MINUTES

Financial Accounting Standards Board

To: Board Members

From: Kubic (x296)

Subject: November 17, 2009 Board Meeting Minutes: Accounting for Financial Instruments

Date: December 18, 2009

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

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Topic: Accounting for Financial Instruments: Amortized Cost Definition

Basis for Discussion: Board Memorandum No. 24

Length of Discussion: 2:00 to 2:30 p.m.

Attendance:

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

Board members participating by phone: FASB: Herz

Staff in charge of topic: Ampofo

Other staff at Board table: Golden, Stoklosa, Sangiuolo, C. Smith, Wilkins, Burnap, and Homant

Summary of Decisions Reached:

The Board discussed the definition of *amortized cost* for use in its project on accounting for financial instruments. The Board decided that amortized cost should not be reduced by allowances for credit impairments but should be reduced for direct write-offs of principal amounts. The Board will finalize the exact wording of the definition after deciding how interest income should be recognized.

Objective of Meeting:

The objective of the meeting was for the Board to decide on the components of amortized cost. The objective of the meeting was met.

Matters Discussed and Decisions Reached:

Issue 1: Impairment Model

1. Mr. Ampofo stated that at the July 15, 2009 Board meeting, the Board decided that for financial assets and financial liabilities that are measured at fair value with fair value changes partially recognized in other comprehensive income (FV-OCI), the amortized cost of those financial assets and liabilities must be displayed on the face of the balance sheet in addition to a fair value adjustment to arrive at fair value. Mr. Ampofo also noted that at the August 13, 2009 Board meeting, the Board decided that amortized cost must be presented (parenthetically) for an entity's own debt that is measured at fair value with changes in fair value recognized in net income (FV-NI).

2. Mr. Ampofo stated that there are several definitions of amortized cost currently used in U.S. GAAP. Thus, it would be necessary to clarify the definition of amortized cost. Mr. Ampofo stated that the Master Glossary in the *FASB Accounting Standards Codification*™ defines *amortized cost* as "the sum of the initial investment less cash collected less write-downs plus yield accreted to date" (originally defined in paragraph 23 of AICPA Statement of Position 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*).

3. Mr. Ampofo noted that the Master Glossary defines *amortized cost basis* as “the amount at which an investment is acquired, adjusted for accretion, amortization, collection of cash, previous other-than-temporary impairments recognized in earnings (less any cumulative-effect adjustments), foreign exchange, and fair value hedge accounting adjustments” (originally defined in paragraph 19 of FASB Staff Position FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments*).

4. Mr. Ampofo noted that Appendix A of IFRS 9, *Financial Instruments,* refers to paragraph 9 of IAS 39, *Financial Instruments: Recognition and Measurement,* for the definition of *amortized cost* as “the amount at which the financial asset or financial liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortization using the effective interest method of any difference between that initial amount and the maturity amount, and minus any reduction (directly or through the use of an allowance account) for impairment or uncollectability.”

5. Mr. Ampofo noted that Appendix A of the IASB Exposure Draft, *Financial Instruments: Amortized Cost and Impairment*, provides a conceptual definition of amortized cost as “a cost-based measurement of a financial instrument that uses amortization to allocate interest revenue and interest expense.”

6. Mr. Ampofo noted that the staff is presenting two alternatives for the Board’s consideration. Alternative 1 proposes to define amortized cost as follows:

> Amortized cost of a financial asset or financial liability is a cost-based subsequent measurement that adjusts the historical cost for amortization or other allocations. Amortized cost is calculated as the historical cost amount of the financial asset or financial liability adjusted over time as follows:
>
> a. Minus principal repayments
>
> b. Plus or minus the cumulative amortization or accretion of any difference between that initial amount and the maturity amount
>
> c. Plus or minus foreign exchange adjustments
>
> d. Minus direct write-offs of the principal amount.

Alternative 2 proposes to define amortized cost as follows:

> Amortized cost of a financial asset or financial liability is a cost-based subsequent measurement that adjusts the historical cost for amortization or other allocations. Amortized cost is calculated as the historical cost amount of the financial asset or financial liability adjusted over time as follows:
>
> a. Minus principal repayments
>
> b. Plus or minus the cumulative amortization or accretion of any difference between that initial amount and the maturity amount
>
> c. Plus or minus foreign exchange adjustments
>
> d. Minus any reduction for credit impairment (that is, direct write-off of the principal amount and allowances for credit impairments).

Issue 1 Board Vote

7. The Board did not reach a formal decision on which alternative it would like to use. However, it did decide that amortized cost should not be reduced by allowances for credit impairments and should be reduced for direct write-offs of principal amounts. The Board stated that it may want to revisit the issue after a decision is made about interest income.

Issue 1 Board Comments

8. Mr. Herz noted that Alternative 2 is more consistent with IFRSs and Alternative 1 is more consistent with current U.S. GAAP for originated loans. Mr. Ampofo agreed.

9. Mr. Smith noted that there is no guidance on when there should be a direct write-off of a financial asset. He asked the staff if that issue would be brought to the Board in the future. Mr. Stoklosa noted that practice has evolved so that different financial assets are written off at different times because of differences in the instruments. Mr. Stoklosa noted that the staff is planning to bring to the Board proposed guidance on when a financial instrument should be placed on nonaccrual status and when direct write-offs should be recorded.

10. Mr. Herz asked what entities currently do to determine when to place instruments on nonaccrual status. Ms. Smith noted that investors stated that current disclosures for nonaccrual status and direct write-offs vary widely by entity. Ms. Smith stated

that investors would support guidelines for when an instrument should be placed on nonaccrual status and when an instrument should be written off. Ms. Smith noted that some investors stated that the guidelines should differ depending on the nature of the financial asset.

11. Mr. Siegel stated that there is adequate disclosure for when an instrument is placed on nonaccrual status, but no adequate disclosure exists for when an instrument is written off. Mr. Siegel stated that some analyst look at ratios between the allowance for credit losses and direct write-offs. Mr. Siegel noted that this ratio would be hard to compare between entities because of different policies for when to write off a nonperforming instrument.

12. Mr. Linsmeier stated that Alternative 1, which would present the allowance for credit impairments separate from the amortized cost amount, would provide the most decision-useful information to investors. He noted that it is important that the definition be applied both to financial assets and financial liabilities.

13. Mr. Smith stated that neither of the proposed definitions would work for loans acquired with deteriorated credit quality, which are currently accounted for under SOP 03-3. Mr. Smith noted that the definition of amortized cost in SOP 03-3 states that amortized cost is adjusted for “cash received,” which is different from a definition that states that amortized cost is adjusted for “principal repayments.” Mr. Smith noted that under SOP 03-3 there are no cash flows that are specifically related to principal repayment. Rather, there are cash flows that are expected to be collected, and cash flows that are not expected to be collected.

14. Mr. Stoklosa stated that the new model on interest income would replace SOP 03-3. Mr. Smith asked how the new model would treat purchased loans with a significant deterioration in credit quality. Mr. Stoklosa stated that issue would be brought to the Board in December. He noted that the staff recommends one impairment model and one interest income model for all financial assets to reduce complexity.

15. Ms. Seidman noted that many Board members explicitly stated that one of the objectives of the project on accounting for financial instrument is to keep the income statement, and in particular net interest margin, similar to what it is today. She stated that one interest income model would result in changes to the income statement. Ms. Sangiuolo agreed. Mr. Stoklosa acknowledged that the recognition of interest income would remain the same for some financial assets, while the recognition of interest income could change for other financial assets.

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

None

<u>General Announcements:</u>

None