the changes in value in other comprehensive income.

60. Ms. Malcolm noted that it is difficult to determine if the amount of time that an entity holds an asset for is sufficient to say that it intends not to sell the asset and the changes in value should be recognized in other comprehensive income.

61. Mr. Siegel stated that an entity may not be an active trader, but if the value is being realized by trading the asset, then the changes in value should be recognized in net income.

62. Mr. Smith and Ms. Seidman stated that they prefer to have interim remeasurements recognized in other comprehensive income for instruments that are being held as part of a longer-term business activity.

63. Mr. Linsmeier stated that under alternative 3 there are two types of fair value changes that would be recognized in other comprehensive income—changes in value expected to reverse as a result of the entity holding the instrument to term and value remeasurements that have a multiple of one. He does not want to clutter other comprehensive income with both reversible reameasurements and amounts that will be realized when sold. He expressed concern that alternative 3 may allow some value changes that would reverse as well as those that will be realized when the instrument is sold to be recognized in other comprehensive income if recycling and impairment are not permitted.

ISSUE 3(B): CASH FLOW VARIABILITY

64. Ms. Malcolm stated that 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 reporting fair value changes outside net income. The alternatives 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 reporting fair value changes outside net income. The more variable the cash flows, the more likely reporting changes in fair value in net income would reflect what will ultimately be realized.

Alternatives

65. Ms. Malcolm outlined the following four alternatives for the Board's consideration:

a. **Alternative 1:** Only financial instruments other than (a) derivatives or (b) instruments that represent evidence of an ownership interest in another entity would qualify for fair value changes to be recognized in other comprehensive income. Topic 815 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.

b. **Alternative 2:** Only financial instruments other than (a) derivatives or (b) those instruments that do not have a stated maturity date and that contractually can 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 qualify for fair value changes to be recognized in other comprehensive income. 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 fair value changes to be recognized in other comprehensive income compared with the 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.

c. **Alternative 3:** Financial instruments other than loans with basic loan features should recognize changes in value in net income. Loans with basic features would be eligible to recognize changes in fair value in other comprehensive income. The IASB chose the "basic loan features" criterion in its Exposure Draft. It limits the types of instruments that are eligible to recognize changes in value in other comprehensive income as a basis to ones that are considered common in practice and relatively simple.

d. **Alternative 4:** Do not select cash flow variability as a criterion by which to classify financial instruments.

Staff Recommendation

66. Ms. Malcolm stated that the staff recommends alternative 2.

Board Vote

67. The Board decided on alternative 1 with the addition of embedded derivatives that require bifurcation under Topic 815 as an attribute that would require the financial instrument to be recognized at fair value through net income.

Board Comments

68. Mr. Golden clarified that alternative 2 excludes the fair value changes for equity instruments from being recognized in other comprehensive income. Because equity securities do not have a stated maturity date, they do not meet the criteria to have the changes in value recognized in other comprehensive income.

69. Ms. Seidman stated that alternative 1 appears to apply only to standalone derivatives and not to embedded derivatives. If embedded derivatives are added to alternative 1, the issue of accounting for collateralized debt obligations that contain embedded derivatives, interest-only strips, and other instruments containing both upside and downside variability would be addressed. She also suggested having all instruments with embedded derivatives recognize the changes in value through net income without any bifurcation. Ms. Seidman stated that if an instrument has the characteristics prescribed by Subtopic 815-15 on embedded derivatives (originally issued as paragraphs 12 and 13 of Statement 133), the fair value changes of the entire instrument should be recognized in net income. She stated that she would add this qualifier to alternative 1.

70. Mr. Golden clarified that alternative 1 was meant to encompass derivatives and equity instruments, and alternative 2 is meant to encompass derivatives, embedded derivatives, and equity. He noted that Ms. Seidman was adding instruments that contain embedded derivatives that otherwise would have been bifurcated in alternative 1 so that the entire change of the instrument's value would be recognized in net income.

71. Ms. Malcolm stated that all value changes in equity instruments were supposed to be recognized in net income; the language in the handout was an oversight. Mr. Golden clarified that if the Board was going to exclude the changes in value of equity instruments from being recognized in other comprehensive income, they would have to vote for alternative 2 in Issue 3A.

72. Mr. Stoklosa summarized Ms. Seidman's comments by saying that she is adding the embedded derivative criteria to alternative 1. He stated that he believes that type of model was operational and that the staff could do some more analysis to ensure that this is the direction the Board would like to move in and if anything unexpectedly changed, the staff would bring it to the Board's attention.

73. Ms. Malcolm stated that not bifurcating embedded derivatives from host contracts may be a step in the right direction and is what the IASB chose to do. The IASB decided to no longer bifurcate embedded derivatives from host contracts because the instruments will be valued holistically. She stated that she would like to have a separate Board discussion before a decision is made about whether or not to require all instruments with embedded derivatives to be recognized at fair value through net income. She would like to think about how these decisions will interact with the project on liabilities and equity and convertible debt.

74. Mr. Herz asked whether under the IASB's proposed guidance on financial instruments containing interest rate embedded derivatives that are clearly and closely related to the host contract would require changes in value to be recognized in net income. He also noted that the financial instruments whose changes in value would be recognized in other comprehensive income under the FASB's model are similar to the instruments that can be measured at amortized cost in the IASB's model. The line between the net income and amortized cost would be similar to the line the FASB is considering drawing between net income and other comprehensive income. Mr. Herz noted that even if the measurement attributes were not converged, it might be attainable to have the delineation line between what is

recognized at fair value and an alternate method be the same as it is in the IASB's model.

75. Mr. Stoklosa clarified that the IASB is not going to use the current criteria used to separate an embedded derivative from the host contract to determine whether value changes should be recognized in net income. Instead, the IASB is replacing the embedded derivative rules and with the concept of *basic loan features*. He stated that he believes the IASB's model intends to focus on interest rate features. In U.S. generally accepted accounting principles (GAAP), the interest rate features are clearly and closely related to the host instrument and do not require bifurcation. Both U.S. GAAP and IFRSs have a leverage notion in their interest rate rules. Mr. Stoklosa also stated that he believes that the classification of financial instruments under the FASB's proposed model will be similar to that of the IASB's.

