MINUTES

Financial Accounting Standards Board

To: Board Members

From: Kubic (x296)

Subject: October 14, 2009 Board Meeting Minutes: Accounting for Financial Instruments

Date: November 4, 2009

cc: Leisenring, Golden, Bielstein, Stoklosa, Lott, Proestakes, Laungani, 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: Recognition and Initial Measurement
Basis for Discussion:	Board Memorandums No. 16 and No. 17
Length of Discussion:	9:00 to 9:55 a.m.
Attendance:	
Board members present:	FASB: Herz, Seidman, Siegel, and Smith IASB: Leisenring
Board members participating by phone:	FASB: Linsmeier
Staff in charge of topic:	Sangiuolo and K. Yang
Other staff at Board table:	Golden, Stoklosa, Laungani, Wilkins, Burnap, and Kubic
Staff participating by phone:	Willis

Summary of Decisions Reached:

The Board discussed the recognition and initial measurement of financial instruments.

An entity shall recognize all of its financial instruments in its statement of financial position as either financial assets or financial liabilities depending on the entity's present rights or obligations in the contracts.

The Board also decided to amend the existing definition of a *financial instrument* in the Master Glossary of the FASB Accounting Standards Codification™ to align with the recognition principle.

The Board decided that an entity would measure a financial instrument at initial recognition as follows:

1. A financial instrument measured at fair value with changes in fair value recognized in net income (FV-NI) would be initially measured at fair value. A difference between the transaction price and that fair value, if any, would be immediately recognized as a gain or loss in net income.

2. A financial instrument measured at fair value with changes in fair value recognized in other comprehensive income (FV-OCI) and financial instruments measured at amortized cost would be initially measured at the transaction price. For a financial instrument measured at fair value with changes in fair value recognized in other comprehensive income, the difference between the transaction price and fair value upon the first remeasurement would be recognized in other comprehensive income.

The Board decided that an entity would account for transaction costs and fees arising from the purchase or sale of a financial instrument as follows:

1. For a financial instrument measured at fair value with changes in fair value recognized in net income, transaction costs and fees would be recognized in net income immediately at inception of the transaction.

2. For a financial instrument measured at fair value with changes in fair value recognized in other comprehensive income, transaction costs and fees would be deferred in other comprehensive income and recognized as a yield adjustment over the life of the related financial instrument.

Objective of Meeting:

The objective of the meeting was for the Board to make decisions regarding a recognition principle, initial measurement, and transaction costs and fees. The objective of the meeting was met.

Matters Discussed and Decisions Reached:

Issue 1: Recognition Principle

Issue 1 Staff Recommendation

1. Ms. Sangiuolo stated that the first issue relates to the development of a recognition principle. Ms. Sangiuolo stated that the staff believes a broad recognition principle would be appropriate. Ms. Sangiuolo stated that the staff recommended the following recognition principle for financial instruments:

> An entity shall recognize all of its financial instruments in its statement of financial position as either financial assets or financial liabilities depending on the entity's present rights or obligations in the contracts.

2. Additionally, Ms. Sangiuolo stated that the staff recommends that the definition of a *financial instrument*, as defined in the Master Glossary of the Codification, be amended to delete the reference to some financial instruments not being recognized. Ms. Sangiuolo noted that that phrase is inconsistent with the proposed principle and is not a definitional matter. Below are the staff's recommended changes:

> Financial Instrument:
>
> Cash, evidence of an ownership interest in an entity, or a contract that both:
>
> a. Imposes on one entity a contractual obligation either:
>   1. To deliver cash or another financial instrument to a second entity
>   2. To exchange other financial instruments on potentially unfavorable terms with the second entity.
>
> b. Conveys to that second entity a contractual right either:

1. To receive cash or another financial instrument from the first entity
2. To exchange other financial instruments on potentially favorable terms with the first entity.

