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FINANCIAL ACCOUNTING SERIES

EXPOSURE DRAFT

Proposed Accounting Standards Update

Issued: May 26, 2010
Comments Due: September 30, 2010

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)

This Exposure Draft of a proposed Accounting Standards Update of Topic 825 and Topic 815 is issued by the Board for public comment. Written comments should be addressed to:

Technical Director
File Reference No. 1810-100

Financial Accounting Standards Board
of the Financial Accounting Foundation

The *FASB Accounting Standards Codification™* is the source of authoritative generally accepted accounting principles (GAAP) recognized by the FASB to be applied by nongovernmental entities. An Accounting Standards Update is not authoritative; rather, it is a document that communicates how the Accounting Standards Codification is being amended. It also provides other information to help a user of GAAP understand how and why GAAP is changing and when the changes will be effective.

Notice to Recipients of This Exposure Draft of a Proposed Accounting Standards Update

The Board invites individuals and organizations to send written comments on all matters in this Exposure Draft of a proposed Accounting Standards Update. Responses from those wishing to comment on the Exposure Draft must be received in writing by September 30, 2010. Interested parties should submit their comments by email to director@fasb.org, File Reference No. 1810-100. Those without email should send their comments to "Technical Director, File Reference No. 1810-100, FASB, 401 Merritt 7, PO Box 5116, Norwalk, CT 06856-5116." Do not send responses by fax.

All comments received constitute part of the FASB's public file. The FASB will make all comments publicly available by posting them to its website and by making them available in its public reference room in Norwalk, Connecticut.

An electronic copy of this Exposure Draft is available on the FASB's website until the FASB issues a final Accounting Standards Update.

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Proposed Accounting Standards Update

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Summary

Why Is the FASB Issuing This Proposed Accounting Standards Update (Update)?

Before the global economic crisis, both the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) had begun a joint project to revise and improve their respective standards on accounting for financial instruments. The global economic crisis further highlighted the ongoing concern that the existing accounting model for financial instruments with its inherent gaps and inconsistencies is inadequate for today's complex economic environment. In the aftermath of the global economic crisis, effective financial reporting has become the subject of worldwide attention, with a focus on the urgent need for improved accounting standards in a number of areas, including financial instruments. As a result, to support well-functioning global capital markets many investors, preparers, and even high-level governing bodies urged as a top priority the development of a single converged financial reporting model for financial instruments that provides investors with the most useful, transparent, and relevant information about an entity's exposure to financial instruments.

The main objective in developing this proposal is to provide financial statement users with a more timely and representative depiction of an entity's involvement in financial instruments, while reducing the complexity in accounting for those instruments. Currently, a high threshold for recognition of credit impairments impedes timely recognition of losses, while complex hedging requirements produce reported results that lack transparency and consistency. Furthermore, existing U.S. generally accepted accounting principles (GAAP) permit different accounting treatments for similar financial instruments. For example, under existing U.S. GAAP, debt instruments may be measured at amortized cost (for example, loans held for investment or held-to-maturity debt securities), at lower of cost or fair value (for example, loans held for sale), or at fair value (for example, trading securities). This proposal simplifies and improves financial reporting for financial instruments by developing a consistent, comprehensive framework for classifying financial instruments, removes the threshold for recognizing credit impairments, and makes changes to the requirements to qualify for hedge accounting, the result of which should be more consistent and transparent reporting for hedging activities.

Strong opinions about the relative benefits and detriments of amortized cost and fair value have sparked widespread commentary. This proposal would require (1) presentation of both amortized cost and fair value on an entity's statement of financial position for most financial instruments held for collection or payment of contractual cash flows and (2) the inclusion of both amortized cost and fair value

information for these instruments in determining net income and comprehensive income. In addition, this proposal would require that financial instruments held for sale or settlement (primarily derivatives and trading financial instruments) be recognized and measured at fair value with all changes in fair value recognized in net income.

Ideally, this proposal would have been issued jointly with the IASB and contain converged guidance. The goal remains for both Boards to issue comprehensive improvements to this complex area that will foster international comparability of financial information about financial instruments. However, each Board has faced different imperatives that have resulted in different approaches for accounting for certain types of financial instruments, resulting in different timetables for the project. The FASB's main objective is to develop accounting standards that represent an improvement to U.S. financial reporting. What may be considered an improvement in jurisdictions with less developed financial reporting systems applying International Financial Reporting Standards (IFRS) may not be considered an improvement in the United States. In addition, the IASB has been replacing its financial instruments requirements in a phased approach, whereas the FASB has been developing this comprehensive proposal. Those differing factors and timetables have contributed to the Boards' reaching differing conclusions on a number of important technical issues.

Following the issuance of this proposal, the FASB and the IASB have jointly committed to continue attempting to reduce differences in the accounting for financial instruments under U.S. GAAP and IFRS. The strategy calls for both Boards to consider together the comment letters and other feedback received in an effort to try to reconcile differences in views in ways that foster convergence while meeting project objectives.

Who Would Be Affected by the Proposed Guidance?

All entities that have financial instruments would be affected by the proposed requirements. However, the extent of the effect would depend upon the relative significance of financial instruments to an entity's operations and financial position as well as the entity's business strategy. For example, traditional banking-type institutions that currently measure a large number of financial assets at amortized cost would be affected to a greater extent than brokers and dealers in securities and investment companies that currently measure most financial assets at fair value. Insurance companies would be affected to varying degrees depending on their asset mix with companies that invest more heavily in equity securities being the most affected. The effect would likely be less significant for many commercial and industrial entities and for many not-for-profit entities. As noted below, the Board is proposing providing nonpublic entities with less than $1 billion in total assets with an additional 4 years to implement the new requirements relating to loans, loan commitments, and core deposit liabilities that meet certain criteria. In addition, some specific types of financial instruments,

such as pension obligations and leases, would be exempt from the proposed guidance. Also, short-term receivables and payables would continue to be measured at amortized cost (plus or minus fair value hedging adjustments).

What Are the Main Aspects of the Proposed Guidance?

The proposed guidance focuses on providing the most useful, transparent, and relevant information to investors about the financial assets and financial liabilities of an entity. Financial statements have traditionally focused on providing information about how an entity manages its business to provide information to help present and potential investors and creditors and other users in assessing the amounts, timing, and uncertainty of future cash flows. For financial instruments, in addition to obtaining information about how an entity manages its business, information about the risks inherent in the instruments also is important for assessing the amounts, timing, and uncertainty of future cash flows.

Under this proposal, most financial instruments would be measured at fair value in the statement of financial position each reporting period. For some financial instruments, this represents no change. However, for certain other financial instruments for which this represents a change, the proposal acknowledges that amortized cost information also is relevant and would require its presentation along with fair value information.

For derivatives and financial instruments for which an entity's strategy is trading the instruments, fair value would continue to be required, with all changes in fair value recognized in net income each reporting period. Changes in the fair value of equity securities, certain hybrid instruments, and financial instruments that can be contractually prepaid in such a way that the holder would not recover substantially all of its investment also would be recognized in net income each reporting period regardless of an entity's business strategy with respect to those financial instruments. The Board believes that this better reflects the risks presented by volatility associated with those financial instruments.

Financial instruments for which an entity's business strategy is to hold for collection or payment(s) of contractual cash flows, the proposed guidance would recognize the utility to financial statement users of both fair value and amortized cost information by requiring a reconciliation from amortized cost to fair value on the face of the statement of position. By continuing to reflect a "business strategy" approach to what is recognized in net income, the proposed model would enable entities to preserve most of the existing aspects of reporting net income and earnings per share. Financial instruments for which an entity's business strategy is to hold for the collection or payment(s) of the contractual cash flows, net income would remain relatively unchanged because only changes arising from interest accruals, credit impairments, and realized gains and losses would be recognized in net income each reporting period. With the exception of certain liabilities that qualify for the amortized cost option, all other

changes in fair value from these instruments would be recognized in other comprehensive income each reporting period.

A consistent measurement model for all financial instruments should improve both comparability across entities and consistency in how an entity accounts for different financial instruments. Many have said that there should be symmetry between the accounting for financial assets and the financial liabilities funding those assets. This may be particularly relevant for financial institutions as financial liabilities are incurred in order to support related financial asset activity. Asset-liability management is core to the business strategy and analysis of financial institutions. Changes in market variables affect valuations of both financial assets and financial liabilities. Accordingly, like financial assets in the proposed model, many financial liabilities of financial institutions would be measured at fair value (with amortized cost also being presented for certain financial liabilities). In addition, core deposit liabilities would be remeasured each period using a current value method that reflects the economic benefit that an entity receives from this lower cost, stable funding source. Thus, under the proposed model for a financial institution, the effects of changes in market interest rates would be transparent on core deposit and other financial liabilities and the financial assets that they fund.

By presenting both fair value and amortized cost information on the face of financial statements for instruments that are being held for collection or payment(s) of contractual cash flows, investors can more easily incorporate either or both in their analyses of an entity. Fair value would provide users with the best available information about the market's assessment of an entity's expectation of its future net cash flows, discounted to reflect both current interest rates and the market's assessment of the risk that the cash flows will not occur. Amortized cost would provide users with information about the instrument's contractual cash flows. Additionally, the Board believes the proposal would improve the timeliness of fair value information because the Board believes that fair value information would likely be available for public entities at the same time as other material financial information, rather than only being disclosed later in the notes to the financial statements included in regulatory filings. The proposed guidance also would continue to provide, if so desired, prudential regulators with the information necessary to compute regulatory capital using either fair value or amortized cost amounts.

The proposed guidance would remove the existing "probable" threshold for recognizing impairments on loans and proposes a common approach to providing for credit losses on loans and debt instruments. Interest income would be recognized after considering cash flows that are not expected to be collected. This should better reflect a financial instrument's interest yield.

By replacing highly complex, quantitative-based hedging requirements with more qualitative-based assessments that would make it easier to qualify for hedge accounting, the economic effects of hedging should be reported more

consistently over multiple reporting periods. 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. In addition, eliminating the shortcut method and the critical terms match method would result in a more consistent model for assessing hedge effectiveness. 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. Eliminating the ability to discontinue hedge accounting simply by removing a hedging designation would contribute to both increased comparability and transparency.

How Do the Proposed Provisions Compare with IFRS?

Both the proposed guidance and IFRS apply more than one measurement attribute to financial instruments.

Under the proposed guidance, the measurement attribute for most financial assets would be fair value. When specific eligibility criteria are met primarily relating to whether the financial asset is being held for collection of contractual cash flows, amortized cost also would be presented with qualifying changes in fair value recognized in other comprehensive income rather than net income. Under IFRS 9, *Financial Instruments*, when similar eligibility criteria are met, financial assets are measured at amortized cost and fair value information is disclosed in the notes to the financial statements. The qualifying criteria under both the proposed guidance and IFRS 9 are based on the entity's business strategy (held for collection or payment of cash flows) with respect to the financial instrument and the cash flow characteristics of the instrument.

This proposed guidance is based on the view that both amortized cost and fair value information convey important information to users of financial statements about financial instruments that an entity intends to hold for collection or payment(s) of contractual cash flows. For financial assets, IFRS 9 is based on the view that either fair value or amortized cost provides more relevant and useful information about the amounts, timing, and uncertainty of the entity's future cash flows based on the cash flow characteristics of the financial asset and the reporting entity's business strategy for its financial assets.

The difference in the classification categories would result in measuring loans at fair value under the proposed guidance (with amortized cost also being presented), and measuring most loans at amortized cost under IFRS 9 if the qualifying criteria are met (with fair value information disclosed in the notes to the financial statements). Under the proposed guidance, all investments in debt and equity securities would be measured at fair value. Under IFRS 9, investments in debt instruments, including those traded in active markets with quoted market prices, may be measured at amortized cost (with fair value information disclosed in the notes to the financial statements) if they meet the qualifying criteria; other

debt instruments would be measured at fair value. IFRS 9 provides an election to recognize changes in fair value in other comprehensive income only for equity instruments that are not held for trading purposes; other equity instruments would be measured at fair value.

Under the proposed guidance, financial liabilities would be measured at fair value, amortized cost (based on eligibility criteria), or a remeasurement amount specifically applicable to core deposit liabilities. Financial liabilities are not in the scope of IFRS 9. However, the IASB tentatively has decided to retain existing guidance for financial liabilities except for financial liabilities measured at fair value under the fair value option. IFRS currently measures most financial liabilities (including core deposit liabilities) at amortized cost if they are not held for trading. The proposed guidance would provide an amortized cost option for qualifying financial liabilities, while IFRS provides a fair value option for qualifying financial liabilities. The proposed guidance would require hybrid financial instruments that would otherwise have been required to be bifurcated under Subtopic 815-15 on embedded derivatives to be classified and measured at fair value in their entirety, while IFRS requires bifurcation of hybrid financial liability instruments in certain situations with the derivative instrument measured at fair value and the host contract measured at amortized cost.

Overall, because of these measurement differences, more financial instruments would be measured at fair value on the statement of financial position under the proposed guidance than those measured in accordance with IFRS. This difference also would result in a difference in reported stockholders' equity. The measurement differences in financial assets primarily would result in differences in the amount of comprehensive income reported with limited differences in reported net income for most entities. However, differences in reported net income may be significant for certain entities because IFRS will continue to require bifurcation of certain hybrid financial liabilities and the proposed guidance would require such liabilities to be measured at fair value with changes in fair value recognized in net income in their entirety.

With regard to impairment of financial assets, the IASB also has issued an Exposure Draft that proposes a different approach to providing for credit losses and to accruing interest income. The Boards have established and are receiving input and advice from an Expert Advisory Panel comprising representatives from major financial institutions and other companies, audit firms, and securities and prudential regulators from around the world. The Expert Advisory Panel is providing operational input on both the FASB's and IASB's approaches that should assist in the Boards' efforts to develop a common approach to impairment of financial assets and accrual of interest income.

The IASB tentatively decided to retain the classification and measurement guidance in IAS 39, *Financial Instruments: Recognition and Measurement,* for financial liabilities. However, the IASB also tentatively decided to amend the fair value option for financial liabilities and issued an Exposure Draft, *Fair Value*

Option for Financial Liabilities (Exposure Draft on fair value option), on May 11, 2010. The IASB expects to issue a proposal on hedge accounting in the near term.

See the comparison of the FASB's and the IASB's proposed models for financial instruments in Appendix A for more information.

When Would the Proposed Amendments Be Effective?

The Board will establish the effective date of the requirements when it issues the final amendments. Whatever that date, nonpublic entities with less than $1 billion in total consolidated assets would be granted an additional 4 years to measure its loans and loan commitments at fair value and remeasure its core deposit liabilities that qualify for changes in fair value to be recognized in other comprehensive income. The Board believes that such a deferral would allow these entities to develop and refine the capabilities and processes necessary for valuing loans, loan commitments, and core deposit liabilities before being required to recognize these amounts on the face of its financial statements. It also would enable the Board to perform a post-implementation review of the new financial instruments' requirements two or three years after the initial effective date but before the requirements become effective for all entities. In the interim, loans, loan commitments, and core deposit liabilities subject to the deferral would continue to be measured in the financial statements under existing U.S. GAAP. Also during the interim, the fair value of loans would be disclosed in the notes to the financial statements.

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. Early adoption would be prohibited.

Questions for Respondents

The Board invites individuals and organizations to comment on all matters in this proposed Update, particularly on the issues and questions below. Comments are requested from those who agree with the proposed guidance as well as from those who disagree. Comments are most helpful if they identify and clearly explain the issue or question to which they relate. Those who disagree with the proposed guidance are asked to describe their suggested alternatives, supported by specific reasoning. For questions requesting comments on operationality, assume an effective date of no earlier than January 1, 2013.

Scope

Questions for All Respondents

Question 1: Do you agree with the scope of financial instruments included in this proposed Update? If not, which other financial instruments do you believe should be excluded or which financial instruments should be included that are proposed to be excluded? Why?

Question 2: The proposed guidance would require loan commitments, other than loan commitments related to a revolving line of credit issued under a credit card arrangement, to be measured at fair value. Do you agree that loan commitments related to a revolving line of credit issued under a credit card arrangement should be excluded from the scope of this proposed Update? If not, why?

Question 3: The proposed guidance would require deposit-type and investment contracts of insurance and other entities to be measured at fair value. Do you agree that deposit-type and investment contracts should be included in the scope? If not, why?

Question 4: The proposed guidance would require an entity to not only determine if they have significant influence over the investee as described currently in Topic 323 on accounting for equity method investments and joint ventures but also to determine if the operations of the investee are related to the entity's consolidated business to qualify for the equity method of accounting. Do you agree with this proposed change to the criteria for equity method of accounting? If not, why?

Questions for Users

Question 5: The proposed guidance would require financial liabilities of investment companies to be measured at fair value with changes in fair value recognized as a net increase (decrease) in net assets. Do you believe that the effect on net asset value will provide decision-useful information? If yes, how will the information provided influence your analysis of the entity? If not, why?

Question 6: The proposed guidance would require money market funds that comply with Rule 2a-7 of the Investment Company Act of 1940 to measure their investments at fair value rather than amortized cost. Do you believe that reporting those investments at fair value rather than amortized cost will provide decision-useful information? If yes, how will the information provided influence your analysis of the fund? If not, why?

Question 7: The proposed guidance would require brokers and dealers in securities to apply the proposed guidance for measuring financial liabilities, which

could mean that qualifying changes in fair value would be recognized in other comprehensive income. Do you believe that this will provide decision-useful information? If yes, how will the information provided influence your analysis of the entity? If not, why?

Initial Measurement

Questions for All Respondents

Question 8: Do you agree with the initial measurement principles for financial instruments? If not, why?

Question 9: For financial instruments for which qualifying changes in fair value are recognized in other comprehensive income, do you agree that a significant difference between the transaction price and the fair value on the transaction date should be recognized in net income if the significant difference relates to something other than fees or costs or because the market in which the transaction occurs is different from the market in which the reporting entity would transact? If not, why?

Question 10: Do you believe that there should be a single initial measurement principle regardless of whether changes in fair value of a financial instrument are recognized in net income or other comprehensive income? If yes, should that principle require initial measurement at the transaction price or fair value? Why?

Question 11: Do you agree that transaction fees and costs should be (1) expensed immediately for financial instruments measured at fair value with all changes in fair value recognized in net income and (2) deferred and amortized as an adjustment of the yield for financial instruments measured at fair value with qualifying changes in fair value recognized in other comprehensive income? If not, why?

Question for Preparers and Auditors

Question 12: For financial instruments initially measured at the transaction price, do you believe that the proposed guidance is operational to determine whether there is a significant difference between the transaction price and fair value? If not, why?

Subsequent Measurement

Questions for All Respondents

Question 13: The Board believes that both fair value information and amortized cost information should be provided for financial instruments an entity intends to

hold for collection or payment(s) of contractual cash flows. Most Board members believe that this information should be provided in the totals on the face of the financial statements with changes in fair value recognized in reported stockholders' equity as a net increase (decrease) in net assets. Some Board members believe fair value should be presented parenthetically in the statement of financial position. The basis for conclusions and the alternative views describe the reasons for those views. Do you believe the default measurement attribute for financial instruments should be fair value? If not, why? Do you believe that certain financial instruments should be measured using a different measurement attribute? If so, why?

Question 14: The proposed guidance would require that interest income or expense, credit impairments and reversals (for financial assets), and realized gains and losses be recognized in net income for financial instruments that meet the criteria for qualifying changes in fair value to be recognized in other comprehensive income. Do you believe that any other fair value changes should be recognized in net income for these financial instruments? If yes, which changes in fair value should be separately recognized in net income? Why?

Question 15: Do you believe that the subsequent measurement principles should be the same for financial assets and financial liabilities? If not, why?

Question 16: The proposed guidance would require an entity to decide whether to measure a financial instrument at fair value with all changes in fair value recognized in net income, at fair value with qualifying changes in fair value recognized in other comprehensive income, or at amortized cost (for certain financial liabilities) at initial recognition. The proposed guidance would prohibit an entity from subsequently changing that decision. Do you agree that reclassifications should be prohibited? If not, in which circumstances do you believe that reclassifications should be permitted or required? Why?

Question 17: The proposed guidance would require an entity to measure its core deposit liabilities at the present value of the average core deposit amount discounted at the difference between the alternative funds rate and the all-in-cost-to-service rate over the implied maturity of the deposits. Do you believe that this remeasurement approach is appropriate? If not, why? Do you believe that the remeasurement amount should be disclosed in the notes to the financial statements rather than presented on the face of the financial statements? Why or why not?

Question 18: Do you agree that a financial liability should be permitted to be measured at amortized cost if it meets the criteria for recognizing qualifying changes in fair value in other comprehensive income and if measuring the liability at fair value would create or exacerbate a measurement attribute mismatch? If not, why?

Question 19: Do you believe that the correct financial instruments are captured by the criteria in the proposed guidance to qualify for measurement at the

redemption amount for certain investments that can be redeemed only for a specified amount (such as an investment in the stock of the Federal Home Loan Bank or an investment in the Federal Reserve Bank)? If not, are there any financial instruments that should qualify but do not meet the criteria? Why?

Question 20: Do you agree that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to a debt instrument measured at fair value with qualifying changes in fair value recognized in other comprehensive income in combination with other deferred tax assets of the entity (rather than segregated and analyzed separately)? If not, why?

Question 21: The Proposed Implementation Guidance section of this proposed Update provides an example to illustrate the application of the subsequent measurement guidance to convertible debt (Example 10). The Board currently has a project on its technical agenda on financial instruments with characteristics of equity. That project will determine the classification for convertible debt from the issuer's perspective and whether convertible debt should continue to be classified as a liability in its entirety or whether the Board should require bifurcation into a liability component and an equity component. However, based on existing U.S. GAAP, the Board believes that convertible debt would not meet the criterion for a debt instrument under paragraph 21(a)(1) to qualify for changes in fair value to be recognized in other comprehensive income because the principal will not be returned to the creditor (investor) at maturity or other settlement. Do you agree with the Board's application of the proposed subsequent measurement guidance to convertible debt? If not, why?

Questions for Users

Question 22: Do you believe that the recognition of qualifying changes in fair value in other comprehensive income (measuring the effects of subsequent changes in interest rates on fair value as well as reflecting differences between management's and the market's expectations about credit impairments) will provide decision-useful information for financial instruments an entity intends to hold for collection or payment(s) of contractual cash flows? If yes, how will the information provided influence your analysis of an entity? If not, why?

Question 23: The proposed guidance would establish fair value with all changes in fair value recognized in net income as the default classification and measurement category for financial instruments. An entity can choose to measure any financial instrument within the scope of this proposed Update at fair value with all changes in fair value recognized in net income, except for core deposit liabilities which must be valued using a remeasurement approach. Do you believe that a default classification and measurement category should be provided for financial instruments that would otherwise meet the criteria for qualifying changes to be recognized in other comprehensive income? If not, why?

Question 24: The proposed guidance would provide amortized cost and fair value information on the face of the financial statements. The Board believes that this would increase the likelihood that both measures are available to users of public entity financial statements on a timely basis and that both measures are given equal attention by preparers and auditors. Do you believe that this approach will provide decision-useful information? If yes, how will the information provided be used in the analysis of an entity? If not, would you recommend another approach (for example, supplemental fair value financial statements in the notes to the financial statements or dual financial statements)?

Question 25: For hybrid financial instruments that currently would require bifurcation and separate accounting under Subtopic 815-15, do you agree that recognizing the entire change in fair value in net income results in more decision-useful information than requiring the embedded derivative to be bifurcated and accounted for separately from the host contract? If yes, how will the information provided be used in the analysis of an entity? If not, for which types of hybrid financial instruments do you believe that it is more decision useful to account for the embedded derivative separately from the host contract? Why?

Question 26: IFRS 9 requires hybrid financial assets to be classified in their entirety on the basis of the overall classification approach for financial assets with specific guidance for applying the classification approach to investments in contractually linked instruments that create concentrations of credit risk. Also, for hybrid financial liabilities, the IASB, in order to address the effects of changes in the credit risk of a liability, tentatively has decided to retain existing guidance that requires embedded derivatives to be bifurcated and accounted for separately from a host liability contract if particular conditions are met. Do you believe that the proposed guidance for hybrid financial instruments or the IASB's model for accounting for financial hybrid contracts will provide more decision-useful information? Why?

Question 27: Do you believe that measuring certain short-term receivables and payables at amortized cost (plus or minus any fair value hedging adjustments) will provide decision-useful information? If yes, how will the information provided be used in your analysis of an entity? If not, why?

Questions for Preparers and Auditors

Question 28: Do you believe that the proposed criteria for recognizing qualifying changes in fair value in other comprehensive income are operational? If not, why?

Question 29: Do you believe that measuring financial liabilities at fair value is operational? If not, why?

Question 30: Do you believe that the proposed criteria are operational to qualify for measuring a financial liability at amortized cost? If not, why?

Question 31: The proposed guidance would require an entity to measure its core deposit liabilities at the present value of the average core deposit amount discounted at the difference between the alternative funds rate and the all-in-cost-to-service rate over the implied maturity of the deposits. Do you believe that this remeasurement approach is operational? Do you believe that the remeasurement approach is clearly defined? If not, what, if any, additional guidance is needed?

Presentation

Questions for All Respondents

Question 32: For financial liabilities measured at fair value with all changes in fair value recognized in net income, do you agree that separate presentation of changes in an entity's credit standing (excluding changes in the price of credit) is appropriate, or do you believe that it is more appropriate to recognize the changes in an entity's credit standing (with or without changes in the price of credit) in other comprehensive income, which would be consistent with the IASB's tentative decisions on financial liabilities measured at fair value under the fair value option? Why?

Question 33: Appendix B describes two possible methods for determining the change in fair value of a financial liability attributable to a change in the entity's credit standing (excluding the changes in the price of credit). What are the strengths and weaknesses of each method? Would it be appropriate to use either method as long as it was done consistently, or would it be better to use Method 2 for all entities given that some entities are not rated? Alternatively, are there better methods for determining the change in fair value attributable to a change in the entity's credit standing, excluding the price of credit? If so, please explain why those methods would better measure that change.

Question 34: The methods described in Appendix B for determining the change in fair value of a financial liability attributable to a change in an entity's credit standing (excluding the changes in the price of credit) assume that the entity would look to the cost of debt of other entities in its industry to estimate the change in credit standing, excluding the change in the price of credit. Is it appropriate to look to other entities within an entity's industry, or should some other index, such as all entities in the market of a similar size or all entities in the industry of a similar size, be used? If so, please explain why another index would better measure the change in the price of credit.

Questions for Users

Question 35: For financial instruments measured at fair value with qualifying changes in fair value recognized in other comprehensive income, do you believe

that the presentation of amortized cost, the allowance for credit losses (for financial assets), the amount needed to reconcile amortized cost less the allowance for credit losses to fair value, and fair value on the face of the statement of financial position will provide decision-useful information? If yes, how will the information provided be used in your analysis of an entity? If not, why?

Question 36: Do you believe that separately presenting in the performance statement significant changes in the fair value of financial liabilities for changes in an entity's credit standing (excluding the changes in the price of credit) will provide decision-useful information? If yes, how will the information provided influence your analysis of the entity? If not, why? Do you believe that changes in the price of credit also should be included in this amount? If so, why?

Credit Impairment

Questions for All Respondents

Question 37: Do you believe that the objective of the credit impairment model in this proposed Update is clear? If not, what objective would you propose and why?

Question 38: The proposed guidance would require an entity to recognize a credit impairment immediately in net income when the entity does not expect to collect all contractual amounts due for originated financial asset(s) and all amounts originally expected to be collected for purchased financial asset(s).

The IASB Exposure Draft, *Financial Instruments: Amortised Cost and Impairment* (Exposure Draft on impairment), would require an entity to forecast credit losses upon acquisition and allocate a portion of the initially expected credit losses to each reporting period as a reduction in interest income by using the effective interest rate method. Thus, initially expected credit losses would be recorded over the life of the financial asset as a reduction in interest income. If an entity revises its estimate of cash flows, the entity would adjust the carrying amount (amortized cost) of the financial asset and immediately recognize the amount of the adjustment in net income as an impairment gain or loss.

Do you believe that an entity should immediately recognize a credit impairment in net income when an entity does not expect to collect all contractual amounts due for originated financial asset(s) and all amounts originally expected to be collected for purchased financial asset(s) as proposed in this Update, or do you believe that an entity should recognize initially expected credit losses over the life of the financial instrument as a reduction in interest income, as proposed in the IASB Exposure Draft on impairment?

Question 39: Do you agree that a credit impairment should not result from a decline in cash flows expected to be collected due to changes in foreign

exchange rates, changes in expected prepayments, or changes in a variable interest rate? If not, why?

Question 40: For a financial asset evaluated in a pool, the proposed guidance does not specify a particular methodology to be applied by individual entities for determining historical loss rates. Should a specific method be prescribed for determining historical loss rates? If yes, what specific method would you recommend and why?

Question 41: Do you agree that if an entity subsequently expects to collect more cash flows than originally expected to be collected for a purchased financial asset, the entity should recognize no immediate gain in net income but should adjust the effective interest rate so that the additional cash flows are recognized as an increase in interest income over the remaining life of the financial asset? If not, why?

Question 42: If a financial asset that is evaluated for impairment on an individual basis has no indicators of being individually impaired, the proposed guidance would require an entity to determine whether assessing the financial asset together with other financial assets that have similar characteristics indicates that a credit impairment exists. The amount of the credit impairment, if any, would be measured by applying the historical loss rate (adjusted for existing economic factors and conditions) applicable to the group of similar financial assets to the individual financial asset. Do you agree with this requirement? If not, why?

Questions for Users

Question 43: The credit impairment model in this proposed Update would remove the probable threshold. Thus, an entity would no longer wait until a credit loss is probable to recognize a credit impairment. An entity would be required to recognize a credit impairment immediately in net income when an entity does not expect to collect all of the contractual cash flows (or, for purchased financial assets, the amount originally expected). This will result in credit impairments being recognized earlier than they are under existing U.S. GAAP.

Do you believe that removing the probable threshold so that credit impairments are recognized earlier provides more decision-useful information?

Question 44: The proposed guidance would require that in determining whether a credit impairment exists, an entity consider all available information relating to past events and existing conditions and their implications for the collectibility of the cash flows attributable to the financial asset(s) at the date of the financial statements. An entity would assume that the economic conditions existing at the end of the reporting period would remain unchanged for the remaining life of the financial asset(s) and would not forecast future events or economic conditions that did not exist at the reporting date. In contrast, the IASB Exposure Draft on

impairment proposes an expected loss approach and would require an entity to estimate credit losses on the basis of probability-weighted possible outcomes.

Do you agree that an entity should assume that economic conditions existing at the reporting date would remain unchanged in determining whether a credit impairment exists, or do you believe that an expected loss approach that would include forecasting future events or economic conditions that did not exist at the end of the reporting period would provide more decision-useful information?

Question 45: The proposed guidance would require that an appropriate historical loss rate (adjusted for existing economic factors and conditions) be determined for each individual pool of similar financial assets. Historical loss rates would reflect cash flows that the entity does not expect to collect over the life of the financial assets in the pool. Do you agree with that approach?

Questions for Preparers and Auditors

Question 46: The proposed guidance would require that in determining whether a credit impairment exists, an entity consider all available information relating to past events and existing conditions and their implications for the collectibility of the cash flows attributable to the financial asset(s) at the date of the financial statements. An entity would assume that the economic conditions existing at the end of the reporting period would remain unchanged for the remaining life of the financial asset(s) and would not forecast future events or economic conditions that did not exist at the reporting date. In contrast, the IASB Exposure Draft on Impairment proposes an expected loss approach and would require an entity to estimate credit losses on basis of probability-weighted possible outcomes.

Do you agree that an entity should assume that economic conditions existing at the reporting date would remain unchanged in determining whether a credit impairment exists, or do you believe that an expected loss approach that would include forecasting future events or economic conditions that did not exist at the end of the reporting period would be more appropriate? Are both methods operational? If not, why?

Question 47: The proposed guidance would require that an appropriate historical loss rate (adjusted for existing economic factors and conditions) be determined for each individual pool of similar financial assets. Historical loss rates would reflect cash flows that the entity does not expect to collect over the life of the financial assets in the pool. Would such an approach result in a significant change in practice (that is, do historical loss rates typically reflect cash flows that the entity does not expect to collect over the life of the financial assets in the pool or some shorter period)?

Interest Income

Questions for All Respondents

Question 48: The proposed guidance would require interest income to be calculated for financial assets measured at fair value with qualifying changes in fair value recognized in other comprehensive income by applying the effective interest rate to the amortized cost balance net of any allowance for credit losses. Do you believe that the recognition of interest income should be affected by the recognition or reversal of credit impairments? If not, why?

Question 49: Do you agree that the difference in the amount of interest contractually due that exceeds interest accrued on the basis of an entity's current estimate of cash flows expected to be collected for financial assets should be recognized as an increase to the allowance for credit losses? If not, why?

Question 50: The proposed guidance would permit, but would not require, separate presentation of interest income on the statement of comprehensive income for financial assets measured at fair value with all changes in fair value recognized in net income. If an entity chooses to present separately interest income for those financial assets, the proposed guidance does not specify a particular method for determining the amount of interest income to be recognized on the face of the statement of comprehensive income. Do you believe that the interest income recognition guidance should be the same for all financial assets?

Question 51: Do you believe that the implementation guidance and illustrative examples included in this proposed Update are sufficient to understand the proposed credit impairment and interest income models? If not, what additional guidance or examples are needed?

Questions for Users

Question 52: Do you believe that the method for recognizing interest income on financial assets measured at fair value with qualifying changes in fair value recognized in other comprehensive income will provide decision-useful information? If yes, how will the information provided be used in your analysis of an entity? If not, why?

Question 53: The method of recognizing interest income will result in the allowance for credit impairments presented in the statement of financial position not equaling cumulative credit impairments recognized in net income because a portion of the allowance will reflect the excess of the amount of interest contractually due over interest income recognized. Do you believe that this is understandable and will provide decision-useful information? If yes, how will the information provided be used? If not, why?

Question 54: The proposed guidance would require interest income to be calculated for financial assets measured at fair value with qualifying changes in fair value recognized in other comprehensive income by applying the effective interest rate to the amortized cost balance net of any allowance for credit losses. Thus, the recognition of a credit loss would result in a decrease in interest income recognized. Similarly, a reversal of a previously recognized credit loss would increase the amount of interest income recognized. The IASB Exposure Draft on Impairment proposes that an entity calculate interest by multiplying the effective rate established at initial recognition by the amortized cost basis. The IASB's definition of *amortized cost basis* is the present value of expected future cash flows discounted by the effective interest rate established at initial recognition and, therefore, includes credit losses recognized to date. Thus, as initially expected credit losses are allocated over the life of the instrument, the amount of interest income decreases.

Both the FASB's and the IASB's models for interest income recognition are similar in that the recognition of an impairment reduces the amount of interest income recognized. However, as noted in the questions above, the timing of credit impairments and the determination of the effective interest rate differ in the two proposed models. Thus, the amount of interest income recognized under the two proposed models will differ. Do you believe that the FASB's model or the IASB's model provides more decision-useful information? Why?

Question 55: Do you agree that an entity should cease accruing interest on a financial asset measured at fair value with qualifying changes in fair value recognized in other comprehensive income if the entity's expectations about cash flows expected to be collected indicate that the overall yield on the financial asset will be negative? If not, why?

Hedge Accounting

Questions for All Respondents

Question 56: Do you believe that modifying the effectiveness threshold from *highly effective* to *reasonably effective* is appropriate? Why or why not?

Question 57: Should no effectiveness evaluation be required under any circumstances after inception of a hedging relationship if it was determined at inception that the hedging relationship was expected to be reasonably effective over the expected hedge term? Why or why not?

Question 58: Do you believe that requiring an effectiveness evaluation after inception only if circumstances suggest that the hedging relationship may no longer be reasonably effective would result in a reduction in the number of times hedging relationships would be discontinued? Why or why not?

Questions for Users

Question 59: Do you believe that a hedge accounting model that recognizes in net income changes in the fair value and changes in the cash flows of the risk being hedged along with changes in fair value of the hedging instrument provides decision-useful information? If yes, how would that information be used? If not, why?

Question 60: Do you believe that the proposed changes to the hedge accounting model will provide more transparent and consistent information about hedging activities? If yes, why and how would you use the information provided? If not, what changes do you disagree with and why?

Questions for Preparers and Auditors

Question 61: Do you foresee any significant operational concerns or constraints in calculating ineffectiveness for cash flow hedging relationships? If yes, what constraints do you foresee and how would you alleviate them?

Question 62: Do you foresee any significant operational concerns or constraints in creating processes that will determine when changes in circumstances suggest that a hedging relationship may no longer be reasonably effective without requiring reassessment of the hedge effectiveness at each reporting period? If yes, what constraints do you foresee and how would you alleviate them?

Question 63: Do you foresee any significant operational concerns or constraints arising from the inability to discontinue fair value hedge accounting or cash flow hedge accounting by simply dedesignating the hedging relationship? If yes, what constraints do you foresee and how would you alleviate them?

Question 64: Do you foresee any significant operational concerns or constraints arising from the required concurrent documentation of the effective termination of a hedging derivative attributable to the entity's entering into an offsetting derivative instrument? If yes, what constraints do you foresee and how would you alleviate them?

Disclosures

Question for All Respondents

Question 65: Do you agree with the proposed disclosure requirements? If not, which disclosure requirement do you believe should not be required and why?

Questions for Users

Question 66: For purchased financial assets, do you believe that the requirement to disclose the principal balance, the purchaser's assessment of the discount related to credit losses inherent in the financial instrument at acquisition, any additional difference between the amortized cost and the principal balance, and the amortized cost in each period will provide decision-useful information? If yes, how will the information provided influence your analysis of an entity? If not, why?

Question 67: Are there any other disclosures that you believe would provide decision-useful information and why?

Effective Date and Transition

Questions for All Respondents

Question 68: Do you agree with the transition provision in this proposed Update? If not, why?

Question 69: 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?

Questions for Preparers and Auditors

Question 70: How much time do you believe is needed to implement the proposed guidance?

Question 71: Do you believe the proposed transition provision is operational? If not, why?

Public Roundtable Meetings

The Board plans to hold four public roundtable meetings on this proposed Update—two on October 12, 2010, and two on October 21, 2010. The purpose of roundtable meetings is to listen to the views of, and obtain information from, interested constituents about this proposed Update. The Board plans to seek participants for the meetings that represent a wide variety of constituents, including users, preparers, auditors, and others to ensure that it receives broad input. Any individual or organization desiring to participate must notify the FASB by sending an email to director@fasb.org and submitting its comments on the proposed Update in writing by September 1, 2010. Roundtable meetings can accommodate a limited number of participants. Depending on the number of

responses received, the Board may not be able to accommodate all requests to participate.

Field Visit Volunteers

The Board also is soliciting entities that would be willing to participate with the staff, on a confidential basis, in a field visit to discuss the provisions of this proposed Update. The purpose of field visits is to assess the operationality and the costs and benefits of the proposed guidance. Entities interested in volunteering can contact Upaasna Laungani, Project Manager, at ulaungani@fasb.org.

Proposed Guidance

Introduction

1. The Proposed Guidance section of this proposed Accounting Standards Update describes the accounting, hedging, presentation, and disclosure requirements that would result from the related amendments to the *FASB Accounting Standards Codification™*. The Board recognizes that the proposed guidance will have a pervasive effect on the existing accounting guidance for financial instruments. The table in Appendix C has been included to provide an indication of the effect of the proposed guidance on relevant areas of the Accounting Standards Codification. The table is based on a preliminary assessment of the necessary updates to the Accounting Standards Codification. It presents only the significant changes to the Accounting Standards Codification that are expected to arise from the proposed guidance and is not intended to be a comprehensive list of updates to the Accounting Standards Codification. The amendments to implement the proposed requirements described in this Proposed Guidance section are not included. The Board expects to issue those proposed amendments and proposed amendments to the XBRL Taxonomy during the comment period on this proposed Update.

Objective

2. The objective of the proposed guidance is to provide an improved and consistent financial reporting model for the recognition, measurement, and presentation of financial instruments in an entity's financial statements. The model increases the decision usefulness of the information provided in the financial statements to users by recognizing and measuring many financial instruments at fair value, without eliminating amortized cost information.

Scope

Entities

3. The proposed guidance applies to all entities. However, for a **nonpublic entity** with less than $1 billion in total consolidated assets, the effective date for particular requirements is deferred for 4 years. Paragraphs 134–136 explain that deferral and the required accounting and disclosures in the interim.

Financial Instruments and Transactions

4. The proposed guidance applies to all financial instruments except for the following:

a. An instrument held or issued by an entity that is classified in its entirety in the entity's stockholders' equity. (See the guidance on distinguishing liabilities from equity in Topic 480 and the guidance on equity in Topic 505.)
b. An equity component that has been bifurcated from a hybrid instrument and classified in an entity's stockholders' equity in accordance with the guidance on debt in Topic 470, Topic 480, or another Topic that requires separate accounting for the components of a hybrid financial instrument.
c. An employer's or plan's obligation and the related assets, if any, that are within the scope of any of the following Topics:
   1. Topic 710 on compensation (see the guidance beginning in paragraph 710-10-15-3)
   2. Topic 712 on nonretirement postemployment benefits (see the guidance beginning in paragraph 712-10-15-3)
   3. Topic 715 on retirement benefits (see the guidance beginning in paragraph 715-10-15-3)
   4. Topic 718 on stock compensation (see the guidance beginning in paragraph 718-10-15-3)
   5. Topic 960 on accounting by defined benefit pension plans
   6. Topic 962 on accounting by defined contribution pension plans
   7. Topic 965 on accounting by health and welfare benefit plans.
d. An insurance contract within the scope of Topic 944 on financial services and insurance. However, the following are included in the scope of this proposed Update:
   1. A contract within the scope of the deposit method of accounting set forth in Subtopic 340-30 on insurance contracts that do not transfer insurance risk
   2. An investment contract accounted for in accordance with paragraphs 944-825-25-1 through 25-2 on accounting for insurance entities.
e. An investment in the equity instruments of another entity that qualifies for use of the equity method in accordance with Topic 323 on the equity method and joint ventures. (See paragraph 130 for the criteria to qualify for use of the equity method of accounting.)
f. An equity investment in a consolidated subsidiary (see Subtopic 810-10 on consolidation).
g. A **noncontrolling interest** in a consolidated subsidiary (see Subtopic 810-10).
h. An interest in a variable interest entity that the entity is required to consolidate in accordance with Subtopic 810-10.

i. A financial asset or financial liability pertaining to a lease that is within the scope of Topic 840 on leases.
j. A loan commitment and a financial standby letter of credit held by a potential borrower.
k. A loan commitment related to a revolving line of credit issued under a credit card arrangement.
l. The conditional obligation under a registration payment arrangement that shall be accounted for separately from the financial instrument(s) subject to the agreement in accordance with Subtopic 825-20 on registration payment arrangements. However, a holder of a financial instrument that is subject to a registration payment arrangement is within the scope of this proposed Update.
m. A contingent consideration arrangement that is not based on an observable market or an observable index. For example, a contingent consideration arrangement that is based on the future stock price of the acquirer that is observable in the market would be within the scope of this proposed Update.
n. A not-for-profit entity's pledge receivable or payable resulting from a voluntary, nonreciprocal transfer.
o. The following financial guarantee contracts:
    1. A contract that provides for payments that constitute a vendor rebate (by the guarantor) based either on the sales revenues of or the number of units sold by the guaranteed party, or on the volume of purchases by the buyer
    2. A guarantee or an indemnification, the existence of which prevents the guarantor from being able either to account for a transaction as the sale of an asset or to recognize the profit from that sale transaction
    3. A guarantee or an indemnification of an entity's own future performance (for example, a guarantee that the guarantor will not take a specified action)
    4. A product warranty or other guarantee for which the underlying is related to the functional performance (and not the price) of nonfinancial assets that are owned by the guaranteed party
    5. A guarantee issued between a parent and its subsidiary or between entities under common control
    6. A parent's guarantee of its subsidiary's debt to a third party
    7. A subsidiary's guarantee of debt owed to a third party by either its parent or another subsidiary of that parent.
p. Forward contracts that require physical settlement by repurchase of a fixed number of the issuer's equity shares in exchange for cash accounted for in accordance with paragraph 480-10-35-3.

5. In addition, the following instruments or transactions that are excluded from the scope of Topic 815 on derivatives and hedging also are excluded from the

scope of this proposed Update. Subtopic 815-10 describes criteria that must be met for some of the following scope exceptions:

a. A forward contract related to a regular-way securities trade
b. A derivative that is an impediment to one party's use of sale accounting under Topic 860 on transfers and servicing
c. An investment contract that is subject to Topic 960
d. A contract that is not exchange-traded if the underlying is any of the following:
   1. A climatic or geological variable
   2. The price or value of a nonfinancial asset or liability of one of the parties to the contract provided that the asset is not readily convertible to cash
   3. Specified volumes of sales or service revenues of one of the parties to the contract.
e. A policyholder's investment in a life insurance contract that is accounted for under Subtopic 325-30 on investments in insurance contracts
f. A contract between a potential acquirer and seller to enter into a business combination at a future date.

Glossary

6. The proposed guidance uses the terms in paragraphs 7–9 with the specified meanings. The terms are organized whether they are new terms to be added to the Master Glossary of the Accounting Standards Codification by this proposed Update, existing terms from the Master Glossary that this proposed Update would amend, or existing terms used without change.

7. Defined terms to be added to the Master Glossary include the following:

All-in-Cost-to-Service Rate

A rate that includes the net direct costs to service core deposit liabilities, including all of the following:

a. Interest paid on the deposits;
b. The expense of maintaining a branch network; minus
c. Fee income earned on the deposit accounts.

Alternative Funds Rate

A rate associated with the next available source of funds if core deposit liabilities are not an available source of funds. The alternative funds source must be cost effective and sufficient in volume and duration to replace the core deposit liabilities as a source of funds. A blended rate may be used if one source alone is not sufficient in volume.

Core Deposit Liabilities

Deposits without a contractual maturity that management considers to be a stable source of funds, which excludes transient and surge balances (these balances are further described in paragraph IG22).

Debt Instrument

A receivable or payable that represents a contractual right to receive cash (or other consideration) or a contractual obligation to pay cash (or other consideration) on fixed or determinable dates, whether or not there is any stated provision for interest.

Implied Maturity

For a core deposit liability, management's assessment of the average life by account type. Management may make that assessment on the basis of either an analysis of internal data or an analysis of peer information.

Writeoff

A reduction of the amortized cost of a financial asset because of its uncollectibility.

8. Existing terms and definitions to be amended as indicated by ~~strike throughs~~ (deleted text) and underlines (new text):

Amortized Cost

~~The sum of the initial investment less cash collected less write-downs plus yield accrued to date.~~

A cost-based measure of a financial asset or financial liability that adjusts the initial cash inflow or outflow (or the noncash equivalent) for factors such as amortization or other allocations. Amortized cost is calculated as the initial cash outflow or cash inflow (or the noncash equivalent) of a financial asset or financial liability adjusted over time as follows:

a. Decreased by principal repayments
b. Increased or decreased by the cumulative accretion or amortization of any original issue discount or premium and cumulative amortization of any transaction fees or costs not recognized in net income in the period of acquisition or incurrence
c. Increased or decreased by foreign exchange adjustments
d. Decreased by writeoffs of the principal amount.

