



FASB Exposure Draft

Proposed Accounting Standards Update

Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities

Kai Haussmann

Public Discussion

Frankfurt, 05.07.2010



Table of content

1. Background
2. Scope
3. Classification and Measurement
4. Presentation
5. Impairment
6. Disclosures
7. Hedge Accounting
8. Reclassification
9. Effective Date
10. Key differences between FASB and IASB approaches



1. Background (I)

FASB-DP „*Reducing Complexity in Reporting Financial Instruments*“

- simultaneous and (nearly) congruent with the IASB-DP
- Published 28.03.2008
- Comment deadline 19.09.2008

FASB-ED „*Accounting for Hedging Activities*“

- Published 06.06.2008
- Comment deadline 15.08.2008



1. Background (II)

FASB Exposure Draft

- Published on 26 May 2010
- Open for comment until 30 September 2010
- Objectives of the Exposure Draft:
 - Improve accounting for financial instruments
 - Bring more transparency
 - Reduce complexity
 - Provide financial statement users with a more timely and representative depiction of an entity's involvement in financial instruments



1. Background (III)

Main content / focus of the FASB-ED

- New classification and measurement (Fair Value vs. Amortized Cost)
 - New impairment rules
 - Simplifications for hedge accounting
- Changes in regard of Topic 815 (=Derivatives/Hedging) and TOPIC 825 (=FI)

Structure of the FASB-ED (see also next slide)

- Requirements/main text, IG (incl. examples), BC, Comparison with IASB's model
- 71 questions for constituents to comment on

FASB's project approach

- New requirements for financial instrument accounting in one package
- Proposals detached from the IASB and its three-phase project
- FASB' proposals not congruent with IASB's proposed model

2. Scope – Content of the ED

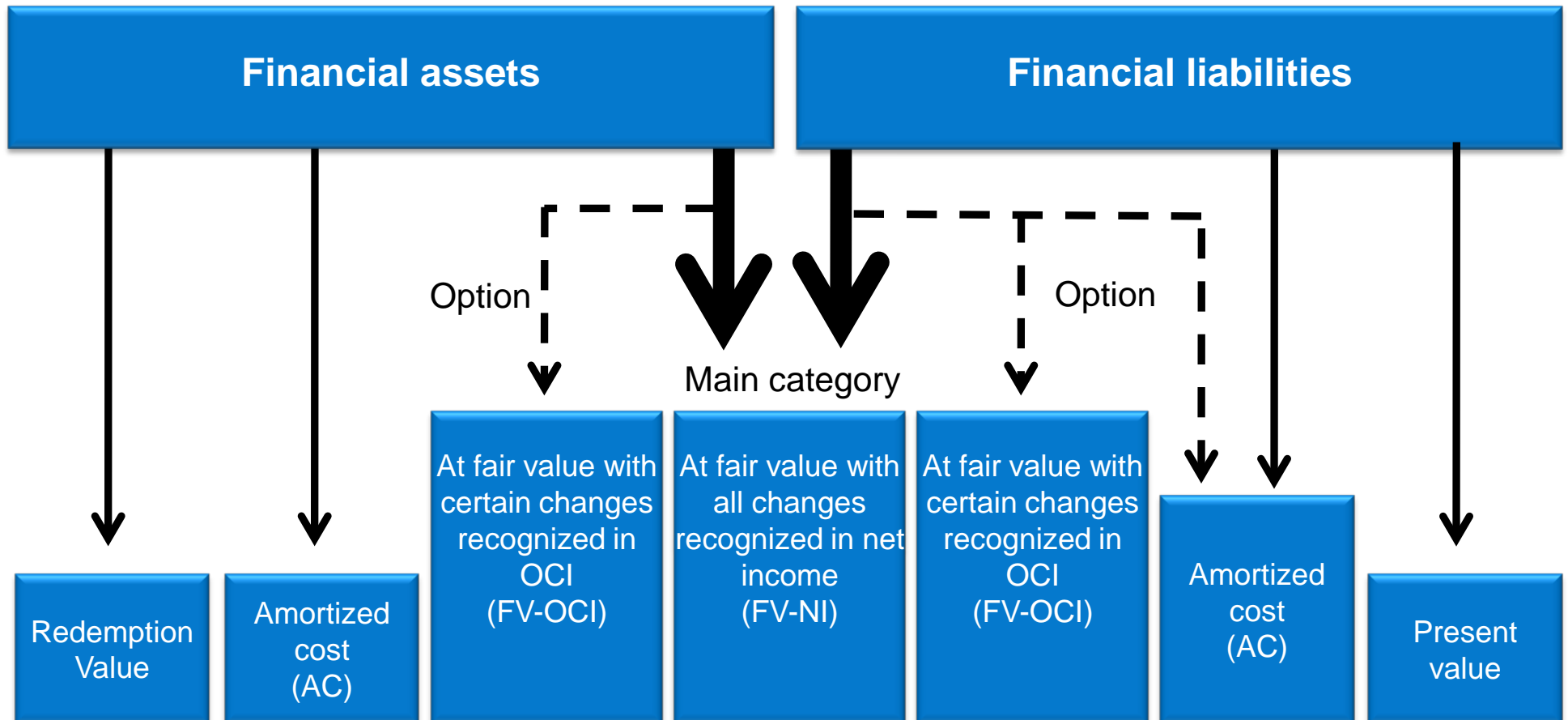
Topic	Para. in the main text	... in the IG	... in the BC
Introduction	1	1	1-16
Objective	2	---	---
Scope	3-5	2-6	17-43
Glossary	6-9	---	---
Recognition	10-11	---	---
Initial Measurement	12-18	7-24	44-52
Subsequent Measurement	19-35	25-106	53-166
Impairment	36-74	107-168	167-199
Interest Income Recognition	75-82	107-168	200-208
Other Presentation Matters	83-96	---	---
Disclosures	97-109	169-171	209-211
Derivatives and Hedging	110-128	172-181	212-235
Equity Method	129-132	---	---
Effective Date / Transition	133-140	---	236-243
Alternative Views	---	---	244-252



