MINUTES

Financial Accounting
Standards Board

To: Board Members

From: Fair Value Option Team
(Cronin, ext. 443; Cowan, ext. 233)

Subject: Minutes of the June 19, 2006—Fair Value Option Roundtable for Phase 1

Date: July 6, 2006

cc: Bielstein, Smith, MacDonald, Leisenring, Allen, Fair Value Option Team, Fair Value Measurements Team, Gabriele, Polley, Swift, Sutay, Carney, FASB Intranet

Topic: Roundtable for Phase 1

Basis for Discussion: Proposed FASB Statement, *The Fair Value Option for Financial Assets and Financial Liabilities*

Length of Discussion: 8:00 a.m. to 12:00 p.m.

Attendance:

Board members present: Herz, Batavick, Crooch, Schipper, Seidman, Trott, and D. Young

Moderator: Seidman

Other staff at Board table: L. Smith, Wilkins, Lott, Barker, Lusniak, Cowan, and Cronin

Outside participants: See list in Exhibit 1

Summary of Decisions Reached:

No decisions were made.

Objective of Meeting:

The objective of the roundtable was to provide information to assist the Board in its redeliberations of the proposed FASB Statement, *The Fair Value Option for Financial Assets and Financial Liabilities*. The objective was met.

<u>Matters Discussed</u>:

Introduction

1. Ms. Seidman began the roundtable discussion by explaining that the participants are not being asked to state their overall views on the proposed Statement. She noted that the Board members have read all the comment letters and that the general views of respondents have been summarized in the staff's comment letter analysis, which is available on the FASB website. Ms. Seidman stated that the purpose of the roundtable discussion is to focus on specific points about which Board members want more information.

Scope Issues

2. Ms. Seidman explained that the scope issues would be discussed in three subcategories:
   a. Comments on the proposed exclusions
   b. New exclusions recommended
   c. New inclusions recommended.

Scope Exclusions

3. To begin discussions on exclusions, Ms. Seidman asked Mr. E. Smith and Mr. Tejerina to further explain their responses on exclusions noted in their comment letters.
4. Mr. E. Smith stated that Credit Suisse believes that the scope of the proposed Statement should include all financial assets and liabilities, including leases. Mr. E. Smith clarified that Credit Suisse's belief that recognized leases be included in the scope of the fair value option is a conceptual point rather than based on its business needs. He further commented that the scope issue regarding leases should not be allowed to delay issuance of a final Statement on Phase 1. Mr. Tejerina stated that the accounting for leases is already complicated and should not be further complicated by including them in the scope of the proposed Statement. He further stated KPMG's belief that the Board should clarify paragraph 4(c) to explicitly exclude lessors' recognized assets related to sales-type, direct-financing, and leveraged leases.

New Scope Exclusions—Equity Method Investments

5. Ms. Seidman began the discussion of items that respondents believe should be excluded from the scope of the proposed Statement by asking Mr. Beier to share PwC's view on equity method investments. Mr. Beier explained that companies typically take a minority position in a company for two reasons: (a) as an investment (for purposes of potential capital appreciation) and (b) as a strategic move. He stated that the relevance and reliability of reporting on equity method investments can differ depending on the reason that the company acquired the minority position. Mr. Beier stated that some strategic investments are held for a long period of time and are difficult to value because of the absence of market observable inputs. In the situations where the fair value is not readily determinable, PwC believes that reliability is more important than reporting the equity method investment at fair value. Because of this belief, he explained that PwC recommended that equity method investments made for strategic purposes that would be valued using level 3 inputs (as discussed in the fair value measurement project) should be outside the scope of the proposed Statement.
6. In response to Mr. Beier's comments, Mr. Trott expressed his view that such an exclusion would introduce unnecessary complexity. Mr. Trott stated the optionality of the proposed Statement would deal with the problem described by Mr. Beier. That is, companies would report equity method investments at fair value or under the equity method depending on which alternative would provide the best information. Ms. Schipper asked Mr. Beier (a) whether he would apply management intent regarding trading versus investment more broadly and (b) whether his concern regarding reliability applies to nonequity investments. He responded that he does not favor applying such management intent more broadly and indicated that, for equity method investees, there is a wide range of possible fair values when no readily determinable fair value exists. Ms. Seidman observed that Mr. Beier's suggestion is similar to the approach described in the forthcoming AICPA Statement of Position that would clarify the scope of the AICPA Audit Guide on investment companies.