~~Amortized Cost Basis~~

~~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.~~

Collateral-Dependent ~~Loan~~ Financial Asset

A ~~loan~~financial asset for which the repayment is expected to be provided ~~solely by the underlying collateral~~ primarily or substantially through the operation or sale of the collateral.

Direct Loan Origination Costs

Direct loan origination costs represent costs associated with successfully originating a loan. Direct loan origination costs of a completed loan shall include only the following:

a. Incremental direct costs of loan origination incurred in transactions with independent third parties for that loan
b. Certain costs directly related to specified activities performed by the lender for that loan. Those activities include all of the following:
   1. Evaluating the prospective borrower's financial condition
   2. Evaluating and recording guarantees, collateral, and other security arrangements
   3. Negotiating loan terms
   4. Preparing and processing loan documents
   5. Closing the transaction.

The costs directly related to those activities shall include only that portion of the employees' total compensation and payroll-related fringe benefits directly related to time spent performing those activities for that loan and other costs related to those activities that would not have been incurred but for that loan. See Section 310-20-55 for examples of items.

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.

Loan Commitment

Loan commitments are legally binding commitments to extend credit to a counterparty under certain prespecified terms and conditions. They have fixed expiration dates and may either be fixed-rate or variable-rate. Loan commitments can be either of the following:

a. Revolving (in which the amount of the overall line of credit is reestablished upon repayment of previously drawn amounts)
b. Nonrevolving (in which the amount of the overall line of credit is not reestablished upon repayment of previously drawn amounts).

Loan commitments can be distributed through syndication arrangements, in which one entity acts as a lead and an agent on behalf of other entities that will each extend credit to a single borrower. Loan commitments generally permit the lender to terminate the arrangement under the terms of covenants negotiated under the agreement.~~ This is not an authoritative or all-encompassing definition.~~

Loan Origination Fees

Origination fees consist of all of the following:

a. Fees that are being charged to the borrower as prepaid interest or to reduce the loan's nominal interest rate, such as interest buy-downs (explicit yield adjustments)
b. Fees to reimburse the lender for origination activities
c. Other fees charged to the borrower that relate directly to making the loan (for example, fees that are paid to the lender as compensation for granting a complex loan or agreeing to lend quickly)
d. Fees that are not conditional on a loan being granted by the lender that receives the fee but are, in substance, implicit yield adjustments because a loan is granted at rates or terms that would not have otherwise been considered absent the fee (for example, certain syndication fees addressed in paragraph 310-20-25-19)
e. Fees charged to the borrower in connection with the process of originating, refinancing, or restructuring a loan. This term includes~~, but is not limited to,~~ points, management, arrangement, placement, application, underwriting, and other fees pursuant to a lending or leasing transaction and also includes syndication and participation fees to the extent they are associated with the portion of the loan retained by the lender.

Effective Interest Rate

The rate of return implicit in the ~~loan~~financial asset or financial liability, that is, the contractual interest rate adjusted for any net deferred loan fees or costs, premium, or discount existing at the origination or acquisition of the ~~loan~~financial asset or financial liability.

9. Existing terms and definitions used without change include the following:

Embedded Derivative

Implicit or explicit terms that affect some or all of the cash flows or the value of other exchanges required by a contract in a manner similar to a derivative instrument.

Financial Asset

Cash, evidence of an ownership interest in an entity, or a contract that conveys to one entity a right to do either of the following:

a. Receive cash or another financial instrument from a second entity
b. Exchange other financial instruments on potentially favorable terms with the second entity.

Financial Liability

A contract that imposes on one entity an obligation to do either of the following:

a. Deliver cash or another financial instrument to a second entity
b. Exchange other financial instruments on potentially unfavorable terms with the second entity.

Hybrid Instrument

A contract that embodies both an embedded derivative and a host contract.

Noncontrolling interest

The portion of equity (net assets) in a subsidiary not attributable, directly or indirectly, to a parent. A noncontrolling interest is sometimes called a minority interest.

Nonpublic Entity

An entity that does not meet any of the following conditions:

a. Its debt or equity securities trade in a public market either on a stock exchange (domestic or foreign) or in the over-the-counter market, including securities quoted only locally or regionally.
b. It is a conduit bond obligor for conduit debt securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets).
c. It files with a regulatory agency in preparation for the sale of any class of debt or equity securities in a public market.
d. It is controlled by an entity covered by the preceding criteria.

Recognition

Recognition Principle

10. **Upon acquisition or incurrence, an entity shall recognize a *financial instrument* in its statement of financial position as either a *financial asset* or a *financial liability* depending on the entity's present rights or obligations in the instrument.**

11. The proposed guidance uses the terms *acquisition* and *incurrence* in their broadest sense to refer to the obtaining of an asset or a liability, regardless of how it is obtained. For example, a financial institution may acquire a loan by originating it.

Initial Measurement

Initial Measurement Principle

12. **An entity shall initially measure a financial instrument as follows:**

a. A financial asset or financial liability at its fair value if all subsequent changes in the fair value of the financial asset or financial liability will be recognized in net income.

b. **A financial asset or financial liability at the transaction price if the qualifying portion of subsequent changes in fair value of the financial asset or financial liability will be recognized in other comprehensive income. See paragraphs 14–17 for a discussion of situations in which an entity has reason to expect that the fair value of such a financial instrument may differ significantly from the transaction price.**

c. **A financial liability at the transaction price if the financial liability will be subsequently measured at either of the following:**
   1. **Amortized cost in accordance with paragraph 28**
   2. **Remeasurement amount in accordance with paragraph 31.**

Accounting for Fees and Costs

13. An entity shall include in net income the transaction fees and costs related to a financial instrument to which paragraph 12(a) applies. For financial assets that meet the criteria to recognize qualifying changes in fair value in other comprehensive income, certain **loan origination fees**, net of **direct loan origination costs**, as defined in Subtopic 310-20, shall be deferred. Those fees and costs shall be recognized in net income as a yield adjustment over the life of the related financial asset. See paragraph 78 for further discussion of the accounting for loan origination fees, net of direct loan origination costs.

If the Transaction Price Differs Significantly from the Fair Value

14. An entity that has reason to expect that the transaction price of a financial instrument to which paragraph 12(b) and (c) apply may differ significantly from the fair value shall determine whether reliable evidence indicates that such a significant difference does, in fact, exist. If reliable evidence indicates that the transaction price differs significantly from the fair value, and the entity determines that the difference is at least partially due to the existence of other elements in the transaction as discussed in paragraph 820-10-30-3(c), the financial instrument and the other element(s) in the transaction shall be measured separately.

15. In circumstances where the difference in the transaction price and the fair value are due, at least in part, to the existence of other elements in the transaction, the entity shall initially measure the financial instrument at its fair value and shall account for any other element or elements in the transaction in accordance with their nature, recognizing any asset or liability that qualifies as such under U.S. GAAP. Any other amount that does not represent an asset or liability shall be accounted for in accordance with the guidance in paragraph 17,

except for differences due to the circumstances described in the following paragraph.

16. The following shall not be considered significant differences between the transaction price and the fair value of a financial instrument for the purposes of applying this guidance:

a. Differences between the transaction price and the fair value attributable to transaction fees and costs, as discussed in paragraph 820-10-30-3(c)
b. Differences between the transaction price and the fair value because the market in which the transaction occurs is different from the market in which the reporting entity would sell the asset or transfer the liability, as discussed in paragraph 820-10-30-3(d).

17. If the difference between the transaction price and fair value is not attributable to either of the factors in the preceding paragraph, and an entity cannot identify another element in the transaction or cannot determine the value of the other element or elements in the transaction, the entire difference between the transaction price of the financial instrument and the fair value shall be recognized in net income in the period of acquisition or incurrence. Paragraphs IG7–IG9 provide additional implementation guidance for considering whether reliable evidence indicates that the transaction price of a financial instrument differs significantly from its fair value.

Application to Not-for-Profit Entities

18. In applying paragraph 12, a not-for-profit entity within the scope of Topic 958 on not-for-profit entities shall determine whether a particular financial asset or financial liability meets the criteria in paragraph 21. If it does, the entity shall initially measure it at the transaction price regardless of the fact that a not-for-profit entity does not report net income and other comprehensive income. (Also see paragraph 27, which deals with a similar issue in applying the guidance on subsequent measurement.)

Subsequent Measurement

Subsequent Measurement Principle

19. **An entity shall measure a financial asset or a financial liability at its fair value (as described in Topic 820) on each reporting date after acquisition or incurrence unless the financial asset or financial liability qualifies for an exception under paragraphs 28–34.**

Recognizing Changes in the Fair Value of Financial Instruments

20. An entity shall include in net income for the current period all changes in the fair values of its financial instruments except for specified changes in the fair value of a debt instrument that meets the criteria in paragraph 21. For example, an entity shall report in net income all changes in the fair values of equity instruments held (with the exception of investments in equity securities that are accounted for using the equity method as described in Topic 323 or that result in consolidation of an entity). Similarly, an entity shall report in net income all changes in the fair values of derivatives (with the exception of derivatives designated as the hedging instrument in a cash flow hedge or a hedge of a net investment in a foreign operation).

Recognizing a Change in Fair Value in Other Comprehensive Income

21. An entity may recognize the qualifying portion (see paragraph 24) of a change in fair value of a financial instrument that meets all of the following criteria in other comprehensive income rather than in net income:

a. It is a **debt instrument** held or issued with all of the following characteristics:
   1. There is an amount transferred to the debtor (issuer) at inception that will be returned to the creditor (investor) at maturity or other settlement, which is the principal amount of the contract adjusted by any original issue discount or premium.
   2. The contractual terms of the debt instrument identify any additional contractual cash flows to be paid to the creditor (investor) either periodically or at the end of the instrument's term.
   3. The debt instrument cannot contractually be prepaid or otherwise settled in such a way that the investor would not recover substantially all of its initial investment, other than through its own choice.

b. The entity's business strategy for the instrument is to collect or pay the related contractual cash flows rather than to sell the financial asset or settle the financial liability with a third party. The possibility that a debt instrument may be settled with the counterparty before the stated maturity date (that is, the instrument may be prepaid) because of exercise of an embedded call or put option would not prevent an entity from having a business strategy to collect or pay the instrument's contractual cash flows.

c. It is not a **hybrid instrument** 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. The entire change in the fair value of a hybrid instrument for which those criteria would have required separate accounting for the embedded derivative shall be recognized in net income.

22. In applying the criterion in paragraph 21(b), an entity shall evaluate its business strategy for a financial instrument on the basis of how the entity manages its financial instruments rather than on its intent for an individual instrument. For this purpose, the entity's business strategy shall be to hold instruments for a significant portion of their contractual terms.

23. At the time an entity initially recognizes a financial instrument that meets the criteria in paragraph 21, it shall decide whether to recognize qualifying subsequent changes in the financial instrument's fair value in net income or in other comprehensive income. The entity shall not subsequently change its decision made at initial recognition.

Change in Fair Value That Qualifies for Recognition in Other Comprehensive Income

24. An entity shall recognize in other comprehensive income in accordance with paragraphs 21–23 only the following portion of the total change in fair value during the reporting period of a debt instrument:

a. Total change in fair value during the reporting period
b. Minus current-period interest income or expense, including amortization or accretion of both of the following:
   1. Premium or discount upon acquisition
   2. Certain deferred loan origination fees and costs as described in paragraph 13.
c. Plus or minus current-period amount of credit impairment for financial assets
d. Plus or minus the change in fair value attributable to the hedged risk if the financial instrument is designated as the hedged item in a qualifying fair value hedging relationship.

An entity shall recognize items (b), (c), and (d) in paragraph 24 in net income. For changes in fair value that have been recognized in other comprehensive income, an entity shall recognize in net income any realized gains or losses from sales and settlements for the reporting period.

Application to Loan Commitments and Financial Standby Letters of Credit

25. An entity that makes a loan commitment or issues a financial standby letter of credit (the potential creditor) shall classify the loan commitment or standby letter of credit in the same way that it will classify the underlying loan. For

example, the creditor shall report all changes in the fair value of a loan commitment in net income if and only if it will report all changes in the fair value of the underlying loan in net income.

Application to Specialized Industries

26. The proposed guidance in paragraphs 12–17 and 19–25 would apply to a broker and dealer in securities and an investment company as follows:

a. A broker and dealer in securities that is subject to the guidance in Topic 940 shall measure all of its financial assets at fair value and include all changes in their fair value in net income in accordance with that Topic. The option to report changes in the fair value of a qualifying financial asset in other comprehensive income is not available to a broker and dealer in securities. A broker and dealer in securities shall apply the proposed guidance to all of its financial liabilities.
b. An investment company that is subject to the guidance in Topic 946 shall measure both its financial assets and its financial liabilities at fair value and include all changes in their fair value in the net increase (decrease) in net assets for the period. Neither the option to report changes in the fair value of a qualifying financial asset or financial liability in other comprehensive income nor the amortized cost option for qualifying financial liabilities is available to an investment company.

Application to Not-for-Profit Entities

27. The proposed guidance in paragraphs 19–25, as well as related presentation guidance in paragraphs 84–86 and 90–94, is structured in terms of whether all changes in the fair value of a financial instrument are recognized in net income or whether qualifying changes in the fair value of a financial instrument are recognized both in net income and other comprehensive income. A not-for-profit entity within the scope of Topic 958 does not report net income or other comprehensive income, but a not-for-profit entity within the scope of Topic 954 on health care entities may report a performance indicator that is comparable to net income. An entity within the scope of Topic 954 that reports a performance indicator shall report amounts that a business entity would report in net income within the performance indicator and amounts that a business entity would report in other comprehensive income outside the performance indicator. An entity within the scope of Topic 954 that does not report a performance indicator shall report the total change in the fair value of a financial instrument as a change in the appropriate net asset class in its statement of activities.

Exceptions to the Subsequent Measurement Principle

Qualifying Financial Liabilities

28. An entity may subsequently measure at amortized cost a financial liability that meets both of the following criteria:

   a. The liability meets the criteria in paragraph 21 to have the qualifying portion of the changes in its fair value recognized in other comprehensive income.
   b. Measuring the liability at fair value would create or exacerbate a measurement attribute mismatch of recognized assets and liabilities.

29. An entity shall decide whether to measure at amortized cost a liability that meets those criteria when it issues or otherwise incurs the liability and shall not subsequently change that decision.

30. Measurement of a financial liability at fair value would be deemed to create or exacerbate a measurement attribute mismatch only if at least one of the following criteria apply:

   a. The financial liability is contractually linked to an asset not measured at fair value. A financial liability that is collateralized by an asset, or that is contractually required to be settled upon the derecognition of an asset is contractually linked to that respective asset.
   b. The financial liability is issued by and recorded in, or evaluated by the chief operating decision-maker as part of an operating segment for which less than 50 percent of the segment's recognized assets are subsequently measured at fair value.
   c. The financial liability meets neither item (a) nor (b) but is the liability of a consolidated entity for which less than 50 percent of consolidated recognized assets are subsequently measured at fair value.

In applying the quantitative tests in this paragraph, *recognized assets* are the assets recognized in accordance with U.S. GAAP as of the end of the immediately preceding reporting period (less assets that are contractually linked to a financial liability), plus any assets acquired by issuing the financial liability. Cash (exclusive of cash equivalents) is not considered to be measured at fair value for purposes of applying the quantitative tests in paragraphs 30(b) and 30(c).

Demand Deposit Liabilities

31. An entity shall measure its **core deposit liabilities** 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 (the core deposit liabilities remeasurement approach). An entity shall determine that remeasurement amount separately for each major type of demand deposit, such as noninterest-bearing checking, savings, and money market accounts. Paragraphs IG20–IG24 provide additional guidance on applying the remeasurement approach required for core deposit liabilities.

32. A deposit liability that is not a core deposit liability shall be measured at its fair value. The maturity of some deposit liabilities that are not core deposit liabilities may be so short, however, that their face amount reasonably approximates their fair value.

Short-Term Receivables and Payables

33. An entity may measure its receivables and payables arising in the normal course of business that are due in customary terms not exceeding one year and that also meet the criteria in paragraph 21 at their amortized cost (plus or minus any fair value hedging adjustments). However, the exception for short-term receivables and payables is not applicable to short-term lending arrangements, such as credit card receivables, or investments in short-term debt securities.

Investments That Can Be Redeemed Only for a Specified Amount

34. Particular types of investments are not held for capital appreciation and can be redeemed with the issuer only for a specified amount. An entity shall subsequently measure an investment that has all of the following characteristics at its redemption value:

a. It has no readily determinable fair value because ownership is restricted and it lacks a market.
b. It cannot be redeemed for an amount greater than the entity's initial investment.
c. It is not held for capital appreciation but rather to obtain other benefits, such as access to liquidity or assistance with operations.
d. It must be held for the holder to engage in transactions or participate in activities with the issuing entity.

One example of such an investment is the stock in the Federal Home Loan Bank System that a financial institution must hold to qualify to borrow from a Federal Home Loan Bank. Another example is stock in the Federal Reserve Banks that a financial institution must hold as a condition of membership in the system. Other examples may include investments in certain agricultural cooperatives.

Deferred Tax Assets

35. An entity shall evaluate the need for a valuation allowance on a deferred tax asset related to a financial instrument for which qualifying changes in fair value are recognized in other comprehensive income in combination with the entity's other deferred tax assets. (See Topic 740 for guidance on accounting for income taxes.)

Credit Impairment of Financial Assets

Objective

36. The objective of the guidance related to credit impairment is to establish a model for recognition and measurement of credit impairment of financial assets measured at fair value with qualifying changes in fair value recognized in other comprehensive income on the basis of an entity's expectations about the collectibility of cash flows, including the determination of cash flows not expected to be collected. An entity's expectations about collectibility of cash flows shall include all available information relating to past events and existing conditions but shall not consider potential future events beyond the reporting date.

Applicability of Guidance

37. The guidance related to impairment applies to all of the following financial assets that are subject to losses related to credit risk:

a. Financial assets measured at fair value with qualifying changes in fair value recognized in other comprehensive income. Financial assets shall meet the criteria discussed in paragraph 21 to be eligible to have qualifying changes in fair value recognized in other comprehensive income.
b. Short-term receivables measured at their amortized cost (plus or minus any fair value hedging adjustments) as discussed in paragraph 33.
c. Financial assets that can be redeemed for a specified amount that are measured at their redemption value as discussed in paragraph 34.

Evaluating Financial Assets for Credit Impairment

38. **An entity shall recognize a credit impairment in net income for a financial asset (or group of financial assets) when it does not expect to collect all contractual amounts due for originated financial asset(s) and all amounts originally expected to be collected upon acquisition for purchased financial asset(s).**

39. An entity shall assess at the financial reporting date the amount of cash flows expected to be collected for its financial assets as compared with the contractual amounts due for originated financial asset(s) and all amounts originally expected to be collected upon acquisition of purchased financial asset(s). An entity shall not wait until a credit loss is probable to recognize a credit impairment.

40. For originated financial assets, the phrase *all contractual amounts due* refers to both the contractual interest payments and the contractual principal payments. An entity shall not automatically conclude that a financial asset is not impaired because all of the contractual amounts due or all amounts originally expected to be collected have been received to date.

41. An entity shall consider both the timing and amount of the cash flows expected to be collected. If an entity's expectation of the amount of cash flows expected to be collected decreases, a financial asset shall be considered to be impaired. If an entity expects that it will not collect amounts due on a financial asset on the payment dates specified by contractual terms or when cash flows were originally expected to be collected, but the entity expects to recover any shortfall through the existence of sufficient collateral, the financial asset shall not be considered to be impaired. If cash flows expected to be collected are delayed, the change in timing is an adverse change in cash flows expected to be collected. If the entity expects to not receive interest on the delayed cash flows (that is, interest on both delayed principal and delayed interest cash flows), the financial asset shall be considered to be impaired. However, a financial asset is not impaired during a period of delay in payment if the entity expects to collect all amounts due, including interest accrued for the period of the delay. An entity need not consider an insignificant delay or insignificant shortfall in the amount of payments as meeting the criteria in paragraph 38.

42. In determining whether a credit impairment exists, an entity shall consider all available information relating to past events and existing conditions and their implications for the collectibility of the cash flows attributable to the financial asset(s) at the date of the financial statements. These conditions encompass both economic conditions and factors specific to the borrower or issuer of a financial asset that exist at the date of the financial statements. An entity shall incorporate into the impairment assessment the effect of those known conditions and factors in developing estimates of cash flows expected to be collected for financial asset(s) over the remaining life of the asset(s). In estimating cash flows expected to be collected for its financial assets at each reporting date, an entity shall assume that the economic conditions existing at that point in time would remain unchanged for the remaining life of the financial assets. An entity shall not forecast future events or economic conditions that did not exist at the reporting date in determining whether a credit impairment exists.

43. An entity shall consider all relevant information, circumstances, and conditions in developing an expectation about the collectibility for financial

assets. Numerous factors shall be considered when evaluating whether a credit impairment exists. The information to be considered by an entity includes all of the following:

a. The financial condition of the borrower or the issuer of a financial asset
b. Expectations (based on past events and existing conditions) about potential default by the borrower or issuer of a financial asset
c. Failure of the borrower or issuer of a financial asset to make scheduled interest or principal payments
d. Any changes by a rating agency to the credit rating of the borrower or the issuer of a debt security
e. The level of delinquencies, bankruptcies, charge-offs, and recoveries and changes in those levels compared with previous experience
f. The remaining payment terms of the financial asset and any changes to the remaining payment terms (that is, modifications related to credit such as those made in troubled debt restructurings)
g. The fair value of any underlying collateral if the financial asset is collateralized
h. Current environmental factors, such as industry, geographical, economic, and political data such as the following:
    1. The existing business climate in a particular industry to which the entity has exposure
    2. Global, national, regional, or local economic conditions and changes in such conditions compared with previous experience.
i. Effects of credit concentrations
j. The payment structure of the financial asset (for example, nontraditional loan terms, such as terms that permit negative amortization, a high loan-to-value ratio, or an initial interest rate that is below the market interest rate for the initial period of the loan term that may increase significantly when that period ends) and the likelihood of the borrower or issuer of a financial asset being able to satisfy the payment terms.

44. In assessing the factors in the preceding paragraph, the entity shall consider available published data to the extent the data are relevant to the collectibility of the financial asset. For example, the entity shall consider both of the following:

a. Industry analyst and regulatory reports
b. Sector credit ratings.

45. Specific changes in circumstances may cause an entity to have an expectation about credit impairment of financial assets that differs from its expectation in the previous reporting period. For example, this may be in response to the occurrence of an event or changes in specific conditions, such

as those described in paragraph 43. If an entity has previously recognized a credit impairment in net income, but in a later period obtains information about the collectibility of cash flows of financial assets that indicates that there is an improvement in the amount and/or the timing of expected cash flows, the entity shall recognize a reversal of credit impairment expense in net income, except as indicated in paragraph 79.

46. Changes in cash flows expected to be collected that relate to any of the following factors shall not in and of themselves give rise to a credit impairment:

a. For foreign-currency-denominated financial assets, changes in foreign exchange rates used to remeasure financial assets under the guidance in Subtopic 830-20
b. For financial assets that are contractually prepayable, changes in expected prepayments
c. For financial assets with contractual interest rates that vary on the basis of subsequent changes in an index or rate (such as the prime rate, the London Interbank Offered Rate [LIBOR], or the U.S. Treasury bill's weekly average), changes in those variable indexes or rates.

47. As discussed in paragraph 92, for a foreign-currency-denominated financial instrument that meets the criteria to have qualifying changes in fair value recognized in other comprehensive income, the component of the overall change in fair value of a financial instrument that relates to changes in currency exchange rates shall be reported in other comprehensive income together with other changes in fair value of a financial instrument. Therefore, an entity shall not recognize as a credit impairment the decline in cash flows expected to be collected due to changes in foreign exchange rates.

48. Changes in anticipated prepayments or actual prepayments on contractually prepayable instruments affect cash flows expected to be collected. However, those changes in cash flows expected to be collected shall not in and of themselves give rise to a credit impairment because they are generally not related to credit. As discussed in Subtopic 310-20, in certain circumstances, an entity is permitted to consider the effect of anticipated prepayments in determining the effective interest rate for a financial asset.

49. For financial assets with contractual interest rates that vary on the basis of subsequent changes in an index or rate (such as the prime rate, LIBOR, or the U.S. Treasury bill's weekly average), estimates of cash flows expected to be collected in future periods shall be recalculated at each reporting date on the basis of the index or rate as it changes over the life of the financial asset. An entity shall not project changes in the index or rate for purposes of estimating cash flows expected to be collected.

50. In some circumstances it may be difficult to isolate the effect of a change in one specific component from the overall change in cash flows. When changes in expected cash flows due to variable rates or prepayments cannot be separated

from the overall decline in expected cash flows, an entity shall account for the entire decline in cash flows expected to be collected as a credit impairment.

Measurement of Credit Impairment

51. **An entity shall recognize in net income at the end of each financial reporting period the amount of credit impairment related to all contractual amounts due for originated financial asset(s) that the entity does not expect to collect and all amounts originally expected to be collected for purchased financial asset(s) that the entity does not expect to collect.**

52. An entity shall assess its financial assets for credit impairment and shall measure the amount of credit impairment at the end of each financial reporting period. Measuring credit impairment requires judgment and estimates, and the eventual outcomes may differ from those estimates.

53. An entity shall recognize any unfavorable change in cash flows expected to be collected as a credit impairment during the reporting period in net income and shall establish or increase the allowance for credit losses related to the financial asset (presented as a contra-asset account) by an equal amount. In addition, if the entity expects a favorable change in cash flows expected to be collected as compared with its expectations in a previous reporting period, as discussed in paragraph 45, an entity shall recognize a reversal of previously recognized credit impairment expense and a corresponding decrease in the allowance for credit losses (except as discussed in paragraph 79).

54. As discussed in paragraph 41, changes in expectations about both the amount and timing of cash flows expected to be collected shall be considered in assessing financial assets for impairment and measuring the amount of credit impairment (or reversal of previously recognized credit impairment expense).

55. The total amount of credit impairment to be recognized in net income in each financial reporting period is the sum of amounts measured for financial assets that are evaluated for credit impairment on a collective pool basis and the amounts measured for financial assets that are evaluated and considered impaired on an individual basis.

Financial assets evaluated on a collective (pool) basis

56. Financial assets for which impairment is evaluated and measured collectively are those groups of financial assets that, based on their shared characteristics, may have some credit impairment even though that credit impairment cannot be identified with a specific financial asset. If a credit impairment exists, it shall be recognized in net income even though the particular financial assets for which cash flows are uncollectible may not be separately identifiable.

57. For the purpose of assessing and measuring impairment of pools of financial assets, an entity shall aggregate financial assets on the basis of similar risk characteristics. For example, similar risk characteristics include the following:

a. Internal or external (third-party) credit score or ratings
b. Risk ratings or classification
c. Financial asset type
d. Collateral type
e. Size
f. Interest rate
g. Term
h. Geographic location
i. Industry of the borrower.

58. In determining the amount of impairment to be recognized for a pool of financial assets with similar risk characteristics, an entity shall consider historical loss experience for financial assets that have those characteristics. The entity shall develop historical loss rates, which shall be adjusted for all information relevant to the collectibility of the financial assets, including the effect of past events and existing economic factors and conditions. In determining the adjustment of historical loss rates on the basis of past events and existing conditions, the entity shall consider the factors discussed in paragraphs 43 and 44. In the case of an entity that has no experience of its own, reference to peer group data may be appropriate if the attributes of the financial assets that compose the peer group loss experience data are similar to the financial assets held by the entity.

59. An appropriate historical loss rate (adjusted for existing economic factors and conditions) shall be determined for each individual pool of similar financial assets. Historical loss rates shall reflect cash flows that the entity does not expect to collect over the life of the financial assets in the pool. An entity shall select a historical time period appropriate for the specific financial assets in the pool to determine a historical loss rate. This proposed guidance does not specify a particular methodology to be applied by an entity for determining historical loss rates. That methodology may vary depending on the size of the entity, the range of the entity's activities, the nature of the entity's pools of financial assets, and other factors.

60. The amount of credit impairment recognized for a particular pool of financial assets shall be based on a historical loss rate for that pool adjusted for existing economic factors and conditions. In each reporting period, the amount of credit impairment (or the reversal of a credit impairment recognized in a previous period) that shall be recognized in net income for a pool of financial assets is the difference between the allowance for credit losses for the pool determined by applying the historical loss rate adjusted for existing economic factors and conditions to the current principal balance of the pool at the reporting date and

the existing balance of the allowance for credit losses attributable to the pool of financial assets.

Financial assets evaluated individually

61. An entity may identify financial assets to be individually evaluated for credit impairment. However, the proposed guidance does not provide a specific requirement for how an entity should identify financial assets that are to be evaluated individually for collectibility.

62. When an entity identifies an individually evaluated financial asset as impaired, the entity shall measure the amount of credit impairment on the basis of a present value technique, unless it elects the practical expedient for certain loans described in paragraphs 71–74. In estimating the present value of cash flows expected to be collected, an entity shall consider past events and existing economic conditions, which may include historical statistics related to financial assets with similar characteristics. The historical statistics shall reflect the nature of the financial assets for which credit impairment is being measured and shall be adjusted if existing economic factors and conditions differ from those on which the statistics were based. If the present value of cash flows expected to be collected is less than the amortized cost of the financial asset, an entity shall recognize a credit impairment in net income and establish an allowance for credit losses. The entity shall calculate the present value of cash flows expected to be collected for the impaired financial asset discounted at the asset's **effective interest rate**.

63. Some financial assets that are identified for evaluation and are individually considered impaired have risk characteristics that are unique to an individual borrower or issuer, and an entity shall assess those financial assets and apply the measurement methods on an asset-by-asset basis. Other financial assets that are identified for evaluation and are individually considered impaired and share similar risk characteristics (as described in paragraph 57) with other impaired financial assets. An entity may aggregate those financial assets that have similar risk characteristics for the purposes of measuring impairment and shall use a present value technique as a means of measuring the amount of credit impairment.

64. After the initial recognition of impairment in net income, an impairment (or reversal of credit impairment expense) shall be measured and recognized in net income on the basis of changes in the present value of cash flows expected to be collected.

65. For a financial asset evaluated for impairment on an individual basis, where there are no past events or existing conditions indicating that the financial asset is impaired, an entity shall not automatically conclude that no credit impairment exists. The entity shall determine whether assessing the financial asset together with other financial assets that have similar characteristics indicates that a credit

impairment exists. If the entity determines that a credit impairment exists in that circumstance, the entity shall recognize a credit impairment in net income. The amount of the credit impairment shall be measured by applying to that financial asset the historical loss rate (adjusted for existing economic factors and conditions) applicable to the group of similar financial assets referenced by the entity in its assessment.

Determination of the effective interest rate

66. For originated financial assets and financial assets purchased at an amount that does not include a discount related to credit quality, the effective interest rate is the rate that equates the contractual cash flows (adjusted for any net deferred loan fees or costs, premium, or discount existing at the origination or acquisition of the loan as required by the guidance on nonrefundable fees and other costs in Subtopic 310-20) with the initial cash outflow. For financial assets acquired at an amount that includes a discount related to credit quality, the effective interest rate is the rate that equates the entity's estimate of cash flows expected to be collected with the purchase price of the financial asset. In measuring the amount of credit impairment for fixed-rate financial assets, generally, an entity shall discount the cash flows expected to be collected at the financial asset's original effective interest rate.

67. In measuring the amount of credit impairment for a financial asset with a contractual interest rate that varies on the basis of subsequent changes in an interest rate or index of interest rate (for example, the prime rate, LIBOR, or the U.S. Treasury bill's weekly average), an entity shall discount the cash flows expected to be collected using the effective interest rate calculated on the basis of the appropriate interest rate or index as it changes over the life of the asset. For those financial assets, the effective interest rate is based on the contractual cash flows over the life of the asset. Past cash flow amounts shall be based on the historical rate or index in effect at each contractual payment date. Estimates of cash flows expected to be collected in future periods shall be recalculated at each reporting date on the basis of the index or rate as it changes over the life of the financial asset. An entity shall not project changes in the index or rate for purposes of determining the effective interest rate.

68. An entity shall discount the cash flows expected to be collected for purchased financial assets at the effective interest rate implicit in the financial asset at the date of acquisition. However, if the effective interest rate is adjusted as a result of the circumstance described in paragraph 79, such that the entity recalculates the effective interest rate for the financial asset on the basis of revised cash flows expected to be collected, the entity shall discount the expected cash flows at the revised effective interest rate on a prospective basis.

Loans that are modified or restructured in a troubled debt restructuring

69. Subtopic 310-40 provides guidance on troubled debt restructurings. A loan that is modified or restructured in a troubled debt restructuring is an impaired loan. If a loan that was modified or restructured was previously included in a pool of assets evaluated for impairment on a collective pool basis as described in paragraphs 56–60, the loan shall be removed from the pool of financial assets and the guidance in paragraphs 62–65 shall be applied to the individual loan when it is modified or restructured.

70. For a loan that has been modified or restructured in a troubled debt restructuring, the contractual terms of the loan agreement refers to the contractual terms specified by the original loan agreement, not the contractual terms specified by the restructuring agreement. The effective interest rate for a loan restructured in a troubled debt restructuring is based on the original contractual rate, not the rate specified in the restructuring agreement. A troubled debt restructuring does not result in a new loan but rather represents part of an entity's ongoing effort to recover its investment in the original loan. Therefore, the interest rate used to discount cash flows expected to be collected on a restructured loan shall be the same interest rate used to discount cash flows expected to be collected on an impaired loan.

Practical expedient for measurement of impairment

71. As a practical expedient, an entity may measure credit impairment for an individually impaired financial asset on the basis of the fair value of the collateral if the financial asset is a **collateral-dependent financial asset**. If an entity uses the fair value of the collateral to measure impairment of a collateral-dependent financial asset and repayment or satisfaction of the asset depends on the sale of the collateral, the fair value of the collateral shall be adjusted to consider estimated costs to sell (on a discounted basis). However, if repayment or satisfaction of the financial asset depends only on the operation, rather than the sale, of the collateral, the measure of impairment shall not incorporate estimated costs to sell the collateral. Additionally, a creditor shall measure impairment on the basis of the fair value of the collateral if the creditor determines that foreclosure is expected to occur.

72. If the fair value of the collateral is less than the amortized cost of the financial asset, an entity shall recognize a credit impairment in net income and establish an allowance for credit losses. After the initial recognition of impairment in net income, subsequent measurement of impairment (or reversal of previously recognized impairment expense) shall be recognized in net income on the basis of changes in the fair value of the collateral.

73. Use of the practical expedient described in the preceding paragraph results in no credit impairment for the individual financial asset if the fair value of the collateral is greater than the amortized cost of the asset (that is, the measure of impairment is zero). In that case, the entity shall recognize no additional credit impairment in net income for that financial asset. That is, the entity shall not include that financial asset in a pool of financial assets for which credit impairment is measured on a collective pool basis.

74. The measurement method selected for an individual impaired financial asset shall be applied consistently to that financial asset.

Measuring Interest Income on Debt Instruments Held

Applicability of Guidance

75. The guidance for recognition of interest income applies to all interest-earning debt instruments (hereinafter referred to as financial assets for purposes of paragraphs 76–82) that are measured at fair value with qualifying changes in fair value recognized in other comprehensive income. Financial assets shall meet the criteria discussed in paragraph 21 to be eligible for that classification.

Interest Income Recognition

76. An entity shall include in net income an amount of interest income related to financial assets measured at fair value with qualifying changes in fair value recognized in other comprehensive income. The amount of interest income to be recognized in net income for these financial assets shall be determined by applying the financial asset's effective interest rate to the amortized cost balance net of any allowance for credit losses. The effective interest rate for originated or purchased financial assets (both fixed-rate and variable-rate financial assets) shall be determined as discussed in paragraph 66–68.

77. As discussed in paragraph 66, for financial assets that meet the criteria to recognize qualifying changes in fair value in other comprehensive income, the amount recognized in net income as interest income for the period shall include amortization or accretion of premium or discount upon acquisition. For purchased financial assets, the purchase discount shall be recognized in net income over the remaining contractual life of the financial asset or the estimated life of the financial asset only for situations in which prepayments can be reliably estimated.

78. In addition, as discussed in paragraph 13, interest income determined on the basis of the financial asset's effective interest rate shall include the effects of amortizing certain loan origination fees, net of direct loan origination costs. The initial measurement of financial assets that meet the criteria to recognize qualifying changes in fair value in other comprehensive income is based on the transaction price, which includes amounts that qualify as loan origination fees

and direct loan origination costs as defined in Subtopic 310-20. By recognizing the change in fair value of such financial assets, those loan origination fees and direct loan origination costs are initially deferred in other comprehensive income and recognized in net income as a yield adjustment over of the life of the related financial asset.

79. For a financial asset acquired at an amount that includes a discount related to credit quality, an assessment of current information based on past events and existing conditions may indicate an improvement in cash flows expected to be collected from the cash flows previously expected to be collected. If an allowance for credit losses had been established previously for that financial asset (after purchase of the financial asset), an increase in cash flows expected to be collected shall be recognized in net income as a reversal of credit impairment expense to the extent of the previously recognized allowance. If no allowance for credit losses had been established for that financial asset since acquisition, or if the amount of the increase in cash flow expected to be collected exceeds the allowance for credit losses, an entity shall recalculate the effective interest rate for the financial asset on the basis of the revised (increased) cash flows expected to be collected. If, subsequently, the entity expects a decrease in cash flows expected to be collected from the cash flows previously expected to be collected, an entity shall recalculate the effective interest rate for the financial asset on the basis of the revised (decreased) cash flows expected to be collected but shall not revise the rate below the original effective interest rate. If the revised estimate of cash flows expected to be collected is less than the original estimate of cash flows expected to be collected, after reversing the adjustment of the effective interest rate, the entity shall recognize any additional decrease in cash flows expected to be collected as a credit impairment.

80. The method of recognizing interest income on the basis of a financial asset's amortized cost balance net of any allowance for credit losses results in a difference between the amount of interest contractually due (or, for purchased financial assets acquired at an amount that includes a discount related to credit quality, interest cash flows originally expected to be collected) and the amount of interest income accrued for the financial asset. The difference between the amount of the accrued interest receivable based on the amount of interest contractually due and the amount of interest income accrued shall be recognized as an increase in the allowance for credit losses.

81. If, as a result of applying the requirement in paragraph 80, the allowance for credit losses exceeds an entity's estimate of cash flows not expected to be collected related to its financial assets at the reporting date, the entity shall adjust the allowance for credit losses and shall recognize the adjustment in net income as a reversal of credit impairment expense. An entity shall not classify the adjustment as interest income.

Financial assets for which no accrual of interest shall be made

82. An entity shall cease accruing interest income on a financial asset only if the entity's expectations about cash flows expected to be collected indicate that the overall yield on the financial asset will be negative. In this situation, an entity shall use the cost recovery method. For example, if the total cash flows expected to be collected that relate to a financial asset are less than the original principal amount, no amount of interest income shall be recognized in net income once it is determined that the overall yield will be negative. However, any previously recognized interest income shall not be reversed. In all scenarios other than the one discussed in this paragraph, an entity shall account for decreases in cash flows expected to be collected as a credit impairment and shall not cease accruing interest income.

Writeoffs of Financial Assets

83. An entity shall write off a financial asset or part of a financial asset in the period in which the entity has no reasonable expectation of recovery of the financial asset (or part of the financial asset). The allowance for credit losses shall be reduced by the amount of the financial asset balance written off. Recovery of a financial asset (or a part of a financial asset) previously written off shall be recognized when cash is received. In this context, a recovery means that an entity has received cash receipts in satisfaction of contractually required interest or principal payments following a writeoff of the financial asset. Such recoveries shall be recognized in net income.

Other Presentation Matters

Statement of Financial Position

84. An entity shall display financial assets and financial liabilities separately on the face of the statement of financial position depending on whether all changes in their fair value are recognized in net income or whether qualifying changes in their fair value are recognized in other comprehensive income.

Financial Instruments for Which All Changes in Fair Value Are Recognized in Net Income

85. An entity shall present on the face of the statement of financial position only the following amounts for financial instruments for which all changes in fair value are recognized in net income:

a. The fair value of the instrument

b. The amortized cost of the entity's own outstanding debt instruments.

Financial Instruments for Which Qualifying Changes in Fair Value Are Recognized in Other Comprehensive Income

86. For financial assets and financial liabilities for which qualifying changes in fair value are recognized in other comprehensive income, an entity shall, at a minimum, present separately on the face of the statement of financial position all of the following:

a. Amortized cost
b. Allowance for credit losses on financial assets
c. Accumulated amount needed to reconcile amortized cost less allowance for credit losses to fair value
d. Fair value.

Core Deposit Liabilities

87. An entity shall present separately on the face of the statement of financial position all of the following for its core deposit liabilities:

a. The amortized cost of the deposits (amount due on demand)
b. The amount needed to adjust amortized cost to the amount in item (c)
c. The amount of the deposits determined using the core deposit liabilities remeasurement approach.

Accumulated Other Comprehensive Income

88. An entity shall present separately on the face of the statement of financial position amounts included in accumulated other comprehensive income (and allocated to noncontrolling interests, if applicable) related to the qualifying changes in fair value or qualifying changes in the remeasurement amount for financial instruments for which those changes are recognized in other comprehensive income.

Statement of Comprehensive Income

89. The guidance in the proposed Accounting Standards Update, *Comprehensive Income (Topic 220): Statement of Comprehensive Income* (proposed Update on comprehensive income), would require an entity to present a continuous statement of comprehensive income.

Financial Instruments for Which All Changes in Fair Value Are Recognized in Net Income

90. At a minimum, an entity shall separately present within net income on the face of the statement of comprehensive income one aggregate amount for realized and unrealized gains or losses on financial instruments for which all changes in fair value are recognized in net income.

Financial Instruments for Which Qualifying Changes in Fair Value Are Recognized in Other Comprehensive Income

91. At a minimum, an entity shall present separately within net income on the face of the statement of comprehensive income all of the following items for financial assets and financial liabilities for which qualifying changes in fair value are recognized in other comprehensive income:

a. Current-period interest income and expense, including amortization (accretion) of premium (discount) recognized upon acquisition
b. Credit impairment for the current period on financial assets
c. Realized gains or losses (by means of an offsetting entry to other comprehensive income if prior periods' unrealized gains or losses on the instruments were recognized in other comprehensive income).

92. The total change during a period in the fair value of a financial instrument denominated in a foreign currency may be made up of both of the following components:

a. A change in the price of the instrument in the currency in which it is denominated
b. A change in the exchange rate between the currency of denomination and the functional currency, which the guidance on foreign currency matters in Topic 830 refers to as a transaction gain or loss.

An entity shall not separate the total change in the fair value of a foreign-currency-denominated financial instrument for which qualifying changes in fair value are recognized in other comprehensive income into the components in (a) and (b) above. As a consequence, the entity shall not present separately a transaction gain or loss in net income as otherwise would be required by Topic 830.

Financial Liabilities Measured at Amortized Cost

93. An entity that subsequently measures qualifying financial liabilities at amortized cost in accordance with paragraphs 28–30 shall present separately within net income both of the following:

a. Current-period interest expense, including amortization (accretion) of premium (discount) recognized upon acquisition
b. Realized gains or losses on settlement of the liabilities.

Changes in an Entity's Own Credit Standing

94. An entity shall present separately on the face of the statement of comprehensive income the amount of significant changes in the fair value of its financial liabilities arising from changes in the entity's own credit standing during the period, excluding changes related to changes in the price of credit. Significant changes in fair value arising from changes in the entity's credit standing, excluding changes in the price of credit, shall be presented separately for financial liabilities for which all changes in fair value are recognized in net income and for financial liabilities for which qualifying changes in fair value are recognized in other comprehensive income.

Core Deposit Liabilities

95. An entity may present changes in the remeasured amount of its core deposit liabilities in other comprehensive income if the deposits meet the criteria in paragraph 21. An entity that chooses instead to present those changes in its core deposit liabilities in net income shall present separately, at a minimum, on the face of the statement of comprehensive income, an aggregate amount for realized and unrealized gains or losses on the core deposit liabilities.

96. An entity that presents changes in the remeasured amount of its core deposit liabilities in other comprehensive income shall present current-period interest expense separately within net income on the face of the statement of comprehensive income.

Disclosures

97. An entity shall disclose all the information in paragraphs 98–109 for each interim and annual reporting period by class of financial instrument. In identifying classes of financial assets and liabilities, the entity shall determine the appropriate level of disaggregation on the basis of the nature, characteristics, or risks of the financial instruments.

Financial Liabilities Measured at Fair Value

98. For financial liabilities with significant changes in the fair value arising from changes in the entity's own credit standing (excluding changes related to changes in the price of credit), an entity shall disclose both of the following:

a. Qualitative information about the reasons for changes in fair value attributable to changes in the entity's credit standing, excluding changes related to changes in the price of credit
b. How the gains and losses attributable to changes in the entity's credit standing, excluding changes related to changes in the price of credit, were determined.

Financial Instruments for Which Qualifying Changes in Fair Value Are Recognized in Other Comprehensive Income

99. For financial assets for which qualifying changes in fair value are recognized in other comprehensive income, an entity shall disclose information about the contractual maturities of those instruments as of the date of the most recent statement of financial position. Maturity information may be combined in appropriate groupings on the basis of time to maturity. Instruments not due at a single maturity date, such as mortgage-backed securities, may be disclosed separately rather than allocated over several maturity groupings. If allocated, the basis for allocation also shall be disclosed.

100. For financial assets and financial liabilities for which qualifying changes in fair value are recognized in other comprehensive income that an entity sells or settles before their contractual maturity, an entity shall disclose all of the following by class:

a. The proceeds from sales of the financial assets, or cash paid to settle the financial liabilities, and the gross realized gains and gross realized losses that have been recognized in net income as a result of those sales or settlements
b. The basis on which the cost of the instrument was determined (that is, specific identification, average cost, or other method used)
c. Qualitative information about the reasons for the sale or settlement of the financial instruments.

101. For purchased financial assets for which qualifying changes in fair value are recognized in other comprehensive income, an entity shall disclose all of the following:

a. The principal amount of the financial assets
b. The purchaser's assessment of the discount related to credit losses inherent in the financial assets at acquisition, if any, and qualitative information on how the purchaser determined the discount related to credit losses
c. Any additional difference between amortized cost and the principal amount
d. The amortized cost basis of the financial assets.

102. For interest-earning financial assets measured at fair value with qualifying changes in fair value recognized in other comprehensive income, an entity shall disclose both of the following:

a. The method used for calculating interest income on a pool of financial assets that are collectively assessed for impairment
b. If interest income is calculated on a pool basis, the amortized cost basis, allowance for credit losses, and weighted-average interest rate of each pool.

103. An entity shall disclose the amortized cost and fair value of financial assets for which no accrual of interest is made because the entity's expectations about cash flows expected to be collected indicate that the overall yield on the financial asset will be negative.