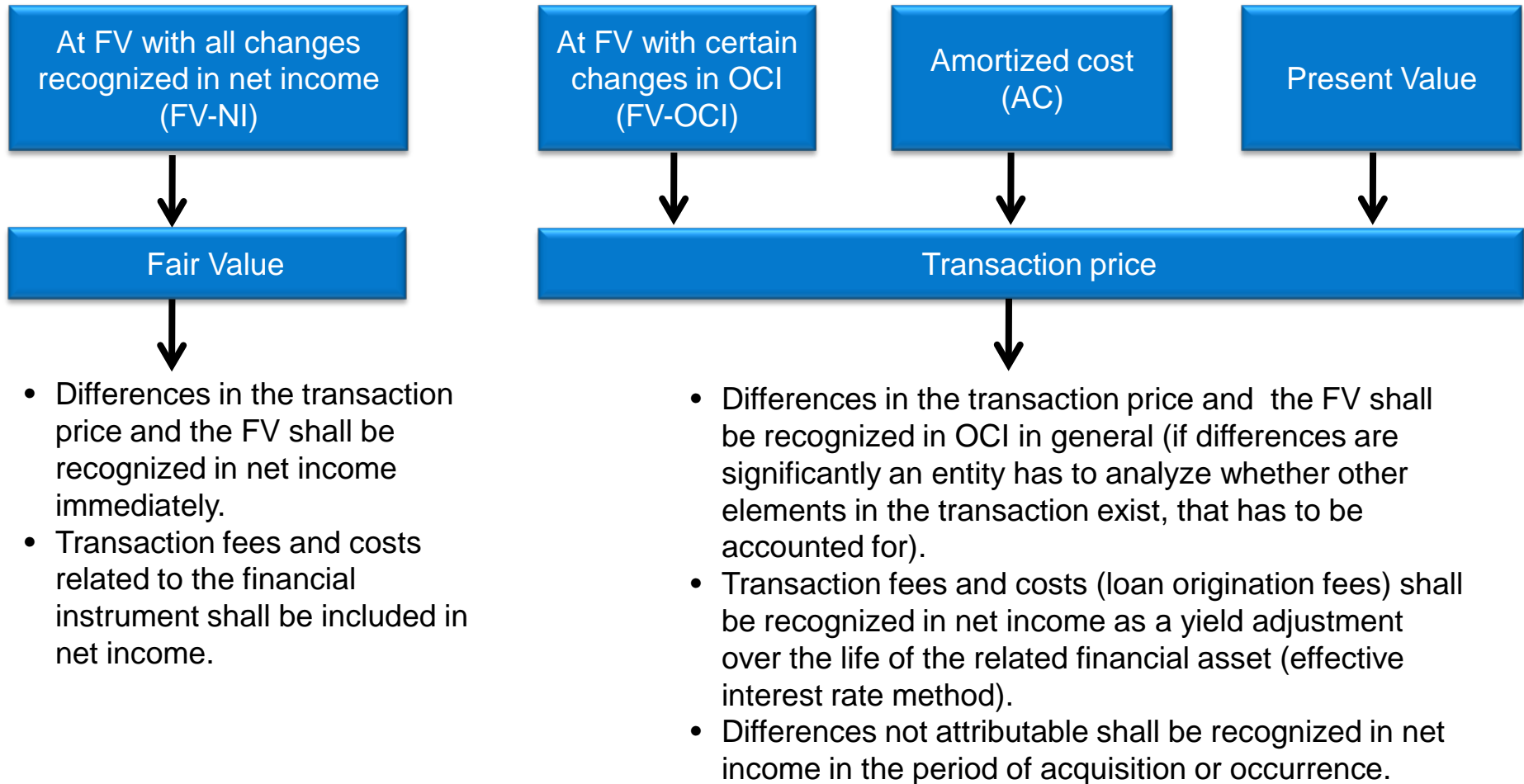
2. Scope

- All financial instruments (as defined) are included in the scope of this standard
- Certain exceptions, for example:
 - Employee benefits including pensions, share-based payments and other compensation contracts
 - Insurance contracts
 - An investment in the equity instruments of another company that qualifies for use of the equity method
 - Lease contracts
 - Certain financial guarantees
- Separate guidance for investment companies and broker/dealer in securities

3. Classification and Measurement - Overview



3. Classification and Measurement – Initial Measurement





3. Classification and Measurement – Categorization (I a)

At fair value with all changes recognized in net income (FV-NI)

- All financial instruments that have variable cash flows or that are regularly traded, in particular
 - Equity securities
 - Derivatives
 - Trading
 - Some hybrid instruments
- Default category for any other instrument, for which possible options are not used



3. Classification and Measurement – Categorization (I b)

At fair value with all changes recognized in net income (FV-NI)

- Presentation in the statement of financial position:
 - The fair value of the instrument
 - The amortized cost of the entity's own outstanding debt instruments
- Presentation in the statement of comprehensive income:
 - At a minimum, an entity shall separately present within net income on the face of the statement of comprehensive income one aggregate amount for realized and unrealized gains or losses on these financial instruments



3. Classification and Measurement – Categorization (II a)

At fair value with certain changes recognized in OCI (FV-OCI)

- Option to classify debt instruments held or issued in FV-OCI category if
 - the instrument has all of the following characteristics:
 - Principal amount will be returned at maturity or other settlement (including adjustments by any original issue discount or premium)
 - Contractual terms identify any additional contractual cash flows to be paid either periodically or at the end of the instrument's term
 - Instrument cannot contractually be prepaid or otherwise settled in such a way that the investor would not recover substantially all of its initial investment
 - the entity's business strategy is to hold these instruments for collection or payment of contractual cash flows rather than to sell or settle with a third party, and
 - It is not a hybrid instrument for which current guidance would have required the embedded derivative to be accounted for separately from the host.
- Decision to use the option to be made irrevocably on initial recognition



3. Classification and Measurement – Categorization (II b)

At fair value with certain changes recognized in OCI (FV-OCI)

- Presentation in the statement of financial position:

