Financial Accounting Standards Board

Accounting for Financial Instruments Roundtable Meeting
Norwalk, CT
October 19, 2010
9 a.m.–12 p.m.

Participants

Jeff Arricale (via phone)	T. Rowe Price
Paul Beswick	Securities and Exchange Commission
Robert Esson	National Association of Insurance Commissioners
Stacey Friday	Federated Investors, Inc.
Brad Hunkler	American Council of Life Insurers
Krishnan Iyengar	Reval.com
Joyce Joseph	Standard and Poor's
Bob Laux	Microsoft
Richard Levy	Wells Fargo
Art Lindo	Board of Governors of the Federal Reserve System
Susan McFarland	Capital One
Mark Newsome	ING Capital LLC
Enrique Tejerina	KPMG
Robert Traficanti	Citigroup

FASB and IASB Participants

Russ Golden	FASB Board Member
Tom Linsmeier	FASB Board Member
Marc Siegel	FASB Board Member
Larry Smith	FASB Board Member
Kevin Stoklosa	FASB Assistant Director
Sue Lloyd	IASB Associate Director
Upaasna Laungani	FASB Project Manager
Chris Roberge	FASB Project Manager
Ben Couch	FASB Practice Fellow
Kristy Putnam	FASB Postgraduate Technical Assistant

Financial Accounting Standards Board

Proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities—Financial Instruments (Topic 825) and Derivatives and Hedging (Topic 815)*

Public Roundtable Meetings Discussion Questions

October 18, 2010 and October 19, 2010

The Board issued proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities—Financial Instruments (Topic 825) and Derivatives and Hedging (Topic 815)*, on May 26, 2010. The comment period for the proposed Accounting Standards Update ended on September 30, 2010.

The Board and staff educated constituents about the proposal through webcasts, podcasts, focused newsletters, participation in various conferences, and by holding numerous meetings with investors, preparers, auditors, and regulators. The Board also implemented an extensive outreach plan to obtain feedback on this comprehensive proposal from all constituents, including investors, preparers, auditors, and regulators. Constituents provided feedback on this proposal through the following channels:

a. Public comment letters
b. Investor questionnaires
c. Field visits with preparers
d. In-person meetings and conference calls.

These public roundtable meetings are another channel for constituents to provide feedback on this proposal. Participants in these meetings represent a wide variety of constituents, including users, preparers, auditors, and others to ensure that the Board receives broad input and also to facilitate dialog between constituents and the Board.

The Board and staff will analyze feedback received through all outreach activities as part of the Board's redeliberations process. The Board intends to coordinate its redeliberations with the IASB to issue a final Accounting Standards Update on accounting for financial instruments.

Topics and Related Questions for Discussion

Classification and Measurement

The proposed classification and measurement model for financial instruments focuses on the characteristics of the instrument and how an entity manages those financial instruments. Financial instruments for which an entity's business strategy is to trade the instruments, fair value measurement would be required with all changes in fair value recognized in net income (FV-NI category) each reporting period. Debt instruments for which an entity's business strategy is to hold the instruments for collection or payment(s) of contractual cash flows, both amortized cost and fair value information would be presented by requiring a reconciliation from amortized cost to fair value on the face of the statement of position. Net income would reflect an amortized cost measurement approach because changes in interest accruals and credit impairments would continue to be recognized in net income each reporting period. The remainder of the fair value change would be recognized in other comprehensive income (FV-OCI category) for these financial instruments. In addition, realized gains and losses on these financial instruments would continue to be recognized in net income each reporting period.

The proposal would allow an entity to elect at initial recognition to measure any financial instrument at fair value with all changes in fair value recognized in net income. Generally, financial liabilities would be accounted for similarly to financial assets, reflecting how financial assets and liabilities are managed together. However, the proposal would allow for amortized cost measurement of certain financial liabilities and would require core deposit liabilities to be measured using a remeasurement approach. Also, the proposal would permit an entity to measure certain short-term receivables and payables at amortized cost.

