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Fair Value Option Project Phase 1: FASB Continues Redeliberations

Introduction

On January 25, 2006, the Financial Accounting Standards Board (“FASB” or “Board”) issued an Exposure Draft, *The Fair Value Option for Financial Assets and Financial Liabilities*, as Phase 1 of a broader fair value option (“FVO”) project. The comment period for the Exposure Draft (“ED”) ended on April 10, 2006.

In the overall project (Phase 1 and Phase 2), the Board is considering whether to permit entities a one-time election to report certain financial instruments (and perhaps selected non-financial instruments) at fair value with changes in fair value reported in current earnings. The main objectives of this project are:

- To alleviate accounting asymmetries in reported earnings related to some assets or liabilities being reported at fair value, but other related liabilities and assets being reported at another measurement attribute, such as amortized cost.
- To enable entities to achieve financial reporting symmetry for the changes in the fair values of related assets and liabilities without having to adhere to more stringent and complex hedge accounting requirements.

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- To achieve further convergence with the IASB, which has incorporated a fair value option for financial instruments in its IAS 39, *Financial Instruments: Recognition and Measurement*.
- To expand the use of fair value measurement, particularly for financial instruments.

SFG Observation: *For certain financial instruments such as debt security investments, entities currently have the option to apply fair value accounting with changes in fair value included in reported earnings (e.g., FAS 115 “trading” securities). Entities who have early adopted the provisions of FAS 155, Accounting for Certain Hybrid Financial Instruments (“FAS 155”), also have the option to account for certain hybrid financial instruments at fair value.*

A key limitation in FAS 155 is that a financial instrument must have an embedded derivative requiring bifurcation to qualify for the fair value election. Some companies have matched positions where one of the financial instruments may not have an embedded derivative yet the combined position (asset and liability) is managed as a unit.

While the FVO may provide a potential alternative to the application of hedge accounting to certain fair value hedging relationships under FAS 133, Accounting for Derivative Instruments and Hedging Activities (“FAS 133”), it will not provide substantive relief to certain cash flow hedging relationships. For example, recording both an interest rate swap and a related floating rate asset / liability at fair value with changes in fair value reported in current earnings may not provide an accounting offset in earnings.

When considering the impact of the FVO, entities should also consider the effect of the newly issued FAS 157, Fair Value Measurements (“FAS 157”). FAS 157 provides guidance on the computation of fair value, including a requirement to consider the impact of one's own credit in valuing liabilities.

The FVO project has been split into two phases:

- Phase 1 addresses permitting a fair value option for financial assets and financial liabilities.
- Phase 2 will address permitting a fair value option for selected non-financial items.

The Board's redeliberations on the Phase 1 ED began in August 2006. The FASB will begin activity on Phase 2 after a final statement on Phase 1 is issued.

Recent Developments

At its August 16th, 2006 meeting, the FASB began its redeliberations on the proposed guidance in the Phase 1 ED. The Board continued its discussions related to Phase 1 of the FVO project at its September 6th and October 18th meetings. This advisory summarizes a number of the decisions reached at those meetings.

Scope Issues

The Phase 1 ED originally excluded written loan commitments not accounted for under FAS 133 from its scope because the determination of their fair values involves consideration of non-financial components. Based on responses to the Phase 1 ED, the Board decided that written loan commitments not accounted for under FAS 133 should be included in the scope of Phase 1 of the FVO project.

The Board decided to amend the scope of the Phase 1 ED for lease contracts to exclude both financial assets and financial liabilities recognized under lease contracts as defined in FAS 13, *Accounting for Leases*. Previously, the Phase 1 ED only excluded financial liabilities recognized under lease contracts from its scope.

The Board discussed whether the financial host contract in a hybrid instrument that contains a non-financial embedded derivative requiring bifurcation is within the scope of Phase 1 of the FVO project. The Board chose to allow the FVO election for the host contract in the example above, as long as the scope exceptions in the final FVO Standard (“Standard” or “Statement”) are not applicable to the financial host contract.

The following contracts will be excluded from the scope of the final FVO Standard:

- Contracts issued or held by a reporting enterprise that are indexed to its own stock and classified in stockholders’ equity; and
- Contracts issued or held by a reporting enterprise that contain embedded derivatives that are indexed to its own stock and would, on a standalone basis, be classified in stockholders’ equity.

The final FVO Standard will amend the scope language in FAS 115, *Accounting for Certain Investments in Debt and Equity Securities* (“FAS 115”). FAS 115 currently excludes from its scope “investments in equity securities accounted

for under the equity method” of accounting in APB 18 , *The Equity Method of Accounting for Investments in Common Stock* (“APB 18”). The revised FAS 115 language will exclude from its scope all investments that, absent a FVO election under the final FVO Standard, would have to be accounted for under the equity method of accounting in APB 18.