> The use of the term financial instrument in this definition is recursive (because the term financial instrument is included in it), though it is not circular. The definition requires a chain of contractual obligations that ends with the delivery of cash or an ownership interest in an entity. Any number of obligations to deliver financial instruments can be links in a chain that qualifies a particular contract as a financial instrument.
>
> Contractual rights and contractual obligations encompass both those that are conditioned on the occurrence of a specified event and those that are not. All contractual rights (contractual obligations) that are financial instruments meet the definition of asset (liability) set forth in FASB Concepts Statement No. 6, *Elements of Financial Statements*~~, although some may not be recognized as assets (liabilities) in financial statements—that is, they may be off-balance-sheet—because they fail to meet some other criterion for recognition~~.
>
> For some financial instruments, the right is held by or the obligation is due from (or the obligation is owed to or by) a group of entities rather than a single entity.

Issue 1 Board Vote

3. The Board agreed with the staff's recommendation outlined in paragraphs 1 and 2 above. All Board members agreed.

Issue 1 Board Comments

4. Mr. Herz asked if any staff members knew why the phrase "although some may not be recognized as assets (liabilities) in financial statements—that is, they may be off-balance-sheet—because they fail to meet some other criterion for recognition" was included in the original definition of a financial instrument.

5. Ms. Willis stated that the phrase was developed for FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*, as well as to deal with derivative financial instruments that were not recognized before issuance of

FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities.*

Issue 2: Initial Measurement

6. Ms. Yang stated that the second issue relates to initial measurement and that the staff is presenting three alternatives for the Board's consideration.

7. Ms. Yang stated that Alternative 1 would use the transaction price for initial measurement. She noted that at initial measurement this alternative would be the simplest approach but would establish a principle for initial measurement that may be different from the subsequent measurement attribute for financial instruments. In instances in which the transaction price of a financial instrument differs from its fair value at initial recognition, measurement based on transaction price would not result in a day one gain or loss. However, because the financial instrument would be required to be subsequently measured at fair value, the difference between the transaction price and fair value would have to be dealt with in the period of initial recognition. The staff has identified the following options for dealing with that difference.

8. Ms. Yang stated that the first option, Alternative 1A, would recognize the difference between the transaction price and fair value upon the first remeasurement of the financial instrument. She noted that under this alternative the difference between the transaction price and fair value would be recognized following the classification of the instrument, in net income or other comprehensive income, upon the first remeasurement of the instrument. If recognized in other comprehensive income upon the first remeasurement, that difference would remain in other comprehensive income, and offset with subsequent changes in fair value, until the instrument was sold or matured, at which time the remaining difference, if any, would be realized in net income.

9. Ms. Yang stated that the second option, Alternative 1B, would not recognize the difference between the transaction price and the initial fair value and recognize only subsequent changes in fair value. Ms. Yang noted that under this alternative, the fair value at inception would be compared with the fair value at the first subsequent remeasurement. The difference between the two fair values would be recognized in either net income or other comprehensive income. However, the difference between the transaction price and the initial fair value would not be recognized until final settlement.

10. Ms. Yang stated that Alternative 2 would initially measure financial instruments at fair value. This alternative would result in a day one gain or loss if the transaction price of a financial instrument differs from its fair value at initial recognition. This would require the need to address whether the day one gain or loss should be recognized in net income or other comprehensive income. Ms. Yang noted that the staff identified two options for dealing with that difference.

11. The first option, Alternative 2A, would recognize all day one gains and losses immediately in net income regardless of the classification of the financial instrument as FV-NI or FV-OCI.

12. The second option, Alternative 2B, would recognize the day one gain or loss consistent with the recognition of subsequent fair value changes based upon the classification of the instrument. For instruments classified as FV-NI, the day one gain or loss would be recognized immediately in net income. For financial instruments classified as FV-OCI instruments, the day one gain or loss would be recognized in other comprehensive income.

13. Ms. Yang noted that Alternative 3 would base the initial measurement of the financial instrument on the subsequent classification and measurement of the financial instrument. Thus, financial instruments measured at FV-NI would be initially measured at fair value. The difference between the transaction price and that fair value, if any, would be immediately recognized as a gain or loss in net income. Financial instruments measured at FV-OCI and financial instruments

measured at amortized cost would be initially measured at the transaction price. The difference between the transaction price and fair value upon the first remeasurement would be recognized in other comprehensive income.

