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**EARLY ADOPTION OF FAS 159, THE FAIR VALUE OPTION FOR
FINANCIAL ASSETS AND FINANCIAL LIABILITIES,
MAY REQUIRE ACTION IN THE FIRST QUARTER OF 2007**

Introduction

Entities are now permitted to measure many financial instruments and certain other assets and liabilities at fair value on an instrument-by-instrument basis under a fair value option (FVO). The FVO is established in Financial Accounting Standards Board (FASB or the Board) Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities - Including an Amendment of FASB Statement No. 115* (FAS 159 or Standard), which was issued on February 15, 2007.

Calendar year-end entities that wish to elect the FVO for 2007 will need to do so in the first quarter of 2007. The FVO represents a significant step in the evolution of financial reporting because it considerably expands the ability of entities to select the measurement attribute for certain assets and liabilities. The key implications of FAS 159 include the following:

- By electing the measurement attribute for most financial instruments (i.e., either historical cost or fair value) entities will be able to mitigate potential "mismatches" that arise under the current mixed measurement attribute model.

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For example, potential "mismatches" may arise because certain financial assets are required to be measured at fair value but the related financial liabilities are required to be measured at amortized historical cost. The election is made on an instrument-by-instrument basis and is irrevocable;

- Entities will be able to offset changes in the fair values of a derivative instrument and the related hedged item by selecting the FVO for the hedged item. Entities can avoid having to apply the complex hedge accounting provisions of FASB Statement 133, *Accounting for Derivative Instruments and Hedging Activities* (FAS 133) by using the FVO; and
- The FVO is not a requirement, so FAS 159 may result in reduced comparability of entities' financial reporting, both among similar entities and within a single entity because similar assets or liabilities could be reported under different measurement attributes (i.e., some at historical cost and some at fair value).

IFRS Convergence

A fair value option is also permitted by International Financial Reporting Standards (IFRS), specifically IAS 39, *Financial Instruments: Recognition and Measurement* (Revised January 2006). However, under IAS 39 an entity can use the FVO only for certain contracts.

IAS 39 permits use of the FVO:

1. For instruments containing embedded derivatives;
2. To report more relevant information because it eliminates or reduces an "accounting mismatch" between the measurement of assets and liabilities; or
3. When a group of financial assets or liabilities (or both) is managed and evaluated on a fair value basis.

SFG Observation: *The establishment of a FVO under US GAAP that already exists under IFRS is a step toward international convergence. The two standards are not identical due to differences in the scope and application of the two FVOs.*

FAS 159 is based on the definition of fair value in FASB Statement No. 157, Fair Value Measurements (FAS 157), which differs from IAS 39's definition of fair value. The IASB has a project to address whether the FAS 157 definition of fair value is appropriate for measuring fair value under IFRS.

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Scope – Items Included

FAS 159 represents the results of phase 1 of the FASB's efforts to promulgate a FVO. FAS 159 applies primarily to financial assets and financial liabilities.

In phase 2, the FASB will consider permitting the FVO for certain non-financial items, such as inventory and real estate. FAS 159 applies to common financial assets and financial liabilities, such as loans receivable and payable, as well as:

- Equity-method investments that are subject to Accounting Principles Board Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock* (APB 18).
- Investments in equity securities that do not have readily determinable fair values, as described in paragraph 3 of FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (FAS 115).
- Rights and obligations under insurance contracts that are financial instruments, as well as under insurance contracts that are not financial instruments because (1) they require or permit the insurer to provide goods or services rather than a cash settlement and (2) the insurer can settle by paying a third party to provide goods and services.
- Rights and obligations under a warranty that is not a financial instrument because it requires or permits the warrantor to provide goods or services rather than a cash settlement, and the warrantor can settle by paying a third party to provide goods and services.
- Host financial instruments that are the result of separating an embedded derivative instrument from a hybrid instrument, as required by FAS 133 (for example, a hybrid instrument in which the value of the bifurcated embedded derivative is payable in cash, services, or merchandise but the debt host is payable only in cash).
- Firm commitments for financial instruments that do not meet the definition of a derivative contract (for example, a forward purchase contract for a loan that is not readily convertible to cash and that consequently does not qualify as a derivative instrument under FAS 133).

