MINUTES

Financial Accounting Standards Board

To: Board Members

From: Reager (x393)

Subject: December 15, 2008 Board Meeting Minutes: Financial Instruments and Short-Term Impairment Projects

Date: January 19, 2009

cc: Leisenring, Golden, Bielstein, Stoklosa, Trench, Laungani, Lott, Proestakes, Mills, Allen, Wilkins, C. Smith, Brickman, Malcolm, Homant, Pfeiffer, Vaheb, Fanning, Reager, Mussatt, Chookaszian, Posta, Glotzer, Mechanick, Gabriele, Finden, FASB Intranet, Klimek

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Topic:	Financial Instruments and Short-Term Impairment Projects
Basis for Discussion:	Board Memorandum No. 4
Length of Discussion:	3:02 p.m. to 5:30 p.m.
Attendance:	
Board members present:	Herz, Linsmeier, Seidman, Siegel, and Smith
Staff in charge of topic:	Trench and Wilkins
Other staff at Board table:	Golden, Stoklosa, C. Smith, Laungani, Mills, Maroney, and Reager

Summary of Decisions Reached

The Board discussed input from constituents regarding the accounting for financial instruments in light of the global financial crisis. Based on that input and consultation with other Board members, the FASB chairman announced his decision to add to the technical agenda a comprehensive project to address the complexity in existing standards of accounting and reporting for financial instruments. That project will be undertaken jointly with the IASB.

The FASB chairman also announced his decision to add four short-term projects to the Board's agenda to address current practice issues related to financial instruments. The Board discussed these four projects and directed the staff to draft exposure documents relating to the following three projects:

- Practice Issues with EITF Issue 99-20
- Disclosures of Certain Financial Instruments
- Clarification of the Embedded Credit Derivative Scope Exception in Paragraph 14B of Statement 133.

The Board will continue discussion of the fourth short-term project on Recoveries of Other-Than-Temporary Impairments (Reversals) at a future meeting.

Short-Term Project 1—Practice Issues with EITF Issue 99-20

The Board decided to address practice issues with EITF Issue No. 99-20, "Recognition of Interest Income and Impairment on Purchased Beneficial Interests and Beneficial Interests That Continue to Be Held by a Transferor in Securitized Financial Assets," by making the impairment guidance in it consistent with FASB Statement 115. That is, as in Statement 115, a decline in fair value below the amortized cost basis that is other than temporary would be recognized as a realized loss through earnings.

The Board noted that this change simplifies U.S. GAAP. However, the Board acknowledges that differences continue to exist between U.S. GAAP and IFRS with regard to the accounting for financial instruments and that a comprehensive project to address the complexity in reporting for financial instruments will address those differences.

Effective Date, Transition, and Comment Period

The Board decided that the guidance should be effective as of the last day of all interim and annual reporting periods ending after December 15, 2008 and applied prospectively. In the first fiscal year that this FSP is applied, information related to quarterly interim periods that began on or before September 15, 2008 may be omitted. The Board also decided that the comment period for the exposure document should end on December 30, 2008. The Board expects to issue a proposed FSP on or around December 19, 2008, to allow for a comment period of approximately 10 days.

Short-Term Project 2—Disclosures of Certain Financial Assets

The Board agreed to require enhanced disclosures about the impairment of:

1. Debt securities classified as available-for-sale
2. Debt securities classified as held-to-maturity
3. Loans
4. Long-term receivables.

The Board decided that for those instruments within the scope of this project, an entity should disclose:

1. The pro forma effects on pretax net income as if the instruments were (a) carried at fair value and (b) measured based on the incurred loss
2. The amount of the instruments reported in the statement of financial position and the amounts that would have been reported had they been measured:
    a. At fair value
    b. On a historical cost basis using an incurred loss method of measuring impairment
3. Qualitative disclosures including the valuation methodologies and factors resulting in the differences among the three measures of the instruments’ value.

The IASB is undertaking a similar project. The two Boards share a goal of requiring similar disclosures that would help investors when comparing financial statements of entities holding financial instruments within the scope of the proposed guidance.

Effective Date, Transition, and Comment Period

The Board decided that an entity should provide the disclosures in financial statements for fiscal years ending after December 15, 2008, and for quarterly interim periods within those fiscal years. In the first fiscal year that this FSP is applied, the disclosures may omit information related to quarterly interim periods that began on or before September 15, 2008. The Board decided that disclosures are required only for the current reporting period. The Board further decided that the comment period for the exposure document should end on January 15, 2009. The Board expects to issue a proposed FSP on or around December 23, 2008, to allow for a comment period of approximately 20 days.

Short-Term Project 3—Recoveries of Other-Than-Temporary Impairments (Reversals)

The Board decided to consider whether an entity should be permitted to reverse, through earnings, a previously recognized other-than-temporary impairment loss when evidence exists that a loss has reversed. The Board also decided that the scope of the project includes all debt securities classified as held-to-maturity and available-for-sale. The Board decided to coordinate such a change with the IASB to ensure the consistency of accounting standards internationally.

Short-Term Project 4—Clarification of the Embedded Credit Derivative Scope Exception in Paragraph 14B of Statement 133

The Board decided that FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, should be amended as follows:

1. Delete the first sentence of paragraph 14B to clarify that the scope exception for embedded credit derivatives applies only to the concentration of credit in the form of subordination of one financial instrument to another

2. Revise examples from FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments*, and provide additional examples to clarify application of the scope exception.

The Board decided that this guidance and amending language will be provided as a Statement 133 Implementation Issue.

Effective Date, Transition, and Comment Period

The Board decided that the guidance should be effective for fiscal quarters beginning after December 15, 2008. Upon adoption of the guidance, an entity should assess only those preexisting contracts that were acquired or issued on or after the date of each reporting entity's adoption of Statement 155, determining whether any of those contracts contain one or more embedded credit derivatives that, under the revised paragraph 14B, would no longer qualify for the scope exception in that paragraph. The provisions of paragraphs 12, 13, and 14A should be applied to such contracts at the date of adoption of the guidance to determine whether the embedded credit derivative is required to be separated from the host contract and accounted for separately.

At adoption, any difference between the total carrying amount of the individual components of the existing bifurcated hybrid financial instrument and the carrying amount of the combined hybrid financial instrument prior to the bifurcation should be recognized as a cumulative-effect adjustment to beginning retained earnings. An entity should separately disclose the gross gains and losses that make up the cumulative-effect adjustment, determined on an instrument-by-instrument basis. Prior periods should not be restated.

Further, the Board decided that if a contract is required to be separated into a host contract and a derivative instrument at adoption of the Implementation Issue and if the contract is a hybrid financial instrument, the entity may irrevocably elect to initially and subsequently measure that contract in its entirety at fair value (with changes in fair value recognized in earnings). The Board also decided that the fair value election should be determined on an instrument-by-instrument basis and supported by documentation completed by the end of the fiscal quarter of initial adoption.

The Board decided that the proposed Statement 133 Implementation Issue should be exposed for a comment period ending no earlier than February 6, 2009.

Objective of Meeting:

The objective of the meeting was to discuss complexity in the accounting and reporting for financial instruments and consider several short-term projects to address those issues in a timely manner. This meeting included a discussion of feedback that the Board has received from (a) roundtables held jointly with the IASB, (b) other meetings related to the financial crisis, and (c) unsolicited comment letters. The objective of the meeting was met.

Matters Discussed and Decisions Reached:

Financial Instruments

1. Mr. Trench stated that at today's meeting, the staff will present to the Board a summary of the roundtables recently held relating to the global financial crisis. He further stated that the staff will also discuss with the Board several issues resulting from the roundtables and other input from constituents related to the accounting for financial instruments.

