



EXPOSURE DRAFT

Proposed Accounting Standards Update

Issued: February 14, 2013
Comments Due: May 15, 2013

Financial Instruments—Overall (Subtopic 825-10)

Recognition and Measurement of Financial Assets and Financial Liabilities

This Exposure Draft of a proposed Accounting Standards Update of Subtopic 825-10 is issued by the Board for public comment. Comments can be provided using the electronic feedback form available on the FASB website. Written comments should be addressed to:

Technical Director
File Reference No. 2013-220

Financial Accounting Standards Board
of the Financial Accounting Foundation

The *FASB Accounting Standards Codification*[®] is the source of authoritative generally accepted accounting principles (GAAP) recognized by the FASB to be applied by nongovernmental entities. An Accounting Standards Update is not authoritative; rather, it is a document that communicates how the Accounting Standards Codification is being amended. It also provides other information to help a user of GAAP understand how and why GAAP is changing and when the changes will be effective.

Notice to Recipients of This Exposure Draft of a Proposed Accounting Standards Update

The Board invites comments on all matters in this Exposure Draft and is requesting comments by May 15, 2013. Interested parties may submit comments in one of three ways:

- Using the electronic feedback form available on the FASB website at [Exposure Documents Open for Comment](#)
- Emailing a written letter to director@fasb.org, File Reference No. 2013-220
- Sending written comments to “Technical Director, File Reference No. 2013-220, FASB, 401 Merritt 7, PO Box 5116, Norwalk, CT 06856-5116.”

Do not send responses by fax.

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Proposed Accounting Standards Update

Financial Instruments—Overall (Subtopic 825-10)

Recognition and Measurement of Financial Assets and Financial Liabilities

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Summary and Questions for Respondents

Why Is the FASB Issuing This Proposed Accounting Standards Update (Update)?

Before the global financial crisis that began in 2008, both the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) began a joint project to improve their respective standards on accounting for financial instruments. The global economic crisis further highlighted the ongoing concern that the existing accounting model for financial instruments with its inherent gaps and inconsistencies is inadequate for today's complex economic environment. As a result, the development of a financial reporting model for financial instruments that provides investors with more useful, transparent, and relevant information about an entity's exposure to financial instruments became a priority.

The main objective in developing this proposed Update is to provide financial statement users with more decision-useful information about an entity's involvement in financial instruments, while reducing the complexity in accounting for those instruments. The guidance in this proposed Update would improve financial reporting for financial instruments by developing a consistent, comprehensive framework for classifying those instruments that links the measurement of financial assets to the way in which an entity expects to benefit from the cash flows embedded in those assets. Additionally, this proposed guidance would improve the clarity and organization of the guidance on financial instruments, which in turn improves its accessibility.

The guidance in this proposed Update covers the recognition, classification, measurement, and presentation of financial instruments. The Board separately addressed impairment of debt instruments in proposed Accounting Standards Update, *Financial Instruments—Credit Losses (Subtopic 825-15)*, which was issued in December 2012.

Who Would Be Affected by the Amendments in This Proposed Update?

The proposed guidance would affect all entities that hold financial assets or owe financial liabilities. The extent of the effect on an individual entity would depend on the significance of financial instruments to the entity's operations and financial position. For example, traditional banking-type institutions and insurance companies would be affected to varying degrees depending on their asset mix and the business models within which they manage their financial assets. The

effect likely would be less significant for many commercial and industrial entities and many not-for-profit entities.

What Are the Main Provisions?

The guidance in this proposed Update focuses on creating a comprehensive framework for the classification and measurement of the financial instruments within its scope. An entity would determine the classification and measurement of a financial asset, upon initial recognition, by first considering whether the contractual terms of the asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding (the contractual cash flow characteristics criterion). If so, an entity then would consider the business model in which the asset is managed along with other financial assets to determine its classification and measurement. An entity would be required to measure financial assets that do not meet the contractual cash flow characteristics criterion at fair value with all changes in fair value recognized in net income.

A financial asset that passes the contractual cash flow characteristics criterion and is managed along with other financial assets within a business model for which the objective is to hold assets for collection of contractual cash flows would be measured at amortized cost. A financial asset that passes the contractual cash flow characteristics criterion and is managed along with other financial assets within a business model for which the objective is both to hold assets to collect contractual cash flows and to sell assets would be measured at fair value with qualifying changes in fair value recognized in other comprehensive income. That is, for such financial assets, an entity has not yet determined at recognition whether it will hold the individual asset to collect contractual cash flows or to sell the asset. Financial assets that qualify for neither of those two categories would be measured at fair value with all changes in fair value recognized in net income.

Equity investments would be measured at fair value with all changes in fair value recognized in net income (other than certain investments that are accounted for under the equity method of accounting). A practicability exception is provided for equity investments without readily determinable fair values that do not qualify for the practical expedient to estimate fair value in accordance with paragraph 820-10-35-59 (that is, the net asset value per share expedient). An entity that elects the practicability exception would be permitted to measure equity investments without readily determinable fair values at their cost, adjusted for both impairment and changes that result from observable price changes in orderly transactions for the identical or a similar investment of the same issuer. The proposed guidance also would simplify the impairment method for assessing impairment of equity investments that qualify for the practicability exception and for investments accounted for under the equity method of accounting. An equity investment without a readily determinable fair value that qualifies for the practicability exception or an investment that is accounted for by the equity method is impaired

if it is more likely than not that the fair value of the investment is less than its carrying value. An impairment loss would be recognized in net income equal to the entire difference between the investment's carrying value and its fair value if an impairment exists.

The proposed guidance also would eliminate the fair value option under existing U.S. generally accepted accounting principles (GAAP) for investments accounted for under the equity method of accounting held by business entities. The proposed guidance would require that when an equity investment first qualifies for the equity method, the entity would consider specified indicators to determine whether it holds the investment for sale. If the investment is held for sale, the entity would measure it at fair value with all changes in fair value recognized in net income. The proposed guidance would retain the separate, portfolio-wide option for not-for-profit entities, other than health care entities, to account for their equity method investments at fair value.

An entity would reclassify a financial asset if the business model changes, which is expected to occur very infrequently. The entity would account for the reclassification prospectively and would recognize the reclassification on the last day of the reporting period in which the business model changes.

An entity would measure its financial liabilities within the scope of this proposed guidance at amortized cost unless the entity's business strategy at the incurrence of the liability is to subsequently transact at fair value or the liability results from a short sale. Furthermore, in circumstances in which financial assets would be used to settle nonrecourse financial liabilities, an entity would measure its financial liabilities on the same measurement basis as the related financial assets.

The Board recognizes that users utilize both amortized cost and fair value information. Therefore, this proposed guidance would require a public entity to present parenthetically on the face of the statement of financial position the fair value of financial assets and financial liabilities (except for demand-deposit liabilities) that are measured at amortized cost. The fair value amounts presented parenthetically would be measured consistent with the requirements in Topic 820, Fair Value Measurement. A nonpublic entity would not be required to present or disclose fair value amounts for such financial instruments.

The proposed guidance also would eliminate the embedded derivative bifurcation requirements in Subtopic 815-15, Derivatives and Hedging—Embedded Derivatives, for hybrid financial assets. The proposed guidance would require an entity to classify and measure hybrid financial assets that give rise to cash flows that are not solely payments of principal and interest on the principal amount outstanding at fair value through net income. However, the proposed guidance would retain the embedded derivative bifurcation requirements for hybrid financial liabilities. For hybrid financial liabilities, an entity would first apply the guidance on bifurcation and separate accounting in Topic 815, Derivatives and Hedging, Topic 470, Debt, or Topic 480, Distinguishing Liabilities from Equity, as

appropriate for a particular instrument, before applying the proposed classification and measurement model. As a result, only a financial liability host or a debt-equity hybrid instrument with both debt and equity components that either is accounted for as a financial liability in its entirety or has a separately reportable financial liability component would be classified and measured in accordance with the proposed guidance.

The proposed guidance would replace the unconditional fair value option in today's U.S. GAAP that permits an entity to elect to measure many financial instruments (within the scope of this proposed guidance) at fair value, with all changes in fair value recognized in net income, with conditional fair value options. An entity would be permitted to elect to measure at fair value with all changes in fair value recognized in net income groups of financial assets and financial liabilities for which the entity manages the net exposure on a fair value basis. An entity would be able to elect a fair value option for hybrid financial liabilities under specified conditions to avoid bifurcation and separate accounting for an embedded derivative. An entity also would be able to elect a fair value option for financial assets that meet the contractual cash flow characteristics criterion and are managed within a business model for which the objective is both to hold assets to collect contractual cash flows and to sell assets.

The proposed guidance also would eliminate the fair value option for hybrid nonfinancial instruments in current U.S. GAAP and would provide a new fair value option for hybrid nonfinancial liabilities. In contrast, for a hybrid nonfinancial asset the proposed guidance would require the hybrid contract to be measured at fair value (with changes in fair value recognized in net income) if certain conditions are met.

For a financial liability measured at fair value with all changes in fair value recognized in net income under the conditional fair value option, an entity would be required to present separately in other comprehensive income the portion of the total change in the fair value of the liability that results from a change in the instrument-specific credit risk.

The guidance in this proposed Update does not address impairment of debt instruments. The Board separately addressed impairment of debt instruments in the proposed Accounting Standards Update on credit losses, which was issued in December 2012.

How Would the Main Provisions Differ from Current U.S. Generally Accepted Accounting Principles (GAAP) and Why Would They Be an Improvement?

One important way in which the main provisions of this proposed Update differ from the guidance on financial instruments in current U.S. GAAP is that the measurement of financial assets no longer would depend on their legal form, that is, whether an asset qualifies as a security or as a loan. Under current U.S. GAAP, an entity classifies its debt securities as trading (measured at fair value with all changes in fair value recognized in net income), available for sale (measured at fair value with qualifying changes in fair value recognized in other comprehensive income), or held to maturity (measured at amortized cost). However, loans are classified as either held for sale (measured at lower of cost or fair value) or held for investment (measured at amortized cost) using different criteria.

Current U.S. GAAP requires investments in equity securities that have readily determinable fair values to be classified as either trading or available for sale and prescribes the cost method for equity securities without a readily determinable fair value. The equity method of accounting is required if certain conditions are met.

The proposed guidance would improve not only the relevance of the information about financial assets in an entity's financial statements, but also the comparability of that information across entities because the legal form of the financial asset is not relevant in determining how to measure it, either initially or subsequently.

An entity would classify its financial assets by applying both a contractual cash flow characteristics criterion and a business model criterion. The business model assessment would require an entity to classify and measure a financial asset that meets the contractual cash flow characteristics criterion on the basis of how the entity would manage that financial asset together with other financial assets within a distinct business model.

An entity also would no longer be able to classify an equity instrument with a readily determinable fair value as available for sale, and the cost method of accounting would be eliminated. The proposed guidance would provide a practicability exception for an equity investment without a readily determinable fair value that does not qualify for the practical expedient to estimate fair value in accordance with paragraph 820-10-35-59 (that is, the net asset value per share expedient). In addition, the proposed guidance also would eliminate the other-than-temporary impairment model for equity investments under existing U.S. GAAP and replace it with a one-step impairment model based on assessment of

qualitative factors to determine when it is more likely than not that the fair value of the equity investment is below its carrying amount.

The proposed guidance would reduce alternative accounting methods, thereby improving comparability, by replacing the existing unconditional fair value option for financial instruments (within the scope of this proposed guidance) with limited fair value options.

Hybrid financial assets that do not give rise to cash flows that are solely payments of principal and interest on the principal amount outstanding would no longer be eligible for separate accounting for the derivative and nonderivative components and would be measured in their entirety at fair value with all changes in fair value recognized in net income. That provision would simplify the accounting for those instruments in addition to increasing the relevance of the information in financial statements by including in net income the change in fair value of a financial asset that has more than insignificant cash flow variability.

The proposed guidance would eliminate the need for bifurcation and separate accounting for hybrid nonfinancial assets by requiring the hybrid contract to be measured at fair value (with changes in fair value recognized in net income) if the hybrid nonfinancial asset contains an embedded derivative that would have required bifurcation and separate accounting under Subtopic 815-15.