The roundtable discussion relates only to financial instruments within the scope of the proposal. Based on outreach performed to date and comment letters received, almost all constituents agree that derivative instruments and financial instruments for which an entity's business strategy is to trade the instruments, fair value measurement with all changes in fair value recognized in net income should be required. Feedback received also indicates that most constituents do not agree that the primary measurement attribute for loans and financial liabilities held for collection or payment(s) of contractual cash flows should be fair value. The discussion questions below focus on the classification, measurement, and presentation of financial instruments other than derivatives and those for which an entity's business strategy is to trade the instruments.

Financial Assets

Loans

1. What do you believe should be the primary measurement attribute for loans that an entity intends to hold for collection of contractual cash flows? Why?

2. Do you believe that the primary measurement attribute should be different for purchased loans that an entity intends to hold for collection on contractual cash flows? Why or why not?

Debt Securities

3. What do you believe should be the primary measurement attribute for debt securities that an entity intends to hold for collection of contractual cash flows? Why?

4. Do you believe the level of market activity should be a criterion in classifying and measuring debt securities? For example, if an observable market exists for a debt security held for collection of contractual cash flows, should that debt security be accounted for similarly to a debt security held for collection of contractual cash flows for which an observable market does not exist? Why or why not?

5. Do you believe cash flow variability also should be a criterion in classifying and measuring debt securities? For example, how should a holder measure an investment in a beneficial interest with the following characteristics?

    a. The holder intends to hold the beneficial interest for collection of contractual cash flows.
    b. An observable market does not exist for the beneficial interest.
    c. The holder may not recover substantially all of its initial investment.

Equity Securities

6. Do you agree that all equity securities (excluding equity method investments) should be measured at fair value with all changes in fair value recognized in net income? Why or why not?

7. Should the level of market activity, an entity's business strategy, or both determine the classification and measurement of equity securities? For example, should private equity securities be accounted for similarly to public equity securities? Why or why not?

Financial Liabilities

Generally, financial liabilities would be accounted for similarly to financial assets, reflecting how financial assets and liabilities are managed together. However, in addition to the two categories for financial assets (FV-NI and FV-OCI), the proposal provides for two additional classification and measurement categories for financial liabilities: amortized cost for certain financial liabilities and a remeasurement approach for core deposit liabilities.

An entity may measure financial liabilities at amortized cost if those financial liabilities qualify for the FV-OCI category and measuring the financial liabilities at fair value would create or exacerbate a measurement attribute mismatch. The proposal also would permit an entity to measure its short-term receivables and payables at amortized cost.

Core deposit liabilities would be required to be measured at the present value of the average core deposit amount during the period discounted at the difference between the alternative funds rate and the all-in-cost-to-service rate over the implied maturity of the deposits.

8. Do you believe financial liabilities held for payment of contractual cash flows should be accounted for similarly to financial assets held for collection of contractual cash flows? Why or why not? If not, what should be the primary measurement attribute for financial liabilities held for payment of contractual cash flows?

9. Do you believe core deposit liabilities should be subsequently remeasured at fair value or should a remeasurement approach similar to the approach included in the proposal be used instead? Do you believe core deposit liabilities should be measured at amortized cost? Why?

10. If the Board decides to measure certain financial liabilities at amortized cost, do you believe a fair value option should continue to be provided for those financial liabilities? Why?

Risk Management

11. Do you believe financial statements should provide transparency about an entity's interest rate risk, duration risk, credit risk, and liquidity risk exposures for financial instruments? If yes, for which financial instruments should this information be provided? How are these risk exposures best portrayed, through disclosures in the notes to the financial statements or through the measurement of the financial instrument?

Reclassifications and Tainting

The proposal would not permit reclassifications of financial instruments for changes in an entity's business strategy. An entity would be required to determine the classification and measurement of financial instruments when the entity initially recognizes the financial instruments and would not be

allowed to subsequently change that decision made at initial recognition. The proposal also would eliminate the tainting notion currently in U.S. GAAP for held-to-maturity securities by reducing the main classification and measurement categories for financial instruments to FV-NI and FV-OCI.