Financial assets

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

Financial liabilities

Amortized Cost	XXX
<u>FV Adjustment</u>	<u>(XX)</u>
Fair Value	XXX



3. Classification and Measurement – Categorization (II) c

At fair value with certain changes recognized in OCI (FV-OCI)

- Presentation in the statement of comprehensive income:
 - Net income
 - Current-period income and expense, including amortization (accretion) of premium (discount) recognized upon acquisition (effective interest rate method)
 - Credit impairment got the current period on financial assets
 - Fair value changes due to hedged risks
 - Realized gains or losses on sales or settlements (by means of an offsetting entry to OCI if prior periods' unrealized gains or losses on the instrument were recognized in OCI - recycling)
 - Other comprehensive income
 - Residual changes in the fair value of the instrument
 - Cumulative translation adjustment



3. Classification and Measurement - Categorization (III a)

Amortized cost (AC)

- Option to classify a financial liability in the AC category, if:
 - it qualifies for the FV-OCI category **and**
 - measuring it at fair value would create or exacerbate a measurement attribute mismatch, but only if at least one of the following criteria apply:
 - a) the financial liability is contractually linked to an asset not measured at fair value, or
 - b) the financial liability is part of an operating segment for which less than 50% of the segment's recognized assets are subsequently measured at fair value, or
 - c) the financial liability meets neither item a) nor b) but is the liability of a consolidated entity for which less than 50% of consolidated recognized assets are subsequently measured at fair value.
- Decision to use the option to be made irrevocably on initial recognition



3. Classification and Measurement – Categorization (III b)

Amortized Cost (AC)

- Presentation in the statement of financial position :
 - Amortized cost

- Presentation in the statement of comprehensive income:
 - Current-period expense, including amortization (accretion) of premium (discount) recognized upon acquisition (effective interest rate method)
 - Realized gains or losses on settlement of the liabilities



3. Classification and Measurement - Categorization (IV)

Short-term receivables and payables (AC)

- Option to measure receivables and payables at their amortized cost, if:
 - they arise in the normal course of business and are due in customary terms not exceeding one year **and**
 - they also qualify for the FV-OCI category.
- The exception for short-term receivables and payables is not applicable to short-term lending arrangements, such as
 - Credit card receivables or
 - Investments in short-term debt securities



3. Classification and Measurement - Categorization (V a)

Core deposit liabilities (Present Value)

- *core deposits* = deposits without a contractual maturity that management considers to be a stable source of funds, which excludes transient and surge balances
- Core deposit liabilities shall be measured at their present value
- Determining the present value:
 - the average core deposit amount during the period,
 - discounted at the difference between the alternative funds rate and the all-in-cost-to-service rate over the implied maturity of the deposits



3. Classification and Measurement – Categorization (V b)

Core deposit liabilities (Present Value)

- Presentation in the statement of financial position:
 - The amortized cost of the deposits (amount due on demand)
 - The amount needed to adjust amortized cost to the present value
 - The amount of the deposits determined using the core deposit liabilities remeasurement approach
- Presentation in the statement of other comprehensive income:
 - Option to present changes in the remeasured amount of its core deposit liabilities in OCI) except for the portion presenting current-period interest expense (⇒ net income) **and** the deposits qualify for the FV-OCI category or instead to present those changes in net income separately, at a minimum, an aggregate amount for realized and unrealized gains or losses on the core deposit liabilities