Under current U.S. GAAP, changes in the fair value of a financial liability designated under the fair value option that result from a change in the instrument-specific credit risk are included in net income. The proposed guidance would require the portion of a change in the fair value of a financial liability resulting from a change in instrument-specific credit risk to be recognized in other comprehensive income and presented separately. That proposed amendment would improve the relevance of the information about financial liabilities measured at fair value by excluding from net income gains or losses that the entity may not realize because those financial liabilities designated under the fair value option are not usually settled at their fair value before maturity.

When Would the Amendments Be Effective?

The Board will establish the effective date of the proposed requirements when it issues the final amendments. An entity would apply the proposed guidance by means of a cumulative-effect adjustment to the statement of financial position as of the beginning of the first reporting period in which the guidance is effective. An entity may early adopt the presentation guidance related to the presentation of changes in instrument-specific credit risk for hybrid financial liabilities that will qualify for the fair value option upon issuance of the amendments in the final Update.

How Do the Proposed Provisions Compare with International Financial Reporting Standards (IFRS)?

In January 2012, the FASB and the IASB decided to jointly redeliberate selected aspects of their classification and measurement models in an attempt to reduce differences in several important areas. Those redeliberations were successful in increasing convergence in the areas reconsidered and, in November 2012, the IASB proposed amendments to IFRS 9, *Financial Instruments*, to implement changes resulting from the joint redeliberations, although some parts of the FASB's proposed guidance and the proposed amendments to IFRS 9 would still differ.

Under both the FASB's proposed guidance and the proposed amendments to IFRS 9, an entity would classify and subsequently measure financial assets on the basis of the results of contractual cash flow characteristics and business model assessments. The IASB tentatively decided to add to IFRS 9 a category of fair value with qualifying changes in fair value recognized in other comprehensive income.

Therefore, both Boards' models contain three classification and measurement categories for financial assets, including fair value with all changes in fair value recognized in net income, fair value with qualifying changes in fair value recognized in other comprehensive income, and amortized cost. However, under certain circumstances, the application of the business model assessment in this proposal may result in different classification outcomes when compared with the proposed amendments to IFRS 9 because the guidance in this proposed Update would provide, among other things, detailed guidance on when sales of financial assets that are classified at amortized cost are not permitted. In addition, IFRS 9 includes an option for an entity to make an irrevocable election at recognition to present in other comprehensive income subsequent changes in the fair value of an equity security not held for trading. The FASB's proposed guidance would require all equity investments to be classified and measured at fair value through net income, with a practicability exception provided for measuring equity investments without readily determinable fair values that do not qualify for the net asset value per share expedient.

The FASB's proposed guidance for reclassification of financial assets is similar to the guidance in the proposed amendments to IFRS 9. However, the FASB decided that the reclassification date would be the last day of the reporting period in which an entity's business model changes, while IFRS 9 considers the reclassification date to be the first day of the first reporting period following the change in business model.

The FASB's proposed guidance would provide a conditional fair value option to allow an entity to measure at fair value with all changes in fair value recognized in net income groups of financial assets and financial liabilities for which the

entity manages the net exposure. An entity would be able to elect the fair value option for hybrid financial liabilities to avoid bifurcation and separate accounting if certain conditions are met. An entity also would be able to elect a fair value option for financial assets that meet the contractual cash flow characteristics criterion and are managed within a business model for which the objective is both to hold assets to collect contractual cash flows and to sell assets. In contrast, IFRS 9 allows an entity to elect a fair value option for financial liabilities or financial assets otherwise measured at amortized cost to eliminate or significantly reduce an accounting mismatch between assets and liabilities. Similarly, the proposed amendments to IFRS 9 also would permit a fair value option for financial assets measured at fair value with qualifying changes in fair value recognized in other comprehensive income if measuring the asset(s) at fair value through net income would eliminate or significantly reduce an accounting mismatch. IFRS 9 also permits an entity to measure financial liabilities at fair value with all changes in fair value recognized in net income if a group of financial liabilities or financial assets and financial liabilities are managed on a fair value basis. In addition, similar to the FASB's proposed guidance, IFRS 9 also permits an entity to elect a fair value option for hybrid financial liabilities to avoid bifurcation and separate accounting if certain conditions are met. The IASB also tentatively decided to extend the accounting mismatch fair value option to financial assets that otherwise would be measured at fair value with qualifying changes in fair value recognized in other comprehensive income.

For financial liabilities that an entity designates as fair value with all changes in fair value recognized in net income, IFRS 9 requires an entity to present in other comprehensive income the amount of the change in fair value that is attributable to changes in instrument-specific credit risk unless that treatment would create a mismatch in profit or loss. The FASB's proposed guidance would require an entity to recognize and present separately in other comprehensive income changes in fair value that result from a change in instrument-specific credit risk for financial liabilities that are designated under the fair value option and thus measured at fair value with all changes in fair value recognized in net income.

The IASB retained most of the classification and measurement guidance in IAS 39, *Financial Instruments: Recognition and Measurement*, for financial liabilities but added the presentation requirement for changes in credit risk of financial liabilities measured at fair value. Under IFRS 9, an entity is required to measure all financial liabilities at amortized cost with certain exceptions, including derivatives that are liabilities and liabilities for which the fair value option has been elected. The FASB's proposed guidance also would require all financial liabilities within the scope of this proposed guidance to be measured at amortized cost with certain exceptions. Financial liabilities for which an entity's business strategy at inception is to transact subsequently at fair value and financial liabilities that result from short sales would be measured at fair value with all changes in fair value recognized in net income.

Questions for Respondents

The Board invites individuals and organizations to comment on all matters in this proposed Update, particularly on the issues and questions below. Comments are requested from those who agree with the proposed guidance as well as from those who do not agree. Comments are most helpful if they identify and clearly explain the issue or question to which they relate. Those who disagree with the proposed guidance are asked to describe their suggested alternatives, supported by specific reasoning.

Scope

Questions for All Respondents

Question 1: Do you agree with the scope of financial instruments included in this proposed Update? If not, which other financial instruments should be included or excluded from the guidance in this proposed Update and why?

Question 2: Do you agree with the industry-specific specialized guidance scope exceptions in paragraph 825-10-15-9? If not, why? What would you propose instead?

Recognition

Questions for Users

Question 3: The proposed amendments would require an entity to classify financial assets into the appropriate subsequent measurement category (that is, at amortized cost, at fair value with qualifying changes in fair value recognized in other comprehensive income, or at fair value with all changes in fair value recognized in net income) on the basis of the contractual cash flow characteristics of the instrument and the business model within which financial assets are managed. Does the classification of financial assets based on the cash flow characteristics and the business model assessment provide decision-useful information? If yes, how will this classification influence your analysis of the entity? If not, why?

Questions for All Respondents

Question 4: Do the proposed amendments appropriately convey the principle associated with the contractual cash flow characteristics assessment? If not, why? What would you propose instead?

Question 5: The proposed amendments define *principal* as the amount transferred by the holder at initial recognition. Should the definition of *principal* be expanded to include repayment of the principal amount at maturity or other settlement? If so, what instruments would fail (or pass) the contractual cash flow characteristics criterion as a result of this change?

Question 6: Do the proposed amendments contain sufficient application guidance and illustrations on implementing the cash flow characteristics assessment? If not, why?

Question 7: Should a financial asset with a contractual term that modifies the economic relationship (see paragraphs 825-10-55-17 through 55-20) between principal and interest be considered to contain cash flows that are solely payments of principal and interest? Should this be the case if, and only if, the contractual cash flows could or could not be more than insignificantly different from the benchmark cash flows as discussed in paragraph 825-10-55-19? If not, why? What would you propose instead?

Question 8: Do the proposed amendments contain sufficient application guidance in paragraphs 825-10-55-17 through 55-20 on assessing a modified economic relationship? If not, why?

Question 9: For beneficial interests in securitized financial assets, the proposed amendments would require an entity to look through to the underlying pool of instruments in determining whether the tranche contains payments of solely principal and interest. Do you agree with this look-through approach? If not, why? What would you propose instead?

Question 10: Do the proposed amendments appropriately convey the principle associated with the business model assessment? If not, why? What would you propose instead?

Question 11: Do the proposed amendments provide sufficient application guidance and illustrations on how to distinguish among the three business models, including determining whether the business model is to manage assets both to collect contractual cash flows and to sell? Do you agree with the proposed guidance provided to describe those business models? If not, why?

Question 12: Should the classification and measurement model for financial instruments contain an explicit tainting notion or should it rely on the principle and exercise of professional judgment? Why?

Question 13: The proposed amendments would require loan commitments, a revolving line of credit, or a commercial letter of credit (the potential creditor) to be measured on the basis of the likelihood of exercise of the commitment and the classification of the underlying loan that would be made upon exercise of the commitment. Do you agree with the proposed classification of loan commitments? If not, why? What would you propose instead?

Initial Measurement

Questions for All Respondents

Question 14: Do you agree with the initial measurement principles for financial instruments? If not, why?

Subsequent Measurement

Questions for Users

Question 15: The proposed amendments would eliminate the unconditional fair value option (for financial instruments within the scope of this proposed guidance) in existing U.S. GAAP and, instead, permit an entity to elect to measure at fair value, with all changes in fair value recognized in net income, all of the following:

- a. A group of financial assets and financial liabilities if the entity both:
 1. Manages the net exposure relating to those financial assets and financial liabilities (which may be derivative instruments) on a fair value basis
 2. Provides information on that basis to the reporting entity's management.
- b. Hybrid financial liabilities that meet certain prescribed criteria.
- c. Financial assets that meet the contractual cash flow characteristics criterion and are managed within a business model that has the objective of both holding financial assets to collect contractual cash flows and selling financial assets (in accordance with paragraph 825-10-25-25(b)).

Do these options provide decision-useful information? If not, why?

Questions for All Respondents

Question 16: Should financial liabilities subsequently be measured at amortized cost, unless certain exceptions are met? If not, why?

Question 17: The proposed amendments would require a nonrecourse financial liability that is settled with only the cash flows from the related financial assets (see paragraph 825-10-35-11) to be measured on the same basis as those assets. Do you agree with the proposed amendments? If not, why? What would you propose instead?

Question 18: The proposed amendments would require financial assets measured at amortized cost that are subsequently identified for sale to continue to be classified and measured at amortized cost less impairment and would prohibit recognition of the gain, until the sale is complete. Do you agree with the proposed classification and measurement requirements? If not, why?

Question 19: The proposed amendments would provide a practicability exception for measuring equity investments without readily determinable fair values that do not qualify for the practical expedient in paragraph 820-10-35-59 (that is, the net asset value per share expedient) and a one-step impairment model for all equity investments subject to the practicability exception. Do you agree with the proposed amendments? If not, why?

Question 20: Should an entity evaluate the need for a valuation allowance on a deferred tax asset related to a debt instrument measured at fair value with qualifying changes in fair value recognized in other comprehensive income separately from the other deferred tax assets of the entity (rather than combined and analyzed together)? If not, why?

Question 21: Under the amendments in this proposed Update, hybrid financial assets would not be required to be analyzed for bifurcation under Subtopic 815-15 and would be assessed in their entirety on the basis of the proposed classification requirements. In contrast, hybrid financial liabilities would be assessed for bifurcation and separate accounting under Subtopic 815-15, and the financial liability host contract would be subject to the proposed amendments. Do you agree with this proposal? If not, why? What would you propose instead?

Question 22: The proposed amendments would require reclassification of financial assets when a change in business model occurs and prescribes how those changes should be subsequently accounted for. Do you agree with the proposed amendment on reclassifications? If not, why?

Presentation

Questions for Users

Question 23: The proposed amendments would require public entities to parenthetically present fair value for items measured at amortized cost on the face of the statement of financial position. Does that presentation requirement provide decision-useful information? If not, why? What would you propose instead?

Question 24: The proposed amendments would exempt nonpublic entities from parenthetical and footnote disclosures of fair value. Should nonpublic entities be required to parenthetically present fair value information on the face of the statement of financial position for financial instruments measured at amortized cost? If not, should fair value disclosures in notes to the financial statements be required for some or all nonpublic entities for financial instruments measured at amortized cost?

Question 25: The proposed amendments would require an entity to separately present changes in fair value attributable to changes in instrument-specific credit risk in other comprehensive income for financial liabilities for which that entity has elected the fair value option. Would the proposed presentation requirement provide decision-useful information? If not, why? What would you propose instead?