12. Do you agree that reclassifications should not be permitted? If not, what criteria, if any, should be used to evaluate the appropriateness of the reclassification?

13. If the Board decides to measure certain financial instruments at amortized cost and reclassifications are permitted, do you believe a tainting notion should be retained? Why or why not?

Hybrid Financial Instruments

The proposal would eliminate bifurcation and separate accounting of embedded derivatives from the host contract for hybrid financial instruments. An entity would be required to measure a hybrid financial instrument in its entirety at fair value with all changes in fair value recognized in net income each reporting period for which the guidance on derivatives and hedging in Subtopic 815-15 would otherwise have required the embedded derivative to be accounted for separately from the host contract. All other hybrid financial instruments may qualify for FV-OCI but would still be measured in their entirety at fair value.

14. Do you agree with the elimination of bifurcation and separate accounting of embedded derivatives from the host contract for hybrid financial instruments? If not, why?

Presentation

15. For financial instruments that you believe should not be measured at fair value, should fair value information be presented in the financial statements? If yes, how should fair value information be provided?

    a. Should fair value be parenthetically disclosed on the face of the statement of financial position?
    b. Should supplemental fair value schedules or financial statements be required? If yes, what type of schedule should be required (for example, a fair value rollforward or a schedule with only fair value balances)?
    c. Should fair value only be disclosed in the notes to the financial statements?

16. If you believe fair value information for financial liabilities should be provided in the financial statements, should significant fair value changes related to changes in an entity's credit standing be separately presented? Should that amount exclude the changes in the price of credit? Why or why not?

Credit Impairment and Interest Income Recognition

The proposal provides a single credit impairment model for all financial assets not classified as FV-NI. An entity would not be required to determine that the loss is probable of occurring to qualify for recognition, which would allow for more timely recognition of credit losses.

The proposal would not permit an entity to forecast future events or macroeconomic conditions, such as future economic downturns, when determining if a financial asset is impaired. An entity should consider all available information relating to past events and existing conditions in assessing financial assets for impairment. Impairment would be recognized in net income for cash flows (both principal and interest) not expected to be collected.

The assessment and measurement of impairment that occurs at the end of the first reporting period after origination or purchase would result in reflecting a lifetime credit impairment loss. The loss recognized represents all cash flows associated with the financial asset or pool of financial assets that the entity does not expect to collect over the remaining estimated or contractual life of the assets.

Financial assets can be evaluated on a collective (pool) basis or individual basis for credit impairment. For financial assets that an entity evaluates on a pool basis, the entity would apply a loss rate that would capture cash flows (principal and interest) not expected to be collected over the estimated or contractual life of the pool of financial assets. For financial assets evaluated for impairment on an individual basis, credit impairment would be measured using the present value of cash flows not expected to be collected if the financial asset is determined to be impaired. The proposal provides guidance on the determination of the effective interest rate used to discount cash flows for measuring impairment on an individual basis. The effective interest rate to be used would depend on whether the financial asset is originated, purchased, or purchased at amount that includes a discount related to credit quality.

If the financial asset evaluated for impairment on an individual basis is determined to be performing, the entity must consider a pool of similar financial assets to determine an appropriate historical loss rate to be applied.

The proposal would allow an entity to recognize a reversal of previously recognized credit impairments as a decrease in the allowance for credit losses.

For financial assets in the FV-OCI category, interest income to be recognized in net income would be determined by applying the financial asset's effective interest rate to the amortized cost balance net of any allowance for credit losses. Generally, any difference between the amount of accrued interest receivable based on the amount of interest contractually due and the amount of interest income accrued would be recognized as an increase in the allowance for credit losses.

17. Do you agree that an entity should recognize a credit impairment when an entity does not expect to collect all contractual amounts due for the life of the instrument? If not, do you believe that credit impairment should be recognized when it is probable or incurred or based on some other threshold?

18. Do you believe the credit impairment and interest income recognition models should be integrated (either by adjusting the yield or by accruing interest on the credit adjusted principal balance)? Why or why not?

19. Do you agree that an entity should not be permitted to forecast future events or macroeconomic conditions when determining if a financial asset is impaired? If not, do you believe an entity should be permitted to forecast through the life of the loan or over some other time horizon?

