FASB Update
Financial Instruments Project
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These background materials include:

1. A summary of the FASB decisions reached to date (includes decisions reached through August 19, 2009)
2. A comparison of the FASB's Current Guidance and Tentative Approach and the IASB's Current Guidance and Proposed Approach

1. A Summary of FASB Decisions to Date (includes decisions reached through August 19, 2009)

Project Objective

The objective of the project is to significantly improve the decision usefulness of financial instrument reporting for users of financial statements. The goal of the project is to replace the FASB's and IASB's respective financial instruments standards with a common standard. The Boards believe that simplification of the accounting requirements for financial instruments should be an outcome of this improvement. Although the project objective is comprehensive, it is also the Boards' objective that the project should be completed expeditiously.

This project will:

1. Reconsider the recognition and measurement of financial instruments
2. Address issues related to impairment of financial instruments
3. Improve the financial reporting of hedging activities to make the accounting model and associated disclosures easier to understand for users of financial statements as well as simplify and resolve practice issues in accounting for hedging activities

Scope

The scope of the financial instruments project is based on the present definition of a **financial instrument** in the Master Glossary of the FASB Accounting Standards Codification™. That definition is:

> A *financial instrument* is defined as 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 rights or 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

The following financial instruments will be excluded from the scope of the project:

1. Employers' and plans' obligations for pension benefits; other postretirement benefits, including health care and life insurance benefits, postemployment benefits, employee stock option and stock purchase plans; and other forms of deferred compensation arrangements as defined in the following:

   a. Topic 715 on compensation (originally issued as FASB Statement No. 43, *Accounting for Compensated Absences*, and APB Opinion No. 12, *Omnibus Opinion—1967)*

b. Topic 712 on nonretirement postemployment benefits (originally issued as FASB Statement No. 112, *Employers' Accounting for Postemployment Benefits)*
c. Topic 715 on compensation for retirement benefits (originally issued as FASB Statements No. 87, *Employers' Accounting for Pensions,* and No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions)*
d. Topic 960 on plan accounting for defined benefit pension plans (originally issued as FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans)*
e. Topic 718 on shared-based payment (originally issued as FASB Statement No. 123 (revised 2004), *Share-Based Payment).*

2. Contracts within the scope of Topic 944 on insurance (originally issued as FASB Statements No. 60, *Accounting and Reporting by Insurance Enterprises*, No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts,* and No. 163, *Accounting for Financial Guarantee Insurance Contracts*), except for deposit-type and investment contracts issued by insurance entities as defined in that Topic.

3. Noncontrolling interests in consolidated subsidiaries

4. Equity investments in consolidated subsidiaries

5. Equity instruments issued by the entity and classified in stockholders' equity, in their entirety, in the statement of financial position. (Financial instruments with equity-like features that are classified as liabilities under U.S. generally accepted accounting principles would be subject to the Board's proposal. The scope also would not apply to equity components of hybrid financial instruments that require bifurcation.)

6. An interest in a variable interest entity that the entity is required to consolidate.

7. Lease assets and liabilities that are accounted for under Topic 840 on leases (originally issued as FASB Statement No.13, *Accounting for Leases*).

Classification and Measurement

The default method is to account for all financial instruments at fair value in the statement of financial position with all changes in fair value recognized in net income. An entity is eligible to account for financial instruments at amortized cost with an adjustment to fair value on face of the statement of financial position if the following criterion is met.

If an entity's business strategy is to hold debt instruments with principal amounts for collection or payment(s) of contractual cash flows rather than to sell or settle the financial instruments with a third party, certain changes in fair value for those instruments may be recognized in other comprehensive income with other changes recognized in net income.

For hybrid financial instruments containing embedded derivatives that do not meet the clearly-and-closely related criterion and require separate accounting under Topic 815(originally issued as FASB Statement No.133, *Accounting for derivative Instruments and Hedging Activities*), the entire hybrid financial instrument would be accounted for at fair value in the statement of financial position with all changes in fair value recognized in net income. For hybrid financial instruments containing embedded derivatives that meet the clearly-and-closely-related criterion under Topic 815 and the entity's business strategy is to hold the instruments for collection or payment(s) of contractual cash flows rather than to sell or settle the financial instruments with a third party, the entire hybrid financial instrument would be accounted for at amortized cost with adjustment to fair value in the statement of financial position with certain changes in fair value recognized in other comprehensive income and other changes recognized in net income.

If eligible, the amount of the change in fair value that is permitted to be recognized in other comprehensive income equals the total change in fair value less current period interest accruals and, if applicable, the current portion of the change in value attributable to credit losses on financial assets (measured based on a future Board future decision). Both the current period interest accrual and the current portion of the change in credit losses on financial assets would be recognized in net income. In addition, any realized gains or losses from sales or settlements of those instruments would be recognized in net income.