7. Mr. S. Young expressed concerns about the application of APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, to securitization interests, noting that such interests differ from investments made for capital appreciation purposes. Ms. Dealy stated that Morgan Stanley had several equity method investments where Morgan Stanley viewed itself as a passive investor holding the investments primarily for capital appreciation. She explained that these investments would be marked to market because fair value is a better measure. She also stated that Morgan Stanley had strategic joint ventures for which the fair value option would not be elected.
8. In response to a question on valuing equity method investments from Mr. Herz, Ms. Dealy stated that calculating fair values for equity method investments can be difficult and complex, but that the difficulties and complexities were not unique to equity method investments.
9. Mr. Bukspan noted that all companies will not report equity method investments in a way that makes the most sense, a point that has been illustrated through experience with FASB Statement No. 87, *Employers' Accounting for Pensions*, and FASB Statement No. 123, *Accounting for Stock-Based Compensation*. He stated that Standard & Poor's Rating Services' (Standard & Poor's) main concern was comparability among companies. Mr. Bukspan stated that broadly speaking, investments that are managed at fair value are more like securities subject to FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, than an equity method investment, even if they qualify for equity method accounting.
10. Ms. McEnally stated that the CFA Institute believes that equity method investments should be in the scope of the proposed Statement, that such investments should be measured at fair value, and that similar or identical transactions should be reported in a consistent manner. She further stated that the CFA Institute does not believe that management's intentions should be considered in recognition or measurement of any items in the financial statements. Mr. E. Smith stated that making a distinction based on strategic

versus investment intent is problematic because strategic is not well defined in the literature. Further, Mr. E. Smith said that he was concerned with basing any approaches on reliability levels in accounting guidance that is not yet finalized (for example, the fair value measurements project).

New Scope Exclusions—Insurance Contracts

11. Ms. Seidman asked Mr. Yanosy to comment on The Hartford Financial Services Group's (The Hartford) view regarding insurance contracts. Mr. Yanosy stated that most insurance contracts meet the definition of a financial liability, and he believes that it is fairly clear which contracts would be in the scope of the proposed Statement.
12. Mr. Valoroso disagreed with Mr. Yanosy's assertions and stated that there are too many issues regarding insurance that need to be resolved before the Board should include them in the scope of a fair value option. Mr. Spataro agreed with Mr. Valoroso's comments. Mr. Spataro stated that many insurance contracts are settled with goods or services and the method of settlement is not entirely clear in all contracts. He stated that the significant nonfinancial components contained in insurance contracts warrant a scope exception from Phase 1 of the fair value option project. In response to a question from Mr. Trott, Mr. Spataro indicated that even life insurance contracts have significant nonfinancial components and could not serve as a class of insurance contracts that could easily be included in the scope of Phase 1.
13. Mr. Schroeder noted that Goldman Sachs Group was particularly interested in reinsurance contracts being within the scope of the fair value option. He noted that most of the contracts are cash settled and are based on a different underlying but are very similar to commodities and other items. He further noted that many areas have difficult valuation issues, but that the issues can be understood and addressed.
14. In response to a question from Mr. Crooch, Mr. Spataro indicated that the value of insurance contracts can be determined by the cost to reinsure them or the cost associated with the contracts in a business combination. However, he further explained that the difficulty in applying the fair value

option is the need to continually remeasure the contracts at fair value without the presence of transactions. Mr. Spataro asserted that the significant nonfinancial components and subjectivity associated with hypothetical scenarios used to determine fair values of insurance contracts impede the reliability to a point that it is no longer relevant.