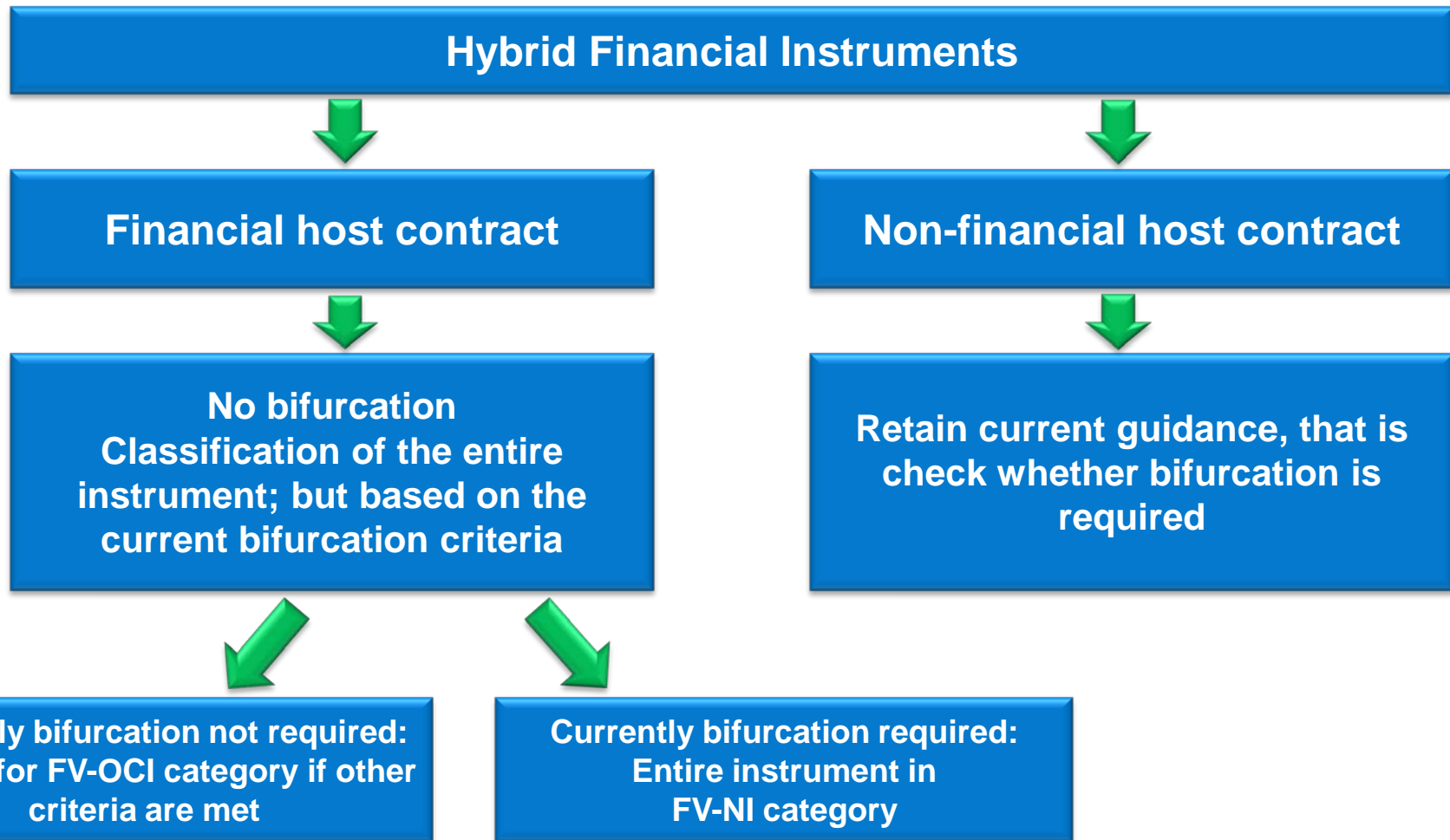


3. Classification and Measurement - Categorization (VI)

Particular types of investments (Redemption Value)

- Particular types of investments are not held for capital appreciation and can be redeemed with the issuer only for a specified amount. An entity shall subsequently measure an investment that has all of the following characteristics at its redemption value:
 - It has no readily determinable fair value because ownership is restricted and it lacks a market
 - It cannot be redeemed for an amount greater than the entity's initial investment
 - 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
- Examples of such investments are the stock in the Federal Reserve Banks, the stock in the Federal Home Loan Bank or investments in certain agricultural cooperatives

3. Classification and Measurement – Categorization (VII)





3. Classification and Measurement – Categorization (VIII)

Equity-Method Investments

- An investor shall apply the equity method of accounting only if both of the following criteria are met:
 - The investor has significant influence over the investee as described in Topic 323
 - The operations of the investee are considered related to the investor's consolidated operations
- Fair value option eliminated for equity method investments

