Accounting for Financial Instruments
Summary of Decisions Reached to Date During Redeliberations
As of September 7, 2011

The Summary of Decisions Reached to Date is provided for the information and convenience of constituents who want to follow the Board's deliberations. All of the conclusions reported are tentative and may be changed at future Board meetings. Decisions become final only after a formal written ballot to issue a final Accounting Standards Update.

Initial Measurement of Financial Instruments

The initial measurement principle would depend upon the subsequent measurement of a financial instrument. Financial instruments subsequently measured at fair value with all changes in fair value recognized in net income (FV-NI) would be initially measured at fair value. Financial instruments subsequently measured at fair value with fair value changes recognized in other comprehensive income (FV-OCI) or subsequently measured at amortized cost would be initially measured at transaction price.

Entities that follow specialized industry guidance in Topic 946 on investment companies would continue to initially measure their financial instruments at transaction price.

In certain circumstances, an entity would be required to evaluate whether the consideration given or received at recognition for a financial instrument that is not otherwise required to be initially measured at fair value indicates that an element other than the financial instrument is included in the transaction.

Subsequent Measurement of Financial Instruments

The classification and measurement of financial instruments would be based on both the characteristics of the financial instrument and the entity's business strategy for the instrument. The characteristics of the instrument criterion would be similar for both financial assets and financial liabilities, but a different business strategy criterion would apply to financial assets than to financial liabilities.

Characteristics of the Financial Instrument

A financial instrument that does not meet the following criterion would be measured at FV-NI:

It is a *debt instrument* held or issued that has all of the following characteristics:

a. It is not a financial derivative instrument subject to the guidance in Topic 815 on derivatives and hedging.

b. An amount is 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 discount or premium at acquisition.

c. 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.

Trade receivables and payables generally would meet the criterion above. A financial instrument that meets the criterion above then would be classified and measured on the basis of an entity's business strategy.

The classification and measurement of specific types of financial instruments are outlined below.

Derivatives

Derivatives would be measured at FV-NI except derivatives designated as the hedging instrument in a cash flow hedge or a hedge of a net investment in a foreign operation.

Hybrid Financial Instruments

Bifurcation and separate accounting for embedded derivative features in both hybrid financial assets and hybrid financial liabilities would be retained as currently required under Subtopic 815-15 on embedded derivatives. Therefore, bifurcated embedded derivatives would be measured at FV-NI. An entity would apply the classification and measurement model separately to the host contract, which would require classification and measurement based on both the characteristics of the contract and the entity's business strategy for the contract.

From the issuer's perspective, convertible debt instruments that qualify for the exception in paragraph 815-10-15-74(a) and that do not require separation under paragraph 470-20-25-12 would be measured at amortized cost in their entirety. This decision would not affect the classification and measurement of convertible debt instruments that require bifurcation under current U.S. GAAP.

Equity Securities

Equity securities would be measured at FV-NI.

Nonpublic entities would be provided a practicability exception to fair value measurement for investments in nonmarketable equity securities. The practicability exception would permit nonmarketable equity securities to be measured at cost less any impairment plus upward adjustments in fair value when information about a change in price is observable.

A nonpublic entity would use observable price changes in orderly transactions for the identical or a similar financial asset with the same issuer as an input for adjusting the carrying value of a nonmarketable equity security. When information about a change in price is observable, a nonpublic

entity would be required to adjust the carrying value of a nonmarketable equity security upward or downward.

(The Board's decisions on equity securities do not apply to instruments that can only be redeemed for a certain amount or that are measured according to the equity method of accounting.)

An Entity's Business Strategy

Financial Assets

An entity would classify financial assets that meet the characteristics of the financial instrument criterion based on the business activity the entity uses to manage those financial assets rather than on the entity's intent for an individual financial asset. An entity would be permitted to manage identical or similar assets through different business activities. An entity would be required to classify all financial assets into one of three categories as follows:

Amortized Cost Category

The business activity for these financial assets must meet *all* of the following conditions:

1. Financial assets issued or acquired for which an entity's business strategy, at origination or acquisition of the instrument, is to manage the instruments through customer financing or lending activities. These activities primarily focus on the collection of substantially all of the contractual cash flows from the borrower.

2. Financial assets for which the holder of the instrument has the ability to manage credit risk by negotiating any potential adjustment of contractual cash flows with the counterparty in the event of a potential credit loss. Sales or settlements would be limited to circumstances that would minimize losses due to deteriorating credit, or to exit a particular market for risk management purposes.