76. Mr. Leisenring stated that the IASB's proposal to no longer bifurcate embedded derivatives would eliminate the notion of *clearly and closely related* and replace it with the ambiguous notion of *basic loan features*.

77. Ms. Malcolm stated that some of the bifurcation exceptions in Topic 815 may need to be considered. For example, Ms. Malcolm asked whether the embedded derivative would cause the entire instrument to be accounted for at fair value through net income if Statement 133 Implementation Issue No. C22, "Exception Related to Embedded Credit Derivatives," is applied to an embedded credit derivative resulting from a concentration of credit risk.

78. Mr. Stoklosa stated that the exception would be effectively superseded by the guidance as currently proposed. He stated that the concentration of credit risk exception would need to be carried over into the new guidance if the Board wishes to retain it.

79. Mr. Linsmeier stated that under the proposed model, debt instruments with embedded credit derivatives that require bifurcation from the host contract would be required to recognize the changes in value in net income. Instruments that have

interest rate derivatives that are clearly and closely related to the host contract would recognize the changes in fair value in other comprehensive income. He also stated that he does not understand why cash flow variability due to foreign exchange and credit derivatives was important to bifurcating derivatives but variability due to interest rate derivatives was not.

80. Ms. Seidman clarified that any type of instrument could require bifurcation. The instruments that require separate accounting today would be the ones whose entire change in value of the instrument would be recognized in net income.

81. Mr. Linsmeier stated that he does not want to carry forward the guidance in Topic 815 because he thinks that the concepts do not capture cash flow variability well.

82. Ms. Malcolm stated that there is an existing conclusion that certain financial instruments create enough variability that the value changes in the embedded derivatives should be recognized in net income.

83. Mr. Linsmeier stated that he does not like that certain forms of risks that are embedded in an instrument are not sufficient to bifurcate the instrument because the embedded derivative is deemed to be clearly and closely related to the host contract.

84. Mr. Stoklosa stated that the clearly-and-closely-related approach generally only applies to items with accelerated principal repayment and cash flow variability does not exist. Cash flow variability exists when there is leverage or a feature that can significantly change the value of an investment, as outlined by Subtopic 815-15.

85. Mr. Herz stated that he would like an analysis of the application of the FASB's clearly-and-closely-related approach compared to the IASB's basic loan feature approach.

86. Mr. Linsmeier stated that what has occurred is that most derivatives are going to be measured at fair value with changes recognized in net income and those changes in the value of equity securities will also be recognized in net income. He then observed that for debt, an entity would decide how to recognize the changes in

value based on the business model. He asked what the Board would achieve by permitting different recognition based on management's intent to sell. If management's intent provides substantive information, why are value changes in equity securities not being considered for recognition in other comprehensive income?

87. Mr. Herz asked if it would be appropriate to have all of the value changes of equity instruments recognized in net income. He noted that the IASB has an option for equity instruments to be recognized at amortized cost if an entity asserts that it is holding the equity instruments for strategic purposes. Mr. Smith stated that the only way to realize the value of an equity security is to sell it. However, the value of a debt security can be realized by holding the instrument until maturity or for a substantial portion of the life of the security, at which time the fair value starts approaching par value. The method of how value is realized on the two types of securities is significantly different. He added that disclosures could provide users with an understanding of when the value of the instrument is being realized and recycled. Ms. Seidman added that the net income approach obviates the need for a special impairment test for equities.

88. Mr. Linsmeier asked what type of disclosures an entity could make about debt securities that have value changes recognized in other comprehensive income but that the entity expects to sell soon. He noted that an entity would have to split up the amounts in other comprehensive income, which would result in difficulties similar to those discussed early in the discussion on management's intent.

89. Mr. Herz stated that he is comfortable with exposing alternative 1, but noted that he does not like that all of the value changes of equity securities would be recognized in net income. He stated that the same idea of not actively trading and holding for a long period of time dictates that another comprehensive income approach would be appropriate for certain equity instruments.

ISSUE 4: ISSUES RELATED TO SPECIFIC TYPES OF INSTRUMENTS

ISSUE 4(A): LIABILITIES INCLUDING OWN DEBT

90. Ms. Malcolm stated that while the financial instrument recognition and measurement model would apply to financial assets and liabilities, the discussions at education sessions led the staff to believe the Board may want to separately confirm categorization criteria related to certain liabilities. The two primary reasons for recording an entity's debt at fair value are asset-liability duration mismatches and procyclicality.

91. Ms. Malcolm stated that the asset-liability mismatch is often cited as an argument for recognizing debt at fair value. If an entity's financial assets are measured at fair value but their financial liabilities are not, then the model will not identify duration mismatches. The asset-liability mismatch argument has also been used as an argument against recognizing liabilities, particularly long-term debt, at fair value. An entity may have assets not recognized at fair value or significant unrecognized assets, such as internally developed intangibles assets. Changes in the fair value of an entity's long-term liabilities due to changes of an entity's own-credit quality will often reflect changes in the value of those assets that the entity has not recognized or assets that are not reported at fair value. Ms. Malcolm stated that another argument for measuring own debt at fair value is that it has a counter-cyclical effect and dampens the volatility resulting from measuring financial assets at fair value.

92. Ms. Malcolm outlined three alternatives for the Board's consideration.

    a. **Alternative 1:** Make no adjustment to the model for financial liabilities.
    b. **Alternative 1(a):** Make no adjustment to the model for financial liabilities but provide an "amortized cost" option for entities who believe that measuring own debt at fair value will create accounting mismatches.
    c. **Alternative 2:** Exclude long-term debt from the model.

Staff Recommendation

93. Ms. Malcolm stated that the staff recommends alternative 2. The staff also recommends that the Board exclude long-term debt liabilities from the financial instrument recognition and measurement model and allow them to be measured at amortized cost.