Allowance for Credit Losses

104. For financial assets with an allowance for credit losses, an entity shall disclose both of the following:

a. The activity in the allowance for credit losses by class and in the aggregate, including the balance of the allowance at the beginning and end of each period, additions charged to net income, additions representing the amount by which interest contractually due (or, for purchased financial assets acquired at an amount that includes a discount related to credit quality, interest cash flows originally expected to be collected) exceeds interest accrued, writeoffs charged against the allowance, amounts due to changes in methods and estimates, if any, and recoveries of amounts previously charged off. This disclosure shall be provided separately for financial assets assessed individually or on a pool basis for credit impairment.
b. A description of the accounting policies and methodology used to estimate the allowance for credit losses. This shall include a description of the factors that influenced management's judgment as well as quantitative and qualitative information about inputs and assumptions used to measure credit impairments recognized in the performance statement. Examples of significant inputs include performance indicators of the underlying assets in the instrument (including default rates, delinquency rates, and percentage of nonperforming assets), collateral values, loan-to-collateral-value ratios, third-party guarantees, current levels of subordination, vintage, geographic concentration, and credit ratings. Any changes to a creditor's accounting policies or methodology from the prior period shall be identified, and management's rationale for the change should be discussed.

105. For financial assets that are individually considered to be impaired, an entity shall disclose all of the following:

a. Management's policy for determining which financial assets the entity individually assesses for impairment
b. The cumulative allowance for credit losses and the related fair value, amortized cost, and unpaid principal balance
c. The average carrying amount and the related amount of interest income recognized during each reporting period for impaired financial assets.

Core Deposit Liabilities

106. For its core deposit liabilities, an entity shall disclose the inputs and assumptions (qualitative and quantitative) for all of the following by type of deposit:

a. The calculation of the average core deposit balances
b. The determination of the implied maturity period
c. The alternative funds rate used and the reasons for its use
d. The all-in-cost-to-service rate
e. A measurement uncertainty analysis conducted in accordance with the guidance in paragraph 107.

107. To comply with the measurement uncertainty analysis in paragraph 106(e), an entity shall disclose the effect of a 10 percent increase and the effect of a 10 percent decrease in the discount rate (that is, the difference between the alternative funds rate and the all-in-cost-to-service rate) used to remeasure core deposit liabilities. For example, if the entity used a discount rate of 10 percent to remeasure its core deposit liability, the reporting entity would disclose the effect of using an 11 percent discount rate and a 9 percent discount rate to remeasure its core deposit liabilities.

Financial Liabilities Measured at Amortized Cost

108. An entity that subsequently measures qualifying financial liabilities at amortized cost in accordance with paragraph 28–30 shall disclose both of the following:

a. An explanation of the reasons why measuring the financial liability at fair value would create or exacerbate a measurement attribute mismatch
b. The fair value of the financial liability.

Level 3 Fair Value Measurement Uncertainty Analysis

109. For annual reporting periods, for all financial instruments measured at fair value and classified as Level 3 in the fair value hierarchy, except investments in unquoted equity instruments, an entity shall comply with the measurement uncertainty disclosures in Topic 820 on fair value measurement. (The guidance for disclosing measurement uncertainty will be included in a separate proposed Accounting Standards Update on fair value measurement that will be issued during the second quarter of 2010.) For interim periods, if the unobservable inputs (Level 3) used to measure fair value have changed significantly from the last reporting period, the reporting entity shall provide this disclosure in the current period. If the unobservable inputs (Level 3) used to measure fair value have not changed significantly from the last reporting period, the entity shall disclose that fact and is not required to provide this disclosure in that interim period.

Derivative Instruments and Hedging Activities

Structure and Applicability of Proposed Guidance for Derivative Instruments and Hedging Activities

110. The proposed guidance does not present the overall revised guidance on derivatives and hedging. Only the proposed changes to the guidance on derivatives and hedging in Topic 815 are described in this section (paragraphs 112–128). The proposed changes to the guidance affects all hedging relationships, whether the hedging instrument is a financial derivative instrument or a nonfinancial derivative instrument and whether the hedged item is (or hedged transaction involves) a financial instrument or nonfinancial instrument.

111. All of the following main features of the derivative instruments and hedging activities guidance in Topic 815 are retained by the proposed guidance:

a. The types of items and transactions that are eligible for hedge accounting in Topic 815 would continue to apply.
b. An entity would be able to continue to designate particular risks in financial items as the risks being hedged in a hedging relationship. Only the effects of the risks hedged would be recognized in net income.
c. The types of risks eligible as hedged risks in Topic 815 would continue to apply.

Bifurcation of Embedded Derivative Features

112. Embedded derivative features in hybrid financial instruments within the scope of the proposed guidance shall no longer be bifurcated and accounted for

separately as derivative instruments. Rather, hybrid financial instruments that contain embedded derivative features that meet the criteria in paragraph 815-15-25-1(a) and (c) shall be reported at fair value with all changes in fair value for the entire hybrid financial instrument recognized in net income. Consequently, the second criterion for bifurcation in paragraph 815-15-25-1(b) is not met. Embedded derivative features in hybrid nonfinancial instruments shall continue to be analyzed under existing guidance in paragraph 815-15-25-1 to determine whether they are required to be bifurcated and accounted for separately.

Hedge Effectiveness

113. The qualifying criteria for designating a hedging relationship requires that the hedging relationship, at its inception and on an ongoing basis, is expected to be reasonably effective (rather than highly effective) in achieving offsetting changes in fair values or cash flows attributable to the hedged risk during the period of the hedging relationship. The risk management objective expected to be achieved by the hedging relationship and how the hedging instrument is expected to manage the risk or risks inherent in the hedged item or forecasted transaction shall be documented. For most relationships, compliance with the reasonably effective criterion is demonstrated by a qualitative (rather than quantitative) assessment that establishes that an economic relationship exists between the hedging instrument and either the hedged item in a fair value hedge or the hedged transaction in a cash flow hedge. A quantitative assessment is necessary if a qualitative assessment cannot establish compliance with the reasonably effective criterion.

114. Although an entity may use a qualitative assessment to demonstrate that a hedging relationship is reasonably effective, an entity shall not assume at inception that there will never be any ineffectiveness to recognize in net income during the period of the hedge. Similarly, an entity shall not ignore whether it will collect the payments it is owed or make the payments it will owe under the provisions of the hedging derivative instrument in determining fair value for assessing effectiveness.

115. The shortcut method and critical terms matching method are eliminated and shall not be used to assume either that a hedging relationship is completely effective or that no ineffectiveness needs to be recognized in net income during the term of the hedge.

116. When using a qualitative assessment of effectiveness, an entity shall provide the basis for expecting that the hedging instrument is reasonably effective in offsetting the changes in the hedged item's fair value attributable to the hedged risk or the variability in the hedged transaction's cash flows attributable to the hedged risk over the life of the hedging relationship. That basis shall include identifying both of the following:

a. The sources of volatility associated with the fair value of the hedged item or the cash flows of the forecasted transaction.

b. The factors supporting a conclusion that the hedging instrument is reasonably effective in offsetting changes in the hedged item's fair value or the variability in the hedged cash flows over the life of the hedging relationship.

117. After inception of the hedging relationship, an entity shall qualitatively (or quantitatively, if necessary) reassess effectiveness only if changes in circumstances suggest that the hedging relationship is no longer reasonably effective in offsetting.

118. For cash flow hedging relationships in which the designated forecasted transaction is the variability in cash flows related to a group of transactions within a specific time period (such as a hedge of forecasted foreign-currency-denominated sales occurring over the course of a four-week period), an entity may assess effectiveness using a method that includes a derivative that settles within a reasonable period of time of the cash flows related to the hedged transactions. That time period is reasonable if the difference is minimal between the forward rate on that derivative and the forward rate on a derivative or derivatives that exactly offset the changes in cash flows of the forecasted transactions.

Dedesignation of a Hedging Relationship

119. An entity shall not remove the designation of an effective fair value or cash flow hedging relationship after it has been established at inception. A hedging relationship shall be discontinued only if either of the following criteria are met:

a. The qualifying criteria for designating a hedging relationship are no longer met, such as if the relationship no longer is expected to be reasonably effective in achieving offsetting changes in fair values or cash flows.
b. The hedging instrument expires or is sold, terminated, or exercised.

120. A hedging derivative instrument may be considered to be effectively terminated when an offsetting derivative instrument is entered into; however, concurrent documentation of this effective termination is required to terminate the hedging relationship. An offsetting derivative instrument shall be expected to fully offset future changes in the fair value or cash flows of the original derivative instrument. An entity shall not later designate either of those two derivative instruments (that is, either the original hedging derivative instrument or the offsetting derivative instrument) in a new hedging relationship.

121. An entity may modify the hedging instrument for an existing hedging relationship by adding a derivative to that existing hedging relationship that would not offset fully the existing hedging derivative and would not reduce the effectiveness of the hedging relationship. That modification would not result in the termination of the hedging relationship, although the documentation for the hedging relationship would need to be updated.

Measuring and Reporting Ineffectiveness in Cash Flow Hedging Relationships

122. The measurement of hedge ineffectiveness shall be based on a comparison of the change in fair value of the actual derivative designated as the hedging instrument and the present value of the cumulative change in expected future cash flows on the hedged transaction. For example, an entity could compare the change in fair value of the actual derivative with the change in fair value of a derivative that would mature on the date of the forecasted transaction, be priced at market, and provide cash flows that would exactly offset the hedged cash flows.

123. An entity shall adjust accumulated other comprehensive income associated with the hedged transaction to a balance that reflects the amount necessary to offset the present value of the cumulative change in expected future cash flows on the hedged transaction from inception of the hedge less the amount previously reclassified from accumulated other comprehensive income into net income, if any. Thus, ineffectiveness is recognized for both overhedges and underhedges.

124. When measuring the ineffectiveness to be recognized in net income by using a derivative that would mature on the date of the forecasted transaction and provide cash flows that would exactly offset the hedged cash flows, an entity may use the same credit risk adjustment as that used in calculating the fair value of the actual hedging derivative instrument.

125. When measuring ineffectiveness to be recognized in net income when a purchased option contract (including a net purchased option contract) is used as the hedging instrument in a cash flow hedge to provide only one-sided protection against the hedged risk, an entity may use, as a benchmark to calculate ineffectiveness, a purchased option derivative that would mature on the date of the forecasted transaction and provide cash flows that would exactly offset the one-sided change in the hedged cash flows. When measuring a purchased option derivative that would mature on the date of the forecasted transaction and provide cash flows that would exactly offset the one-sided change in the hedged cash flows to determine ineffectiveness to be recognized in net income, an entity may use total changes in the option's cash flows or may include only changes in the option's intrinsic value. If the entity chooses to measure the total changes in the option's cash flows, it shall reclassify from other comprehensive income to net income each period on a rational basis an amount that adjusts net income for the amortization of the cost of the option.

126. For cash flow hedging relationships in which the designated forecasted transaction is the variability in cash flows related to a group of transactions within a specific time period, an entity may measure ineffectiveness by comparing the change in fair value of the actual derivative designated as the hedging instrument with the change in fair value of a derivative that would settle within a reasonable

time period of the cash flows related to the hedged transactions. That time period is reasonable if the difference is minimal between the forward rate on that derivative and the forward rate on a derivative or derivatives that would exactly offset the changes in cash flows of the forecasted transactions.

Additional Disclosures Related to Derivative Instruments and Hedging Activities

127. In annual and interim reporting periods, an entity shall disclose all of the following for assets and liabilities reported within a single line item in the statement of financial position for which the carrying amount includes fair value adjustments related to fair value hedging in Subtopic 815-25:

a. The carrying amount of the assets or liabilities included within the line item
b. Cumulative fair value adjustments related to fair value hedging relationships discussed in Subtopic 815-25
c. Cumulative fair value adjustments other than those related to fair value hedging relationships discussed in Subtopic 815-25
d. The carrying amount of the assets or liabilities excluding any fair value adjustments.

128. In annual and interim reporting periods, an entity that designates interest rate risk in a hedging relationship of its own issued debt or other liabilities that are measured at amortized cost shall disclose all of the following as part of its debt disclosure:

a. Its use of derivative contracts (interest rate swaps) to convert a portion of its fixed-rate debt to variable-rate debt, its variable-rate debt to fixed-rate debt, or both
b. The relationship of the maturity structure of the derivatives to the maturity structure of the debt being hedged
c. The overall weighted-average interest rate both including and excluding the effects of derivatives designated as a hedge of its debt or the related interest payments.

Equity Method of Accounting

Structure of Proposed Guidance for Equity Method of Accounting

129. The changes to the guidance on equity method of accounting in Topic 323 are described in this section (paragraphs 130–132). The proposed guidance does not present the overall revised guidance on equity method of accounting.

Criteria for Evaluating if an Investee Should Be Accounted for under the Equity Method

130. An investor shall apply the equity method of accounting only if the investor has significant influence over the investee as described in Topic 323 and if the operations of the investee are considered related to the investor's consolidated operations. If only one of the two criteria is met, the investor shall account for the investment in the equity security at fair value with all changes in fair value recognized in net income. The following factors, which are not all inclusive, shall be evaluated to determine if the operations of the investee are considered related to the investor's consolidated operations:

a. A significant portion of the operations of the investee involve the sale of the investor's products or services, including providing product financing and providing access to markets that otherwise would be inaccessible or more difficult to access.
b. A significant portion of the operations of the investee expand the investor's ability to purchase inputs for its products or services.
c. The operations of the investor and the investee are similar.
d. The investee's management personnel are current or former managers of the investor.
e. The investor and investee have common employees or employees that transfer between the investor and investee.
f. The investor or investee provides significant management services to the other entity.
g. There are significant intra-entity transactions between the investor and the investee that are relevant to the consolidated operations of the investor.

There is no one single factor that necessarily carries any more weight than the others.

Elimination of the Fair Value Option for Equity Method Investments

131. Upon the effective date of the proposed guidance, a reporting entity may not elect the fair value option for investments in equity securities that are accounted for using the equity method as described in Topic 323.

Additional Disclosures Related to Equity Method Investments

132. For each interim and annual reporting period, an entity shall disclose management's rationale for concluding how an investment in an equity security over which it has significant influence is considered related to the entity's consolidated businesses. This disclosure shall include factors management considered when making its assessment.

Effective Dates and Transition

Effective Dates

133. The requirements in the proposed guidance shall be effective for financial statements issued for fiscal years beginning after [date to be inserted after exposure] and interim periods within those fiscal years, except as noted in paragraphs 134–136. Early adoption is prohibited.

134. The effective date of specific requirements of the proposed guidance shall be effective for financial statements issued for fiscal years beginning after [date to be inserted that is 4 years later than the effective date for other entities] and interim periods within those fiscal years for a **nonpublic entity** that reports less than $1 billion of assets in its consolidated statement of financial position. An entity that meets that criterion at the beginning of a fiscal year need not subsequently measure in its financial statements for that fiscal year and interim periods within it any of the following in accordance with the requirements in paragraphs 21, 25, and 31:

a. Loans (including accounts receivable [with terms exceeding one year] and notes receivable) to other entities for which qualifying changes in their fair value would be recognized in other comprehensive income in accordance with paragraph 21
b. Loan commitments made for which qualifying changes in the fair value of the underlying loan would be recognized in other comprehensive income in accordance with paragraphs 21 and 25
c. Core deposit liabilities for which qualifying changes in the remeasured amount determined in accordance with paragraph 31 would be recognized in other comprehensive income in accordance with paragraph 21.

135. In financial statements for reporting periods in which an entity is not subject to the specific requirements of the proposed guidance in accordance with the preceding paragraph, an entity shall continue to apply U.S. GAAP requirements in existence before [the deferred effective date in preceding paragraph of this proposed Update to be inserted] to qualifying loans, loan commitments, and core deposit liabilities. In addition, the entity shall disclose in the notes to the financial statements the fair value of loans that meet the criteria in paragraph 134(a), determined in accordance with the guidance in Topic 820, in a reporting period for which application of the proposed guidance is deferred.

136. An entity shall determine whether it qualifies for the delayed effective date of specific requirements of the proposed guidance at the beginning of each fiscal year during the four-year delayed effective date period. If an entity determines that it no longer meets the criteria for the delayed effective date of specific requirements of the proposed guidance, it also shall no longer be eligible for the

delayed effective date at the beginning of subsequent fiscal years during the four-year delayed effective date period.

Transition

137. An entity shall 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. The statement of financial position for that reporting period shall be restated in the first set of financial statements issued after the effective date. For example, an entity for which the effective date is January 1, 20X4, would restate in its first quarter's financial report its statement of financial position as of December 31, 20X3.

138. An entity shall determine the amount of the cumulative-effect adjustment in accordance with the guidance on accounting changes and error corrections in Topic 250. An entity shall disclose all of the following in the fiscal period in which the proposed guidance is adopted and, if the entity provides interim-period financial statements and adopts the proposed guidance in an interim period, also in the annual financial statement that include that interim period:

a. The nature and reason for the change in accounting principle, including an explanation of the newly adopted accounting principle.
b. The method of applying the adoption.
c. The effect of the adoption on any line item in the statement of financial position for the reporting period that immediately precedes the effective date. Presentation of the effect on financial statement subtotals is not required.
d. The cumulative effect of the change on retained earnings or other components of equity in the statement of financial position as of the reporting period that immediately precedes the effective date.

139. Financial statements of subsequent periods need not repeat the disclosures required by the proposed guidance. If the proposed guidance has no material effect in the period of adoption but is reasonably certain to have a material effect in later periods, the preceding disclosures shall be provided whenever the financial statements of the period of adoption are presented.

140. The transition requirements described in the preceding paragraphs shall also be applied in the first reporting period an entity no longer qualifies for the delayed effective date of specific requirements of the proposed guidance.

Proposed Implementation Guidance

IG1. The implementation guidance below further explains and illustrates the application of the proposed guidance. This implementation guidance does not address all possible variations. The actual facts and circumstances of particular financial instruments or transactions must be considered carefully in relation to the proposed guidance.

Scope

IG2. The proposed guidance applies to financial assets and financial liabilities that are not specifically excluded from the scope by paragraph 4. For example, the scope of the proposed guidance would include the following types of financial assets and liabilities:

a. Accounts receivable and payable
b. Other receivables and payables
c. Originated and purchased loans
d. Investments in debt securities
e. Investments in equity securities (except investments in equity securities that qualify for the use of the equity method of accounting as discussed in paragraph 129)
f. Core and noncore deposits
g. Issued debt
h. Hybrid financial instruments
i. Financial derivative instruments
j. Financial guarantees not covered by paragraph 4(d) and (o)
k. Loan commitments and standby letters of credit (except loan commitments excluded from the scope by paragraph 4(j) and (k)).

IG3. With respect to financial derivative instruments, the proposed guidance includes in its scope both those financial derivative assets and financial derivative liabilities that meet the definition of a derivative in Topic 815 and those financial derivative instruments that do not meet that definition because they do not have one or more characteristics of a derivative.

IG4. Nonfinancial hybrid instruments are not subject to the scope of the proposed guidance. In addition, the proposed guidance is not applicable to hybrid instruments with insurance host contracts or lease host contracts because those types of financial instruments are excluded from the scope of the proposed guidance. In addition, the proposed guidance would require holders of hybrid instruments containing equity hosts to be measured at fair value with all changes in fair value recognized in net income.

IG5. In addition, hybrid financial instruments containing a liability component and an equity component will continue to be evaluated under guidance in Topic 470, 480, or another Topic to determine whether separation of an equity component is required. If so, the scope exception in paragraph 4(b) applies to that equity component and the proposed guidance would apply to the liability component.

IG6. The proposed guidance does not present the overall revised guidance on derivatives and hedging. Only the changes to the guidance on derivatives and hedging in Topic 815 are described. The changes affect all hedging relationships, whether the hedging instrument is a financial derivative instrument or a nonfinancial derivative instrument and whether the hedged item is (or hedged transaction involves) a financial instrument or a nonfinancial instrument.

Initial Measurement

IG7. Paragraph 14 states that when an entity initially recognizes a financial asset or financial liability that meets the criteria for qualifying changes in fair value to be recognized in other comprehensive income, the entity must determine whether there is reliable evidence to indicate that the transaction price may be significantly different from the fair value of the financial instrument. Paragraph 820-10-30-3 discusses conditions that may indicate that a transaction price might not represent the fair value of an asset or liability. The proposed guidance about whether a significant difference exists focuses on the condition discussed in paragraph 820-10-30-3(c) that the financial instrument is only one element of a transaction that may involve other elements. Accordingly, if no reliable evidence indicates that there may be a significant difference between the transaction price and the fair value, the entity would use the transaction price to initially measure the financial instrument. However, if reliable evidence indicates that there may be a significant difference between the transaction price and the fair value, the entity would be required to determine if the difference is attributable to the existence of other elements in the transaction.

IG8. In assessing whether reliable evidence exists that indicates that the transaction price differs significantly from the fair value of a financial instrument, such that other element(s) exist in the transaction, the factors that an entity should consider include any of the following:

a. The terms of a financial instrument, such as upfront and ongoing fees, duration, collateral, and restrictive covenants
b. Prevailing rates offered to other borrowers or offered by other lenders for similar financial instruments that are not influenced by unstated or stated rights and privileges
c. Prevailing rates of other financial instruments with the same borrower or lender that are not influenced by unstated or stated rights and privileges

d. The price that a third-party buyer would be willing to pay to acquire a financial asset or to assume a financial liability
e. If noncash items are exchanged, the current cash price for the same or similar items exchanged in the transaction.

IG9. An entity should consider all relevant facts and circumstances to decide whether the transaction price is significantly different from the fair value. An entity should exercise judgment to decide what is considered a significant difference. For example, if the market interest rate on a 30-year conforming loan is 5.50 percent and if an entity originates a similar loan at 4 percent with no fees or other consideration to compensate the lender for the rate differential, the transaction price of the loan may be significantly different from its fair value. Another example would be a loan commitment with fees that are significantly less than the price an entity would pay to a third party for assuming the liability, which would include credit risk and interest risk associated with the commitment.

IG10. Consistent with the guidance in paragraph 820-10-30-3(c), if the transaction involves a financial instrument and other elements, each element must be separately recognized. As discussed in Section 835-30-25, the other element or elements in the transaction may represent unstated rights and privileges that should be given proper accounting recognition. One example of a transaction that may include stated or unstated rights or privileges is a loan offered at an off-market interest rate as sales incentives by a manufacturer, a financing subsidiary of a manufacturer, or a financial entity. Another example is a credit facility offered at an off-market rate in exchange for goods or services at off-market prices.

IG11. In these circumstances, the financial instrument should be initially recognized at its fair value in accordance with the fair value measurement guidance in Topic 820 or Subtopic 835-30 if a present value technique is used. The other elements in the transaction that gave rise to the significant difference between the transaction price and the fair value (not attributable to transaction fees or costs or because the market in which the transaction occurs is different from the market in which the entity would sell the asset or transfer the liability) should be recognized in net income unless any of those elements qualifies as an asset or a liability under existing U.S. GAAP.

IG12. The following Examples illustrate the application of the initial measurement principles.

Example 1

IG13. On March 1, 20X0, the financing subsidiary of an automobile manufacturer issued a 3-year balloon loan of $30,000 at 2 percent interest rate to a consumer to finance an automobile purchase from the manufacturer. The financing subsidiary also provides financing to other consumers who do not purchase vehicles from that particular automobile manufacturer. The loan meets the criteria for being subsequently measured at fair value with qualifying changes

in fair value recognized in other comprehensive income, and the entity does not choose to measure the loan at fair value with all changes in fair value recognized in net income. The financing subsidiary should initially measure the loan at the transaction price unless reliable evidence indicates that the transaction price of the loan is significantly different from its fair value.

IG14. After reviewing evidence such as the borrower's credit rating, loans of similar terms to other borrowers, and the interest rates charged by other financial institutions in the same geographic area for similar loans, the financing subsidiary determines that several pieces of reliable evidence indicate that the market rate for similar loans is approximately 5 percent. The financing subsidiary further determines that because of the interest rate difference, there is a significant difference between the transaction price and the fair value of the loan. Therefore, the financing subsidiary should measure the loan at its fair value of $27,550, calculated by discounting the net cash flow ($600 for Year 1, $600 for Year 2, and $30,600 for Year 3) of the loan to the present value at the market rate of 5 percent.

IG15. Next, the financing subsidiary must determine what caused the difference of $2,450 on the loan, which is the difference between the fair value of the loan and its transaction price. After analyzing all facts and circumstances relating to this transaction, the financing subsidiary determines that the difference is associated with the agreement between the financing subsidiary and the automobile manufacturer (parent company) through which it subsidizes the financing subsidiary for any loans originated by the financing subsidiary for the automobile manufacturer's vehicles. In its separate financial statements, the subsidiary should recognize an intra-entity receivable from the parent company. The parent company should recognize a corresponding intra-entity payable and recognize the difference of $2,450 as a loss in net income (for example, as a reduction of sales revenue). Therefore, the difference of $2,450 should be recognized as a loss in net income at the consolidated level.

Example 2

IG16. Entity A purchased 100,000 shares of Company C's common stock through Broker B for $5,005,000. The quoted market price for the same stock on the day of the transaction is $50 per share. Because the stocks are subsequently measured at fair value with all changes in fair value recognized in net income, at initial measurement, these stocks are measured at their fair value of $5,000,000 ($50 × 100,000). The remaining difference of $5,000 is attributable to commissions charged by Broker B; therefore, that difference, which is a transaction cost, should be immediately recognized as an expense.

Example 3

IG17. On November 1, 20X0, a lender charged a borrower $400 of nonrefundable fees for entering into a 5-year fixed-rate mortgage loan with a face

value of $10,000. The lender incurred $300 of direct costs on appraisal, underwriting, and so forth, in association with the loan. During the negotiation, the borrower agreed to pay an upfront fee of $544 in exchange for a lower interest rate of 3 percent, while the market rate without the upfront fee was 5 percent. On the closing date of December 31, 20X0, the lender funded the borrower a net of $9,056 ($10,000 – $400 – $544) after deducting the fees. The lender's business strategy is to hold the loan for collection of interest and principal and, therefore, classifies the loan as a loan that would be measured at fair value with qualifying changes in fair value recognized in other comprehensive income.

IG18. In this example, the lender determines that there is no reliable evidence that indicates that there is a significant difference between the transaction price of the loan and the initial fair value. The fees received, including the fee received by the lender in exchange for a lower interest rate, and costs incurred by the lender would not result in a significant difference between the transaction price and the fair value of the loan. Therefore, the loan should be initially measured at its transaction price.

IG19. Upon subsequent measurement at fair value, the net nonrefundable fees and loan origination costs of $100 ($400 – $300) and the $544 fee paid by the borrower to obtain a lower interest rate are deferred in other comprehensive income and the yield of the loan should be adjusted during its term.

Remeasurement of Core Deposit Liabilities

IG20. For core deposit liabilities, a subsequent remeasurement is required at each reporting date. In each subsequent remeasurement, management of the reporting entity must use judgment in determining the appropriate inputs and assumptions. The primary method for determining appropriate assumptions would be the analysis of internal data. If the reporting entity has no appropriate data (that is, its internal data prove to be unreliable or the entity has not been in existence enough years), then the reporting entity may utilize peer data in determining the appropriate assumptions.

IG21. An entity should remeasure the core deposit amount separately for each major product type. In determining the appropriate level of disaggregation of deposits, management should strike a balance between obscuring major product types as a result of too much aggregation and disaggregating excessive detail that may not assist financial statement users to understand the entity's deposit portfolio. At a minimum, management should consider all of the following in determining the appropriate level of disaggregation:

a. Ownership (for example, public, private, interbank, or foreign)
b. Interest bearing (for example, interest bearing and noninterest bearing)
c. Type (for example, demand, savings, or money market accounts).

Inputs and Assumptions to Core Deposit Liabilities Remeasurement Approach

IG22. Management should analyze its demand deposits to determine whether the deposits are core deposit liabilities. Deciding which balances are not core deposit liabilities is determined by type of deposit because there are varying inputs (such as implied maturity) by type of deposit. For example, in determining whether the demand deposits are core deposit liabilities, the following balances would not be considered core deposit liabilities by type of deposit:

a. Surge balances due to seasonal factors or economic uncertainty
b. Temporary accounts for a specific purpose that are not expected to be retained over the implied maturity (such as escrow funds)
c. Other accounts that management believes are transient (such as highly interest-rate-sensitive accounts).

Management judgment is needed in determining which demand deposits are core deposit liabilities. Core demand accounts include all balances that management believes will provide a lower cost of funding versus alternative funding sources over the implied maturity.

IG23. The alternative funds source should be cost-effective and sufficient in volume and duration to replace core deposit liabilities as a funding source. The alternative funds rate would be used as the next available source of funds if core deposit liabilities are not an available source of funding. If one source of funding alone is not sufficient in volume, a blended rate may be used. Management should use judgment in considering sources of funds based on availability as well as rates that would be available to the entity if such funding was needed.

IG24. In determining the all-in-cost-to-service rate, management should consider direct income and expenses to service the core deposit liabilities, including interest expense, branch maintenance expense, and fee income. For purposes of this measurement, branch maintenance expense includes overhead (building rent, building depreciation, utilities, administrative support, and executive salaries) and selling costs (advertising, promotional expenses, and salaries of branch employees).

Subsequent Measurement

Classification and Measurement of Financial Instruments

Meeting the Criteria to Recognize Qualifying Changes in Fair Value in Other Comprehensive Income

IG25. Paragraph 21 outlines the criteria that should be satisfied for an entity to recognize the qualifying portion of a change in fair value of a financial instrument in other comprehensive income rather than in net income. Under paragraph 21, financial instruments that are not hybrid instruments containing an embedded derivative feature must meet a business strategy criterion and a cash flow characteristics criterion. Financial instruments that are hybrid instruments should satisfy an additional criterion that Subtopic 815-15 would not otherwise have required the embedded derivative to be accounted for separately from the host contract.

Cash flow characteristics criteria

IG26. Paragraph 21(a) sets forth the criteria related to the cash flow characteristics of a financial instrument that should be satisfied for an entity to recognize the qualifying portion of a change in fair value of a financial instrument in other comprehensive income. To meet these criteria, the financial instrument should be a debt instrument with contractual cash flows issued or held by an entity with a principal amount transferred initially and returned upon maturity or other settlement. Investments in equity instruments do not meet these criteria and, therefore, do not qualify to report any changes in fair value in other comprehensive income. Instead, all fair value changes relating to investments in equity instruments, other than those that qualify for accounting under the equity method of accounting, should be recognized in net income in the period in which they occur.

IG27. Paragraph 21(a)(1) indicates that the debt instrument issued or held involves an amount transferred to the debtor (issuer) at inception that will be returned to the creditor (investor) at maturity or other settlement, which is the principal amount of the contract adjusted by any original issue discount or premium. A debt instrument that meets this criterion involves an upfront transfer of funds that is an initial investment of the principal amount and a return of the principal at the maturity or other settlement of the instrument. This criterion distinguishes debt instruments as contemplated from other instruments that provide a return based on interest rates, such as derivatives in the scope of Topic 815. Some derivative instruments may have a fairly significant initial net investment. However, that initial net investment does not represent the notional amount and the notional amount will not be returned at maturity or other

settlement of the contract. In addition, this criterion distinguishes debt instruments from instruments that have no initial transfer of funds or a two-way transfer of funds at the inception of the contract, which occurs in some derivative contracts.

IG28. Financial instruments that do not have the characteristic of a debt instrument described in paragraph 21(a)(1) should be measured at fair value with all changes in fair value recognized in net income. For example, derivatives within the scope of Topic 815 should be measured at fair value with all changes in fair value recognized in net income.

IG29. Paragraph 21(a)(2) indicates that the debt instrument held or issued has contractual terms that identify any additional contractual cash flows to be paid to the creditor (investor) either periodically or at the end of the instrument's term. For more traditional debt instruments, the contractual cash flows might be determined by the application of an interest rate to the debt instrument's principal amount. For example, periodic interest cash flows on a traditional loan or bond typically are determined by applying the contractual or stated interest rate to the principal amount. The interest rate can be either fixed or variable. However, the return on a debt instrument does not necessarily have to be computed on the basis of the application of a rate to the principal amount to satisfy this characteristic. That is, the return on the debt instrument may be determined in a manner that does not involve application of a rate or index to a principal amount. However, such instruments may need to be evaluated under the separate criterion related to hybrid financial instruments. A financial instrument may satisfy this characteristic if it involves a single cash flow at the maturity or settlement of the instrument that includes both a return of principal plus an additional return, rather than interim cash flows. For example, a principal-only strip and a zero coupon bond could meet this characteristic.

IG30. Paragraph 21(a)(3) indicates that a debt instrument issued or held cannot contractually be prepaid or otherwise settled in such a way that the creditor (investor) would not recover substantially all of its initial investment, other than through its own choice. Debt instruments often may include contractual terms to allow prepayments or other features that will result in earlier settlement of the instrument. If the contractual terms could result in the creditor's not being able to recover substantially all of its initial investment, even if the probability of prepayment or another form of settlement is remote, the debt instruments would not satisfy this characteristic. The probability of prepayment or other forms of settlement that would result in the holder's not recovering substantially all of its initial investment is not relevant in determining whether the provisions apply to those debt instruments.

IG31. The application of this characteristic focuses on the investor's potential for loss in accordance with the contractual terms; however, if the investor would not recover substantially all of its initial investment, then both the issuer and the investor would not satisfy this characteristic for a debt instrument to report

qualifying changes in fair value in other comprehensive income. That is, the characteristic described in paragraph 21(a)(3) applies symmetrically to both the issuer and the holder of such instruments. In addition, the application of the characteristic is at the initial recognition of the financial instruments. For the issuer, this is at the date of issuance of the financial instrument. For the investor, this is the date of acquisition of the financial instrument. Because the investor may acquire the financial instrument in the secondary market, the investor's and issuer's analyses of this characteristic of the financial instrument may occur at different dates.

IG32. An entity should use judgment in assessing whether the investor will not recover *substantially all* of its initial investment. For example, investments in mortgage-backed securities or callable securities purchased at an insubstantial premium may satisfy this criterion.

IG33. This characteristic does not encompass situations in which events that are not the result of contractual provisions cause the holder not to recover substantially all of its initial investment. Examples of such events are borrower default or changes in the value of an instrument's denominated currency relative to the entity's functional currency.

IG34. This characteristic results in the following financial assets not meeting the qualifying criteria in paragraph 21(a):

a. Any debt instrument that has no principal balance and for which payments are derived from prepayable financial assets
b. Any loan or debt instrument purchased at a substantial premium over the amount at which it can be prepaid
c. Beneficial interests that due to prepayment risk in the securitization structure reflected in the contractual terms of the interest result in the potential that the investor may not recover substantially all of its initial investment in the beneficial interest
d. Subordinated, non–pro rata beneficial interests if they can be contractually prepaid or otherwise settled in such a way that the investor may not recover substantially all of its initial investment.

Business strategy criterion

IG35. Paragraph 21(b) sets forth the criterion for recognizing qualifying changes in fair value of a financial instrument in other comprehensive income on the basis of an entity's business strategy to collect or pay the related contractual cash flows rather than to sell or settle the instrument with a third party. Paragraph 22 states that in complying with this guidance, an entity's business strategy for financial instruments is to evaluate those instruments on the basis of how the entity manages its financial instruments on a portfolio basis rather than based on the entity's intent for an individual financial instrument. The business strategy

determines how an entity manages its financial instruments, which encompasses the reasons for which financial instruments are acquired and sold or settled.

IG36. Classification of financial instruments based on an entity's business strategy need not be determined on a reporting entity level. An entity may have more than one business strategy for managing its financial instruments. For example, a trading unit of a financial institution may hold debt securities as part of a trading strategy or market-making activity, and another business unit within the same entity may hold the same or similar debt instruments as part of an investing strategy. An entity is not prevented from employing different business strategies for the same or similar financial instruments, thereby creating a difference in the accounting for those financial instruments. A portfolio of instruments held to realize short-term gains and that has a high turnover would not meet the qualifying criterion in paragraph 21(b), while a portfolio of financial instruments held as part of a longer term investing strategy could meet that criterion.

IG37. In order to meet the business strategy criterion, an entity's strategy should be to hold instruments in a portfolio designated as held for collection or payment of contractual cash flows for a significant portion of their contractual term. Within a portfolio of financial instruments that is held for collection or payment of contractual cash flows, an occasional sale or settlement may occur without preventing an entity from considering instruments acquired in the future under the same business strategy as being held for collection or payment of contractual cash flows. However, a large number of sales or settlements may be an indication that an entity's business strategy has changed. As stated in paragraph 23, any instruments that previously met the criteria to recognize qualifying changes in fair value in other comprehensive income that were accounted for as such should not be reclassified.

IG38. Contractual terms of a financial instrument that affect the effective life of the instrument do not contradict an entity's business strategy for designating a financial instrument for collection or payment of contractual cash flows and, therefore, do not necessarily prohibit classification as such. For example, if the contractual terms of a loan permit the debtor to prepay the loan, the entity (as creditor) is not prevented from considering the loan as held for collection of the contractual cash flows before prepayment. However, the entity would still be required to consider the cash flow characteristics of the instrument, including whether the instrument can be contractually prepaid or otherwise settled in such a way that the entity would not recover substantially all of its initial investment, before concluding that the qualifying portion of a change in fair value of the instrument may be recognized in other comprehensive income.

Hybrid financial instruments criterion

IG39. Paragraph 21(c) sets forth the criterion for recognizing qualifying changes in fair value of a financial instrument in other comprehensive income on the basis of whether the financial instrument is a hybrid instrument 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. If under Subtopic 815-15 the hybrid financial instrument requires bifurcation, it would be measured in its entirety at fair value with all changes in fair value recognized in net income. Only if bifurcation is not required under Subtopic 815-15 would the hybrid financial instrument be eligible to have qualifying changes in fair value recognized in other comprehensive income.

IG40. The proposed guidance related to the classification and measurement of hybrid financial instruments relates to those hybrid financial instruments that have debt host contracts. Hybrid financial instruments can be either investments of an entity (assets) or obligations of an entity (liabilities). The guidance in Subtopic 815-15 applies to both assets and liabilities. Certain provisions are analyzed from the perspective of the holder, but the conclusion affects the reporting by both parties to the instrument (that is, whether the embedded derivative feature is clearly and closely related or not). However, certain scope exceptions provided in Topic 815 may result in different outcomes for the investor and the issuer.

IG41. The criteria for bifurcation are included in paragraph 815-15-25-1, which states:

> An **embedded derivative** shall be separated from the host contract and accounted for as a **derivative instrument** pursuant to Subtopic 815-10 if and only if all of the following criteria are met:
>
> a. The economic characteristics and risks of the embedded derivative are not clearly and closely related to the economic characteristics and risks of the host contract.
> b. The **hybrid instrument** is not remeasured at **fair value** under otherwise applicable generally accepted accounting principles (GAAP) with changes in fair value reported in earnings as they occur.
> c. A separate instrument with the same terms as the embedded derivative would, pursuant to Section 815-10-15, be a derivative instrument subject to the requirements of this Subtopic. (The initial net investment for the hybrid instrument shall not be considered to be the initial net investment for the embedded derivative.)

IG42. The criteria in paragraph 815-15-25-1(a) and (c) are relevant to the analysis of hybrid financial instruments required by paragraph 21(c). The criterion in paragraph 815-15-25-1(b) is not relevant because the proposed guidance would be the primary source of guidance for determining whether a financial instrument is required to be measured at fair value with all changes in fair value recognized in net income.

IG43. As discussed in Subtopic 815-15, a hybrid instrument contains two components: a host contract and an embedded derivative feature. The notion of *clearly and closely related* in Subtopic 815-15 focuses on whether the economic risks and characteristics of the embedded derivative feature within a contract are related or unrelated to the host contract. If the embedded derivative feature meets the definition of a derivative in Subtopic 815-10 (tested as if it was a freestanding derivative), and the feature is deemed to be unrelated to the host contract, the embedded derivative feature should be accounted for separately from the host contract under existing U.S. GAAP.

IG44. Subtopic 815-15 generally results in no bifurcation of an embedded derivative feature if that feature introduces no risk that is atypical of the type of host contract. Therefore, an embedded derivative in a debt host contract is not clearly and closely related to the host debt instrument if it introduces risk or risks that are not characteristic of debt instruments. For debt hosts, the analysis mainly focuses on whether the economic risks and characteristics of the embedded derivative feature are related or unrelated to interest rates. If the embedded derivative feature is related to interest rates, special tests apply to determine whether bifurcation is required. The guidance on embedded derivatives containing interest-rate-related embedded derivative features is included in Section 815-15-25.

IG45. If the embedded derivative feature is unrelated to interest rates, bifurcation of the hybrid financial instruments is generally required. This would be the case, for example, if the hybrid financial instrument contained a debt host contract and an embedded derivative feature based on changes in equity prices or commodity prices. Therefore, such hybrid financial instruments would be measured at fair value with all changes in fair value recognized in net income. Section 815-15-25 also contains relevant guidance on the analysis of the non-interest-rate-related embedded derivative features.

Interests in securitized financial assets

IG46. Paragraphs 815-15-25-11 through 25-13 require the cash flow characteristics of interests in securitized financial assets (beneficial interests) to be analyzed to determine the classification and measurement under the proposed guidance. These paragraphs apply to senior interests, subordinated interests, and residual interests. In addition, they apply to both purchased

beneficial interests and those interests that continue to be held by a transferor of financial assets in a transfer accounted for as a sale under Topic 860.

IG47. The interest would first be evaluated to determine if it is a derivative under Topic 815 in its entirety, in which case it would be measured at fair value with all changes in value recognized in net income. If the interest is not a derivative in its entirety, the interest would be evaluated under Subtopic 815-15. As required by paragraph 815-15-25-13, a holder of an interest in securitized financial assets should obtain sufficient information about the payoff structure and the payment priority of the interest to determine whether an embedded derivative exists. If the interest contains an embedded derivative that would otherwise have been required to be accounted for separately from the host contract, then the proposed guidance would require all changes in the fair value of the hybrid financial instrument to be recognized in net income.

Subsequent Measurement Illustrations

IG48. The following Examples illustrate the application of the guidance for determining the subsequent measurement of financial instruments.

Example 4: Trade receivables/payables due within one year

IG49. Entity A is a manufacturing company that, in the ordinary course of business, makes sales on credit with payment due within 120 days of the sale. Most credit sales are due within 30 days, but in an effort to expand its customer base, Entity A will occasionally make credit sales to a new customer with payment due in 90 or 120 days.

IG50. *Analysis:* Because the customary payment terms of the trade receivables arising from the credit sales transactions that arise in the normal course of business require payment within one year, Entity A can measure those trade receivables (including the receivables from new customers) at amortized cost (plus or minus fair value hedging adjustments, if any) under the subsequent measurement exception for receivables and payables in paragraph 33.

Example 5: Variable-rate originated loans

IG51. Entity B makes a 30-year loan with a variable interest rate at LIBOR plus a fixed spread.

IG52. *Analysis:* If Entity B's business strategy for the loan receivable is to hold for collection of contractual cash flows (thereby meeting the business strategy criterion in paragraph 21(b)), the fact that the interest is not a fixed amount does not in itself disqualify the instrument from being measured at fair value with qualifying changes in fair value recognized in other comprehensive income

because the variable-rate loan meets the debt instrument criteria in paragraph 21(a). In this case, if the loan is not a hybrid financial instrument that requires bifurcation under Subtopic 815-15, the loan would meet the criteria for fair value with qualifying changes in fair value recognized in other comprehensive income.

IG53. Under paragraph 815-15-25-26(a) or (b), certain floors, caps, collars, or other options on interest rates may result in meeting the requirements in paragraph 815-15-25-1(a) and (c) for bifurcation of the embedded financial derivative feature. If bifurcation would otherwise be required, the loan would not meet the criterion in paragraph 21(c) and, thus, cannot be measured at fair value with qualifying changes in fair value recognized in other comprehensive income. In that case, the loan should be measured at fair value with all changes in fair value recognized in net income and no embedded derivative features would be bifurcated.

Example 6: Purchased loans (fixed-rate and variable-rate)

IG54. Entity C's business strategy is to purchase portfolios of long-term financial assets, such as mortgage loans, and to hold them to collect the cash flows from those assets. Those portfolios may or may not include financial assets for which Entity C does not expect to collect all amounts due according to the contractual terms. After the purchase, Entity C monitors the credit risk of the portfolios closely.

IG55. *Analysis:* The fact that the portfolio will not generate exactly the same cash flows as stated in the contractual terms of the portfolio's financial assets does not in itself disqualify Entity C from meeting the business strategy criterion in paragraph 21(b). Therefore, purchased loans may meet the criteria for fair value with qualifying changes in fair value recognized in other comprehensive income if the entity intends to hold them to collect the contractual cash flow rather than sell them to collect cash and if the purchased loans do not include embedded derivative features that would meet the bifurcation criteria in paragraph 815-15-25-1(a) and (c).

Example 7: Debt securities (fixed-rate and variable-rate)

IG56. Entity D holds 15-year bonds issued by Entity E, which is a strategic business partner of Entity D. The bonds pay interest semiannually and are frequently traded on the secondary market. Entity D's business strategy is to hold the bonds to collect the contractual cash flows. The bonds do not include embedded derivative features that would meet the bifurcation criteria in paragraph 815-15-25-1(a) and (c).

IG57. *Analysis:* Some debt securities are traded in an active market and are readily convertible to cash. Nevertheless, an entity holding those types of investments may have a business strategy to hold the investments to collect the

securities' contractual cash flows rather than sell them before maturity. In this example, Entity D has a long-term strategic business relationship with Entity E, but such a relationship is not essential for an entity to have a business strategy to hold debt securities to collect their contractual cash flows. Because the criteria in paragraph 21 are met, the bonds may be measured at fair value with qualifying changes in fair value recognized in other comprehensive income.

Example 8: Equity securities (including equity securities without a readily available fair value, such as private equities or equities that are not actively traded)

IG58. Entity F holds a 10 percent equity investment in the common stock of Entity G (a start-up company) and does not exercise significant influence over Entity G's operating and financial policies. Entity G's common stock is held by a group of private investors and is not traded in the public marketplace.

IG59. *Analysis:* Entity F should measure its equity investment in Entity G at fair value with all changes in fair value recognized in net income because the investment does not meet the criteria in Subtopic 323-10 for application of the equity method of accounting and is not a debt instrument that potentially could be measured at fair value with qualifying changes in fair value recognized in other comprehensive income in accordance with paragraph 21.

Example 9: Loans held for sale and interest-only strip retained in a transfer of financial assets

IG60. Entity H has a business strategy with the objective of originating prepayable loans to customers and subsequently selling those loans to investors as a portfolio. Entity H continues to service the loan portfolio in exchange for a contractually specified periodic servicing fee, which is more than adequate compensation for the service rendered. In addition, upon sale of the loans, Entity H receives 1 percent interest on the loan payments (in the form of an interest-only strip). Consolidation of the loans upon sale under Topic 810 is not required.