3. Financial assets that are not held for sale at acquisition.

FV-OCI Category

The business activity for these financial assets must meet *all* of the following conditions:

1. Financial assets issued or acquired in a business activity for which an entity's business strategy, at origination or acquisition of the assets, is to invest the cash of the entity *either* to:

a. Maximize total return by collecting contractual cash flows or selling the asset; *or* to

b. Manage the interest rate or liquidity risk of the entity by either holding or selling the asset.

2. Financial assets that are not held for sale at acquisition or issuance.

FV-NI Category

The business activity for these financial assets must meet *either* of the following conditions:

1. Financial assets that are held for sale at acquisition; *or*

2. Financial assets that are actively managed and monitored internally on a fair value basis and do not qualify for the FV-OCI category.

Financial Assets Subsequently Identified for Sale and Tainting

An entity may have financial assets that qualify for the amortized cost category at initial recognition that it subsequently identifies for sale. In such circumstances, an entity should continue to classify and measure the financial assets at amortized cost (less impairment) and recognize resulting gains, if any, only when the sale is complete. Impairment of a financial asset subsequently identified for sale should be recognized in net income in an amount equal to the entire difference between the asset's amortized cost basis and its fair value.

An entity may anticipate that a portion of a pool of similar financial assets will be sold while the other portion will continue to be managed through its customer financing (lending) activities. However, individual assets that will be subsequently sold are not specifically identified for sale at initial recognition. In these circumstances, an entity must classify and measure all financial assets into one of the three categories according to the defined business activities. An entity would not be prevented from managing the same or similar financial assets through different business activities.

The Board will consider at a future meeting presentation or disclosure alternatives for financial assets originally classified in the category measured at amortized cost that the entity subsequently sells. Such subsequent sales would not taint an entity's financial assets classified at amortized cost.

Recognition of realized gains and losses

For financial assets classified as FV-OCI, realized gains and losses from sales or settlements would be recognized in net income.

Financial Liabilities

An entity would measure financial liabilities that meet the characteristics of the instrument criterion at amortized cost unless *either* of the following conditions is met:

1. Financial liabilities for which an entity's business strategy at acquisition, issuance, or inception, is to subsequently transact at fair value.
2. Financial liabilities that are short sales.

Financial liabilities that meet either of the conditions above would be classified as FV-NI.

In circumstances in which financial assets will be used to settle nonrecourse financial liabilities, an entity should measure the financial liabilities consistently with the measure of the related financial assets, taking into account the same factors in determining each amount. For example, if both the assets and the liabilities are measured at amortized cost and the reported amount of the assets is reduced by a credit impairment, the reported amount of the nonrecourse liabilities should include the same reduction.

Loan Commitments, Revolving Lines of Credit, and Standby Letters of Credit

Loan commitments, revolving lines of credit, and standby letters of credit would not be required to meet the characteristics of the instrument criterion. An entity would classify loan commitments, revolving lines of credit, and standby letters of credit as FV-NI if its business strategy for the underlying loans is to hold them for sale.

For all other loan commitments, revolving lines of credit, and standby letters of credit, an entity would recognize any fees received in accordance with existing guidance in Subtopic 310-20. Under that guidance, if the likelihood is that exercise of the commitment is remote, any commitment fees received would be recognized as fee income over the commitment period. If the likelihood is that exercise is not remote, any commitment fees received would be deferred and recognized over the life of the funded loan as an adjustment of yield.

Reclassifications

An entity would be required to classify its financial instruments upon initial recognition and would not be permitted to subsequently change that decision.

Impairment and Interest Income Recognition

Nonmarketable Equity Securities Accounted for Under the Practicability Exception

For a nonmarketable equity security accounted for under the practicability exception, an entity would apply a single-step approach in which an entity assesses qualitative factors (that is, impairment indicators) to determine whether it is more likely than not the fair value of a nonmarketable equity security is less than its carrying amount (that is, an impairment exists). If an impairment exists, an impairment loss would be recognized in earnings equal to the entire difference between the investment's carrying value and its fair value.

Financial Assets That are Debt Instruments

Impairment for financial assets that are debt instruments would follow a "three-bucket" approach in which an allowance balance is established capturing three different phases of deterioration in credit quality. Generally, the "three-bucket" approach can be described as follows:

Bucket 1: In the context of portfolios, financial assets evaluated individually or collectively for impairment that do not meet the criteria for Bucket 2 or 3 (this would include loans that have suffered changes in credit loss expectations as a result of macroeconomic events that are not specific to either a group of loans or a specific loan).