Questions for Preparers and Auditors

Question 26: The proposed amendments would require an entity to separately recognize in net income changes in fair value attributable to foreign currency gain or loss on foreign-currency-denominated debt securities measured at fair value through other comprehensive income (see paragraphs 825-10-45-14 through 45-15). Is the proposed fair-value-based method provided for computing the foreign currency gain or loss component operable? If not, why? What would you propose instead?

Disclosures

Questions for Users

Question 27: The proposed amendments would require a public entity to provide disclosure of the core deposit liability balance, implied weighted-average maturity period, and the estimated all-in-cost-to-service rate by significant type of core deposit liability. Do you agree with the proposed disclosure requirement and, if so, how would you use that information? If not, what information should be provided and why? Is it appropriate not to require this information for nonpublic entities?

Question 28: Are there any other disclosures that would provide decision-useful information and why?

Questions for All Respondents

Question 29: Do you agree with the proposed disclosure requirements? If not, which disclosure requirement would you change and why?

Transition and Open Effective Date Information

Questions for All Respondents

Question 30: Should an entity be permitted to early adopt only the proposed presentation requirements related to changes in instrument-specific credit risk for hybrid financial liabilities that would qualify for the fair value option under the proposed requirements? If not, why?

Question 31: Should the effective date be the same for both public entities and nonpublic entities?

Questions for Preparers and Auditors

Question 32: How much time is needed to implement the proposed guidance?

Question 33: Are the transition provisions in this proposed Update operable? If not, why?

Equity Method Accounting

Questions for All Respondents

Question 34: The proposed amendments would require investments that qualify for the equity method of accounting in Subtopic 323-10, Investments—Equity Method and Joint Ventures—Overall, to be subsequently measured at fair value with changes in fair value recognized in net income if the investment is held for sale at initial recognition. Are the proposed indicators/conditions operable? If not, why? What would you propose instead?

Question 35: The proposed amendments would change the current two-step impairment model for equity method investments to a one-step impairment model for all equity investments. Do you agree with the proposed one-step equity impairment model? If not, why? What would you propose instead?

Question 36: Do you agree that the current portfolio-wide option for not-for-profit entities, other than health care entities, to account for their equity method investments at fair value should be retained? If not, why? Should that option also be made available to not-for-profit health care entities that are within the scope of Topic 954, Health Care Entities?

Nonfinancial Hybrid Instruments

Questions for All Respondents

Question 37: The proposed amendments would eliminate the fair value option for hybrid nonfinancial instruments in current U.S. GAAP and would provide a new fair value option for hybrid nonfinancial liabilities. For a hybrid nonfinancial liability, an entity would apply the bifurcation and separate accounting requirements in Subtopic 815-15 and account for the embedded derivative in accordance with Topic 815. The financial liability host that results from separation of the nonfinancial embedded derivative would be subject to the proposed amendments. However, an entity would be permitted to initially and subsequently measure the entire hybrid nonfinancial liability at fair value (with changes in fair value recognized in net income) if after applying Subtopic 815-15 the entity determines that an embedded derivative that requires bifurcation and separate accounting exists. In contrast, for a hybrid nonfinancial asset the proposed amendments would require the hybrid contract to be measured at fair value (with changes in fair value recognized in net income) if the hybrid nonfinancial asset contains an embedded derivative that would have required bifurcation and separate accounting under Subtopic 815-15. Do you agree with the proposed amendments? If not, why? What would you propose instead?

Proposed Guidance

Introduction

1. The Proposed Guidance section of this proposed Accounting Standards Update provides the amended Subtopic, Financial Instruments—Overall, as it would appear in the *FASB Accounting Standards Codification*[®] (with a link to transition paragraph 825-10-65-2) as a result of this proposed Update. The proposed guidance herein is a revision of the guidance in proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities—Financial Instruments (Topic 825) and Derivatives and Hedging (Topic 815)*, which was issued in May 2010.
2. None of the proposed guidance is shown underlined as new text, nor is the existing guidance shown ~~struck-out~~ as amended or deleted text.
3. The proposed guidance will affect all entities that hold financial assets or owe financial liabilities. The extent of the effect on an individual entity would depend on the significance of financial instruments to the entity's operations and financial position.
4. The amendments to existing guidance to supersede all of the Subsections of Subtopic 825-10 and to replace them with the proposed guidance are not shown. Those amendments to Subtopic 825-10 and to other Topics (for example, Topic 815, Topic 310, Receivables, Topic 320, Investments—Debt and Equity Securities, and Topic 325, Investments—Other) affected by the guidance in this proposed Update will be exposed for public comment during the comment period. Certain Subsections and paragraphs of existing Subtopic 825-10 will be moved to other relevant Subsections and paragraphs in Subtopic 825-30.
5. This proposed Update also contains guidance that would be added to Subtopic 323-10. Amendments as a result of that proposed guidance to Subtopic 323-10 will be included along with other amendments to various Topics as discussed in paragraph 4.
6. The Board expects to issue proposed amendments to the XBRL Taxonomy that would result from this proposed Update during the comment period on this proposed Update.

Subtopic 825-10

Accounting for Financial Instruments—Overall

Objectives

825-10-10-2 The objective of the guidance in the Overall Subtopic is to establish an improved and more consistent financial reporting model for the recognition, measurement, and presentation of **financial instruments** in an entity's financial statements. The guidance increases the decision usefulness of the information about an entity's financial assets provided in its financial statements by linking the measurement of the assets to the manner in which the entity expects to benefit from the related cash flows. The measurement of financial liabilities also takes into account whether the entity expects to pay the contractual cash flows or to settle the liability at its **fair value**.

Scope and Scope Exceptions

> Overall Guidance

825-10-15-1 This Subtopic establishes the scope for this Topic with specific differences noted in the other Subtopics of this Topic.

> Entities

825-10-15-2 The guidance in this Subtopic applies to all entities.

> Financial Instruments

825-10-15-8 This Subtopic applies to all **financial instruments** except for the following:

- a. An instrument held or issued by an entity that is classified in its entirety in the entity's stockholders' equity in accordance with the guidance in Topics 480 and 505.
- b. An equity component that has been separated from a **hybrid instrument** and classified in an entity's stockholders' equity in accordance with the guidance in Topic 470, 480, or another Topic that requires separate accounting for the components of a hybrid financial instrument.

- c. An employer's or plan's obligation and the related plan's assets, if any, that are within the scope of any of the following Topics:
 - 1. Topic 710
 - 2. Topic 712
 - 3. Topic 715
 - 4. Topic 718
 - 5. Topic 960
 - 6. Topic 962
 - 7. Topic 965.
- d. A financial instrument within the scope of Topic 944 except for the following, which are included in the scope of this Subtopic:
 - 1. A mortgage loan subject to Subtopic 944-310. However, the presentation requirements for mortgage loans in Section 944-310-45 remain in effect.
 - 2. An investment in debt or equity securities subject to Subtopic 944-320.
 - 3. An investment subject to Subtopic 944-325.
 - 4. Debt subject to Subtopic 944-470.
- e. A policyholder's investment in a life insurance contract that is accounted for under Subtopic 325-30.
- f. An investment in another entity that qualifies for use of the equity method in accordance with Topic 323, except for investments that are held for sale in accordance with paragraph 323-10-15-20.
- g. An equity investment in a consolidated subsidiary, a **noncontrolling interest** in a consolidated subsidiary, and an interest in a variable interest entity that the entity is required to consolidate (see Subtopic 810-10).
- h. A financial asset or financial liability pertaining to a lease that is in the scope of Topic 840.
- i. A **loan commitment** and a commercial letter of credit held by a potential borrower.
- j. The conditional obligation under a registration payment arrangement that is accounted for separately from the financial instrument(s) subject to the agreement in accordance with Subtopic 825-20.
- k. An acquisition-related contract and a contingent consideration arrangement in the scope of Topic 805.
- l. A **not-for-profit entity's** receivable or payable in accordance with a **promise to give** (often called a contribution receivable or contribution payable) within the scope of Topic 958.
- m. A financial guarantee contract within the scope of Topics 450, 460, 815, 840, or 944.
- n. A forward contract that requires physical settlement by repurchase of a fixed number of the issuer's equity shares in exchange for cash accounted for in accordance with paragraph 480-10-30-3.

- o. A forward contract that requires physical settlement by repurchase of a fixed number of the issuer's equity shares in exchange for cash and mandatorily redeemable financial instruments accounted for in accordance with paragraph 480-10-35-3.
- p. A **derivative instrument** that is in the scope of Topic 815.
- q. A forward contract related to a regular-way securities trade in accordance with paragraphs 815-10-15-15 through 15-21.
- r. A derivative that is an impediment to one party's use of sales accounting under Topic 860 in accordance with paragraphs 815-10-15-63 through 15-64.
- s. Certain contracts that are not exchange-traded in accordance with paragraphs 815-10-15-59 through 15-62.

> Status of Certain Specialized Industry Guidance

825-10-15-9 Entities in the following industries shall continue to apply the pertinent specialized industry guidance as described below:

- a. Brokers and dealers in securities subject to Topic 940 shall follow its guidance in all of the following areas:
 - 1. Initial measurement of all of the following:
 - i. Fail-to-deliver assets and fail-to-deliver liabilities (see Subtopic 940-20)
 - ii. Financial restructuring transactions (see Subtopic 940-325)
 - iii. Proprietary trading securities (see Subtopic 940-320)
 - iv. Exchange memberships (see Subtopic 940-340).
 - 2. Subsequent measurement of all of the following:
 - i. Securities underlying suspense accounts (see Subtopic 940-20)
 - ii. Shares that a broker-dealer is firmly committed to purchase but that have not yet been subscribed to by customers (see Subtopic 940-20)
 - iii. Investments in the form of equity or financing provided to another entity in connection with financial restructuring transactions (see Subtopic 940-325)
 - iv. Proprietary trading securities (see Subtopic 940-320)
 - v. Exchange memberships (see Subtopic 940-340). However, an entity shall apply the impairment guidance for an equity investment for which **fair value** is not readily determinable in paragraphs 825-10-35-18 through 35-19 to investments in exchange memberships recognized as ownership interests.

- b. Investment companies subject to Topic 946 shall follow its guidance in all of the following areas:
 - 1. Initial measurement of investments in debt and equity securities in Subtopic 946-320
 - 2. Subsequent measurement of investments in debt and equity securities in Subtopic 946-320
 - 3. Measurement of all of the following in Subtopic 946-310:
 - i. Dividends and interest
 - ii. Investment securities sold and capital stock sold
 - iii. Other accounts receivable, such as receivables from related parties, including expense reimbursement receivables from affiliates and variation margin on open futures contracts.
 - 4. Measurement of foreign currency gains or losses in Subtopic 946-830.
- c. Agricultural entities subject to Topic 905 shall follow its guidance on accounting for investments in agricultural cooperatives of farmers as follows:
 - 1. Recognition (see paragraphs 905-325-25-1 through 25-3)
 - 2. Initial measurement (see paragraphs 905-325-30-1 through 30-3)
 - 3. Subsequent measurement (see paragraphs 905-325-35-1 through 35-2).
- d. Depository and lending entities subject to Topic 942 shall follow its guidance in both of the following areas:
 - 1. Subsequent measurement of Federal Home Loan Bank and Federal Reserve Bank stock (see paragraph 942-325-35-1). An entity shall apply the impairment guidance for an equity investment for which fair value is not readily determinable in paragraphs 825-10-35-18 through 35-19 to investments in Federal Home Loan Bank and Federal Reserve Bank stock.
 - 2. Subsequent measurement of National Credit Union Share Insurance Fund deposits of credit unions (see paragraph 942-325-35-4).

Glossary

All-in-Cost-to-Service Rate

A rate that includes the net direct costs to service core deposit liabilities, including interest paid on those deposits and the expense of maintaining a branch network minus fee income earned on those deposit accounts.

Amortized Cost

A cost-based measure of a financial asset or financial liability that adjusts the initial cash inflow or outflow (or the noncash equivalent) for factors such as amortization or other allocations. Amortized cost is calculated as the initial cash outflow or cash inflow (or the noncash equivalent) of a financial asset or financial liability adjusted over time as follows:

- a. Decreased by principal repayments
- b. Increased or decreased by the cumulative accretion or amortization of any original issue or purchase discount or premium and cumulative amortization of any transaction fees or costs not recognized in net income in the period of acquisition or incurrence
- c. Increased or decreased by foreign exchange adjustments
- d. Increased or decreased by the change in fair value attributable to the hedged risk for the hedged item in a fair value hedge
- e. Decreased by writeoffs.