2. Mr. Trench stated that the FASB and IASB agreed to work together in responding to the global financial crisis. He said that as part of that response, both Boards organized and participated in three public roundtables over the last month in London, Norwalk, and Tokyo to obtain input on accounting issues that may require immediate attention, as well as broader financial reporting issues arising from the global financial crisis. Mr. Trench said that roundtable participants represented the views of investors, preparers, practitioners, regulators, and others. In addition, he stated that both Boards have considered informal input from other organizations, such as the Center for Audit Quality, the American Council of Life Insurers, and the SEC.

3. Mr. Trench stated that the majority of comments at the roundtables focused on impairment and fair value issues. He said that the following specific topics were discussed:

a. **Triggers for recognition of impairment losses –** the focus of the discussion was on the assertion of the intent and ability to hold to recovery and the call for a single trigger for all impairments.

b. **Subsequent accounting for impairment losses –** this discussion centered on the multiple impairment models in U.S. GAAP and IFRS and the call for a model that separates the credit component of the loss and recognizes only that piece in earnings and the remainder of the impairment loss is reported in other comprehensive income.

c. **How to measure fair value in an inactive market?**

d. **When to use fair value?** Users supported the use of fair value stating it was the most relevant measurement even though it is subjective.

e. **Reclassification of securities within investment categories**

f. **Reclassification out of the fair value option in inactive markets**

g. **Disclosures regarding impairment and fair value –** Users, among other things, requested more information surrounding the variability and uncertainty of numbers reported in the financial statements. Preparers suggested disclosure of the value of assets and liabilities using a non-fair value measurement.

4. Mr. Trench then said that he would like to turn the discussion over to the Board members to provide any comments or observations with regard to the constituent feedback from the roundtables as well as other feedback received over the last few months.

Financial Instrument Board Comments

5. Mr. Linsmeier stated that he had heard several common themes from the roundtables at the SEC and the Joint IASB/FASB roundtables held in North America, Europe, and Japan. He said that preparers have raised significant issues with fair value measurements and the impairment model suggesting the accounting model has exaggerated losses and caused pro-cyclicality in the market response to the credit crisis. He stated that users have uniformly told the FASB that fair value, while not perfect, is the best measurement attribute in these markets. He said that if fair value measures are augmented by additional disclosures about judgments and uncertainties in fair value measures, these measures could introduce significant understanding of where losses are located which could lead to markets becoming more liquid.

6. Mr. Linsmeier stated that some key facts raised doubts about preparers' views that fair value is a key issue in this financial crisis. He said that for seventeen banks closed by the FDIC between January 25th, 2008 and October 31st, 2008, net assets required to be carried at fair value represented just ten percent of the total assets on average. He stated that in early November 2008, RiskMetrics shared evidence that investors pricing of banks in general suggests banks' assets are overstated, not understated, with almost 60% of publicly traded banks trading below book value, and with 40% of these banks trading at more than 80% below book value. He stated that this, along with the fact that (a) banks won't loan to each other and (b) the two banks purchased in non-forced sales in recent months were purchased at a price 30% below book value, suggests a general distrust of reported values on banks' financial statements which perhaps has lead to market illiquidity. He stated that this leads him to the conclusion that accounting is not the primary contributor to pro-cyclicality, but rather our problems have arisen from the awareness that original credit losses in sub-prime loans have spread to prime loans and credit cards receivables, and from Wall Street to Main Street. He said that if anything is likely, it is likely that accounting is contributing to the financial crisis by providing insufficient information to identify which financial institutions are likely to survive this crisis, leading to a total crisis of confidence in markets and a market psychology that views all banks as extremely troubled, leading to further depressed market prices.

7. Mr. Linsmeier stated that in the 1980s and 1990s two significant credit crises occurred that provided significant lessons for accounting and bank regulation. He said that in the United States in the 1980s and Japan in the 1990s, the failure to record losses on a timely basis for U.S. savings and loans and Japanese banks lead to more severe economic losses and prolonged the crises. Mr. Linsmeier stated that the delay of loss recognition in both instances was promoted by bank regulators and/or the federal government as a way to create confidence in troubled markets. He said that these efforts failed to infuse confidence in markets and by delaying the inevitable, caused the economic problems to be magnified. He stated that we appear to be on a similar journey today.

8. Mr. Linsmeier stated that in the 1970's, U.S. President Nixon broke the Bretton Woods' accord that pegged the world's foreign currency rates to the U.S. dollar. He said that ever since that time, finance has become increasingly more risky with increased volatilities in foreign currency rates, interest rates, and commodity prices that often are exacerbated by derivatives. He stated that at the same time, there have been efforts to deregulate financial institutions that have lead to increasingly lower regulatory capital requirements. Mr. Linsmeier stated that accounting has contributed to these efforts by continuing not to fully portray the risks in financial instruments.

9. Mr. Linsmeier stated that the standard setting answer for him is a wholesale, but expedited effort to rethink the accounting model for financial instruments to ensure the risks and rewards of these instruments are understood by investors and regulators. He said that this effort would be most effective if it concentrated on full fair value accounting for all financial instruments with a required holistic, disaggregated presentation in the income statement and footnotes for these instruments. He stated that it is only with this type of accounting model that investors and regulators will have timely enough information to act to prevent the decline in market confidence that lead to the liquidity problems we are now experiencing. Mr. Linsmeier stated that he therefore strongly supports adding an expedited project to the agenda to holistically look at accounting and reporting for financial instruments in recognition, measurement, and disclosure. He said that he comes out of the roundtables skeptical of calls for emergency

standard setting efforts that delay recognition of losses since investors are already skeptical that losses haven't been recognized enough already, or have the outcome of delaying the transparent communication of differential problems in our economies. He stated that to make markets work, information must be provided that reduces widespread uncertainties about banks' asset values. He said that this requires even more transparent and consistent reporting, not less.

10. Mr. Smith stated that he is concerned with the lack of ability to value securities in an illiquid, almost non-existent market. He said that he has thought about this in relation to some of the various short-term project proposals people have put forward as well as the long term proposal discussed by Mr. Linsmeier. He stated that from a practical standpoint, he does not agree that fair value accounting for all financial instruments through the income statement is the answer to the problem, but he is willing to listen if a long term financial instrument project is undertaken. Mr. Smith stated that he is frustrated at banking regulators' apparent unwillingness to consider changes to regulatory capital based on disclosures the Board might consider adding to financial statements. He said that banking regulators insist on pegging regulatory capital to current accounting standards even though banking regulators have the ability to adjust their banking regulations.

11. Mr. Smith stated that he considered the proposal to segregate impairment losses into a credit component versus other changes with the credit component adjustment going through the income statement. He said that there are certain aspects of that which he believes should be explored further. Mr. Smith said that, much like the Pozen Committee concluded, he believes that how companies manage their assets should influence how you account for them. He stated that there are many people who believe that all financial instruments should be measured at fair value because companies do not hold their financial instruments to maturity. He said that he disagrees with this premise and believes that many financial institutions hold their instruments to maturity. Mr. Smith stated that as recently as last week, he spoke to the chair of an audit committee of a local community bank who stated that the local community bank never sold any of their debt securities prior to maturity and they clearly indicate what loans are originated for purposes of

selling versus loans originated for purposes of holding to maturity. He said that he thinks amortized cost does have a place in the accounting model.