15. Mr. Yanosy stated that as an entity that manages the assets and liabilities at fair value, The Hartford acknowledges the difficulty involved in measuring insurance contracts at fair value, but it believes that fair value is critical information that should be known and provided. Mr. Spataro noted that the IASB was currently working on a project to determine whether fair value really is the most relevant measure for insurance contracts. He further explained that cost and complexity were not the only issues being considered; stating that the IASB was unsure whether hypothetical values provided the best information.
16. Mr. Yanosy noted that FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, also uses valuation (that is, embedded value) for disclosure. Mr. Spataro noted that European insurers have said that embedded value would not be the best measure. Mr. E. Smith explained that many people are valuing morbidity and mortality risk and that the market for such items is developing everyday.
17. Mr. Valoroso stated that there are too many issues with insurance contracts. For example, what should happen with premium accounting? He explained that including insurance contracts within the scope of Phase 1 of the fair value option seems premature given the activities that the IASB and FASB have currently evaluating insurance. Mr. Valoroso asserted that if the FASB acts now, it may bias the decisions and activities undertaken by the two Boards as they reevaluate accounting for insurance, which could ultimately lead to a suboptimal decision. Mr. Beier noted that, because of its optionality, the fair value option may be a good way for practice to develop ways to deal with insurance contracts as an intermediate step to requiring fair value measurement of insurance contracts.

New Scope Exclusions—Reliability Concerns

18. Ms. Seidman noted that several respondents to the Exposure Draft mentioned concerns about the reliability of fair value measurements. She asked Mr. Holm to articulate some of the concerns that the Federal Reserve had regarding reliability.

19. Mr. Holm stated that if a reliable fair value calculation cannot be made, it is not relevant. He asserted that the Board could determine the scope of the fair value option based on a criterion of reliability of the fair value measure using the current fair value measurements framework. That is, if the range of fair values is wide, do not allow the fair value option. Mr. Holm noted that the fair value option provided in international accounting standards limits what items could be considered eligible. He further noted that regulators have encountered problems in the past when companies have used fair value measurements.

20. Mr. S. Young stated that he had a different perspective than the regulators. He explained that many parties focus on marking assets up and do not consider that the fair value option requires that assets be marked up and down. When a company is marking something to fair value, that measurement forces the entity to focus harder on the investments and how they are managed, which can actually lead to better decisions.

21. Mr. Kispert explained that Ernst & Young was concerned that the future use of fair value may be impacted if the fair value option results in bad experiences with fair value measurements. For example, significant diversity in difficult areas may emerge and hurt the future use of fair values. The scope of Phase 1 should be anchored on the scope of FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments,* which excludes certain items on the basis of valuation difficulties.

22. Ms. McEnally stated that the CFA Institute believes relevance trumps reliability, but that it also acknowledges the difficulty involved in measuring at fair value. She further stated that the CFA Institute believes those difficulties can be addressed through appropriate disclosures. Ms. McEnally explained that if users are provided with information about the methods and

assumptions that management uses, they can make adjustments and decisions according to their own judgments. Ms. McEnally reiterated the CFA Institute's belief that all items should be measured at fair value and other issues should be handled through disclosures.

23. In response to Mr. Trott's question regarding what in the banking world would be difficult to measure at fair value, Mr. Storch stated that some financial institutions had incorrectly measured residual interests in securitizations, which resulted in expensive failures. Mr. Storch explained that part of the Federal Deposit Insurance Corporation's (FDIC) concern is the range of fair values that can be calculated and the level of sophistication of different financial institutions as it relates to their ability to measure items at fair value. He stated that there is a larger concern with broad ranges of fair values and a bias to report in an advantageous manner. For example, report a liability at the low end of a wide range of fair values. Mr. Storch explained that those situations present regulators with a significant challenge since it is difficult to question the fair value measures because of the subjectivity involved. Mr. Geer agreed with Mr. Storch and added that the fair value option effectively gives entities a license to engage in those types of activities. He explained that examining items with wide ranges of fair value measurements is expensive and time consuming for the regulators.

24. Mr. Holm asserted that many people assume that financial instruments are easy to measure at fair value. Mr. Holm questioned how reliable such measures are and suggested that the Board research the reliability of fair value measures for financial instruments and develop a principle for determining reliability.