Core Deposit Liabilities

Deposits without a contractual maturity that management considers to be a stable source of funds, which excludes surge balances due to seasonal factors or economic uncertainty and other balances that management believes are transient (such as highly interest-rate-sensitive accounts).

Debt Instrument

A receivable or payable that represents a contractual right to receive cash (or other consideration) or a contractual obligation to pay cash (or other consideration) on fixed or determinable dates, whether or not there is any stated provision for interest.

Derivative Instrument

Paragraphs 815-10-15-83 through 15-139 define the term *derivative instrument*.

Direct Loan Origination Costs

Direct loan origination costs represent costs associated with originating a loan. Direct loan origination costs of a completed loan shall include only the following:

- a. Incremental direct costs of loan origination incurred in transactions with independent third parties for that loan
- b. Certain costs directly related to specified activities performed by the lender for that loan. Those activities include all of the following:
 1. Evaluating the prospective borrower's financial condition
 2. Evaluating and recording guarantees, collateral, and other security arrangements
 3. Negotiating loan terms
 4. Preparing and processing loan documents
 5. Closing the transaction.

The costs directly related to those activities shall include only that portion of the employees' total compensation and payroll-related fringe benefits directly related to time spent performing those activities for that loan and other costs related to those activities that would not have been incurred but for that loan. See Section 310-20-55 for examples of items.

Embedded Derivative

Implicit or explicit terms that affect some or all of the cash flows or the value of other exchanges required by a contract in a manner similar to a derivative instrument.

Fair Value

The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Financial Asset

Cash, evidence of an ownership interest in an entity, or a contract that conveys to one entity a right to do either of the following:

- a. Receive cash or another financial instrument from a second entity
- b. Exchange other financial instruments on potentially favorable terms with the second entity.

Financial Instrument

Cash, evidence of an ownership interest in an entity, or a contract that both:

- a. Imposes on one entity a contractual obligation either:
 1. To deliver cash or another financial instrument to a second entity
 2. To exchange other financial instruments on potentially unfavorable terms with the second entity.
- b. Conveys to that second entity a contractual right either:
 1. To receive cash or another financial instrument from the first entity
 2. To exchange other financial instruments on potentially favorable terms with the first entity.

The use of the term *financial instrument* in this definition is recursive (because the term *financial instrument* is included in it), although it is not circular. The definition requires a chain of contractual obligations that ends with the delivery of cash or an ownership interest in an entity. Any number of obligations to deliver financial instruments can be links in a chain that qualifies a particular contract as a financial instrument.

Contractual rights and contractual obligations encompass both those that are conditioned on the occurrence of a specified event and those that are not. All contractual rights (contractual obligations) that are financial instruments meet the definition of asset (liability) set forth in FASB Concepts Statement No. 6, *Elements of Financial Statements*, although some may not be recognized as assets (liabilities) in financial statements—that is, they may be off-balance-sheet—because they fail to meet some other criterion for recognition.

For some financial instruments, the right is held by or the obligation is due from (or the obligation is owed to or by) a group of entities rather than a single entity.

Financial Liability

A contract that imposes on one entity an obligation to do either of the following:

- a. Deliver cash or another financial instrument to a second entity
- b. Exchange other financial instruments on potentially unfavorable terms with the second entity.

Hybrid Instrument

A contract that embodies both an **embedded derivative** and a host contract.

Implied Weighted-Average Maturity

For a **core deposit liability**, management's assessment of the weighted-average expected life by account type.

Loan Commitment

Loan commitments are legally binding commitments to extend credit to a counterparty under certain prespecified terms and conditions. They have fixed expiration dates and may either be fixed-rate or variable-rate. Loan commitments can be either of the following:

- a. Revolving (in which the amount of the overall commitment is reestablished upon repayment of previously drawn amounts)
- b. Nonrevolving (in which the amount of the overall commitment is not reestablished upon repayment of previously drawn amounts).

Loan commitments can be distributed through syndication arrangements, in which one entity acts as a lead and an agent on behalf of other entities that will each extend credit to a single borrower. Loan commitments generally permit the lender to terminate the arrangement under the terms of covenants negotiated under the agreement.

Loan Origination Fees

Origination fees consist of all of the following:

- a. Fees that are being charged to the borrower as prepaid interest or to reduce the loan's nominal interest rate, such as interest buy-downs (explicit yield adjustments)
- b. Fees to reimburse the lender for origination activities
- c. Other fees charged to the borrower that relate directly to making the loan (for example, fees that are paid to the lender as compensation for granting a complex loan or agreeing to lend quickly)
- d. Fees that are not conditional on a loan being granted by the lender that receives the fee but are, in substance, implicit yield adjustments because a loan is granted at rates or terms that would not have otherwise been considered absent the fee (for example, certain syndication fees addressed in paragraph 310-20-25-19)
- e. Fees charged to the borrower in connection with the process of originating, refinancing, or restructuring a loan. This term includes points, management, arrangement, placement, application, underwriting, and other fees pursuant to a lending or leasing transaction and also includes syndication and participation fees to the extent they are associated with the portion of the loan retained by the lender.

Noncontrolling Interest

The portion of equity (net assets) in a subsidiary not attributable, directly or indirectly, to a parent. A noncontrolling interest is sometimes called a minority interest.

Not-for-Profit Entity

An entity that possesses the following characteristics, in varying degrees, that distinguish it from a business entity:

- a. Contributions of significant amounts of resources from resource providers who do not expect commensurate or proportionate pecuniary return
- b. Operating purposes other than to provide goods or services at a profit
- c. Absence of ownership interests like those of business entities.

Entities that clearly fall outside this definition include the following:

- a. All investor-owned entities
- b. Entities that provide dividends, lower costs, or other economic benefits directly and proportionately to their owners, members, or participants, such as mutual insurance entities, credit unions, farm and rural electric cooperatives, and employee benefit plans.

Promise to Give

A written or oral agreement to contribute cash or other assets to another entity. A promise carries rights and obligations—the recipient of a promise to give has a right to expect that the promised assets will be transferred in the future, and the maker has a social and moral obligation, and generally a legal obligation, to make the promised transfer. A promise to give may be either conditional or unconditional.

Public Entity

An entity that meets any of the following criteria:

- a. Its debt or equity securities are traded in a public market, including those traded on a stock exchange or in the over-the-counter market (including securities quoted only locally or regionally).
- b. It is a conduit bond obligor for **conduit debt securities** that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets).
- c. Its financial statements are filed with a regulatory agency in preparation for the sale of any class of securities.

Readily Determinable Fair Value

An equity investment has a readily determinable fair value if it meets any of the following conditions:

- a. The fair value of an equity investment is readily determinable if sales prices or bid-and-asked quotations are currently available on a securities exchange registered with the U.S. Securities and Exchange Commission (SEC) or in the over-the-counter market, provided that those prices or quotations for the over-the-counter market are publicly reported by the National Association of Securities Dealers Automated Quotations systems or by Pink Sheets LLC.
- b. The fair value of an equity investment traded only in a foreign market is readily determinable if that foreign market is of a breadth and scope comparable to one of the U.S. markets referred to above.
- c. The fair value of an investment in a mutual fund is readily determinable if the fair value per share (unit) is determined and published and is the basis for current transactions.

Transaction Costs

The costs to sell an asset or transfer a liability in the principal (or most advantageous) market for the asset or liability that are directly attributable to the disposal of the asset or the transfer of the liability and meet both of the following criteria:

- a. They result directly from and are essential to that transaction.
- b. They would not have been incurred by the entity had the decision to sell the asset or transfer the liability not been made (similar to costs to sell, as defined in paragraph 360-10-35-38).

Recognition

> Recognition Principle

825-10-25-14 Depending on an entity's present rights or obligations in the instrument upon acquisition or incurrence, the entity shall recognize a **financial instrument** in its statement of financial position as either of the following:

- a. A **financial asset**
- b. A **financial liability**.

825-10-25-15 The recognition principle uses the terms *acquisition* and *incurrence* in their broadest sense to refer to the obtaining of an asset or a liability, regardless of how it is obtained. For example, a financial institution may acquire

a loan by originating it or by purchasing it from another entity, or an entity may incur a liability by issuing bonds or by undertaking the obligation to settle another entity's liability.

> Classification of Financial Assets

825-10-25-16 Upon recognition, an entity shall classify each financial asset into the appropriate subsequent measurement category on the basis of both of the following:

- a. The contractual cash flow characteristics of the asset (see paragraphs 825-10-25-17 through 25-24)
- b. The entity's business model for managing the asset (see paragraph 825-10-25-25).

A financial asset is classified at something other than fair value with all changes in **fair value** recognized in net income if it meets the contractual cash flow characteristics criterion and is managed within a business model in accordance with paragraph 825-10-25-25(a) through (b). (See paragraph 825-10-35-10 for guidance on the subsequent measurement of financial liabilities, which does not depend on classifying those liabilities on the basis of their contractual cash flow characteristics or the business model in which they are managed.)

>> Contractual Cash Flow Characteristics

825-10-25-17 A financial asset satisfies the contractual cash flow characteristics criterion if the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

825-10-25-18 For purposes of this Subtopic, *principal* is the amount transferred by the holder at initial recognition. *Interest* is consideration for the time value of money and for the credit risk associated with the principal amount outstanding during a particular period of time, which may include a premium for liquidity risk. If a financial asset satisfies the cash flow characteristics criterion, an entity shall apply the business model criterion in paragraph 825-10-25-25 to determine the appropriate classification category for the asset.

825-10-25-19 A financial asset with terms that could result in cash flows that are not solely payments of principal and interest does not satisfy the contractual cash flow characteristics criterion and shall subsequently be measured in accordance with paragraph 825-10-35-9. An entity shall not apply the business model criterion in paragraph 825-10-25-25 to a financial asset that fails to satisfy the contractual cash flow characteristics criterion.

825-10-25-20 A contractual term may change the timing or amount of payments of principal or interest on the principal amount outstanding. Such a contractual term results in cash flows that are solely payments of principal and interest on

the principal amount outstanding only if the contractual term is any of the following:

- a. A variable interest rate that is consideration for the time value of money and the credit risk associated with the principal amount outstanding (the consideration for credit risk may be determined at initial recognition only and, therefore, may be fixed)
- b. A prepayment option that meets the conditions in paragraph 825-10-55-21
- c. An extension option that meets the conditions in paragraph 825-10-55-22.

825-10-25-21 See paragraphs 825-10-55-17 through 55-20 for application of the contractual cash flow characteristics criterion to financial assets in which the economic relationship between principal and the consideration for the time value of money and the credit risk is modified by leverage or an interest rate reset feature.

825-10-25-22 See paragraphs 825-10-55-23 through 55-25 for application of the contractual cash flow characteristics criterion to financial assets that contain cash flows that are contingent on a future event or circumstance.

825-10-25-23 See paragraphs 825-10-55-26 through 55-27 for application of the contractual cash flow characteristics criterion to beneficial interests in securitized financial assets.

825-10-25-24 See paragraphs 825-10-55-44 through 55-69 for illustrative guidance on applying the contractual cash flows characteristics criterion.

> > **Business Model**

825-10-25-25 An entity shall classify a financial asset that meets the cash flow characteristics criterion into one of the following three categories depending on how the asset is managed together with other financial assets within a distinct business model:

- a. The asset is held and managed within a business model that has the objective of holding the assets to collect contractual cash flows.
- b. The asset is held and managed within a business model that has the objective of both:
 1. Holding financial assets to collect contractual cash flows
 2. Selling financial assets. (That is, at recognition, the entity has not yet determined whether it will hold the individual asset to collect contractual cash flows or sell the asset.)
- c. The asset fails to qualify for either (a) or (b).

See paragraphs 825-10-55-28 through 55-39 for illustrative guidance on applying the business model criterion.

> Applying the Recognition Principle and Classification Guidance to Particular Financial Instruments

> > Hybrid Financial Instruments

825-10-25-26 For a **hybrid instrument** that is a financial asset, an entity shall apply the classification criteria in paragraphs 825-10-25-17 through 25-24 to the instrument in its entirety. That is, the entity shall not separate the hybrid instrument into its **derivative instrument** and nonderivative instrument components and account for the components separately.