IG61. *Analysis:* Entity H has an objective to realize the cash flows on the loan portfolio by selling the loans to other investors. Therefore, it does not meet the business strategy criterion in paragraph 21(b) of holding the debt instruments to collect contractual cash flows. The loans (before their sale) would not meet the criteria for fair value with qualifying changes in fair value recognized in other comprehensive income and, thus, should be measured at fair value with all changes in fair value recognized in net income.

IG62. When the loan portfolio is sold and the loans are derecognized, Entity H would recognize both a servicing asset relating to the servicing rights (which is not a financial asset) and a financial instrument relating to the interest-only strip,

which does not meet the criterion in paragraph 21(a)(3) for recognizing qualifying changes in fair value in other comprehensive income because the interest-only strip on the prepayable loans could be contractually prepaid or otherwise settled in such a way that Entity H would not recover substantially all of its initial investment (that is, the fair value of the interest-only strip upon its initial recognition at the time the loans were sold).

IG63. If, when the loan portfolio is legally transferred to the investor, an entity does not qualify for sale accounting under Topic 860 and should continue to report the loans as its financial assets, the subsequent measurement of those loans cannot change pursuant to paragraph 23. Those loans should continue to be measured at fair value with all changes in fair value recognized in net income.

Example 10: Convertible debt

IG64. Entity I issues Instrument J, a fixed-rate debt instrument that is convertible at the option of the investor into Entity I's common stock on or after a specified date and at a fixed conversion price. Interest is paid annually.

IG65. *Analysis:* From the perspective of the investor in the convertible debt, Instrument J is a hybrid financial instrument subject to Subtopic 815-15 that contains an embedded derivative (the conversion option) that meets the bifurcation criteria in paragraph 815-15-25-1(a) and (c). Thus, under paragraph 21(c), the investor's investment in Instrument J does not meet the criteria for fair value with qualifying changes in fair value recognized in other comprehensive income. From the perspective of Entity I (the issuer of the convertible debt), Instrument J does not meet the criterion under paragraph 21(a)(1) because the principal will not be returned to the creditor (investor) at maturity or other settlement in those cases in which the convertible debt is settled in accordance with the investor's exercise of the conversion option (which exercise is outside the issuer's control). Thus, the issuer's convertible debt does not meet the criteria for fair value with qualifying changes in fair value recognized in other comprehensive income. Consequently, the fixed-rate convertible debt instrument should be measured at fair value with all changes in fair value recognized in net income by both the issuer and the investor.

Example 11: Financial instruments that are derivatives within the scope of Topic 815

IG66. Instrument K is an option contract to buy the debt securities of Entity L at a fixed price. The contract allows net settlement and requires a small upfront fee.

IG67. *Analysis:* Because Instrument K meets the definition of a derivative under Topic 815, it is not a debt instrument under paragraph 21(a) and, consequently, does not meet the criteria for being measured at fair value with

qualifying changes in fair value recognized in other comprehensive income. Instrument K should be measured by the holder (investor) at fair value with all changes in fair value recognized in net income. If debt securities are eventually purchased under exercise of Instrument K, the subsequent measurement of the purchased debt securities is independent of the subsequent measurement of the related option contract. Those debt securities may meet the criteria in paragraph 21 to be measured at fair value with qualifying changes in fair value recognized in other comprehensive income.

Example 12: Interests in securitized debt instruments

IG68. Entity M holds fixed-rate bonds and issues three tranches of securities to investors: a senior fixed-rate tranche, a subordinated fixed-rate tranche, and a residual tranche that is entitled to the remainder of the fixed-rate payments from the bonds after any credit losses on the fixed-rate bonds. The first two tranches have a limited risk of loss to credit losses on the fixed-rate bonds.

IG69. *Analysis:* The senior, subordinated, and residual tranches may be eligible for measurement at fair value with qualifying changes in fair value recognized in other comprehensive income. None of the tranches could be contractually settled in such a way that the creditor (investor) would not recover substantially all of its initial investment. Only if the debtors under the fixed-rate bonds held by the securitization structure (Entity M) default on their contractual obligations would the investor in the residual tranche (or any of the other tranches) potentially not recover substantially all of its initial investment. Therefore, all of the tranches would meet the criteria in paragraph 21(a) and, thus, all of the tranches may qualify to be measured at fair value with qualifying changes in fair value recognized in other comprehensive income if the other criteria for this subsequent measurement are met. The embedded credit protection among tranches arising solely from subordination of a tranche does not meet the bifurcation criteria in paragraph 815-15-25-1(a) and (c).

Example 13: Interests in various securitized financial assets

IG70. Entity N holds fixed-rate bonds and has issued a credit default swap on a referenced credit that is unrelated to the fixed-rate bonds. The written credit default swap has a smaller notional amount than the fixed-rate bonds held. Entity N issues to investors three tranches of credit-linked beneficial interests that differ in terms of priority for the distribution of cash flows from securities: a senior fixed-rate tranche, a subordinated fixed-rate tranche, and a residual tranche. The assets in Entity N are sufficient to fund any losses on the credit default swap. Furthermore, none of the tranches expose the investors to potential future payments related to defaults on the written credit default swap. Rather, the investors are exposed to a potential reduction in future cash inflows, which is the effect of both the credit risk related to the written credit default swap and the

default risk on the fixed-rate bonds. That reduction in future cash flows is allocated among the tranches by the subordination of one tranche to another.

IG71. *Analysis:* An investor's investment in any tranche would not meet the criteria for measuring the investment at fair value with qualifying changes in fair value recognized in other comprehensive income because it includes an embedded derivative feature that meets the bifurcation criteria in paragraph 815-15-25-1(a) and (c). Consequently, the criterion in paragraph 21(c) is not met. Thus, its investment in any tranche should be measured at fair value with all changes in fair value recognized in net income.

IG72. Had an investor in the senior fixed-rate tranche or the subordinated fixed-rate tranche decided to begin its analysis by first applying the criteria in paragraph 21(a) to its investment in a tranche, the investor would initially analyze at inception the maximum extent of possible losses under the contractual terms of the written credit default swap to determine whether those possible losses expose the investor in those two tranches to potentially not recovering substantially all of its initial investment. (Because losses on the credit default swap are allocated first to the residual tranche, an investor in the residual tranche is clearly exposed to potentially not recovering substantially all of its initial investment.) Any tranche for which the investor is exposed by the contractual terms of the written credit default swap to potentially not recovering substantially all of its initial investment in that tranche would not meet the criteria in paragraph 21(a). In contrast, if the investor in either the senior fixed-rate tranche or the subordinated fixed-rate tranche is not exposed by the contractual terms of the written credit default swap to potentially not recovering substantially all of its initial investment in that tranche, that tranche would meet the criteria in paragraph 21(a). However, as noted above, when the investor applies the criterion in paragraph 21(c) to its investment in a tranche, the investor would conclude that the investment in any tranche does not meet that criterion and cannot be measured at fair value with qualifying changes in fair value recognized in other comprehensive income.

Example 14: Perpetual instruments

IG73. Instrument O is a perpetual instrument (that is, an instrument not required to be redeemed unless the entity decides to or is forced to liquidate its assets and settle claims against the entity) that pays interest annually; however, the issuer may call the instrument at any time and pay the holder the par amount plus accrued interest due. Instrument O pays a market interest rate but payment of interest is not required unless the issuer is able to remain solvent immediately afterwards. No additional interest is accrued for deferred interest.

IG74. *Analysis:* The fact that the instrument can be called at any time by the issuer of the instrument does not in itself indicate that the holder of the instrument does not intend to hold the instrument to collect contractual cash flow.

In this example, the holder of the instrument would be able to collect substantially all the principal and interest either through holding the instrument or when the instrument is called by the issuer. Therefore, the instrument would meet the criterion in paragraph 21(b), but the instrument would not meet the criteria in paragraph 21(a) because it does not have the characteristics of a debt instrument as described in that paragraph. Therefore, Instrument O should be measured at fair value with all changes in fair value recognized in net income.

Example 15: Financial assets with leverage features

IG75. Instrument P is a debt instrument that has an interest rate adjustment feature that significantly increases the interest rate if LIBOR exceeds a specified threshold.

IG76. *Analysis:* The provisions of paragraph 815-15-25-26(b), which generally consider embedded interest rate derivative features to be not clearly and closely related if the embedded interest rate derivative feature could potentially double the initial rate of return on the host contract, would be applied to determine if the embedded interest rate derivative feature is clearly and closely related to the debt host contract. If it is not clearly and closely related, the instrument would meet the bifurcation criteria in paragraph 815-15-25-1(a) and (c) and, thus, would not meet the criterion in paragraph 21(c). Consequently, in that case, the financial instrument would be measured at fair value with all changes in fair value recognized in net income.

Example 16: Prepayable or puttable financial assets

IG77. Instrument Q is an interest-bearing debt instrument that was issued at par and is prepayable by the debtor at par at the debtor's option. Instrument R is an interest-bearing debt instrument that was issued at par and is puttable by the creditor at par at the creditor's option.

IG78. *Analysis:* The embedded call option feature in Instrument Q and the embedded put option feature in Instrument R are clearly and closely related to their related debt host contract pursuant to paragraphs 815-15-25-40 through 25-43. Consequently, the instruments would not meet the bifurcation criteria in paragraph 815-15-25-1(a) and (c). Thus, Instruments Q and R would meet the debt instrument criteria in paragraph 21(a) and the bifurcation criterion in paragraph 21(c). If the creditor meets the business strategy criterion in paragraph 21(b) of holding the debt instruments to collect the contractual cash flows, the debt instruments could be measured at fair value with qualifying changes in fair value recognized in other comprehensive income. Similarly, if the debtor meets the business strategy criterion in paragraph 21(b) of holding the debt instruments to pay the contractual cash flows, the debt instruments could be measured at fair value with qualifying changes in fair value recognized in other comprehensive

income. The ability of the debtor or creditor to accelerate the payment or collection of principal through exercise of the respective contractual call or put option would not prevent the criterion in paragraph 21(b) from being met.

Example 17: Equity or commodity-indexed bonds

IG79. Instrument S is an interest-bearing debt instrument for which the principal payable at maturity is adjusted for changes in the quoted market price of the common stock of a referenced publicly traded entity. Instrument T is an interest-bearing debt instrument for which the principal payable at maturity is adjusted for changes in the quoted market price of a traded commodity.

IG80. *Analysis:* The embedded derivative features in Instruments S and T related to the indexing of the principal to be paid at maturity are not clearly and closely related to their related debt host contracts in accordance with paragraphs 815-15-25-48 through 25-49 and are effectively net settled at the host contract's maturity date. Consequently, the instruments meet the bifurcation criteria in paragraph 815-15-25-1(a) and (c) and, thus, do not meet the criterion in paragraph 21(c). Instruments S and T should be measured at fair value with all changes in fair value recognized in net income.

Loan Commitments

IG81. Loan commitments should be measured at fair value and classified on the basis of the business strategy for the underlying borrowing. From the perspective of the writer of the loan commitment (potential lender), if changes in fair value of the related loan would be recognized in net income, changes in fair value of the related loan commitment also would be recognized in net income. If the related loan is held for collection of contractual cash flows and meets the criteria to report qualifying changes in fair value recognized in other comprehensive income, qualifying changes in fair value of the related loan commitment should be recognized in other comprehensive income. Issuers of loan commitments should determine the classification of the potential loan at the inception of the related loan commitment.

IG82. A loan commitment that relates to a funded loan with all changes in fair value recognized in net income should be initially and subsequently measured at its fair value. At initial measurement, any difference between the fair value of the loan commitment and the commitment fee should be recognized in net income. If the loan commitment is exercised, the funded loan should be initially recognized at its fair value and the loan commitment should be derecognized with any resulting gain or loss recognized in net income.

IG83. A loan commitment that relates to a funded loan that meets the criteria to report qualifying changes in fair value in other comprehensive income should be initially recognized at its transaction price. However, if the entity has reason to expect at initial recognition that the transaction price of the loan commitment

differs significantly from the fair value, and the entity determines that there is reliable evidence indicating that the transaction price is significantly different from the fair value, the loan commitment should initially be measured at its fair value. In that scenario, the entity should account for the other element in the transaction in accordance with other U.S. GAAP. An amount that does not represent an asset or liability under U.S. GAAP should be recognized in net income. Subsequently, the qualifying changes in fair value of those loan commitments are recognized in other comprehensive income. If the loan commitment is exercised, any gain or loss previously recognized in accumulated other comprehensive income during the commitment period should be deferred in other comprehensive income together with changes in fair value of the related funded loan until the loan is paid off or disposed of, at which time, the remaining gain or loss, if any, should be recycled into net income.

IG84. Fees received for a commitment to originate a loan or establish a line of credit in which the qualifying changes in fair value of the related funded loan are recognized in other comprehensive income should be recognized in net income in a manner that is generally consistent with the guidance in Subtopic 310-20. Consistent with the guidance in Subtopic 310-20, fees received for a commitment to originate a term loan should be recognized in interest income as an adjustment of the yield of the related loan. As discussed in paragraph 310-20-25-12, direct loan origination costs incurred to make a commitment to originate a loan should be offset against any related commitment fee. Fees received for a commitment to establish revolving lines of credit that have the characteristics discussed in paragraph 310-20-35-3(b) (that is, the amount of the commitment fee is determined retrospectively as a percentage of the line of credit available but unused in a previous period, that percentage is nominal in relation to the stated interest rate on any related borrowing, and that borrowing will bear a market rate of interest at the date the loan is made) should be recognized in net income as of the determination date.

IG85. Loan commitments associated with lines of credit under credit card and similar charge card arrangements are excluded from the scope of the proposed guidance. Therefore, fees received for a commitment to establish a line of credit under such arrangements should be recognized in accordance with the guidance in Subtopic 310-20.

IG86. If a loan commitment expires unexercised, any remaining loan commitment liability (or asset) is derecognized and the value of the commitment is recognized in net income.

Example 18: Loan Commitments

IG87. The following Example illustrates the accounting for loan commitments. It does not address how loan commitments should be valued, which is covered by the guidance in Topic 820.

IG88. On March 1, 20X1, Entity A enters into a 45-day loan commitment with a borrower to issue a 2-year balloon loan with a principal amount of $100,000 at the current market rate of 5 percent. Entity A charges an upfront nonrefundable fee of $1,000 for committing to fund the loan at the stated rate if the borrower exercises the commitment within the stated period. For simplicity, this illustration assumes that the commitment fee represents the fair value of the loan commitment at inception; however, in reality, this may not always be the case. On March 31, 20X1, the prevailing interest rate for similar loans increases to 5.8 percent, and the fair value of the loan commitment is $1,500. For simplicity, this Example assumes there is no other change in interest rates or any other market factors during the loan commitment period.

IG89. Based on the classification of the loan commitment and the underlying loan, the following two scenarios could occur.

Case A: Changes in fair value of the loan commitment and the loan are recognized in net income

Accounting for the loan commitment during the period the commitment is outstanding

IG90. On March 1, 20X1, Entity A issues the loan commitment and recognizes the loan commitment at its fair value of $1,000.

	Dr.	Cr.
Dr. Cash	$1,000	
Cr. Loan commitment		$1,000

IG91. On March 31, 20X1, the fair value of the loan commitment changes to $1,500. Entity A recognizes the change in fair value of the loan commitment in net income.

	Dr.	Cr.
Dr. Net income	$500	
Cr. Loan commitment		$500

Accounting for the expiration of the loan commitment

IG92. If the loan commitment expires unexercised on April 15, 20X1, the loan commitment is derecognized.

	Dr.	Cr.
Dr. Loan commitment	$1,500	
Cr. Net income		$1,500

Accounting for the exercise of the loan commitment

IG93. If the borrower exercised the loan commitment, for example, on April 1, 20X1, Entity A recognizes the loan at its initial fair value of $98,500 (according to the initial recognition principle for financial instruments with all changes in fair value recognized in net income) and the loan commitment balance is relieved.

Dr. Loan receivable	$98,500	
Dr. Loan commitment	1,500	
Cr. Cash		$100,000

Accounting for the drawn loan

IG94. During the next two years, Entity A recognizes interest on the funded loan and adjusts the loan to its fair value at the end of each reporting period as shown below. To simplify this Example, it assumes there is no credit loss on the loan during the life of the loan.

	Cash Interest	**Loan's Fair Value at March 31**
20X2	$5,000	$99,000
20X3	5,000	$100,000
Total	$10,000	

IG95. On March 31, 20X2, Entity A accounts for subsequent changes in fair value of the loan and recognizes interest.

Dr. Loan receivable	$500	
Cr. Net income		$500
Dr. Cash	$5,000	
Cr. Net income		$5,000

IG96. On March 31, 20X3, Entity A accounts for subsequent changes in fair value of the loan and recognizes interest.

Dr. Loan receivable	$1,000	
Cr. Net income		$1,000

Dr. Cash	$5,000	
Cr. Net income		$5,000

Accounting for the derecognition of the loan

IG97. The loan is fully paid off on March 31, 20X3. Entity A derecognizes the loan and records cash received.

Dr. Cash	$100,000	
Cr. Loan receivable		$100,000

Case B: Qualifying changes in fair value of the loan commitment and the loan are recognized in other comprehensive income

Accounting for the loan commitment during the period the commitment is outstanding

IG98. On March 1, 20X1, Entity A issues the loan commitment and recognizes the loan commitment at its transaction price, which is the same as its fair value of $1,000.

Dr. Cash	$1,000	
Cr. Loan commitment		$1,000

IG99. On March 31, 20X1, the fair value of the loan commitment changes to $1,500. Entity A recognizes the change in fair value of the loan commitment in other comprehensive income.

Dr. Other comprehensive income	$500	
Cr. Loan commitment		$500

Accounting for the expiration of the loan commitment

IG100. If the loan commitment expires unexercised on April 14, 20X1, the loan commitment is derecognized. The balance in other comprehensive income is relieved.

Dr. Loan commitment	$1,500	
Cr. Other comprehensive income		$500
Cr. Net income		1,000

Accounting for the exercise of the loan commitment

IG101. If the borrower exercises the loan commitment, for example, on April 1, 20X1, Entity A recognizes the loan at its initial fair value of $98,500, and the loan commitment balance is relieved. In this Example, according to the initial recognition principle for financial instruments with qualifying changes in fair value recognized in other comprehensive income, the loan's transaction price must be adjusted to its fair value, because there is another element to the transaction (the loan commitment) that must be given separate recognition and that affects the initial measurement of the loan.

Dr. Loan receivable	$98,500	
Dr. Loan commitment	1,500	
Cr. Cash		$100,000

Accounting for the loss related to the loan commitment deferred in other comprehensive income (not the fee)

IG102. When the commitment is exercised, the loss of $500 on the loan commitment remains deferred in other comprehensive income. In this Example, it will be net to zero in other comprehensive income with the changes in fair value of the related loan.

Accounting for the drawn loan

IG103. During the next two years, Entity A recognizes interest on the funded loan and adjusts the loan to its fair value at the end of each reporting period as shown below. For simplicity, this Example assumes there is no credit loss on the loan during the life of the loan.

	Cash Interest	Loan's Fair Value at March 31
20X2	$5,000	$99,000
20X3	5,000	$100,000
Total	$10,000	

IG104. On March 31, 20X2, Entity A accounts for subsequent changes in fair value of the loan and recognizes interest. The interest income includes the amortization of the commitment fee as an adjustment of yield based on the effective interest rate of approximately 5.54 percent (amortized cost of $99,000 × 5.54 percent). The amortized cost is $100,000 less the initial loan commitment fee of $1,000.

Dr. Loan receivable	$500	
Cr. Other comprehensive income		$500

Dr. Cash	$5,000	
Dr. Other comprehensive income	500	
Cr. Interest income		$5,500

IG105. On March 31, 20X3, Entity A accounts for subsequent changes in fair value of the loan and recognizes interest. The interest income includes the amortization of the commitment fee as an adjustment of yield based on the effective interest rate of approximately 5.54 percent (amortized cost of $99,500 × 5.54 percent).

Dr. Loan receivable	$1,000	
Cr. Other comprehensive income		$1,000

Dr. Cash	$5,000	
Dr. Other comprehensive income	500	
Cr. Interest income		$5,500

Accounting for the derecognition of the loan

IG106. The loan is fully paid off on March 31, 20X3. Entity A derecognizes the loan and records cash received.

Dr. Cash	$100,000	
Cr. Loan receivable		$100,000

Credit Impairment of Financial Assets and Interest Income Recognition

Scope

IG107. The following are types of financial assets that may be eligible to have qualifying changes in fair value recognized in other comprehensive income and, therefore, are included in the scope of the guidance for impairment and interest income recognition:

a. Accounts receivable
b. Originated loans
c. Purchased loans
d. Investments in debt securities, including investments in securitized financial assets that are either of the following:
   1. Purchased beneficial interests
   2. Beneficial interests obtained by a transferor in securitized transactions accounted for as sales in accordance with the guidance in Topic 860.
e. Loans that have been restructured or modified.

Evaluation and Measurement of Credit Impairment of Financial Assets

Assessing Declines in Fair Value of a Financial Asset

IG108. The fact that the fair value of a financial asset is less than its amortized cost may be an indicator that a credit impairment exists. It is inappropriate to conclude automatically that a financial asset is not impaired if its fair value is greater than its amortized cost. It also is inappropriate to conclude automatically that every decline in fair value represents a credit impairment. Further analysis and judgment are required to assess whether a decline in fair value indicates that the entity should recognize a credit impairment related to the collectibility of all of

the contractual cash flows or cash flows expected to be collected from the borrower or issuer.

Consideration of Guarantees or Other Credit Enhancements

IG109. An entity should not combine separate contracts (for example, a debt security and a guarantee or other credit enhancement) to determine whether a financial asset is impaired.

Evaluating Loans and Other Receivables for Credit Impairment

IG110. Evidence of a deterioration in the credit quality of a loan, which is an indicator of credit impairment, includes any of the following:

a. Changes in an internal or external (third party) credit score
b. A downgrade in credit rating
c. A decline in the fair value of collateral
d. Past due status.

IG111. A creditor should apply its normal review procedures in identifying loans that are to be evaluated individually for collectibility. Sources of information that may be useful in identifying individual loans for evaluation include all of the following:

a. A specific-size criterion
b. Regulatory reports of examination
c. Internally generated listings such as watch lists, past due reports, overdraft listings, and listings of loans to management
d. Management's reports of total loan amounts by borrower
e. Historical loss experience by type of loan
f. Loan files lacking current financial data related to borrowers and guarantors
g. Borrowers experiencing problems such as operating losses, marginal working capital, inadequate cash flow, or business interruptions
h. Loans secured by collateral that is not readily marketable or that is susceptible to deterioration in realizable value
i. Loans to borrowers in industries or geographic regions experiencing economic instability
j. Loan documentation and compliance exception reports.

Evaluating Investments in Debt Securities for Credit Impairment

Investments in asset-backed securities

IG112. An indicator of impairment of a debt security includes changes in the financial condition of the issuer of the security or, in the case of an asset-backed debt security, changes in the financial condition of the underlying loan obligors.

IG113. For asset-backed securities issued in securitization transactions, an entity should consider how the existence of credit enhancements affects the expected performance of the security, including consideration of the current financial condition of the guarantor of a security (if the guarantee is not a separate contract as discussed in paragraph IG109). Similarly, an entity should consider whether any subordinated interests are capable of absorbing estimated losses on the loans underlying the security. The remaining payment terms of the security could be significantly different from the payment terms in prior periods (such as for some securities backed by nontraditional loans as discussed in paragraph 43(j)). Thus, an entity should consider whether a security backed by currently performing loans will continue to perform when required payments increase in the future (including balloon payments). An entity also should consider how the value of any collateral would affect the expected performance of the security. If the fair value of the collateral has declined, an entity should assess the effect of that decline on the ability of the entity to collect the balloon payment.

Determination of the Allowance for Credit Losses

IG114. The allowance for credit losses established for each class of financial assets should be appropriate to cover the entity's estimate of the credit impairment for that class of financial assets at each financial reporting date. The approach for determining the allowance for credit losses should be well documented and applied consistently from period to period.

IG115. For financial assets that are individually evaluated for impairment, if there has been a change in the entity's estimate of cash flows expected to be collected, the entity should adjust the allowance for credit losses presented on the statement of financial position so that it represents the net present value of cash flows not expected to be collected. Similarly, for financial assets evaluated for impairment on a collective pool basis, changes in historical loss rates adjusted for existing economic factors and conditions would necessitate an adjustment of the allowance for credit losses.

IG116. The allowance for credit losses should be adjusted if an entity recognizes a credit impairment or a reversal of credit impairment expense

recognized in a previous period. To recognize a credit impairment, an entity should increase the allowance for credit losses for impaired financial assets and recognize a corresponding charge to expense for credit impairment. To recognize a reversal of impairment expense, an entity should decrease the allowance and recognize a corresponding credit to expense for credit impairment.

IG117. The allowance for credit losses should be adjusted also as a result of the method for determining the amount of interest recognized in net income on impaired interest-earning financial assets. As discussed in paragraph 76, recognition of interest in net income should be based on a financial asset's effective interest rate applied to the asset's amortized cost, net of the allowance for credit losses. To the extent a financial asset has an associated allowance for credit losses, this method would result in the amount of interest income contractually due for a financial asset exceeding the amount of interest accrued.

IG118. As discussed in paragraph 80, if there is any difference between the amount of interest contractually due (or, for purchased financial assets acquired at an amount that includes a discount related to credit quality, interest cash flows originally expected to be collected) and the amount of interest income accrued, an entity should recognize the difference as an increase in the allowance for credit losses related to the financial assets. If, as a result of this approach to recognizing interest income, the allowance for credit losses exceeds an entity's estimate of credit impairment related to its financial assets, the entity should adjust the allowance for credit losses and recognize the reduction of credit impairment expense in net income (however, this reversal of credit impairment expense should not be recognized as interest income). Therefore, when determining the amount of credit impairment to be recognized in net income in each period, an entity may need to consider the effect on the allowance attributable to the reduction of the amount of interest recognized in net income.

Illustrations

Example 19: Evaluating and Measuring Financial Assets for Credit Impairment on a Collective (Pool) Basis

IG119. The following Cases illustrate the guidance in paragraphs 36–74:

a. Occurrence of specific event (Case A)
b. Change in current conditions (Case B)
c. Anticipated change in conditions (Case C).

Case A: Occurrence of specific event

IG120. Entity A has a portfolio of commercial loans, which is composed primarily of loans to a number of suppliers of Entity X and other retailers in Palm Beach County, Florida. Entity X, which currently employs about 30 percent of the workforce of the county, has announced that it is closing its plant in 6 months and all employees will be terminated.

IG121. Entity X's announcement to close its plant in Palm Beach County represents a current economic condition that would adversely affect the collectibility of loans to Entity X's suppliers as well as loans to other retailers in the county that would be affected by the termination of Entity X's employees. Even though Entity X has not yet closed its plant, Entity A would assess the loans to the suppliers and other retailers that may be affected by the plant closure in the current period rather than waiting six months for the actual closure.

IG122. If Entity A evaluates each loan individually and determines that some of the loans are not impaired on an individual basis, Entity A would group those loans with other loans with similar characteristics to determine whether impairment should be recognized on the basis of historical loss experience.

Case B: Change in current conditions

IG123. Entity B has a portfolio of single-family mortgage loans concentrated in the Northeast. The portfolio has experienced a significant decline in value because home values have decreased 15 percent from 2 years ago, which in turn brings the overall loan-to-value ratio on mortgages written over the last 4 years to 105 percent from 85 percent. Additionally, unemployment rates have increased by two percentage points in the last year. Entity B has not experienced an increase in writeoffs in the portfolio of loans. Entity B anticipates that economic conditions will continue to decline for the next two years and then begin to improve.

IG124. The declining values of single-family homes and the rising unemployment rates represent both a past event and an existing condition that Entity B would consider, among others, in its credit impairment analysis. Because these loans are evaluated for impairment on a pool basis, the historical loss rate used by Entity B in its impairment assessment would be adjusted to reflect existing economic conditions. Entity B would not include its expectations about future economic conditions in making its assessment.

Case C: Anticipated change in conditions

IG125. Entity C has made unsecured credit card loans of $120 million to individuals with varying credit scores. The average interest rate on the credit card balances is approximately 19 percent, given a range of 8 to 25 percent. The

historical loss rate on credit cards with similar characteristics adjusted for existing economic conditions is approximately 6 percent, and Entity C has recognized an allowance of $7.2 million. Entity C predicts that the economy will decline and unemployment rates will increase in the next 12 to 18 months, leading to additional defaults. However, the economy has been stable over the last three years, and there are no existing economic conditions that indicate additional credit impairments have occurred.

IG126. Entity C would not include its expectations about future economic conditions in making its assessment of credit impairments. Therefore, unless there are specific past events or existing economic conditions that indicate additional credit impairments have occurred, no additional amounts would be recognized.

Example 20: Measuring and Recognizing Credit Impairment and Interest Income on Individual Debt Instruments

IG127. This Example illustrates how the proposed impairment, interest income, and presentation guidance would be applied to an individual debt instrument.

IG128. On January 1, 20X1, Entity D loans a manufacturing company $100,000 at a rate of 12 percent per year. The effective interest rate on the loan is also 12 percent. The loan is not collateralized. The loan agreement calls for interest-only payments for the first five years with the principal due at the end of Year 6. The contractual cash flows due under the loan agreement are as follows:

Year Ended December 31		**Contractual Cash Due**
20X1	$	12,000
20X2		12,000
20X3		12,000
20X4		12,000
20X5		12,000
20X6		112,000
	$	172,000

IG129. The manufacturer pays the $12,000 interest due in 20X1 and 20X2. At the end of the 20X2, the fair value of the loan is $75,000 (for simplicity, assume the fair value in the previous period was $100,000). There has been a significant decline in demand for the manufacturer's product as a result of the recent emergence of a new competitor in the market. The manufacturer has reported losses in the last two quarters, and its credit rating has been downgraded in the

current period. Entity D does not expect to collect all of the contractual cash flows due according to the contractual terms of the loan.

IG130. At the end of 20X2, Entity D estimates that it will receive $124,400 of the remaining $148,000 in contractual principal and interest due on the loan as follows:

Year Ended December 31	**Cash Fows Expected to Be Collected**
20X3	$ 12,000
20X4	12,000
20X5	12,000
20X6	88,400
	$ 124,400

IG131. The net present value of the cash flows expected to be collected is $85,000, calculated by discounting the remaining cash flows expected to be collected at the effective interest rate of 12 percent.

IG132. Entity D would adjust the loan balance to fair value and recognize a credit impairment of $15,000 and a $10,000 change in fair value in other comprehensive income by recording the following journal entry:

	Dr.	Cr.
Dr. Credit impairment	$ 15,000	
Dr. Other comprehensive income	10,000	
Cr. Loan—allowance		$15,000
Cr. Loan—fair value adjustment		10,000

IG133. Entity D would present the following information in the statement of financial position for the year ended December 31, 20X2:

Amortized cost	$100,000
Allowance	(15,000)
Other fair value adjustments	(10,000)
	$75,000

IG134. The cumulative credit impairment recognized in net income as of December 31, 20X2, is $15,000. This amount, plus the $10,000 other fair value adjustment, equals the total $25,000 decline in fair value of the loan.

IG135. During 20X3, Entity D would recognize interest income related to the loan of $10,200 ($85,000 × 12 percent). Because the amount of interest that is contractually due is $12,000, Entity D also would recognize an increase in the allowance for credit losses of $1,800 at the time interest income accrual is recognized. As a result, Entity D would record the following entry:

Dr. Accrued interest receivable	$	12,000		
Cr. Interest income			$	10,200
Cr. Loan—allowance				1,800

IG136. If Entity D collects the $12,000 in contractual interest expected before the end of 20X3, Entity D would record the following:

Dr. Cash	$	12,000		
Cr. Accrued interest receivable			$	12,000

IG137. At the end of 20X3, the fair value of the loan is now $72,000, and the amortized cost less the allowance for credit losses is $83,200 ($85,000 at the end of 20X2 less the $1,800 additional allowance recognized in 20X3). Entity D's expectations about cash flows have not changed; however, the net present value of the remaining cash flows expected to be collected is now $83,200 because of the passage of time. Therefore, no additional adjustments to the allowance for credit losses would be necessary. Because the fair value of the loan decreased by $3,000 and the amortized cost less the allowance for credit losses only decreased by $1,800, an additional $1,200 adjustment (loss) would be reflected in other comprehensive income to adjust the fair value of the loan to $72,000 as follows:

Dr. Other comprehensive income	$	1,200		
Cr. Loan—fair value adjustment			$	1,200

IG138. Entity D would present the following information in the statement of financial position for the year ended December 31, 20X3:

Amortized cost	$100,000
Allowance	(16,800)
Other fair value adjustments	(11,200)
	$72,000

IG139. The cumulative amount recognized in net income as a credit impairment (expense) as of December 31, 20X3, is $15,000. The cumulative amount recognized as a credit impairment is unequal to the allowance because $1,800 of

the overall cash flows not expected to be collected on this loan has been reflected as a reduction of interest income.

IG140. At the end of the loan term, assuming the loan performs as expected, Entity D would have an allowance of $23,600 for the cash flows that it expects will not be collected, with $15,000 recognized in net income as a credit impairment and $8,600 reflected as a reduction of interest income.

IG141. The following table summarizes the accounting by Entity D over the life of the loan:

	Amortized Cost	Allowance	Amortized Cost Less Allowance	Credit Impairment	Cash	Interest Income
Origination	$ 100,000		$ 100,000		$ (100,000)	
20X1 collections					12,000	$ 12,000
Balance	100,000		100,000			
20X2 collections					12,000	12,000
Credit impairment		$ (15,000)	(15,000)	$ 15,000		
Balance	100,000	(15,000)	85,000			
20X3 collections		(1,800)	(1,800)		12,000	10,200
Balance	100,000	(16,800)	83,200			
20X4 collections		(2,000)	(2,000)		12,000	10,000
Balance	100,000	(18,800)	81,200			
20X5 collections		(2,300)	(2,300)		12,000	9,700
Balance	100,000	(21,100)	78,900			
20X6 collections	(76,400)	(2,500)	(78,900)		88,400	9,500
Balance	23,600	(23,600)	$ 0	$ 15,000	$ 48,400	$ 63,400
Writeoff	(23,600)	23,600				
	$ 0	$ 0				

Example 21: Purchase of Debt Instrument at an Amount That Includes a Discount Related to Credit Quality

IG142. This Example illustrates how the proposed impairment and presentation guidance would be applied to a debt instrument acquired at an amount that includes a discount related to credit quality. The following Cases display the effects of various scenarios of cash flow activity over a five-year period:

a. Base case—no credit impairment (Case A)
b. Increase in cash flows expected to be collected (Case B)
c. Credit impairment (Case C).

IG143. This Example assumes that the acquisition involved the purchase of one loan that was acquired at an amount that includes a discount related to credit quality. However, the same guidance would apply to an individual debt security or a pool of loans or debt securities acquired at an amount that includes a discount related to credit quality. Additionally, the guidance illustrated in Case C is the same as the guidance that would be applied to an originated loan or debt instrument acquired at an amount that does not include a discount related to

credit quality when a credit impairment occurs after origination or acquisition as illustrated in Example 20.

Case A: Base case—no credit impairment

IG144. Entity E acquires a loan with a principal balance of $5,046,686 and accrued delinquent interest of $500,000 at a discount because of concerns about the debtor's credit quality that have occurred since the loan's origination. Entity E pays $4,000,000 for the loan on December 31, 20X0. No fees were paid or received as part of the acquisition. The contractual interest rate is 12 percent per year. In addition to the delinquent interest, annual payments of $1,400,000 are due in each of the 5 remaining years to maturity ($7,500,000 due in total). Entity A expects to collect only $1,165,134 per year for 5 years ($5,825,670 in total). For simplification, additional interest that would accrue under the contractual terms of the loan for the debtor's failure to make timely payments of the contractual principal and interest is not illustrated.

IG145. On December 31, 20X0, the fair value and amortized cost of the loan are $4,000,000, and the loan would be presented on the statement of financial position at $4,000,000 with no allowance or fair value adjustment. Additionally, in the notes to the financial statements, Entity E would disclose the principal balance of $5,046,686, the net present value of the cash flows not expected to be collected (excluding accrued delinquent interest) at acquisition discounted at the original contractual rate of 12 percent ($846,639), the amount of the other non-credit-related difference between the principal balance and the purchase price (an additional discount) of $200,047, and the amortized cost of $4,000,000. Entity E also would be required to provide any additional disclosures required by the proposed disclosure guidance.

IG146. Entity E calculates the effective interest rate that equates all cash flows expected to be collected ($5,825,670) with the purchase price of the loan ($4,000,000) as 14 percent.

IG147. During 20X1, Entity E would recognize interest income related to the loan of $560,000 ($4,000,000 × 14 percent) as follows:

Dr. Accrued interest receivable	$	560,000		
Cr. Interest income			$	560,000

IG148. If Entity E receives the $1,165,134 expected during the year, Entity E would record the following entry:

Dr. Cash	$	1,165,134		
Cr. Accrued interest receivable			$	560,000
Cr. Loan—amortized cost				605,134

IG149. On December 31, 20X1, the fair value of the loan is $3,200,000 compared with the amortized cost of $3,394,866 ($4,000,000 – $605,134). Therefore, Entity E would record the following entry:

Dr. Other comprehensive income	$ 194,866	
Cr. Loan—fair value adjustment		$ 194,866

IG150. Entity E would present the following information in the statement of financial position for the year ended December 31, 20X1:

Amortized cost	$3,394,866
Other fair value adjustments	(194,866)
	$3,200,000

IG151. Additionally, Entity E would disclose the principal balance, the net present value of the cash flows not expected to be collected, and the amortized cost in the notes to the financial statements.

IG152. If Entity E receives all the cash flows that it expected to collect, the following is a summary of the effects of that activity (excluding the effects of any fair value changes recognized in other comprehensive income):

	Amortized Cost	Allowance	Amortized Cost Less Allowance	Credit Impairment	Cash	Interest Income
Acquisition	$ 4,000,000		$ 4,000,000		$ (4,000,000)	
20X1 Collections	(605,134)		(605,134)		1,165,134	$ 560,000
Balance	3,394,866		3,394,866			
20X2 Collections	(689,853)		(689,853)		1,165,134	475,281
Balance	2,705,013		2,705,013			
20X3 Collections	(786,432)		(786,432)		1,165,134	378,702
Balance	1,918,581		1,918,581			
20X4 Collections	(896,533)		(896,533)		1,165,134	268,601
Balance	1,022,048		1,022,048			
20X5 Collections	(1,022,048)		(1,022,048)		1,165,134	143,086
Balance	$ 0		$ 0		$ 1,825,670	$ 1,825,670

Case B: Increase in cash flows expected to be collected

IG153. Assume that at December 31, 20X2, Entity E estimates that cash flows expected to be collected will be $250,000 more in 20X3 than previously expected but makes no changes to its expectations of cash flows in years 20X4 and 20X5.

IG154. Because Entity E has not previously recognized a credit impairment in net income for cash flows not expected to be collected, the increase in the cash flows expected to be collected should be reflected as an adjustment in the effective interest rate used to calculate interest income and not as a reversal of credit impairment expense in net income. The rate that equates all remaining

cash flows expected to be collected ($1,415,134 in 20X3 and $1,165,134 in 20X4 and 20X5, for a total of $3,745,402) with the current amortized cost of the loan ($2,705,013) is 18.9603 percent.

IG155. If Entity E receives all cash flows that it expected to collect (including the increase of $250,000 in 20X3), the following is a summary of the effects of that activity (excluding the effects of any fair value changes recognized in other comprehensive income):

	Amortized Cost	Allowance	Amortized Cost Less Allowance	Credit Impairment	Cash	Interest Income
Acquisition	$ 4,000,000		$ 4,000,000		$ (4,000,000)	
20X1 Collections	(605,134)		(605,134)		1,165,134	$ 560,000
Balance	3,394,866		3,394,866			
20X2 Collections	(689,853)		(689,853)		1,165,134	475,281
Balance	2,705,013		2,705,013			
20X3 Collections	(902,256)		(902,256)		1,415,134	512,878
Balance	1,802,758		1,802,758			
20X4 Collections	(823,326)		(823,326)		1,165,134	341,808
Balance	979,432		979,432			
20X5 Collections	(979,432)		(979,432)		1,165,134	185,702
Balance	$ 0		$ 0		$ 2,075,670	$ 2,075,670

Case C: Credit impairment

IG156. Assume instead that at December 31, 20X2, because of declining market conditions, Entity E estimates that it will collect $100,000 less in each of the remaining 3 years than expected at acquisition (that is, Entity E expects to collect $1,065,134 per year).

IG157. The net present value of the cash flows expected to be collected discounted at the effective interest rate of 14 percent is $2,472,850.

IG158. Entity E would recognize a credit impairment of $232,163 ($2,705,013 amortized cost – $2,472,850 cash flows expected to be collected) as follows:

Dr. Credit impairment	$ 232,163	
Cr. Loan—allowance		$ 232,163

IG159. Fair value of the loan at December 31, 20X2, is $2,300,000. Therefore, the cumulative amount that should be recognized in accumulated other comprehensive income is a debit of $172,850. Because $194,866 was recognized at December 31, 20X1, the following entry would be required:

Dr. Loan—fair value adjustment	$ 22,016	
Cr. Other comprehensive income		$ 22,016

IG160. Entity E would present the following information in the statement of financial position for the year ended December 31, 20X2:

Amortized cost	$2,705,013
Allowance	(232,163)
Other fair value adjustments	(172,850)
	$2,300,000

IG161. During 20X3, Entity E would recognize interest income related to the loan of $346,199 ($2,472,850 × 14 percent). Because the amount of interest that Entity E originally expected to receive was $378,702, Entity E also would recognize an increase in the allowance for credit losses of $32,503 ($378,702 – $346,199).

IG162. At the end of the loan term, assuming the loan performs as expected, Entity E would have an allowance of $300,000 for the cash flows the entity expects not to collect, with $232,163 recognized in net income as a credit impairment and $67,837 reflected as a reduction of interest income.

IG163. If Entity E receives all the cash flows that it expected to be collected, the following is a summary of the effects of that activity (excluding the effects of any fair value changes recognized in other comprehensive income):

	Amortized Cost	Allowance	Amortized Cost Less Allowance	Credit Impairment	Cash	Interest Income
Acquisition	$ 4,000,000		$ 4,000,000		$ (4,000,000)	
20X1 Collections	(605,134)		(605,134)		1,165,134	$ 560,000
Balance	3,394,866		3,394,866			
20X2 Collections	(689,853)		(689,853)		1,165,134	475,281
Impairment		$ (232,163)	(232,163)	$ 232,163		
Balance	2,705,013	(232,163)	2,472,850			
20X3 Collections	(686,432)	(32,503)	(718,935)		1,065,134	346,199
Balance	2,018,581	(264,666)	1,753,915			
20X4 Collections	(796,533)	(23,053)	(819,586)		1,065,134	245,548
Balance	1,222,048	(287,719)	934,329			
20X5 Collections	(922,048)	(12,281)	(934,329)		1,065,134	130,805
Balance	300,000	(300,000)	$ 0	$ 232,163	$ 1,525,670	$ 1,757,833
Writeoff	(300,000)	300,000				
	$ 0	$ 0				

Example 22: Financial Assets for Which No Accrual of Interest Is Made

IG164. This Example illustrates the guidance in paragraph 82.

IG165. On January 1, 20X1, Entity F makes a $500,000 loan to a construction company. Interest-only payments of 10 percent, or $50,000, are due annually

with the principal of $500,000 due at the end of 3 years. The loan is secured by the condominium complex that the construction company is building. At origination, $150,000 is placed in an escrow account and will be used to pay the yearly interest payments.

IG166. At the end of 20X1, there were no events or conditions that would indicate the loan was impaired, and the lender collected $50,000 in interest from the escrow account.

IG167. During 20X2, the construction company announces that construction is behind progress, sales of condominium units are extremely low, and there is the possibility that the project will be discontinued. Entity F estimates that it will not collect the $500,000 principal due at the end of Year 3 although collection of the remaining $100,000 in escrow is assured. (For simplicity, this Example assumes that the collateral has no value.)

IG168. Because Entity F expects to have a negative overall return on this loan, Entity F would cease recognizing any interest on the loan (that is, place the loan on nonaccrual status) and recognize a credit impairment of $400,000 for the difference between the loan balance and the remaining cash flows expected to be collected. As cash is collected from escrow, Entity F would recognize a reduction in the amortized cost, so that the amortized cost is equal to the $400,000 allowance at the end of the term.

Disclosures

Level of Disaggregation

IG169. An entity should disaggregate its disclosures by nature, characteristics, or risks of the financial instruments. At a minimum, an entity should segregate financial instruments on the basis of subsequent measurement (fair value with all changes in fair value recognized in net income, fair value with qualifying changes in fair value recognized in other comprehensive income, remeasurement amount, or amortized cost). Additional disaggregation should be in a manner consistent with the level of disaggregation required by other Topics, allowing users of financial statements to compare disclosures on a consistent basis across footnotes. For example, the disclosures on accounting for financial instruments should be disaggregated in a manner that is consistent with the disaggregation by class in Topic 820.

IG170. When complying with the disclosure requirements, industry-specific guidance requires certain institutions to provide a greater level of disaggregation. An entity subject to specialized industry guidance should continue to follow that guidance.

IG171. An entity should determine, in light of facts and circumstances, how much detail it is required to provide to satisfy the disclosure requirements, and

how it disaggregates information into classes for assets with different risk characteristics. An entity should strike a balance between obscuring important information as a result of too much aggregation and overburdening financial statements with excessive detail that may not assist financial statement users in understanding the entity's financial instruments and allowance for credit losses. For example, an entity should not obscure important information by including it with a large amount of insignificant detail. Similarly, an entity should not disclose information that is so aggregated that it obscures important differences between the different types of financial instruments and associated risks.

Derivatives and Hedging Activities

Example 23: Cash Flow Hedge of Forecasted Purchase of Natural Gas (to Illustrate Proposed Guidance on Overhedges and Underhedges)

IG172. On January 1, 20X6, an entity forecasts the purchase of natural gas in Iowa in one year. The 1-year forward price for natural gas to be delivered in Iowa is $7.50 per MMBTU. A derivative that would mature on the date of the forecasted transaction and be expected to exactly offset the hedged cash flows would be a forward contract to purchase (lock in the price of) natural gas for delivery in Iowa at $7.50 per MMBTU. The entity enters into an over-the-counter forward contract to purchase natural gas for $7.00 per MMBTU as a hedge against the forecasted purchase in Iowa. The difference between the two contracts is attributed to transportation costs and location of delivery.

IG173. At December 31, 20X6, the spot price of natural gas for delivery in Iowa is $8.50 per MMBTU. Thus, the derivative that would be expected to exactly offset the hedged cash flows would be in a gain position of $1.00 per MMBTU. The entity purchases the natural gas at the $8.50 per MMBTU price. Below is an illustration of the journal entries for two situations: when the change in value of the actual derivative is greater than the change in value of the derivative that would be expected to exactly offset the hedged cash flows and when the change in value of the derivative that would be expected to exactly offset the hedged cash flows is greater than the change in value of the actual derivative.