3. Classification and Measurement – Summary (I)

Financial assets				
Type of instrument	Basically all FI	Debt instruments	Short-term receivables	Particular types of investments
Criteria to be met	none (=default category)	<ul style="list-style-type: none"> • Cash flow characteristics • Business strategy 	<ul style="list-style-type: none"> • Short-term • Cash flow characteristics • Business strategy 	To be redeemed to the issuer only
Option or mandatory	Basically mandatory	Option	Option	Option
	FV-NI	FV-OCI	AC	Redemption Value

3. Classification and Measurement - Summary (II)

Financial liabilities					
Type of instrument	Basically all FI	(issued) Debt instruments	(issued) Debt instruments	Short-term payables	Core deposit liabilities
Criteria to be met	None (=default category)	<ul style="list-style-type: none"> • Cash flow characteristics • Business strategy 	<ul style="list-style-type: none"> • Cash flow characteristics • Business strategy • Accounting Mismatch if at FV 	<ul style="list-style-type: none"> • Short-term • Cash flow characteristics • Business strategy 	none
Option or mandatory	Basically mandatory	Option	Option	Option	Mandatory
	FV-NI	FV-OCI	AC	AC	Present Value



4. Presentation (I)

Continuous statement of comprehensive income

- Subtotal for net income with total comprehensive income
- Earnings per share based on net income only
- Major components of
 - Net income
 - Other comprehensive income
- Interest income
 - The amount on 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



4. Presentation (II)

Changes in an entity's own credit standing

- An entity shall present separately on the face of the statement of comprehensive income the amount of significant changes in the fair value of its financial liabilities arising from changes in the entity's own credit standing during the period, excluding changes related to changes in the price of credit
- Significant changes in fair value arising from changes in the entity's credit standing, excluding changes in the price of credit, shall be presented separately for financial liabilities in the FV-NI category and for financial liabilities in the FV-OCI category



5. Impairment (I)

- A single credit impairment model for
 - Financial assets in the FV-OCI category
 - Short-term receivables measured at their amortized cost
 - Financial assets that can be redeemed for a specified amount that are measured at their redemption value
- 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
- An entity would be required to determine if recognition of a credit impairment is required at the end of each reporting period:
 - No “probable” threshold for recognizing a credit impairment



5. Impairment (II)

- 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. In estimating cash flows expected to be collected for its financial assets at each reporting date, an entity shall assume that the economic conditions existing at that point in time would remain unchanged for the remaining life of the financial assets.
- Financial assets can be evaluated on an individual or pool basis



6. Disclosures

- Financial liabilities in the FV-NI category
 - qualitative information about the effects of changes in an entity's credit standing
- Financial instruments in the FV-OCI category
 - Information about the contractual maturities
 - Qualitative and quantitative information in case of early sale or settlement
 - Further disclosures for purchased financial assets
- Allowance for credit losses
 - Qualitative and quantitative information, in particular activities in the account
 - Additional information for assets that are individually considered to be impaired
- Disclose the inputs and assumptions in measuring core deposit liabilities
- Financial liabilities in the AC category: reasons for mismatch / fair value
- Level 3 FV measurement uncertainty analysis: reference to Topic 820



7. Hedge Accounting (I)

- Bifurcation by risk (benchmark interest risk, foreign currency and credit 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 fair value and cash flow hedges
- Elimination of shortcut method and the critical-terms-match method



7. Hedge Accounting (II)

- All ineffectiveness associated with the hedged risk recognized in net income (for both overhedges and underhedges)
- Dedesignation only if criteria for hedge accounting not met or hedging instrument expired, sold, terminated, or exercised (dedesignation will not be elective)