825-10-25-27 For a hybrid instrument that is a financial liability, an entity shall first apply the guidance in Subtopic 815-15, Topic 470, or Topic 480 on whether to separate the hybrid instrument into its derivative and nonderivative components. The entity shall then measure the financial liability host contract or the instrument that is recognized in its entirety as a financial liability in accordance with the guidance in paragraph 825-10-35-10, absent specialized guidance in Subtopic 470-20.

> Exceptions to the Recognition Principle or the Classification Criteria

> > Loan Commitments, Revolving Lines of Credit, and Commercial Letters of Credit

825-10-25-28 An entity that issues a **loan commitment**, a revolving line of credit, or a commercial letter of credit (the potential creditor) for which the likelihood of exercise is deemed to be not remote at inception of the instrument, shall classify that instrument in accordance with the classification of the underlying loan that would be made upon exercise of the commitment. An entity shall not apply the classification guidance in paragraph 825-10-25-25 to the loan commitment, revolving line of credit, or commercial letter of credit itself but rather shall look to the classification of only the underlying loan to be made under the commitment. Thus, an entity would classify a loan commitment consistent with the classification categories in paragraph 825-10-25-25 only if the underlying loan that would be made upon exercise of the commitment meets the contractual cash flow characteristics criterion in paragraph 825-10-25-17 and is managed in a business model consistent with paragraph 825-10-25-25.

825-10-25-29 Paragraphs 825-10-35-20 through 35-21 provide guidance on the potential creditor's subsequent measurement of a loan commitment, a revolving line of credit, or a commercial letter of credit.

> > Pools of Similar Financial Assets

825-10-25-30 Upon recognition of a pool of similar financial assets, such as a pool of loan receivables, an entity may expect to sell a portion of the pool and to

continue to hold and manage the other portion to collect the contractual cash flows. If upon recognition an entity has not yet identified specific assets that it will subsequently sell and the assets in the pool meet the contractual cash flow characteristics criterion in paragraph 825-10-25-17, the entity shall classify a percentage of the pool into one of the three classification categories in paragraph 825-10-25-25.

> Application to Investment Companies

825-10-25-31 In accordance with Topic 946, an investment company recognizes all amounts for a period in net increase (decrease) in net assets. The classification category in paragraph 825-10-25-25(b) is not available to an investment company.

Initial Measurement

> Initial Measurement Principle

825-10-30-1 An entity shall initially measure a **financial instrument** consistent with its subsequent measurement as follows:

- a. At its transaction price for both of the following:
 1. A **financial asset** or **financial liability** subsequently measured at **amortized cost**
 2. A financial asset (or, in limited situations, a financial liability [see paragraph 825-10-35-11]), subsequently measured at **fair value** with qualifying changes in fair value recognized in other comprehensive income.
- b. At its fair value for a financial asset or a financial liability subsequently measured at fair value with all changes in value recognized in net income.

>> Accounting for Fees and Costs

825-10-30-2 For financial assets initially measured at the transaction price in accordance with paragraph 825-10-30-1(a), an entity shall defer certain **loan origination fees**, net of **direct loan origination costs**, in accordance with paragraph 310-20-25-2. An entity shall account for those fees and costs as a yield adjustment over the life of the related financial asset in accordance with Subtopic 310-20. For financial liabilities that are initially measured at the transaction price, an entity shall account for the issuance costs in accordance with paragraph 835-30-45-3.

825-10-30-3 For financial assets and financial liabilities initially measured at fair value with changes in fair value recognized in net income in accordance with

paragraph 825-10-30-1(b), an entity shall include in net income the transaction fees and **transaction costs** related to a financial instrument.

> > **If the Transaction Price Includes Consideration for Something Other Than the Financial Instrument**

825-10-30-4 If part of the consideration given or received is for something other than the financial instrument, an entity shall initially measure the financial instrument at fair value.

825-10-30-5 An entity's assessment at the inception of a transaction of whether part of the consideration given or received is for something other than the financial instrument shall be made in light of the specific terms of the transaction and the overall consideration exchanged by the parties to the transaction.

825-10-30-6 An entity that determines at the inception of a lending or other transaction that the consideration given or received includes a component other than the financial instrument shall allocate the consideration between the financial instrument and the other component. The difference between the **fair value** of the financial instrument and the consideration given or received is the amount to be allocated to the remaining component of the transaction. An entity shall recognize that difference between the fair value of the financial instrument and the consideration given or received in accordance with Subtopic 835-30. (See paragraphs 825-10-55-40 through 55-43 for implementation guidance on applying this paragraph.)

> > **Application to Not-for-Profit Entities**

825-10-30-7 In applying paragraph 825-10-30-1, a **not-for-profit entity** within the scope of Topic 958 shall determine whether a financial asset meets the criteria for subsequent measurement at fair value with qualifying changes in fair value recognized in other comprehensive income in accordance with paragraph 825-10-35-8(b) (or a financial liability subject to paragraph 825-10-35-11). If it does, the entity shall initially measure it at the transaction price regardless of the fact that a not-for-profit entity does not report net income and other comprehensive income (see paragraph 825-10-35-15, which deals with a similar issue in applying the guidance on subsequent measurement).

Subsequent Measurement

> **Subsequent Measurement Principle**

825-10-35-8 An entity shall subsequently measure the **financial assets** classified into each category in paragraph 825-10-25-25 as follows:

- a. Held-to-collect contractual cash flows—at **amortized cost**

- b. Held-to-collect contractual cash flows and to sell—at **fair value** with qualifying changes in fair value recognized in other comprehensive income (fair value through other comprehensive income)
- c. Financial assets that do not qualify for (a) or (b)—at fair value with all changes in fair value recognized in net income (fair value through net income).

825-10-35-9 An entity shall subsequently measure a financial asset that does not meet the contractual cash flow characteristics criterion in paragraph 825-10-25-17 at fair value with all changes in fair value recognized in net income.

825-10-35-10 An entity shall subsequently measure its **financial liabilities** at amortized cost, except for a liability that meets either of the following conditions:

- a. The entity's business strategy at incurrence of the liability is to subsequently transact at fair value, for example, to transfer the obligation to a third party.
- b. The financial liability results from a short sale.

An entity shall subsequently measure a liability that meets either of those conditions at fair value with all changes in fair value recognized in net income.

825-10-35-11 If the contractual terms of a nonrecourse financial liability require an entity to settle the entire liability with only the cash flows from the related financial assets, the entity shall do both of the following:

- a. Subsequently measure the nonrecourse financial liability on the same measurement basis as the related financial assets. For example, if the assets are measured at fair value with qualifying changes in fair value recognized in other comprehensive income, the liability also shall be measured on that basis.
- b. Take into account in measuring the nonrecourse financial liability the same factors that are used in measuring the financial assets. For example, if both the asset and the liability are measured at amortized cost and the reported amount of the asset is reduced by recognition of credit losses, the reported amount of the nonrecourse liability shall include a similar reduction. That is, the nonrecourse liability shall be measured at the same amount as the related financial assets.

This guidance shall not be applied to nonrecourse financial liabilities that require settlement of the obligation from cash flows associated with both financial and nonfinancial assets. Except for the nonrecourse liabilities to which this paragraph applies, an entity shall not subsequently measure financial liabilities at fair value with qualifying changes in fair value recognized in other comprehensive income.

> > Change in Fair Value That Qualifies for Recognition in Other Comprehensive Income

825-10-35-12 For financial assets in paragraph 825-10-35-8(b) (and financial liabilities subject to the preceding paragraph), an entity shall recognize in other comprehensive income changes in fair value except for the following, which shall be recognized in net income during the reporting period:

- a. Current-period-interest income or expense, including amortization or accretion of both of the following:
 1. Premium or discount upon acquisition
 2. Deferred **loan origination fees** and costs as described in paragraph 825-10-30-2.
- b. Current period amount of credit losses on financial assets
- c. Change in fair value attributable to the hedged risk if the **financial instrument** is designated as the hedged item in a qualifying fair value hedging relationship
- d. Realized gains and losses from sales or settlements
- e. Foreign currency gains and losses on foreign-currency-denominated debt instruments in accordance with paragraph 825-10-45-14.

> Application of the Subsequent Measurement Principle to Particular Financial Instruments

> > Equity Investments

825-10-35-13 An entity shall subsequently measure an equity investment at fair value with all changes in fair value recognized in net income unless the investment qualifies for the equity method of accounting or results in consolidation. (See paragraph 825-10-35-17 for an exception to the subsequent measurement principle for an equity investment without a **readily determinable fair value** that does not qualify for the practical expedient to estimate fair value in accordance with paragraph 820-10-35-59.)

> > Financial Assets Subsequently Identified for Sale

825-10-35-14 An entity may subsequently identify for sale a financial asset that at recognition qualified for the amortized cost classification. In that circumstance, the entity shall continue to classify and measure the financial asset at amortized cost (less allowance for expected credit losses) and shall recognize a related gain, if any, only when the sale is complete. If the fair value of the financial asset subsequently identified for sale is below the net carrying amount (including allowance for expected credit losses), an entity shall measure impairment of a financial asset subsequently identified for sale as the entire amount of the difference between the asset's net carrying amount and its fair value and include

that impairment loss in net income. See paragraphs 825-10-45-7 through 45-8 for guidance for presenting in the statement of financial position financial assets that an entity initially classifies in the amortized cost category but subsequently identifies for sale.

> Application to Not-for-Profit Entities

825-10-35-15 The guidance in paragraphs 825-10-35-8 through 35-11 is structured in terms of whether qualifying changes in the fair value of a financial instrument are recognized in other comprehensive income (see paragraph 825-10-35-8(b)) or whether all changes in the fair value of a financial instrument are recognized in net income (see paragraph 825-10-35-8(c)). A **not-for-profit entity** within the scope of Topic 958 does not report net income or other comprehensive income, but a not-for-profit entity within the scope of Topic 954 may report a performance indicator that is comparable to net income. An entity within the scope of Topic 954 that reports a performance indicator shall report amounts that a business entity would report in net income within the performance indicator and amounts that a business entity would report in other comprehensive income outside the performance indicator. All other not-for-profit entities within the scope of Topic 958, including those in Topic 954 that do not report a performance indicator, shall report the total change in the fair value of a financial instrument as a change in the appropriate net asset class in its statement of activities.

> Deferred Tax Assets

825-10-35-16 An entity shall evaluate the need for a valuation allowance on a deferred tax asset related to unrealized losses on a financial instrument classified in the fair value through other comprehensive income category separately from the entity's other deferred tax assets. (See Topic 740 for guidance on accounting for income taxes.)

> Exceptions to the Subsequent Measurement Principle

> > Equity Investments without Readily Determinable Fair Values

825-10-35-17 An entity, except for a broker and dealer in securities that is subject to the guidance in Topic 940 or an investment company that is subject to the guidance in Topic 946, may measure an equity investment without a readily determinable fair value that does not qualify for the practical expedient to estimate fair value in accordance with paragraph 820-10-35-59 at its cost minus impairment, if any, plus or minus changes resulting from observable price changes in orderly transactions for the identical investment or a similar investment of the same issuer. An entity shall reassess at each reporting period whether the equity investment without a readily determinable fair value qualifies for the measurement exception in accordance with this paragraph.

825-10-35-18 An equity investment without a readily determinable fair value that does not qualify for the practical expedient to estimate fair value in accordance with paragraph 820-10-35-59 and is measured in accordance with the preceding paragraph is impaired if it is more likely than not that the fair value of the investment is less than its carrying value, which is determined using the guidance in the preceding paragraph. At each reporting period, an entity that holds an equity investment shall make a qualitative assessment considering impairment indicators to evaluate whether the investment is impaired. Impairment indicators that an entity considers include the following:

- a. A significant deterioration in the earnings performance, credit rating, asset quality, or business prospects of the investee
- b. A significant adverse change in the regulatory, economic, or technological environment of the investee
- c. A significant adverse change in the general market condition of either the geographic area or the industry in which the investee operates
- d. A bona fide offer to purchase, an offer by the investee to sell, or a completed auction process for the same or similar investment for an amount less than the cost of that investment
- e. Factors that raise significant concerns about the investee's ability to continue as a going concern, such as negative cash flows from operations, working capital deficiencies, or noncompliance with statutory capital requirements or debt covenants.