25. Ms. Schipper asked Mr. Storch if there was something particular to fair value measurements that caused reliability concerns as opposed to other areas, such as the allowance for loan losses. Mr. Storch responded that the FDIC is concerned about loan losses too, but that the staff of the FDIC has significant experience with loan losses and requires the use of estimates that are based on supportable and verifiable assumptions. Mr. Valoroso asserted that reliability and scope issues are interconnected. He stated that practitioners

and auditors are not particularly adept at fair value issues and because of this reality it is too soon to permit such broad application of fair value.

26. In response to a question by Mr. Batavick, Mr. S. Young stated that there was a lot of learning to be done in the area of fair value measurements. Mr. S. Young explained that a company's ability related to fair value depends on the frequency with which they use fair value and deal with it. He asserted that there is value in allowing companies to learn, develop skills, and evolve toward fair value through the use of a fair value option. Mr. Spataro stated that standardization should be looked at separately from relevance and reliability. He further stated that relevance and reliability are not necessarily mutually exclusive characteristics. He believes that a minimum level of reliability is needed before a fair value can be relevant.

27. Mr. E. Smith asserted that some loans are easier to measure at fair value than under FASB Statement No. 5, *Accounting for Contingencies,* clarifying that *fair value* does not necessarily mean more difficult. Mr. Valoroso responded by stating that there is a range of difficulties. Mr. E. Smith agreed but noted that private equity investments contained similar difficulties and are being reported by banks, insurance companies, and others at fair value currently.

28. Mr. Herz noted the difficulty in using fair value when many companies and professionals still need to develop the knowledge and skills required. He stated that prescribing detailed rules and restrictions on the use of fair value is an alternative approach that can be taken. Mr. Herz also noted that fair value is generally acknowledged as the way forward in financial reporting. The main issue is choosing the path to get there. He hypothesized that perhaps the banking regulators should tell banks that the fair value option cannot be elected until certain skills are developed.

New Scope Inclusions—Demand Deposit Accounts (DDAs)

29. Ms. Seidman asked Mr. Storch to express the FDIC's sentiments regarding DDAs. Mr. Storch stated that the FDIC was concerned about the nonfinancial components and about unit of account issues of DDAs. He stated that the primary concern was whether the intangible should be included, and he

believes that the Board should clarify what types of deposit liabilities are DDAs. Mr. S. Young stated that he agrees with Mr. Storch that DDAs are difficult to value, but because of the importance and size they are also an important area to address.

30. Mr. Holm stated that the Federal Reserve was mainly concerned with reliability surrounding fair value measurements of DDAs. He stated that there are too many issues to resolve to include DDAs within the scope of Phase 1. Mr. Geer stated that the Office of Thrift Supervision (OTS) has used a fair value model for DDAs for 13 years and it is consistently a point of contention with the financial institutions. Ms. Bloomer expressed concern about unit of account issues and DDAs. She explained that it was uncertain how the contract-by-contract election requirement would impact portfolio valuations. Ms. Bloomer also explained that Deloitte & Touche did not see the reason for excluding DDAs from the scope of Phase 1 when insurance contracts and equity method investments are included in the scope. Mr. Beier stated that because of the optionality of the proposed Statement, PwC supported including DDAs in the scope of Phase 1. If an institution is capable of accounting for DDAs at fair value, then it should have the option.

New Scope Inclusions—Written Loan Commitments

31. Ms. Seidman explained that loan commitments were intended to be addressed in the second phase of the project because of certain embedded nonfinancial components. She asked Ms. Lynn to comment on including written loan commitments in Phase 1 of the fair value option project. Ms. Lynn asserted that it was important to include written loan commitments because they are an important part of credit risk hedging activities. In response to a question from Ms. Schipper, Ms. Lynn explained that most loan commitments would likely be in level 2 of the fair value hierarchy but that some would also be in levels 1 and 3. Mr. Schroeder stated that Goldman Sachs Group supported all commitments being included in the scope of Phase 1, but that if there were significant concerns about the servicing intangible assets Goldman Sachs Group would also support removing mortgage loan commitments from Phase 1 and including them in Phase 2.