Bucket 2: Debt instruments affected by the occurrence of events that indicate a direct relationship to possible future defaults, however the specific debt instruments in danger of default have not yet been identified.

Bucket 3: Debt instruments for which information is available that specifically identifies that credit losses are expected to, or have, occurred on individual debt instruments.

The allowance balance for debt instruments in Buckets 2 and 3 would be an estimate of remaining lifetime expected losses.

The approach to classifying and transferring financial assets between the buckets would be based on credit risk management systems, recognizing that credit risk management is a holistic process that includes evaluating all available information.

A "relative credit risk" model would underpin the classification and transfer of financial assets between the three buckets. The overall objective of the "relative credit risk" model is to reflect the deterioration or improvement in the credit quality of financial assets, thus making the maximum use of credit risk management practices. Under this approach, all originated and purchased financial assets would initially start in Bucket 1 and would move into Bucket 2 and Bucket 3 as credit loss expectations deteriorate, affecting the uncertainty in collectability of cash flows.

The Boards also discussed the measurement of expected loss on financial assets in Bucket 1. The Boards agreed to keep the calculation of the impairment allowance for Bucket 1 operationally simple and explore an allowance calculation that would incorporate either 12 or 24 months' worth of expected losses. The calculation of 12 months' worth of expected losses in Bucket 1 would be based on an *annual* rather than an *annualized* loss rate (that is, looking to the losses that are expected to occur in the next 12 months, as opposed to calculating the lifetime losses and dividing by the number of years remaining). The same logic would apply to a calculation based on 24 months.

The Boards will discuss the following at a future meeting:

1. Applying the relative credit risk model to loans acquired at a discount because of credit losses.
2. Approaches to measuring the expected loss on financial assets in Bucket 1that would calculate the allowance using 12 or 24 months' worth of losses expected to occur.

Below is a summary of decisions reached on impairment issues prior to development of the "three-bucket" approach. These issues may be reconsidered by the Boards at future meetings, if deemed necessary.

Uncollectibility

A financial asset is considered uncollectible if the entity has no reasonable expectation of recovery. Therefore, an entity would 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).

A *write-off* would be defined as "a direct reduction of the amortized cost of a financial asset resulting from uncollectibility."

Estimating Expected Losses

An entity should use the best available and supportable information at the date of estimation (historical, current, and forecasted) to estimate expected losses. Expected losses should be estimated with the objective of an expected value. An expected value identifies possible outcomes (or a representative sample of the possible outcomes), estimates the likelihood of each outcome, and calculates a probability-weighted average.

However, other appropriate methods could be used to achieve the objective of an expected value. An example of a suitable method would be a loss rate method and the use of probabilities of default, loss given default, and exposure at default data. In performing this calculation, an entity must not ignore

observations and possibilities that are known. (The Boards directed the staff to draft language that will be transparent to constituents to apply this objective.)

Expected losses should be measured as all shortfalls in cash flows (both principal and interest) on a discounted basis. That is, the measurement of expected losses should reflect the effect of discounting. A variety of techniques can be used to measure the discounted amount and that the unit of account need not be an individual loan.

Unwinding the Discounting of Expected Credit Losses

The effect of unwinding the discounting of expected credit losses should be included in the credit losses line item on the statement of comprehensive income.

(The Board will consider at a later date whether to require disclosure of the effect of unwinding on the allowance for credit losses, after considering any operational issues.)

Interest Income Recognition

Interest income should be determined by applying the effective interest rate to an amortized cost balance that is not reduced for credit impairment.

Purchased Financial Assets

An entity should account for credit impairment of purchased financial assets for which the entity has no explicit expectation of losses at the individual asset level, even when acquired as part of a portfolio, in the same way as for originated financial assets. Interest income for these financial assets would be recognized on the basis of contractual cash flows, thus aligning credit impairment accounting and interest income recognition for originated financial assets and purchased financial assets (those for which the entity has no explicit expectation of losses at the individual asset level at acquisition). (The Boards will determine the appropriate credit impairment accounting model for these financial assets during redeliberations).