825-10-35-19 If an equity investment without a readily determinable fair value is impaired, an entity shall include an impairment loss in net income equal to the difference between the fair value of the investment and its carrying amount. That is, if the investment is deemed to be impaired after conducting the evaluation required by the preceding paragraph, the entity shall estimate the fair value of the investment to determine the amount of the impairment loss.

> > Loan Commitments, Revolving Lines of Credit, and Commercial Letters of Credit

825-10-35-20 Paragraph 825-10-25-28 requires a creditor to classify a **loan commitment**, a revolving line of credit, or a commercial letter of credit for which the probability of exercise is not remote in accordance with the classification of the underlying loan to be made under the commitment. Thus, if the underlying loan, when originated, is measured at fair value, the loan commitment also would be measured at fair value. If the underlying loan is measured at amortized cost, the creditor shall defer the commitment fee received, if any, and recognize it over the life of the funded loan in accordance with the guidance in Subtopic 310-20.

825-10-35-21 If the exercise of a loan commitment, a revolving line of credit, or a commercial letter of credit is deemed to be remote, a creditor shall recognize the

commitment fee received, if any, over the commitment period in accordance with the guidance in Subtopic 310-20.

> Reclassification of Financial Assets

825-10-35-22 With one exception, which is expected to occur very infrequently, an entity shall subsequently measure and account for financial assets in accordance with their classification determined upon recognition of the assets. However, an entity shall prospectively reclassify financial assets if, and only if, the business model within which the assets are held and managed changes. A change in the business model that requires reclassification of financial assets must be determined by an entity's senior management as a result of external or internal change, must be significant to the entity's operations, and must be demonstrable to external parties. See paragraphs 825-10-55-86 through 55-87 for Examples that constitute changes in the business model as well as those that do not.

825-10-35-23 An entity shall reclassify the financial assets that are subject to a change in the business model as of the last day of the reporting period in which the change in the business model occurs. The accounting for a change in the business model depends on the nature of the change, as follows:

- a. If the reclassification is from fair value with all changes in fair value recognized in net income to:
 1. Fair value with qualifying changes in fair value recognized in other comprehensive income, the financial assets shall continue to be measured at fair value with qualifying changes in fair value after the reclassification date recognized in other comprehensive income
 2. Amortized cost, the fair values of the financial assets on the reclassification date shall be the assets' new carrying amounts for amortized cost purposes.
- b. If the reclassification is from fair value with qualifying changes recognized in other comprehensive income to:
 1. Fair value with all changes in fair value recognized in net income, the financial assets shall continue to be measured at fair value. Any accumulated balances in other comprehensive income shall be recognized in net income on the date of reclassification by means of an offsetting entry to accumulated other comprehensive income. The fair values of the financial assets on the reclassification date shall be the assets' new carrying amounts.
 2. Amortized cost, the financial assets shall be measured at their fair values on the reclassification date. The related balance in accumulated other comprehensive income at the reclassification date shall be derecognized by means of an offsetting entry to the carrying amount of the financial assets.
- c. If the reclassification is from amortized cost to:

1. Fair value with all changes in fair value recognized in net income, the financial assets shall be measured at fair value on the reclassification date with any difference between the previous carrying amounts and the new carrying amounts (fair value on the reclassification date) recognized in net income
2. Fair value with qualifying changes recognized in other comprehensive income, the financial assets shall be measured at fair value on the reclassification date with any difference between the previous carrying amounts and new carrying amounts (fair value on the reclassification date) recognized in other comprehensive income.

Other Presentation Matters

> Statement of Financial Position

825-10-45-4 An entity shall present **financial assets** and **financial liabilities** separately on the face of the statement of financial position, grouped by measurement category.

> > Financial Instruments Measured at Amortized Cost

825-10-45-5 A **public entity** shall present parenthetically on the face of the statement of financial position the **fair value** of financial assets and financial liabilities that are measured at **amortized cost**. That parenthetical disclosure of fair value is not required for either of the following:

- a. Receivables or payables due in less than a year
- b. Demand deposit liabilities.

825-10-45-6 Subtopic 825-15 provides additional guidance on presentation of financial assets measured at amortized cost and related disclosure requirements.

> > > Financial Assets Initially Classified as Held-to-Collect Contractual Cash Flows That Are Subsequently Identified for Sale

825-10-45-7 An entity shall present financial assets that are initially classified as held-to-collect contractual cash flows but that are subsequently identified for sale as a separate line item on the statement of financial position. That is, an entity shall not aggregate such financial assets with financial assets that are still held-to-collect contractual cash flows and present both in the same line item.

825-10-45-8 If the fair value of financial assets subsequently identified for sale is greater than their net carrying amount, the assets shall be presented at amortized cost less expected credit losses with fair value disclosed

parenthetically. However, if fair value is less than the net carrying amount, financial assets subsequently identified for sale shall be reported at fair value with the amortized cost less allowance for expected credit losses disclosed parenthetically.

> > Financial Instruments for Which All Changes in Fair Value Are Recognized in Net Income

825-10-45-9 An entity shall present on the face of the statement of financial position the following amounts for financial assets and financial liabilities for which all changes in fair value are recognized in net income:

- a. The fair value of the instrument
- b. The amortized cost, presented parenthetically, of the entity's own outstanding **debt instruments**.

825-10-45-10 An entity shall present separately an investment that is held for sale in accordance with paragraph 323-10-15-20 from other equity method investments that qualify for the equity method of accounting in accordance with Subtopic 323-10.

> Statement of Comprehensive Income

825-10-45-11 Topic 220 requires an entity to present either a single continuous statement of comprehensive income or two separate but consecutive statements. An entity shall apply the guidance in paragraphs 825-10-45-12 through 45-18 in presenting a statement of comprehensive income in either of those formats.

> > Financial Instruments Measured at Amortized Cost

825-10-45-12 An entity shall present separately within net income all of the following for financial instruments subsequently measured at amortized cost:

- a. Interest income or expense for the current period, including amortization (accretion) of premium (discount) recognized upon acquisition or incurrence
- b. Changes in expected credit losses on financial assets for the current period
- c. Realized gains and losses from sales or settlements.

> > Financial Instruments for Which Qualifying Changes in Fair Value Are Recognized in Other Comprehensive Income

825-10-45-13 At a minimum, an entity shall present separately within net income all of the following for financial assets (and financial liabilities to which the exception in paragraph 825-10-35-11 applies) for which qualifying changes in fair value are recognized in other comprehensive income:

- a. Interest income or expense for the current period, including amortization (accretion) of premium (discount) recognized upon acquisition or incurrence
- b. Changes in expected credit losses on financial assets for the current period
- c. Realized gains and losses from sales or settlements
- d. Foreign currency gain and loss (see paragraphs 825-10-45-14 through 45-15).

825-10-45-14 The total change during a period in the fair value of a financial instrument denominated in a foreign currency may be made up of both of the following components:

- a. A change in the price of the instrument in the currency in which it is denominated
- b. A change in the exchange rate between the currency of denomination and the functional currency, which the guidance on foreign currency matters in Topic 830 refers to as a transaction gain or transaction loss.

An entity shall separate the total change in the fair value of a foreign-currency-denominated financial instrument for which qualifying changes in fair value are recognized in other comprehensive income into (a) and (b), and the entity shall separately present the resulting transaction gain or loss (see (b)) in net income as required by Topic 830.

825-10-45-15 An entity shall separate the components of the total change in the fair value of a financial instrument as required by the preceding paragraph using a fair-value-based method applied consistently from period to period for each type of foreign currency. For example, an acceptable fair-value-based method for computing the foreign currency gain or loss would be to multiply the end-of-period fair value of the instrument measured in the foreign currency by the difference between the end-of-period spot exchange rate and the beginning-of-period spot exchange rate. An entity may use beginning-of-period, end-of-period, or average-of-period fair value of the instrument. However, an entity shall apply the same period consistently regardless of the period selected. Other fair-value-based approaches also would be appropriate. An investment company shall continue to make that separation by applying the method described in Subtopic 946-830.

> > Financial Instruments for Which All Changes in Fair Value Are Recognized in Net Income

825-10-45-16 At a minimum, an entity shall present separately in a separate line item within net income an aggregate amount for realized and unrealized gains or losses on financial instruments for which all changes in fair value are recognized in net income.

825-10-45-17 If an entity has designated a financial liability under the fair value option in accordance with Subtopic 825-30, the financial liability shall be measured at fair value with qualifying changes in fair value recognized in net income. An entity shall present separately in other comprehensive income the portion of the total change in the fair value of such a liability that results from a change in the instrument-specific credit risk. The entity may consider the portion of the total change in fair value that exceeds the amount resulting from a change in a base market risk, such as a risk-free interest rate, to be the result of a change in instrument-specific credit risk. Alternatively, an entity may use another method that it considers to more faithfully represent the portion of the total change in fair value resulting from a change in instrument-specific credit risk. An entity shall apply the method consistently from period to period.

825-10-45-18 Upon derecognition of a financial liability, an entity shall include in net income the cumulative amount of the gain or loss on the liability that resulted from changes in instrument-specific credit risk.

Disclosure

> General Guidance

825-10-50-33 An entity shall disclose all of the information in paragraphs 825-10-50-34 through 50-42 for each interim and annual reporting period unless otherwise noted by class of **financial instrument** (see paragraph 820-10-50-2B).

> Financial Instruments Measured at Amortized Cost

825-10-50-34 For financial instruments that are measured at **amortized cost**, a **public entity** shall disclose all of the following, in accordance with Topic 820, about the **fair value** information that is presented parenthetically on the face of the statement of financial position:

- a. The level of the fair value hierarchy within which the fair value measurements are categorized in their entirety (Level 1, Level 2, or Level 3)
- b. For fair value measurements categorized within Level 3 of the fair value hierarchy, quantitative information about the significant unobservable inputs used in the fair value measurement
- c. For fair value measurements categorized within Level 2 and Level 3 of the fair value hierarchy, a description of the valuation technique(s) and the inputs used in the fair value measurement
- d. A description of the changes in the method(s) and significant assumptions used to estimate the fair value of financial instruments, including the reason(s) for making the change, if any, during the period

- e. For fair value measurements categorized within Level 3 of the fair value hierarchy, a description of the valuation processes used by the reporting entity (including, for example, how an entity decides its valuation policies and procedures and analyzes changes in fair value measurements from period to period).

825-10-50-35 An entity that has sold financial assets during the reporting period that were carried at amortized cost shall disclose (a) through (d) below. An entity that has subsequently identified the asset(s) for sale in accordance with paragraph 825-10-35-14 but has not yet sold them shall disclose (d) and (e):

- a. The net carrying amount of the asset(s) sold
- b. The net gain or loss in accumulated other comprehensive income that was recognized in net income related to any derivative that hedged the forecasted acquisition of the amortized cost security
- c. The realized gain or loss on the asset(s) sold
- d. The circumstances leading to the decision to sell the asset(s)
- e. The amortized cost basis, fair value, and the unrealized gain or loss on the asset(s) subsequently identified for sale.

> Financial Assets Measured at Fair Value with Qualifying Changes in Fair Value Recognized in Other Comprehensive Income

825-10-50-36 An entity with financial assets measured at fair value with qualifying changes in fair value recognized in other comprehensive income shall disclose all of the following:

- a. The amortized cost basis of the assets
- b. The fair value of the assets
- c. Total gains for financial assets with net gains in accumulated other comprehensive income
- d. Total losses for financial assets with net losses in accumulated other comprehensive income.

825-10-50-37 An entity that has sold financial assets during the reporting period that were measured at fair value with qualifying changes in fair values recognized in other comprehensive income shall disclose both of the following:

- a. The proceeds from sales and the gross realized gains and gross realized losses that have been recognized in net income as a result of those sales
- b. The amount of the net unrealized holding gain or loss on assets for the period that previously had been recognized in accumulated other comprehensive income.

> Financial Assets Reclassified Because of a Change in the Business Model

825-10-50-38 An entity that has reclassified financial assets because of a change in its business model shall disclose all of the following:

- a. The date of reclassification
- b. An explanation of the reason for the change in the business model and a qualitative description of its effect on the entity's financial statements
- c. The amount reclassified into and out of each measurement category.