- Written loan commitments.

Scope – Items Excluded

The following items are explicitly excluded from the scope of FAS 159:

- An interest in an entity that the investor is required to consolidate (e.g., a subsidiary or a primary beneficiary's interest in a variable-interest entity).
- Employers' and plans' financial obligations with respect to pension benefits, other postretirement benefits, post employment benefits, employee stock options, employee stock purchase plans, and other forms of deferred compensation arrangements.
- Financial assets and liabilities recognized under lease contracts, as defined in FASB Statement No. 13, *Accounting for Leases* (except for a guarantee of a third-party lease obligation or a contingent obligation arising from a cancelled lease).
- Financial instruments, in whole or in part, classified as equity (including "temporary" or "mezzanine" equity). For example, convertible debt that has a non-contingent beneficial conversion feature would be precluded from the FVO due to its equity classification.
- Deposit liabilities (deposits that can be withdrawn on demand) of banks, credit unions, savings and loan associations, and other similarly regulated financial institutions.

SFG Observation: *In Phase 2 of its FVO project, the FASB will reconsider whether demand-deposit liabilities of financial institutions should qualify for the FVO.*

All other items listed will remain outside the scope of a FVO. Other GAAP applies to these items and the FASB will only address the measurement attribute for such items during any reconsideration of those specific accounting pronouncements.

Some insurance and investment contracts include features that permit the insured (or the investor) to withdraw (i.e., "demand") amounts specified in the contract.

We believe that such contracts are eligible for the FVO because the scope exception described above is limited to demand-deposit liabilities of specified financial institutions. The valuation of such contracts, however, would need to reflect the value of the right of the insured/investor to withdraw.

Method of Electing the FVO

FAS 159 permits entities to choose the FVO on an instrument-by-instrument basis. An entity can elect the FVO for certain loans, individual shares, or participations, but not for others.

If the FVO is not elected for all eligible instruments within a group of similar instruments, the entity is required to disclose:

1. The reasons for its partial election;
2. The amounts to which it applied the FVO; and
3. The amounts to which it did not apply the FVO within that group.

Exceptions to the instrument-by-instrument election exist for the following:

- If multiple advances are made to one borrower under a single instrument (such as a line of credit or construction loan) and the individual advances lose their identity and become part of the larger loan balance, the FVO may only be applied to the larger loan balance and not the individual advances.
- If an investment would otherwise be accounted for under the equity method of accounting pursuant to APB 18, the election of the fair value option must be applied to all of the investor's financial interests (equity and debt, including guarantees) in that investee that would qualify for the FVO, rather than on an instrument-by-instrument basis.
- The FVO must be applied to all claims and obligations under an eligible insurance or reinsurance contract.
- If the FVO is elected for insurance contracts containing integrated or non-integrated contract features or coverages, the FVO cannot be elected for only the non-integrated contract features or coverages even though those features and coverages are accounted for separately under AICPA Statement of Position 05-1, *Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection With Modifications or Exchanges of Insurance Contracts*.

The FVO does not need to be elected for all instruments issued or acquired in a single transaction. For example, an investor in a bond offering may apply the FVO to a portion of the bonds acquired in a single transaction; however, entities are required to comply with the disclosure requirements (see above).

A financial instrument that represents a single contract may not be separated into parts for purposes of electing the FVO. However, a loan syndication arrangement may result in multiple loans issued to the same borrower. Under FAS 159, each of those loans is a separate instrument, and the FVO may be elected for some loans but not others.

SFG Observation: SEC Staff Accounting Bulletin 105, *Application of Accounting Principles to Loan Commitments (SAB 105)*, specifies that in estimating the fair value of loan commitments that are subject to FAS 133, an entity should exclude from its calculation the expected future cash flows related to the associated servicing of the loan.

It is unclear whether the guidance in SAB 105 would also apply to loan commitments that are not subject to FAS 133 but are eligible for the FVO under FAS 159. The SEC Staff has requested that an industry group led by the Mortgage Bankers Association assist in resolving this issue.