In complying with the criterion permitting recognition of certain fair value changes in other comprehensive income, an entity's business strategy for a financial instrument would be evaluated based on how the entity manages its financial instruments rather than based on the entity's intent for an individual financial instrument. To be eligible for this treatment, the entity also would be required to demonstrate that it holds a high proportion of similar instruments for long periods of time relative to their contractual terms.

The decision whether instruments would be accounted for (1) at fair value with changes in fair value recognized in net income only or (2) at amortized with adjustment to fair value with changes in fair value recognized in both net income and other comprehensive income would be made at the initial recognition of the instrument and could not be changed subsequently.

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An entity also may elect to measure its own debt at amortized cost only if (1) the entity's business strategy is to hold the financial liability for payment(s) of contractual cash flows rather than to sell or settle the financial liability with a third party and (2) by measuring the financial liability at fair value the entity would create a measurement attribute mismatch.

Presentation

Entities would be required to present one statement of financial performance containing a total for comprehensive income and a subtotal for net income as part of the basic financial statements at each reporting period. Entities would continue to report only basic and diluted earnings per share based on net income.

Financial instruments with changes in fair value recognized in net income only would be displayed separately on the face of the statement of financial position from financial instruments with changes in fair value reported in both net income and other comprehensive income.

Financial Instruments with Changes in Fair Value Recognized in Net Income Only

An entity would be required to present on the face of the statement of financial position the fair value amount of financial instruments whose changes in fair value are recognized in net income only. For these instruments, the entity also would be required to present the amortized cost of its own debt on the face of the statement of financial position. However, an entity that so chooses also may present, either in the statement of financial position or in the notes to the financial statements, both the amortized cost and the amount needed to adjust the amortized cost to arrive at fair value for financial instruments whose changes in fair value are recognized in net income only.

For financial instruments whose changes in fair value are recognized in net income only, an entity would be required, at a minimum, to present separately on the face of the statement of financial performance the aggregate amount representing the realized and unrealized gains or losses on financial instruments. An entity that so chooses also may present current period interest income/expense accruals, dividend income/expense accruals, or credit losses on financial assets as separate line items in the statement of financial performance but separate presentation of those items would not be required for financial instruments whose changes in fair value are recognized in net income only.

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Financial Instruments with Changes in Fair Value Recognized in Both Net Income and Other Comprehensive Income

For financial instruments whose changes in fair value are recognized in net income and other comprehensive income, an entity would be required to present separately the following line items in the statement of financial position: amortized cost, the amount needed to adjust amortized cost to arrive at fair value and the fair value amount.

For financial assets whose changes in fair value are recognized in net income and other comprehensive income, an entity also would be required to present a separate line item for cumulative credit losses (measured based on a future Board decision) on the face of the statement of financial position. Therefore, for these financial assets, an entity would be required to separately present the amortized cost, cumulative credit losses, remaining fair value adjustment, and fair value on the face of the statement of financial position.

An entity would be required, at minimum, to present separately in net income current period interest income/expense accruals, credit losses (for financial assets and based on the Board's future decision on impairment), and total realized gains or losses on sale or settlement of these financial instruments.

An entity would not be required to present foreign currency transaction gains or losses on a financial instrument denominated in a foreign currency as a separate line item in net income in the statement of financial performance. Those changes in fair value would continue to be presented in other comprehensive income together with other changes in fair value of financial instruments whose changes in fair value are recognized in other comprehensive income.

Financial Instruments for Which the Amortized Cost Option Is Elected

For an entity's own debt for which the amortized cost option is elected, the entity would be required to present separately in the performance statement both the current period interest accruals and realized gains or losses.

Improvements to Decision Makers of Capital Providers

The Board believes the approach presented provides the most useful information to enable investors, creditors, and other users to assess the consequences of an entity's investment and financing strategies, that is, to assess its performance. In addition, information about how an entity manages its financial instruments is provided to help investors and other users evaluate how and when cash flows are expected to be realized.

Next Steps

The FASB expects to issue one Exposure Draft that addresses the measurement, classification, and impairment of financial instruments, as well as hedge accounting, by the end of this year or early 2010. The Board considered approaching the project in several phases and issuing multiple exposure documents. However, the Board believes that these issues are interrelated and that its comprehensive approach will result in requirements that are more coherent making it easier for constituents to react to and understand. For example, the Board is considering various impairment models and the possibility of selecting one of those impairment models for all financial instruments. The Board's decision on impairment depends on the overall classification and measurement model for financial instruments as the classification and measurement model will influence the relevance and cost/benefit of each impairment model. The Board also must consider overlapping issues with respect to hedge accounting. In addition, a comprehensive approach to accounting for financial instruments also may also reduce the possibility of entities having to change their accounting policies and systems on several occasions.