> Core Deposit Liabilities

825-10-50-39 A public entity that has **core deposit liabilities** shall disclose for each annual reporting period all of the following information about those liabilities. If the core deposits include different types of liability accounts, for example, demand deposits and savings accounts, the entity shall disclose the following information on an appropriately disaggregated basis by significant types of core deposit accounts:

- a. The core deposit liability balance
- b. The **implied weighted-average maturity** period
- c. The estimated **all-in-cost-to-service rate**.

> Nonrecourse Financial Liabilities

825-10-50-40 An entity with nonrecourse financial liabilities shall disclose both of the following:

- a. Qualitative information about the relationship between nonrecourse financial liabilities and the financial assets that will be used to settle them and about the line items in which the nonrecourse liabilities and the related assets are reported
- b. The carrying amounts of the nonrecourse financial liabilities and the related financial assets that will be used to settle the liabilities.

> Financial Liabilities Measured at Fair Value under the Fair Value Option

825-10-50-41 An entity that subsequently measures some of its financial liabilities at fair value because it has elected the fair value option for them in accordance with Subtopic 825-30 shall disclose all of the following about the effects of the instrument-specific credit risk and changes in it:

- a. The amount of change, during the period and cumulatively, in the fair value of the financial liability that is attributable to changes in the instrument-specific credit risk

- b. How the gains and losses attributable to changes in the instrument-specific credit risk were determined
- c. If a liability is settled during the period, the amount, if any, recognized in other comprehensive income that was recognized in net income at settlement.

> Equity Investments without Readily Determinable Fair Values

825-10-50-42 An entity that applies the practicability exception to fair value measurement in paragraph 825-10-35-17 for equity investments without **readily determinable fair values** shall disclose all of the following:

- a. The carrying amount of investments without readily determinable fair values
- b. The amount of impairments and upward and downward adjustments, if any, both annual and cumulative
- c. As of the date of the most recent statement of financial position, additional information (in narrative form) that is sufficient to permit financial statement users to understand the quantitative disclosures and the information that the entity considered in reaching the carrying amounts and upward or downward adjustments resulting from observable price changes.

Implementation Guidance and Illustrations

> Implementation Guidance

> > Classification of Financial Assets

> > > Contractual Cash Flows

825-10-55-14 In accordance with paragraph 825-10-25-17, for a **financial asset** to qualify for subsequent measurement at other than **fair value** with all changes in fair value recognized in net income, the financial asset must give rise on specified dates to contractual cash flows that are solely payments of principal and interest on the principal amount outstanding. Cash flows that are interest always have a close relation to the amount advanced to the debtor (that is, the funded amount) because interest is consideration for the time value of money and for the credit risk associated with the issuer of the instrument and with the instrument itself.

825-10-55-15 An entity is required to assess whether contractual cash flows are solely payments of principal and interest on the principal amount outstanding for the currency in which the financial asset is denominated.

825-10-55-16 If the contractual cash flows include payments that are unrelated to principal, the time value of money, and the credit risk, the contractual cash flows do not represent solely payments of principal and interest. Paragraphs 825-10-55-17 through 55-27 provide guidance for applying the contractual cash flows characteristics criterion.

> > > **Modified Economic Relationship**

825-10-55-17 A contractual term of a **financial instrument** may introduce leverage that modifies the economic relationship between principal and the consideration for the time value of money and the credit risk. More than insignificant leverage increases the variability of the contractual cash flows so that they do not have the economic characteristics of interest. Thus, those contracts do not result in cash flows that are solely payments of principal and interest on the amount of principal outstanding.

825-10-55-18 Similarly, the economic relationship between principal and the consideration for the time value of money and the credit risk in a financial asset may be modified by an interest rate reset feature in which the frequency of the reset does not match the period of time covered by the interest rate. For example, the interest rate may be reset monthly to a three-month rate. In those cases and in the case of leverage (collectively referred to as modified economic relationship), an entity is required to assess the modification to the economic relationship to determine whether the contractual cash flows represent solely payments of principal and interest on the principal amount outstanding. If the modification to the economic relationship could result in cash flows that are more than insignificantly different from the benchmark cash flows (see the following paragraph), the financial asset does not meet the contractual cash flow characteristics criterion in paragraph 825-10-25-17. The reason for the rate being set in this way does not affect the analysis. For example, the conclusion would be unchanged whether the rate is set in this way to provide consumer protection or is included in a bespoke structured instrument to achieve a particular economic outcome.

825-10-55-19 In assessing the economic relationship that is modified by a contractual term of the instrument, an entity is required to consider the cash flows of a comparable financial asset (that is, a benchmark instrument) that does not contain the modification. The benchmark instrument is a contract of the same credit quality and with the same contractual terms, except for the contractual term under evaluation. For example, if the financial asset under assessment contains a variable interest rate that is resettable monthly to a three-month interest rate, the benchmark instrument would be an instrument with the identical contractual terms and the identical credit quality except that the variable interest rate is resettable to a monthly interest rate. An entity may make the assessment using either an actual financial asset or a hypothetical financial asset. An entity need not make a detailed assessment if it is clear with little or no analysis that the cash flows of the financial asset under assessment could or could not be

more than insignificantly different from the cash flows of the benchmark instrument.

825-10-55-20 In assessing the modified economic relationship, an entity is required to consider variables that could affect future cash flows. For example, if an entity is assessing a constant maturity bond with a five-year term and a variable rate that is reset semiannually to a five-year rate and the interest rate curve at the time of the assessment is such that the difference between a five-year rate and a semiannual rate is not more than insignificant, that in itself does not enable the entity to conclude that the contractual cash flows are solely payments of principal and interest. The entity also is required to consider whether the relationship between the five-year rate and the semiannual rate could change over the life of the instrument such that the contractual cash flows over the life of the instrument could be more than insignificantly different from the benchmark cash flows. However, an entity is required to only consider reasonably possible scenarios rather than every possible scenario. If an entity is unable to conclude that contractual cash flows could not be more than insignificantly different from the cash flows of the benchmark instrument, the financial asset must be measured at fair value with all changes in fair value recognized in net income.

> > > Prepayment Options

825-10-55-21 A contractual provision may either permit or require the issuer (the debtor) to prepay a **debt instrument** or permit or require the holder (the creditor) to put a debt instrument back to the issuer (that is, to demand repayment) before maturity. A financial asset with one of those types of contractual provisions results in contractual cash flows that are solely payments of principal and interest on the principal amount outstanding provided that both of the following conditions are met:

- a. The provision is not contingent on future events, other than to protect either of the following:
 1. The holder against the credit deterioration of the issuer (for example, defaults, credit downgrades, or loan covenant violations) or a change in control of the issuer
 2. The holder or issuer against changes in relevant taxation or law.
- b. The prepayment amount substantially represents unpaid amounts of principal and interest on the principal amount outstanding, which may include reasonable additional compensation for the early termination of the contract.

> > > Extension Options

825-10-55-22 A contractual provision may permit or require the issuer or the holder to extend the contractual term of a debt instrument. A financial asset with

such a contractual provision results in contractual cash flows that are solely payments of principal and interest on the principal amount outstanding provided that both of the following conditions are met:

- a. The provision is not contingent on future events, other than to protect either of the following:
 1. The holder against the credit deterioration of the issuer (for example, defaults, credit downgrades, or loan covenant violations) or a change in control of the issuer
 2. The holder or issuer against changes in relevant taxation or law.
- b. The terms of the contractual provision result in contractual cash flows during the extension period that are solely payments of principal and interest on the principal amount outstanding.

> > > Contingent Features

825-10-55-23 A contractual term that is contingent on a future event or circumstance could result in one or more contingent cash flows that are solely payments of principal and interest on the principal amount outstanding.

825-10-55-24 In assessing whether the contractual cash flows are solely payments of principal and interest, an entity must not consider the probability that the contingent event will actually occur. That is, an entity must not consider the probability of the contingent event on determining whether the contractual cash flows are solely payments of principal and interest in applying the contractual cash flow characteristics criterion. Although an entity must not consider the probability of occurrence of the contingent event that would affect the instrument's contractual cash flows, the entity must disregard the contingent term if it would affect the instrument's contractual cash flows only on the occurrence of an event that is extremely rare, highly abnormal, and very unlikely to occur.

825-10-55-25 For example, a privately issued debt instrument contains a contractual term that requires that if the issuing entity does not become a publicly traded entity within a specified time period, the interest rate on the debt instrument would be reset to a market rate for a comparable privately issued debt instrument. In assessing the contingent feature, an entity must not consider the probability of the issuing entity becoming a publicly traded entity. The nature of the contingency is to maintain an appropriate rate of return on the instrument that represents compensation for the time value of money and the credit risk. Therefore, the contingent feature results in cash flows that are solely payments of principal and interest on the principal amount outstanding. In contrast, if the contractual term of the instrument results in the interest rate being reset to a punitive rate if the issuing entity does not become a publicly traded entity, such a contractual term would result in cash flows that are not solely payments of principal and interest on the principal amount outstanding.

> > > Application to Beneficial Interests in Securitized Financial Assets

825-10-55-26 A beneficial interest in a securitized financial asset gives rise to contractual cash flows that are solely payments of principal and interest on the principal amount outstanding if all of the following conditions are met:

- a. The contractual terms of the beneficial interest being assessed for classification (without looking through to the underlying pool of financial instruments) give rise to cash flows that are solely payments of principal and interest on the principal amount outstanding (for example, the interest rate on the beneficial interest is not linked to a commodity index). A tranche is deemed to satisfy this condition if it otherwise would have payments that are solely principal and interest but is prevented from meeting this requirement solely because it is prepayable if a prepayment occurs in the underlying pool.
- b. The underlying pool of financial instruments has the following cash flow characteristics:
 1. The underlying pool is required to contain one or more instruments that have contractual cash flows that are solely payments of principal and interest on the principal amount outstanding.
 2. The underlying pool also may include instruments that do either of the following:
 - i. Reduce the cash flow variability of the instruments in (b)(1) and, when combined with the instruments in (b)(1), result in cash flows that are solely payments of principal and interest on the principal amount outstanding (for example, an interest rate cap or floor or a contract that reduces the credit risk on some or all of the instruments in (b)(1))
 - ii. Align the cash flows of the tranches of beneficial interests with the cash flows of the pool of underlying instruments in (b)(1) to address differences in and only in any of the following:
 01. Whether the interest rate is fixed or floating
 02. The currency in which the cash flows are denominated, including inflation in that currency
 03. The timing of the cash flows.An entity must look through until it can identify the underlying pool of instruments that are creating, rather than passing through, the cash flows. This is the underlying pool of financial instruments that (b) refers to.
- c. The exposure to credit risk in the underlying pool of financial instruments that are inherent in the tranche of beneficial interest is equal to or lower than the exposure to credit risk of the underlying pool of financial instruments. For example, this condition would be met if the underlying pool of instruments were to lose 50 percent as a result of

credit losses and under all circumstances the tranche would lose 50 percent or less.

825-10-55-27 If the holder of a beneficial interest in securitized financial assets cannot assess the criteria in the preceding paragraph at recognition, the beneficial interest must be measured at fair value with all changes in fair value recognized in net income. Furthermore, if the underlying pool of financial instruments can change after recognition in such a way that the pool may not meet the criterion in (b) of the preceding paragraph, the beneficial interest must be measured at fair value with all changes in fair value recognized in net income. However, if the underlying pool includes instruments that are collateralized by assets that do not meet the criterion in (b) of the preceding paragraph, the collateral shall be disregarded for the purposes of applying this paragraph.

> > > Business Model

825-10-55-28 An entity classifies a financial asset (that meets the contractual cash flow characteristics criterion) at recognition into one of three subsequent measurement categories on the basis of an entity's business model in accordance with paragraph 825-10-25-25. The classification of a financial asset (that meets the contractual cash flow characteristics criterion) is determined at recognition by the entity's key management personnel on the basis of how the asset will be managed together with other financial assets within a distinct business model. An entity may have more than one business model for managing its financial assets. For example, an entity may hold a portfolio of investments that it manages to collect contractual cash flows and another portfolio of investments that it manages to realize fair value changes. The entity's business model for managing financial assets is evidenced by the way the business is managed, including how its performance is evaluated by the entity's key management personnel. The entity's business model for managing financial assets determines the entity's likely future cash flows from the financial assets. The determination of the business model for managing financial assets is not driven by a single factor; rather, all objective evidence that is relevant to assessing the entity's business model should be considered, including the following:

- a. How the performance of the business is reported to the entity's key management personnel
- b. How management is compensated, for example, whether the compensation is based on fair value of the assets managed
- c. The frequency and volume of sales in prior periods, why sales have occurred in the past, and expectations about the sales activity in the future.