12. Mr. Smith stated that he does not think the Board has the ability to address these proposals by this year end. Mr. Smith further stated that he believes the frustration about the current crisis is (a) the lack of information that is available and (b) the ability of people to evaluate certain instruments and how those instruments (and the underlying assets) are functioning in order to come up with reasonable values. He said that a lot of the information is outside of the accounting model and cannot be required. Mr. Smith said that he is open to discussion of a solution in the context of a comprehensive project, but in the short term he did not think there is time to address some of the proposals that have been put forth to the Board. He stated that he is frustrated by the lack of information in the market place, particularly when there is not significant market activity.

13. Mr. Siegel stated that he attended the roundtables in Norwalk, London, and Tokyo, he has listened to the media, and he has listened to the debate around the world. He said that he is troubled by some of the assumptions being made about fair value that seem to lack a factual basis. He stated that many banks are analyzed based on tangible book value and that half of all banks are trading below tangible book value. He said that of the commercial banks, 65% of the financial assets at the end of the second quarter were not accounted for at fair value. Mr. Linsmeier added that of the 35% of commercial bank financial assets at fair value, 17% of commercial bank financial assets went through the income statement and 18% of commercial bank financial assets went through equity.

14. Mr. Siegel stated that he heard at the roundtables that accounting for impairments is far from ideal. He noted that under U.S. GAAP, the accounting guidance for financial instruments (a) has multiple classifications for financial assets and (b) multiple impairment models. This accounting guidance, in particular the guidance related to impairment, differs from the guidance under IFRS. Mr. Siegel said that he heard from most constituents that the impairment models should be addressed in a thoughtful manner and with joint consideration from both the FASB and IASB. Mr. Siegel stated that he did not think constituents wanted changes to impairment guidance to be rushed. He said that

he is supportive of a comprehensive financial instruments project and in the near term he is supportive of increasing financial instrument transparency through additional disclosures.

15. Ms. Seidman stated that she would make points similar to the points made by Mr. Siegel and passed on making any general comments at this time.

16. Mr. Herz stated that what he understood from the roundtables and other discussion with constituents was that most people feel the issues laid out in the Discussion Paper, *Reducing Complexity in Reporting Financial Instruments*, are valid, but there needs to be a comprehensive look at all the issues. He said that most people think that the best step forward is for the FASB and the IASB to work together to find some common answers for financial instruments and this should be done sooner rather than later even though it cannot be done for this year end. He stated that there was no unanimity of point of view among constituents, with fairly significant differences between preparer views and investor views.

17. Mr. Herz stated that U.S. constituents suggested some short-term projects for this year end. He said that he agrees that there are opportunities for greater transparency. He stated that he believes that one of the factors that has lead to illiquid markets in a number of asset classes is the lack of readily available information to perform economic evaluations of these instruments. He said that another factor that has lead to illiquid markets is the massive degree of uncertainty concerning the direction of the economy. Mr. Herz stated that situations exist where preparers may value assets differently than investors depending on each group's expectations. He said that on the one hand, some preparers think that some fair value measurements overstate current market distress. On the other hand, he also said that some users believe that some fair value estimates have been overly optimistic.

18. Mr. Herz stated that it is not clear what the proper path forward is in the short-term and the longer term. He said that the FASB agrees that there should be a joint project with the IASB relating to the comprehensive issues related to financial instrument accounting models. Consequently, Mr. Herz, after consulting with the other Board

members, stated that he has added to the Board's agenda a comprehensive joint project to address the accounting and reporting for financial instruments.

Issue 1: Changes to Measurement of Impairment for Certain Financial Instruments

19. Mr. Trench stated that based on the addition of a comprehensive financial instrument project, the remainder of the meeting would focus on issues relating to financial instruments that could potentially be addressed in the short term.

20. Mr. Trench stated that the Board has received numerous unsolicited comment letters and other feedback (both formal and informal) regarding the measurement of impairment for financial instruments. He said that, specifically, concerns have been raised by constituents about the impact to the statement of income of impairment losses in the current economic environment. He stated that some constituents have noted that loans and debt securities are economically similar financial instruments but that the accounting for impairments differs significantly.

21. Mr. Trench stated that the staff has identified three potential options suggested by constituents as being potential short-term projects related to the measurement of impairments for financial instruments. He said that the options are as follows:

a. **Option A—**The measurement of the other-than-temporary impairment for debt securities does not change under this option (that is, the other-than-temporary impairment is the difference between the amortized cost and the fair value). However, only the portion of those impairments representing probable losses of contractual cash flows are recognized in earnings (representing a surrogate for the amount of the impairment related to credit). The remaining portion of the other-than-temporary impairment loss is recognized in other comprehensive income until the debt security is sold or matures. In addition, a consideration under this option is to eliminate the options for reporting other comprehensive income permitted by Statement 130, *Reporting Comprehensive Income*, and to require a single statement of comprehensive income (with net income as a subtotal in that statement).

b. **Option B—**Under the pretext of convergence with the recent amendments made by the IASB to IAS 39, *Financial Instruments: Recognition and Measurement*, and IFRS 7, *Financial Instruments: Disclosures*, in distressed or disorderly markets, allow entities to categorize securities similar to that of a held-to-maturity classification when an entity can justify they have no intention to sell those debt securities.

c. **Option C—**Address the practice issues with Issue 99-20, *Recognition of Interest Income and Impairment on Purchased Beneficial Interests and Beneficial Interests That Continue to Be Held by a Transferor in Securitized Financial Assets*.

22. Mr. Trench stated that the practice issues with Issue 99-20 arise from the scope (paragraph 5(e)) and the impairment model (paragraph 12(b)) in that Issue. He said that the scope of Issue 99-20 includes beneficial interests that are not beneficial interests in securitized financial assets of a high credit quality that cannot contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment. He stated that the staff believes that interpretations of what "high credit quality" means have been too stringent and are not consistent with the original intent of Issue 99-20. Mr. Trench said that consequently, the higher threshold has subjected a larger number of debt securities that are beneficial interests to the accounting guidance in Issue 99-20 and, specifically, to the impairment model in that guidance.

23. Mr. Trench stated that paragraph 16 of Statement 115, creates a threshold for impairment recognition based on whether it is probable that the investor will be unable to collect all amounts due according to the contractual terms of a debt security. However, he said that paragraph 12(b) of Issue 99-20 creates a different impairment threshold that is based on a holder's best estimate of cash flows that a market participant would use in determining the current fair value. He stated that in practice, when the fair value is below the book value almost any adverse change in fair value results in an other-than-temporary

impairment. Mr. Trench said that this is because it is difficult to argue that market participant expectations about cash flows have not been adversely impacted when there has been a significant decrease in fair value.

24. Mr. Trench stated that the combination of the practice issues relating to the scope and the creation of different impairment models based on credit rating and type of debt security has been highlighted by the recent credit crisis.

25. Ms. Smith stated that the staff spoke with 12 investors from the buy- and sell-side whose focus is on financial services and insurance sectors to understand how investors view impairment under Issue 99-20 and Statement 115. She said that the investors had very strong but differing opinions. She said that many of those in support of eliminating or changing Issue 99-20 were surprised to learn of the difference in impairment models between Issue 99-20 and Statement 115 and the fact that Issue 99-20 contains more sensitive triggers for impairment. She stated that these analysts thought that there should be a single impairment model for these instruments and that the Statement 115 model was the more appropriate model. She further stated that these analysts were specifically concerned with the use of market participant cash flows required under Issue 99-20 when certain structured investments do not have an observable, liquid market.

26. Ms. Smith stated that there was another group of investors not in favor of eliminating or changing Issue 99-20. She said that these investors thought that (a) changing Issue 99-20 was a step in the wrong direction, (b) Statement 115 should have more sensitive impairment triggers, (c) credit and liquidity are part of the market participant view and are so intertwined that their impact cannot be meaningfully separated, and (d) the complexity that arises from the different impairment models is not overly burdensome. Ms. Smith said that these investors feel that any change to financial instruments should move in the direction of increased use of fair value measurement for financial instruments.