Timing: When Entities May Elect the FVO

An entity can elect the FVO only at the date of initial adoption of FAS 159 for existing assets and liabilities. Refer to “Effective Date and Transition” section below.

An entity can choose to apply the FVO on the date when any one of the following occurs:

- The entity first recognizes the eligible item.
- The entity enters into an eligible firm commitment.
- Financial assets that, because of specialized accounting principles, have been reported at fair value with unrealized gains and losses included in earnings cease to qualify for fair value measurement (e.g., an investment ceases to be subject to the American Institute of Certified Public Accountants' audit and accounting guide, *Investment Companies*).

- An investment in an entity becomes subject to the equity method of accounting (e.g., the investor acquires additional shares of the investee's common stock).
- An investor ceases to consolidate a subsidiary or variable-interest entity but retains an ongoing interest in the VIE (e.g., because the investor no longer holds a majority voting interest but continues to hold a smaller amount of common stock).
- As a result of a particular event, an eligible item must be measured at fair value at the time of the event (hereafter referred to as the "remeasurement event") but GAAP does not require ongoing re-measurements at fair value. Examples include:
 1. Impairment under lower-of-cost-or-market (LOCOM) accounting, or other-than-temporary impairment (OTTI);
 2. Business combinations as defined in FASB Statement No. 141, *Business Combinations*;
 3. The consolidation of a variable interest entity; and
 4. A significant modification of a debt instrument, as defined by the Emerging Issues Task Force in Issue 96-19, *Debtor's Accounting for a Modification or Exchange of Debt Instruments*.

SFG Observation: FAS 159 requires entities to make a separate decision about whether to elect the FVO for each eligible item.

Entities may also elect the fair value option based on a pre-existing policy for specified types of eligible items.

We believe that the level of documentation of such a policy may vary among entities but that such documentation should be sufficiently clear so that items that are subject to the FVO under the policy are easily understood.

Accounting Impact of Electing the FVO

When FAS 159 is applied, any upfront costs and fees related to items must be recognized in current earnings and not be deferred.

For example, if the FVO is elected for an insurance contract, the entity should not recognize any deferred acquisition costs (DAC) related to that contract. Similarly, if the FVO is elected for a loan receivable, the entity should not recognize any deferred loan-origination fees or costs related to that loan.

SFG Observation: *Immediate recognition of previously deferred income and expense items will significantly change both the timing of recognition and the presentation (i.e., the geography) of income or expense in the income statement.*

For example, the direct costs of originated loans that are not measured using the FVO are capitalized as a basis adjustment under FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases (FAS 91). The costs are amortized to interest income or recognized as part of the gain/loss on sale of the loan.

When an originated loan is measured using the FVO, the costs and fees are not deferred and are recognized in current earnings in the applicable expense or revenue accounts (e.g., salaries, legal fees, fee revenue, etc.).

FAS 159 states that it does not establish requirements for recognizing and measuring dividend income, interest income, or interest expense but that the company's policy for such recognition should be disclosed. The Standard amends Accounting Principles Board Opinion No. 21, *Interest on Receivables and Payables* (APB 21), to specify that amortization of premiums and discounts does not apply to items for which the FVO has been elected.

SFG Observation: *FAS 159 allows for policy discretion in how to recognize interest income and expense for items under the FVO. We believe entities may apply one of the following models for recognizing interest income/expense:*

- 1. Present the entire change in fair value of the FVO item, including the component related to accrued interest, in a single line item in the income statement.*
- 2. Separate the "cash" interest accrual (i.e., the stated rate or the coupon rate) from the full change in fair value of the FVO item and present that amount as interest income/expense. The remainder of the change in the fair value measurement should be presented in a separate line item in the income statement.*
- 3. Separate an accrual using the effective yield method (i.e., contractual rate and "amortization" of initial premium/discount) from the full change in fair value of the FVO item and present that amount as interest income/expense. All other changes in fair value should be presented in a separate line item in the income statement.*

All of the above presentations are based on the same net change in fair value of the FVO item but can result in significant differences in individual line items in the income statement.