20. Do you agree that an entity should immediately recognize a credit impairment in net income when an entity does not expect to collect all contractual amounts or do you believe that an entity should allocate initially expected credit losses over the life of the financial asset? Why? Is your view different for financial assets evaluated on a pool basis versus financial assets evaluated on an individual basis?

21. If the credit impairment model does not allow an entity to forecast future events or macroeconomic conditions, do believe it would be appropriate to allocate expected credit losses over the life of the financial asset? Why or why not?

22. If you believe an entity should allocate initially expected credit losses over the life of the financial asset, do you believe changes in expectations about the collectibility of cash flows should be recognized immediately in net income, allocated over the life of the financial asset, or some other method?

23. Do you agree that when a financial asset evaluated for impairment on an individual basis has no indicators of being individually impaired, an entity should determine whether assessing the financial asset together with other financial assets that have similar characteristics would indicate that a credit impairment exists? If not, why?

24. Do you believe there should be a different model for measuring credit impairment for originated financial assets and purchased financial assets? Why or why not?

Hedge Accounting

The proposal replaces highly complex, quantitative-based hedging requirements with more qualitative-based assessments that would make it easier to qualify for hedge accounting and allow for economic effects of hedging to be reported more consistently over multiple reporting periods. The effectiveness threshold to qualify for hedge accounting would be modified from *highly effective* to *reasonably effective*. An entity could continue to designate particular risks in financial items as the risks being hedged in a hedging relationship, with only the effects of the hedged risks reflected in net income each reporting period. The shortcut method and the critical terms match method would be eliminated. Ineffectiveness would be recognized in net income for both overhedges and underhedges in cash flow hedging relationships. Hedge accounting would be discontinued only if the criteria for hedge accounting are no longer met or the hedging instrument expires, is sold, terminated, or exercised.

25. Do you agree that the effectiveness threshold for qualifying for hedge accounting should be modified from *highly effective* to *reasonably effective?* If not, why? If yes, do you believe the term *reasonably effective* is operational?

26. Do you agree that a quantitative effectiveness assessment should not be required? If not, why?

27. Do you agree that an entity should continue to be allowed to designate particular risks in financial items as the risks being hedged in a hedging relationship, with only the effects of the hedged risks reflected in net income each reporting period regardless of whether the hedged item is measured at fair value or amortized cost?

28. Do you agree that an entity should be prohibited from discontinuing hedge accounting by simply dedesignating the hedging relationship? If not, why?

29. Do you agree that an entity should recognize ineffectiveness in net income on all cash flow hedging relationships (including underhedges)? If not, why?

Other Topics

30. Do you agree that deposit-type and investment contracts of insurance and other entities should be included in the scope of the proposal? If not, why?

31. Do you agree that transaction costs and fees should be expensed in net income for financial instruments measured at fair value with all changes in fair value recognized in net income? Do you believe investment companies should be provided with an exception to this guidance allowing investment companies to initially measure their investments at the transaction price? Why or why not?

32. The proposal would require financial liabilities of investment companies to be measured at fair value with all changes in fair value recognized in net increase (decrease) in net assets. In addition, the proposal would require all investments in money market funds to be measured at fair value with all changes in fair value recognized in net increase (decrease) in net assets. Would the effect on net asset value per share because of these changes provide decision-useful information?

33. Do you agree that an entity should not only determine if it has significant influence over an investee as described currently in Topic 323 on accounting for equity method investments and joint ventures but also determine if the operations of the investee are related to the entity's consolidated business to qualify for the equity method of accounting? If not, why?

34. Do you agree that the fair value option should be eliminated for equity method investments? If not, why?

35. An entity would apply the proposed guidance by means of a cumulative-effect adjustment to the statement of financial position for the reporting period that immediately precedes the effective date. Do you agree with the transition provisions of the proposal? If not, why?

36. Do you agree with the proposed delayed effective date for certain aspects of the proposed guidance for nonpublic entities with less than $1 billion in total consolidated assets? If not, why?