Accounting for Financial Instruments

Overview of FASB Exposure Draft

June 17, 2010

IASB Education Session

Organization of Topics

- Objective and Overview
- Classification & Measurement
- Presentation
- Credit Impairment
- Interest Income Recognition
- Revisions to Hedge Accounting
- Effective Date and Transition

Objective and Overview of FASB Financial Instruments Model

- The objective of the model is to provide information about (1) how an entity operates its business (business model) and (2) the risks inherent in the financial instruments the entity uses in operating its business.
- Financial instruments that have variable cash flows or that are regularly traded are accounted for at fair value with changes in fair value recognized in net income.
- For financial instruments for which it is an entity's business strategy to collect or pay the related cash flows information is provided about both the entity's business model (amortized cost) and the risks inherent in the instruments (fair value) in both the balance sheet and the performance statement.

Objective and Overview of FASB Financial Instruments Model

- From the balance sheet perspective an entity will present the amortized cost balance of the instrument, cumulative credit impairments, and the fair value of the instrument. The balance sheet will total to fair value as the Board believes the fair value attribute provides more relevant information than amortized cost.
- Given that fair value is the more predominant measurement attribute in this model equity needs to total to fair value. As a result, from the performance statement perspective the entity will recognize in net income current period interest accruals and for financial assets an amount attributable to management's expectation of credit losses.
- OCI is then generally used for items in which management expects the changes in fair value to reverse as the instruments are held for collection or payment of cash flows. OCI is also used for changes in fair value attributable to the market's estimate of credit losses on financial assets that are in excess of management's estimates.

Objective and Overview of FASB Financial Instruments Model

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- Financial liabilities 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, enabling more timely loss recognition
- Hedge accounting criteria will be simplified, leading to more consistent accounting over reporting periods

Scope and Scope Exceptions

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All financial instruments (as defined) are included in the scope of this project except:

- Employee benefits including pensions, share-based payments and other compensation contracts
- Insurance contracts
- Lease contracts
- Equity investments in consolidated subsidiaries
- Variable interest entities
- Noncontrolling interests in consolidated entities
- Certain financial guarantees
- Contingent consideration arrangements not based on an observable market
- Certain financial instruments excluded from the scope of Topic 815

Proposed Classification and Measurement Model

- Most financial instruments would be measured on the balance sheet at fair value with either:
  - All changes in fair value recognized in net income (FV-NI), or
  - Qualifying changes recognized in other comprehensive income (FV-OCI)
- Limited amortized cost option for certain financial liabilities
- Certain short-term receivables and payables at amortized cost
- Remeasurement approach for core deposit liabilities
- Redemption value (*limited application*)
- No reclassifications allowed

Initial Measurement

- An entity shall initially measure a financial instrument based on its subsequent measurement classification
  - At fair value if FV-NI
  - At the transaction price if FV-OCI, unless reliable evidence indicates that the transaction price differs significantly from the fair value
  - At the transaction price if it is a financial liability measured at amortized cost or a core deposit liability measured using the remeasurement approach

Subsequent Measurement: FV-NI Category

- Fair value with all changes in fair value recognized in net income (FV-NI) → Default
- Financial instruments required to be classified as FV-NI:
  - Trading instruments
  - Derivatives
  - Equity securities
  - Hybrid instruments containing embedded derivatives that would otherwise require bifurcation and separate accounting

Subsequent Measurement: FV-OCI Category

- An entity is eligible to measure a financial instrument at fair value with certain changes in fair value recognized in other comprehensive income (FV-OCI category) if:
  - It is a debt instrument with a principal amount that will be returned at maturity or other settlement; and
  - The entity's business strategy is to hold these debt instruments for collection or payment of contractual cash flows rather than to sell or settle with a third party
    - Instrument cannot be contractually prepaid such that the holder would not recover substantially all of its recorded investment
    - Based on how the entity manages financial instruments as a group rather than intent for an individual financial instrument
    - Must demonstrate that it holds instruments for a significant portion of their contractual terms

Subsequent Measurement: FV-OCI Category

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- Examples of financial instruments that could qualify for FV-OCI:
  - Loans
  - Debt securities
  - Certain beneficial interests
- Instruments in the FV-OCI category will be subject to a credit impairment model

Hybrid Financial Instruments

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- Hybrid financial instruments containing embedded derivative features that are not clearly-and-closely related to the host contract and meet the bifurcation criteria in Topic 815 would be entirely in the FV-NI category (no bifurcation)
- Hybrid financial instruments containing embedded derivative features that would not require separate accounting under current Topic 815 could be classified as FV-OCI if the instrument meets the other FV-OCI criteria
- Hybrid instruments with non-financial hosts and hosts excluded from the scope of the Exposure Draft would continue to follow current guidance related to bifurcation

Example A – Callable or Puttable Debt

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- Assume an interest-bearing debt instrument was issued at par and is either prepayable (callable) by the debtor at par or puttable by the creditor at par
- *Analysis*: The ability to accelerate the payment or collection of principal through exercise of the respective contractual call or put option would not prevent the business strategy criterion from being met
- *Conclusion*: May be eligible for FV-OCI

Example B – Commodity-Indexed Bonds

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- Assume the issuance of 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
- *Analysis*: The embedded derivative feature related to the indexing of the principal to be paid at maturity is not clearly and closely related to the related debt host contract.
- *Conclusion*: Not eligible for FV-OCI

Example C – Securitized Financial Assets

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- Assume a securitization structure that holds interest-bearing bonds and has issued a credit default swap (CDS) on unrelated bonds then issues several tranches of beneficial interests.
- *Analysis*: The BI's embedded derivative feature related to the CDS is not clearly and closely related to the debt host contract.
- *Conclusion*: Investments in the BIs not eligible for FV-OCI.