Issue 2 Staff Recommendation

14. The staff recommended Alternative 2B, which is initial measurement at fair value. In instances in which fair value is different from the transaction price, the day one gain or loss would be recognized immediately in net income for instruments classified as FV-NI and the day one gain or loss would be recognized in other comprehensive income for instruments classified as FV-OCI.

Issue 2 Board Vote

15. The Board decided to require Alternative 3; that is, financial instruments measured at fair value with changes in fair value recognized in net income would be initially measured at fair value. The difference between the transaction price and that fair value, if any, would be immediately recognized as a gain or loss in net income. Financial instruments measured at fair value with changes in fair value recognized in other comprehensive income and financial instruments measured at amortized cost would be initially measured at the transaction price. For financial instruments measured at fair value with changes in fair value recognized in other comprehensive income, the difference between the transaction price and fair value upon the first remeasurement would be recognized in other comprehensive income.

Issue 2 Board Comments

16. Ms. Seidman asked what the IASB decided for initial measurement. Ms. Yang stated that at initial recognition, an entity would measure a financial asset or financial liability at its fair value if subsequent measurement would be at fair value. Initial measurement would be at transaction price if subsequent measurement would not be at fair value for the instrument.

17. Mr. Herz noted that convergence was an important objective. Therefore, he noted his support for Alternative 3.

18. Mr. Linsmeier noted that there are situations in which the transaction price is different from fair value at initial measurement. He stated that in those situations, he believes there should be adequate disclosures to explain the reasons for the difference between the transaction price and fair value. Ms. Sangiuolo stated that the staff had not considered disclosures in the memorandum on initial measurement, but would consider disclosures at a future date and also would consider his recommendation.

19. Ms. Seidman stated that for financial instruments classified as FV-NI, initial measurement at the transaction price or fair value would have the same effect on the performance statement in the first reporting period. However, Ms. Seidman noted that if instruments are initially measured at fair value, the fair value measurement at day one would be subject to a review process to illustrate how fair value was determined, and to explain the difference, if any, between the transaction price and fair value. Thus, Ms. Seidman stated that initial measurement at the transaction price would reduce this complexity.

20. Additionally, Ms. Seidman noted that it would be easier to have initial measurement at the transaction price for certain instruments, such as an entity's own debt, measured at amortized cost. Ms. Seidman noted that in the event an instrument is subsequently recorded at amortized cost, initial measurement based on the transaction price would reduce complexity. Ms. Sangiuolo agreed that initial measurement at the transaction price may be easier. However, she stated that the staff believes initial measurement at fair value is more conceptually in line with the fair value measurement model.

21. Mr. Stoklosa stated that he believes initial measurement at fair value would be simpler. He stated that because an entity would subsequently measure instruments at fair value, it should be able to determine fair value at initial measurement. Mr. Golden agreed and noted that having initial measurement at the transaction price

and subsequent measurement at fair value could confuse constituents as to the measurement attribute. Ms. Seidman asked Mr. Golden what he believes the initial measurement should be for instruments subsequently measured at amortized cost, such as an entity's own long-term debt. Mr. Golden noted that he would initially measure such instruments at the transaction price. Mr. Golden stated that the initial measurement of an instrument should be aligned with the subsequent measurement of the instrument.

22. Mr. Smith asked if there was a premium or discount on day one on an instrument not measured at FV-NI, if the different initial measurement attributes would affect the accounting treatment for the discount or premium. Mr. Smith also asked if there would be similar treatment of the premium or discount if the instrument was initially measured at fair value. Ms. Seidman stated that this issue would not create a problem if the Board decided on Alternative 3 for initial measurement. Mr. Linsmeier stated that he believes Alternative 3 is inconsistent because it would result in different initial measurement attributes for instruments with the same subsequent measurement attribute. Mr. Golden stated that with the current decision to present both amortized cost and fair value on the face of the statement of financial position for FV-OCI instruments, it would be necessary to identify both the transaction price and fair value at initial recognition. Mr. Linsmeier agreed.