Board Vote

94. The Board voted to make no adjustment to the model for financial liabilities but provide an amortized cost option for entities who believe that measuring own debt at fair value will exacerbate accounting mismatches. This alternative is similar to alternative 1(a) outlined above; however, the original phrase *create accounting mismatch* was replaced with *exacerbate accounting mismatch*.

Board Comments

95. Mr. Linsmeier asked how long-term debt would be defined. He stated that the phrase *long-term debt* is open to interpretation. Ms. Malcolm noted that the staff had not created an exact definition of *long-term debt*. Mr. Linsmeier stated that there could be a problem if long-term debt is defined as debt classified as long-term liabilities because many financial institutions do not have classified balance sheets. He stated that there can be some confusion about what qualifies as debt and what qualifies as long term. There would be some benefit in defining long-term debt.

96. Ms. Seidman expressed concern about providing an amortized cost option for long-term debt and not for other financial liabilities. She stated that creating an exception for long-term debt seems arbitrary; she does not want to approach this issue from an exception standpoint. Ms. Malcolm stated that the staff looked primarily at own debt because it was considered to be the liability with the greatest potential to create accounting mismatches.

97. Mr. Linsmeier stated that there were two primary issues to address. The first issue is the reporting of changes in the fair value of own debt due to changes in own credit. The second issue is the accounting mismatch created when related assets and liabilities are reported and recognized differently.

98. Ms. Seidman stated that some users had expressed concerns over the own-credit portion of the fair value of an entity's debt being recognized in net income. She stated that an entity that currently elects the fair value option for its own debt will probably use the FV-NI model, which means the credit portion will still be flowing through net income.

99. Ms. Seidman referenced the IASB's paper related to issuer's own-credit risk, which explored the possibility of isolating components of changes in fair value related to an entity's own-credit risk. She inquired about the possibility of a model in which changes in the fair value of an entity's debt flowed through net income, with the portion related to the credit mark flowing into other comprehensive income. This solution would address the concerns that some users have about the own-credit portion flowing through net income.

100. Mr. Linsmeier stated that own long-term debt could meet categorization criteria for measurement at fair value through other comprehensive income, in which case changes in the fair value of debt due to changes in an entity's own credit would be recorded in other comprehensive income. Mr. Linsmeier asked if the staff considered making a disclosure requirement for changes in the fair value of long-term debt due to a change in own-credit risk for all financial liabilities measured in other comprehensive income. Mr. Linsmeier noted that if users understand a change in fair value of a financial liability reported in other comprehensive income is a change that could reverse, then reporting a change in fair value of own debt due to a change in credit quality in other comprehensive income would not be as big of a problem because users would understand there is a chance that the amount may or may not reverse.

101. Mr. Herz also expressed concern about the own-credit portion of debt. He stated that the gain on an entity's own debt arising from a change in that entity's credit rating could only be realized if that entity was in a trading position. Thus, a gain from a change in credit would not be realized by shareholders in many situations. He said that he would like disclosure of own-credit risk when long-term debt is

recorded at fair value, but he also realizes the difficulty of determining the credit portion. Mr. Siegel agreed.

102. Mr. Leisenring stated that it could be difficult to determine the change in fair value due to a change in own-credit risk. He expressed concerns about operationality. Mr. Herz acknowledged that separating out the own-credit portion would be difficult.

103. Mr. Linsmeier stated that this issue could be partially addressed with disclosure requirements. He stated that for any debt measured at fair value, the credit component of any change in fair value could be separately disclosed. Mr. Siegel agreed.

104. Mr. Herz raised a concern about recording own debt at fair value when the corresponding asset is recorded at cost. He provided an example of a mortgage on an asset such as a building. In that situation, reporting debt at fair value would create a mismatch because the building would not be recorded at fair value. Ms. Seidman expressed a similar concern about an institution that used a portfolio of debt instruments to fund some assets recorded at fair value through earnings and some assets reported in a different manner.

105. Mr. Herz stated that it is important to create symmetry between the treatment of the asset and corresponding liability. Mr. Siegel agreed. Mr. Herz stated that for liabilities related to an asset that is recorded at fair value with changes running through earnings, the debt should be recorded at fair value through net income. For liabilities related to an asset that would have changes reporting in other comprehensive income, such as loans that are held for the long term, the liability should be recorded at fair value through other comprehensive income. Then, for a manufacturing firm with assets that are not measured at fair value, the corresponding debt should be recorded at amortized cost. Mr. Linsmeier stated that under the proposed recognition and measurement model, changes in debt could be recorded in earnings, other comprehensive income, or both. Then, the creation of an amortized cost option would address the accounting mismatch created when

assets are not recorded at fair value. Mr. Linsmeier expressed support for the creation of an amortized cost option.

106. Mr. Linsmeier stated that comment letters received in response to the Discussion Paper, *Preliminary Views on Financial Statement Presentation,* suggest that financial institutions very seldom would use an amortized cost option because liabilities are considered in conjunction with the corresponding asset.

107. Mr. Herz stated that with the creation of an amortized cost option there would have to be certain “gating” criteria to control the use of the amortized cost option. Mr. Linsmeier stated that he thinks the phrase *create an accounting mismatch* is not the most appropriate language because a mismatch would already exist in many situations. Mr. Linsmeier proposed that the wording be changed from *create an accounting mismatch* to *exacerbate an accounting mismatch.*

108. A tentative criterion to qualify for the amortized cost option was defined as “debt that would qualify for fair value with changes reported in other comprehensive income and would exacerbate an accounting mismatch if accounted for at fair value.” Mr. Golden asked if the mismatch referred to a mismatch on the balance sheet or in earnings. He stated that for an asset that is reported at fair value with changes in other comprehensive income, the recording of a liability at cost would create a mismatch on the balance sheet in comprehensive income but not in net income. Therefore, he concluded that the *exacerbate an accounting mismatch* language would refer to a mismatch on the balance sheet and in comprehensive income.

109. Mr. Linsmeier stated that if alternative 1(a) were elected, there may not be a need for the fair value option because under the model all entities would be able to record their debt at fair value with changes in fair value recognized in earnings.