Change in Value of the Actual Derivative Is Greater Than the Change in Value of the Derivative That Would Be Expected to Exactly Offset the Hedged Cash Flows

IG174. On December 31, 20X6, the spot price of natural gas for delivery under the over-the-counter contract is $8.30 per MMBTU. Thus, the entity has a $1.30 per MMBTU gain on its derivative contract. Comparing the $1.30 gain on the actual derivative with the $1.00 gain on the derivative that would exactly offset

the hedged cash flows results in a $0.30 overhedge. On December 31, 20X6, the entity would make the following journal entries to record the purchase of the natural gas, the deferral of the effective portion of the hedge in other comprehensive income, and the ineffective portion of the hedge in net income:

Dr. Natural gas inventory	$8.50	
Cr. Cash		$8.50

Dr. Forward contract	$1.30	
Cr. Other comprehensive income		$1.00
Cr. Net income		0.30

IG175. On January 1, 20X7, the entity would make the following journal entry for the settlement of the forward contract:

Dr. Cash	$1.30	
Cr. Forward contract		$1.30

IG176. Assume that the entity sold the natural gas on February 28, 20X7. The entity would make the following journal entries on February 28, 20X7, to remove the natural gas from inventory and reclassify the gain from accumulated other comprehensive income to net income. The entity's policy is to classify the effective portion of the change in fair value of the hedging instrument in cost of goods sold.

Dr. Cost of goods sold	$8.50	
Cr. Natural gas inventory		$8.50

Dr. Accumulated other comprehensive income	$1.00	
Cr. Cost of goods sold		$1.00

IG177. On February 28, 20X7, the day that the hedged forecasted transaction affected net income, the statement of comprehensive income reflects cost of goods sold at $7.50, which represents what would be the locked-in price of the derivative that would exactly offset the hedged cash flows. Cumulatively, the statement of comprehensive income reflects $7.20, the actual cash paid after taking into account the $8.50 paid for the natural gas in the spot market and the $1.30 received upon settlement of the derivative. However, that actual price is reflected in the statement of comprehensive income over multiple reporting periods.

Change in Value of the Derivative That Would Be Expected to Exactly Offset the Hedged Cash Flows Is Greater Than the Change in Value of the Actual Derivative

IG178. On December 31, 20X6, the spot price of natural gas for delivery under the over-the-counter contract is $7.80 per MMBTU. Thus, the entity has a $0.80 per MMBTU gain on its derivative contract. Comparing the $0.80 gain on the actual derivative with the $1.00 gain on the derivative that would exactly offset the hedged cash flows results in a $0.20 underhedge. On December 31, 20X6, the entity would make the following journal entries to record the purchase of the natural gas, the deferral of the effective portion of the hedge in other comprehensive income, and the ineffective portion of the hedge in net income:

Dr. Natural gas inventory	$8.50	
Cr. Cash		$8.50

Dr. Forward contract	$0.80	
Dr. Net income	0.20	
Cr. Other comprehensive income		$1.00

IG179. On January 1, 20X7, the entity would make the following journal entry for the settlement of the forward contract:

Dr. Cash	$0.80	
Cr. Forward contract		$0.80

IG180. Assume that the entity sold the natural gas on February 28, 20X7. The entity would make the following journal entries on February 28, 20X7, to remove the natural gas from its books and reclassify the gain from accumulated other comprehensive income to net income. The entity's policy is to classify the effective portion of the change in fair value of the hedging instrument in cost of goods sold.

Dr. Cost of goods sold	$8.50	
Cr. Natural gas inventory		$8.50

Dr. Accumulated other comprehensive income	$1.00	
Cr. Cost of goods sold		$1.00

IG181. On February 28, 20X7, the day that the hedged forecasted transaction affects net income, the statement of comprehensive income reflects cost of goods sold at $7.50, which represents what would be the locked-in price of the derivative that would exactly offset the hedged cash flows. Cumulatively, the statement of comprehensive income reflects $7.70, the actual cash paid after taking into account the $8.50 paid for the natural gas in the spot market and the $0.80 received upon settlement of the derivative. However, it is reflected in the statement of comprehensive income over multiple reporting periods and, in many cases, in more than one line item.

The proposed guidance was approved for publication by three members of the Financial Accounting Standards Board. Ms. Seidman and Mr. Smith voted against publication of the proposed guidance. Their alternative views are set out at the end of the basis for conclusions.

Members of the Financial Accounting Standards Board:

Robert H. Herz, *Chairman*
Thomas J. Linsmeier
Leslie F. Seidman
Marc A. Siegel
Lawrence W. Smith

Background Information, Basis for Conclusions, and Alternative Views

Introduction

BC1. The following summarizes the Board's considerations in reaching the conclusions in this proposed Update. It includes reasons for accepting certain approaches and rejecting others. Individual Board members gave greater weight to some factors than to others.

BC2. The Board concluded that the objective of the proposed guidance should be to significantly improve the decision usefulness of financial instruments reporting for users of financial statements.

BC3. The Board believes that simplification of the accounting requirements for financial instruments should be an outcome of this improvement. Although the project's objective is comprehensive, it also is the Board's objective that the project should be completed expeditiously.

BC4. The proposed guidance covers the recognition, measurement, classification, and impairment of financial instruments, as well as hedge accounting for financial instruments.

Background Information

BC5. Over time, financial instruments have increased in complexity, risks, and volume. Some constituents believe that accounting models have not been appropriately modified during this time period to reflect those complexities and risks in the financial statements. As a result, increases in risk, and the effect of an entity's risk management strategies on that risk, are not adequately captured by or disclosed in the financial statements.

BC6. Since 2005, the FASB and the IASB have had a long-term objective to improve and simplify the reporting for financial instruments. In March 2006, the Boards further clarified their intentions to work together to improve and converge financial reporting standards by issuing a Memorandum of Understanding (MoU), *A Roadmap for Convergence between IFRSs and US GAAP—2006–2008*. As part of the MoU, the Boards worked jointly on a research project to reduce the complexity of the accounting for financial instruments. This joint effort resulted in the IASB's issuance of the March 2008 Discussion Paper, *Reducing Complexity in Reporting Financial Instruments*, which the FASB also published for comment by its constituents. That paper discussed the main causes of complexity in reporting financial instruments and possible intermediate and long-term

approaches to improving financial reporting and reducing complexity. The Boards received 162 comment letters. In the discussions leading to this proposed Update, the Board considered relevant recommendations and suggestions about classification and measurement from those comment letters.

BC7. The Board also was asked on multiple occasions to address numerous issues on many aspects of hedge accounting. As a result, in January 2007, the Board directed the staff to research (a) issues causing difficulties in the application of hedge accounting and (b) potential approaches to accounting for hedging activities. On June 6, 2008, the Board issued an Exposure Draft, *Accounting for Hedging Activities*, to address the identified issues. The Board received 127 comment letters and considered concerns raised by respondents in its deliberations on hedge accounting.

BC8. Although accounting requirements were not the cause of the recent global financial crisis, the crisis highlighted particular issues with the present mixed-attribute measurement model for financial instruments. In brief, the present mixed-attribute measurement model sometimes provides inadequate information that an entity and its advisors and investors need to effectively assess risk. The present model relies too heavily on subjective classification of financial instruments that determines either or both their measurement attribute and how the resulting gains or losses are recognized.

BC9. In October 2008, as part of a joint approach to dealing with the accounting and reporting issues arising from the global financial crisis, the FASB and the IASB established the Financial Crisis Advisory Group (FCAG), which comprises senior leaders with broad international experience in financial markets. The FCAG was asked to consider how improvements in financial reporting could help enhance investors' confidence in financial markets. The advisory group was asked to identify any accounting issues that require the Boards' urgent and immediate attention, as well as issues for longer term consideration.

BC10. The FASB and the IASB also organized three roundtable meetings—one each in London (November 14, 2008), Norwalk (November 25, 2008), and Tokyo (December 3, 2008). The purpose of the roundtables was both to:

a. Receive input from a wide range of stakeholders, including users, preparers, and auditors of financial statements, regulators, and others
b. Identify accounting issues to enhance investors' confidence in financial markets.

BC11. Participants in the roundtables made general comments about the importance of both:

a. Achieving convergence of U.S. GAAP and IFRS
b. Allowing sufficient due process before any changes to existing guidance are made by the Boards.

BC12. Participants raised the following issues at the roundtables:

a. Impairment
b. Fair value option
c. Fair value as a measurement attribute
d. Clarification of the interaction between conflicting accounting standards
e. Clarification for investments in collateralized debt obligations.

BC13. In addition to considering the potential for short-term responses to the credit crisis, both Boards emphasized their commitment to working jointly to provide greater transparency and reduce complexity in the accounting for financial instruments.

BC14. In November 2008, the IASB added to its agenda a project on accounting for financial instruments, with the understanding that the FASB would soon consider adding a related project to its technical agenda. In December 2008, the FASB added such a project to its agenda. This proposed Update has been issued as a result of that project.

BC15. The IASB decided to complete its deliberations on the project in three phases:

a. Phase 1: Classification and measurement—In November 2009 the IASB issued IFRS 9 for financial assets in time to allow, but not require, early adoption for 2009 calendar year-end financial statements. The IASB made a tentative decision to retain the existing classification and measurement guidance in IAS 39 for financial liabilities. However, the IASB also tentatively decided to propose changes to the fair value option for financial liabilities and issued an Exposure Draft on fair value option on May 11, 2010. The comment period ends on July 16, 2010.
b. Phase 2: Impairment—The IASB has made tentative decisions about impairment and issued an Exposure Draft on impairment, in November 2009. The comment period ends on June 30, 2010.
c. Phase 3: Hedge accounting—The IASB is currently deliberating hedge accounting issues and plans to issue an Exposure Draft in the near term.

BC16. The FASB considered approaching the project in several phases and issuing multiple exposure documents. However, the Board believes that these

issues are interrelated and a comprehensive approach will result in requirements that are more coherent, thereby making it easier for constituents to react to and understand the proposed guidance. For example, the Board considered various impairment models and selected one model for all financial instruments (see paragraphs BC167–BC199). The Board's decision on impairment depended on the overall classification and measurement model for financial instruments because the classification and measurement model influences the relevance and the costs and benefits of each impairment model. The Board also considered overlapping issues on hedge accounting. In addition, a comprehensive approach to accounting for financial instruments may reduce the possibility of an entity having to change its accounting policies and systems on several occasions.

Scope

Entities Included in the Scope

BC17. Although the issues that gave rise to the Board's consideration of the proposed guidance were raised in the context of financial institutions, the Board believes that the proposed guidance should not be limited to the accounting by those institutions. The Board's approach to standard setting generally has been to consider the accounting for a specific transaction or financial instrument and try to develop an accounting method that can be applied to all industries, particularly considering that the transactions generally are common to many different industries.

BC18. The Board considered whether certain entities should be excluded from the scope of the proposed guidance on the basis of industry, size, or nonpublic status and decided that all entities that transact in financial instruments should apply this comprehensive accounting model for financial instruments. Risks and market forces have blurred the distinction between industries and have heightened the need for greater comparability in the financial statements of entities in different industries, including the consistency of reported information within an entity's financial statements. Those factors reinforced the Board's belief that all entities with similar financial instruments should account for those instruments in a similar manner.

BC19. The Board also considered exempting from the scope of the proposed guidance not-for-profit entities, such as health and welfare organizations, hospitals, colleges and universities, religious institutions, trade associations, and private foundations. The Board believes that a not-for-profit entity should be subject to the proposed guidance because the model would represent an improvement in financial reporting and also would further the comparability of financial statements of not-for-profit entities.

BC20. The Board also understands that entities in certain industries apply specialized accounting practices that include accounting for substantially all

investments in debt and equity securities at fair value, with the changes in those values recognized in net income or net assets. For brokers and dealers in securities, the Board decided that the measurement and reporting guidance should apply to the financial liabilities of those entities, thus permitting the qualifying changes in fair value for some liabilities to be recognized in other comprehensive income. However, the Board decided that the financial assets of those entities should be reported at fair value with all changes in fair value recognized only in net income. The Board's proposal acknowledges that accounting for financial assets of brokers and dealers in securities at fair value with changes in fair value recognized only in net income provides more relevant information for users of their financial statements and, as such, that requirement is retained in the proposed guidance. For financial liabilities of brokers and dealers in securities, the Board believes the proposed guidance would be an improvement in financial reporting, and, as such, financial liabilities would be required to follow the provisions of the proposed guidance.

BC21. For investment companies, the Board decided that the financial assets and liabilities should be reported at fair value with all changes in fair value included in determining the net increase (decrease) in net assets resulting from operations. Because investment companies do not currently report other comprehensive income, the Board believes that recognizing all financial assets and liabilities at fair value with changes in fair value included in determining the net increase (decrease) in net assets resulting from operations would provide the most relevant information for users of their financial statements.

BC22. The Board decided to provide a delayed effective date to nonpublic entities with less than $1 billion in total consolidated assets for certain aspects of the accounting for financial instruments model included in the proposed guidance because of cost-benefit concerns. The basis for that decision is discussed in the effective date and transition section (see paragraphs BC236–BC238).

Financial Instruments Excluded from the Scope

BC23. The Board decided to exclude certain types of financial instruments from the scope of the proposed guidance (see paragraphs 4 and 5). Many of the excluded financial instruments, such as those stemming from share-based compensation arrangements, would be subject to existing requirements that the Board determined require no reconsideration at this time. Others, including insurance (and related financial guarantees) and lease contracts, are the subject of other projects on the Board's agenda.

Equity Method Investments

BC24. The Board believes that an entity generally should measure investments in equity securities at fair value with all changes in fair value recognized in net income because the only way to realize gains or losses from equity securities is

to sell the equity securities as compared to debt securities, which can be held for collection of contractual cash flows. However, the Board decided that for those equity investments in which the entity has significant influence over the investee and the investee's operations are related to those of the entity's consolidated operations, it is appropriate to account for those investments in accordance with the guidance on the equity method and joint ventures in Topic 323. For those investments, the Board continues to believe that the equity method of accounting would provide the most appropriate representation of the underlying economic activity in the entity's financial statements.

BC25. The Board decided to eliminate the option to measure at fair value investments in equity securities that qualify for the equity method of accounting. The Board believes that the additional criteria to qualify for the equity method of accounting would result in an investor being required to recognize its investment at fair value when this is appropriate, rather than allowing the reporting entity to make such an election. The Board believes that reporting entities have historically elected the fair value option when the investee's operations were not considered related to those of the investor's consolidated operations. Accordingly, those entities would now be required to measure such investments at fair value rather than having the option to do so.

Pledge Receivables and Payables

BC26. The Board decided to exclude from the proposed guidance the receivables and payables of a not-for-profit entity that represent pledges arising from voluntary nonreciprocal transfers. At issue is whether the measurement attribute for pledges arising from voluntary nonreciprocal transfers should be articulated in the proposed guidance or in later guidance after the Board has more fully considered recommendations related to the accounting for a not-for-profit entity, including whether there are specific attributes or implementation issues related to receivables and payables of a not-for-profit entity that represent pledges arising from voluntary nonreciprocal transfers. Therefore, the Board decided that it would be more efficient to address the measurement attribute for receivables and payables of a not-for-profit entity after the Board has reviewed broader recommendations as they relate to accounting for a not-for-profit entity.

Registration Payment Arrangements

BC27. Subtopic 825-20 addresses the accounting for financial instruments with registration payment arrangements. Under the requirements of that Subtopic, a registration payment arrangement is considered a separate unit of account and is measured in accordance with the guidance on loss contingencies in Subtopic 450-20. Currently, registration payment arrangements are excluded from Topics 460 on guarantees, 480 on distinguishing liabilities from equity, and 815 on derivatives and hedging.

BC28. The Board decided to exclude a registration payment arrangement from the scope of the proposed guidance for similar reasons to those noted in Topic 825 on financial instruments, which include the following:

a. Some Board members noted concern about the relevance and reliability of using a fair value measurement because similar arrangements are not entered into on a standalone basis.
b. Some Board members were concerned about the ability to reasonably estimate the price that would be paid to transfer the liability under a registration payment arrangement in an orderly transaction between market participants, considering that a key assumption is the entity's ability to obtain (and maintain) an effective registration statement.
c. Some Board members believe that, in many cases, the fair value of a registration payment arrangement would be minimal at inception and that the difficulties of determining fair value outweigh the costs, particularly in circumstances in which the likelihood of payment is low and the value is immaterial.

Financial Guarantees

BC29. The Board decided that the financial guarantees listed in paragraph 4(o) would be excluded from the scope of the proposed guidance, consistent with its decisions on the recognition and measurement of certain guarantees while deliberating FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others.*

Interaction between the Proposed Guidance and Topic 815

BC30. The Board believes that the accounting for financial instruments that meet the definition of a *derivative* in Topic 815 would not be changed by the proposed guidance. That is, derivatives that are within the scope of Topic 815 would continue to be measured at fair value with changes in value recognized in net income (unless designated and effective as a cash flow hedging instrument or as a hedge of a net investment in a foreign operation).

BC31. The Board believes that derivatives within the scope of Topic 815 do not meet the criteria to have qualifying changes in fair value recognized in other comprehensive income. One characteristic of a derivative instrument in the scope of Topic 815 is that it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors. This characteristic distinguishes investments in debt instruments that have the characteristics described in paragraph 21(a) from the investment that would be required to enter into a contract that provides similar exposure to risk without directly holding (or issuing) the asset related to the underlying. Another

characteristic of a derivative instrument in the scope of Topic 815 is that it has a notional amount or payment provision. For most derivatives, the notional amount does not change hands as part of the contract. Some derivatives (such as cross-currency swaps) involve a two-way exchange. In developing the criteria in paragraph 21(a) for instruments that may have qualifying changes in fair value recognized in other comprehensive income, the Board contemplated debt instruments that involve a one-way exchange of principal rather than no exchange or a two-way exchange as would occur for a derivative. Therefore, the Board decided that derivatives included within the scope of Topic 815 would continue to be subject to its recognition, measurement, presentation, and disclosure requirements, subject to any specific changes to those requirements resulting from the proposed guidance.

Financial Instruments That Are Excluded from the Scope of Topic 815 by a Scope Exception

BC32. This section (paragraphs BC32–BC43) discusses certain exceptions from the scope of Topic 815 for derivative instruments related to the following and the Board's decisions about whether such instruments should be excluded from the scope of the proposed guidance:

a. Regular-way security trades
b. Certain contracts that are not traded on an exchange
c. Derivatives that prevent sale accounting
d. Investments in life insurance
e. Certain investment contracts
f. Contracts between an acquirer and seller to enter into a business combination at a future date
g. Forward purchase contracts for the reporting entity's shares that require physical settlement.

Regular-way security trades and trade date versus settlement date accounting

BC33. Existing U.S. GAAP has no requirement for an entity to consistently recognize security purchases and sales at the trade date or settlement date. Some transfers of securities are recognized as of the trade date, the date the entity agrees to purchase or sell the securities, while others are recognized as of the date the securities are actually transferred and the transaction is settled. For entities operating in certain industries (for example, brokers and dealers in securities and investment companies), security trades are required to be recognized as of the trade date.

BC34. The Board considered that, while IFRS permits an entity to recognize purchases and sales of securities at either the trade date or the settlement date,

if settlement date accounting is used, IAS 39 requires recognition of changes in fair value of a purchased security between trade and settlement dates. More specifically, between the trade date and the settlement date, although the asset is not yet recognized, the entity is required to account for changes in its fair value on the basis of the classification of the acquired asset once it is recognized (that is, changes in fair value are recognized in profit and loss for assets classified as fair value through profit and loss, in other comprehensive income for assets classified as available for sale, and not recognized for assets carried at amortized cost).

BC35. The Board decided not to address the issue of the trade date versus the settlement date as part of the proposed guidance. Board members see merits to both trade date and settlement date accounting. Board members acknowledged that if the financial instrument is recognized at the trade date, any changes between the trade date and the settlement date would be recognized according to the classification of the financial instruments. In that case, if a substantial security trade occurs before a reporting date but is not settled until after the reporting date, under settlement date accounting the transfer of risk associated with that security trade is not properly reflected in the financial statements. Board members also acknowledge that for practical reasons, settlement date accounting should be permitted. Board members observed that the period between the trade date and the settlement date is very short for regular-way security trades. The Board decided not to require a change to the existing practice of recording security trades at the trade date or the settlement date. The Board also decided to provide a scope exception from the proposed guidance for forward contracts in regular-way security trades.

Certain contracts that are not traded on an exchange

BC36. Topic 815 provides a scope exception for contracts that are not exchange-traded if the underlying is any of the following:

a. A climatic or geological variable
b. The price or value of a nonfinancial asset or liability of one of the parties to the contract provided that the asset is not readily convertible to cash
c. Specified volumes of sales or service revenues of one of the parties to the contract.

BC37. Those instruments would meet the definition of the term *financial instrument* if they are settled either in cash (including net cash settlement) or by delivery of another financial instrument, even though the underlying (that is, the reference price or index used to compute the gain or loss on the contract) may be nonfinancial in nature. However, the Board believes that although these contracts do not meet the definition of an *insurance contract*, they are similar to an insurance contract. Insurance contracts are excluded from the scope of the

proposed guidance. Therefore, the Board decided to provide a scope exception for those instruments from applying the proposed guidance.

Derivatives that prevent sale accounting

BC38. Certain derivatives may prevent sale accounting under Topic 860. For example, a call option that enables a transferor to repurchase transferred financial assets can cause the transfer not to meet a criterion for sale accounting. Topic 815 provides a scope exception for derivatives that prevent one party to a transaction from achieving sale accounting under Topic 860. Accounting for the derivative would effectively measure changes in the value of the transferred assets twice because the holder continues to recognize in its financial statements the assets that it has the option to purchase. Therefore, consistent with the reason those derivatives were originally excluded from Topic 815, the Board decided to provide a scope exception from the proposed guidance for derivative financial instruments that would prevent sale accounting.

Investments in life insurance

BC39. Topic 815 provides a scope exception for a policyholder's investment in a life insurance contract or a life settlement contract that is accounted for under Subtopic 325-30 on investments. The Board believes that investments in life insurance contracts also should be excluded from the scope of the proposed guidance because the contracts have an insurance element. Such contracts generally are purchased for funding purposes, for example, to fund deferred compensation agreements or postemployment death benefits, and the entity purchasing life insurance is either the owner or beneficiary of the contract. The Board determined that it would be inappropriate to address policyholder accounting as part of this project. Furthermore, the Board understands there may be significant practical issues about the measurement of these contracts at fair value.

BC40. However, the Board believes that life settlement contracts do not have a direct insurance element. These contracts do not involve an insurable interest, and the investor is not a policyholder. The Board decided that life settlement contracts should be included in the scope of the proposed guidance. The Board observed that requiring fair value measurement would, in effect, eliminate the option to use the *investment method* described in Subtopic 325-30.

Certain investment contracts

BC41. Investment contracts held by entities included within the scope of the guidance on defined benefit pension plans in Topic 960 are excluded from the scope of Topic 815. The Board observed that these investment contracts also should be excluded from the scope of the proposed guidance to be consistent

with its previous decision to exclude employers' and plans' obligations for pension benefits and related assets as defined in Topics 960, 962 on defined contribution pension plans, and 965 on health and welfare benefit plans. The Board noted that, from the issuer's perspective, these contracts are included in the scope of the proposed guidance.

Contracts between an acquirer and a seller to enter into a business combination at a future date

BC42. A scope exception for contracts between an acquirer and a seller to enter into a business combination at a future date was added to Topic 815 as a result of the issuance of FASB Statement No. 141 (revised 2007), *Business Combinations*. The Board decided that for those contracts, a scope exception would be necessary to preserve the objective of the guidance related to business combinations to value all forms of consideration transferred on the date that the assets acquired and liabilities assumed. Therefore, the Board decided to provide a scope exception from the proposed guidance for financial derivative contracts between an acquirer and a seller to enter into a business combination at a future date.

Forward purchase contracts for the reporting entity's shares that require physical settlement

BC43. Forward contracts that require settlement by the reporting entity's delivery of cash in exchange for the acquisition of a fixed number of its equity shares are excluded from the scope of Topic 815 on derivatives and hedging. Those forward contracts are currently accounted for under Topic 480 on distinguishing liabilities from equity. Those contracts were excluded from the scope of Topic 815 because, as discussed in paragraph B27 in the basis for conclusions of FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, the Board rejected the view that forward purchase contracts that must be physically settled by delivering cash should be reported like other derivative instruments. The Board concluded in that Statement that the unconditional obligation should result in recognition of a liability that, like many other liabilities that require cash payments, should be subsequently measured at the present value of the full repurchase price, if the amounts to be paid and the settlement date are fixed, or at the (undiscounted) amounts that would be paid under the conditions specified in the contract if the shares were repurchased at the reporting date if the amounts or settlement date can vary. The Board decided that the specialized measurement guidance for these forward contracts, which results in accruing to the forward contract amount over the life of the contract, should not be changed as part of this project. Therefore, the Board decided that such contracts should be excluded from the scope of the proposed guidance.

Initial Measurement

Transaction Price

BC44. The Board decided that a financial instrument subsequently measured at fair value with all changes in fair value recognized in net income should initially be measured at its fair value. The Board believes that because all subsequent changes in fair value of the instrument are recognized in net income, the initial measurement should follow the same principle; therefore, any initial gain or loss also would be recognized in net income.

BC45. The Board decided that a financial instrument for which qualifying changes in fair value are recognized in other comprehensive income should initially be measured at its transaction price. The Board observed that this would result in recognizing the difference between a financial instrument's transaction price and its fair value (not attributable to other elements in the transaction) in other comprehensive income upon the first remeasurement to fair value. The Board believes this is most consistent with recognizing subsequent changes in fair value for these financial instruments in other comprehensive income.

BC46. The Board observed that in many cases, the transaction price will equal the exit price and, therefore, will represent the fair value of the financial instrument at initial recognition. Paragraph 820-10-30-3 indicates that a transaction price might not represent the fair value of an asset or liability at initial recognition if any of the following conditions exist:

a. The transaction is between related parties.
b. The transaction occurs under duress or the seller is forced to accept the price in the transaction. For example, that might be the case if the seller is experiencing financial difficulty.
c. The unit of account represented by the transaction price is different from the unit of account for the asset or liability measured at fair value. For example, that might be the case if the asset or liability measured at fair value is only one of the elements in the transaction, the transaction includes unstated rights and privileges that should be separately measured, or the transaction price includes transaction costs.
d. The market in which the transaction occurs is different from the market in which the reporting entity would sell the asset or transfer the liability, that is, the principal market or most advantageous market. For example, those markets might be different if the reporting entity is a securities dealer that transacts in different markets, depending on whether the counterparty is a retail customer (retail market) or another securities dealer (interdealer market).

BC47. The Board decided that if the transaction price of a financial instrument for which qualifying changes in fair value are recognized in other comprehensive

income is significantly different from its fair value, and that difference is attributable to other elements in the transaction, the financial instrument should be measured at its fair value. This would ensure that any other elements in the transaction or any stated or unstated rights or privileges involved in the transaction would be accounted for properly in accordance with other applicable U.S. GAAP.

BC48. However, the Board decided that differences between the transaction price and the fair value of a financial instrument attributable to transaction costs as discussed in paragraph BC46(c) or due to the market in which the transaction occurs being different from the market in which the entity would sell the financial asset as discussed in paragraph BC46(d) should not be considered significant differences for the purpose of applying the initial measurement guidance. Any differences attributable to factors other than the existence of other elements in the transaction would be recognized in other comprehensive income upon the first remeasurement of the financial instrument to fair value. This is consistent with the decision that transaction costs related to financial instruments that have qualifying fair value changes recognized in other comprehensive income be deferred in other comprehensive income and recognized in net income over the life of the related financial instrument. In cases in which there is a significant difference between the transaction price and the fair value of a financial instrument but the entity cannot reasonably identify the other element or elements involved in a transaction, the Board decided that an entity should recognize a day one gain or loss in net income.

BC49. The Board considered existing guidance in Subtopic 835-30 on imputation of interest. The Board believes that the proposed guidance on initial measurement is generally consistent with the guidance in Subtopic 835-30. The Board decided to base the determination of whether there may be other elements in the transaction on the existence of a s*ignificant difference* between the transaction price and fair value of a financial instrument rather than on the concept of the *stated interest rate being unreasonable* as discussed in Section 835-30-25 on imputation of interest and in the initial measurement guidance for receivables in Section 310-10-30. The Board believes that the comparison of the transaction price and fair value of a financial instrument for this purpose is a more robust approach and is also more consistent with the proposed measurement guidance that is primarily based on fair value.

BC50. The Board reconsidered the exception in Section 835-30-15 for the customary cash lending activities and demand or savings deposit activities of financial institutions whose primary business is lending money. The Board decided that these transactions should not be exempt from the initial measurement principle for financial instruments.

Transaction Costs and Fees

BC51. The Board decided that transaction costs and fees relating to financial instruments measured at fair value with all changes in fair value recognized in net income should be recognized as an expense in net income when incurred. The Board believes that these transaction costs should be reflected as current-period expenses rather than capitalized and deferred because such costs do not directly relate to the financial asset or liability's fair value, which is consistent with the guidance in Topic 820.

BC52. The Board decided that certain transaction fees and costs relating to financial instruments measured at fair value with qualifying changes in fair value recognized in other comprehensive income should be deferred. The Board decided that the deferred fees and costs should be limited to those loan origination fees and direct loan as defined in Subtopic 320-10. The Board continues to believe the statement in the basis for conclusions on FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases,* that the fees and costs relating to a loan origination are integral to the lending transaction and, therefore, should be recognized over the life of a loan. Accordingly, for financial instruments whose qualifying changes in fair value are recognized in other comprehensive income, the Board decided that the recognition of fees and costs should be consistent with existing guidance in Subtopic 310-20. Therefore, these net fees and costs would be accreted or amortized as an adjustment of yield over the life of the financial instrument. The Board believes that deferring these fees and costs and recognizing them in this manner would preserve net interest margin for those financial instruments in a manner that is consistent with existing accounting standards.

Subsequent Measurement

BC53. The Board believes that many of the reporting issues arising during the current financial crisis stem from the existing mixed-attribute measurement model for financial instruments in which the attribute used for a particular instrument may vary depending on factors such as the nature of the entity that holds or owes it and management's stated purpose for holding a financial instrument. The existing mixed-attribute measurement model prescribes different models for similar financial instruments. Debt instruments may be measured at amortized cost (for example, loans held for investment or held-to-maturity securities), at lower of cost or fair value (for example, mortgage and nonmortgage loans held for sale), or at fair value (for example, trading securities). The measurement models for certain classes of instruments based on management's intentions (for example, debt and equity securities as defined in Topic 320, and mortgage loans as defined in Topic 948) also cause differences in measurement of similar instruments. The Board recognized at the outset that it might not be feasible to

require the same attribute for all financial instruments in all situations, although it should be able to at least reduce the factors or situations that result in a different measurement attribute for particular instruments.

BC54. The Board considered the following three measurement attributes to improve the measurement of financial instruments:

a. Fair value—defined as an exit price in Topic 820
b. Another remeasurement method—referred to as current value
c. Amortized cost.

BC55. In addition, the Board also considered two variations of fair value measurement—one in which all changes in fair value are recognized in net income in the period in which the change occurs and another in which qualifying changes in fair value are recognized in other comprehensive income.

BC56. Paragraph BC3 of the Discussion Paper on reducing complexity states that fair value is the only measurement attribute that is appropriate for all types of financial instruments. Some investor groups have supported that view over time, and virtually all constituents favor use of fair value for some financial instruments, such as trading accounts. The Board also has at several times described fair value as the most relevant attribute for financial instruments.

BC57. Fair value measurement has been a very controversial subject, one on which many knowledgeable people hold differing and strongly held views. Although most agree that fair value is a more relevant measure than amortized cost for financial instruments that are part of a trading portfolio or are otherwise held for sale, there are differences in views about using fair value for financial instruments that are being held for collection or payment(s) of contractual cash flows. Critics of fair value for these types of financial instruments argue that it improperly reflects the business strategy or the way management runs the business and that it results in misleading volatility in reporting and can misstate underlying economic values. They also see issues about operationality and auditability, particularly in estimating fair values for nontraded and illiquid items, and about the effects of changes in an entity's credit standing on the measurement of financial liabilities. They express concerns over potential negative effects on management's incentives at financial institutions and on the perceived stability of institutions and the financial system. At the same time, many investors, financial analysts, economists, and others state that fair value is more relevant than amortized cost even if the business strategy does not involve the trading or sale of financial instruments. The supporters of fair value state that fair value reflects the underlying economics better than amortized cost, that it enhances relevance and comparability, and that it provides a better starting point for understanding and analyzing credit risks, interest rate risks, duration mismatches, sustainability of net interest margins, and liquidity risks. Some also view fair value as an essential tool in proper risk management of financial institutions and as providing an early warning system for developing problems at institutions and across the financial system.

BC58. The Board recognizes that there are strongly held views on both sides of the fair value versus amortized cost debate and believes that the proposed guidance reflects both viewpoints in the financial statements. The proposed guidance would provide more transparent information about financial instruments on the face of the financial statements. By continuing to reflect a "business strategy" approach to what is recognized in net income, it enables entities to preserve most of the current aspects of reporting net income and earnings per share. Presenting both fair value information and amortized cost information on the face of financial statements for instruments that are being held for collection or payment(s) of contractual cash flows enables investors to more easily incorporate either or both fair value and amortized cost information in their analyses of an entity. Also, the Board believes that fair value information would now likely be available at the time of earnings releases rather than only being disclosed later in the notes to the financial statements for public entities. In addition, the proposed guidance would continue to provide regulators with the information necessary to compute regulatory capital using either fair value or amortized cost amounts, if so desired.

BC59. The following discussion first describes the other two measurement attributes the Board considered and their perceived advantages and disadvantages. Then it discusses the benefits of fair value and explains the Board's reasons for choosing fair value as the default measurement attribute for financial instruments, with qualifying changes in fair value recognized in other comprehensive income.

BC60. The Board believes that the proposed classification and measurement model would reduce the overall complexity in accounting for financial instruments because it would simplify the existing mixed-attribute model and also would obviate the need for a fair value option. The Board also believes that the proposed classification and measurement model would increase understandability, comparability, and decision usefulness of reported information for financial instruments.

Current Value

BC61. The current value measurement method uses a discounted cash flows technique to calculate the present value of expected future cash flows for a financial instrument an entity intends to hold. This method excludes other, sometimes unidentifiable, factors such as illiquidity risk and market imperfections, addressing recent concerns about fair value measurements. The value calculated by this method is not based on an exchange price but instead on the basis of the cash flows in the instrument that an entity would realize through the collection or payment of the cash flows with the counterparty to the instrument. This method also addresses the shortcomings of the amortized cost model by providing information in current financial reports about both the cash flows and some components of value changes of the financial instrument as well as eliminating the need for impairment and loan loss reserves guidance.

BC62. Paragraph 25 of FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, states that the only objective of present value, when used in accounting measurements at initial recognition and fresh-start measurements, is to estimate fair value. Present value should attempt to capture the elements that taken together would make up a market price if one existed, that is, fair value. However, when Concepts Statement 7 was written, fair value was not defined as an exit price as currently defined in Topic 820. The current value measurement method would apply the general concepts of present value as reflected in both Concepts Statement 7 and Topic 820 to particular financial instruments but does not have the objective of measuring exit price as currently specified in Topic 820.

BC63. The purpose of current value was not to create a new measurement objective or to change the measurement objective for the present value technique described in Concepts Statement 7, but instead to use the process in that Concepts Statement to calculate a value for financial instruments in certain situations in periods after initial measurement.

BC64. Paragraph 39 of Concepts Statement 7 describes the following elements that together capture the economic differences between various assets and liabilities:

a. An estimate of the future cash flow or, in more complex cases, series of future cash flows at different times
b. Expectations about possible variations in the amount or timing of those cash flows
c. The time value of money, represented by the risk-free rate of interest
d. The price for bearing the uncertainty inherent in the asset or liability
e. Other, sometimes unidentifiable, factors including illiquidity and market imperfections.

The current value measurement method incorporates items (a)–(d) but excludes item (e).

BC65. Some constituents noted that for particular financial instruments the recent dislocated markets environment has highlighted the difficulties of incorporating item (e) and questionable valuations resulting from including factors in item (e).

BC66. The Board obtained feedback from users, preparers, auditors, and others about the potential operationality and usefulness of a current value measurement method. Although there was some support for current value, a majority of the input received was that current value was not sufficiently defined, resulting in wide-spread confusion about what it was meant to represent. Overall, there was little support for its use as an alternative to either fair value or amortized cost.

BC67. The Board believes that to implement current value measurement, it would need to develop a robust definition for consistent application, similar to the exercise undertaken in defining fair value in Topic 820. The Board decided not to undertake a project to further define *current value* because of the perceived limited usefulness of current value as an alternate to fair value or amortized cost. Therefore, the Board decided that it would consider only amortized cost as a potential alternative to fair value measurement for financial instruments.

BC68. However, for the reasons discussed in paragraphs BC123–BC127, the Board believes that a measurement attribute similar to current value would be useful for core deposit liabilities. The Board decided to develop a remeasurement approach for core deposit liabilities that incorporates the key features of current value.

Amortized Cost

Definition of Amortized Cost

BC69. The term *amortized cost* has not been consistently defined in U.S. GAAP. For example, the Master Glossary in the Accounting Standards Codification defines amortized cost for loans in the scope of Subtopic 310-30 as:

> The sum of the initial investment less cash collected less write-downs plus yield accreted to date.

Amortized cost basis is defined 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.

BC70. Paragraph 11 of IAS 39 includes a definition of *amortized cost* that, unlike the FASB's existing definition, applies to liabilities as well as assets:

> The amortized cost of a financial asset or financial liability is 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 rate 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 uncollectibility.

BC71. FASB Concepts No. Statement 5, *Recognition and Measurement in Financial Statements of Business Enterprises,* refers to *historical proceeds* as the measurement attribute for liabilities that is comparable to cost for assets, and the related accounting method for liabilities would be amortized historical proceeds. However, in practice, the term *amortized cost* often is applied to both assets and liabilities, and both this project and other current or recent Board projects use the term *amortized cost* for assets and liabilities.

BC72. The Board decided that the Master Glossary should include only one definition of amortized cost, which should be consistent with the proposed guidance. That definition is based on the previous definition of *amortized cost basis*. The Board also decided to clarify that the definition of amortized cost applies to both financial assets and liabilities.

BC73. In addition, the Board decided to clarify that amortized cost should not be reduced for credit impairments (as credit impairments would be shown as a separate line item on the statement of financial position) but would be reduced for writeoffs of principal amounts. The definition now refers to *writeoffs of the principal amount* rather than *previous other-than-temporary impairments*. In addition, fair value hedge accounting adjustments have been deleted from the definition. Those adjustments were in the previous definition because Topic 815 required them to be included in the amortized cost of the hedged item. The hedge accounting adjustments then were amortized in net income. The measurement attribute in the proposed guidance should be fair value, except for financial instruments explicitly excluded from the subsequent measurement principle in paragraph 19 by paragraphs 28–34. Fair value hedge accounting adjustments are not needed for financial assets or financial liabilities measured at fair value. (Also see paragraph BC235, which discusses fair value hedge accounting adjustments for financial instruments designated as the hedged item in a qualifying hedging relationship that continue to be measured at amortized cost.)

Amortized Cost as a Measurement Attribute for Financial Instruments

BC74. Under existing U.S. GAAP, the primary types of financial instruments accounted for at amortized cost are loans not held for sale, receivables, debt securities classified as held to maturity under Topic 320, and an entity's own issued debt.

BC75. Preparers have generally favored the use of amortized cost for instruments that an entity intends to hold and realize its benefits through collection of contractual cash flows. Amortized cost accounting recognizes reported interest as the primary "earnings" of the entity and also places emphasis on the timing of the realization of changes in value by the entity rather than simply on the amount of the change in value. For example, an entity that is in the

"spread" business is concerned about maximizing interest margin through collection of interest income and payment of interest expense while minimizing credit losses. Realizing temporary value changes is not the immediate goal of that business strategy.

BC76. Some view the amortized cost method for financial instruments as consistent with how a nonfinancial entity recognizes its profit—at the point of sale (realization) of the value added through the manufacturing process rather than as it builds or produces its inventory. In addition, in some situations, an entity may be unable to realize changes in value through a mechanism other than collecting or paying the contractual cash flow payments. For example, an entity may be unable to transfer some types of its own debt to a third party at fair value or may be restricted to settling it by making the contractual cash flows to the creditor.

BC77. Many contend that reporting volatility in the statement of comprehensive income by recognizing short-term changes in fair value that an entity may never realize is misleading and might create incentives to take short-term actions that are not in its best interest over the long term. They note that use of amortized cost avoids much of that volatility.

BC78. The primary perceived disadvantages of amortized cost can be summarized as follows:

a. Amortized cost reflects a historical transaction price that is not relevant for current investment decisions. For example, amortized cost does not reflect current market conditions such as interest rates and market prices. Some argue that an entity that relies on amortized cost measures may not fully understand the risks inherent in its financial instruments and may lose out on certain current opportunities as a result. Fair value would provide information about opportunity cost because it reflects current market conditions.
b. Under amortized cost, an entity can change its intent and realize in net income short-term changes in value. Some view the use of amortized cost as delaying the recognition of economic gains and losses. An entity could sell assets that are performing favorably and hold on to underperforming assets to meet short-term market expectations.
c. The use of amortized cost relies on complex impairment models. Estimating impairment losses and using valuation accounts are complicated and subjective and could create opportunities to smooth the recognition of income.
d. Complex tainting rules may be necessary if some instruments are measured at amortized cost and others are measured at fair value with management's intentions used as the basis for determining which measurement bases should be used for a particular instrument.

BC79. The Board acknowledges that amortized cost information may be relevant for certain financial instruments that an entity intends to hold for

collection or payment(s) of contractual cash flows. The Board also decided to provide an amortized cost option for financial liabilities that an entity intends to hold for payment of contractual cash flows if measuring that liability at fair value would create or exacerbate a measurement attribute mismatch. The Board's decisions on financial liabilities are discussed in paragraphs BC106–BC122 below.

BC80. In addition to the narrow amortized cost option, the Board believes that amortized cost should be prominently displayed in the financial statements for certain financial instruments. The basis for that conclusion is discussed in paragraphs BC103, BC112, and BC157.

Fair Value

BC81. The Board considered two variations of a fair value measurement basis—one in which all changes in fair value are recognized in net income in the period in which the change occurs and one in which qualifying changes in fair value are recognized in other comprehensive income in the period in which the change occurs. The Board decided to provide both categories for classification of financial instruments in the proposed guidance.

Financial Instruments Measured at Fair Value with All Changes in Fair Value Recognized in Net Income

BC82. Supporters of fair value measurement note that it provides users with the most realistic depiction of the market's assessment of the present value of net future cash flows, discounted to reflect both current interest rates and the market's assessment of the risks that the cash flows will not occur. Furthermore, fair value measurement provides information to enable investors to perform real-time assessments of management's decisions about the allocation of resources. Paragraph 41 in the basis for conclusions of FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, supports the requirement to disclose fair value information for financial instruments. It states the following:

> Information about fair values better enables investors, creditors, and other users to assess the consequences of an entity's investment and financing strategies, that is, to assess its performance. For example, information about fair value shows the effects of a decision to borrow using fixed-rate rather than floating-rate financial instruments or of a decision to invest in long-term rather than short-term instruments. Also, in a dynamic economy, information about fair value permits continuous reassessment of earlier decisions in light of current circumstances.

BC83. Part A of Section 3 of the Discussion Paper on reducing complexity notes that, for instruments with highly variable cash flows (such as many derivatives), fair value is the only measurement attribute that helps in assessing future cash flows. Because the cash flows of highly variable instruments may be very small at inception or otherwise not highly correlated with the ultimate cash flows of the instrument, a cost-based measure without adjustment has no value in the assessment of future cash flows. It further states that for instruments with fixed or slightly variable cash flows, a cost-based measure is a feasible measurement attribute if the instruments are held to maturity and it is highly likely that the contractual cash flows will occur. However, there is a risk that the contractual cash flows will not occur, necessitating the need for an impairment model and leading to some of the same complexity that exists in practice today. Compared with cost-based measures, the fair value of a financial instrument better reflects the price that would be received at the measurement date. Fair value information is more useful because events and circumstances beyond management's control may create a need to sell the financial instrument. Therefore, even if management has no plans to sell the financial instrument, it is useful for users of financial statements to know the potential effects of such events and transactions, even if they are not considered highly probable by management.

BC84. Fair value measurement is favored by many users of financial statements as the most transparent method for measuring financial instruments. Fair value is the measure that exposes information about the risks assumed by an institution. The use of fair value accounting imposes market discipline because it forces an entity to cope with current market conditions (especially in times of market turmoil, when fair value measurement of all financial instruments would serve as an "early warning system"). As stated in the March 2009 International Monetary Fund (IMF) Working Paper, *Procyclicality and Fair Value Accounting*:

> FVA [fair value accounting] that captures and reflects *current* market conditions on a timely basis could lead to a better identification of a banks' risk profile, if better information is provided. An earlier warning that can prompt corrective action by shareholders, management, and supervisors allows for a timelier assessment of the impact of banks' risky actions on regulatory capital and financial stability. Moreover, since FVA should lead to earlier recognition of bank losses, it could have a *less* protracted impact on the economy than, for example, loan portfolios whose provisions for losses are usually made when the economy is already weak. [page 9]

BC85. Similarly, in an April 17, 2008 press release, *CFA Institute Centre Says Fair Value 'Smoothing' Will Mask the Reality of Market Conditions and Allow Companies to Hide Risk*, the CFA Institute stated that fair value measurement is

essential to building a more effective risk management system. The linkage between fair value measurement and risk management practices cited by the CFA Institute implies that fair value measurement of financial instruments for reporting purposes would force the discipline in managing risk, to the extent such discipline is lacking internally for entities that assume risk through financial instrument transactions. Specifically, the CFA Institute stated:

> We strongly agree that fair value accounting and supportive disclosures are a cornerstone to building the infrastructure needed for a more broadly effective risk management system. Fair value measurement of financial instruments will ultimately provide the market data necessary for best-in-class risk management, by requiring companies to more fully understand their risk profiles and communicate this to investors and other providers of capital on a timely basis.

BC86. Today's accounting framework for financial instruments is a mixed-attribute model, meaning that there are multiple measurement attributes used for financial instruments based on certain characteristics of the financial instruments, such as their nature, legal form, or business purpose. In addition, because financial instruments are not accounted for uniformly, the scope of existing standards may cause economically similar instruments to be accounted for differently. Users of financial statements need to understand not only the detailed requirements and interaction of numerous standards, but also the existence of elections available for certain financial instruments. Such elections may create a lack of uniformity in accounting for classes of financial instruments.

BC87. Paragraph 33 of FASB Concepts Statement No. 1, *Objectives of Financial Reporting by Business Enterprises*, states that "the role of financial reporting requires it to provide evenhanded, neutral or unbiased information." It also states that it is not a function of financial reporting to try to determine or influence the outcomes of the decisions of investors, creditors, and others who make capital formation decisions. A fair value model is not dependent on management's intentions, realization, or other actions of the entity for timing and measurement of gains and losses in value. As such, it removes the accounting consequences of actions from the decision-making process of both investors and management.