Entities should select a policy for income statement presentation that is appropriate for their individual facts and circumstances, disclose the policy in the notes to financial statements, and follow it consistently.

Any upfront costs and fees related to items measured at fair value upon the adoption of FAS 159 should be removed from the statement of financial position and reflected in the cumulative-effect adjustment (see “Effective Date and Transition” section below).

FAS 159 vs. Hedge Accounting

Adoption of the FVO may appeal to entities that want to achieve economic offset in the income statement for changes in the fair values of related financial assets and financial liabilities without having to apply the hedge accounting provisions of FAS 133.

SFG Observation: *When assessing the benefits of the FVO, entities should consider:*

- 1. The FAS 159 disclosure requirements;*
- 2. The long term effects of the irrevocable election; and*
- 3. The potential volatility of recording all changes in fair value of the instrument in current earnings.*

Applying the provisions of FAS 159 instead of FAS 133 can have significant implications on (i) period-to-period net income as well as (ii) income statement geography.

FAS 133 allows for application of a benchmark interest rate hedge which results in a partial mark-to-market (i.e., the change in fair value due to changes in interest rates) of the hedged debt by excluding the impact of changes in credit spreads of the issuer.

The FVO requires a full mark-to-market (i.e., the full change in fair value) of the debt including the impact of fluctuations in the issuer’s credit spread from period-to-period. As such, the FVO introduces additional basis risk between

the hedging instrument (e.g., an interest rate swap) and the debt that will be recognized in current earnings.

SFG Observation: *An entity should consider the implications of applying the FVO to its long-term debt, which would require full mark-to-market as discussed above.*

For example, recognizing changes in the debt's fair value in current earnings might adversely impact the entity's compliance with debt covenants and/or its regulatory and capital requirements. In addition, debt issuance costs, which are often significant, would be expensed immediately.

The FVO will require an independent estimate of the change in fair value of the debt under FAS 157. As a result, the change in value of the debt generally will be different under the FVO than the adjustment to the hedged item under hedge accounting in FAS 133.

The SEC staff has previously said that unless a derivative is in a qualifying FAS 133 hedging relationship, all changes in fair value of the derivative, including changes from interest accruals or net interest cash flows, should be presented in a single line item in the income statement.

For qualifying FAS 133 hedging relationships, entities often split the interest accrual (income or expense) of the derivative from the total change in fair value of the derivative and present the interest accrual component in the same line item where the hedged item's interest is presented.

FAS 159 does not establish any income statement presentation requirements for changes in fair value related to interest income or expense when an entity elects the FVO.

The SEC staff has not provided any guidance or views on income statement presentation for instruments measured under the FVO.

We believe that entities may select an accounting policy for income statement presentation of interest income/expense for instruments being measured under the FVO.

Expanded Disclosure Requirements

The FASB recognized that the elective feature of FAS 159 has the potential to reduce the comparability of financial reporting. One of the Board's objectives for the required disclosures is to ensure that the reader of an entity's financial

statements can assess the extent of use of the FVO and its affect on earnings for the period.

Although FAS 159 permits entities to apply the FVO on an instrument-by-instrument basis, entities may elect the FVO for all of the items in a group of similar items. Therefore, FAS 159 requires additional disclosures if the FVO is elected for only some of the eligible items within a group of similar eligible items (e.g., a description of those similar items and reasons for partial election).

Appendix B of FAS 159 includes an example of a disclosure that integrates FAS 159's disclosure requirements with the requirements in both FAS 157 and FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*. The example is for illustrative purposes only and does not present the only method to comply with the disclosure requirements.

Effective Date and Transition

FAS 159 is effective as of the beginning of an entity's fiscal year that begins after November 15, 2007. For entities with a calendar year-end, the Standard can be adopted as of January 1, 2008.

FAS 159 permits early adoption if:

1. The Standard is adopted within 120 days of the beginning of the entity's fiscal year (e.g., for a calendar-year-end company, within 120 days of January 1, 2007);
2. The entity has not yet issued financial statements, including any interim-period of the fiscal year in which the Standard is applied early (e.g., the first quarter financial statements); and
3. The entity early adopts FAS 157.