27. Ms. Smith noted that almost all of the investors contacted were supportive of increased disclosure about unrealized losses on securities. These analysts acknowledged that while fair value is not perfect, when augmented with disclosures, fair value provides

a better starting point for their analysis. Ms. Smith stated that additional disclosures suggested by users include more information on (a) the cause of changes in fair value (credit versus liquidity), (b) the assumptions used to evaluate whether or not an impairment has occurred and whether that impairment should be recognized through earnings, and (c) the severity and duration of impairment. She further stated that while this information is being provided to some degree in the 10-K's, the consistency and quality of information is diminished in the 10-Q's.

28. Mr. Herz asked if the investors were evenly divided over whether Issue 99-20 should be changed and Ms. Smith told him investors were evenly divided.

29. Mr. Siegel asked if the investors who supported not changing Issue 99-20 would favor a more sensitive impairment trigger in Statement 115. Ms. Smith said that these investors directionally favored a more sensitive impairment trigger. She said that she feels these investors would favor not doing anything in the short term, and moving forward with the completion of the comprehensive financial instruments project.

Issue 1 Staff Recommendation

30. Mr. Trench stated that the staff recommends the Board address practice issues with Issue 99-20 (Option C). He said that the staff believes that two different impairment models for economically similar financial instruments creates complexity and reduces comparability. He stated that both Options A and B represent significant changes to current recognition and measurement of impairments and are better suited to be addressed in a comprehensive project rather than a short-term project to be completed for year end or the first quarter of 2009.

Issue 1 Board Vote

31. The Board decided to address practice issues with EITF Issue No. 99-20 (Option C).

Issue 1 Board Comments

32. Mr. Linsmeier stated that he is unsure of why the inconsistency in the impairment model between Issue 99-20 and Statement 115 needs to be addressed immediately. He said that the impairment model is problematic and that there are multiple impairment models with inconsistent triggers within U.S. GAAP and IFRS. Mr. Linsmeier asked why the impairment model in Issue 99-20 should be addressed immediately and not other impairment models. Mr. Golden stated that Issue 99-20 should be addressed immediately and has been specifically identified because Issue 99-20 is not an other-than-temporary impairment model even though it is an interpretation of Statement 115. Mr. Herz stated that Issue 99-20 is not being applied as an other-than-temporary impairment model.

33. Mr. Siegel asked if the Issue 99-20 model is not working because it is a bad model or because it is difficult to determine the proper fair value amount. Mr. Golden pointed out that the impairment model in Issue 99-20 does not allow for consideration of the ability and intent to hold to recovery. Mr. Smith asked if Issue 99-20 was written in such a way that whenever fair value is below cost, from a practical standpoint, there is viewed to be a credit impairment and an other-than-temporary impairment is taken. Mr. Herz stated that Issue 99-20 says that one should take a market participant's estimate of cash flows and compare it to the former estimate of cash flows; then measure whether the present value of those two things has changed using a constant interest rate. Practically, he said that if the fair value of the instrument decreases it ends up immediately defaulting to using fair value.

34. Mr. Linsmeier stated that he believes Issue 99-20 is being discussed because SEC Chairman Cox at the AICPA Conference suggested that the SEC views Issue 99-20 as an important area to examine in terms of impairment guidance. Mr. Linsmeier stated that he does not understand why impairment should be addressed in this isolated situation, especially considering that users are split on this issue. He said that he understands that some users see potential benefits to changing the Issue 99-20 impairment model to increase consistency. He stated that he is greatly concerned that the reason there is pressure to act on Issue 99-20 is that preparers are looking to avoid recognizing losses.

35. Mr. Linsmeier stated that he is willing to expose this proposal, but he wants to see in the comment letters that there really are economic circumstances that are being accounted for improperly as a result of not changing Issue 99-20. He stated that he remains skeptical of this proposal, but he is willing to expose this proposal because some users find it beneficial.

36. Mr. Smith stated that the Board has been supplied with information from preparers indicating their frustration with dealing with illiquid markets and determining fair values in such markets. He said that preparers have given the Board examples where the preparers' assessment of the individual credit risk does not correspond well with the values indicated by brokers or others. He stated that these preparers are then, as a result, forced to take charges for securities under the scope of Issue 99-20 that they otherwise would not recognize if the securities were within the scope of Statement 115. Mr. Smith said that these preparers do not believe there are credit losses embedded in these securities, which gives him pause about how Issue 99-20 is functioning with regard to impairment. He noted that the impairment models should not be different. Mr. Smith stated that he supports the staff recommendation to issue an exposure draft addressing practice issues with Issue 99-20, but he does believe there should be some specific questions in the exposure draft about whether an entity can assess the cash flows related to the individual items.

37. Mr. Siegel stated that users are not pushing for the change to Issue 99-20. He said that he is ambivalent about exposing this issue given that there seems to be mixed views from users, but he is not opposed to exposing this issue. However, Mr. Siegel pointed out that he would be concerned with a result where impairment losses are delayed by a quarter due to the issuance of the proposal.

38. Mr. Smith stated that if Issue 99-20 is changed, losses will still have to be recognized if losses are incurred similar to the Statement 115 other-than-temporary impairment model. He further stated that an adequate assessment will still be required and subject to audit. Mr. Linsmeier noted that it is highly likely that an instrument that was impaired

pursuant to Issue 99-20 is other-than-temporarily impaired pursuant to Statement 115 and this needs to be made clear in the proposal.

39. Ms. Seidman stated that the Board is being asked to remove a specific, nonconvergent impairment rule from the literature, which would seem to simplify GAAP and make it easier to explain the impairment trigger for securities to investors. She stated that the Board has heard anecdotally about certain types of beneficial interests where the underlying loans are fully performing according to the servicer, but they are being quoted at pennies on the dollar. She said that it seems the only way to remedy this situation is for the servicers and sponsors of these deals to provide full and timely disclosure of the composition and performance of the assets making up the pools, including information about collections, collateral values, defaults, foreclosures, modifications, etc. She stated that this would significantly reduce the uncertainty about the quality of these securities, and provide better information for all market participants, not just the servicers, to estimate fair value in the absence of trades. Ms. Seidman said that she did not think this is an issue for general purpose financial reports, but rather a market regulation issue. She stated that she read the recent report of SIFMA and the ASF, which includes an action plan for the industry relating to providing the initial and ongoing pool information, the creation of third party pricing sources, and several other constructive suggestions. She said that she would urge the industry and regulators to require these enhancements immediately, and broadly for all asset classes, so that the market knows where the losses are and also, where they are not.

40. Ms. Seidman stated that under any accounting approach to this issue, we will continue to stagnate in uncertainty until this information is provided to the markets. She said that other participants in the financial system can also take immediate action to significantly improve the quality of information provided to the markets and help bring consensus to the valuation of these instruments.

41. Ms. Seidman stated that she has very mixed feelings about this proposal, primarily because she fears it will be perceived as a pass on recognizing impairments for the fourth

quarter, which it is not, and then the issue will resurface as a fair value issue. She said that she wanted to stress that this change does not automatically lead to a different conclusion about whether an other-than-temporary impairment has occurred. She stated that entities will need to understand the assets that make up the pools underlying their beneficial interests, and be able to evaluate whether it is probable that they will collect the contractual cash flows and whether they can hold the security to recover the decline in value.

42. Ms. Seidman stated that she supports the staff's proposal, which is to expose an amendment to Issue 99-20 for comment, but that she looks forward to receiving comments about the need for these changes to occur in tandem with possibly voluntary (and hopefully mandatory) improved information about the assets in these securitized pools.