BC88. In a mixed-attribute model, management must weigh the accounting consequences of its actions, in addition to the economic consequences. This can limit management's flexibility in responding to changes in the economic environment in which the entity operates. For example, it may be in an entity's best interest to sell certain assets that were previously held to maturity. However, management must consider either the gain or loss that would result from selling an asset previously measured at amortized cost as well as the tainting that would result from such an action.

BC89. As noted earlier, virtually all constituents agree that at least some financial instruments should be measured at fair value with all changes in fair value recognized in net income. Specifically, virtually all constituents agree that financial instruments included in an entity's trading portfolio should be measured at fair value with all changes in fair value recognized in net income. The same cannot be said for any other measurement attribute, whether amortized cost, current value, or any other measurement used or contemplated.

BC90. In light of all the factors noted, the Board concluded that fair value with all changes in fair value recognized in net income should be considered the default measurement for financial instruments. That is, a financial instrument should be measured at fair value at each reporting date unless conceptual or practical factors indicate that another attribute (that attribute would be amortized cost in the proposed guidance) would provide additional relevant and more representationally faithful information to investors and other capital providers.

Financial Instruments Measured at Fair Value with Qualifying Changes in Fair Value Recognized in Other Comprehensive Income

BC91. The Board concluded that certain changes in the fair values of some financial instruments should be recognized in other comprehensive income. The Board also concluded that an exception to fair value as the measurement attribute should be made for certain financial liabilities. The reasons for that are discussed in paragraphs BC117–BC127. The following paragraphs discuss why the Board decided that qualifying changes in the fair value of financial instruments may be recognized in other comprehensive income.

BC92. The Board's decision to allow certain financial instruments to be measured at fair value with qualifying changes in fair value recognized in other comprehensive income reflects an acknowledgment of the merits of both sides of the fair value accounting debate. The Board concluded that it is not possible to resolve that debate to everyone's satisfaction at this time. Both sides make reasonable points. Therefore, the Board decided that:

a. An entity should be required to report in its statement of financial position the amortized cost as well as the fair value of financial instruments for which qualifying changes in fair value are recognized in other comprehensive income.
b. Certain changes in the fair value of financial instruments that satisfy particular criteria may be recognized in other comprehensive income rather than in net income.

BC93. The Board discussed various criteria to determine which financial instruments should be eligible to recognize qualifying changes in fair value in other comprehensive income. The Board decided that there should be two

criteria for a financial instrument to be eligible to have qualifying changes in fair value recognized in other comprehensive income—one related to the business strategy employed for the instrument and one related to the characteristics of the instrument itself. The Board believes that it would be insufficient to classify financial instruments based on only one criterion.

Characteristics of the instrument

BC94. The Board believes that the characteristics of a financial instrument are an important factor when deciding how to classify financial instruments. The Board notes that the only way to realize the value of an equity security is to sell it. However, the value of a debt security can be realized by holding the instrument until maturity or a substantial portion of the life of the security, at which time the fair value starts approaching par value. Therefore, the Board decided that in order to qualify for certain changes to be recognized in other comprehensive income, the financial instrument must be a debt instrument because the Board believes that only for debt instruments could unrealized gain and loss reverse if the instrument is held for collection or payment of contractual cash flows. This decision would require equities and derivatives to be measured at fair value with all changes in fair value recognized in net income because these instruments only realize value by sale or settlement in a variable amount of cash. The proposed classification decision on derivatives would be consistent with the guidance in Topic 815.

BC95. The Board also believes that financial instruments subject to significant prepayment risk should be measured at fair value with all changes in fair value recognized in net income. To achieve that result, the Board decided to include in the classification criteria the notion that the debt instrument cannot contractually be prepaid or otherwise settled in such a way that the creditor (investor) would not recover substantially all of its initial investment, other than through its own choice according to the contract.

Business strategy of the entity

BC96. The Board refers to a business strategy as how an entity achieves its business purpose. That is, a business strategy is how an entity uses the financial instrument rather than management's intentions for its use. It is a top-down approach to management's intentions in which management decides how to use the entity's assets and liabilities within the business strategy to achieve its business purpose. Management's intent is an application of the business strategy to individual financial instruments. Both terms refer to management's intended manner of realizing the value of the financial instrument or its intended means of settling financial instruments. At a high level, management determines how to use assets and liabilities by deciding whether to sell assets and transfer liabilities or whether to settle them through the receipt or delivery of the contractual cash

flows on the basis of the terms of the agreement with the counterparty. Management's intentions related to the use of the entity's assets and liabilities provides management's view of the utility of those financial instruments in attaining the overall business purpose of the entity.

BC97. The Board believes that it is appropriate to distinguish between financial instruments that an entity is trading or otherwise holding for sale and financial instruments that are part of an entity's long-term asset-liability management or investment activities. The Board believes that fair value changes for financial instruments that an entity intends to hold for collection or payment of cash flows potentially will reverse during the life of the instrument and, therefore, should be recognized in other comprehensive income. The Board believes that for financial instruments that an entity intends to trade, the fair value changes are realized in the near term and should be immediately reflected in net income. The Board also decided not to require detailed guidelines about assertions of intent, holding periods, and so forth, but rather to convey a principle that such instruments should be held as part of a longer term business activity in which sales are infrequent, therefore, eliminating the current tainting notion.

BC98. The Board also believes that asset-liability management is core to the business strategy and analysis of financial institutions. The effects of changes in market variables affect valuations of both financial assets and financial obligations. Accordingly, like financial assets in the proposed model, many financial liabilities of financial institutions would be measured at fair value (with amortized cost also being presented for all financial liabilities). In addition, core deposit liabilities would be remeasured each period using a current value method that reflects the economic benefit that an entity receives from this lower cost, stable funding source. Thus, under the proposed model for a financial institution, the effects would be transparent on both core deposits and other financial liabilities and the financial assets they fund as market interest rates change.

Classification and measurement

BC99. The Board believes that the approach to allow qualifying changes in fair value for eligible financial instruments to be recognized in other comprehensive income with the requirement to disclose the amortized cost for these financial instruments would provide information on both:

a. Management's expectations and intentions about how and when the entity will realize the cash flows associated with the entity's financial instruments
b. The current changes in fair value of an entity's financial instruments.

BC100. The Board believes that recognizing qualifying changes in fair value for financial instruments for which an entity's business strategy is to hold for collection or payment of contractual cash flows in other comprehensive income also would enable entities to preserve most of the traditional concept of net

income (including net interest margin) and earnings per share. Also, the Board believes that (a) information about the realization of cash flows is important for financial instruments an entity intends to hold for collection or payment(s) of contractual cash flows and (b) amortized cost would provide information on current-period cash flow realizations in net income. The Board believes that the portion of the change in fair value that is recognized in other comprehensive income would provide additional information by indicating either (a) the gains or losses that may be realized if the financial instruments cannot be held to collection or payment(s) of contractual cash flows or (b) the amount of opportunity gain or loss if the financial instruments are held to collection or payment(s) of contractual cash flows. The fair value also would provide users with the best available information of the market's assessment of an entity's expectation of its future net cash flows, discounted to reflect both current interest rates and the market's assessment of the risk that the cash flows will not occur.

BC101. The Board also believes that amortized cost measurement with recognition of impairment based on a probable threshold provides insufficient warning to investors and regulators about when asset prices are declining and when risk levels for financial institutions are increasing and, therefore, decided to remove this threshold. The Board believes that the qualifying changes in fair value recognized in other comprehensive income would provide additional information to investors and regulators about interest rate sensitivities and current market conditions.

BC102. The Government Accounting Office (GAO) issued its April 22, 1991 Report to Congressional Committees, "Failed Banks: Accounting and Auditing Reforms Urgently Needed," on 39 failed institutions that accounted for 80 percent of the losses incurred by the bank insurance fund during 1988 and 1989 associated with the savings and loan crisis. When the institutions were put in receivership, FDIC investigators determined that these institutions had suffered losses of $8.1 billion on their loan portfolios. However, up until the point of insolvency, the banks had reported losses of just $1.3 billion in their call reports to banking regulators. Thus, the GAO Report noted:

> Accounting rules are flawed in that they allow bank management considerable latitude in determining carrying amounts for problem loans and repossessed collateral. Recognizing decreases from historical cost to market value has an adverse effect on a bank's reported financial condition. This gives bank management an incentive to use the latitude in accounting rules to delay loss recognition as long as possible. [page 6]

The Board believes that providing both amortized cost and fair value information, in addition to changes to the proposed impairment model would increase transparency and possibly would provide the early-warning information about

potential credit impairments that eluded investors and regulators in past crises. The Board believes that without fair value information, which incorporates market's expectations about credit losses, an equally subjective and difficult-to-measure impairment model would be required to meet the objective of reflecting financial assets such as loans and debt securities at the discounted net amounts expected to be collected. The Board believes that measuring these financial assets at fair value would decrease the complex and subjective other-than-temporary impairment rules in existing U.S. GAAP while preserving the traditional concept of net income and increasing transparency.

BC103. The Board also believes that requiring presentation on the statement of financial position of both amortized cost and fair value of financial instruments for which qualifying changes in fair value are recognized in other comprehensive income would permit users, including bank regulators, to select the number or numbers to which they will pay most attention. In addition, the Board believes that it would subject both measures to equal care in measurement by preparers and equal scrutiny by auditors. Also, the Board believes that fair value information now likely would be available at the time of earnings releases for public entities rather than being disclosed only later in the notes to the financial statements.

BC104. The Board believes that hybrid financial instruments are complex instruments with significant cash flow variability and decided that they should be measured at fair value. The Board decided that, rather than creating a new set of criteria to assess whether the cash flow variability of a hybrid financial instrument was incompatible with criteria developed for measuring a financial asset at fair value with qualifying changes in fair value recognized in other comprehensive income, it would instead rely on the bifurcation and separate accounting guidance on embedded derivatives in Subtopic 815-15. The Board decided that for hybrid financial instruments to be measured at fair value with qualifying changes in fair value recognized in other comprehensive income, all of the following criteria must be met:

a. The hybrid financial instrument has a debt host contract with a principal amount and contractual cash flows.
b. The entity's business strategy is to hold the hybrid instrument for collection or payment.
c. The hybrid financial instrument contains no embedded derivative that requires bifurcation and separate accounting under Subtopic 815-15.

BC105. The Board decided not to allow an entity the option to reclassify instruments from one classification category to another from period to period. The Board is concerned that if reclassifications were allowed, entities may measure financial instruments that they initially elected to measure at fair value with qualifying changes in fair value recognized in other comprehensive income at fair value with all changes in fair value recognized in net income to recognize gains in net income on appreciated financial assets for which an entity is not

recognizing losses. The Board believes that if reclassifications are allowed, an entity may manage earnings by "selling winners and holding losers." In addition, because the Board took a top-down approach to management's intentions for classification purposes, the Board believes that presenting realized gains and losses separately on the performance statement would be sufficient for users to evaluate management's financial instrument activities.

Financial Liabilities

Arguments for and against fair value measurement

BC106. The Board considered whether to require a different classification and measurement model for financial liabilities than for financial assets. The Board considered a number of arguments for and against measuring financial liabilities at fair value that the Board considered, including relevance, measurement attribute mismatch, volatility, and effects of changes in an entity's own credit risk.

BC107. An asset-liability mismatch often is cited as an argument for measuring financial liabilities at fair value. If an entity's financial assets are measured at fair value but its financial liabilities are not, then the model that results would not promote identification of duration or other mismatches. For example, during the savings and loan crisis, entities funded long-term, fixed-interest loans with short-term deposits. When interest rates increased, the entities had to pay higher interest on their deposits than they were receiving on their loans. If only the loans were measured at fair value, financial statement users would be provided with information about how the loans react to changes in interest rates but would not be provided with information about how well or how poorly management has economically managed that exposure with its liabilities.

BC108. An asset-liability mismatch also has been used as an argument against recognizing financial liabilities, particularly long-term debt, at fair value. An entity may have significant unrecognized assets, such as internally developed intangible assets. Changes in the fair value of an entity's long-term debt may reflect changes in the value of those assets that the entity has not recognized or changes in the value of assets that are not financial assets and, therefore, are not recognized at fair value, such as recognized intangible assets and productive assets. If all financial assets are recognized at fair value, with changes recognized in either net income or other comprehensive income, measuring financial liabilities at fair value would offset the volatility resulting from valuing financial assets at fair value. However, if an entity has significant unrecognized assets or nonfinancial assets that are not measured at fair value, measuring financial liabilities at fair value may increase volatility.

BC109. A significant concern that constituents have raised about recognizing financial liabilities at fair value relates to changes in fair value attributable to changes in an entity's own credit risk. When changes in an entity's own credit

risk are reflected in the measurement of a financial liability, an entity recognizes a gain from a decrease in its own credit risk and a loss for an increase in its own credit risk. Many constituents have stated that recognizing a gain due to a decrease in credit risk is misleading and inappropriate, because an entity often lacks the ability to realize such gains. Additionally, constituents who oppose recognizing changes in fair value related to changes in an entity's own credit risk note that changes in an entity's own credit risk are likely to be offset by changes in unrecognized intangible assets or assets that are not recognized at fair value.

BC110. Constituents who favor measuring all financial liabilities at fair value note that recognizing a financial liability at fair value, including changes attributable to an entity's own credit risk, provides information about effective interest rates and likely refinancing requirements. Those constituents note that the Discussion Paper on reducing complexity provides arguments for why an unrealized gain should be recognized on a financial liability when negative things happen. Paragraph 3.74 (a)–(d) of the Discussion Paper on reducing complexity notes the following:

(a) The liability is a contract between two entities. Generally, when circumstances change that result in one entity incurring a loss, it might be expected that the other party will have a gain. That leads to a conclusion that, when a lender recognises a loss, the borrower should recognise a gain.
(b) A financial liability's fair value on initial recognition reflects its credit risk. It seems inconsistent to include credit risk in the initial fair value measurement of a financial liability but not in the subsequent measurement of the financial liability.
(c) The apparent gain does not occur in a vacuum. The reason why a borrower is unable to pay is that it has suffered losses or expects to have shortfalls in profits. If those losses are fully recognised in the financial statements of the borrower, the amount of the losses is likely to exceed the amount of gain arising from a decrease in the fair value of the liability. However, not all of the losses or shortfalls are recognised in financial statements. For example, losses arising from decreases in value of unrecognised intangible assets are not recognised. The gain on the liability might provide a signal to users of the borrower's financial statements that unrecogised losses or shortfalls have been incurred.
(d) Equity holders of an entity are not required to make any additional investment to cover losses incurred by the entity except to the extent that the equity holders have a binding obligation to do so. However, when the credit risk of an

instrument increases, the lender might suffer a loss. Therefore, the apparent gain to the borrower can be seen as an allocation of deficits from the owners of the borrower to the lender.

BC111. The Board believes that there is merit to both the arguments for and the arguments against measuring financial liabilities at fair value. However, the Board decided that fair value would be a more appropriate measurement attribute than cost in situations in which the majority of an entity's assets are measured at fair value.

BC112. Additionally, the Board believes that its presentation decisions for certain types of financial liabilities, which would permit changes in the fair value to be recognized in other comprehensive income while requiring that current-period interest expense accruals to be recognized in the net income, maintains an emphasis on the timing and method of realization that the entity employs in its business.

BC113. The Board considered an alternative measurement approach for financial liabilities with principal amounts held for payment of contractual cash flows that would have involved subsequently measuring those financial liabilities at a current value that ignores changes in an entity's own credit risk. The Board rejected that alternative because it would have added complexity by introducing another measurement attribute. Additionally, the Board believes that measuring financial liabilities at an "adjusted" fair value excluding credit would continue to contribute to asset-liability mismatches in situations in which the majority of an entity's assets are measured at fair value. Also, the Board believes that using this alternative measurement attribute to measure financial liabilities would not appropriately reflect equity.

BC114. The Board considered whether to retain existing bifurcation requirements for financial liabilities with embedded derivatives that otherwise would require bifurcation in accordance with Subtopic 815-15 that are held for payment of contractual cash flows, so that the host would be measured at fair value with qualifying changes in fair value recognized in other comprehensive income (or potentially at amortized cost if measurement at fair value would create a measurement attribute mismatch). Retaining existing bifurcation requirements would limit the effects of changes in an entity's own credit risk recognized in net income to derivatives. Instead, changes in the entity's own credit risk related to the host would be recognized in other comprehensive income or would not be recognized if the liability qualified for the amortized cost option. However, the Board decided not to retain existing bifurcation requirements for financial liabilities because of the complexity involved in bifurcating a financial liability between the host and derivative feature and then measuring the change in fair value of each component so that the change could be bifurcated between net income and other comprehensive income (unless the host qualified to be measured at amortized cost). Additionally, the Board believes that retaining

existing bifurcation requirements for financial liabilities while eliminating the requirements for assets would add unnecessary complexity.

BC115. The Board decided that all changes in fair value of a financial liability with an embedded derivative that otherwise would require bifurcation in accordance with Subtopic 815-15 should be recognized in net income even if the liability is being held for payment of contractual cash flows. The Board believes that the variability caused by the embedded derivative is enough to require that changes in the fair value of these instruments be recognized in net income.

BC116. To address concerns about changes in fair value attributable to changes in an entity's own credit risk, the Board decided to require an entity to separately present significant changes in fair value that are attributable to changes in the entity's credit standing. That decision is further discussed in paragraphs BC160–BC165.

Amortized cost option

BC117. The Board decided that financial liabilities should be classified using the same criteria as financial assets unless measuring the financial liability at fair value would create or exacerbate a measurement attribute mismatch. In those situations, an entity would be permitted to measure the financial liability at amortized cost. The Board believes that measuring these qualifying financial instruments at amortized cost addresses many of the concerns raised about the volatility introduced in income from an asset-liability mismatch arising from measuring financial liabilities at fair value when significant nonfinancial assets are not measured at fair value.

BC118. The Board decided that an entity may irrevocably elect to measure a financial liability at amortized cost if the financial liability meets both of the following criteria:

a. The financial liability meets the criteria to have the qualifying portion of the changes in its fair value recognized in other comprehensive income.
b. Measuring the financial liability at fair value would create or exacerbate a measurement attribute mismatch of recorded assets and liabilities.

BC119. Measuring a financial liability at fair value would be deemed to create or exacerbate a measurement attribute mismatch only in the following circumstances:

a. The financial liability is contractually linked to an asset not measured at fair value. A financial liability that is collateralized by an asset, or is contractually required to be settled upon the derecognition of an asset, is contractually linked to that respective asset.

b. The financial liability is issued by and recorded in, or evaluated by the chief operating decision maker as part of an operating segment for which less than 50 percent of the segment's recognized assets are subsequently measured at fair value.
c. The financial liability meets neither item (a) nor (b) but is the liability of a consolidated entity for which less than 50 percent of consolidated recognized assets are subsequently measured at fair value.

BC120. The Board believes that if a financial liability is contractually linked to an asset that is not subsequently measured at fair value (for example, a mortgage collateralized by a building), an entity should not be required to measure the financial liability at fair value. Additionally, the Board believes that if the majority of the assets of an entity are not measured at fair value, the entity should not be required to measure at fair value financial liabilities that are held for payment of contractual cash flows that would not otherwise require bifurcation in accordance with Topic 815. The Board considered how an entity should determine whether the majority of its assets are measured at fair value and decided that the determination should be based on a 50 percent quantitative test. The Board recognizes that by allowing this assessment to be based on a simple 50 percent majority, measurement attribute mismatches will continue to exist (for example, if 40 percent of an entity's assets are measured at fair value, an argument could be made that 40 percent of the liabilities should be measured at fair value). However, the Board notes that measurement attribute mismatches cannot be entirely avoided unless all assets and liabilities are recognized at fair value (including intangible assets that are currently unrecognized). The Board believes that the proposed solution would improve financial reporting.

BC121. The Board discussed at what level an entity should perform the quantitative test. The Board decided to first perform the test at the operating segment level. The Board acknowledges that this approach may lead to a measurement attribute mismatch at the consolidated level, but it believes that the results better reflect an entity's economics in the financial statements. The Board determined that cash should not be considered to be measured at fair value for purposes of applying the quantitative test because there are no changes in fair value reflected in the performance statement.

BC122. The Board considered two alternative approaches for determining when a financial liability could be measured at amortized cost—allowing all financial liabilities that meet the criteria to have the qualifying portion of the changes in their fair value recognized in other comprehensive income to be measured at amortized cost or allowing all financial liabilities that are not trading, derivative liabilities, or obligations to return securities sold short (short sales) to be measured at amortized cost. However, the Board believes that these alternatives would not have met the objective to effectively and faithfully represent the extent of asset-liability matching.

Core deposit liabilities

BC123. The Board decided that deposits with a maturity should be measured in accordance with the proposed classification and measurement criteria applicable to other liabilities. The Board decided that demand deposits, however, should be split into their core and noncore components. Demand deposits that are not considered core demand deposits would be valued at fair value, which the Board believes is reasonably close to their face amount because of the short-term nature of these deposit liabilities. The Board believes that core demand deposits should be remeasured equal to the present value of the average core deposit amount discounted at the difference between the alternative funds rate and the all-in-cost-to-service rate over the implied maturity of the deposits. Many constituents have noted that core deposits often are the main source of value for a financial institution, and the Board believes that this remeasurement approach for core demand deposits would demonstrate how interest rates affect the core demand deposits, which is useful information for investors in reflecting asset-liability exposure to a duration mismatch.

BC124. The Board also considered alternative measurement approaches for demand deposits but determined that the remeasurement approach described in the preceding paragraph would better reflect the economics of core deposit liabilities as a stable funding source. While the Board acknowledges that even though a customer could withdraw their deposit on demand, there is statistical evidence that core deposit liabilities are held for longer time periods that are reasonably predictable and relatively insensitive to interest rate conditions. Additionally, the Board notes that the fair value of core deposit liabilities would require measurement of significant nonfinancial components, for example, the customer relationship. In contrast, the remeasurement approach proposed would be focused on capturing the benefits associated with the liability that relates to its value as a cheaper source of funding without considering the other intangible benefits.

BC125. Present values reflecting remeasurement assumptions can be significantly lower than the face value of the deposits. In support of such valuations, financial institutions commonly buy and sell deposit liability accounts at discounts; that is, a buyer will assume deposit liabilities in exchange for a cash-equivalent amount that is less than their face value. In addition, financial statement users would have better information to identify an asset-liability funding mismatch and be able to more accurately analyze the funding base of an institution with management's own estimates.

BC126. Because the proposed guidance would not require a fair value measurement for demand deposits, the proposed remeasurement approach would represent an exception to the guidance in Concepts Statement 7, which establishes that the objective of a present value technique is to measure fair value. The proposed remeasurement approach would use the entity's own assumptions based on all information available to the entity. Those assumptions

should consider all relevant facts and circumstances and, if applicable, be consistent with information tracked and monitored through the entity's asset-liability management activities and used to assist in making operational decisions.

BC127. The Board concluded that the average core deposit should be discounted at the difference between the alternative funds rate and the all-in-cost-to-service rate over the implied maturity of the deposits. This calculated rate would capture the value, if any, of the cost savings attributable to core demand funds.

Application of Proposed Guidance to Specific Financial Instruments

Loan commitments

BC128. The scope of the proposed guidance includes commitments to originate and purchase loans. The Board understands that measuring all loan commitments at fair value would be a significant change in practice for many financial institutions that issue loan commitments. Topic 815 requires only those loan commitments issued to originate mortgage loans that will be held for sale to be accounted for as derivatives under Topic 815 and measured at fair value.

BC129. The Board discussed whether to require an entity that issues loan commitments to recognize changes in fair value of the commitment in net income or whether qualifying changes in fair value could be recognized in other comprehensive income if the related funded loan would meet the criteria to have qualifying changes in fair value recognized in other comprehensive income. Some Board members believe that conceptually, it would be appropriate to account for loan commitments and other written options in a similar manner. The Board considered the similarities between loan commitments and written options and whether it would be appropriate to account for both as derivatives under Topic 815. The Board determined that evaluating whether various types of loan commitments meet the definition of a derivative under Topic 815 would create complexity and could lead to potentially different outcomes for different types of loan commitments. Therefore, the Board decided not to rely on a broader application of the definition of a derivative to determine the method of accounting for loan commitments.

BC130. The Board decided that the classification of the loan commitment should be consistent with the classification of the related loan that would be funded through exercise of the commitment. The Board believes that loan commitments are integral to the funded loans. Therefore, for purposes of classifying loan commitments under the proposed guidance in paragraph 25, the Board decided that loan commitments should be classified on the basis of the business strategy for the underlying borrowing.

BC131. The Board decided that the original commitment fee should not be separately recognized from other changes in fair value of the loan commitment during the commitment period. The Board acknowledges that this pattern of recognition of the fee differs from the Board's decision on the accounting for transaction costs and fees related to financial instruments with all changes in fair value recognized in net income that fees and costs should be recognized in net income at the date of initial recognition of the financial instrument.

BC132. The Board decided that under certain circumstances, fees received for a commitment to originate a loan or establish a line of credit should be recognized in net income in a manner that is generally consistent with the guidance in Subtopic 310-20. For example, the Board decided that if a loan commitment would result in funding a term loan that meets the criteria for recognition of qualifying changes in fair value in other comprehensive income, the commitment fee would be deferred in other comprehensive income until a loan is funded, at which time, the commitment fee would be recognized in net income as an adjustment of the yield on the loan. The Board observed that this would be most consistent with the decision to preserve the treatment under Subtopic 310-20 of non-refundable fees and costs as yield adjustments for financial instruments that meet the criteria to report qualifying changes in fair value in other comprehensive income.

BC133. The Board observed that an entity should apply the existing framework in Topic 820 to measure the fair value of loan commitments that are within the scope of the proposed guidance. In general, if Level 3 inputs are used in the valuation of a loan commitment, an entity should consider, among other things, inputs such as interest rates, credit risk of the borrower, costs of maintaining availability of funds during the commitment period, and the probability that the loan commitment will result in a drawn loan.

BC134. The Board considered implementation issues that could be encountered by issuers in measuring certain types of loan commitments at fair value. Conceptually, the Board believes that for potential lenders, all types of loan commitments should be included within the scope of the proposed guidance. However, the Board decided for practical reasons to provide a scope exception for lines of credit under credit card arrangements, considering the generally small balances of the associated credit card receivables, the revolving nature of these lines of credit, and the high volume of these lines of credit and related receivables. Therefore, credit card fees would continue to be accounted for under Subtopic 310-20.

BC135. The Board considered specific implementation challenges that could be encountered by potential borrowers. Conceptually, the Board believes that the accounting for loan commitments by potential borrowers and potential lenders should be symmetrical. However, the Board understands that it may be impracticable for many borrowers to measure purchased loan commitments at

fair value. Therefore, the Board decided to provide a scope exception for holders of loan commitments (potential borrowers).

BC136. The Board decided to provide a delayed effective date up to 4 years after the original effective date of certain provisions in the proposed guidance for a nonpublic entity with less than $1 billion in total consolidated assets. In the interim period, a nonpublic entity with less than $1 billion in total consolidated assets should measure at amortized cost those loans that would meet the criteria to recognize qualifying changes in fair value in other comprehensive income. To be consistent with the delayed transition, the Board decided to permit the entity to account for loan commitments issued during the interim period under existing accounting guidance within Subtopic 310-20. In addition, the Board intends to perform a post-implementation review two or three years after the effective date and address any issues identified.

BC137. The Board decided that once the proposed guidance is effective, loan commitments issued would be subject to the classification, measurement, and disclosure proposed guidance and that no loan commitments would be subject to the guidance in Topic 815. The Board believes that eliminating loan commitments from the scope of Topic 815 would reduce complexity.

Standby letters of credit

BC138. The Board decided that a standby letter of credit would be accounted for in a manner consistent with the Board's decision on loan commitments because a standby letter of credit has similar characteristics as a loan commitment such as the obligation to fund the loan if certain criteria are met. The issuer would account for the instrument at fair value and classify the instrument on the basis of the classification that would result if the standby letter of credit was funded. The Board decided that the potential borrower under a financial standby letter of credit should be excluded from the scope of the proposed guidance.

Interest-only and principal-only strips

BC139. An interest-only strip or principal-only strip is excluded from the scope of Topic 815 if it has both of the following characteristics:

a. It represents the right to receive only a specified proportion of the contractual interest cash flows of a specific debt instrument or a specified proportion of the contractual principal cash flows of that debt instrument.
b. It does not incorporate any terms not present in the original debt instrument.

BC140. An allocation of a portion of the interest or principal cash flows of a specific debt instrument to provide for a guarantee of payments, for servicing in

excess of adequate compensation, or for any other purpose would not meet the intended narrow nature of the scope exception.

BC141. The Board acknowledged that the scope of the proposed guidance would include interest-only and principal-only strips and may change the recognition and measurement of some of those instruments. Consistent with the classification proposed guidance, an entity would be permitted to measure financial assets at fair value with qualifying changes in fair value recognized in other comprehensive income if the entity's business strategy is to hold the instrument for collection of contractual cash flows and the additional criteria related to cash flow characteristics of the instrument were satisfied. One qualifying criterion discussed in paragraph 21(a)(3) is that the debt instrument could not be contractually prepaid or otherwise settled in such a way that the holder would not recover substantially all of its initial investment, other than through its own choice. The Board believes that the consequence of applying the criterion in paragraph 21(a)(3) is that a nonprepayable interest-only strip could potentially meet the criteria in paragraph 21 to have qualifying changes in fair value recognized in other comprehensive income, but prepayable interest-only strips could not qualify for that treatment.

Contingent consideration arrangements

BC142. The Board believes that all contingent consideration arrangements would be within the scope of the proposed guidance, unless they are specifically excluded, because they would meet the definition of a *financial instrument*, which encompasses all contractual rights and obligations that are financial assets and liabilities, even those that are contingent on a specified event.

BC143. Topic 805 specifies the accounting for contingent consideration for the acquirer in a business combination. Specifically, if contingent consideration is classified as an asset or a liability, Topic 805 requires that it be remeasured to fair value at each reporting date until the contingency is resolved. The changes in fair value are recognized in net income (unless the arrangement is a hedging instrument for which Topic 815 requires the changes to be initially recognized in other comprehensive income). Therefore, the accounting for contingent consideration by the acquirer in a business combination would not change as a result of the proposed guidance.

BC144. Statement 141(R) eliminated the scope exception in Topic 815 for contingent consideration issued in business combinations. Therefore, contingent consideration arrangements that meet the definition of a derivative are measured at fair value by both the acquirer and the seller with all changes in fair value recognized in net income.

BC145. For contingent consideration arrangements accounted for by the seller in a business combination and by both the acquirer and the seller in an asset acquisition that do not meet the definition of a derivative, the Board decided that

only those arrangements that are based on an observable market or observable index should be within the scope of the proposed guidance. For example, a requirement to make a payment on the basis of a specified level of future sales of a product would not be subject to the requirements of the proposed guidance. However, a requirement to make a payment on the basis of the observable share price of the acquirer would be within the scope of the proposed guidance.

BC146. The Board acknowledges that including all contingent consideration arrangements within the scope of the proposed guidance would result in consistent accounting for all contingent consideration arrangements by both the acquirer and the seller in a business combination or asset acquisition. However, some Board members were concerned about the ability of a seller to reasonably estimate fair value of such an arrangement that is not based on an observable market or an observable index, because the seller may not have access to the information necessary to make an estimate on a regular basis. Additionally, the Board notes that there are other significant differences in the accounting for business combinations and asset acquisitions, including the accounting for transaction costs, goodwill, and in-process research and development. The Board notes that the purpose of this project is not to address those differences and decided that existing practice should continue for accounting for contingent consideration arrangements in asset acquisitions unless the arrangement is based on an observable market or observable index.

Short-term receivables and payables

BC147. The Board considered whether receivables and payables arising in the normal course of business that are due in customary terms not exceeding one year (excluding short-term lending arrangements, such as credit card receivables, and short-term debt securities) for which an entity's business strategy is to hold the instrument for collection or payment of contractual cash flows should be included within the scope of this project. The Board proposed that they should be within the scope of the proposed guidance; however, such instruments would be measured at amortized cost (plus or minus any fair value hedging adjustments). The Board provided this practicability exception for cost-benefit reasons because it believes that for these instruments, amortized cost often would approximate fair value. The Board also noted that these instruments would still be subject to the impairment model.

Investments that can be redeemed only for a specified maximum amount

BC148. The Board considered whether particular types of investments that are not held for purposes of capital appreciation and can be redeemed with the issuer only for a specified maximum amount should be included within the scope of the proposed guidance. The Board decided that an entity should subsequently

measure such an investment at its redemption value if the investment exhibits the following four characteristics:

a. It does not have a readily determinable fair value because ownership is restricted and it lacks a market.
b. The holder must own the instrument in order to engage in transactions or participate in activities with the entity or organization.
c. The investment cannot be exited at an amount greater than the initial investment.
d. The investment is not held for capital appreciation. Rather, the investment is held for other benefits, such as access to liquidity or assistance with operations.

The Board proposed that those investments should be measured at redemption value because this would approximate fair value. The Board believes these instruments would include stock in the Federal Home Loan Bank System, stock in the Federal Reserve Banks, National Credit Union Share Insurance Fund Deposits, and investments in certain agricultural cooperatives.

Presentation

BC149. The Board decided that it is important for users to distinguish between reported amounts for financial instruments measured at fair value with all changes in fair value recognized in net income and reported amounts for financial instruments measured at fair value with qualifying changes in fair value recognized in other comprehensive income. The Board believes that information helps users to understand an entity's financial position and reported performance for the period. It also provides predictive value in assessing future cash flows. Therefore, the proposed guidance would require separate presentation of financial assets and financial liabilities depending on whether the changes in their fair value are recognized in net income or in other comprehensive income.

BC150. The Board also believes that the presentation requirements in the proposed guidance would address differing needs of different financial statement users and provide financial statement users with enough information so that they would then be able to include or exclude amounts when they are analyzing financial statements of different entities.

BC151. The Board decided that an entity should present a continuous comprehensive performance statement because of the accounting for financial instruments model developed. The Board believes that it is necessary for users to see the changes in fair value for all financial instruments (those measured at fair value with all changes in fair value recognized in net income and those measured at fair value with qualifying changes in fair value recognized in other comprehensive income) in one statement to get a complete picture of an entity's performance for the period. On October 27, 2009, the Board added a joint project to provide guidance on comprehensive income reporting. The Board issued a

proposed Update on comprehensive income at the same time as the issuance of the proposed guidance.

BC152. The Board decided not to require an entity to perform two earnings-per-share calculations—one based on net income and one based on comprehensive income. The Board believes requiring two earnings-per-share calculations would add complexity. Additionally, the Board believes that the requirement of presenting one statement of financial performance with total comprehensive income and a subtotal for net income would allow users to make their own adjustments to the earnings-per-share calculations based on net income.

Financial Instruments Measured at Fair Value with All Changes in Fair Value Recognized in Net Income

BC153. The Board considered whether the requirements for presenting financial instruments on the face of the statement of financial position and the statement of other comprehensive income should be the same or different for financial instruments measured at fair value with all changes in fair value recognized in net income and those measured at fair value with qualifying changes in fair value recognized in other comprehensive income. The Board decided that less detailed requirements would be needed for instruments measured at fair value with all changes in fair value recognized in net income.

BC154. Financial instruments measured at fair value with all changes in fair value recognized in net income generally would be those that the entity holds for a relatively short period of time for purposes other than collecting interest or dividends on assets. Payment of a return on liabilities in that category also generally would be a relatively insignificant part of an entity's financial performance. An entity also often sells or settles assets and liabilities measured at fair value with all changes in fair value recognized in net income before their maturity. Those factors make amortized cost information relatively insignificant to users in making decisions in their capacity as capital providers. Accordingly, the Board decided not to require an entity to present the amortized cost of financial instruments for which all changes in fair value are recognized in net income, with one exception (discussed in paragraph BC154). Not requiring presentation of the amortized cost of instruments measured at fair value with all changes in fair value recognized in net income also would be consistent with the requirements in Topic 320 for securities held for trading purposes. However, the Board also decided that it would be inappropriate to restrict the information that an entity voluntarily provides about instruments measured at fair value with all changes in fair value recognized in net income. The proposed guidance, therefore, notes that an entity may present amortized cost and the amount needed to adjust amortized cost to fair value for any or all instruments that it measures at fair value with all changes in fair value recognized in net income.

BC155. The one exception to not providing amortized cost information for financial instruments measured at fair value with all changes in fair value

recognized in net income is an entity's own debt. The amortized cost of an entity's own debt may have predictive value for the amount, timing, and uncertainty of future cash flows, regardless of where in the statement of comprehensive income changes in its value are recognized. Rating agencies and other users of financial statements have told the Board that they want that information, and the proposed guidance would require entities to present it. Disclosing the amortized cost of an entity's own debt on the face of the statement of financial position in addition to the fair value information would give the rating agencies and other users information about cash flows the entity is required to pay contractually in the future.

BC156. The reasons for presenting the required information about the changes in the fair value of financial instruments measured at fair value with all changes in fair value recognized in net income in the statement of comprehensive income are essentially the same as those for presenting information on the statement of financial position. The Board has heard from users that interest received or paid and credit losses are relatively insignificant factors for instruments for which the business strategy is not to hold them for collection or payment of contractual cash flows but rather to sell or settle them with a third party before maturity. Therefore, the Board decided not to require presentation of that information. In contrast, gains and losses are of interest to users and would be presented under the proposed requirements. However, the Board decided that it would not restrict an entity from disaggregating changes in fair value related to interest, dividends, credit losses, and unrealized or realized gains and losses in the statement of comprehensive income.

Financial Instruments Measured at Fair Value with Qualifying Changes in Fair Value Recognized in Other Comprehensive Income

BC157. An important reason for reporting specified components of the change in fair value of financial instruments that are measured at fair value with qualifying changes in fair value recognized in other comprehensive income is that both fair value information and amortized cost information are relevant for a debt instrument that an entity's business strategy is to hold for collection or payment of contractual cash flows. Therefore, the Board decided that for financial instruments measured at fair value with qualifying changes in fair value recognized in other comprehensive income an entity should present on the face of the statement of financial position the amortized cost, the allowance for credit losses for financial assets, and the accumulated amount needed to reconcile amortized cost less allowance for credit losses to fair value on those instruments in addition to measuring them at fair value. The Board believes that this would enable an entity to preserve the information available to users today, while also providing additional relevant information about the fair value of those instruments.

BC158. The Board decided that an entity should present separately on the face of the statement of financial position amounts in accumulated other comprehensive income (and allocated to noncontrolling interests, if applicable) related to the qualifying changes in the fair value or the qualifying changes in the remeasurement amount for financial instruments for which those changes are recognized in other comprehensive income. The Board believes that requiring this presentation would provide users with information about the effects of accumulated changes in fair value and changes in the remeasurement amount on an entity's equity. The Board believes this proposed presentation requirement would allow the effects of both fair value and amortized cost on an entity's equity and comprehensive income to be transparent to users.

BC159. The Board also decided that information about interest earned or paid and information about credit losses during the period on financial instruments measured at fair value with qualifying changes in fair value recognized in other comprehensive income are important components of an entity's financial performance. If an entity's strategy is to hold a debt instrument for collection or payment of contractual cash flows, the amount of those cash flows earned or paid and the change in the amount of cash flows the entity does not expect to collect—its credit losses related to financial assets—during the period would be relevant for assessing the amounts, timing, and uncertainty of future cash flows. The Board decided that those amounts, therefore, should be separately presented in the statement of comprehensive income.

Changes in an Entity's Own Credit Standing

BC160. Concerns of some of the Board's constituents about including the effect of changes in an entity's own credit risk in measuring the financial performance of financial liabilities were discussed in paragraphs BC112 and BC113. The Board decided that an entity should present on the face of the statement of comprehensive income significant changes in fair value of a financial liability that are attributable to changes in the entity's own credit standing (excluding the change in the price of credit), disaggregated according to whether changes in the fair value of the liability are recognized in net income or in other comprehensive income.

BC161. The Board believes that requiring separate presentation of significant changes in fair value attributable to changes in the entity's own credit standing (excluding the change in the price of credit) would address differing needs of different financial statement users and would provide financial statement users with the ability to include or exclude those amounts when they are analyzing financial statements of different entities.

BC162. The Board considered whether any entities should be required to separately present all changes in fair value attributable to a change in an entity's own credit standing (that is, the portion of the discount rate that is not the benchmark/risk-free interest rate). In FASB Statement No. 159, *The Fair Value*

Option for Financial Assets and Financial Liabilities (included in Subtopic 825-10), the Board decided that for financial liabilities for which the fair value option has been elected with fair values that have been significantly affected during the reporting period by changes in instrument-specific credit risk, an entity should disclose all of the following:

a. The estimated amount of gains and losses from fair value changes recognized in net income that are attributable to changes in the instrument-specific credit risk
b. Qualitative information about the reasons for those changes
c. How the gains and losses attributable to changes in instrument-specific credit risk were determined.

However, the Board decided not to provide guidance about when a change in instrument-specific credit risk is considered significant or detailed computational guidance about how to determine the approximation of the amount of the liability's fair value change attributable to the change in instrument-specific credit risk. The Board understands that, in practice, changes in instrument-specific credit risk are generally determined on the basis of changes in the reporting entity's own credit spreads or credit default swap spreads. However, the approach can vary depending on the nature of the liability.

BC163. IFRS 7, *Financial Instruments: Disclosures*, requires an entity to disclose for all liabilities measured at fair value the amount of change (during the period and cumulatively) in fair value that is attributable to changes in the credit risk of the liability. IFRS 7 indicates that the change in fair value attributable to credit risk can be determined in either of two ways:

a. As the amount of change in the liability's fair value that is not attributable to changes in market conditions that give rise to market risk
b. Using an alternative the entity believes more faithfully represents the amount of change in its fair value that is attributable to changes in the credit risk of the liability.

Under IFRS 7, changes in fair value other than changes related to a change in the benchmark rate are generally attributed to a change in the credit risk.

BC164. The Board believes that the change in fair value attributable to the change in an entity's credit spread does not accurately reflect the change in an entity's own credit because it also measures the change in the price of credit, which affects not just the individual entity, but also other entities in the industry and the economy. Thus, the Board decided that an entity should present separately on the face of the statement of comprehensive income significant changes in fair value of a financial liability that are attributable to changes in the entity's own credit standing, excluding the price of credit. The Board believes such information would be meaningful to users of the financial statements because an entity would be required to present changes in fair value related to

changes in its credit risk only when there has been a change in the entity's own credit standing. Changes in the price of credit solely related to changes in market conditions would not be presented.

BC165. The Board recognizes that there may be several different methods to determine the change in fair value attributable to a change in an entity's own credit standing excluding the change in the price of credit and the proposed guidance does not prescribe a method for determining that change.

Deferred Tax Assets

BC166. The Board concluded that the assessment of a valuation allowance for a deferred tax asset relating to the change in fair value recognized in other comprehensive income of debt instruments measured at fair value with qualifying changes in fair value recognized in other comprehensive income should be performed in combination with other deferred tax assets and liabilities of the entity. The Board believes that deferred tax assets relating to the change in fair value of debt instruments measured at fair value with qualifying changes in fair value recognized in other comprehensive income should be accounted for consistently with other deferred tax assets and liabilities recognized for items recognized in other comprehensive income under Topic 740 on income taxes. The Board also believes this approach would be consistent with Topic 740's requirements that the ultimate income tax calculation be based on the entity's entire tax position. Therefore, the Board believes that the tax calculation should not be segregated by tax amounts on the entity's specific assets and liabilities.

Credit Impairment

BC167. The Board decided that if an entity's business strategy is to hold a financial asset for collection of contractual cash flows rather than to sell the financial instrument to a third party, certain changes in fair value of the financial asset may be recognized in other comprehensive income. The Board considered whether all changes in fair value should be recognized in other comprehensive income without a subsequent transfer ("recycling") from other comprehensive income to net income. The Board decided that if an entity is holding a financial asset for collection of cash flows, the entity should recognize any credit impairment of the financial asset in net income.

BC168. The Board decided that a single, comprehensive impairment model should be developed for all financial assets that meet the criteria for recognizing qualifying changes in fair value in other comprehensive income. The Board observed that a credit impairment model is necessary for receivables, loans, and investments in debt instruments for which qualifying changes in the fair value are recognized in other comprehensive income. An impairment model would not be necessary for investments in equity instruments because they do not satisfy the

criteria for recognizing qualifying changes in fair value in other comprehensive income.

BC169. The Board considered existing impairment models for debt securities and loans in developing a comprehensive model. Existing impairment requirements differ for different types of financial assets (for example, loans versus debt securities) and for the same types of financial assets with different characteristics (for example, beneficial interests, purchased debt securities acquired at an amount that includes a discount related to credit quality, and other debt securities). The guidance for impairments of loans and debt securities is included in Topics 310, 320, 325, and 450.

BC170. The existing impairment model for loans is based on the recognition of probable credit losses that have been incurred. Under that model, an entity does not recognize impairment of a loan until, on the basis of current information and events, it is probable that the entity will be unable to collect all contractual cash flows due or, for purchased loans acquired at an amount that includes a discount related to credit quality, all cash flows previously expected to be collected. Once it is determined that it is probable that an impairment has occurred, the amount of the impairment is estimated on the basis of expectations about the collectibility of future cash flows.

BC171. The existing impairment model for debt securities is an other-than-temporary impairment approach that focuses on the difference between fair value and amortized cost basis. If fair value is less than the amortized cost basis and an entity intends to sell a debt security or it is more likely than not that the entity will be required to sell the debt security before the anticipated recovery of its amortized cost basis, the entity is required to recognize the entire difference between fair value and the amortized cost basis in net income. The Board decided that because a financial asset would meet the criteria for recognizing qualifying changes in fair value in other comprehensive income only if the entity's business strategy for the instrument is to collect the related contractual cash flows rather than sell the financial asset, it would not be necessary to retain the requirement that the entire difference between fair value and amortized cost be recognized in net income. This would be the case even if the entity intends to sell a debt security or it is more likely than not that the entity will be required to sell the debt security before the anticipated recovery of its amortized cost basis. The Board believes that retaining such a requirement could lead to a tainting notion in the classification and measurement of financial instruments. Also, because all financial instruments would be measured at fair value, the Board believes it would not be necessary to retain an other-than-temporary impairment approach to assess a financial asset for impairment when fair value is less than cost.

BC172. Existing impairment guidance for debt securities also requires that if a credit impairment exists, an entity must present the entire difference between fair value and amortized cost in net income with an offset for any amount of the total other-than-temporary impairment that is recognized in other comprehensive

income. The Board believes that such presentation would not be necessary under the proposed guidance because the proposed Update on comprehensive income would require an entity to display total comprehensive income in a continuous statement of comprehensive income that will include a profit or loss or net income section and an other comprehensive income section.