110. Ms. Seidman proposed a situation in which a financial institution had significant trading operations and a significant banking book, with the changes in fair value of certain financial instruments reported in other comprehensive income and other

changes in fair value reported in earnings. She questioned if such an entity had several sources of funding, would the funding be accounted at fair value through other comprehensive income or fair value through net income? Mr. Golden responded that funding used to manage assets that qualify for fair value through other comprehensive income would be reported in fair value through other comprehensive income and funding used to support trading activities would be recorded in fair value through net income.

111. Ms. Malcolm stated that an entity expressed that it views unsecured debt like a put option and uses that debt to buy an investment. In that case, the entity recorded the debt and the asset at fair value, demonstrating that it believes its own debt is similar to its asset, indicating that some debt has a different purpose than other debt. That suggests it would be beneficial to provide entities with the option to determine the purpose of their debt and then select the measurement and recognition method that most closely mirrors the treatment of the corresponding asset.

112. Ms. Seidman asked if this approach would result in there being a portfolio view on the asset side and an individual instrument view on the liability side. Ms. Malcolm stated that the classification could still be on a portfolio view. Mr. Linsmeier stated that it would be possible for an entity to have a portfolio of debt in each of the three categories. Mr. Herz agreed.

113. Ms. Malcolm noted that there should be consideration given to embedded derivatives that today would require bifurcation under Topic 815. Under the new approach, the entire instrument would be measured at fair value through net income, which could create asset-liability mismatches. Mr. Linsmeier stated that this issue should be revisited at a future meeting.

114. Ms. C. Smith asked if an entity would still report the fair value of its own debt on the balance sheet if it elects the amortized cost option. Ms. Malcolm stated that if an entity elects the amortized cost option, then just amortized cost would be reported on the balance sheet. Mr. Linsmeier noted that the fair value of such debt would still be disclosed in the footnotes.

115. Ms. Sangiuolo asked if the amortized cost option would apply only to long-term debt or if it would apply to a broader range of liabilities. Ms. Seidman stated that the scope of the option should be broader than long-term debt. Ms. Malcolm clarified that the amortized cost option could be used for any financial liability that qualifies for measurement at fair value through other comprehensive income. Mr. Linsmeier asked the staff to do more research to determine which instruments would qualify for the amortized cost option. Mr. Golden stated that consideration should be given to mezzanine financial instruments.

ISSUE 4(B): PRIVATE EQUITY INTERESTS

116. Ms. Malcolm stated that there was a suggestion at the July 8, 2009 education session that equity interests in privately held entities should not be measured at fair value if management intends not to trade the instrument for an extended period of time. The staff proposed two alternatives.

a. **Alternative 1:** Create an exception to the model for private equity investments.
b. **Alternative 2:** Do not create an exception to the model for private equity investments.

Staff Recommendation

117. Ms. Malcolm stated that the staff recommends alternative 2. The staff finds it 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 unintended consequences.

Board Vote

118. The Board voted not to create an exception to the model for private equity investments. All Board members agreed.

Board Comments

119. At the July, 8, 2009 education session, Mr. Smith expressed a concern that the cost of determining the fair value of a private equity security could outweigh the value. He stated that he no longer has that concern.

ISSUE 4(C): DEPOSIT LIABILITIES

120. Ms. Malcolm stated that she wanted to briefly address concerns expressed about deposit liabilities but the Board would not be asked to make a decision. The basic issue relates to a conflict between the two objectives of fair value measurement based on exit price for financial instruments.

121. The first issue is the definition of a financial instrument because deposit liabilities contain a nonfinancial aspect. The price for which demand deposits are traded generally includes three components—the demand deposit agreement, the depository institution's obligation to pay the depositor, and other benefits of the demand deposit relationship. All of these components do not meet the definition of a financial instrument. The value of the demand deposit includes all three components, which are not traded separately in the marketplace. The second issue is the use of observable market prices when available. The only observable prices are for sales of portfolios, which include the intangible assets related to these instruments. An education session to discuss demand deposits has been scheduled for July 29, 2009, and is open to the public.

ISSUE 5(A): RECLASSIFICATION (RECYCLING)

122. Ms. Malcolm stated that a key issue in the FV-OCI model is determining whether changes in fair value that are recognized in other comprehensive income should be reclassified (recycled) into net income. 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.

123. Ms. Malcolm outlined the following alternatives for the Board's consideration:

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

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

c. **Alternative 3:** Recycle no realized gains and losses in net income.

Staff Recommendation

124. Ms. Malcolm stated that the majority of the staff recommends alternative 2, which would require the credit portion of the impairment amount to be separately recognized within net income as it appears that both users and preparers would prefer this alternative. The staff also recommends requiring separate presentation of recycled realized gains and losses. 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 recognized in other comprehensive income.

125. Ms. Malcolm stated that 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 not recycling 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.

126. Ms. Malcolm asked if recognition of credit-related impairments within net income of the FV-OCI model should be required and if separate recognition within net income of other realized gains and losses be required.

Board Vote

127. The Board voted to separately recognize both credit-related impairments in net income and other realized gains and losses in net income. All Board members agreed.

Board Comments

128. Mr. Smith stated that the answer to this issue depends on the alternative selected in Issue 3(A). He stated that there are some Board members who believe that if alternative 3 of Issue 3(A) is chosen, which uses intention to sell as a classification basis, they would not want recycling. There are also some that think if alternative 2 of Issue 3(A) is selected, which provides a more stringent determination of how to classify instruments, then there is substance to the chosen instrument classification. Those in favor of alternative 2 of Issue 3(A) therefore believe that recognizing both credit-related impairments in net income and other realized gains and losses in net income would be the best solution (recycling).

129. Mr. Golden stated that he agrees with Mr. Smith's assessment of the different positions and noted that the options for Issue 3(A) include alternative 2 with recycling, alternative 2 without recycling, and alternative 3 without recycling.