Issue 3: Transaction Costs

23. Ms. Yang stated that the next issue addressed the accounting for transaction costs and fees. She stated that in different projects the Board has decided to account for transaction costs differently. For example, at the June 18, 2009 Board meeting on the subject of financial instruments with characteristics of equity, the Board decided to expense all transaction costs for asset and liability instruments on the basis that transaction costs are not an attribute of an asset or a liability. Thus, Ms. Yang stated that included in the alternatives for the Board's consideration are approaches that would be consistent with the Board's previous decisions in different projects.

24. Alternative 1 would expense transaction costs and recognize fees in net income (such as loan origination fees) immediately at inception of the transaction for all financial instruments. The treatment of fees and costs for all financial instruments would be the same.

25. Alternative 2 would adjust the cost basis of all financial instruments for transaction costs and fees and recognize upon first remeasurement in either net income or other comprehensive income. Alternative 2 is consistent with the guidance in the AICPA Audit and Accounting Guide, *Investment Companies,* which would result in including the transaction costs in the basis of the security upon initial measurement and then immediately recognizing a loss on day two when financial instruments are measured at fair value. This is because the fair value (day two measurement) does not include transaction costs. Some believe this simplifies day one accounting because it requires no separation of transaction costs from the transaction price.

26. Alternative 3 would base the recognition of transaction costs and fees on the classification of the financial instrument. For financial instruments classified as FV-NI, transaction costs and fees would be recognized in net income immediately at inception of the transaction (same as Alternative 1). For financial instruments classified as FV-OCI, transaction costs and fees would be deferred in other comprehensive income and recognized as a yield adjustment over the life of the related financial instrument, similar to the approach required by FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases.* Ms. Yang noted that if the Board decides to accept Alternative 3, it could decide which fees and costs to defer initially in other comprehensive income and which fees and costs to recognize immediately in net income.

27. Alternative 4 would also recognize transaction costs and fees based on the classification of the financial instrument. For financial instruments classified as FV-NI, transaction costs and fees would be recognized in net income immediately at inception of the transaction (same as Alternative 1). For financial instruments

classified as FV-OCI, all transaction costs would be expensed, but fees would be deferred in other comprehensive income and recognized as a yield adjustment over the life of the related financial instrument.

Issue 3 Staff Recommendation

28. Ms. Yang stated that the majority of the staff recommends Alternative 3. For a financial instrument measured at FV-NI, transaction costs and fees would be recognized in net income immediately at inception of the transaction. For a financial instrument measured at FV-OCI, transaction costs and fees would be deferred in other comprehensive income and recognized as a yield adjustment over the life of the related financial instrument.

Issue 3 Board Vote

29. The Board voted for Alternative 3. All Board members agreed.

Issue 3 Board Comments

30. Mr. Linsmeier noted that there are different approaches on accounting for transaction costs and fees in many different projects. He stated that Alternative 4 would be similar to the approach used in the project on insurance contracts. Mr. Golden also noted that in the insurance project, both the IASB and the FASB have agreed to expense transaction costs as incurred. Mr. Linsmeier stated that it would be appropriate to consider the approach for transaction costs in the insurance contracts project in the project on accounting for financial instruments. However, Mr. Linsmeier noted that Alternative 4 would not be an appropriate approach for accounting for the transaction costs related to a financial instrument. He noted that it would make no sense to expense transaction costs on day one, but defer fees and recognize them over the life of the instrument. He proposed immediately recognizing some fees relating to the initial transaction costs and deferring only the portion relating to an interest buy-down.

31. Mr. Smith asked Mr. Linsmeier why it would be more appropriate to offset transaction fees and costs for financial instruments, but to defer all fees in the insurance project. Mr. Linsmeier noted that originating a loan is different from originating an insurance contract. For example, he observed that nonrefundable fees related to lending would be received regardless of whether or not the loan was originated, while the premium on an insurance contract would only be received if the contract is signed.