For purchased financial assets for which the entity has an explicit expectation of loss at the individual financial asset level (that is, for financial assets that are purchased at a “deep discount”), interest income recognized should be based on expected collectible cash flows estimated at the date of acquisition (that is, the purchase price should be accreted to expected cash flows). A separate credit impairment expense would not be recognized at the date of acquisition as a result of limiting the recognition of interest income for these credit-deteriorated financial assets by basing interest income on expected cash flows as opposed to contractual cash flows,.

(The Boards' decisions are subject to future discussions on related issues, including determining what constitutes a "deep discount" to differentiate purchased portfolios of financial assets.)

Nonaccrual

In light of the decisions reached to date as described in this document, a nonaccrual principle would not be required.

Financial Statement Presentation of Financial Instruments

(Some of the following presentation requirements apply only to public entities. The Board will discuss at a future meeting presentation or disclosure requirements for nonpublic entities.)

Statement of Financial Position

An entity would be required to separately present financial assets and financial liabilities on the statement of financial position by classification and measurement category.

Financial Assets and Financial Liabilities Measured at Amortized Cost

A public entity would be required to present parenthetically on the face of the statement of financial position the fair value, measured consistently with the requirements in Topic 820, for financial assets and financial liabilities, except for demand deposit liabilities, that are measured at amortized cost. A public entity would be required to disclose a present value amount for demand deposit liabilities in the notes to the financial statements.

Receivables and payables due in less than a year would not be subject to the parenthetical disclosure of fair value.

All entities would be required to separately present cumulative credit losses on the face of the statement of financial position.

Financial Liabilities Measured at Fair Value

All entities would be required to present parenthetically on the face of the statement of financial position the amortized cost of an entity's own debt that is measured at fair value.

Statement of Comprehensive Income

Financial Assets

An entity would be required to present in net income an aggregate amount for realized and unrealized gains or losses for financial assets measured at fair value with all changes in fair value included in net income.

An entity would be required to separately present the following items in net income for both financial assets measured at fair value with changes in value recognized in other comprehensive income and financial assets measured at amortized cost:

1. Current-period interest income
2. Current-period credit losses
3. Realized gains and losses

Financial Liabilities

An entity would be required to present in net income an aggregate amount for realized and unrealized gains or losses for financial liabilities measured at fair value with all changes in fair value recognized in net income.

An entity would be required to separately present the following items in net income for financial liabilities measured at amortized cost:

1. Current-period interest expense
2. Realized gains and losses.

An entity would not be required to present the changes in the fair value of financial liabilities attributable to changes in the entity's own credit risk separately from other changes in fair value. (The Board noted that it might revisit this decision if the population of financial liabilities subsequently measured at fair value significantly increases as a result of future redeliberations on the fair value option for financial liabilities.

Fair Value Option for Financial Instruments

An unconditional fair value option would not be provided for either financial assets or financial liabilities. However, an entity would be permitted to measure a group of financial assets and financial liabilities at fair value with changes in fair value recognized in net income if both of the following conditions are met:

1. The entity manages the net exposure relating to those financial assets and financial liabilities (which may be derivative instruments); and
2. The entity provides information on that basis to the reporting entity's management.

An entity would only be permitted to elect that conditional fair value option for a group of financial assets and financial liabilities at recognition, and the election could not subsequently be changed.

An entity also would be able to elect at recognition to apply a conditional fair value option for both hybrid financial assets and hybrid financial liabilities to avoid bifurcation and separate accounting for an embedded derivative feature. An entity would be allowed to measure a hybrid financial asset or financial liability at fair value in its entirety after the entity has determined that an embedded derivative feature that would otherwise require bifurcation and separate accounting exists.

Disclosures

The Board is developing liquidity and interest rate risk disclosures related to an entity's involvement in financial instruments.

Scope

The proposed disclosures about liquidity risk would be required for all entities, but only *financial institutions* would provide disclosures about interest rate risk. *Financial institutions* includes banks, savings and loan associations, savings banks, credit unions, finance companies, and insurance entities as the term is described in paragraph 942-320-50-1 of the *FASB Accounting Standards Codification®*.

The disclosures for *financial institutions* would apply to reportable segments of entities, for example, reportable segments that engage in transactions that involve lending to or financing the activities of others. The term *reportable segment* is described in Section 280-10-50 of the Codification.

Qualitative Disclosures

For interest rate risk and liquidity risk arising from financial instruments, an entity would disclose all of the following:

1. The exposure to risks and how they arise
2. The entity's objectives, policies, and processes for managing the risks and the methods used to measure the risks
3. Any changes in (a) or (b) from the previous period and the reasons for the changes.