130. Mr. Smith stated that if alternative 3 is selected and there is no recycling, then the fundamental performance indicators in the United States would be re-characterized. He also stated that he is unsure how financial institutions would react to such accounting treatments, but noted that he is confident that the industrial world will not favor the change in fundamental performance indicators.

131. Ms. Seidman stated that she approaches this issue by thinking about whether it is appropriate to recognize realized gains and losses in net income. She mentioned that Topic 220 on comprehensive income (originally issued as FASB Statement No. 130, *Reporting Comprehensive Income)* requires reclassification adjustments for unrealized gains and losses that were initially recognized in other comprehensive income that are later recognized in net income when realized to avoid double counting. She stated that it is unclear why the double-counting issue is not considered today when a previous Board thought it was a significant issue. Mr. Herz clarified that double counting would not occur because there would be separate lines for items that are being reclassified and those that are initially recognized in other comprehensive income and net income.

132. Mr. Linsmeier stated that if there is a single comprehensive statement of net income, there will be two subtotals that will have meaning—net income and comprehensive net income. He stated that he thinks recycling does not make sense in the model that is being developed because if users review comprehensive income and included within comprehensive income are some components that are likely to be realized and subsequently recognized in net income, then there is a chance an amount would be double counted. If instead alternative 2 is elected, other comprehensive income will only contain amounts that could reverse because it is likely that all of the instruments are to be held to maturity. However, if users believe reclassification is important, the numbers may not be that important because they will not review the numbers until they are realized and recycled. He stated that he prefers not to include both reversible and nonreversible amounts in other comprehensive income, given the opportunity for double counting. He further stated that if it is the Board's intention to preserve net income, other comprehensive income needs to have some sort of consistent meaning. He stated that in both his and Mr. Herz's ideal world there would be no recycling or impairments, and all of the numbers in a comprehensive income statement would only need to be looked at once. Under the change in stocks-and-flows approach, the changes in flows would be recognized in net income (which would have multiples applied to it) and the changes in comprehensive income would contain changes in stocks (at a potential multiple of one). He stated that he recognizes that a complete change in stocks-and-flows approach is not currently attainable because this notion would only apply to financial instruments and not to other items with changes in value recognized in other comprehensive income.

133. Mr. Smith stated that he is not trying to protect net income, but is acknowledging that net income is considered the most important performance indicator in the United States. He asked if there is a way to re-characterize alternative 2 of Issue 3(A) to include the notion that if an instrument is held for a substantial portion of the duration of the instrument, it could be recognized and measured at something other than fair value through net income without having to draw a brightline. He

stated that if there is a way to incorporate such a notion into the alternative, he could support alternative 2 in issue 3(A).

134. Mr. Linsmeier clarified that instead of the qualifier being a substantial portion of the duration of the instrument, the qualifier could be a substantial portion of the instruments in a portfolio.

135. Mr. Herz stated that the issue is where to recognize the changes in value of instruments that have long maturities when there are unrealized value changes. Instruments that are actively traded have more flows or realized value. Instruments that are held have more changes in stocks (unrealized value). The issue is deciding whether some of the changes in value are more stock-like or flow-like.

136. Mr. Smith stated that clarifying the criteria of what is being held and what is being traded could help alleviate some of the preparer-auditor battles regarding tainting.

137. Ms. Malcolm clarified that the notion is not that an entity is going to hold the instruments to collect a substantial amount of the cash flows; rather, it is that an entity is going to realize the cash flows over an extended period of time. She noted that it is a time-horizon focus.

138. Mr. Herz stated that his preference is to have the changes in value of long-term securities that occur in the early years, which are not very flow-like, recorded in other comprehensive income. Dividend and interest payments are flow-like and should be recognized in net income. Mr. Siegel stated that if the ultimate resolution of the security is going to be a sale or transfer, he would prefer to see the changes in value recognized in net income. Mr. Herz stated that he would distinguish between where the changes in value should be recognized by what a multiple would be applied to.

139. Mr. Smith gave the example of an entity that buys a 10-year security at par that it initially intended to hold for the foreseeable future, but the security was sold after 8.5 years because the market was beneficial. Eighty-five percent of the interest cash flows have been collected and the principal is being realized, in addition to a

gain due to market fluctuations. Given this situation, it is appropriate to account for the changes in fair value over the eight and a half years through other comprehensive income. The gain or loss on the sale of the security in year 8.5 should be separately presented in the income statement.

140. Regarding the term *foreseeable future,* Mr. Golden asked if an entity had the intention of holding a security for one and a half years if it would qualify to have the changes in value recognized in other comprehensive income. He also clarified that what is being considered is whether the predominant amount of cash flows from the security will be obtained from holding the instrument. Mr. Siegel noted that arbitrary distinctions create the notion of *foreseeable future*. Mr. Linsmeier stated that he is not comfortable with the term *foreseeable future*. He would like the alternative classification to apply when the vast majority of a portfolio of securities will generally be held for collection or payment. If some securities are sold, it is expected to be only a small portion of the portfolio. In summary, the predominant activity (the business model) of the entity is to hold a portfolio of securities until maturity or close to maturity, and only a few are sold when there are sales or transfers of the securities. The idea is that almost all of the securities are held until they are almost completely matured. Mr. Leisenring clarified that this approach is only applicable if alternative 2 of Issue 3(A) is selected.

141. Ms. Seidman stated that she likes Mr. Linsmeier's interpretation of alternative 2 of Issue 3(A). Mr. Linsmeier stated that this interpretation of alternative 2 of Issue 3(A) is a top-down approach that begins with the business model of the entity, and not a bottom-up approach that begins with each individual instrument. He reiterated the importance of applying a top-down approach to analyzing the instruments. Ms. Seidman restated that the interpretation of alternative 2 of Issue 3(A) is as follows: the predominant business activity of the portfolio of financial instruments is to hold them for a significant amount of time, and sales will be occasional and not the norm.