Objective of the Credit Impairment Model

BC173. The Board decided that the objective of the credit impairment model should be based on an entity's assessment of cash flows expected to be collected related to its financial assets measured at fair value with qualifying changes in fair value recognized in other comprehensive income. The Board believes that an entity should recognize in net income a credit impairment when it does not expect to collect all contractual amounts due for originated financial asset(s) and all amounts originally expected to be collected for purchased financial asset(s). An entity's expectations on collectibility of cash flows would consider all available information about past events and existing conditions but would not consider potential future economic events beyond the reporting date.

BC174. The Board considered requiring an entity to continue to apply an incurred loss model in accordance with Topic 310 on loan impairment. The Board decided that the impairment model should not be based on a notion of incurred losses. The Board decided that a credit loss need not be deemed probable of occurring to recognize a credit impairment. The Board believes that removing the probable threshold would result in an entity recognizing credit impairments in net income earlier on the basis of its expectations about the collectibility of cash flows rather than on a potentially arbitrary recognition threshold. Elimination of the probable threshold would be consistent with the Board's decisions in FASB Staff Position FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments*, issued in April 2009, which modified the impairment guidance for debt securities. One of the changes made by that FSP was to remove the probable threshold for assessing whether a debt security is other than temporarily impaired. The Board made that change to clarify that an entity should not wait for an event of default or other shortfall of cash flows to conclude that a credit impairment exists. The Board believes that the credit impairment model in the proposed guidance would differ from a probable incurred loss model because recognition of credit impairment would not be based on any triggering event.

BC175. The Board also considered requiring an entity to apply an expected loss approach. Under an expected loss approach, an entity would forecast expected cash flows over the life of a financial asset or pool of financial assets and would recognize credit impairment of its financial assets in net income on the basis of those expectations. The Board believes the model in the proposed guidance is different from an expected loss model because it would require an entity to consider the effects of past events and existing conditions in estimating the cash flows it expects to collect in future periods that make up the remaining life of its

financial assets, but it would not permit an entity to forecast future events or economic conditions in developing those estimates as would occur in an expected loss model. In addition, the Board understands that the timing of recognition of credit impairments under an expected loss model would differ from the timing of recognition of credit impairments under the model in the proposed guidance. Under an expected loss model, the Board understands that an entity would recognize a constant rate of credit impairments through the life of the financial asset based on expectations about losses on the date of acquisition or origination, with any changes from initial expected credit impairments recognized in the period of the change. With respect to the timing of recognition, under the model in the proposed guidance, all credit impairments would be recognized in the period in which they are estimated, rather than being allocated and recognized at a constant rate over the life of the financial asset on the basis of expectations upon origination or acquisition. The Board decided not to pursue an expected loss model because the Board believes that oftentimes it would be difficult for an entity to accurately forecast expected cash flows through the life of a financial asset on the basis of forecasted future events. The Board also believes that it would be inappropriate to allocate an impairment loss over the life of a financial asset.

Evaluating Financial Assets for Credit Impairment

BC176. The Board decided that an entity should recognize a credit impairment for the amount of cash flows that an entity does not expect to collect. The Board believes that an entity should consider both the timing and the amount of cash flows expected to be collected in measuring credit impairments. However, in considering the timing of cash flows expected to be collected, the Board believes that a credit impairment would not generally exist unless there is an expected delay in the collection of cash flows originally expected to be collected and the entity will not be compensated for the delay.

BC177. The Board decided that in determining whether a credit impairment exists, an entity should consider all available information about past events and existing economic conditions and their implications for the collectibility of the financial asset(s) at the date of the financial statements. The Board acknowledges that judgment is required in determining whether factors exist that indicate that a credit impairment exists at the end of the reporting period. Those judgments are based on subjective as well as objective factors, including knowledge and experience about past and current events and assumptions about the future collection of cash flows.

BC178. The Board believes that an entity should consider past events and existing conditions in assessing financial assets for impairment rather than forecasting macroeconomic factors, such as future economic downturns, through the life of the financial asset. However, the Board believes that when an event has occurred, the entity should consider the implications of that event on future cash flows. The entity should not wait until it is probable that cash flows will not

be collected. For example, if a plant closure is announced, the entity would not wait until an employee of the plant is laid off or is delinquent on a loan to assess whether the entity expects a decrease in cash flows expected to be collected.

BC179. Topic 320 currently requires an entity to evaluate a debt security for impairment only when the fair value of the debt security is less than its amortized cost basis. However, the Board intends for all credit impairments to be recognized in net income regardless of the fair value of the financial asset. Therefore, although the fact that fair value is less than cost may be an indicator that a credit impairment exists, an entity should not automatically assume that no credit impairment exists if fair value is greater than amortized cost. If it is determined that a credit impairment exists, that impairment should be recognized in net income even if the fair value of the financial asset has increased (for example, due to a decrease in interest rates).

BC180. For financial assets evaluated for impairment in a pool of financial assets, the Board considers historical loss experience to be a past event that should be considered, along with the implications of existing conditions, in determining the collectibility of a pool of financial assets. Therefore, if an individual financial asset is included in a pool of similar assets that is being evaluated for impairment, an entity may recognize a credit impairment associated with that pool of financial assets in the first reporting period after that individual asset is originated or purchased on the basis of past events and current conditions associated with the pool. However, the Board believes it is not necessary for an entity to recognize an impairment loss for a pool of financial assets in all circumstances. Determining whether an impairment loss should be recognized should be based on the entity's historical loss experience with financial assets with similar risk characteristics.

BC181. Existing impairment guidance does not allow debt securities to be evaluated for impairment in a pool. Rather, debt securities must be evaluated on an individual basis. The Board believes that there should be one impairment model for all financial assets and that there are insufficient reasons for prohibiting the evaluation of debt securities in a pool if they have similar risk characteristics. However, the Board believes that debt securities will more often have unique risk characteristics that will result in their being evaluated individually.

BC182. The proposed guidance does not specify how an entity should identify financial assets that are to be evaluated individually for impairment. The Board believes that allowing an entity to apply its normal review procedures in making that judgment would minimize the cost of implementing the proposed guidance.

BC183. The Board considered whether the effect of various factors that may result in a decrease in cash flows expected to be collected should be recognized as a credit impairment. The Board decided that an entity should not be required to report foreign currency transaction gains or losses on a foreign-currency-denominated financial instrument in net income. Instead, those changes in fair value would be recognized in other comprehensive income with other changes in

fair value for a financial instrument for which changes in the fair value are recognized in other comprehensive income. Therefore, an entity would not recognize a credit impairment only for a decline in cash flows expected to be collected due to change in foreign exchange rates.

BC184. Subtopic 325-40 requires the consideration of prepayments in the calculation of cash flows expected to be collected. Therefore, changes in expectations about prepayments that would adversely affect the net present value of cash flows expected to be collected for investments in beneficial interests included in the scope of Subtopic 325-40 are reflected in the measurement of credit impairment. The Board considered this and determined that because changes in expectations about prepayment speeds are linked to changes in interest rates and a decrease in the net present value of cash flows expected to be collected because of an anticipated increase in prepayments should generally be reflected as an adjustment to interest income and not as a credit impairment. The Board notes that in situations in which an entity may not recover substantially all of its investment because of prepayments (for example, an interest only strip that allows for prepayment of the associated principal), an increase in expected prepayment speeds could be considered similar to a credit impairment. However, the Board decided that such instruments would not qualify for measurement at fair value with changes in fair value recognized in other comprehensive income. Therefore, all changes in fair value would be recognized in net income, and it would be unnecessary to retain the existing requirements in Subtopic 325-40 to consider anticipated prepayments in the calculation of cash flows expected to be collected.

BC185. The Board decided to retain the guidance in Subtopic 310-20 that permits an entity to consider estimates of future principal prepayments in the calculation of the constant effective yield necessary to apply the interest method if an entity holds a large number of similar loans for which prepayments are probable and the timing and amount of prepayments can be reasonably estimated. Under this guidance, if differences arise between the prepayments anticipated and the actual prepayments received, the entity is required to adjust the effective yield to reflect actual payments to date and anticipated future payments. Additionally, the entity is required to adjust the net investment in the loans to the amount that would have existed had the new effective yield been applied and recognize a corresponding charge or credit to interest income.

Measurement of Credit Impairment

BC186. The Board decided that an entity should recognize in net income the amount of credit impairment when it does not expect to collect all contractual amounts due for originated financial asset(s) and all amounts originally expected to be collected for purchased financial asset(s). The Board decided to allow for latitude in the measurement of credit impairments on the basis of the facts and circumstances of the entity. Specifically, the Board decided not to require the use of the net present value method for measuring credit impairments in all

situations. The Board believes that an entity should be permitted to use an appropriate measurement technique to estimate the amount of losses expected, including using a historical loss rate method to measure credit impairments for a pool of financial assets. However, when a financial asset is individually identified as impaired, the Board believes that the entity should measure the amount of credit impairment as the difference between the amortized cost of the financial asset and the present value of cash flows expected to be collected. The term *cash flows expected to be collected* should represent the cash flows that the entity expects to collect after a careful assessment of all available information. The interest rate used to discount the cash flows expected to be collected should be the same rate that is used to calculate interest income.

BC187. The Board decided to retain the practical expedient in existing loan impairment guidance that allows an entity to measure impairment on the basis of the fair value of the collateral if the loan is a collateral-dependent loan. The Board decided to expand that practical expedient to include all collateral-dependent financial assets. In addition, the Board decided to allow the practical expedient to apply to financial assets for which repayment is expected to be provided primarily or substantially through the operation or sale of the collateral rather than to restrict the expedient to situations in which the repayment was expected to be provided solely by the underlying collateral. The Board believes that for a collateral-dependent financial asset, the fair value of the collateral, adjusted for estimated costs to sell if repayment of the financial asset is dependent on the sale of the collateral, is a reasonable approximation of the cash flows expected to be collected on the loan. The Board decided to retain the existing guidance for loans that an entity is required to measure impairment on the basis of the fair value of the financial asset when the creditor determines that foreclosure is expected to occur.

BC188. The Board acknowledges that applying judgment to determine cash flows expected to be collected may be complex, but that complexity is the unavoidable result of the need for information about the effect of credit impairments on an entity's results of operations. The Board believes that practical decisions, such as permitting an entity to use the fair value of the collateral of a collateral-dependent financial asset, should reduce cost and complexity. Additionally, the Board believes that continuing to permit an entity to aggregate loans with similar characteristics and use historical experience in calculating the present value of cash flows expected to be collected also should reduce cost and complexity.

BC189. In situations in which all or a portion of a loan portfolio consists of a large number of small-dollar-value homogeneous loans (such as consumer installment loans, residential mortgages, or credit card loans), creditors typically use a formula based on various factors to estimate an allowance for loan losses. Those factors include past loss experience, recent economic events and current conditions, and portfolio delinquency rates. The Board recognizes the established practice of using a formula approach for estimating losses related to

these types of loans and the proposed guidance would not change that approach.

BC190. If an entity determines that an impairment loss should be recognized on a pool of financial assets, the Board decided that the amount recognized should be determined by applying a loss rate that reflects cash flows the entity does not expect to collect over the life of the financial assets in the pool to the principal balance of the pool. The Board believes that it would be inappropriate for an entity to apply an annual loss rate to the pool, which would result in allocating losses over the life of the financial assets in the pool.

BC191. For financial assets evaluated for impairment individually, the Board believes that an entity's calculation of cash flows expected to be collected would not be significantly different from current practice. Instead, the Board believes that by eliminating the probable threshold for recognizing an impairment and requiring that interest be calculated on amortized cost less the allowance, impairments would be recognized earlier in net income. However, the Board acknowledges that by developing one approach for all types of financial assets, in situations in which cash flows expected to be collected have not been calculated in the same manner for all types of financial assets (for example, due to differences in the treatment of changes in expectations about prepayments) there may be differences in an entity's calculation of credit impairment under the proposed model as compared with current practice.

BC192. For financial assets evaluated for impairment individually, it may be the case that no past events or existing conditions currently exist that would indicate that the financial asset is impaired (for example, when a loan is originated). In those situations, the Board believes an entity should not automatically conclude that no credit impairment exists. An entity should determine whether assessing the financial asset together with other financial assets with similar risk characteristics indicates that a credit impairment exists. The Board believes that financial assets often are priced assuming a certain amount of losses on the total pool even though the entity initially expects to collect on each individual asset. The Board believes that an entity should not delay recognition of an impairment loss on a group of financial assets by evaluating them individually when historical experience indicates that a loss is likely to have occurred, but has not yet been specifically identified.

Presentation of Credit Impairments and Recognition of Recoveries

BC193. Existing impairment guidance for debt securities requires that if an entity recognizes an other-than-temporary impairment, the portion of the impairment that is recognized in net income (that is, the credit impairment) is reflected as an adjustment to the amortized cost basis of the security. Any subsequent increases in cash flows expected to be collected are reflected in net income on a prospective basis as interest income through an adjustment of the effective

interest rate. In contrast, existing impairment guidance for loans requires the recognition of an allowance and permits an entity to reverse a previously recognized allowance if there is an upward change in expectations about the collection of future cash flows. The requirement to adjust the effective interest rate on a prospective basis can result in an unusually high effective rate if a large credit impairment is recognized and there are significant subsequent increases in expectations about the collection of cash flows. Some constituents have expressed concerns that this requirement has led to some entities recognizing excessive writeoffs in one period in order to present higher yields in a future period.

BC194. The Board decided that credit impairments should be recognized through a valuation allowance for all financial assets. However, the Board decided that an entity should write off a financial asset or part of a financial asset in the period in which the entity has no reasonable expectation of recovery of the financial asset (or part of the financial asset). The Board acknowledges that determining whether there is a reasonable expectation of recovery of a financial asset would require judgment based on specific facts and circumstances.

BC195. The Board also decided that an entity should be permitted to recognize a reversal of credit impairment expense in net income for all financial assets if there is an increase in cash flows expected to be collected. The Board believes that if an impairment was initially recognized in net income as a credit impairment, any changes to the entity's expectations about the amount of the impairment should be reflected as a decrease in credit impairments and not as an increase in interest income.

Purchased Financial Assets

BC196. The Board intends for the calculation of credit impairments for purchased financial assets to be the same as for originated financial assets except that the effective interest rate used to discount cash flows expected to be collected would be based on the purchase price and expectations about cash collections on the acquisition date and not the contractual amounts due.

BC197. The Board acknowledges that the price an acquirer is willing to pay for a debt instrument reflects the acquirer's estimate of credit losses over the life of the instrument and considered whether those estimated credit losses should be reflected as an allowance for credit losses on the acquiring entity's financial statements. The Board decided that it would be inappropriate for an entity to present credit impairments inherent in the instrument as an allowance for credit losses at acquisition. Using an allowance for credit losses to address the collectibility of cash flows the investor does not expect receive initially (and, therefore, presumably did not pay for) would not faithfully represent the substance of the underlying event. Rather, allowances for credit losses should reflect only those impairments incurred by the investor after acquisition (that is, the present value of cash flows expected at acquisition that ultimately are not to

be received). The allowance for credit losses recorded by the acquirer should reflect only impairments that have occurred after the acquisition of the asset, rather than (a) impairments that occurred while the financial asset was held by the transferor or (b) the acquirer's estimate at acquisition of credit impairments over the life of the financial asset. However, the Board decided that an entity should disclose the net present value of the acquirer's estimate of credit losses inherent in the financial asset on the acquisition date.

BC198. The Board also considered whether in situations in which an entity subsequently expects to collect more cash flows than originally expected, the entity should recognize an immediate gain in net income (offset by an increase in the amortized cost) instead of prospectively adjusting the effective interest rate. The Board acknowledges that requiring an entity to adjust the effective interest rate for increases in expected cash flows above original expectations and recognize immediate credit impairments for decreases in expected cash flows below original expected cash flows carries forward some of the complexity from the existing impairment and interest recognition model for purchased financial assets with evidence of credit deterioration. However, the Board notes that the original effective rate depends on the amount of the difference between the purchase price and the contractual cash flows due that is allocated to cash flows not expected to be collected versus a premium or discount (accretable versus nonaccretable yield). Therefore, if additional cash flows were expected at acquisition, those additional cash flows would have been recognized through a higher initial effective interest rate and not an immediate gain.

BC199. Given the judgment involved in initially estimating the cash flows not expected to be collected and that a credit impairment is not initially recognized in net income for cash flows not expected to be collected at acquisition, the Board generally believes that it would be inappropriate to allow an entity to recognize an immediate gain in net income for a change in the entity's initial estimate. Some Board members believe that an entity should be permitted to recognize an immediate gain for an increase in cash flows expected to be collected if there is evidence that the change in expectations is based on new information and not a new evaluation or new interpretation by management of information that was available on the acquisition date. However, the Board decided that such a requirement would be difficult to apply and would create additional complexity.

Interest Income Recognition

BC200. Existing interest income recognition models vary on the basis of the nature of the financial asset (for example, loans versus beneficial interests), the credit quality, and whether the financial asset was purchased or originated. For loans that are not impaired, interest income is generally calculated by multiplying the recorded balance of the loan by an effective interest rate. The effective interest rate is generally the contractual rate adjusted for any net deferred loan fees or costs, premium, or discount existing at the purchase or origination. There

is no existing guidance for how an entity should recognize, measure, or display interest income on an individually impaired loan. However, methods may include accruing interest on the net carrying value of the loan, a cost-recovery method, a cash-basis method, or some combination of those methods. For debt securities, interest income is calculated by multiplying the amortized cost of the security, which includes any impairment previously recognized in net income, by the appropriate effective rate. Additionally, for loans acquired with evidence of deterioration in credit quality, interest income is calculated by multiplying the net loan balance, including any allowance for credit losses recognized after acquisition, by the effective interest rate.

BC201. The Board is concerned that the existing interest income recognition method for loans (other than loans acquired with evidence of deterioration in credit quality) is based on the initial investment without deducting the allowance for credit impairments, which allows an entity to continue to recognize interest income on principal that is not expected to be collected. Some Board members believe that in recent years entities have relaxed their underwriting standards and lent to borrowers with lower credit ratings at higher interest rates so that higher interest income could be reflected in net income in earlier years even though the entities expected to have losses in the future on some portion of the loans. Board members also are concerned that because there is limited guidance on when an entity should cease accruing interest on a loan, entities may delay putting a loan on non-accrual status and accrue interest on loans even when a borrower has failed to make contractual interest payments.

BC202. The Board believes that it is inappropriate for an entity to accrue interest on an amount that it does not expect to collect. Therefore, the Board decided that interest income should be calculated on the basis of the amortized cost less any allowance for credit impairments of the financial asset. The Board notes that because all financial assets would be measured at fair value, any interest income recognition model, combined with the credit impairment model, would be a means to allocate fair value changes between net income and other comprehensive income. The Board notes that users of financial statements place significant value on the reported net interest margin. The Board believes that net interest margin should reflect the interest an entity expects to receive on the basis of current assessments of credit impairments. The proposed impairment model would result in the yield (or net interest margin) of a financial asset changing as a result of changes in the credit impairments.

BC203. The Board considered an alternative approach that would permit an entity to calculate interest income by multiplying amortized cost by the effective interest rate and would provide guidance on when an entity should cease accruing interest on financial assets (that is, when a financial asset should be placed on nonaccrual status). However, the Board believes that general nonaccrual guidance could not be developed to fit all situations. The Board believes that interest income could be too high if nonaccrual policies allow entities to continue to accrue interest on nonperforming loans or on performing

loans for which cash shortfalls are expected. For example, an entity may have received all contractual interest payments on a loan that requires interest-only payments for a period of time but may not expect to receive all principal amounts due. The Board believes that the entire estimated shortfall should not be reflected as a credit impairment; rather, a portion of the expected loss should be reflected through a lower effective interest rate. Additionally, the Board believes that accruing interest on the basis of the effective rate multiplied by amortized cost without deducting the allowance for credit impairments would result in an upwardly biased number because any pool of financial assets with a single credit impairment would have an actual yield net of credit impairments at less than the effective rate. Because no individual asset would be identified as impaired when financial assets are evaluated in a pool, it would not be possible to place a financial asset on nonaccrual to prevent interest income from being overstated.

BC204. The Board decided to retain existing guidance on calculating the effective interest rate that is used to calculate interest income (that is, the contractual rate adjusted for any net deferred loan fees or costs, premium, or discount existing at the purchase or origination for originated financial assets and high-credit-quality purchased financial assets and the rate that equates the present value of the investor's estimate of the future cash flows of the financial asset with the purchase price of the asset for financial assets acquired at an amount that includes a discount related to credit quality). However, because the effective interest rate would be multiplied by the amortized cost less any allowance for credit impairments and not only the amortized cost of the financial asset, the yield that would result from the application of the proposed model would change for certain financial assets.

BC205. For purchased financial assets, the Board considered whether to require an effective interest rate that would accrete from the purchase price to the contractual amount of principal cash flows, which would effectively result in an entity recognizing more interest income and credit impairments in net income for credit losses on the financial asset that the entity expects on acquisition. The Board believes that the effective interest rate for a purchased financial asset should be based on expectations about cash flows at the date of acquisition and not on the principal balance of the financial asset. However, the Board decided that an entity should present additional information about the principal balance and the net present value of cash flows not expected to be collected on the acquisition as well as any increases in cash flows expected to be collected since the acquisition date.

Differences between Contractual Interest and Interest Accrued

BC206. Because interest income would be recognized on amortized cost less any allowance, there would be a difference in the amount of interest contractually due (or, for purchased financial assets acquired at an amount that includes a discount related to credit quality, interest cash flows originally expected to be collected) and interest income accrued. In situations in which an entity expects

cash shortfalls in later periods, the entity would likely collect cash in excess of interest income recognized in earlier periods. The Board decided that an entity should recognize an increase in the allowance for credit losses for the difference in the amount of interest contractually due (or interest cash flows originally expected to be collected) and interest income recognized at the time interest income is accrued. For loans that are individually evaluated for impairment, if there has been no change in the entity's estimate of the collection of cash flows, the Board believes that this difference would primarily be attributable to the passage of time and would result in the amortized cost less the allowance for credit losses equaling the net present value of cash flows expected to be collected. If there has been a change in the entity's estimate of the collection of cash flows, it may be necessary to recognize a reversal of credit impairment expense or additional credit impairment in net income so that the allowance presented on the statement of financial position represents the net present value of cash flows expected to not be collected. Similarly, for financial assets evaluated in pools, it may be necessary for the entity to recognize a reversal of credit impairment expense for the difference in the amount of interest contractually due (or interest cash flows originally expected to be collected) and interest income recognized if the entity determines that the allowance originally recognized on the pool is adequate.

BC207. Because any difference in the amount of interest contractually due (or interest cash flows originally expected to be collected) and interest income recognized would be recognized as an increase in the allowance for credit losses or as a reversal of credit impairment expense, cumulative credit impairments recognized in net income would not equal the allowance for credit losses. The allowance for credit losses would equal the cumulative credit impairments recognized in net income plus a reduction in interest income compared to contractual interest due. The Board believes that this presentation would be appropriate because expected shortfalls in cash flows should be allocated between principal and interest and should not just be reflected as a loss of principal, which is the case under the current interest income recognition model.

Ceasing Accrual of Interest Income

BC208. Because interest income would be recognized on amortized cost less any allowance under the proposed guidance, interest would be accrued only on amounts expected to be collected. Therefore, the Board believes that it will generally not be necessary to place financial assets on nonaccrual status. However, in certain situations an entity may determine that the overall yield on a financial asset will be negative (that is, the total cash flows expected to be collected are less than the original cash outflow for the financial asset). In those situations, the Board believes it would not be appropriate for the entity to recognize any additional interest income on the financial asset once it is determined that the yield would be negative. Instead, a credit impairment (and allowance for credit losses) equal to the principal balance outstanding less the

cash flows expected to be collected should be recognized. In this situation, an entity should apply the cost recovery method.

Disclosures

BC209. The Board believes that the proposed financial statement disclosures would provide information that is useful in analyzing an entity's exposures to risks from financial instruments. In considering the disclosures to be required, the Board considered input from users of financial statements as well as disclosures that are currently required.

BC210. The Board proposed that the disaggregation be based on nature, characteristics, or risks of the financial instruments. The disaggregation principle is designed to promote consistency and comparability within footnotes while acknowledging the need for management judgment in determining the appropriate disaggregation for each footnote.

BC211. The proposed disclosures would augment existing disclosures and were designed to address the changing needs of financial statement users on the basis of the proposed model of accounting for financial instruments.

Derivative Instruments and Hedging Activities

BC212. Since the original effective date FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (Topic 815), the Board has been asked to address numerous issues on many aspects of hedge accounting, including but not limited to, issues related to assessing hedge effectiveness and measuring hedge ineffectiveness. As a result, in May 2007, the Board added a project to its agenda to reconsider the hedge accounting guidance in Statement 133. The Board decided that (a) the accounting for hedging activities should be simplified to make it easier for preparers of financial reports to comply with the guidance and (b) the financial reporting of hedging activities should be improved to make the hedge accounting results more useful and transparent to investors and other users of financial information. The changes summarized in the proposed guidance help accomplish those goals.

Scope

BC213. The Board decided that the types of items and transactions currently eligible for hedge accounting under Topic 815 would continue to be eligible under the proposed guidance. Because more financial instruments would be reported at fair value with changes recognized in net income on the basis of the classification and measurement approach included in the proposed guidance, fewer financial instruments would be eligible for fair value hedges.

Bifurcation of Embedded Derivative Features

BC214. The Board decided that, under the proposed classification and measurement approach, hybrid financial instruments containing embedded derivative features that would have otherwise required bifurcation and separate accounting should be reported in their entirety at fair value with all changes recognized in net income. The Board believes that fair value is the most relevant measure for those hybrid instruments and that eliminating the requirement that those embedded derivative features be bifurcated and accounted for separately as derivative instruments would facilitate simplification. The Board is aware that, because those embedded derivative features are not bifurcated, they may not be designated as hedging instruments.

BC215. Hybrid instruments that have a nonfinancial host contract such as a commodity purchase or sale contract are excluded from the scope of the proposed guidance. For these instruments, Subtopic 815-15 would continue to be applied to determine if bifurcation of an embedded derivative feature is required. If so, the contract would be bifurcated into the nonfinancial host contract and a derivative. The derivative component would be measured at fair value with changes in value recognized in net income, unless it is designated and effective as a cash flow hedging instrument or as a hedge of a net investment in foreign operations. The Board noted that existing presentation and disclosure guidance in Topic 815 related to bifurcated instruments would apply to this subset of hybrid instruments.

Hedge Effectiveness Requirements

BC216. The proposed guidance would amend the hedge effectiveness guidance in Topic 815 to no longer require that a hedging relationship be highly effective. It also would no longer require a quantitative assessment of the effectiveness of a hedging relationship or an ongoing effectiveness test (although in rare circumstances the latter two may still be necessary). The proposed guidance also would eliminate the shortcut method and critical terms match method. Therefore, an entity would no longer have the ability upon compliance with strict criteria to assume that a hedging relationship is completely effective and recognize no ineffectiveness in net income during the term of the hedge. Because of the high cost and complicated nature of complying with the hedge accounting requirements as well as an entity's desire to not recognize ineffectiveness in net income, entities have applied the shortcut method and critical terms match method to assume that a hedging relationship is highly effective with no ineffectiveness being recognized in net income. However, difficulties in complying with the strict criteria in the shortcut method and critical terms matching have led to numerous practice problems and restatements.

BC217. The proposed guidance would require that a hedging relationship be reasonably effective. It also would permit a qualitative assessment of the hedging relationship's effectiveness at inception of the hedging relationship. In certain

situations, a quantitative assessment may be necessary at the inception of a hedging relationship to demonstrate that changes in fair value of the hedging instrument are expected to be reasonably effective in offsetting changes in fair value of the hedged item or variability in cash flows of the hedged transaction.

BC218. The Board decided to amend the hedge effectiveness requirements in Topic 815 to reduce the complexity of qualifying for hedge accounting, make it easier for entities to consistently apply hedge accounting, and provide comparability and consistency in financial statement results, but only if all ineffectiveness is recognized in net income. For example, under the existing requirements in Topic 815, an entity may apply hedge accounting in one period because the hedging relationship is deemed highly effective, and then not meet the highly effective criteria in the next period, resulting in hedge accounting being applied inconsistently from period to period. Alternatively, an entity may not apply hedge accounting to a hedging relationship that it believes is highly effective because it is unable to demonstrate that the hedge will meet a specified level of effectiveness in each reporting period of the hedging relationship. The Board believes that amending the hedge effectiveness threshold to reasonably effective would reduce the frequency of both those occurrences. In addition, to provide for further simplification, the Board decided that, after inception of the hedging relationship, an entity would need to qualitatively (or quantitatively, if necessary) reassess effectiveness only if changes in circumstances suggest that the hedging relationship may no longer be reasonably effective. Thus, the need for reassessing effectiveness at least quarterly would be eliminated unless changes in circumstances suggest that a hedging relationship may no longer be reasonably effective. The Board believes that the costs of compliance would be reduced because an entity would not have to develop sophisticated quantitative statistical models to prove a hedging relationship is effective in situations in which it is obvious that a hedging relationship is effective. Users of financial statements also would be served by not having to deal with on-again, off-again hedge accounting for the same derivative and hedged item.

BC219. The Board considered eliminating hedge effectiveness requirements entirely. However, the Board rejected that approach because it could result in creating a fair value option for assets and liabilities that the Board has not decided should have that option. For example, without hedge effectiveness requirements, an entity could designate an interest rate swap as a hedge against changes in fair value of its tire inventory. The entity would then be able to measure the tire inventory at fair value even though the changes in fair value of the interest rate swap might not offset the changes in fair value of the tires. That would result in effectively creating a fair value measurement option for the tire inventory instead of achieving one of the objectives of hedge accounting, which is to provide a means of compensating for situations in which measurement anomalies between a hedged item and a hedging instrument result in recognizing offsetting gains and losses in net income in different periods. The Board believes that guidance resulting in a fair value option for all assets and liabilities, whether

financial or nonfinancial, should not be promulgated in a proposed Update on financial instruments and hedge accounting.

Reasonably Effective Criterion

BC220. The Board decided not to define *reasonably effective* for purposes of determining when hedge accounting could be applied and when it could not be applied. The Board believes that it is necessary to use judgment when determining whether a hedging relationship is reasonably effective. That judgment should include a holistic consideration of all the facts and circumstances that led an entity to enter into a hedging relationship. That would include, for example, consideration of whether the objective of applying hedge accounting was to compensate for accounting anomalies or to achieve a fair value measurement option for items not currently eligible for fair value measurement.

Dedesignation of a Hedging Relationship

BC221. Paragraphs 815-25-40-1 and 815-30-40-1 require an entity to discontinue the special accounting for fair value hedges and cash flow hedges if (a) any criterion for fair value hedge accounting or for cash flow hedge accounting is no longer met, (b) the derivative hedging instrument expires, is sold, terminated, or exercised, or (c) the entity removes the designation of the fair value or cash flow hedge. Criteria (a) and (b) relate to the termination of a hedging relationship and the third criterion (c) relates to the dedesignation of a hedging relationship.

BC222. The Board decided that an entity should not be permitted to discontinue fair value hedge accounting or cash flow hedge accounting by simply dedesignating (or removing the designation of) the hedging relationship. The Board believes that discontinuing the special accounting that is permitted under hedge accounting would be appropriate if criterion (a) or (b) above is met. However, the Board believes that discontinuing the special accounting that is permitted under hedge accounting is not appropriate if criterion (c) is met. Because the economics of the relationship between the hedging instrument and hedged item (or forecasted transaction) have not changed, the Board believes that the accounting should not change. The Board acknowledges that an entity could override the special accounting under fair value and cash flow hedges by terminating the derivative designated as the hedging instrument and entering into a similar new derivative, which action involves actual economic transactions. However, the Board does not believe that arbitrary dedesignation (which does not involve actual economic transactions) should be used as a tool for changing measurement attributes and/or managing the classification of certain items reported in net income.

BC223. Many hedging strategies would not be affected by the proposal to not permit the dedesignation of a hedging relationship after it has been established.

However, it may be necessary to change the way a hedging relationship is designated in order to achieve the same financial statement results as are currently being obtained under Topic 815.

Measuring and Reporting Ineffectiveness in Cash Flow Hedging Relationships

BC224. Currently in a cash flow hedging relationship under Topic 815, the actual derivative hedging instrument is measured at fair value on the statement of financial position, and accumulated other comprehensive income is adjusted to a balance that reflects the lesser of either the cumulative change in the fair value of the actual derivative or the cumulative change in the fair value of a hypothetical derivative.

BC225. The amount of ineffectiveness, if any, recognized in net income is equal to the excess of the cumulative change in the fair value of the actual derivative over the cumulative change in the fair value of the hypothetical derivative. Thus, Topic 815 requires ineffectiveness to be recognized in net income only when the cumulative change in fair value of the actual derivative exceeds the cumulative change in fair value of the hypothetical derivative (referred to as an overhedge). If the cumulative change in fair value of the actual derivative is less than the cumulative change in fair value of the hypothetical derivative (referred to as an underhedge), the balance of accumulated other comprehensive income equals the cumulative change in fair value of the actual derivative; the ineffectiveness of the cash flows related to the hypothetical derivative is not reported in the financial statements. The basis for conclusions in Statement 133 states that the reason for not recognizing ineffectiveness on underhedges is that only ineffectiveness due to excess expected cash flows on the derivative should be reflected in net income, because otherwise a nonexistent gain or loss on the derivative would be deferred in other comprehensive income and recognized in net income.

BC226. The proposed guidance would require that measurement of hedge ineffectiveness be based on a comparison of the change in fair value of the actual derivative designated as the hedging instrument and the present value of the cumulative change in expected future cash flows of the hedged transaction. For example, that could be accomplished by comparing the change in fair value of the actual derivative and the change in fair value of a derivative that would mature on the date of the forecasted transaction and that would provide cash flows that would exactly offset the hedged cash flows. The balance of accumulated other comprehensive income would reflect the amount necessary to offset the present value of the cumulative change in expected future cash flows on the hedged transaction from inception of the hedge less the amount previously reclassified from accumulated other comprehensive income into net income. That would result in reporting ineffectiveness in net income regardless of whether (a) the cumulative change in fair value of the actual derivative exceeded the cumulative change in fair value of the derivative that would mature on the

date of the forecasted transaction and that would provide cash flows that would exactly offset the hedged cash flows or (b) the cumulative change in fair value of the derivative that would mature on the date of the forecasted transaction and provide cash flows that would exactly offset the hedged cash flows exceeded the cumulative change in fair value of the actual derivative.

BC227. The primary objective of cash flow hedge accounting is to manage the timing of recognition in income of the gains and losses on a derivative instrument used to lock in or fix the price of a future transaction. If the gains and losses on the derivative are deferred until the forecasted transaction occurs, the effect of locking in or fixing the price of the future transaction would be reflected in net income in the same period or periods in which the forecasted transaction affects net income. However, locking in or fixing the price of the future transaction would occur only if an entity entered into a derivative that would mature on the date of the forecasted transaction and that would provide cash flows that would exactly offset the hedged cash flows. If an entity does not enter into a derivative that would mature on the date of the forecasted transaction and that would provide cash flows that would exactly offset the hedged cash flows, the effective price of the future transaction would be different from the market price at the date the forecasted transaction occurs and would not lock in a specific price at the forecasted transaction date. The actual net price in that situation would not be determined until the forecasted transaction occurs and the amount of the gain or loss on the derivative is known.

BC228. The Board believes that ineffectiveness should be recognized in net income if an entity enters into a derivative that would not mature on the date of the forecasted transaction and provide cash flows that would exactly offset the hedged cash flows (that is, not locking in or fixing the price). The Board also believes that in those situations there should be no distinction between whether the change in value of the actual derivative is greater than or less than the change in value of a derivative that would mature on the date of the forecasted transaction and provide cash flows that would exactly offset the hedged cash flows. In both of those cases, the recognizing of ineffectiveness results in consistently reflecting in the statement of comprehensive income the difference between the actual price of the forecasted transaction and what would have been the locked-in price if a derivative that would exactly offset the hedged cash flows were used. The Board believes that it is preferable to treat overhedges and underhedges consistently. In addition, amounts recognized in accumulated other comprehensive income under the existing Topic 815 cash flow hedging model are not limited solely to unrecognized gains or losses on the hedging derivative that have not yet been reclassified to net income. Rather, the amounts in accumulated other comprehensive income also can reflect the adjustments necessary to, for example, adjust interest expense to achieve the synthetic fixed interest rate on a debt instrument.

BC229. The Board also considered how ineffectiveness was reported when an entity entered into a derivative that would not exactly offset the variability in

expected future cash flows on the hedged transaction within the net investment foreign currency hedging model. The net investment foreign currency hedging model in Topic 815 requires ineffectiveness to be recognized in net income when the change in value of the actual derivative is either greater than or less than the change in value of a derivative that would not exactly offset the variability in expected future cash flows on the hedged transaction. The proposed guidance for reporting ineffectiveness in a cash flow hedge would be consistent with other areas of cash flow hedge accounting in Topic 815.

Purchased Options as Hedging Instruments in Cash Flow Hedges

BC230. Eliminating of critical terms match method in this proposed guidance would invalidate paragraphs 815-20-25-126 through 25-129 and paragraphs 815-30-35 through 35-37 (originally issued as Statement 133 Implementation Issue No. G20, "Assessing and Measuring the Effectiveness of a Purchased Option Used in a Cash Flow Hedge"). The Board decided, however, to continue to permit entities to defer the changes in fair value of a purchased option associated with the time value component of the option when used in a cash flow hedge.

BC231. The Board believes that the time value component of a purchased option represents ineffectiveness that should be recognized in net income. However, to simplify the cash flow hedge accounting model and to provide consistency with the way the time value component of a purchased option is accounted for under the foreign currency cash flow hedging model, the Board decided to allow deferral of the time value component. If an entity defers the time value component in other comprehensive income, it would need to reclassify from other comprehensive income to net income each period on a rational basis an amount that adjusts net income for the amortization of the cost of the option.

Hedging Provisions That Are Not Changed

Hedged Risk

BC232. The Board considered modifying the criteria for assessing hedge effectiveness and requiring an approach that permits hedging either all risks or only (a) foreign currency risk for all hedged items or transactions and (b) interest rate risk on an entity's own debt at issuance as an approach that would facilitate simplification of compliance. Some believe that approach, which would prohibit hedging only interest rate risk or only credit risk, perhaps would provide the best solution for resolving practice issues related to hedge accounting while concurrently improving financial reporting to make the hedge accounting results more useful to those who make economic decisions. However, the Board rejected that proposed hedge accounting approach because it would no longer provide hedge accounting for different hedgeable risks, which the Board wished

to retain at this time, especially in light of the classification and measurement approach included in the proposed guidance. That decision was heavily influenced by the relatively narrow application of amortized cost in measuring financial instruments. If the use of amortized cost would be broadened, the Board may choose to significantly limit hedge accounting for the variety of separate risks currently permitted by Section 815-20-25.

BC233. Because the proposed guidance addresses the accounting and reporting for financial instruments, the Board did not reconsider the hedged risks for which hedge accounting is permitted with respect to nonfinancial instruments.

Fair Value Hedge Accounting

BC234. The Board also considered a special approach for fair value hedges of hedged items that would be reported at fair value with qualifying changes in fair value recognized in other comprehensive income. Under that approach, the effective portion of the hedging instrument's changes in fair value would be recognized in other comprehensive income rather than net income. The Board rejected that approach for various reasons, including the approach's inconsistency with the basic classification and measurement approach included in the proposed guidance. Furthermore, the complexity arising from that approach would require further guidance about determining the amounts for reclassifications from other comprehensive income.

BC235. For financial instruments with qualifying changes in fair value not recognized in net income, the accounting for fair value hedges is not changed. For financial instruments whose qualifying changes in fair value are recognized in other comprehensive income, the change in the hedged item's fair value attributable to the hedged risk would continue to be recognized immediately in net income rather than in other comprehensive income as discussed in paragraph 24. For other financial instruments that are reported at amortized cost, the change in the hedged item's fair value attributable to the hedged risk would continue to be an adjustment of the hedged item's carrying amount. Under paragraph 86, an entity would be required to present as separate line items in the statement of financial position the amortized cost and the accumulated amount needed to reconcile amortized cost less allowance for credit losses to fair value for the financial instruments whose changes in fair value are not recognized in net income. That amortized cost amount is not the same as the hedged item's carrying amount under fair value hedge accounting.

Effective Date and Transition

Effective Date

BC236. The Board decided that certain aspects of the measurement proposed guidance should be effective for nonpublic entities that have less than $1 billion in consolidated total assets as of the beginning of their fiscal year 4 years after the effective date for all other entities. The Board considered several criteria to determine which entities should have a delayed effective date. In outreach performed by the staff, many constituents communicated that a delayed effective date should be based on the consolidated asset size of the entity. These constituents noted that regulatory agencies have different requirements for entities of different sizes, thus acknowledging different levels of sophistication. These constituents noted that at certain asset sizes, there is some change in the level of sophistication. For example, financial institutions with total consolidated assets greater than $1 billion are subject to the FDIC's Improvement Act of 1991 requirement for management's assessment of the effectiveness of internal control over financial reporting as well as an auditor's attestation on management's assessment requirements.

BC237. The Board decided that a delayed effective date should be provided for those entities to accommodate transitioning them to the comprehensive model of accounting for financial instruments as well as to allow the Board to consider findings from its post-implementation review, which is tentatively scheduled approximately two to three years after the initial effective date. The Board acknowledges both:

a. The need for these entities to develop the infrastructure to effectively remeasure core deposit liabilities in accordance with the proposed guidance
b. The need for these entities to gain experience in estimating fair value of loans and loan commitments in accordance with the exit price notion in Topic 820 before it becomes the primary measurement attribute for loans and loan commitments.

The Board believes that the costs, including resources associated with both developing the infrastructure and implementing appropriate systems related to these aspects of the measurement guidance, would be more significant for nonpublic entities subject to the deferral of the effective date.

BC238. Additionally, the Board noted that the financial statements, as well as the notes to the financial statements of these entities, generally would be available at the same time so stakeholders in those entities would have access to the fair value disclosures about loans at the same time as the financial statements therefore alleviating the Board's concern about the timing of public dissemination of both amortized cost and fair value information applicable to public companies. Nonpublic entities generally do not issue press releases.

Therefore, the fair value information disclosed in the notes to the financial statements would be available at the same time as the amortized cost information on the face of the financial statements.

Transition

BC239. The Board decided that the proposed guidance should require a cumulative-effect adjustment to the statement of financial position immediately before the effective date. The prior-period statement of financial position would be restated in the first financial statements issued after the effective date of the proposed guidance. The Board rejected other methods, including methods requiring full retrospective transition. The Board acknowledged that retrospective transition methods provide the most useful information. However, the Board determined them to be impracticable to apply because of the requirements to make significant estimates of amounts and assumptions about management's intentions.

Benefits and Costs

BC240. The objective of financial reporting is to provide information that is useful to present and potential investors, creditors, donors, and other capital market participants in making rational investment, credit, and similar resource allocation decisions. However, the benefits of providing information for that purpose should justify the related costs. Present and potential investors, creditors, donors, and other users of financial information benefit from improvements in financial reporting, while the costs to implement new guidance are borne primarily by present investors. The Board's assessment of the costs and benefits of issuing new guidance is unavoidably more qualitative than quantitative because there is no method to objectively measure the costs to implement new guidance or to quantify the value of improved information in financial statements.

BC241. Based on an extensive due process and significant input received from more than 100 financial statement users employed by various organizations and representing a variety of perspectives, the Board believes that the proposed guidance would provide users with more relevant, reliable, and timely information about an entity's financial position and financial performance.

BC242. The Board recognizes that the proposed guidance may require significant effort for many entities to gather the necessary data for application and that the review and audit procedures to ensure compliance with the proposed guidance may require significant additional effort. Additionally, the Board also considered the operationality of the requirements of the proposed guidance, especially the expanded fair value measurement for financial instruments. The Board concluded that identifying the fair value of some instruments for small entities may be particularly burdensome. In response, the

Board decided to allow these entities additional time to develop systems and methods to comply with the requirements of this proposed guidance.

BC243. Notwithstanding these potential additional costs, the Board concluded that the costs associated with complying with the proposed guidance do not outweigh the significant benefits of improved information about financial instruments. The Board developed this proposed guidance to provide users of financial statements with relevant information about financial instruments held by an entity. The proposed guidance is expected to improve:

a. The recognition and measurement of financial instruments under different scenarios
b. The measurement of credit impairments for certain financial instruments and the related interest income recognized by the entity
c. The transparency of both management's and the market's expectations of cash flows to be received or paid related to its involvement with financial instruments
d. The application of accounting for hedging relationships and transactions
e. A user's ability to understand and assess an entity's financial instruments, credit impairments, and hedging transactions.

Alternative Views

BC244. The existing accounting standards for financial instruments were established on a piecemeal basis to address urgent reporting issues. Accordingly, instruments that are economically similar, such as a loan and a debt security, can be accounted for differently because of several possible factors, including the legal form of the instrument, the nature of the reporting entity, and whether specialized industry guidance applies. Ms. Seidman and Mr. Smith strongly support the goal of establishing comprehensive principles to classify and measure all financial instruments, which would simplify the accounting literature and the financial statements in a manner that reflects the nature of the instruments and the way they are used by the reporting entity. Ms. Seidman and Mr. Smith agree with the proposed changes relating to impairment of debt investments, which is widely agreed to be the most deficient and inconsistent aspect of existing accounting standards, both in the United States and internationally. Ms. Seidman and Mr. Smith dissent from several aspects of the proposed guidance, primarily because it would introduce fair value accounting for some nonmarketable, plain-vanilla debt instruments that are held for collection (long-term investment), and most liabilities held for payment, which they believe would not reflect the likely realization of those items in cash and, therefore, would not be the most relevant way to measure those items in the statement of financial position and comprehensive income.

BC245. Ms. Seidman and Mr. Smith believe there are three primary criteria that should be considered to determine the measurement attribute and the classification of financial assets. They believe that those criteria are the variability of the cash flows, the marketability of the instrument, and the business practice of the entity. Their model would require fair value accounting if the cash flows of the instrument are variable (using the same proposed guidance on standalone and embedded derivatives), a quoted market price is readily available, or the business practice of the entity is not to hold the instrument to collect its contractual cash flows. If any of these criteria are met, the instrument would be carried at fair value because fair value appropriately reflects the cash flows that the entity is likely to realize from the instrument. Ms. Seidman and Mr. Smith would then classify instruments carried at fair value in a manner that is similar to the proposed model (that is, the change in the fair value of instruments with variable cash flows or that are not being held for collection of contractual cash flows would be recorded in income, while changes in the fair value of instruments being held for contractual cash flows that do not have variable cash flows would be recorded in other comprehensive income). The main area of disagreement between their proposed framework and the proposed guidance relates to financial assets with the following characteristics: they do not have quoted prices readily available, they do not have variable cash flows, and the reporting entity intends to hold them (for example, traditional loans held for investment and demand deposits). Ms. Seidman and Mr. Smith would carry these items at amortized cost, not at fair value, with the improved approach to impairment of debt investments and better disclosure about interest rate risk. They believe that for these nonmarketable, plain-vanilla debt instruments that an entity holds as part of a long-term business strategy, it is inappropriate for subjective, unrealized gains and losses to form the basis for the entity's statement of financial position, including book equity, as well as comprehensive income, when those unrealized gains and losses are expected to reverse. Ms. Seidman and Mr. Smith also would carry liabilities that do not contain embedded derivatives at amortized cost, unless they are part of a trading activity. They note that constituents have not expressed concern about the accounting for financial liabilities, other than the counterintuitive effect of reflecting gains and losses relating to changes in an issuer's own credit standing in net income (for the few liabilities that are currently carried at fair value). Ms. Seidman and Mr. Smith would require that the fair value of all financial instruments carried at amortized cost be presented parenthetically on the face of the statement of financial position.