32. Mr. D. Young asked Ms. Lynn if she supported the fair value option for items that are in level 3 of the fair value hierarchy. Ms. Lynn explained that she did not think the fair value option should be restricted by level and further explained that most loan commitments would not be in level 3 and commitments that would be in level 3 are not as likely to be hedged. In responding to a question from Mr. D. Young about the business purpose of using the fair value option for level 3 loan commitments that are not going to be hedged, Mr. S. Young stated that it would make sense if the loan commitment was part of a trading business that would ultimately syndicate and sell the loan. Ms. Dealy also added that the fair value option may be more representationally faithful since management may manage level 3 loan commitments on a fair value basis as part of a trading business.
33. In response to a question from Ms. Seidman regarding the unit of account concern, Ms. Lynn stated that she does not believe that the unit of account issue with DDAs was prevalent with loan commitments since in many cases loan commitments would be handled on an individual basis. Mr. S. Young indicated that the fair values of commercial loan commitments are generally on an item-by-item basis, but that the fair value of residential mortgage loan commitments is typically done on a portfolio basis.
34. Ms. Seidman asked Mr. Bukspan to clarify whether Standard & Poor's believes that written loan commitments should be within the scope of Phase 1. Mr. Bukspan stated that Standard & Poor's did not object to including written loan commitments or any other items as long as disclosures were sufficient to provide the reasons why fair value elections were made and how fair values were calculated and applied.

New Scope Inclusions—Commodity and Energy Contracts

35. Mr. Goodman stated that the liquidity of the market for energy commodity contracts was such that a fair value could be easily determined in a narrow range. He asserted that items for which a fair value can be readily determined through a highly liquid market are ideally suited for the fair value option. Because of this point, Mr. Goodman stated that energy commodity contracts should be included within the scope of Phase 1. Mr. Schroeder

stated that this issue was also very important to Goldman Sachs Group because of the mixed-attributes model that currently exists in this area. He stated that the applicability of the fair value option to commodities could greatly simplify accounting in this area (for example, application of the definition of a derivative) and provide better information. Mr. Goodman stated that Occidental Petroleum would like to present its trading operations at fair value, which is what Goldman Sachs Group can do for identical items because of the way that the broker dealer rules work. Further, Mr. Goodman explained that Occidental Petroleum's business, as well as similar companies' businesses, is managed at fair value and it has to translate its operations back to Generally Accepted Accounting Principles (GAAP), which does not represent the economics or the way that the business is managed.

36. Mr. E. Smith asserted that the liquidity of the market would not be a good demarcation because it does not encompass many items that are hedged and risk managed by entities. There are many items that are difficult to value, but they are risk managed and hedged. Ms. Bloomer said that the scope determination based on financial and nonfinancial instruments is a good one because it is widely understood. She stated that in using fair values there are a number of presentation issues to address.

Eligibility Criteria

37. Ms. Seidman stated that the second topic of discussion is whether the Board should establish a set of qualifying characteristics that must be met to elect the fair value option. Ms. Seidman noted that the Exposure Draft did not prescribe any qualifying characteristics and that most respondents generally supported not having explicit eligibility criteria. She also noted, however, that some respondents asserted that the fair value option might result in unintended consequences if such qualifying characteristics are not required.

38. Mr. Bukspan stated concern with providing this type of an option to preparers. He noted that to the extent that the mixed-attribute model is in place, users need to understand why certain entities have elected the fair value option and why entities would not elect the option. He asserted that entities should only be permitted to elect the fair value option if they are eliminating an accounting

mismatch or if it is consistent with its risk management strategy. Another participant pointed out that the option may be elected for operational simplicity. Mr. Bukspan asked the Board (a) to clarify when the option should be allowed and (b) to require the appropriate disclosures of this information.

39. Mr. Holm agreed and noted that the IASB developed a set of reasonable criteria in its deliberations of IAS 39, *Financial Instruments: Recognition and Measurement*. Mr. Storch noted that the fair value option is a convergence issue and, therefore, the Board should address why the FASB opted not to include the qualifying characteristics found in IAS 39.

40. Mr. Valaroso contended that the need for eligibility criteria depends largely on the scope of the proposed Statement. He stated that a broad scope, applying to many different assets and liabilities, might necessitate qualifying characteristics for election. Alternatively, eligibility requirements might not be an issue for a narrowly defined scope.

