Summary of FASB's Tentative Classification and Measurement Model for Financial Instruments

June 14, 2011 FASB/IASB Joint Meeting

Agenda Paper 6

Agenda

- Introduction
- Initial measurement
- Summary of subsequent measurement
- Characteristics of the instrument criterion
- Financial Assets: Subsequent classification and measurement
- Financial Liabilities: Subsequent classification and measurement
- Fair value option
- Topics yet to be discussed
- Questions & Answers
- Comparison to the Exposure Draft

Introduction

- Feedback received through about 2,800 comment letters, 5 roundtables, numerous outreach meetings, and field visits
- Majority of feedback indicated:
  - Amortized cost measurement for loans held for collection, core deposits, and other liabilities
  - Preparers – 3 distinct business activities
  - Users – debt securities at fair value
  - Private company concerns

Initial Measurement

- Initial measurement depends upon the subsequent measurement of the instrument
  – FV-NI instruments initially measured at fair value
  – FV-OCI and amortized cost instruments initially measured at the transaction price
- Principle for evaluating if consideration given includes an element other than the financial instrument
  – Similar to principle in IFRS 9 added by IFRS 13
- Investment companies initially measure at transaction price (no change to current U.S. GAAP)

Summary of Subsequent Measurement

- Classification and measurement based on:
  - Characteristics of the instrument
  - An entity's business strategy
- If a financial instrument does not meet the characteristics of the instrument criterion, it would be measured at FV-NI
- Business strategy criterion for financial assets leads to three categories:
  - FV-NI
  - FV-OCI
  - Amortized cost
- Financial liabilities generally at amortized cost
- Hybrid financial instruments analyzed for potential bifurcation and separate accounting of embedded derivative features
- No reclassifications

Characteristics of the Instrument Criterion

- A **debt instrument** with the following characteristics could qualify for a category other than FV-NI:
  - Not a financial derivative instrument subject to Topic 815.
  - 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.
  - 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.

Characteristics of the Instrument Criterion: Application

- Trade receivables and payables would generally meet the criteria
- Derivatives measured at FV-NI (including bifurcated embedded derivatives)
- Equity securities measured at FV-NI
  - Practicability exception for nonmarketable equities held by nonpublic entities

Practicability Exception for Nonmarketable Equity Securities

- Available to nonpublic entities
- Measure at cost less impairment plus upward and downward adjustments in fair value when a change in price is observable
  - Observable price changes in orderly transactions for **identical or similar** assets by the **same issuer**
- Single step impairment approach
  - Qualitative impairment indicators
  - "More likely than not" the fair value of the asset is less than the carrying amount
  - If impaired, recognize in net income the difference between fair value and the carrying amount

Financial Assets:
Subsequent classification and measurement

Categories	Business Strategy Criterion
Amortized cost	Must meet *all* of the following: • Manage through customer financing or lending activities with a primary focus on collection of substantially all contractual cash flows • Holder has 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 limited to circumstances that would minimize losses due to deteriorating credit. • Not held for sale
FV-OCI	Must meet *all* of the following: • Investing *either to:* a. Maximize total return by collecting contractual cash flows or selling b. Manage the interest rate or liquidity risk of the entity by holding or selling • Not held for sale
FV-NI	Must meet *either* of the following: • Held for sale • Actively managed and monitored internally on a fair value basis but do not qualify for the FV-OCI category

Financial Assets:
Subsequent classification and measurement

- Business strategy assessment
  - Based on business activities for managing financial assets rather than intent
  - Assessment would not be at the individual asset level but instead at a higher level within the organization
  - An entity would not be prevented from managing the same or similar financial assets through different business activities
- No tainting
  - Impairment of a financial asset subsequently identified for sale equal to entire difference between amortized cost basis and fair value
- Realized gains and losses recycled to net income for FV-OCI financial assets

Financial Liabilities:
Subsequent classification and measurement

- Amortized cost measurement
  - Must meet the characteristics of the instrument criterion
- FV-NI is required when:
  - Financial liabilities are short sales
  - Financial liabilities are held for transfer at inception and the holder has the ability and means to transact at fair value
- Financial assets used to settle non-recourse financial liabilities:
  - Measure those financial liabilities in accordance with the measurement of the associated financial assets

Fair Value Option

- No fair value option for financial assets
- Conditional fair value option for hybrid financial liabilities
  - If embedded derivative feature identified that would otherwise require bifurcation and separate accounting

Topics yet to be discussed

- Recognition and calculation of fair value changes related to own credit
- Presentation
- Disclosures
  - Risk disclosures being developed
- Loan commitments
- Instruments that can only be redeemed for a certain amount
- Scope
- Effective date and transition

Questions and Answers

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Comparison to the Exposure Draft

	FASB Exposure Draft	FASB Tentative Model
Initial Measurement	FV-NI → Fair value Others → Transaction price	No significant changes
Characteristics of the Instrument Criterion	Based on type of instrument and cash flow characteristics	No significant changes
Business Strategy Criterion	Intent Based	Business Activity Based
Categories for Financial Assets	Two categories (FV-NI and FV-OCI)	Three categories (FV-NI, FV-OCI, and Amortized Cost)
Categories for Financial Liabilities	Three categories (FV-NI, FV-OCI, Amortized Cost)	Two categories (FV-NI, Amortized Cost)
Core Deposit Liabilities	"Remeasurement" Approach	Amortized Cost
Equities	FV-NI	FV-NI Practicability exception added
Hybrid Financial Instruments	Bifurcation of embedded derivatives eliminated	Bifurcation of embedded derivatives retained
Tainting & Reclassifications	No	No