43. Mr. Herz said that he shares the same thoughts and concerns that his fellow Board members stated. He also said that he supports issuing an exposure document with proposed changes to Issue 99-20 that would bring the Issue 99-20 impairment guidance in line with the more generalized impairment model in Statement 115.

44. Mr. Herz stated that many constituents are complaining about differences in the impairment model between loans and securities. He said that it is important to remember accounting for impairments is not the only accounting situation with different accounting models. He also said that it is important to remember that the guidance for impairment models in loans and securities comes from the guidance in Statement 114 and Statement 115, respectively, which were developed concurrently in part as a response to the Savings & Loan crisis. Mr. Herz stated that part of the issue is that the amount of securitizations backed by loans has increased in the past few years and the structures have grown more complex. He said that since things have changed, it is important to take another look at the accounting for these transactions due to changed circumstances.

45. Mr. Herz stated that there are some people who feel that there should not be a difference in the impairment model between loans and securities, which is why this issue

needs to be addressed. He also said that there are differences in opinion as to which impairment model is the most appropriate. Mr. Herz stated that he does not believe the impairment model represents the underlying economics. He said that he sees usefulness in understanding what has happened to financial instruments in terms of market values in both current and projected cash flows. However, he said that he does not see significant value in some of the calculations that are done under impairment models which is an issue that is being addressed in the financial statement presentation project.

46. Mr. Herz stated that it seems that there is a problem with the application of Issue 99-20. He said that the fact that the same security can be treated differently depending on when the security was bought and its credit rating at the time it was bought does not seem appropriate. He stated that he believes the application of Issue 99-20 has largely resulted from the inability to separately isolate market participant cash flows which may result in the acceleration of losses that do not exist at the time. He said that there is some benefit to changing the Issue 99-20 impairment model to be more in line with the Statement 115 impairment model because it may force more of a focus on evaluating the underlying data to make assessments about cash flows, collateral, and so on.

47. Mr. Herz stated that Options A and B presented by the staff would better be addressed in the broader Financial Instruments project that was added to the Board’s agenda today. Mr. Linsmeier stated that Option C does not involve a corollary issue with the IASB which makes the Issue easier to address immediately.

Issue 1A: Approaches for Addressing the Practice Issues with Issue 99-20, Effective Date, and Comment Period

48. Mr. Trench stated that the staff believes that there are two approaches to address the practice issues with Issue 99-20:

a. **Approach 1—**Require that all debt securities (including beneficial interests) determine other-than-temporary impairments under Statement 115. That is, supersede Issue 99-20 in its entirety. Under this approach, beneficial interests previously in the scope of Issue 99-20 would be subject to SOP 03-3 for interest income recognition.

b. **Approach 2—**Amend paragraph 12b of Issue 99-20 to be consistent with paragraph 16 of Statement 115 by removing "market participants" and requiring that there has been a "probable" adverse change in estimated cash flows. In addition, a similar amendment would be required for paragraph 12a with regard to interest income recognition.

Issue 1A Staff Recommendation

49. Mr. Trench stated that the staff recommends Approach 2.

50. Mr. Trench stated the staff recommends that the guidance should be effective as of the last day of all interim and annual reporting periods ending after December 15, 2008 (that is, for periods beginning October 1, 2008), and applied prospectively.

51. Mr. Trench suggested a comment period of 10 days in order to issue the proposed changes to Issue 99-20 before earnings releases.

Issue 1A Board Vote

52. The Board decided to address practice issues with Issue 99-20 by making the impairment guidance in it consistent with Statement 115. That is, as in Statement 115, a decline in fair value below the amortized cost basis that is other than temporary would be recognized as a realized loss through earnings.

53. The Board noted that this change simplifies U.S. GAAP. However, the Board acknowledges that differences continue to exist between U.S. GAAP and IFRS with regard to the accounting for financial instruments and that a comprehensive project to address the complexity in reporting for financial instruments will address those differences.

54. The Board also decided that the guidance should be effective as of the last day of all interim and annual reporting periods ending after December 15, 2008, and applied

prospectively. In the first fiscal year that this FSP is applied, information related to quarterly interim periods that began on or before September 15, 2008, may be omitted. The Board also decided that the comment period for the exposure document should end on December 30, 2008. The Board expects to issue a proposed FSP on or around December 19, 2008, to allow for a comment period of approximately 10 days.

55. The Board asked the staff to proceed with a ballot draft for the proposed changes to Issue 99-20.

Issue 1A Board Comments

56. Mr. Smith stated that his concern with Approach 1 is that he would rather not deal with any unintended consequences of changing the scope of SOP 03-3 so he preferred Approach 2. Ms. Seidman agreed with Mr. Smith.

57. Mr. Linsmeier asked how the SEC guidance about what is high quality would be addressed under Approach 2. Mr. Golden said that the SEC guidance would not be relevant for impairment, but it would be relevant for interest income. Mr. Linsmeier stated he would prefer to eliminate Issue 99-20 but understood the challenges with changing the scope of SOP 03-3 in the limited timeframe.

58. Mr. Siegel and Mr. Herz stated that they agreed with Approach 2.

59. Ms. Seidman asked Ms. Smith whether she had spoken to users about transition. Ms. Smith responded that she had not. Ms. Seidman stated that she thinks it is odd to make a change like this in the 4th quarter because there would not be comparability of similar instruments in the same year. She said that the proposal should include a question to this effect.

60. Mr. Herz stated that he supports the transition suggested by the staff.

61. Mr. Linsmeier stated that he had concerns with only having a 10-day comment period. Mr. Golden stated that it would be difficult to have a longer comment period if the proposed changes to Issue 99-20 would be effective in the 4th quarter of 2008 because of the timing of press releases for major financial institutions.

Issue 2: Disclosures of Certain Financial Instruments

62. Mr. Trench stated that at the roundtable held on November 25, 2008, as well as through the staff's research, users acknowledged that disaggregating the incurred loss component from fair value-based impairment charges related to financial instruments would be useful information to be disclosed. He said that some users have observed that an incurred loss model does not necessarily equate to the credit loss component. However, with sufficient disclosure, users agreed that this information for financial instruments is helpful in understanding financial statements.

Scope

63. Mr. Trench stated that he would now discuss the scope and potential increased disclosures of certain financial instruments. He said that under U.S. GAAP, the accounting for financial instruments is encompassed in numerous pieces of accounting guidance. He stated that the goal of requiring disclosures is to provide comparable measurements for those financial instruments where an impairment analysis is necessary. Accordingly, Mr. Trench stated that financial instruments that are measured at fair value through earnings would not be included in the scope of the disclosures because these instruments reflect changes in fair value immediately in earnings. Examples of these financial instruments are debt and equity securities classified as trading under Statement 115 and securities or loans where the fair value option has been elected pursuant to Statement 159.

64. Mr. Trench stated that financial instruments that are subject to an impairment analysis that are not measured at fair value through earnings include debt and equity securities classified as held-to-maturity, debt and equity securities classified as available-for-sale, loans, and non-security receivables.

65. Mr. Trench stated that the staff believes there are two options regarding the type of disclosures for financial instruments. (Debt securities and loans are used in the options below. However, this is for illustrative purposes). Those options include:

a. **Option A—**Disclose the pro forma effects on earnings and shareholders' equity as if:

   i. All debt securities and loans were carried at fair value with changes in fair value through earnings.

   ii. All debt securities and loans were carried at the present value of expected future cash flows discounted at the debt security's or loan's original effective interest rate (consistent with Statement 114) with changes through earnings. In the instance where the debt security has a variable rate, the current interest rate would be used.

b. **Option B—**Same as Option A. In addition, disclose the valuation of debt securities and loans in the statement of financial position under the following heading:

   i. As reported in the statement of financial position

   ii. At fair value

   iii. Based on the present value of expected future cash flows discounted at the debt security's or loan's effective interest rate (consistent with Statement 114).