41. Ms. McEnally stated that the applicability of the fair value option should not be constrained. She noted her preference of allowing business entities the widest possible application of the proposed Statement in the interest of moving forward to a full fair value system. To compensate for the lack of comparability this will create, she advocated full disclosure of why the fair value option was elected.

How to Make the Fair Value Option Election

42. Ms. Seidman stated that the next topic deals with the details of how to make the fair value option election. She noted that the proposal in the Exposure Draft requires companies electing the fair value option to irrevocably elect fair value as the initial and subsequent measurement attribute for certain financial assets and liabilities on a contract-by-contract basis. She stated that respondents generally commented on how to identify items for designation purposes as well as for valuation-related issues.

43. Mr. Yanosy stated that variable annuity contracts are very prevalent in the life insurance business and that these contracts often have a significant amount of embedded equity risk. As a result, The Hartford issues guarantees so that the policyholder is not subject to the full amount of equity risk but is still able

to receive their principal. He asserted that because death benefits are scoped out of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, portions of the contract are accounted for separately yet they cannot be bifurcated for hedging purposes. In other words, the various elements of an insurance contract might receive different accounting treatment under the current system. Mr. Yanosy contended that the fair value option should apply to each of the elements separately, rather than to the contract as a whole, even though each element is not transferable separately.

44. Ms. Bloomer noted that operational difficulties would arise when using a contract-by-contract notion to evaluate equity method investments for the fair value option. To qualify as an equity method investment, it is first necessary to have a critical mass of contracts, which would make it difficult to evaluate the entire investment on a contract-by-contract basis. Additionally, she questioned if subsequent purchases of an equity investment would then be carried at fair value.

45. Mr. Tejerina asked for the Board to provide clarification of the term *contract.* For example, is an entire $1 million bond a single contract, or can an entity designate a proportionate amount of that entire bond as a separate contract? Mr. S. Young agreed that this is an important issue that should be given additional consideration by the Board.

46. Ms. Dealey stated that a contract-by-contract basis could be construed to mean a CUSIP-by-CUSIP notion, which would mean that all of a debt issue would comprise a single contract. Mr. Valaroso disagreed and noted that because of its optional nature the use of the fair value option should not be arbitrarily restricted.

47. Mr. Tejerina stated that the contract-by-contract requirement for election of the fair value option should be entirely separate from the notion of valuation. Ms. Seidman clarified that in some instances existing GAAP will require a certain treatment for valuation purposes.

48. Mr. Bukspan added that the irrevocability of the fair value option is questionable if election of the option is to correspond to an entity's risk

management strategy. According to the proposal in the Exposure Draft, an entity would not be able to reverse its decision to elect fair value for certain financial instruments, even if its risk management strategy has changed. Mr. Bukspan contended that the same optionality that is granted on day one should also be granted subsequently on day two and thereafter because circumstances can change over time. Mr. Trott questioned the comparability of information that would arise if the Board allowed an entity to opt in and out of the fair value option. Mr. Herz agreed with Mr. Trott and added that if fair value is deemed to be the most relevant measurement attribute for financial instruments, why should it be permissible to change to a less relevant measurement basis for the same instruments.

49. Ms. Rogers advocated the use of proportionate designation, which would allow a hedge of $50 million of a $100 million exposure, but all of the risk associated with that half. She cited the Board's objective to address the volatility in the financial statements and noted that precluding the ability to designate a percentage of the exposure would introduce volatility to the loan piece as opposed to the credit default swap.

Changes in Creditworthiness

50. Ms. Seidman stated that the next topic deals with the effect of changes in an entity's own creditworthiness on its liabilities. She noted that the comments received on this issue varied.

51. Mr. Storch contended that the change in fair value attributable to a change in an entity's own creditworthiness should not be reflected as part of the change of the fair value of the financial liability. He would permit the fair value option for financial liabilities but expressed concern about including the portion due to an entity's own creditworthiness in the fair value measurement, specifically in cases of deteriorating credit standing. In such a case, an entity could show ongoing profitability and thereby veil the true quality of capital, which is a key indicator from a regulatory perspective. Mr. Holm concurred and added that recognizing those gains could mislead investors because the associated losses from the downgrade in creditworthiness might not appear in the

financial statements (that is, a loss related to an intangible asset or franchise value).