Quantitative Disclosures about Liquidity Risk

All entities would provide disclosure about their available liquid funds, which includes unencumbered cash and high-quality liquid assets, and borrowing availability such as lines of credit. This disclosure would include a discussion about the effect of regulatory, tax, legal, and other restrictions that could limit the transferability of funds among entities in the consolidated group, for example, between the parent and its subsidiaries.

Financial institutions would provide a tabular disclosure based on expected maturities of classes of financial assets and financial liabilities. The term *expected maturity* relates to contractual settlement of the instrument, rather than to when the entity expects to sell the instrument. Financial instruments that are measured at fair value with all changes in value included in net income, with the exception of derivatives, would not be placed in maturity buckets and would only show the total carrying amount. The table would include the entity's off-balance-sheet commitments, for example, loan commitments and lines of credit.

Nonfinancial entities would provide a tabular disclosure of their undiscounted cash obligations, including off-balance-sheet obligations.

Quantitative Disclosures about Interest Rate Risk

A financial institution would provide a tabular disclosure about when its classes of financial assets and financial liabilities would reprice (that is, when their interest rate would be reset). The table also would include the weighted-average yield and duration of the classes of financial assets and financial liabilities.

A depository institution would provide a tabular disclosure about its issuance of time deposits during the last four quarters. This disclosure would show the entity's average rate and average life for insured, uninsured, and brokered deposits.

A financial institution would provide a tabular disclosure of the effect of prospective, hypothetical interest rate shifts on the entity's interest-sensitive financial assets and liabilities. The table would present the effects of parallel shifts, flatteners, and steepeners of the yield curve. This disclosure would not incorporate the effects of certain assumptions such as a company's strategy related to assumed growth rate or change in asset mix.

Periods for Which Disclosure Would Be Required

The proposed disclosures would be required for interim and annual reporting periods, except for nonpublic, nonfinancial entities, which would be required to provide the liquidity risk disclosures only for annual reporting periods.

Equity Method of Accounting

Criteria for Application of the Equity Method of Accounting

The proposed Update would have added a "related operations" criterion to the "significant influence" criterion that must be met under current U.S. GAAP to qualify for the equity method of accounting. However, only the "significant influence" criterion will be retained, which leaves the criteria for the equity method of accounting unchanged from current U.S. GAAP.

An entity would be required to classify and measure equity investments that otherwise would qualify for the equity method of accounting at fair value with changes in fair value included in net income if the investment is held for sale. An entity would perform a "held for sale" evaluation upon the investment's initial qualification for the equity method of accounting, and the entity could not subsequently change the classification of the investment. The following indicators would be determinative that an investment is held for sale:

1. The entity has specifically identified potential exit strategies even though it may not yet have determined the specific method of exiting the investment.
2. The entity has defined the time at which it expects to exit the investment, which may be either an expected date or range of dates; a time defined by specific facts and circumstances, such as achieving certain milestones; or the investment objectives of the entity.

Fair Value Option for Equity Method Investments

A fair value option would not be available for equity method investments.

Impairment of Equity Method Investments

An entity would apply a single-step impairment approach for equity method investments in which the entity assesses qualitative factors (that is, impairment indicators) to determine whether an equity method investment is impaired. A single impairment model would be applied to both marketable and nonmarketable equity method investments.

An entity that accounts for an investment under the equity method may not reverse previously recognized impairment losses.

Disclosures of Equity Method Investments

The Board will consider the implications of additional qualitative disclosures about investments accounted for under the equity method at a future meeting.

Hedge Accounting

The Board has not begun redeliberations on hedge accounting. See Proposed *Accounting Standards Update* for a summary of the Board's decisions to date.

In December 2010, the IASB published the Exposure Draft, *Hedge Accounting*. The comment period for the Exposure Draft ended on March 9, 2011. The FASB participated in the IASB's discussion of the feedback that the IASB received on its Exposure Draft and will consider the feedback during its redeliberations.

On February 9, 2011, the FASB issued an Invitation to Comment, *Selected Issues about Hedge Accounting*, to solicit input on the IASB Exposure Draft, in order to improve, simplify, and bring about convergence of the financial reporting requirements for hedging activities. The comment period on the Invitation to Comment ended on April 25, 2011. The FASB has discussed the feedback received on the Invitation to Comment, which it will consider during its redeliberations.