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2. A comparison of the FASB's Current Guidance and Tentative Approach and the IASB's Current Guidance and Proposed Approach

Comparison between current US GAAP and the FASB's tentative approach		
	Current US GAAP	**Proposed US GAAP**
At fair value through net income (NI)		
• Based on terms	• Derivative instruments including bifurcated embedded derivatives	• Equity instruments • Derivatives • Hybrid financial instruments containing embedded derivatives that do not meet the clearly-and-closely related criterion and require separate accounting
• Based on business model	• Instruments classified as trading securities (FAS 115)	• Required for instruments that do not meet the fair value through NI and OCI criterion

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Comparison between current US GAAP and the FASB's tentative approach		
	Current US GAAP	**Proposed US GAAP**
• Based on designation	• Fair value option under various literature	N/A
At amortized cost	• Instruments classified as held-to-maturity securities (FAS 115) • Loans and other receivables	• Own debt by designation, meets the criteria for fair value through NI and OCI, and creates a measurement attribute mismatch
At fair value through NI and OCI – recycling of realized gains and losses, recognition of interest and impairment to profit or loss	• Instruments classified as available-for-sale (FAS 115)	• If an entity's business strategy is to hold debt instruments with principal amounts for collection or payment(s) of contractual cash flows rather than to sell or settle the financial instruments with a third party, certain changes in fair value for those instruments may be recognized in OCI; other changes recognized in NI

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Comparison between current US GAAP and the FASB's tentative approach		
	Current US GAAP	**Proposed US GAAP**
At fair value through NI and OCI – No recycling	N/A	N/A
Measurement exemptions	• Loans held for sale are measured at the lower of cost or fair value	• Exemption for own debt (see above)

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Comparison between current US GAAP and the FASB's tentative approach		
	Current US GAAP	**Proposed US GAAP**
Impairment	• Different models for different instruments: o Loans (FAS 114) - 3 options: ▪ Present value of expected future cash flows discounted at the loan's effective interest rate ▪ Compare to observable market price ▪ Fair value of collateral if loan is collateral dependent o Held-to-maturity or available-for-sale securities: ▪ Difference between fair value and cost ▪ Credit losses presented in NI and non-credit losses presented in OCI for other-than-temporarily impaired debt instruments an entity does not intend to sell or more likely than not will not be required to sell before recovery of its amortized cost basis	• The Board is considering selecting a single model for applicable financial assets qualifying for fair value through NI and OCI

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Comparison between current US GAAP and the FASB's tentative approach		
	Current US GAAP	**Proposed US GAAP**
Other		
"Tainting" provision	• Yes (held-to-maturity securities)	• No
Reclassifications	• Permitted or required under specified circumstances	• Not permitted

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Comparison between IAS 39 and the proposals set out in ED *Financial Instruments: Classification and Measurement*		
	IAS 39	**IASB proposals in ED**
At fair value through net income		
• Based on terms	• Derivatives including separated embedded derivatives	• Instruments that do <u>not</u> have *basic loan features*, except for equity instruments designated at fair value through OCI (see below)
• Based on business model	• Instruments that are held for trading	• Instruments that are <u>not</u> *managed on a contractual yield basis*, except for equity instruments designated at fair value through OCI (see below)
• Based on designation	• *Fair value option* if one of three criteria is met (paragraphs 9 and 11A of IAS 39)	• *Fair value option* to reduce an accounting mismatch

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Comparison between IAS 39 and the proposals set out in ED *Financial Instruments: Classification and Measurement*		
	IAS 39	**IASB proposals in ED**
At amortized cost	• Instrument must have fixed or determinable payments and not be traded in an active market (*loans and receivables*) • If traded in active market, entity must have intent and ability to hold to maturity (*held to maturity*)	• Instrument must have *basic loan features* <u>and</u> must be *managed on a contractual yield basis*
At fair value through NI and OCI – recycling of realized gains and losses, recognition of interest and impairment to profit or loss	• Instruments classified as *available for sale* (default category if none of the other categories applies)	N/A
At fair value through NI and OCI – No recycling	N/A	Equity instruments by designation (described in Topic 3)

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Comparison between IAS 39 and the proposals set out in ED *Financial Instruments: Classification and Measurement*		
	IAS 39	**IASB proposals in ED**
Measurement exemptions	• Unquoted equity instruments where fair value cannot be determined reliably (and physically settled derivatives thereon) are measured at cost less impairment	N/A
Impairment	• Incurred loss model: o Held to maturity/loans and receivables: ▪ impairment loss based on estimated future cash flows ▪ reversals required o Available for sale (debt instruments): ▪ impairment loss based on fair value ▪ reversals required o Available for sale (equity instruments): ▪ impairment loss based on fair value ▪ reversals prohibited	• Single incurred loss model[1] o Impairment loss based on estimated future cash flows o Reversals required applies to all financial assets measured at amortized cost.

[1] The Board intends to deliberate an expected cash flow approach to impairment to replace the current methodology – an exposure draft is expected to be published in Q4 2009

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Comparison between IAS 39 and the proposals set out in ED *Financial Instruments: Classification and Measurement*		
	IAS 39	**IASB proposals in ED**
Other		
"Tainting" provision	• Yes (held to maturity investments)	• No (but separate presentation is required of gains or losses on derecognition of items measured at amortized cost)
Reclassifications	• Permitted or required under rare circumstances	• Not permitted