52. Ms. McEnally and Mr. Bukspan stated that creditworthiness should be taken into account if the fair value option is elected for a debt instrument. Ms. McEnally continued that the basic components of a debt instrument's fair value are the risk-free rate, the risk premium, the duration, and the creditworthiness. She asserted that it would not make sense to include only part of the fundamental drivers in a fair value calculation. Mr. Kispert agreed and noted that if fair value is deemed the most appropriate measurement attribute and is therefore elected under the fair value option, it is necessary to include the change in fair value that is due to a change in creditworthiness.

53. Mr. Spataro noted that insurance liabilities are unique in that they cannot be settled early. He suggested that corporate credit ratings or subsidiary credit ratings of insurers are not an important component of the fair value of insurer's debt due to the existence of credit guarantees. He suggested that a criterion for allowing the realization of the gain could be whether an entity has the intent and ability to capitalize on the decrease in creditworthiness. Ms. Schipper noted that this would create asymmetrical accounting on the asset side of the balance sheet.

54. Ms. Seidman reported that many respondents to this issue claimed that the qualitative disclosure of information proposed in the Exposure Draft was not sufficient and that there should be some attempt made to quantify the effect of changes in credit. She noted that the IASB's fair value option requires a similar calculation. She asked Ms. McEnally and Mr. Bukspan to comment on the need for a quantitative disclosure.

55. Ms. McEnally requested a detailed roll-forward showing the changes in major classifications from the beginning of the period to the end of the period to understand what is causing the fair value of the debt to change. She stated that roll-forwards should be required for all major accounts in the financial statements, not only in circumstances of financial distress.

56. Mr. Kispert noted that this should not be viewed only as a liability disclosure issue. He clarified that disclosure of the key drivers on the asset side would

be useful because the loan loss allowance disclosure goes away when loans are carried at fair value. Mr. Storch stated his support for a similar requirement as to what exists in IASB standards, which requires disclosures for loans and receivables as well as liabilities.

Disclosures

Sensitivity Analyses

57. Ms. Seidman stated that the comment letter from Standard & Poor's made some useful suggestions about potential disclosures including:

    a. A crisp discussion of how items are reported in the income statement
    b. A sensitivity analysis on items for which the fair value option has been elected
    c. A reconciliation to cash flow.

    She then asked other participants to provide feedback on the operationality of those ideas.

58. Mr. Storch stated that the disclosure framework in IFRS 7, *Financial Instruments: Disclosures*, provides a better indication of the risks of financial instruments than U.S. GAAP and would require sensitivity analyses regardless of whether the fair value option was elected or not. Mr. S. Young agreed that IFRS 7 would provide a good reference point for the Board in redeliberations and noted that it would be difficult for entities to disclose this information only for items for which the fair value option has been elected. He indicated that such disclosures should apply more broadly.

Prescriptive Guidance on Income Statement Reporting of Items Elected for the Fair Value Option

59. Ms. Seidman stated that some respondents requested that the Board provide prescriptive guidance as to where and how items for which the fair value option has been elected should be reported. She also acknowledged that other respondents clearly disagreed stating that prescriptive guidance would not be desirable. She asked for participants to explain their views on this issue.

60. Mr. Goodman suggested presenting all fair value measurements in a new statement that would isolate and explain changes in fair values. This would

ease users' understanding of what values on the income statement are realized versus those values that are unrealized.

61. Mr. Bukspan cited the difficulty in understanding where to find the effects of Statement 133 on the income statement and recommended that the Board clearly require entities to indicate where the effects of changes in fair value can be found in the financial statements. He believes that such a requirement is necessary until completion of the financial statement presentation project. Ms. McEnally agreed and stated a preference to see items presented by category and noted that aggregation is not desirable. Mr. S. Young disagreed with the request for prescriptive guidance as to where entities should report certain changes in fair value.