Election of the FVO and Related Documentation Issues

The Board reaffirmed its decision to allow the FVO to be elected on a contract-by-contract basis. While certain Board members voiced their preference that the FVO election be required on either an entity-wide basis or for an entire class of assets / liabilities, a majority of the Board agreed to maintain the election at the individual contract level, as proposed in the Phase 1 ED.

SFG Observation: *The ability to elect the FVO on a contract-by-contract basis will provide more flexibility. However, the Board commented that for certain financial instruments, what constitutes a “contract” might not be apparent.*

The staff, however, did not recommend providing definitional guidance on the term “contract”. Ultimately, the Board requested that the staff develop additional guidance for defining “contract-by-contract” for discussion at a December 2006 FASB meeting.

The FASB reaffirmed its decision that the election of the FVO must be made at initial recognition of a financial asset or liability or upon the occurrence of a new basis event. The FASB clarified that if GAAP requires an entity to recognize a contract on trade date instead of settlement date, the FVO should also be elected at the trade date (which is the date that the contract is initially recognized).

The Board decided not to provide specific documentation guidance in the final FVO Standard; however, the Board did clarify that an enterprise should designate its election of the FVO at the time of initial recognition of a financial asset or liability or upon the occurrence of a new basis event.

The FASB discussed a situation in which financial assets held by a subsidiary (where those assets are being reported at fair value with changes in fair value reported in earnings due to the nature of that subsidiary) are transferred to another entity within the consolidated reporting entity that is not required to report those assets at fair value. The Board decided that the FVO may be elected on the date of transfer.

Recognition, Measurement, and Presentation Issues

The FASB reaffirmed its decision that the total changes in fair value of financial assets and liabilities under the FVO should be recognized in current earnings. The Board also reaffirmed its decision not to permit entities to elect (outside of the hedge accounting models described in FAS 133) to recognize in earnings the change in fair value of a financial asset or liability attributable to a particular risk.

SFG Observation: *The requirement to re-measure financial assets and liabilities at their full fair values through current earnings may introduce different sources of earnings volatility. As noted above, guidance in FAS 157 requires an entity to include the impact of changes in an entity's creditworthiness in earnings when reporting its liabilities at fair value. In other words, volatility in the company's credit spread will cause income statement volatility when the obligation is recorded at fair value.*

Under the fair value hedge accounting model in FAS 133, an entity is not required to re-measure a debt liability for changes in the entity's creditworthiness through current earnings if credit risk is not the designated hedged risk.

The Board concluded that the final FVO Standard should not provide specific presentation guidance related to the effects of fair value measurements on earnings. However, the FASB addressed the need for entities to communicate the effects of changes in the fair values of items for which the FVO election has been made through disclosures.

The Board put forth two alternatives regarding presentation, on the face of the balance sheet, for assets and liabilities measured under the FVO and the carrying amounts of assets and liabilities measured using other measurement attributes:

1. Displaying separate line items for the fair value and non-fair value carrying amounts (2 separate line items); or
2. Presenting the aggregate amount of the fair value and non-fair value amounts and parenthetically disclosing the fair value amount included within that aggregate amount.

The staff recommended, and the Board agreed, that any costs and fees associated with the acquisition of assets or issuance of liabilities for which the FVO is elected upon initial recognition should not be deferred. The costs should be recognized immediately in earnings when incurred.

The Board also concluded that unamortized deferred costs, fees, premiums, and discounts associated with existing assets and liabilities for which the FVO is elected at the initial application of the Standard should be included in the cumulative-effect adjustment to opening retained earnings.

Certain Disclosure Issues

A number of constituents commented that the disclosure guidance in paragraph 12(b) of the Phase 1 ED was too vague. Paragraph 12(b) states that an entity shall disclose:

“Information sufficient to allow users of financial statements to understand the effect on earnings of changes in the fair values of the financial assets and financial liabilities subsequently measured at fair value as a result of a fair value election.”

The Board revised the guidance in paragraph 12(b) of the Phase 1 ED to:

- Include a requirement to disclose the method and significant assumptions used in estimating fair value; and
- Encourage the disclosure of quantitative information about the market risk of instruments measured under the FVO (that fall within Level 3 of the fair value hierarchy defined in FAS 157) that is consistent with the way the entity manages those risks.

The Board decided not to require sensitivity analyses or information regarding model validation procedures.

SFG Observation: FAS 157 requires certain additional quantitative disclosures for those fair value measurements which incorporate significant unobservable inputs (Level 3 of the fair value hierarchy).