66. Mr. Trench stated that the Board has been provided with examples of how the disclosure would appear in the financial statements.

67. The following disclosures were included in the proposed FSP 107-a, "Disclosures for Certain Financial Assets", that was issued for exposure on December 24, 2008.

> An entity shall provide a comparison of measurement attributes for the financial assets noted in paragraph 8 in a tabular format under the following column headings:
>
> a. As reported in the statement of financial position
> b. At fair value
> c. At the incurred loss amount.

The incurred loss amount represents the reported or pro forma carrying amount of the investment under an incurred loss model. For loans and receivables, an entity shall disclose the reported carrying amount based on their existing accounting policies under Statement 114 and Statement 5. For debt securities classified as held-to-maturity and available-for-sale, an entity shall measure the incurred loss amount based on the present value of expected future cash flows discounted at the security's effective interest rate (consistent with Statement 114).

The line-item presentation of the financial assets in the table required in paragraph 10 shall be consistent with the line-item presentation of those financial assets in the entity's statement of financial position. In addition, debt securities accounted for under Statement 115 shall be presented in a manner consistent with the requirement to disclose information by major security type under Statement 115.

An entity also shall provide the following qualitative disclosures:

a. Its accounting policy for each type of financial asset in the table
b. The methodology used to estimate the key inputs used to measure the incurred loss amount (such as estimated cash flows), including any estimates of costs to sell the financial asset
c. To the extent known, a description of the factors causing the differences in measurements for each financial asset presented in the table.

For financial assets within the scope of this FSP, an entity shall disclose the pro forma income from continuing operations (before taxes) as if those financial assets were carried:

a. At fair value with changes in fair value recognized through earnings
b. At the incurred loss amount with changes recognized through earnings.

In addition, an entity shall disclose for comparison purposes the amount of income from continuing operations (before taxes) reported in the statement of income related to those financial assets.

To the extent possible, the disclosures required by this FSP shall be integrated with disclosures required by other accounting pronouncements to improve the cohesiveness of the disclosures and eliminate duplicate disclosures. For example, disclosures about inputs, assumptions, and methodologies used to estimate fair value that are required by Statement 107 and FASB Statement No. 157, *Fair Value Measurements,* would be most useful if they are presented together with the disclosures required by this FSP.]

68. Mr. Trench stated that regardless of the option chosen, qualitative disclosure is necessary to provide the basis for the measurement of the incurred loss. He said that this disclosure would include the entity's methodology for measuring the incurred loss, whether the incurred loss is on an instrument-by-instrument basis or an aggregation of common instruments, and the key inputs used to measure the incurred loss including any estimates of costs to sell.

69. Mr. Trench stated that earlier in the day, the IASB discussed disclosures that are similar to those proposed by the staff. He said that the IASB expressed mixed views about what should be disclosed. He stated that the IASB wanted the benefit of hearing the FASB's deliberations before they proceeded with a discussion about disclosures for certain financial instruments. Mr. Trench stated that an additional disclosure suggested at the IASB meeting was related to the disclosure of the balance sheet amount as reported at fair value and the Statement 114 (incurred loss) amount. He said that it was suggested that the incurred loss amount be removed and replaced with a column for the pro forma amortized cost impairment and a column for the pro forma fair value impairment with the fair value impairment done under available-for-sale guidance. He stated that the available-for-sale approach seems problematic because impairment guidance would have to be applied to loans that it had not been applied to previously. Mr. Herz said that as he understood it, the goal of the disclosure table was to present the columns on a consistent basis because the different accounting literature requires different measurement attributes.

70. Mr. Trench stated that another area the IASB discussion focused on was the effective date of the guidance and whether the effective date should be required for the first quarter 2009.

71. Ms. Seidman stated that the only new number being suggested by the FASB staff is the incurred loss amount on debt securities. She said that she is not sure how much work would be involved in calculating this number. Mr. Trench noted that several IASB members had similar concerns.

72. Mr. Linsmeier pointed out that the incurred loss amount was characterized by Mr. Trench as being a Statement 114 incurred loss approach and that an incurred loss approach under generally accepted accounting principles is different. Ms. Seidman pointed out that it should be the incurred loss under generally accepted accounting practices because she did not want to require a new incurred model for those financial assets not measured using a Statement 114 incurred model. However, Ms. Seidman noted that for debt securities, a Statement 114 incurred model would be required. Mr. Herz stated that if there are no incurred losses than the amortized amount is disclosed.

Issue 2 Staff Recommendation

73. Mr. Trench stated that the staff recommends Option B. He further stated that the staff recommends an effective date and transition for fiscal years ending after December 15, 2008, and interim periods within that fiscal year.

74. Mr. Trench stated that the staff recommends a 20-day comment period ending around January 15, 2009.

Issue 2 Board Vote

75. The Board agreed to require enhanced disclosures about the impairment of:

a. Debt securities classified as available-for-sale
b. Debt securities classified as held-to-maturity
c. Loans
d. Long-term receivables.

76. The Board decided that for those instruments within the scope of this project, an entity should disclose:

a. The pro forma effects on pretax net income as if the instruments were (i) carried at fair value and (ii) measured based on the incurred loss
b. The amount of the instruments reported in the statement of financial position and the amounts that would have been reported had they been measured:
    i. At fair value
    ii. On a historical cost basis using an incurred loss method of measuring impairment
c. Qualitative disclosures including the valuation methodologies and factors resulting in the differences among the three measures of the instruments' value.

77. The Board decided that an entity should provide the disclosures in financial statements for fiscal years ending after December 15, 2008, and for quarterly interim periods within those fiscal years. In the first fiscal year that this FSP is applied, the disclosures may omit information related to quarterly interim periods that began on or before September 15, 2008. The Board decided that disclosures are required only for the current reporting period. The Board further decided that the comment period for the exposure document should end on January 15, 2009. The Board expects to issue a proposed FSP on or around December 23, 2008, to allow for a comment period of approximately 20 days.

78. The Board asked the staff to proceed with a ballot draft for the proposed disclosures for certain financial instruments.

Issue 2 Board Comments

79. Mr. Linsmeier stated that the notion about current value and long term value was suggested at the SEC Roundtables. He said that in this down market, the current value might represent a worst case scenario and an incurred loss model might represent a best case scenario and this may change under different markets. He stated that qualitative disclosures about the inputs for incurred loss amounts and the inputs for fair value might help users better understand what judgments are being made and allow them to contrast the different inputs to the measurements. Ms. Seidman asked about what would be disclosed about the inputs for the incurred loss amount to add clarity for users. Mr. Herz

suggested encouraging preparers to give any information about the two suggested additional disclosure columns (one fair value column and one incurred loss column) that might be helpful to users. He said that it might be helpful to require preparers to provide information on the differences between those two disclosure columns. Ms. Seidman suggested a disclosure table that at a minimum has the same line items as the Statement 157 disclosure table and that loans could be dealt with separately (since they are probably not included in the Statement 157 table).