142. Regarding the interpretation of alternative 2 of Issue 3(A), Mr. Golden asked what is being held for a significant amount of time. He asked if the qualifier would apply only to securities that are similar or to all debt securities or some other grouping. Mr. Linsmeier stated that the determination should be done on a portfolio basis, so what should be held is whatever is designated into the portfolio. The designation will be the group of securities that at day one are designated as being held for collection. Mr. Golden clarified what Mr. Linsmeier described by saying that even if a portfolio of securities is designated as being held for collection, some securities within the portfolio could still be sold.

143. Mr. Golden asked if an entity that invests in 30-year debt securities that are going to be sold in 7 years is different from holding the securities for the collection of contractual cash flows. Ms. Malcolm clarified the interpretation of alternative 2 of Issue 3(A) by stating that what a portfolio ultimately collects is going to be predominantly all of the contractual cash flows. Mr. Herz stated that if a portfolio of 30-year debt securities is always sold in 8.5 years, he would not want to recognize the unrealized changes in value in net income for the first few years. In attempting to value a firm, an investor would not take a multiple of more than one for the changes. He stated that he thinks net income should reflect the flows for the current period.

144. Ms. Malcolm noted that Messrs. Herz and Smith’s models are not the same. Concerning the example of a portfolio of 30-year debt securities that are sold in 8.5 years, Mr. Linsmeier stated that he would recognize the changes in value in net income because of the possibility of double counting. Ms. Seidman stated that she would prefer to recognize the changes in value in other comprehensive income because the entity’s business model is such that it knows it is going to sell the securities in eight and a half years. Ms. Malcolm stated that Mr. Linsmeier is focusing on the business practice of holding to maturity while Ms. Seidman and Messrs. Smith and Herz are focusing on the business practice of holding securities for an extended period of time.

145. Mr. Golden gave the example of a portfolio of 30-year debt securities that are rarely held until maturity, but are on average held for 8.5 years, and asked how the changes in value should be recognized. Mr. Herz stated that he would prefer the remeasurement changes to be recognized in other comprehensive income while Mr. Siegel stated that he would prefer the changes to be recognized in net income.

146. Ms. Malcolm asked the Board to return to Issue 3(A) and discuss management's intent. She asked the Board to consider alternative 2 with the addition of a predominance notion. The predominance notion would encompass the business activity of holding a portfolio of securities for the collection of cash flows.

ISSUE 5(B): PRESENTATION AND EARNING PER SHARE

147. Ms. Malcolm stated that the prominent display of other comprehensive income is a key component of the recognition and measurement model. The staff proposed displaying the components of other comprehensive income below the total for net income in a statement that reports the results of operations. The staff also proposed the possibility of presenting two earnings per share figures—one related to net income and one related to total comprehensive income. During the staff's outreach activities, both users and preparers stated a clear preference for only one earnings-per-share number. They stated that two earnings-per-share numbers would create more complexity. Ms. Malcolm reiterated the goal in displaying the components of other comprehensive income on the face of the income statement, or requiring two earnings-per-share numbers, is to bring more prominence to other comprehensive income.

Staff Recommendation

148. Ms. Malcolm stated that the staff recommends 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 also recommends not requiring separate reporting of comprehensive earnings per share but continuing to report net income per share. Ms. Malcolm noted that this decision was primarily based on input received from resource group members.

Board Vote

149. The Board decided to display the components of other comprehensive income below the net income amount in a single statement that reports results of operations. The Board decided to require earnings per share based on net income only and *not* total comprehensive income to be reported. All Board members agreed.

Board Comments

150. Ms. Seidman asked the staff to clarify if it was suggesting that all components of other comprehensive income be reported on the face of the statement of financial performance. If so, she stated that this would eliminate the alternative presentation models currently available under Topic 220. Ms. Malcolm stated that the staff's recommendation is to present all components of other comprehensive income on the face of the statement of financial performance and agreed that it would eliminate other presentation models. Ms. Malcolm noted that there was a suggestion at another meeting to present only the components of other comprehensive income related to a change in fair value on the face on the income statement and to present the other changes separately. Ms. Malcolm stated that the staff does not support this alternative because it would create complexity.

151. Mr. Herz asked Ms. Malcolm if this proposal was essentially the same as the proposal in the Discussion Paper on financial statement presentation, which has other comprehensive income reported below net income with a single earnings per share for net income. Ms. Malcolm stated that this model is consistent with the model in the Discussion Paper on financial statement presentation. Mr. Herz noted his support for this approach.

152. Ms. Seidman stated that this approach would have a large effect on many entities that do not have a significant amount of financial instruments by requiring them to report all other comprehensive income items on the face of the income statement. She gave an example of an entity that had a large pension adjustment and a large foreign currency adjustment in other comprehensive income and its only significant financial instruments were trade receivables or trade payables. Such an entity, even

though it has few financial instruments, would be greatly affected by this model because it would be required to report its other comprehensive income items on the face of the income statement. Mr. Herz agreed this would affect every entity with other comprehensive income. Ms. Linsmeier stated that this would be an amendment to Topic 220 and that he supports the staff's recommendation.

153. Mr. Siegel noted that he thinks two earnings-per-share numbers would not create complexity. He stated that, currently, entities provide many earnings-per-share numbers, such as pro forma earnings per share and other earnings estimates. However, Mr. Siegel stated that he is satisfied as long as the face of the performance statement has net income, comprehensive income, and the number shares outstanding (including diluted shares outstanding). This information would allow users to make their own earnings-per-share calculations.

154. Ms. C. Smith replied that having two earnings-per-share numbers could create confusion because users already take today's earnings-per-share number and make adjustments. Presenting two numbers would create confusion about which adjustments to make to which number. Ms. Smith noted that there were mixed responses about what should be the one earnings-per-share number. She stated that most users expressed a preference for net income per share while one user in particular preferred comprehensive income per share. Mr. Smith stated that he would not support adding another earnings-per-share number. He would prefer to eliminate the earnings-per-share number.

155. Mr. Golden asked if the recognition and measurement model the Board agreed upon would affect the denominator of the earnings-per-share number because of the effect of convertible liabilities. Ms. Malcolm stated that the denominator would not change. Ms. Seidman stated that the issue will be more thoroughly discussed in the project on financial instruments with characteristics of equity.