Example D – Convertible Debt

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- Assume a fixed-rate bond that is convertible into equity instruments of the issuer
- *Analysis*:
  - Holder's perspective – the embedded derivative (the conversion option) is not clearly and closely related to the debt host contract.
  - Issuer's perspective – principal will not be returned to the creditor (investor) at maturity or other settlement when the convertible debt is settled by the investor's exercise of the conversion option
- *Conclusion*: Not eligible for FV-OCI for both the issuer and holder

Amortized Cost

- An entity may subsequently measure at amortized cost a financial liability that meets both of the following criteria:
  - It qualifies for the FV-OCI category
  - Measuring it at fair value would create or exacerbate a measurement attribute mismatch of recognized assets and liabilities
- An entity may also measure at amortized cost 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 for the FV-OCI classification

Core Deposit Liabilities

- Deposits without a contractual maturity that management considers to be a stable source of funds (excludes transient and surge balances)
- Present value of average “core” deposit liability
- Discount at the rate differential between the rate charged for the next best alternative source of funding and the all-in-cost-to-service rate over the implied maturity
- “Current” value information for core deposits provided in order to better align the accounting for core deposits with the accounting for loans and other financial assets for which the deposits are a primary funding source

Redemption Value

- An entity may subsequently measure an investment that has all of the following characteristics at its redemption value:
  - It is not held for capital appreciation but rather to obtain other benefits, such as access to liquidity or assistance with operations
  - It must be held for the holder to engage in transactions or participate in activities with the issuing entity
  - It cannot be redeemed for an amount greater than the entity's initial investment
  - It has no readily determinable fair value because ownership is restricted and it lacks a market
  - An example is stock in the Federal Reserve Banks that a financial institution must hold as a condition of membership in the system.

Balance Sheet Presentation

- Present only fair value for instruments in the FV-NI category; also amortized cost for entity's own debt.
- Financial assets within FV-OCI category would be presented as follows:

Cost/Amortized Cost	XXX
Cumulative credit losses	(XX)
Residual FV Adjustment	(XX)
Fair Value	XXX

- Financial liabilities within the FV-OCI category would be presented as follows:

Amortized Cost	XXX
FV Adjustment	(XX)
Fair Value	XXX

  - Accumulated other comprehensive income for financial instruments presented separately.

Performance Statement Presentation

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- Continuous statement of comprehensive income
  - Subtotal for net income with total comprehensive income
  - EPS based on net income only
- Net income components unchanged:
  - Interest and dividend accruals
  - Credit impairments for financial assets
  - Realized gains & losses on sales or settlements
  - Components must be presented separately for FV-OCI instruments
- Recognized in other comprehensive income:
  - Remainder fair value change for FV-OCI instruments
  - Cumulative translation adjustment
  - Change in an entity's own credit standing, excluding changes in the price of credit, presented separately for FV-NI and FV-OCI liability instruments

Credit Impairment

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- A single credit impairment model for all financial instruments in the FV-OCI category.
- For financial instruments classified in the FV-OCI category, an entity would be required to determine if recognition of a credit impairment is required at the end of each reporting period.
- An entity would recognize a credit impairment in net income when it does not expect to collect either all contractual amounts due for originated financial assets or all originally expected amounts to be collected for purchased financial assets.
  - No "probable" threshold for recognizing a credit impairment

Credit Impairment

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- The estimate of cash flows not expected to be collected based on all available information relating to past events, current conditions, and their implications that are relevant to the collectibility of the financial asset. An entity would not consider forecasts of possible future conditions
- Financial assets can be evaluated on an individual or pool basis.

Interest Income

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- The amount of interest income to be recognized in net income for FV-OCI financial assets would be determined by applying the financial asset's effective interest rate to the amortized cost balance net of any allowance for credit losses.
- The difference between the amount of the interest received and the amount of interest income accrued shall be recorded as an increase in the allowance for credit losses.

Hedge Accounting

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- Bifurcation by risk allowed for financial items
  - In fair value hedges of an FV-OCI hedged item, the change in its fair value attributable to the hedged risk would be recognized in net income (rather than OCI)
- No change to types of items, transactions, and risks eligible for hedge accounting
- Only qualitative assessments at inception required; reassess only if circumstances suggest a change
- Effectiveness threshold modified from highly effective to reasonably effective for all FV and CF hedges
- Elimination of shortcut method and the critical-terms-match method

Hedge Accounting

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- For cash flow hedges, ineffectiveness will be recognized for both overhedges and underhedges (and not just for underhedges)
- Dedesignation only if criteria for hedge accounting not met or hedging instrument expired, sold, terminated, or exercised (Dedesignation will not be elective.)

Equity Method Investments

- An investor shall apply the equity method of accounting only if both of the following are met:
  – 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
- Fair value option eliminated for equity method investments.

Fair Value Option

- Proposal would eliminate the need for a fair value option for financial instruments within the scope of the proposal.
- The fair value option would remain for instruments outside the scope of the proposal.

Effective Date

- Effective date will be established during redeliberations (not before 2013)
- Four year deferral for nonpublic entities with under $1 billion in total consolidated assets from the following aspects of proposal:
  - Loans and loan commitments in the FV-OCI category (fair value of loans disclosed in the notes)
  - Core deposit liabilities in the OCI category

Transition

- 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.

Future Activities

- Proposed amendments to the Codification to be issued end of July 2010
- Webcast
- Field visits and roundtables
- Investor outreach
- Comment letter process, including the Board’s redeliberations
- Final Update in 1st half 2011