Calendar-year-end public companies that wish to adopt FAS 159 in the first quarter of 2007 should make their decision prior to April 30, 2007.

The effect of adoption should be reported as a cumulative-effect adjustment to the opening balance of retained earnings. Entities should make additional disclosures in their annual and first interim-period financial statements to enable the reader to understand the effects of adopting FAS 159.

Periodic filings that a public entity makes prior to adoption should include the disclosures set forth in SEC Staff Accounting Bulletin No. 74, *Disclosure of the Impact that Recently Issued Accounting Standards will have on the Financial Statements of the Registrant When Adopted in a Future Period* (SAB 74). For

example, a calendar-year-end public entity that does not early adopt will need to disclose in its 2007 first quarter Form 10-Q the potential impact of adopting FAS 159, unless the impact on its financial position and results of operations is not expected to be material.

Available-for-sale (AFS) and held-to-maturity (HTM) securities that an entity holds on the date it adopts FAS 159 are eligible for the FVO on that date. If the FVO is elected for any of these securities, the impact should be reflected in the cumulative-effect adjustment and not be treated as though the securities were reclassified as "trading" under FAS 115.

SFG Observation: *The securities for which the FVO is elected should be treated similar to FAS 115 trading securities in subsequent reporting periods.*

FAS 159 does not create a fourth category of securities (e.g., FVO securities). Some entities may be precluded from engaging in security trading activities by law or regulation. This does not preclude election of the fair value option. For financial reporting purposes, these securities will be presented as trading securities even if the company has no short term intention to sell the securities. In those instances, use of terminology such as "securities carried at fair value" instead of using the "trading" terminology in FAS 115 may be appropriate.

FAS 159 amends FASB Statement No. 95, Statement of Cash Flows (FAS 95), and FAS 115 to specify that cash flows from trading securities (which include securities for which an entity has elected the FVO) should be classified in the statement of cash flows based on why the securities were acquired. Prior to this amendment, FAS 95 and FAS 115 specified that cash flows from trading securities must be classified as cash flows from operating activities.

Once the FVO is elected for an asset that was previously a HTM security, subsequent sales of those securities do not "taint" the HTM portfolio as these securities are no longer HTM securities.

Similarly, selling a security at a loss that was previously an AFS security does not raise questions about management's assertions regarding its intent and ability to hold until recovery when evaluating OTTI prior to the election under the FVO.

Entities should be making assertions about the intent and ability to hold AFS securities with unrealized losses in the balance sheet prior to adoption even if the company plans on adopting the fair value option in the next period. A plan to sell securities or a sale of securities soon after adoption of FAS 159 may call into question prior assertions about intent and ability to hold the securities.

Questions

Questions regarding this advisory may be directed to:

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Required Disclosures as of Each Date for Which an Interim or Annual Statement of Financial Position Is Presented

18. As of each date for which a statement of financial position is presented, entities shall disclose the following:

a. Management's reasons for electing a fair value option for each eligible item or group of similar eligible items

b. If the fair value option is elected for some but not all eligible items within a group of similar eligible items:

(1) A description of those similar items and the reasons for partial election

(2) Information to enable users to understand how the group of similar items relates to individual line items on the statement of financial position

c. For each line item in the statement of financial position that includes an item or items for which the fair value option has been elected:

(1) Information to enable users to understand how each line item in the statement of financial position relates to major categories of assets and liabilities presented in accordance with Statement 157's fair value disclosure requirements (Note 3)

(2) The aggregate carrying amount of items included in each line item in the statement of financial position that are not eligible for the fair value option, if any

d. The difference between the aggregate fair value and the aggregate unpaid principal balance of:

(1) Loans and long-term receivables (other than securities subject to Statement 115) that have contractual principal amounts and for which the fair value option has been elected

(2) Long-term debt instruments that have contractual principal amounts and for which the fair value option has been elected

Footnote 3 -- Paragraph 10 of Statement 107 also requires an entity to relate carrying amounts that are disclosed in accordance with that Statement to what is reported in the statement of financial position.

e. For loans held as assets for which the fair value option has been elected:

(1) The aggregate fair value of loans that are 90 days or more past due

(2) If the entity's policy is to recognize interest income separately from other changes in fair value, the aggregate fair value of loans in non-accrual status

(3) The difference between the aggregate fair value and the aggregate unpaid principal balance for loans that are 90 days or more past due, in non-accrual status, or both

f. For investments that would have been accounted for under the equity method if the entity had not chosen to apply the fair value option, (Note 4) the information required by paragraph 20 of APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock* (excluding the disclosures in paragraph 20(a)(3), 20(b), and 20(e) of that Opinion). (Note 5)

Footnote 4 -- This disclosure applies to investments in common stock, investments in in-substance common stock, and other investments (for example, partnerships and certain limited liability corporations) that (a) would otherwise be required to be accounted for under the equity method under other generally accepted accounting principles (GAAP) and (b) would be required to satisfy the disclosure requirements of paragraph 20 of Opinion 18.

Footnote 5 -- The following guidance from paragraph 20 and subparagraphs (a) and (d) of Opinion 18 is applicable:

The significance of an investment to the investor's financial position and results of operations should be considered in evaluating the extent of disclosures of the financial position and results of operations of an investee. If the investor has more than one investment in common stock, disclosures wholly or partly on a

combined basis may be appropriate. The following disclosures are generally applicable to the equity method of accounting for investments in common stock:

a. Financial statements of an investor should disclose parenthetically, in notes to financial statements, or in separate statements or schedules (1) the name of each investee and percentage of ownership of common stock, [and] (2) the accounting policies of the investor with respect to investments in common stock....

d. When investments in common stock of corporate joint ventures or other investments accounted for under the equity method are, in the aggregate, material in relation to the financial position or results of operations of an investor, it may be necessary for summarized information as to assets, liabilities, and results of operations of the investees to be presented in the notes or in separate statements, either individually or in groups, as appropriate. [Footnote reference omitted.]

Required Disclosures for Each Period for Which an Interim or Annual Income Statement Is Presented

19. For each period for which an income statement is presented, entities shall disclose the following about items for which the fair value option has been elected:

a. For each line item in the statement of financial position, the amounts of gains and losses from fair value changes included in earnings during the period and in which line in the income statement those gains and losses are reported (This Statement does not preclude an entity from meeting this requirement by disclosing amounts of gains and losses that include amounts of gains and losses for other items measured at fair value, such as items required to be measured at fair value.)

b. A description of how interest and dividends are measured and where they are reported in the income statement (This Statement does not address the methods used for recognizing and measuring the amount of dividend income, interest income, and interest expense for items for which the fair value option has been elected.)

c. For loans and other receivables held as assets:

(1) The estimated amount of gains or losses included in earnings during the period attributable to changes in instrument-specific credit risk

(2) How the gains or losses attributable to changes in instrument-specific credit risk were determined

d. For liabilities with fair values that have been significantly affected during the reporting period by changes in the instrument-specific credit risk:

(1) The estimated amount of gains and losses from fair value changes included in earnings that are attributable to changes in the instrument-specific credit risk

(2) Qualitative information about the reasons for those changes

(3) How the gains and losses attributable to changes in instrument-specific credit risk were determined.

20. The disclosure requirements in paragraphs 18 and 19 do not eliminate disclosure requirements included in other GAAP pronouncements, including other disclosure requirements relating to fair value measurement.

Other Required Disclosures

21. In annual periods only, an entity shall disclose the methods and significant assumptions used to estimate the fair value of items for which the fair value option has been elected. (Note 6)

22. If an entity elects the fair value option at the time one of the events in paragraphs 9(d) and 9(e) occurs, the entity shall disclose the following in financial statements for the period of the election:

a. Qualitative information about the nature of the event

b. Quantitative information by line item in the statement of financial position indicating which line items in the income statement include the effect on earnings of initially electing the fair value option for an item.

Footnote 6 -- Paragraph 10 of Statement 107 already requires an entity to disclose annually the methods and significant assumptions used to estimate the fair value of financial instruments. Thus, the effect of this disclosure requirement is essentially limited to instruments outside the scope of Statement 107 (for example, certain insurance contracts) for which the fair value option has been elected.