BC246. Ms. Seidman and Mr. Smith listened intently to the numerous points of view expressed by investors on this central issue. The vast majority of investors found both fair value information and amortized cost information useful. However, the feedback was divided fairly evenly, with respect to illiquid, traditional loans, core deposit liabilities, and other financial liabilities, between those who would prefer that the statement of financial position and reported equity be based on fair value for those items and those who would prefer that fair value information be readily available, but not be the basis for reported equity and comprehensive

income. Some observed that the fair value estimates for those items would be based primarily on unobservable inputs, which would introduce significant subjectivity into comprehensive income and stockholders' equity. In light of those split views, Ms. Seidman and Mr. Smith would have preferred a standard based on their proposed framework.

BC247. Ms. Seidman and Mr. Smith believe that having a coherent framework that provides both historical and current information about all financial instruments, and a consistent impairment test and approach to yields for debt investments, represents a significant improvement and simplification in financial reporting. While their preferred framework is not the same as IFRS 9 (because they would carry marketable securities at fair value, whereas IFRS 9 permits cost accounting if certain conditions are met and does not require fair value to be presented parenthetically on the face of the statement of financial position for instruments carried at amortized cost), it offers a much better starting point for a converged accounting standard than the proposed guidance. World leaders have requested that the Boards develop an improved, converged standard on financial instruments, and Ms. Seidman and Mr. Smith believe that appeal must be weighed heavily in evaluating alternative improvements.

BC248. Regarding the core deposit liabilities of a depository institution, Ms. Seidman and Mr. Smith note that the guidance is proposing a new measurement attribute for core deposit liabilities that would introduce a new element of complexity in the accounting for financial instruments. Ms. Seidman and Mr. Smith believe that the core deposit intangible asset can be a major source of value for a depository institution, yet the measurement of the core deposit intangible asset required by the proposed guidance would not be completely captured by the computation being prescribed by the Board. Ms. Seidman and Mr. Smith believe that the intent of the proposed guidance is to address the accounting for financial instruments, not intangible assets. They believe that it is inappropriate to address the accounting for internally generated intangible assets on an ad hoc basis. Ms. Seidman and Mr. Smith would have preferred that deposits be reported in the statement of financial position at the amount withdrawable on demand. Furthermore, they believe that the issue of interest rate sensitivity can be better addressed through improved disclosures.

BC249. Ms. Seidman and Mr. Smith believe the amortized cost exception provided in the proposed guidance for some financial liabilities lacks an underlying concept, is rules based in nature, and would not be operational. They fear it would become an albatross for the Board, requiring interpretation and causing compliance issues in practice. They would rather have a clear principle behind the classification of liabilities that is primarily driven by the variability of cash flows and the business model of the entity.

BC250. Ms. Seidman also dissents from the change in accounting for yields on debt investments, which would be based on the original effective yield times the amortized cost of the instrument *net of the allowance for doubtful accounts*. The

proposed approach commingles an allowance that sometimes explicitly considers expected interest flows and sometimes does not (such as when a statistical loss rate of principal charge-offs is used), which makes it difficult to describe the objective of the yield calculation. The proposed approach also would introduce subjectivity into both the allowance for doubtful accounts and reported interest income. Mechanically, this approach would frequently give rise to interest receipts on a performing loan that exceed the calculated interest income (net of the allowance). The Board proposes to record any excess interest due over the calculated interest income as an increase in the allowance for doubtful accounts, which could then immediately be recorded as a reversal of credit impairment in income (so, essentially, all of the coupon is recognized currently in income but some of it is reclassified from interest to a reversal of bad debt expense). The feedback received from users of financial statements was that they preferred that yields be reported on the basis of the contractual terms of the instrument, thereby signaling potentially risky instruments for further inquiry. They also preferred that the subjectivity in the estimates be concentrated in the allowance for doubtful accounts. The proposed approach is contrary to the views expressed by users and would be costly to implement. Thus, Ms. Seidman seriously questions the cost-benefit tradeoff of that proposed change.

BC251. Ms. Seidman and Mr. Smith also disagree with the proposed requirement to present separately in the statement of financial position amounts included in accumulated other comprehensive income related to the changes in fair value for financial instruments held for collection. They believe that it is inappropriate to effectively provide a pro forma measure of stockholder's equity, first including and then excluding fair value adjustments for these items. They believe that this presentation sets a bad precedent for future controversial accounting issues, because the Board could always decide to present the "other view" as an adjustment to equity. Mr. Smith would not object if all other comprehensive income items were presented separately, but he disagrees with special presentation of this one item of other comprehensive income.

BC252. Ms. Seidman and Mr. Smith believe that the Board's decision to defer the application of the effective date of certain provisions of the proposed guidance for nonpublic entities with less than $1 billion in assets raises significant questions about the operationality of the proposed standard and whether the improvements in financial reporting and related benefits intended would be achieved in a timely fashion, if at all. The deferral would apply to over 90 percent of banks and credit unions in the United States. The deferral of certain provisions for 4 years to over 90 percent of the entities for which the standard was intended calls into question whether the basic classification and measurement model of the proposed guidance would meet the cost-benefit test.

Appendix A: Comparison of the FASB's and the IASB's Proposed Models for Financial Instruments

A1. The following table provides a side-by-side comparison of the FASB's and the IASB's proposed models for financial instruments. For a complete description of the IASB's model, see (1) IFRS 9 for the finalized requirements for classifying and measuring financial assets and (2) the IASB's financial instruments project website (www.iasb.org) for a summary of its decisions made to date on all other aspects of accounting for financial instruments (such as financial liabilities, impairment, and hedge accounting). In the following table, the IASB's published proposals and tentative decisions are differentiated from finalized requirements.

	The FASB's Proposed Update	**IFRS 9 for Financial Assets and the IASB's Current Tentative Decisions**
Scope	• All financial assets and financial liabilities, as defined (except those for which a specific scope exception has been provided) • Nonpublic entities with less than $1 billion in assets would apply certain requirements in this model relating to loans, loan commitments, and core deposit liabilities 4 years after the original effective date.	• Items within the scope of IAS 39.
Measurement Approaches	• Fair value • Amortized cost • Remeasurement amount (only for core deposit liabilities).	• Fair value • Amortized cost • Separate accounting of embedded derivatives from a liability host if particular conditions are met.[1]

[1]Unless the fair value option is applied.

	The FASB's Proposed Update	IFRS 9 for Financial Assets and the IASB's Current Tentative Decisions
Classification and Measurement Categories	• Fair value with all changes in fair value recognized in net income (FV-NI) • Fair value with qualifying changes in fair value recognized in other comprehensive income (FV-OCI) • Amortized cost.	• Fair value through net income (FV-NI) • Amortized cost • Fair value through other comprehensive income (FV-OCI) (limited option for some investments in equity instruments).
FV-OCI Classification Criteria	• Three qualifying criteria must be satisfied to measure a financial instrument at FV-OCI:[2] 1. It is a debt instrument held or issued with all of the following characteristics: a. There is an amount transferred to the debtor (issuer) at inception that would be returned to the creditor (investor) at maturity or other settlement, which is the principal amount of the contract adjusted by any original issue discount or premium.	• Irrevocable election at initial recognition for investments in equity instruments that are not held for trading.

[2]Classification at FV-OCI is an option, not a requirement.

	The FASB's Proposed Update	IFRS 9 for Financial Assets and the IASB's Current Tentative Decisions
	b. The contractual terms of the debt instrument identify any additional contractual cash flows to be paid to the creditor (investor) either periodically or at the end of the instrument's term. c. The debt instrument cannot contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its initial investment, other than through its own choice. 2. The entity's business strategy for the instrument is to collect or pay the related contractual cash flows rather than to sell the financial asset or to settle the financial liability with a third party. 3. It is not a hybrid instrument for which applying Subtopic 815-15 on embedded derivatives would otherwise have required the	

	The FASB's Proposed Update	IFRS 9 for Financial Assets and the IASB's Current Tentative Decisions
	embedded derivative to be accounted for separately from the host contract.	
Amortized Cost Classification Criteria	• A financial liability may be carried at amortized cost if: 1. The liability meets the criteria for FV-OCI. 2. Measurement at fair value would create or exacerbate a measurement attribute mismatch between recognized assets and liabilities. • Irrevocable election made at the issuance of the financial liability.	• A financial asset (including hybrid financial assets) must be subsequently measured at amortized cost[3] if: 1. The objective of the entity's business model is to hold the asset to collect the contractual cash flows. 2. The asset's contractual cash flows are solely payments of principal and interest. • Most financial liabilities must be subsequently measured at amortized cost[3] if they are not held for trading. Embedded derivatives are separated from a liability host and accounted for as derivatives if particular criteria are met.
Fair Value Option	• Not applicable to financial instruments in the scope of the proposed guidance. • The fair value option under Topic 825 applies to a broader set of instruments than the scope of the proposed guidance and would continue to apply to those instruments that are not within the scope of the proposed	• **Financial assets:** Irrevocable election available at initial recognition if measuring at fair value eliminates or significantly reduces a measurement or recognition inconsistency (an accounting mismatch). • **Financial liabilities:** Irrevocable election would be available at initial recognition if: 1. Measuring at fair value eliminates or significantly reduces an accounting mismatch.

[3]Unless the fair value option is applied.

	The FASB's Proposed Update	IFRS 9 for Financial Assets and the IASB's Current Tentative Decisions
	guidance except for unconsolidated equity investments.	2. A group of financial instruments is managed and its performance is evaluated on a fair value basis. 3. The liability contains one or more separable embedded derivatives and the entity elects to account for the hybrid (combined) contract in its entirety. • The IASB's Exposure Draft on fair value option proposes changes to the fair value option for financial liabilities and is open for comment until July 16, 2010.
Hybrid Financial Assets	• Hybrid financial assets containing embedded derivatives that would otherwise require separate accounting under Topic 815 would be measured in their entirety at FV-NI. • Hybrid financial assets containing embedded derivatives that would not require separate accounting under Topic 815 would be eligible for measurement in their entirety at FV-OCI.	• Hybrids with financial hosts would be classified in their entirety based on the overall classification approach for financial assets. • Specific guidance for applying the classification approach to investments in contractually linked instruments that create concentrations of credit risk.
Hybrid Financial Liabilities	• Hybrid financial liabilities should be measured using the classification criteria described for hybrid financial assets.	• An embedded derivative is separated from the host liability contract if particular conditions are met.[4]

[4]Unless the fair value option is applied.

	The FASB's Proposed Update	IFRS 9 for Financial Assets and the IASB's Current Tentative Decisions
Core Deposit Liabilities	• Subsequent measurement at present value of average core deposit liability discounted at the differential between the alternative funds rate and the all-in-cost-to-service rate over implied maturity. • Qualifying changes in the remeasurement amount may be recognized in other comprehensive income if classification criteria are met.	• No special guidance; generally measured at amortized cost.
Short-Term Receivables and Payables	• Measured at amortized cost (plus or minus any fair value hedging adjustments) if they arise in the normal course of business, if they are due in customary terms, and if the business strategy is to hold for collection or payment of contractual cash flows • Subject to impairment.	• No special guidance; generally measured at amortized cost.
Unconsolidated Equity Investments	• Accounted for under Topic 323 if the entity has significant influence over the investee and the investment is considered related to the entity's consolidated business	• Not within the scope of IFRS 9; accounted for under IAS 28, *Investments in Associates*.

	The FASB's Proposed Update	IFRS 9 for Financial Assets and the IASB's Current Tentative Decisions
	• Measured at fair value with all changes in fair value recognized in net income if the requirements under Topic 323 are not met • No fair value option for these investments.	
Loan Commitments	• Potential lenders classify loan commitments in the same manner as the loan once funded was classified. • If a loan measured at FV-OCI is funded, accounting for the commitment fee would be a yield adjustment of the related loan, which is consistent with the accounting in Subtopic 310-20. • Potential borrowers and issuers of lines of credit issued as part of credit card arrangements would be excluded from the scope.	• Only some loan commitments are within the scope of IFRS 9 and IAS 39. • For those within the scope, subsequent measurement would depend on the terms of the instrument and the entity's circumstances.
Impairment	• For financial instruments measured at FV-OCI, an entity would be required to determine if recognition of a credit impairment is required at the end of each reporting period. • In determining whether a credit impairment exists, an entity would consider all available information relating to past events and existing	• The comment period for the IASB's Exposure Draft on impairment is open until June 30, 2010. • That Exposure Draft proposes an expected loss model that would require an entity to determine the expected credit losses on a financial asset when that asset is first recognized. Initial expectations of credit losses would be included in determining the effective interest rate.

	The FASB's Proposed Update	IFRS 9 for Financial Assets and the IASB's Current Tentative Decisions
	economic conditions and their implications for the collectibility of the financial asset(s). • An entity would recognize in net income the loss related to the amount of credit impairment for all contractual amounts due for originated financial asset(s) and amounts originally expected to be collected for purchased financial asset(s) that an entity does not expect to collect. • An entity would present the allowance for credit losses on the statement of financial position as a separate line item.	• Contractual interest revenue, less the initial expected credit losses, would be recognized over the life of the instrument. • Expected credit losses would be reassessed each period and the effects of any changes in expectations would be recognized in net income immediately.
Realized Gains and Losses from Sales or Settlements	• Recognized in net income for all financial instruments.	• **Financial assets:** Recognized in net income for all financial assets, excluding those classified as FV-OCI for which all gains and losses are recognized in other comprehensive income and are not recycled • **Financial liabilities:** Recognized in net income for all financial liabilities except the IASB tentatively decided that for liabilities designated under the fair value option that gains and losses attributable to changes in own credit risk will be recognized in other comprehensive income and not recycled.

	The FASB's Proposed Update	IFRS 9 for Financial Assets and the IASB's Current Tentative Decisions
Interest and Dividend Accruals	• Recognized in net income for all financial instruments. However, not required to be presented separately for financial instruments measured at FV-NI. Interest would be presented separately for financial instruments measured at FV-OCI.	• Recognized in net income for all financial instruments except for some dividends on financial assets classified as FV-OCI. For those assets, dividends are recognized in other comprehensive income if they clearly represent a recovery of part of the cost of the investment.
Transaction Fees and Costs	• For financial instruments measured at FV-NI, transaction fees and costs would be recognized in net income as expenses upon initial recognition. • For financial instruments measured at FV-OCI, transaction fees and costs would be recognized in other comprehensive income and recognized in net income as a yield adjustment of the related financial instrument over the life of the instrument.	• Recognized in net income immediately for assets and liabilities that are measured at FV-NI • Included in the initial measurement of all assets and liabilities that are not measured at FV-NI.
Tainting	• No tainting.	• No tainting.
Reclassifications	• Not permitted.	• Required for financial assets if the entity's business model for managing its financial assets changes • Prohibited for financial liabilities.
Statement of Financial Position	• Financial instruments would be displayed separately on the face	• No significant changes proposed.

	The FASB's Proposed Update	IFRS 9 for Financial Assets and the IASB's Current Tentative Decisions
	depending on whether they are classified as FV-NI or FV-OCI. • The following amounts would be presented on the face of the statement of financial position for financial instruments measured at FV-NI: 1. Fair value 2. Amortized cost of the entity's own outstanding debt. • The following amounts would be presented on the face of the statement of financial position for financial instruments measured at FV-OCI: 1. Amortized cost 2. Allowance for credit losses 3. Amount needed to adjust amortized cost less allowance for credit losses to fair value 4. Fair value. • Present separately on the face amounts included in accumulated other comprehensive income related to the changes in fair value or changes in the remeasurement amount for financial instruments for which those changes are recognized in other comprehensive income.	

	The FASB's Proposed Update	IFRS 9 for Financial Assets and the IASB's Current Tentative Decisions
Statement of Comprehensive Income	• At the same time that it issues this proposed Update, the FASB expects to issue a proposed Update that would require a continuous statement of comprehensive income with total comprehensive income and a subtotal for net income. Under the comprehensive income proposal, earnings per share would continue to be based on net income only.	• IAS 1, *Presentation of Financial Statements,* permits comprehensive income to be presented in either a single statement or two statements. • The IASB expects to publish an Exposure Draft in the second quarter of 2010 that would require comprehensive income to be presented, partitioned into net income and other comprehensive income. No changes to earnings per share are proposed so it will continue to be based on net income only.
Presentation of Changes in Own Credit	• Present separately significant current period change in fair value attributed to changes in the entity's credit standing, excluding changes in the price of credit.	• The IASB's Exposure Draft on fair value option proposes that for financial liabilities designated under the fair value option, an entity: 1. Present the total fair value change in net income 2. Present the portion attributable to changes in own credit risk in other comprehensive income (with an offsetting entry to net income).

	The FASB's Proposed Update	**IFRS 9 for Financial Assets and the IASB's Current Tentative Decisions**
Hedge Accounting (only main features summarized)	• The types of items and transactions eligible for hedge accounting in Topic 815 would continue to apply. • The shortcut method and critical terms match method would be eliminated. An entity would no longer have the ability to assume a hedging relationship is effective and recognize no ineffectiveness in net income during the term of the hedge. • An entity would not be permitted to discontinue hedge accounting by simply removing the designation of a hedging relationship. Hedge accounting can be discontinued only if the criteria for hedge accounting are no longer met or the hedging instrument expires, is sold, terminated, or exercised. • An entity would be able to designate particular risks as the risk being hedged in a hedging relationship. Only the effects of the risks hedged would be reflected in net income. The types of risks eligible as hedged risks in Topic 815 would continue to apply.	• The IASB expects to publish proposals resulting from its comprehensive review of hedge accounting requirements that will allow finalization in the near term.

	The FASB's Proposed Update	**IFRS 9 for Financial Assets and the IASB's Current Tentative Decisions**
Hedge Effectiveness (only main features summarized)	• After inception of the hedging relationship, an entity would need to qualitatively (or quantitatively, if necessary) reassess effectiveness only if circumstances suggest that the hedging relationship may no longer be reasonably effective. • An entity would be required to perform a qualitative (rather than quantitative) test at inception to demonstrate that an economic relationship exists between the hedging instrument and the hedged item or forecasted transaction. However, in certain situations, a quantitative test may be necessary at inception. • As part of the hedge effectiveness assessment, an entity would be required to demonstrate that changes in fair value of the hedging instrument would be reasonably effective in offsetting the changes in the hedged item's fair value or the variability in the hedged cash flows for the risk or risks hedged by the entity in that hedging relationship.	• The IASB expects to publish proposals resulting from its comprehensive review of hedge accounting requirements that will allow finalization in the near term.

	The FASB's Proposed Update	IFRS 9 for Financial Assets and the IASB's Current Tentative Decisions
Accounting Guidance for Entities Subject to the Delayed Transition	• An entity that qualifies for the delayed effective date may measure loans and loan commitments that meet the criteria for FV-OCI and core deposit liabilities that qualify for remeasurement changes to be recognized in other comprehensive income, in accordance with existing U.S. GAAP during the deferral period. All other provisions of the proposed guidance would apply on the original effective date. • An entity would disclose in the notes to the financial statements the fair value of loans that meet the criteria for delayed transition, determined in accordance with the guidance in Topic 820, in a reporting period for which application of the proposed guidance is deferred for those loans.	• Not applicable.

Appendix B: Possible Methods for Measuring Changes in an Entity's Credit Standing

B1. To address concerns of some of the Board's constituents about including the effect of changes in an entity's own credit risk in measuring its financial performance, the Board decided that an entity should separately present the effect of these changes on the face of the statement of comprehensive income. To provide meaningful information to users, the Board considered whether to require an entity to measure the effect of changes in an entity's own credit risk by determining the change in fair value attributable to a change in the entity's own credit spread (that is, the portion of the discount rate that is not the benchmark/risk-free interest rate), which generally is consistent with current practice for complying with similar requirements under Subtopic 825-10 and IFRS 7. However, the Board believes that the change in fair value attributable to the change in an entity's credit spread does not accurately reflect the change in the entity's own credit alone because it also measures the change in the price of credit, which affects not just the individual entity, but also other entities in the industry and the economy. Thus, the Board decided that an entity should present separately on the face of the statement of comprehensive income significant changes in fair value of a financial liability that are attributable to changes in the entity's credit standing, excluding the change in the price of credit. Such information would be meaningful to users of the financial statements because an entity would be required to present changes in fair value related to changes in its credit risk only when there has been a change in the entity's credit standing. Changes in the price of credit solely due to changes in market conditions would not be presented separately.

B2. The Board recognizes that there may be several different methods to determine the change in fair value attributable to a change in an entity's credit standing, excluding the change in the price of credit, and the proposed guidance does not prescribe a method for determining that change. This appendix describes two methods that could be used to determine the change in fair value attributable to a change in an entity's credit standing, excluding the change in the price of credit. The Board requests that constituents review this appendix in considering Questions 32–34 and 36 in the summary.

Method 1

B3. Under Method 1, if there has been no change in an entity's credit rating from the beginning to the end of the period, the entity would assume that there has been no change in fair value for the period attributable to a change in the entity's credit standing, excluding the change in the price of credit. If a financial

liability is not rated, the entity would estimate what the financial liability's rating would have been at the beginning and end of the period based on the basis of market information.

B4. If an entity experiences a credit rating change from one period to another (or estimates that it would have experienced a rating change had it been rated), the entity would measure the change in the fair value of its liabilities attributable to a change in the entity's credit standing, excluding the price of credit, by calculating the difference in the change in the reported fair values of the entity's liabilities (which are based on the entity's actual discount rates and credit ratings at the beginning and end of the period) and estimated changes in its fair value based on measures of what its discount rate would have been at the end of the period without a change in credit rating.

Method 2

B5. Under Method 2, the change in the fair value of the financial liability attributable to a change in the entity's credit standing, excluding a change in the price of credit, would not be based on whether an entity has had a change in credit rating. Instead, an entity would isolate the portion of the fair value changes of its liabilities related to the change in the price of credit and deduct that amount from the overall change in fair value. An entity would estimate the change in the price of credit by looking to entities in the industry with the same credit standing. Those entities may or may not have debt instruments with the same credit rating as the entity for a number of reasons, including delays in changes in credit ratings and the fact that not all debt instruments are rated.

B6. The Example illustrates the application of the methods described above.

Examples

B7. On January 1, 20X1, Entity A issues at par in a private placement a $2 million AA-rated 5-year fixed-rate debt instrument with an annual interest rate of 10 percent, which is 300 basis points above the risk-free interest rate. The average spread for other entities in Entity A's industry with AA-rated debt is also 300 basis points above the risk-free interest rate on January 1, 20X1.

Scenario A

B8. At December 31, 20X1, Entity A still carries an AA credit rating. Market conditions, including the risk-free interest rate, remain unchanged from the issuance date of the debt instrument. However, the average credit spread for other entities in the industry for an AA credit rating has increased by 100 basis points, and Entity A estimates that its credit spread also has increased by 100 basis points. After considering all market conditions, Entity A concludes that if it

was to issue the debt instrument at the measurement date, the debt instrument would bear an interest rate of 11 percent, and Entity A would receive less than par in proceeds from the issuance of the debt instrument.

B9. For the purpose of this Example, the fair value of Entity A's liability is calculated using a present value technique. Entity A believes a market participant would use all of the following inputs in determining the price the market participant would expect to receive to assume Entity A's obligation:

a. Terms of the debt instrument, including all of the following:
    1. Coupon interest rate of 10 percent
    2. Principal amount of $2 million
    3. Term of 4 years.
b. Change in credit spread from the date of issuance of 100 basis points.

B10. Using a present value technique, Entity A concludes that the fair value of its liability at December 31, 20X1, is $1,937,951, a change of $62,049 from January 1, 20X1.

Method 1

B11. Because there has been no change in Entity A's credit rating, under Method 1, none of the $62,049 change in fair value would be considered attributable to a change in the entity's credit standing. All of the change would be attributable to a change in the price of credit.

Method 2

B12. Under Method 2, the change in the fair value of the financial liability attributable to a change in Entity A's credit standing, excluding a change in the price of credit, would not be based on whether Entity A has had a change in its credit rating. Instead, Entity A would estimate the change in the price of credit by looking to entities in its industry with the same credit standing. Those entities may or may not have debt instruments with the same credit rating as Entity A for a number of reasons, including delays in changes in credit ratings and because not all debt instruments are rated. For example, Entity A may estimate that the average discount rate for entities in its industry with the same credit standing is 10.9 percent at period end based on the effective interest rates on recent debt issuances in the industry, which is a 90 basis points increase in the price of credit during the period. Because the fair value of the debt instrument would have been $1,944,037 if the discount rate was 10.9 percent, Entity A would consider $55,963 ($2,000,000 – $1,944,037) of the change in the fair value of its financial liability for the period to be attributable to a change in the price of credit and the remaining $6,086 attributable to a change in the entity's credit standing.

Scenario B

B13. At December 31, 20X1, Entity A now carries a BBB credit rating. Market conditions, including the risk-free interest rate and average credit spreads for the industry for an AA-quality credit rating remain unchanged from the issuance date of the debt instrument. Entity A estimates that its credit spread has increased by 225 basis points (to 525 basis points over the risk-free interest rate) because of its rating downgrade and a change in its risk of nonperformance. The average spread for other entities in Entity A's industry with BBB-rated debt is 500 basis points above the risk-free interest rate on December 31, 20X1, which is consistent with the average credit spreads for the industry on January 1, 20X1. After considering all market conditions, Entity A concludes that if it was to issue the debt instrument at the measurement date, the debt instrument would bear an interest rate of 12.25 percent, and Entity A would receive less than par in proceeds from the issuance of the debt instrument.

B14. For the purpose of this Example, the fair value of Entity A's liability is measured using a present value technique. Using a present value technique, Entity A concludes that the fair value of its liability at December 31, 20X1, is $1,864,036, a decrease of $135,964 from January 1, 20X1.

Method 1

B15. Because there has been a change in Entity A's credit rating, Entity A would calculate the portion of the change in fair value that relates to the change in the entity's credit standing. Entity A would estimate what fair value would have been for the debt instrument had there been no change in its credit rating. Because there have been no changes in market conditions, including the risk-free interest rate and credit spreads for AA-rated instruments, Entity A calculates that the fair value of the debt instrument absent the change in its credit rating would have continued to be $2 million (that is, Entity A believes that its discount rate would have remained at 10 percent if it had not been downgraded). Therefore, the entire change in fair value of $135,964 would be considered attributable to a change in Entity A's credit standing.

Method 2

B16. Under Method 2, the change in the fair value of the debt instrument attributable to a change in Entity A's credit standing, excluding a change in the price of credit, would not be based on whether Entity A has had a change in its credit rating. Instead, Entity A would estimate the change in the price of credit by looking to entities in the industry with the same credit standing. For example, Entity A may estimate that entities in its industry with the same credit standing have experienced on average of 10 basis points increase in the price of credit during the period. Because the fair value of the debt instrument would have been

$1,993,674 if the discount rate changed by 10 basis points, Entity A would consider $6,326 ($2,000,000 – $1,993,674) of the difference to be attributable to a change in the price of credit and the remaining $129,638 attributable to a change in the entity's credit standing.

Scenario C

B17. At December 31, 20X1, Entity A now carries a BBB credit rating. Entity A estimates that its credit spread has deteriorated by 225 basis points (to 525 basis points over the risk-free interest rate) because of its rating downgrade and a change in its risk of nonperformance. Credit spreads for the industry for an AA-quality credit rating have increased from the issuance date of the debt instrument. However, the risk-free interest rate has not changed. The average spread for other entities in Entity A's industry with AA-rated debt is 350 basis points above the risk-free interest rate on December 31, 20X1. The average spread for other entities in Entity A's industry with BBB-rated debt is 500 basis points above the risk-free interest rate on December 31, 20X1, compared with average credit spreads for the industry on January 1, 20X1, of 400 basis points over the risk-free interest rate. After considering all market conditions, Entity A concludes that if it was to issue the debt instrument at the measurement date, the debt instrument would bear an interest rate of 12.25 percent, and Entity A would receive less than par in proceeds from the issuance of the debt instrument.

B18. For the purpose of this Example, the fair value of Entity A's liability is measured using a present value technique. Using a present value technique, Entity A concludes that the fair value of its liability at December 31, 20X1, is $1,864,036, a decrease of $135,964 from January 1, 20X1.

Method 1

B19. Because there has been a change in Entity A's credit rating, Entity A would calculate the portion of the change in fair value that relates to the change in its credit standing. Entity A would estimate what fair value would have been for the debt instrument had there been no change in its credit rating. Entity A calculates that the fair value of the debt instrument without the change in credit rating would have been $1,968,641, based on an interest rate of 10.5 percent (risk-free interest rate of 7 percent plus 350 basis point spread for other entities in the industry with AA-rated debt), which is a change of $31,359 from January 1, 20X1. Therefore, $104,605 ($135,964 – $31,359) of the change in fair value of the debt instrument would be considered attributable to a change in Entity A's credit standing.

Method 2

B20. Under Method 2, the change in the fair value of the debt instrument attributable to a change in Entity A's credit standing, excluding a change in the price of credit, would not be based on whether Entity A has had a change in credit rating. Instead, Entity A would estimate the change in the price of credit by looking to entities in the industry with the same credit standing. For example, Entity A may estimate that entities in its industry with the same credit standing have experienced an average of 60 basis points increase in the price of credit during the period. Because the fair value of the debt instrument would have been $1,962,450 if the discount rate changed by 60 basis points, Entity A would consider $37,550 ($2,000,000 – $1,962,450) of the difference to be attributable to a change in the price of credit and the remaining $98,414 attributable to a change in the entity's credit standing.

Appendix C: Summary of Proposed Amendments to the *FASB Accounting Standards Codification*™

C1. The proposed guidance section of this proposed Update describes the accounting, hedging, presentation, and disclosure requirements that would result from the related amendments to the Accounting Standards Codification. The Board expects to issue the proposed amendments to the Accounting Standards Codification during the comment period, which ends on September 30, 2010.

C2. The Board recognizes that the proposed guidance would have a pervasive effect on the existing accounting guidance for financial instruments in the Accounting Standards Codification. The table below is designed to provide an indication of the effect of the proposed guidance on relevant areas of the Accounting Standards Codification. The table is based on a preliminary assessment of the necessary updates to the Accounting Standards Codification. It presents only the significant changes to the Accounting Standards Codification that are expected to arise from the proposed guidance and is not intended to be a comprehensive list of updates to the Accounting Standards Codification. Certain Subtopics that are not expected to be substantively affected are noted in the table to provide that information to constituents. The Board expects to issue an updated version of this table when it issues the proposed amendments to the Accounting Standards Codification.

Codification Subtopic	**Action**	**Nature of Changes**
210-10 Balance Sheet—Overall	Amended	• The proposed guidance would amend this Subtopic to reflect the proposed requirement to separately present amounts included in accumulated other comprehensive income (and allocated to noncontrolling interests, if applicable) related to the qualifying changes in fair value or qualifying changes in the remeasurement amount for financial instruments for which those changes are recognized in other comprehensive income.

Codification Subtopic	Action	Nature of Changes
310-10 Receivables—Overall	Amended	• The proposed guidance would substantively change the initial measurement and subsequent measurement guidance. • The proposed guidance would replace the impairment guidance contained in the general Subsection of this Subtopic. Some guidance related to the measurement of impairment on individually assessed loans would be incorporated into the new credit impairment model. • The practical expedient for measuring impairment based on the fair value of the collateral for collateral-dependent loans would be incorporated into the new credit impairment model and would be broadened to apply to any collateral-dependent financial asset. • The guidance related to the recognition of fees and interest discussed in the Acquisition, Development and Construction Arrangements Subsection would be amended. • Certain disclosure requirements from this Subtopic would remain. • Disclosures from the project on the credit quality of financing receivables and the allowance for credit losses would be included in this Subtopic and would be carried forward for financial assets for which qualifying changes in fair value are recognized in other comprehensive income.
310-20 Receivables—Nonrefundable Fees and Other Costs	Amended	• The guidance related to fees, costs, and estimating principal prepayments would be applicable to financial assets in the scope of this Subtopic that have qualifying changes in fair value recognized in other comprehensive income. • The guidance for commitment fees recognized over the commitment period on a straightline basis related

Codification Subtopic	Action	Nature of Changes
		to loan commitments for which the entity's experience with similar arrangements indicates that the likelihood that the commitment will be exercised is remote would be amended such that the commitment fee would be recognized as part of the fair value change of the commitment. • The subsequent measurement guidance related to a purchase of a loan or group of loans would be amended such that the difference between the initial investment and the cash flows expected to be collected (rather than the principal amount) would be recognized as an adjustment of yield. • The option to recognize yield for loans with variable interest rates based on the index or rate in effect at the inception of the loan would be eliminated. • The proposed guidance would necessitate other conforming changes to this Subtopic to reflect the proposed recognition guidance, including the proposed interest income recognition guidance.
310-30 Receivables—Loans and Debt Securities Acquired with Deteriorated Credit Quality	Amended	• The guidance in this Subtopic, other than disclosures, would be superseded by the new credit impairment model. This includes guidance from Accounting Standards Update 2010-18, *Receivables (Topic 310): Effect of a Loan Modification When the Loan Is Part of a Pool That Is Accounted for as a Single Asset.* (However, the new credit impairment model would permit aggregation of individually impaired loans for measurement of impairment based on a present value method and would not require that a loan that is modified or restructured be removed from such a pool.)

Codification Subtopic	Action	Nature of Changes
		• The disclosure requirements in this Subtopic would be modified and carried forward for financial assets purchased at an amount that includes a discount related to credit quality for which qualifying changes in fair value are recognized in other comprehensive income.
310-40 Receivables—Troubled Debt Restructurings by Creditors	Amended	• The guidance related to impairment and the effective interest rate would be incorporated into the proposed credit impairment model. • The proposed guidance indicates that if a loan included in a pool of financial assets for which impairment is determined based on a historical loss rate (adjusted for existing conditions) is restructured in a troubled debt restructuring, the loan would be removed from the pool and the amount of impairment would be measured on an individual asset basis.
320-10 Investments—Debt and Equity Securities—Overall	Amended	• The proposed guidance would supersede the classification and measurement guidance in this Subtopic. • The impairment guidance in this Subtopic would be superseded. • The guidance on the calculation of interest income on certain structured notes would be eliminated. • The proposed guidance would preserve the guidance for recognizing the entire change in fair value of foreign-currency-denominated debt securities in other comprehensive income and would extend that approach to all financial instruments for which qualifying changes in fair value would be recognized in other comprehensive income. However, unlike existing guidance, which requires an entity holding a foreign-

Codification Subtopic	Action	Nature of Changes
		currency denominated available-for-sale security to consider changes in foreign exchange rates since acquisition in determining whether an other-than-temporary impairment has occurred, a change in foreign exchange rates would not result in a credit impairment under the proposed guidance.
323-10 Investments—Equity Method and Joint Ventures—Overall	Amended	• The proposed guidance would change the criteria for an unconsolidated investment in an equity security to qualify to be accounted for under the equity method. • The accounting for equity method investments would not change.
323-30 Investments—Equity Method and Joint Ventures—Partnerships, Joint Ventures, and Limited Liability Entities	Amended	• The guidance in this Subtopic would be amended to reflect proposed changes to Subtopic 323-10.
325-20 Investments—Other—Cost Method Investments	Superseded	• The guidance in this Subtopic would be superseded.
325-30 Investments—Other—Investments in Insurance Contracts	Amended	• The proposed guidance would amend the guidance in the Life Settlement Contract Subsections to eliminate the investment method. Such contracts would be within the scope of the proposed guidance.
325-40 Investments—Other—Beneficial Interests in Securitized Financial Assets	Superseded	• The guidance in this Subtopic would be superseded.

Codification Subtopic	**Action**	**Nature of Changes**
340-30 Other Assets and Deferred Costs—Insurance Contracts that Do Not Transfer Insurance Risk	Amended	• Contracts within the scope of the deposit method of accounting would be within the scope of the proposed guidance.
460-10 Guarantees—Overall	Amended	• Guarantees not explicitly excluded from the scope of the proposed guidance would be subject to the proposed guidance. • Guarantees that are explicitly excluded from the scope of the proposed guidance would continue to follow the guidance in Subtopic 460-10 and Topic 944. • Disclosure requirements in this Subtopic would continue to apply.
470-10 Debt—Overall	Amended	• The proposed guidance would amend this Subtopic to indicate that issued debt would subsequently be measured at fair value, unless an entity is able to elect the amortized cost option. • Other guidance in this Subtopic would remain.
470-20 Debt—Debt with Conversion and Other Options	Amended	• If a financial instrument with an equity component and a debt component requires separation under the guidance in this Subtopic, the liability component would be within the scope of the proposed guidance.
470-30 Debt—Participating Mortgage Loans	Amended	• The proposed guidance would affect the accounting for the liability.
470-60 Debt—Troubled Debt Restructurings by Debtors	Amended	• For a liability that is reported at fair value (whether the changes in its fair value are recognized in net income or the qualifying portion of the changes in its fair value recognized in other comprehensive income), the debtor's accounting for a modification of terms

Codification Subtopic	Action	Nature of Changes
		would be superseded. For a liability that is reported at amortized cost, the debtor's accounting for a modification of terms would not change.
480-10 Distinguishing Liabilities from Equity—Overall	Amended	• The guidance in this Subtopic related to forward contracts that require physical settlement by repurchase of a fixed number of the issuer's equity shares in exchange for cash would not be changed by the proposed guidance. • The measurement guidance for other financial instruments in this Subtopic would be affected by the proposed guidance.
805-30 Business Combinations—Goodwill or Gain from Bargain Purchase, Including Consideration Transferred	Amended	• The proposed guidance would amend this Subtopic to indicate that contingent consideration arrangements based on an observable market or observable index would be within the scope of the proposed guidance.
815-10 Derivatives and Hedging—Overall	Amended	• This Subtopic would be substantially unchanged. All freestanding derivative financial instruments, while also in the scope of the proposed guidance, would continue to be measured at fair value with changes in fair value recognized in net income, with the exception of derivatives designated and effective as cash flow hedges and hedges of a net investment in a foreign operation. • Derivative instruments that are not financial instruments would continue to be included in the scope of Subtopic 815-10. • All loan commitments would be excluded from the scope of Subtopic 815-10 because they would be subject to the scope of the proposed guidance.

Codification Subtopic	Action	Nature of Changes
		• The guidance in the Certain Contracts on Debt and Equity Securities Subsections would be amended to reflect the new classification model.
815-15 Derivatives and Hedging—Embedded Derivatives	Amended	• Hybrid financial instruments in the scope of Subtopic 815-15 would be included in the scope of the proposed guidance. Such hybrids would no longer be bifurcated into a host contract and an embedded derivative feature. • If a hybrid financial instrument with a host contract that is a financial instrument would be required by the guidance in Subtopic 815-15 to be accounted for separately, the proposed guidance would require that the hybrid be measured at fair value in its entirety with changes in fair value recognized in net income. If a hybrid financial instrument would not be required by the guidance in Subtopic 815-15 to be accounted for separately, the proposed guidance would require the hybrid to be measured at fair value in its entirety with qualifying changes in fair value permitted to be recognized in other comprehensive income. • Hybrid financial instruments with a host that would not be within the scope of the proposed guidance (for example, a lease host or an insurance host) or a hybrid instrument with a nonfinancial host contract would continue to be bifurcated if required by the guidance in this Subtopic.
815-20 Derivatives and Hedging—Hedging—General	Amended	• This proposed guidance would amend this Subtopic to reflect proposed changes to hedge accounting requirements. • The shortcut method and the critical terms match method would be eliminated.

Codification Subtopic	Action	Nature of Changes
		• The guidance related to hedge effectiveness would be modified to indicate that the hedge must be "reasonably effective" rather than "highly effective."
815-25 Derivatives and Hedging—Fair Value Hedges	Amended	• The proposed guidance would amend this Subtopic to reflect proposed changes to hedge accounting requirements. • The change in fair value of the hedged item related to the hedged risk would continue to be recognized in earnings (net income) and would be included in the carrying amount of the hedged item (regardless of whether the carrying amount is based on amortized cost or fair value). The guidance related to the interaction between impairment and hedge accounting would be modified to reflect changes to the impairment model.
815-30 Derivatives and Hedging—Cash Flow Hedges	Amended	• The proposed guidance would amend this Subtopic to reflect changes to cash flow hedge accounting. • The guidance in this Subtopic would be amended to reflect the requirement that ineffectiveness from both underhedges and overhedges should be included in net income.
815-35 Derivatives and Hedging—Net Investment Hedges	Substantially unchanged	• The substance of the guidance in this Subtopic would not be changed.
815-40 Derivatives and Hedging—Contracts in an Entity's Own Equity	Substantially unchanged	• The substance of the guidance in this Subtopic would not be changed. • Financial instruments in the scope of this Subtopic that are classified as assets and liabilities would be within the scope of the proposed guidance and would be measured at fair value

Codification Subtopic	**Action**	**Nature of Changes**
		with changes in value recognized in net income, in accordance with the guidance in the Subsequent Measurement Section of this Subtopic.
815-45 Derivatives and Hedging—Weather Derivatives	Unchanged	• The substance of the guidance in this Subtopic would not be changed.
825 Financial Instruments	New guidance to be added	• This Topic would contain the majority of the proposed guidance related to classification, initial measurement, subsequent measurement, impairment, presentation, and incremental disclosures for financial instruments in the scope of the proposed guidance.
825-10 Financial Instruments—Overall	Amended	• The proposed guidance would establish fair value with all changes in fair value recognized in net income as the default classification and measurement category for financial instruments. Therefore, the fair value option would not be needed for financial instruments within the scope of the proposed guidance. The fair value option guidance would be eliminated for equity method investments and amended to apply only to certain other instruments. • The disclosures related to the fair value of financial instruments would be deleted. • The disclosures related to concentration of credit risk would not be changed. • The disclosures related to market risk would not be changed.
825-20 Financial Instruments—Registration Payment Arrangements	Unchanged	• The substance of the guidance in this Subtopic would not be changed.

Codification Subtopic	Action	Nature of Changes
835-30 Interest—Imputation of Interest	Amended	• The guidance in this Subtopic would be amended to be consistent with the guidance on initial measurement in the proposed guidance.
860-20 Transfers and Servicing—Sales of Financial Assets	Amended	• The proposed guidance would supersede the guidance in Section 860-20-35 related to the subsequent measurement of financial assets subject to prepayment.
940-320 Financial Services—Broker and Dealers—Investments—Debt and Equity Securities	Unchanged	• The guidance in this Subtopic would not be changed.
940-325 Financial Services—Broker and Dealers—Investments—Other	Unchanged	• The guidance in this Subtopic would not be changed.
940-405 Financial Services—Broker and Dealers—Liabilities	Amended	• The proposed guidance would amend this Subtopic to indicate that a broker and dealer in securities should report financial liabilities at fair value.
942-310 Financial Services—Depository and Lending—Receivables	Amended	• The proposed guidance would supersede the guidance related to impairment in this Subtopic.
942-320 Financial Services—Depository and Lending—Investments—Debt and Equity Securities	Amended	• The guidance related to level of disaggregation for disclosures would be retained. • The implementation guidance related to a financial institution's ability to hold mortgage securities to maturity would be superseded.
942-325 Financial Services—Depository and Lending—Investments—Other	Amended	• The proposed guidance would supersede guidance related to Federal Home Loan Bank or Federal Reserve Bank Stock and National

Codification Subtopic	Action	Nature of Changes
		Credit Union Share Insurance Fund deposits. Those instruments would apply the proposed measurement guidance related to investments that can be redeemed only for a specified amount. • The guidance for regular-way purchases and sales securities would not be affected.
942-405 Financial Services—Depository and Lending—Liabilities	Amended	• The proposed guidance would amend this Subtopic to reflect the guidance related to core and noncore deposit liabilities.
942-470 Financial Services—Depository and Lending—Debt	Amended	• The proposed guidance would amend the Disclosure of the Fair Value of Core Deposit Liabilities Section of this Subtopic. Core deposit liabilities would now be accounted for under the remeasurement approach.
942-825 Financial Services—Depository and Lending—Financial Instruments	Amended	• The proposed guidance would change the accounting for written loan commitments, standby letters of credit, and financial guarantees that are in the scope of the proposed guidance that are not currently in the scope of Subtopic 815-10 by requiring fair value measurement. Therefore, the disclosure requirements in this Subtopic would be affected.
944-310 Financial Services—Insurance—Receivables	Unchanged	• The guidance related to financial guarantee insurance contracts would not be affected. Those contracts would be excluded from the scope of the proposed guidance.
944-320 Financial Services—Insurance—Investments—Debt and Equity Securities	Unchanged	• The guidance in this Subtopic would not be changed.

Codification Subtopic	Action	Nature of Changes
944-325 Financial Services—Insurance—Investments—Other	Amended	• The proposed guidance would supersede guidance related to equity investments.
944-815 Financial Services—Insurance—Derivatives and Hedging	Amended	• The implementation guidance on cash flow hedges would be amended to reflect changes to hedge effectiveness.
944-825 Financial Services—Insurance—Financial Instruments	Amended	• The proposed guidance would amend this Subtopic to indicate that investment contracts would be included within the scope of the proposed guidance.
946-320 Financial Services—Investment Companies—Investments—Debt and Equity Securities	Amended	• The proposed guidance would amend this Subtopic to require that financial assets and financial liabilities of investment companies initially be measured at fair value.
946-323 Financial Services—Investment Companies—Investments—Equity Method and Joint Ventures	Amended	• The guidance in this Subtopic would be amended to reflect proposed changes to Subtopic 323-10.
946-405 Financial Services—Investment Companies—Liabilities	Amended	• The proposed guidance would amend this Subtopic to require that financial liabilities of investment companies initially and subsequently be measured at fair value.
948-310 Financial Services—Mortgage Banking—Receivables	Amended	• The proposed guidance would supersede the guidance in this Subtopic related to measurement of mortgage loans and loan impairment and would amend the guidance related to fee recognition.

Codification Subtopic	Action	Nature of Changes
954 Health Care Entities (various Subtopics)	Amended	• A health care entity that reports a performance indicator would report in the performance indicator the amounts that a business entity would report in net income. The amounts a business entity would report in other comprehensive income should be reported outside the performance indicator. • An entity that does not report a performance indicator would report the total change in fair value of a financial instrument as a change in the appropriate net asset class in its statement of activities.
958 Not-for-Profit Entities (various Subtopics)	Amended	• The proposed guidance would amend the initial measurement guidance for a not-for-profit entity. • The proposed guidance would amend these Subtopics to reflect the proposed requirement to measure hybrid financial instruments with embedded derivatives at fair value in their entirety.