The FASB decided not to modify the disclosure requirement in paragraph 12(c) of the Phase 1 ED. The Board clarified that the requirement to disclose information indicating where in the income statement gains and losses relating to the election of the FVO are reported applies to all gains and losses (not just unrealized gains and losses).

The Board modified the disclosure requirement in paragraph 12(d) of the Phase 1 ED to clarify that the FVO does not impact methods for recognizing and measuring the amount of interest and dividend income. The staff noted that any change in recognizing and measuring interest and dividend income is

outside the scope of the FVO project (generally, interest and dividend income should be recognized when an instrument is recorded at fair value).

The FASB agreed to require an entity that is reporting a financial liability at fair value under the FVO that has experienced a significant change in creditworthiness during the reporting period to estimate and disclose the portion of the total change in fair value reported in current earnings that relates to changes in the entity's creditworthiness. The Phase 1 ED only required disclosure of qualitative information about the reasons for the change in fair value. The Board also agreed that the final FVO Standard should not provide guidance on when a change in a debtor's creditworthiness should be considered significant.

The FASB staff indicated that it had received comments from users of financial statements and other constituents requesting more disclosure around the election of the FVO. The Board decided that a reporting enterprise should disclose:

- Management's basis for its decision to elect the FVO for a contract or group of similar contracts; and
- The reason(s) why the company chose to apply the FVO to only selected contracts within a group of similar contracts.

The above disclosure is required at each date on which a statement of financial position is presented, and should provide enough information to make it apparent to users how those groups of similar contracts reconcile to the line items presented in the statement of financial position.

The FASB decided to require reporting enterprises to disclose the difference between an asset's fair value carrying amount (as a result of the FVO election) and the aggregate principal amount to be received for those assets. A similar disclosure requirement for liabilities is already incorporated in paragraph 12(a) of the Phase 1 ED.

The final FVO Standard will require, in each period in which an income statement is presented, disclosure of the following for loans and other receivables accounted for at fair value as a result of the FVO election:

- An estimate by the reporting enterprise of the fair value changes due to changes in expected cash flows associated with borrower-specific credit risk; and
- All other changes in fair value included in current earnings.

For loans classified as held for investment for which the entity has elected the FVO, the FASB concluded the entity must disclose the fair value carrying amounts of loans that are ninety days or more past due.

For investments that would normally have to be reported under the equity method of accounting under APB 18, but are instead being accounted for at fair value under the FVO, the Board will require disclosure of the following:

- The name of each investee and the percentage ownership of common stock;
- The accounting policies of the investor related to investments in common stock; and
- Summarized information about the investees, including assets, liabilities, and results of operations.

The Board decided that the disclosure requirements in the final FVO Standard should also apply to those investments that are classified as trading under FAS 115, and to hybrid financial instruments that are being accounted for at fair value under the fair value election in FAS 155.

Effective Date and Transition

The FASB determined that the effective date for the final FVO Standard should coincide with the effective date of FAS 157. Therefore, both standards will be effective for financial statements issued for fiscal years beginning after November 15, 2007.

The Board decided to allow early adoption of the final FVO Standard. Early adoption must occur within 120 days of the beginning of the reporting entity's fiscal year, provided that the entity has not issued interim financial statements for that year. Early adoption will be retroactive to the beginning of that entity's fiscal year.

SFG Observation: *The FASB staff noted, and the Board agreed, that the proposed early adoption provisions would allow reporting entity's to perform a certain amount of "cherry-picking" when deciding whether to early adopt. However, the Board did not find this to be overly troubling, as they viewed it as a one-time issue in Q1 2007 only for those entity's who choose to early adopt the provisions of the final FVO Standard.*

The Board stated that early adoption of the final FVO Standard is only appropriate if the entity also adopts all of the requirements of FAS 157 contemporaneous with or prior to the early adoption of the FVO Standard.

The FASB did not change the requirement in the Phase 1 ED that the impact of initial adoption attributable to the election of the FVO for financial assets and liabilities existing at the effective date be accounted for as a cumulative-effect adjustment through retained earnings. Retrospective application of the final FVO Standard to fiscal years preceding the effective date is not permitted.

For those items reported under the FVO election, the Board will require a reconciliation presenting the current historical / amortized cost amount with the associated fair values as of the date of adoption. The reconciliation, which is a one-time requirement, should be presented by category of assets and liabilities as they are presented on the face of the balance sheet.

Next Steps

The Board asked the staff to revise the wording surrounding the contract-by-contract election and to bring examples of the application of such wording to the Board for its consideration.

The FASB staff was also instructed to begin drafting the final FVO Standard. The FASB staff tentatively anticipates that a final Statement related to Phase 1 of the FVO project will be issued early in the first quarter of 2007.

Questions

Questions regarding this advisory may be directed to:

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