80. Mr. Golden asked if the Board wanted to make a decision about disclosures contingent upon the IASB agreeing with the FASB or if the FASB wanted to make a decision to move forward with disclosures irrespective of the IASB decision. Mr. Smith stated that the FASB could issue an exposure document on disclosure for certain financial instruments independently of the IASB. Mr. Stoklosa stated that the IASB wanted to understand whether additional disclosures on certain financial instruments would improve investor confidence. He said that this is something the IASB wanted to determine before moving forward with these disclosures on a short-term basis. Mr. Stoklosa stated that several of the IASB members concluded that the additional disclosures on certain financial instruments would not improve investor confidence because the desire for these disclosures is preparer driven. He noted that some Board members of the IASB suggested that the disclosure be optional for year end and required in the first quarter 2009. Ms. Seidman stated that preparers wanted recognition of impairments based on an incurred loss model and the proposed disclosures were a compromise.

81. Mr. Siegel stated that right now there is a disconnect between what the market thinks and the price to book. He said that the objective of these disclosures is to provide information to have a robust discussion between the investors and the companies about those issues. He stated that it would be helpful for users to have the information on a fair value basis and an incurred loss basis. Mr. Linsmeier stated that it would be very useful to have information discussing the primary reasons driving the differences between the fair value amount and the incurred loss amount. He said that investors clearly favor fair value, but investors also understand that fair value might be the lower bound at this point

and they might want to understand what the differences are between the lower bound and the upper bound.

82. Mr. Siegel stated that he preferred Option B because additional disclosures for loans are necessary. Ms. Seidman stated that fair value disclosures about loans are already required at least annually under Statement 107. Mr. Stoklosa stated that the information about loans is already available, but Option B would require the information all in one place. Mr. Smith said that from a practical standpoint, the additional work for preparers is to calculate the incurred loss model for available-for-sale securities and held-to-maturity debt securities.

83. Mr. Herz stated that preparers would prefer the incurred loss model be recognized in the financial statements and not just disclosed. Mr. Linsmeier stated that investors value the incurred loss model in disclosures.

84. Mr. Smith asked if the disclosure proposals could be considered on a pre-tax basis. He said that this approach allows companies to not have to deal with any pro forma tax situations. Ms. Seidman agreed with Mr. Smith. Mr. Linsmeier proposed that a question be asked about having disclosures pre-tax or net of tax.

85. Mr. Golden stated that the scope of the disclosures would include loans, debt securities that are available-for-sale securities, and debt securities that are held-to-maturity securities, but trading securities are not in the scope of the disclosures. Mr. Linsmeier added that long-term receivables should be included as well. Ms. Seidman clarified that loans held for sale should not be included.

86. Mr. Golden asked if the Board supported Option B using pre-tax earnings with a question about including disclosures about pro forma net income and shareholders' equity. The Board supported Option B with pre-tax earnings.

87. Mr. Herz asked if the qualitative disclosures should include "to the extent known" language about why securities are valued the way that they are valued. Mr. Golden stated that some companies may have difficulty explaining the difference between a fair value

measure and an incurred loss measure in the current market. Ms. Seidman stated that she is not in favor of including the "to the extent known" language.

Issue 3: Recoveries of Other-Than-Temporary Impairments (Reversals)

88. Mr. Trench stated that the staff will discuss with the Board whether to move forward with guidance on allowing for the recovery through earnings of an other-than-temporary impairment when evidence exists that a loss has reversed. He said that under current U.S. GAAP, when an other-than-temporary impairment has been identified, a loss is recognized in earnings for the difference between the cost of the security and its fair value. He stated that the fair value becomes its new cost basis from which future other-than-temporary impairments are determined.

89. Mr. Trench stated that the staff believes that the consideration for the scope should be based on certain investments in securities as described in Statement 115. Accordingly, he said that the scope could be based on the type of security, the classification of the security, or a combination of the type and classification of a security. The following are the potential options Mr. Trench provided:

a. **Option X—**All debt securities classified as held-to-maturity and available-for-sale

b. **Option X'—**All debt securities classified as available-for-sale

c. **Option Y—**All debt securities classified as held-to-maturity and available-for-sale and all equity securities classified as available-for-sale

d. **Option Y'—**All debt and equity securities classified as available-for-sale.

90. Mr. Trench stated that the discussion that follows is premised on the observation that once an other-than-temporary impairment has been recognized in earnings, a reversal of that impairment charge may occur under certain circumstances. Further, he said that the reversal of the impairment charge through earnings cannot exceed the amortized cost of the security. He stated that the staff believes that the issue for deliberation is the

approach by which the reversal is accomplished once an impairment charge has been recognized in earnings. Mr. Trench stated that two potential approaches are:

a. **Approach 1—**The security is accounted for at the lower of cost or fair value until the amortized cost is recovered.

b. **Approach 2—**The security continues to be subject to the existing other-than-temporary impairment guidance. However, to the extent that a recovery in an impairment loss has occurred and there are currently no unrealized losses associated with that security in other comprehensive income, a recovery of the impairment loss would be recognized in earnings. Therefore, under this method, a security that has been impaired also can have unrealized gains and losses in other comprehensive income. Additional impairment losses are only recognized when they are determined to be other-than-temporary.

Issue 3 Staff Recommendation

91. Mr. Trench stated that the staff recommends that the Board consider allowing the recovery through earnings of an other-than-temporary impairment when evidence exists that a loss has reversed. The staff believes that requiring write-downs of a security but not allowing recoveries represents a conservative bias. However, at this time, the staff recommends that the FASB work together with the IASB to ensure consistency with IFRS guidance. In addition, the staff does not believe it is necessary to resolve this issue for year-end 2008.

Issue 3 Board Vote

92. The Board decided to consider whether an entity should be permitted to reverse, through earnings, a previously recognized other-than-temporary impairment loss when evidence exists that a loss has reversed. The Board also decided that the scope of the project includes all debt securities classified as held-to-maturity and available-for-sale. The Board decided to coordinate such a change with the IASB to ensure the consistency of accounting standards internationally.

Issue 3 Board Comments

93. Mr. Trench stated that under existing IFRS guidance, reversals are allowed for debt securities, but not for equity securities and those reversals are subject to objective evidence that there has been a recovery. Mr. Stoklosa stated that the IASB thought that further guidance on reversals should be dealt with in the comprehensive financial instruments project.

94. Mr. Smith stated that the IFRS model for loss impairment for held-to-maturity securities is a different model. Ms. Seidman stated that she had concerns with rushing guidance about reversals because she was concerned about the scope. She said that she would like to see some examples of Approach 2.

95. Mr. Smith stated that this project is not for this year-end, so a decision did not need to be made about Approach 1 or Approach 2 at this meeting. He said that he was in favor of Option X for the scope. Ms. Seidman, Mr. Linsmeier, and Mr. Siegel also said that they were in favor of Option X for the scope.

Issue 4: Clarification of the Embedded Credit Derivative Scope Exception in Paragraph 14B of Statement 133

96. Mr. Wilkins stated that Statement 155, among other things, added paragraphs 14A and 14B to Statement 133. Paragraph 14A indicates that a holder of an interest in securitized financial assets should assess whether the interest is a derivative in its entirety; if not, the holder should assess whether the interest contains an embedded derivative feature that warrants bifurcation and separate accounting under paragraphs 12 and 13 of Statement 133. Paragraph 14B added a scope exception to the application of paragraphs 12 and 13 with respect to concentrations of credit risk in the form of subordination of one financial instrument to another.

97. Mr. Wilkins noted that some constituents have interpreted the first sentence of paragraph 14B of Statement 133 as an expansion of the scope exception to **all** embedded credit derivatives; such a broad application exceeds the original intent of the Board and is not supported in the basis of conclusions of Statement 155.