156. At an education session, Mr. Linsmeier directed the staff to ask the Securities and Exchange Commission (SEC) if presenting other comprehensive income on the face of the statement of financial performance would require the announcement of the

other comprehensive income number during the preliminary earnings release when earnings-per-share numbers are released. The staff asked the SEC about the effect of Regulation G if other comprehensive income were reported on the face of the statement of financial performance. The preliminary answer is that the amount in other comprehensive income would be released at the preliminary earnings announcement because not announcing the amount in other comprehensive income would be materially misleading. However, there has not been a final conclusion. The staff was asked to follow up with the SEC to determine a final answer.

ISSUE 6: IMPAIRMENT

157. Ms. Malcolm stated that in the recognition and measurement model, amortized cost would be presented on the face of the balance sheet and interest would be reported in net income in the income statement for financial assets and liabilities whose changes in fair value are recognized in other comprehensive income. In a model in which recycling is required, a method for measuring the impairment of financial assets will be necessary. The staff identified three alternative impairment models that differ in terms of timing, triggers, and measurement of impairment. Alternative 1 is an incurred loss model that is currently required under U.S. GAAP. Alternative 2 is an expected loss model that measures impairment on the basis of predictions in shortfalls in future cash flows using economic loss forecasting. Alternative 3 is a fair value model that calculates impairment as the difference between fair value and carrying value when a trigger is met.

Staff Recommendation

158. Ms. Malcolm stated that 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.

Board Vote

159. The Board tentatively decided to use an impairment model based on expected losses. All Board members agreed. The staff will further develop the model for the Board’s consideration at a future Board meeting.

Board Comments

160. Mr. Leisenring stated that while an expected loss model in theory could result in early recognition of losses, the expected loss models he has seen would have huge operational problems. Mr. Leisenring asked if the staff was proposing an expected loss model for equity securities. Ms. Malcolm noted that because equity securities would be accounted for at fair value with changes in earnings, there would be no need for an impairment model for equity securities.

161. Ms. Seidman suggested revising the current incurred loss model. She suggested a model similar to the model in Topic 944 on financial services, insurance (originally issued as FASB Statement No. 163, *Accounting for Financial Guarantee Insurance Contracts*). Under Topic 944, an entity would use current information to determine expected future net cash flows based on the results of an entity's own risk management procedures. Then, the entity would discount those cash flows. She stated that this is in between the current incurred loss model and the expected loss model. She noted that it is not an incurred loss model because the entity is not waiting for an event to trigger the losses. She stated that it was not an expected loss model because it primarily considers internal factors and then considers external data when available.

162. Mr. Smith asked if Ms. Seidman was suggesting that the instrument be reviewed for its entire term to determine which cash flows an entity will and will not collect instead of reviewing broader economic factors. Ms. Seidman stated that this is what she was suggesting, and called it an expected net cash flow model. Mr. Linsmeier noted that Ms. Seidman's model is not an expected loss model, but is an expected cash flow model with management's estimate of current information. Mr. Stoklosa stated that all models are essentially expected cash flow models. He said that the question that should be addressed is what cash flows go into the model—incurred losses or expected losses.

163. Ms. Malcolm noted that the primary question about the expected loss model could best be understood by an example. Take a 30-year mortgage and look out over the life of the loan and determine expected cash flows. When determining those cash flows, does one forecast macroeconomic factors, such as an economic downturn five years from now and build that into an expected loss model? She noted that doing so would be very difficult. Mr. Herz stated that he believes it is not possible to predict future macroeconomic events and build them into an expected loss model. Mr. Leisenring agreed.

164. Ms. Malcolm stated that some entities are currently taking the incurred losses this year and projecting the losses over the next one and a half to three years. Those entities believe this is an expected loss approach. Ms. Malcolm noted that this is not the expected loss model proposed by the staff. Mr. Herz stated that under today's incurred loss model, the losses must be probable. He noted that the impairment triggers would be eliminated. He said that his understanding of an expected loss model is forecasting cash flows based on current information. Mr. Linsmeier clarified that a best estimate would be expected value with current information. Ms. Malcolm asked what discount rate would be used. Mr. Herz stated that he was leaning toward using the contractual rate.

165. Ms. Malcolm noted that the contractual rate was used in the staff's incurred loss model, and a credit-adjusted discount rate was used in the expected loss model. For the expected loss model, the staff proposed two options, one in which the rate could be set at inception and one rate that could be reset over the life of the financial instrument.

166. Mr. Linsmeier said that he would like to explore the expected loss model further, but expressed concern that the expected moss model would be very complex. Mr. Linsmeier stated that after a future education session, if the expected loss model still did not seem feasible, he would support a modified incurred loss model without the impairment triggers.

167. Mr. Leisenring asked whose expectations would be used in expected loss model—management or the market place. Mr. Leisenring expressed concern about the operationality of an expected loss model. Mr. Linsmeier expressed the same sentiment and said that more information is needed. Mr. Siegel agreed and stated that he would not support it if it took two to three years to develop or understand such a model.

ISSUE 7: RECLASSIFICATION

168. Ms. Malcolm stated that with a financial instrument model that permits changes in fair value to be recognized in net income or other comprehensive income depending on certain criteria, a question arises about whether an entity could change its classification so that the location of where fair value changes are recorded could be changed. The possible need for reclassification would arise because of the management intent/business model criteria used to determine the classification. She posed the question of whether it should be permissible to be able to reclassify from fair value through net income to fair value through other comprehensive income or vice versa.

169. Ms. Malcolm described two alternatives for the Board's consideration:

a. **Alternative 1:** Permit reclassification of financial instruments.
b. **Alternative 2:** Preclude reclassification of financial instruments.

Staff Recommendation

170. Ms. Malcolm stated that the staff recommends alternative 2. Reclassification of instruments between categories would create significant accounting and interpretation complexity for users of the financial statements. The staff believes that if management's intent changes and a financial asset or liability is settled, the resulting gain or loss should be presented separately within the income statement. 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.