32. Mr. Linsmeier noted that both the fees from an insurance contract within the scope of the insurance project and fees related to a loan within the scope of the accounting for financial instrument project were fees from contracts with customers. Thus, he stated that those fees would be within the scope of the project on revenue recognition unless a scope exception is made. He said that if the fees, and corresponding costs, are tied to a distinct deliverable, then the revenue recognition project would recognize those fees when the performance obligation is satisfied, not as an adjustment to the yield. For example, he stated that certain components of loan origination fees would be related to distinct performance of originating a loan. Thus, the performance obligation would be originating the loan, which would result in the recognition of loan origination fees in the revenue recognition project. He expressed the need to consider the interaction the accounting for financial instruments project may have with the revenue recognition project.

33. Ms. Seidman noted that certain costs and fees that are deferred and amortized or accreted as an adjustment to the yield, such as an allocation of salaries, would not be deliverables, and therefore would not be in the scope of the revenue recognition project. She also noted that at the time Statement 91 was issued, that Board did not believe that loan origination was a revenue generating activity. Mr. Golden agreed that fees to reimburse a lender for origination activities might not be related to a separate performance obligation.

34. Mr. Leisenring stated that there a decision was made in the revenue recognition project that origination activities were a performance obligation; therefore, revenue would be recognized at the completion of originating the loan. He gave an example of a lender that charged a nonrefundable $400 fee. If the potential borrower paid that fee, then the lender would be able to recognize revenue and it would not matter if the loan was actually made. However, he stated that the revenue recognition project was not considering transaction costs or the possible need to defer transaction costs.

35. Mr. Golden stated that certain fees and costs would be related to a performance obligation, as Mr. Linsmeier had stated, and other fees and costs would not be related to a performance obligation, as Ms. Seidman stated. For example, he noted that a fee should be deferred if it was paid up-front in return for a lower interest rate on the loan. However, a fee should be recognized immediately if the borrower paid a fee for a service, such as credit counseling. Thus, it would be important for preparers to look at the nature of the fees and costs to determine which fees and cost would be in the scope of the revenue recognition guidance and which would be in the scope of the accounting for financial instruments guidance.

36. Mr. Leisenring noted that it could be difficult to determine the nature of a fee and to determine if the fee related to a separate performance obligation or was a prepayment of the interest on the loan. Mr. Golden stated that the revenue recognition project would determine which fees are related to a separate performance obligation, and those fees would be recognized in accordance with the guidance provided by that project. Thus, the purpose of today's discussion was to determine the accounting treatment for fees, such as an interest buy-down, that would be in the scope of the accounting for financial instruments project.

37. Ms. Seidman stated the when making decisions related to recognition and measurement, investors had noted that it was important to keep key metrics intact, such as net interest margin. Ms. Seidman noted that the components of net interest margin would remain the same as current practice if the Board decided on

Alternative 3, which is the same approach used in Statement 91. She continued that if the Board agreed on any approach other than Alternative 3, then net interest margin would be considerably different from today. Ms. Seidman noted that this would be an outcome that would not provide useful information to users.

38. Mr. Herz noted two objectives related to transaction costs and fees. First, the performance statement and net interest margin should remain the same as it is today. Second, convergence should be reached between the FASB and the IASB. He stated that Alternative 3 would best achieve those objectives.

39. Mr. Siegel stated that Alternative 1 is the conceptually appealing. However, Alternative 3 is more appropriate considering the tentative model for recognition and measurement. He also noted that Alternative 3 would keep net interest margin the same as it is today, which is very important for investors. Thus, he noted his support for Alternative 3.

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

<u>None.</u>

<u>General Announcements:</u>

Mr. Herz noted several changes to the technical agenda. He stated that the project on accounting for jackpot liabilities was removed from the technical agenda and that issue will be addressed by the EITF. Mr. Herz noted the project on deferred tax assets and liabilities on available-for-sale securities that are expected to be held to recovery will be removed from the technical agenda and will be addressed in the accounting for financial instruments project.