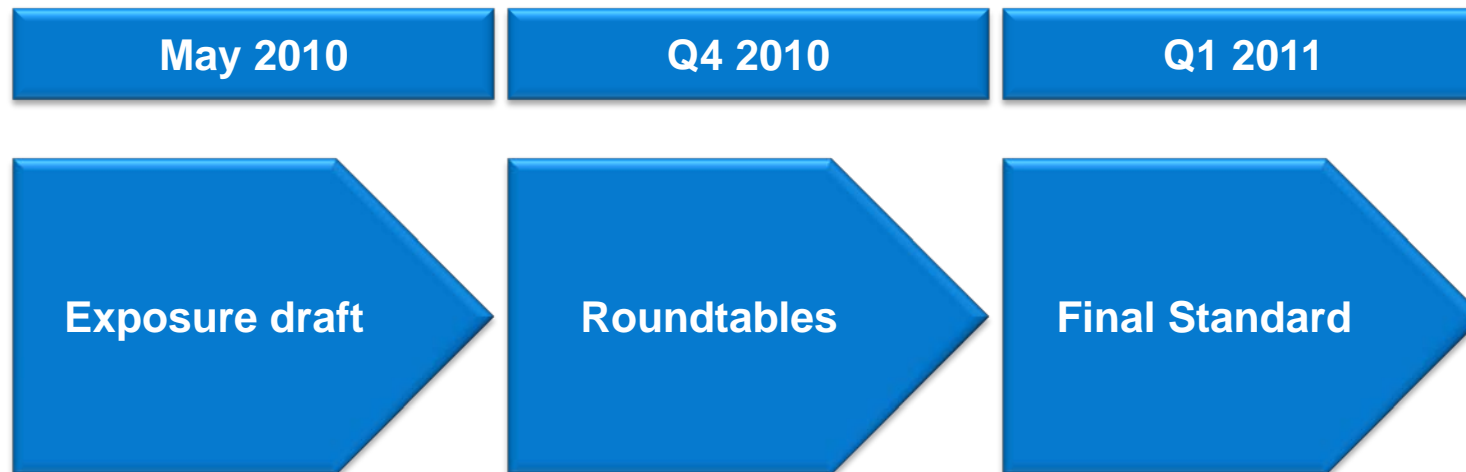
8. Reclassification

- The entity shall not subsequently change its decision made at initial recognition regarding classification of financial instruments. Therefore, subsequent reclassifications are not permitted.



9. 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 the proposal:
 - Loans and loan commitments on the FV-OCI category (fv of loans in the notes)
 - Core deposit liabilities in the OCI category
- Timetable of the FASB:



10. Key differences between FASB and IASB approaches (I)

- FV-NI is the default category under the FASB ED
- Generally impact on net income/P&L should be similar for financial assets under the FASB proposals and the IFRS model

Topic	FASB ED	IASB Approach
Loans and debt securities (assets) meeting the criteria	Option to classify in FV-OCI category	Required to be at amortised cost (subject to FV option)
Equity investments	In the FV-NI category	At FV, but if not held for trading OCI option available
Financial liabilities	Most at FV and many in the FV-NI category	IAS 39 requirements retained expect for presentation changes if FV option is elected, so most financial liabilities at amortised cost or bifurcated
Core deposit liabilities	Remeasurement value (present value as prescribed)	Redemption amount



10. Key differences between FASB and IASB approaches (II)

Topic	FASB ED	IASB Approach
Own credit	<ul style="list-style-type: none"> - Separate presentation in the statement of comprehensive income (impacts net income) - Excludes changes in price of credit 	<ul style="list-style-type: none"> - Requires own credit on FVO liabilities to be transferred to OCI (removed from P&L) - Includes changes in price of credit
Impairment	Determine cash flows not expected to be collected based on past and current conditions only. Can result in Q1 losses	Initial loss expectations allocated over life of the instrument through EIR considering all available information (including forecasts)
Hedge Accounting	Bifurcation by risk only for hedges of financial items	<p>Discussing allowing bifurcation by risk for all hedges (financial and non-financial items)</p> <p>Considering broader changes to hedge accounting model</p>



WP/StB Kai Haussmann

Zimmerstraße 30
10969 Berlin

Tel. 030 20 64 12 29
Fax 030 20 64 12 15

www.drsc.de
haussmann@drsc.de