Board Vote

171. The Board decided to preclude reclassification of financial instruments. All Board members agreed.

Board Comments

172. Mr. Leisenring stated that a model based on management's intent that does not allow reclassifications is inconsistent. He believes that in a model in which one of the original classification criteria is management's intent, one would have to allow reclassifications because management's intent changes over time due to changing circumstances. He stated that if reclassifications were not allowed, then it would be a misnomer to call the model a management's intent model, because in reality the model would be a model based solely on management's original intent.

173. Mr. Leisenring raised concerns about the operationality of the model. He gave an example in which an entity has 1 million similar financial instruments in a portfolio. Under the model (based on the *predominantly held* criteria from Issue 3(A)), it is determined that 80 percent of those securities will be predominately held and, therefore go in fair value through other comprehensive income, and 20 percent of those securities will be trading and thus carried at fair value through net income. Then, when a security from that portfolio is sold, how is it determined if that security was originally one of the 800,000 that was originally predominantly held or if it was one of the 200,000 that was trading. He believes that securities will have to specifically be identified and marked as either trading or predominantly held. Mr. Linsmeier agreed.

174. Ms. Malcolm proposed another solution in which the first 200,000 sold from that portfolio would be considered as held for trading, and thus their accounting would have been correct from the start. Then, when security 200,001 is sold, that security would be considered a sale of a predominantly held security and there would be a separate line item on the income statement to show that sale.

175. Mr. Leisenring believes that specific identification of individual securities would create operational problems. Ms. Seidman stated that under the current model, entities often specifically indentify which financial instruments are sold for tax and other purposes.

176. Mr. Leisenring stated that specific identification of individual securities also contradicts the portfolio approach. Mr. Golden stated that the portfolio approach could still be used. He stated that securities that would be traded could be put in a trading portfolio and securities to be predominantly held could be put in a separate portfolio.

177. Mr. Smith stated that the predominantly held criterion in 3(A) makes it harder to allow reclassifications. He stated that under the old model, reclassifications made sense because an entity could prove a change in management's intent. In the old model, if there was a 10-year note classified as being held to maturity and it was sold in year 7, that is justification to reclassify other securities because it shows management's intent has changed. However, under the new criteria, the assertion is securities are being predominantly held. Thus, if a 10-year note is sold in 7 years, it would be more difficult to justify a reclassification of the other securities in the portfolio that are being predominantly held because holding until year 7 could be considered predominately held.

178. Mr. Herz stated that he is not as concerned about FV-OCI securities subsequently sold because subsequent sale of those securities can be taken care of by separate disclosure. He stated that the bigger problem is with instruments originally designated as trading instruments that, due to the state of the current market, the entity no longer plans to sell or no longer is able to sell. If reclassifications are precluded, the changes in that instrument would still be reported in earnings even though management is not intending to sell the instrument.

179. Mr. Linsmeier stated that one solution would be to allow a reclassification of trading instruments into the predominately held category with changes reported in other comprehensive income as long as at the point in time of the transfer, any gain

or loss from the transfer would be recognized in earnings. Mr. Herz stated that he would only allow that transfer if the fundamental operation of the portfolio changed.

180. Ms. Malcolm stated that with the current categorization criteria, instruments that were originally trading in a market that became inactive still might not be able to categorize the changes in fair value in other comprehensive income. She stated that for an item's changes in value to be reported in fair value through other comprehensive income, the assertion has to be that the entity's holding instrument will be predominately held for collection of contractual cash flows. In the situation in which a trading instrument is in an inactive market, that instrument would not qualify for reporting changes in value in other comprehensive income if management makes the assertion that the instrument is being held until the market becomes active again. In order to be reclassified into fair value through other comprehensive income, management would have to make the assertion that its intention had changed to predominantly hold the portfolio of instruments to receive the contractual cash flows.

181. Mr. Herz stated that while he is sympathetic to that situation, he is concerned that permitting reclassifications would allow an entity to cherry-pick financial instruments in other comprehensive income to move the gains into earnings. Mr. Linsmeier agreed and stated that if reclassifications are allowed, it would create opportunities for earnings management. Entities could move financial instruments from other comprehensive income to earnings by stating that management's intent had changed. He noted that a model with reclassifications would give managers an incentive to "sell winners and hold losers." That means that management might be motivated to sell certain appreciated items with changes reported in other comprehensive income so that the gains are recycled into net income.

182. Mr. Linsmeier stated that the problem of selling FV-OCI securities early is alleviated if the gain/loss from the sale of a FV-OCI instrument is reported separately on the income statement. He stated that if users consistently saw line

items on the income statement showing the sale of items that were accounted for in other comprehensive income, the investors would realize that the changes in fair value in other comprehensive income will be recognized more frequently. He noted his support for a separate line item for the other comprehensive items sold. This would minimize the need for reclassifications from the other comprehensive income into earnings for instruments that originally had changes in fair value reported in other comprehensive income.

183. Mr. Linsmeier suggested that there should be changes to disclosure requirements if reclassifications were precluded. Mr. Herz suggested that certain disclosures, such as intent and average holding period, could be insightful. Mr. Linsmeier suggested that for FV-OCI portfolios there could be disclosures about the percentage of that portfolio that was actually held and the percentage that was sold.

184. Mr. Siegel stated that he is not as troubled by this issue now that, based on the earlier decision, financial instruments are reported at fair value on the balance sheet and the changes are all on the face of the performance statement, whether in other comprehensive income or earnings. He stated that users will be able to find the information and make adjustments as they see appropriate.

Follow-up Items:

185. The staff will continue to work on the following items:

a. Further develop an expected loss impairment model.
b. Gather more information about the deposit liabilities.
c. Provide further analysis of presentation and disaggregation.
d. Provide further analysis of possible disclosures.
e. Analyze which liabilities could possibly qualify for the amortized cost option.
f. Further analyze the bifurcation criteria and embedded derivatives.
g. Develop the scope, effective date, and transition guidance.
h. Gain a better understanding of Regulation G.

General Announcements:

186. An education session to discuss demand deposits has been scheduled for July 29, 2009, and is open to the public.