In Focus

MAY 2010

Proposed Accounting Standards Update: *Financial Instruments*

The global economic crisis has highlighted the ongoing concern that the current accounting model for financial instruments is inadequate for today's complex economic environment. The objective of a final new accounting standard is to provide financial statement users a more timely, transparent, and representative depiction of an entity's exposure to risk from financial instruments based on how they are utilized in an entity's business model.

Today, there also is arguably too high a threshold before an entity is required to record credit impairments resulting in a delayed recognition of losses, while complex hedging requirements produce reported results that lack transparency and consistency.

Current accounting rules allow different accounting treatment for similar financial instruments. If adopted, this proposal would require the presentation of both amortized cost and fair value on the balance sheet and statement of comprehensive income for certain financial instruments held for collection—or payment of principal and interest. (This dual presentation is a way to smooth the transition from old practices to new and better ones.) In the segment of the proposal addressing comprehensive income, an entity would be required to report total comprehensive income and its components in two parts—net income and other comprehensive income—in a continuous statement of financial performance.

By requiring companies to report this way, they would no longer have the option to only display the components of other comprehensive income in the notes to the financial statements or in the statement of changes in equity. This proposal wouldn't affect how earnings per share are calculated or reported.

Other Potential Improvements

- Accounting rules would improve the depiction of results of asset liability management activities at financial institutions.
- The timeliness of fair value information would be accelerated.
- The "probable" threshold for recognizing credit losses on loans would be removed, providing more timely credit loss information to financial statement users.

For certain financial assets being held for collection of cash flows, ***both*** *fair value and amortized cost infomation are relevant and will be tranparent on the balance sheet.*

What Is the Expected Impact?

All entities that have financial instruments will be affected. However, the degree of impact will depend on the extent financial instruments play in an entity's operations and financial position. For example, a large bank that presents a large number of financial assets at amortized cost will be the most affected. Non-banks likely will be least impacted.

To address the impact this proposed update will have on the accounting for certain loans and core deposits for smaller/community banks, the Board is permitting a four (4) year deferral beyond the effective date for non-public banks with less than one billion dollars in total consolidated assets. This deferral would apply to nearly 90% of all U.S. banks that hold just 10% of the country's financial assets. Additionally, some financial instruments such as pension obligations and leases are entirely exempt.

Essential Elements

- The accounting would be based on the characteristics of the financial instrument and how assets and liabilities are used in the business.
- Financial assets that have variable cash flows or that are regularly traded would be accounted for at fair value.
- For financial assets which are held for collection of cash, *both* amortized cost and fair value information would be provided in the financial statements.
- Financial liabilities would be accounted for similar to financial assets, reflecting how financial assets and liabilities are managed together.
- A single model for estimating credit losses for all financial instruments would be created, requiring more timely loss recognition.
- Hedge accounting criteria would be simplified, leading to more consistent accounting over reporting periods.

Project Process Stage

This "Exposure Draft" provides a proposal for a new accounting standard in order to obtain feedback from users, preparers, auditors and investors.

Next Steps—The FASB staff will analyze comment letters, hold public roundtable discussions, and obtain other information. The Board then will re-deliberate the proposed provisions with the IASB at public meetings prior to issuing a final Accounting Standards Update.

A complete snapshot of the process timeline for this project is on page 2.

Comment Deadline

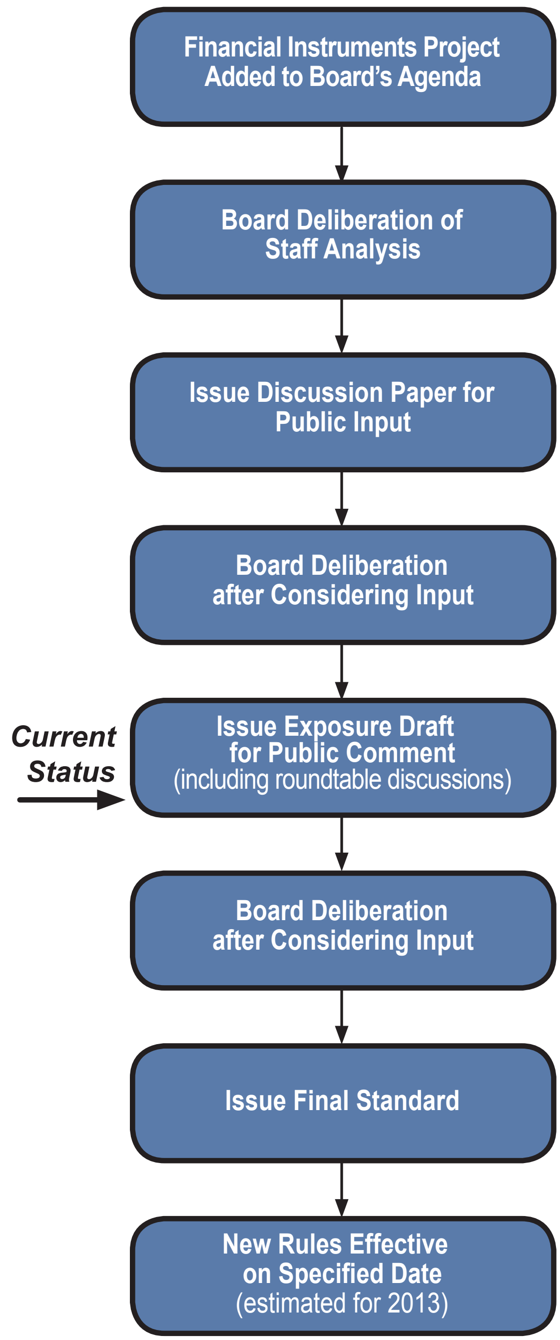
All are encouraged to comment on the proposal through September 30, 2010.

Financial Instruments Proposal

Summary of Changes

	Current approach	Proposed approach
Number of categories and methods to measure	Many categories each with different measurement, presentation, and impairment methods.	Two key categories: • Assets/liabilities traded or with variable cash flows, displayed at fair value with changes in net income. • Assets/liabilities held for collection/payment of principal and interest, present both cost and fair value in balance sheet with changes reported in net income & comprehensive income.
Measurement of losses	Different impairment rules depending on category and instrument type. Tension around probable loss thresholds for impairment.	Only instruments in held for collection/payment category are tested for impairment. No longer have to reach "probable" loss threshold before recording credit impairment.
Hedging activities	Complex quantitative requirements to qualify for hedge accounting.	Less rigorous qualitative assessment, allowing consistent reflection of economic impacts of hedging activities.

Financial Instruments and the FASB Standard-Setting Process



How Loans and Capital Would Look on Balance Sheet

Loans	
Amortized cost	XXX
Allowance for credit losses	(XX)
Residual FV adjustment	(XX)
Fair value	XXX
Capital could be presented as follows	
Common stock	XXX
Retained earnings	XXX
AOCI, excluding fair value changes	XXX
Equity excluding FV changes	YYY
Fair value changes on financial instruments	(XX)
Total comprehensive equity	ZZZ

For more information—and to register for our live webcast on June 30th—visit http://www.fasb.org.

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