Cash Flow Statement

62. Ms. Seidman shifted the conversation to a discussion of the presentation of the cash flow statement. Mr. Bukspan asserted that he is a proponent of the direct method and stated support for creating a cash basis income statement. He contended that the development of a cash basis income statement would allow users to more easily understand where cash values deviate from fair value.

63. Ms. Seidman also noted that comments were received on the proposal to classify cash flows according to the nature of the item. Ms. Bloomer suggested that the Board consider allowing for a change of intent instead of an irrevocable assessment of whether the item should be classified as operating, investing, or financing. She noted that this suggestion would not necessarily be limited to fair value option items.

64. Mr. Tejerina stated that currently an entity is only allowed to change the cash flow classification of a derivative if it satisfies hedge accounting criteria. He suggested allowing companies to change the cash flow classification of an item designated for the fair value option if the item is being used as an economic hedge. Ms. Seidman pointed out that this could cause significant comparability issues regarding presentation on the cash flow statement and asked users to consider the implications of this proposal.

Effective Date and Transition

65. Mr. Seidman noted that Goldman Sachs Group's comment letter presented a transition proposal that would flow the cumulative effect through income rather than through retained earnings. Mr. Schroeder stated that this was intended to address the potential for booking a loss in retained earnings and subsequently reversing it through income. This would alleviate the potential for cherry-picking items for the fair value option. He acknowledged that this approach would not comply with the transition guidance set forth in FASB Statement No. 154, *Accounting Changes and Error Corrections*.
66. Mr. Bukspan suggested a supplemental transition disclosure when moving to fair value accounting that would show the numbers as if they were presented on the original measurement basis. Mr. S. Young contended that this would present preparers with an operational nightmare of preparing two separate sets of books. He stated that the only way to achieve this would be to have two systems running live, which would be extremely costly to implement.
67. Ms. Seidman reported that respondents had a split view as to whether the effective date of the proposed Statement should coincide with the effective date for the draft of a final FASB Statement on fair value measurements.
68. Mr. Kispert concluded that it would not make sense to have the required effective date for the fair value option precede the draft Statement; however, he does not believe that it is appropriate to preclude an entity from early adopting before it adopts the draft Statement.
69. Mr. Storch stated that the disclosures required by FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, might not be prepared with or audited with as much rigor and attention as the more comprehensive disclosures that will be required under the draft Statement. Because of this, he contended that the two Statements should be implemented at the same time. Furthermore, he suggested prohibiting an entity from early adopting the fair value option if it had not already adopted the draft Statement.
70. Ms. Seidman noted that one respondent supported delaying the required effective date of the proposed Statement because companies will need time to determine what instruments they will elect the fair value option for due to its

irrevocable nature. Mr. S. Young and Mr. E. Smith agreed with this position and stated that preparers will need time to implement the necessary systems changes.

Other Issues

71. Mr. Trott welcomed any suggestions from users on how to compensate for the lack of comparability caused by the optionality of the fair value option. Ms. McEnally stated that the disclosures proposed in the CFA Institute's comment letter were developed specifically to address the potential lack of comparability.

Follow-up Items:

None

General Announcements:

None

Outside Participants	**Organization**
Ray Beier	PricewaterhouseCoopers
Carrie Bloomer	Deloitte & Touche LLP
Neri Bukspan	Standard & Poor's Ratings Services
Karen Dealey	Morgan Stanley
Jeffrey Geer	Office of Thrift Supervision
Gordon Goodman	Occidental Petroleum Corporation
Charles Holm	Board of Governors of the Federal Reserve System
Kevin Kispert	Ernst & Young LLP
Thomas Linsmeier	(Incoming Board Member)
Rebecca McEnally	CFA Institute
Jenifer Minke-Girard	Securities and Exchange Commission
Lynn Rogers	International Association of Credit Portfolio Managers (IACPM)
Matthew Schroeder	Goldman Sachs
Eric Smith	Credit Suisse Group
Kevin Spataro	Group of North American Insurance Enterprises
Robert Storch	Federal Deposit Insurance Corporation
Enrique Tejerina	KPMG LLP
Anthony Valoroso	American International Group, Inc.
James Yanosy	The Hartford Financial Services Group, Inc.
Stephen Young	Citigroup, Inc.