Issue 4 Staff Recommendation

98. The staff recommended that modifications be made to paragraph 14B of Statement 133 to be consistent with what the staff believes were the Board's original intentions when issuing Statement 155. The staff recommended that the Board resolve any ambiguities and inconsistencies in the guidance by making changes to Statement 133 as follows:

a. Delete the first sentence in paragraph 14B of Statement 133.

b. Revise paragraph 200D of Statement 133 to make the rationale for Example 38's conclusion consistent with the remaining sentence in paragraph 14B. In particular, the revision would clarify that the scope exception does not apply to the scenario in the example because the embedded derivative is not a concentration of credit risk related to subordination.

99. Mr. Wilkins stated that the staff proposes providing this guidance in the form of a Statement 133 Implementation Issue. In addition, the staff recommended adding two examples to the guidance that illustrate a partially funded embedded CDO. Mr. Wilkins noted that the European Commission's understanding of the current U.S. GAAP guidance, as expressed to the IASB, is another indication that clarification of this issue is needed.

100. Mr. Wilkins stated that the staff believes that two approaches to the effective date and transition should be considered: (a) a prospective approach akin to that for Statement 155 and (b) an immediate-application-to-existing-contracts-without-restatement approach akin to that for Statement 133. He said that the immediate-application-to-existing-contracts-without-restatement approach would be consistent with the general approach for Implementation Issues. The staff recommended the immediate-application-to-existing-contracts-without-restatement approach.

101. Mr. Wilkins noted that unless the Board instructs otherwise, DIG Issue K5 directs the FASB to issue DIG Issues between the sixth and tenth of the month in order to allow

time for entities to apply the new guidance. He noted that Issue K4 is based on the presumption that the effective date of the guidance will be the first day of the entity's first fiscal quarter following the posting of the cleared guidance.

102. Mr. Wilkins stated that the staff recommends providing entities with the opportunity to elect the fair value option. He noted that some companies may wish to elect the fair value option instead of bifurcating the embedded derivative.

103. Mr. Wilkins recommended allowing at least 30 days for the comment period. He noted that the final guidance would likely be issued in March.

Issue 4 Board Vote

104. The Board decided that FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, should be amended as follows:

a. Delete the first sentence of paragraph 14B to clarify that the scope exception for embedded credit derivatives applies only to the concentration of credit in the form of subordination of one financial instrument to another

b. Revise examples from Statement 155 and provide additional examples to clarify application of the scope exception.

105. The Board decided that this guidance and amending language will be provided as a Statement 133 Implementation Issue.

Effective Date, Transition, and Comment Period

106. The Board decided that the guidance should be effective for fiscal quarters beginning after December 15, 2008. Upon adoption of the guidance, an entity should assess only those preexisting contracts that were acquired or issued on or after the date of each reporting entity's adoption of Statement 155, determining whether any of those contracts contain one or more embedded credit derivatives that, under the revised paragraph 14B, would no longer qualify for the scope exception in that paragraph. The provisions of paragraphs 12, 13, and 14A should be applied to such contracts at the date

of adoption of the guidance to determine whether the embedded credit derivative feature is required to be separated from the host contract and accounted for separately.

107. At adoption, any difference between the total carrying amount of the individual components of the existing bifurcated hybrid financial instrument and the carrying amount of the combined hybrid financial instrument prior to the bifurcation should be recognized as a cumulative-effect adjustment to beginning retained earnings. An entity should separately disclose the gross gains and gross losses that make up the cumulative-effect adjustment, determined on an instrument-by-instrument basis. Prior periods should not be restated.

108. Further, the Board decided that if a contract is required to be separated into a host contract and a derivative instrument at adoption of the Implementation Issue and if the contract is a hybrid financial instrument, the entity may irrevocably elect to initially and subsequently measure that contract in its entirety at fair value (with changes in fair value recognized in earnings). The Board also decided that the fair value election should be determined on an instrument-by-instrument basis and supported by documentation completed by the end of the fiscal quarter of initial adoption.

109. The Board decided that the proposed Statement 133 Implementation Issue should be exposed for a comment period ending no earlier than February 6, 2009.

Issue 4 Board Comments

110. Ms. Seidman stated that to better align with the existing examples and the proposed new examples, the rationale in Example 38 of Statement 133 should state that the example does not involve a subordination (or "waterfall") issue. The proposed new examples may involve scenarios for which there appears to be waterfall issues; however, an embedded derivative may fail to qualify for the exemption not due to a waterfall issue, but rather due to the fact that the beneficial interest holders could potentially be required to make payments. Ms. Seidman stated that the use of consistent logic throughout the multiple examples will enable constituents to better understand how to determine when the scope exception does and does not apply.

111. Mr. Wilkins noted that Example 37 in Statement 133 also makes reference to the concentration of credit risk in the form of subordination, but does not refer to the necessary cash flows notion that is in the sentence being deleted from paragraph 14B. Thus, no change to Example 37 is necessary.

112. Mr. Wilkins noted that the focus of the proposed guidance is the scope exception in paragraph 14B rather than the determination of the outcome of the analysis under paragraphs 12, 13, and 14A. He stated that providing guidance about what is clearly and closely related is **not** the intent of the proposed guidance; the intent of the proposed guidance is to clarify that there is a single criterion for the scope exception, and that criterion relates to the concentration of credit risk related to the subordination.

113. Ms. Seidman proposed the following scenario: A trust holds treasury notes of $100 million and purchased a credit derivative with a notional of $100 million based on Company X. The trust issues one class of beneficial interest that is a $100 million note tied to the credit risk of Company X. Ms. Seidman asked if there is an embedded derivative in the beneficial interest that needs to be accounted for separately. Mr. Stoklosa replied that there probably would not be an embedded derivative that needs to be accounted for separately. Ms. Seidman agreed with Mr. Stoklosa's conclusion, and stated that it is important that the proposed guidance is written in a manner that will lead constituents to the same conclusion.

114. Mr. Linsmeier stated that he thinks it is very important to look through structures to answer this embedded derivatives question; however, he believes that looking through the assets within a structure to find the accounting for the claims into the structure is **not** something that should be extrapolated to the general accounting model. Mr. Herz stated that this is an issue related to hiding derivatives and Ms. Seidman agreed. Mr. Linsmeier stated that this is a unique thing being done to deal with the embedded derivative conundrum. Ms. Seidman stated that the proposed guidance should be worded carefully to avoid setting a precedent.

115. Mr. Herz noted his understanding that the use of these structures to synthetically create written default swaps is more prevalent in Europe. Mr. Stoklosa replied that he is

not sure whether these structures are more prevalent in Europe, but he noted that the structures **are** common in the U.S. Mr. Herz asked who would have to make disclosures under Statement 161. Ms. Seidman responded that the variable interest holder would have to make the disclosures.

116. Mr. Herz asked if the Board agreed with the need to clarify this issue. Mr. Smith, Ms. Seidman, and Mr. Siegel agreed that there is a need to clarify this issue. Mr. Linsmeier stated that he views the proposed changes as a correction. Mr. Smith and Mr. Herz view the proposed changes as a clarification.

Effective Date and Transition

117. Mr. Smith commented that the accounting outcome under the proposed effective date and transition would be as if Statement 155 had originally included the proposed guidance.

118. The Board supported including a fair value option in the proposed guidance. Ms. Seidman clarified that the fair value option would be retroactive to the beginning of the period.

119. Ms. Seidman clarified that if an entity is required to recognize an embedded credit derivative under the proposed guidance, where the entity had not previously recognized an embedded credit derivative, then the cumulative effect adjustment is the difference between any impairment previously taken and the new mark-to-market on the credit derivative. Ms. Seidman noted that the company would be required to provide disclosures about the cumulative effect adjustment.

<u>Follow-up Items:</u>

None.

<u>General Announcements:</u>

None.