825-10-55-29 Paragraphs 825-10-55-30 through 55-39 provide implementation guidance for classifying financial assets into the three categories.

>>>> Amortized Cost

825-10-55-30 Financial assets would qualify for **amortized cost** measurement if the objective is to hold the assets for collection of contractual cash flows. That is, a business activity that entails managing financial assets to generate interest income via collection of interest and principal over the life of the instrument is consistent with the objective of amortized cost classification.

825-10-55-31 As part of the business activity for managing financial assets for collection of contractual cash flows, an entity would focus on managing the credit risk of the assets to maximize the collection of contractual cash flows. Sales of financial assets as a result of a significant deterioration in the issuer's creditworthiness would not be inconsistent with the objective of amortized cost classification if the purpose of those sales is to maximize the collection of contractual cash flows through sales rather than through cash collection. However, sales of financial assets that result from managing the credit exposure because of concentrations of credit risk would not be consistent with the objective of amortized cost classification.

825-10-55-32 Sales that result from reasons other than managing credit exposure should be very infrequent. For example, sales that result from the following events or circumstances would not be inconsistent with the objective of amortized cost classification (because the events would occur very infrequently):

- a. A change in tax law that eliminates or reduces the tax-exempt status of interest on debt instruments
- b. A major business combination or major disposition that results in an entity's reassessment of its business model and subsequent realignment of the assets managed within that business model
- c. A change in statutory or regulatory requirements that significantly modifies either what constitutes a permissible investment or the maximum level of investments in certain kinds of debt instruments
- d. A significant increase by a regulator in the industry's capital requirements that causes the entity to sell financial assets to meet regulatory requirements
- e. A significant increase in the risk weights of debt instruments used for regulatory risk-based capital purposes.

Sales that result from events other than a significant deterioration in the issuer's creditworthiness that are isolated, nonrecurring, unusual for the entity, and result from events that could not have been reasonably anticipated would not be inconsistent with the objective of amortized cost classification. Similarly, sales of financial assets that occur close to the maturity of the financial assets and the proceeds from those sales that approximate the collection of the remaining contractual cash flows would not be inconsistent with the objective of amortized cost classification.

825-10-55-33 When assessing a business model's objective for a group of financial assets and whether it would qualify for amortized cost measurement, an entity should consider pertinent historical experience, such as historical sales of financial assets and the reasons for them. A pattern of sales in response to changes in market interest rates, prepayment risk, or foreign exchange risk is inconsistent with the objective of an amortized cost business model. However, it would be permissible to include instruments that are held for collection of contractual cash flows as part of an entity's overall risk management strategy provided that the instruments would not be sold to effect the strategy.

825-10-55-34 Certain regulatory requirements for managing some types of exposures would only entail sales of financial assets in accordance with paragraph 825-10-55-32(c) through (e). Those business activities may entail holding portfolios of highly liquid securities (that are held for collection of contractual cash flows) that are only used to comply with regulatory requirements that affect the industry (rather than the entity). That business activity would be consistent with the primary objective of a held-to-collect business model. For example, if a regulator directs a particular financial institution (rather than all institutions supervised by the regulator) to sell or transfer debt instruments classified at amortized cost, those sales and transfers are inconsistent with paragraph 825-10-55-32(c), which describes a change in regulations applicable to all entities that are affected by the legislation or regulator enacting the change. However, circumstances that cause a regulator to direct an institution to sell securities possibly could be considered an event that is isolated, nonrecurring, and unusual such that it could not have been reasonably anticipated at acquisition of the assets and would not be inconsistent with the primary objective of a held-to-collect business model.

> > > Fair Value through Other Comprehensive Income

825-10-55-35 Financial assets would qualify for subsequent measurement at fair value with qualifying changes in fair value recognized in other comprehensive income if the assets are held and managed within a business model that has the objective of both holding financial assets for collection of contractual cash flows and selling financial assets to realize changes in their fair values. That is, at recognition, the entity has not yet determined whether it will hold the individual asset to collect contractual cash flows or sell the asset to meet certain objectives.

825-10-55-36 For example, a business activity that entails managing exposure to interest rate risk or maintaining a certain yield profile by holding and selling financial assets in accordance with a stated risk management policy would be consistent with the primary objective for fair value through other comprehensive income classification. That business activity may entail less frequent buying and selling or rebalancing activities in stable interest rate, liquidity, and economic environments, whereas rapid or unexpected changes in market conditions may necessitate more frequent buying or selling or more significant rebalancing activities. The objective of that business activity is to manage portfolios of

financial assets by holding and selling financial assets as needed to achieve the targeted yield.

825-10-55-37 Another business activity that could be consistent with the fair value through other comprehensive income classification is liquidity management. An entity may hold and sell financial assets (or rebalance the asset mix in the portfolio to achieve a better asset-liability profile) to meet an entity's liquidity needs. However, liquidity portfolios that are specifically designated for regulatory compliance may have sales of assets in accordance with paragraph 825-10-55-32(c) through (e) without making them inconsistent with amortized cost measurement.

> > > Fair Value through Net Income

825-10-55-38 Financial assets that do not meet the business model for either amortized cost or fair value through other comprehensive income classification would be measured at fair value through net income. Holding financial assets for sale would not be consistent with the primary objective of amortized cost or fair value through other comprehensive income classification.

825-10-55-39 Paragraphs 825-10-55-70 through 825-10-55-85 include Examples of applying the implementation guidance for each measurement category discussed in paragraphs 825-10-55-30 through 55-38.

> > > Initial Measurement

825-10-55-40 Paragraph 825-10-30-1 provides the initial measurement principle for financial assets and financial liabilities, and paragraphs 825-10-30-4 through 30-6 provide guidance for situations in which the transaction price includes consideration for something other than the financial instrument. That guidance requires an entity to consider the terms of the transaction in determining whether part of the consideration given or received is for something other than the financial instrument. For example, an entity might structure the terms of a transaction to provide an explicit incentive or concession to a specific borrower (in a nontroubled situation) that results in an unreasonable interest rate in light of observable market interest rates for a similar transaction with a borrower of similar credit quality. Such a transaction is required to be considered to include something other than the lending component. In that situation, the entity (the lender) should recognize the difference between the fair value of the loan and the amount loaned as an expense (or a reduction of revenue) unless that amount qualifies for recognition as some other good or service.

825-10-55-41 An entity need not conduct a routine comparison of the fair value and transaction price at the inception of every lending or borrowing arrangement or other transaction in which a financial instrument is acquired. In negotiating the terms of, for example, a lending transaction, the parties to the transaction are aware of whether the terms of the instrument have been structured to include an explicit incentive or concession (in a nontroubled situation) to the borrower. An

example of a transaction that would be subject to paragraphs 825-10-30-4 through 30-6 is one in which a long-term loan or receivable carries a stated interest rate of zero. However, that guidance is not limited to loans that carry no stated interest. See the preceding paragraph for guidance on loans with unreasonable rates of interest, which is consistent with the general principle in paragraph 835-30-25-10.

825-10-55-42 An entity should evaluate a **loan commitment** or a similar arrangement consistent with the preceding paragraph and should not reevaluate it when the related loan is funded. At the inception of the transaction, the entity should consider the overall compensation for the lending arrangement, including any upfront commitment fee, any annual fee for the unfunded commitment, and the rate for the funded loan in evaluating the pricing and whether it is reasonable or not.

825-10-55-43 If a loan carries no interest or an unreasonable rate of interest, the difference between the fair value of the loan and the transaction price is an expense or a reduction of income unless the difference between the fair value of the loan and the transaction price qualifies for recognition as another type of asset.

> Illustrations

> > Example 1: Assessing Whether the Contractual Cash Flow Characteristics Criterion Is Met

825-10-55-44 The following Example illustrates how an entity would assess whether the contractual cash flow characteristics criterion in paragraph 825-10-25-17 is met:

- a. Inflation-linked bond (Instrument A)
- b. Variable rate instrument (Instrument B)
- c. Interest-rate-capped variable rate bond (Instrument C)
- d. Collateralized full recourse loan (Instrument D)
- e. Convertible bond (Instrument E)
- f. Inverse floater (Instrument F)
- g. Perpetual instrument (Instrument G).

> > Instrument A: Inflation-Linked Bond

825-10-55-45 Instrument A is a bond with a stated maturity date for which the payments of principal and interest on the principal amount outstanding are linked to an inflation index of the currency in which the instrument is denominated. The inflation link is not leveraged and the principal amount is protected.

825-10-55-46 The contractual cash flows are solely payments of principal and interest on the principal amount outstanding. Linking payments of principal and interest on the principal amount outstanding to an unleveraged inflation index

resets the time value of money to a current level. In other words, the interest rate on the instrument reflects real interest. Thus, the interest amounts are consideration for the time value of money on the principal amount outstanding.

825-10-55-47 However, if the interest payments were indexed to another variable such as the debtor's performance (for example, the debtor's net income) or an equity index, the contractual cash flows would not be solely payments of principal and interest on the principal amount outstanding (unless indexing to the debtor's performance results in an adjustment that only compensates for changes in the credit quality of the instrument). That is because the interest payments are not consideration for the time value of money and for the credit risk associated with the principal amount outstanding. There is variability in the contractual interest payments that is inconsistent with market interest rates.

> > > Instrument B: Variable Rate Instrument

825-10-55-48 Instrument B is a variable interest rate instrument with a stated maturity date that permits the borrower to choose between specified market interest rates on an ongoing basis. For example, at each interest reset date the borrower can choose to pay a three-month London Interbank Offered Rate (LIBOR) for a three-month term or one-month LIBOR for a one-month term.

825-10-55-49 The contractual cash flows are solely payments of principal and interest on the principal amount outstanding as long as the interest paid over the life of the instrument reflects consideration for the time value of money and for the credit risk associated with the instrument. The fact that the LIBOR interest rate is reset during the life of the instrument does not in itself disqualify the instrument.

825-10-55-50 The same analysis would apply if the borrower was able to choose between the lender's published one-month variable interest rate and the lender's published three-month variable interest rate.

825-10-55-51 However, if the borrower is able to choose to pay a one-month interest rate that is reset every three months, the frequency of the reset does not match the period of time covered by the interest rate, such that the contractual term modifies the economic relationship. Similarly, if the instrument has a contractual interest rate that is based on a term that exceeds the instrument's remaining life (for example, an instrument with a five-year maturity pays a variable rate that is reset periodically but always reflects a five-year term), that contractual interest rate modifies the economic relationship. That is because the interest payable in each period is disconnected from both the term of the instrument (except at origination in the latter example) and the time value of money over the period. In those cases, an entity must assess the contractual cash flows against the cash flows on an instrument identical in all respects except for the period of time covered by the interest rate to determine if the payments represent solely principal and interest on the principal amount

outstanding. For example, in assessing a constant maturity bond with a five-year term that pays a variable rate that is reset semiannually but always reflects a five-year maturity, an entity would consider the contractual cash flows on an instrument that resets semiannually to a semiannual interest rate but is otherwise identical.

> > > Instrument C: Interest-Rate-Capped Variable Rate Bond

825-10-55-52 Instrument C is a variable interest rate bond with a stated maturity date that pays a variable market interest rate. That variable interest rate is capped.

825-10-55-53 The contractual cash flows of an instrument that has both a fixed interest rate and a variable interest rate are solely payments of principal and interest on the principal amount outstanding as long as the interest reflects consideration for the time value of money and for the credit risk associated with the instrument during the term of the instrument. Therefore, an instrument that is a combination of both a fixed rate and a variable rate, for example, a bond with an interest rate cap, can have cash flows that are solely payments of principal and interest on the principal amount outstanding. That feature may reduce cash flow variability by setting a limit on a variable interest rate, for example, an interest rate cap or floor, or that feature may increase the cash flow variability because a fixed rate becomes variable. Thus, the instrument can still have cash flows that are solely payments of principal and interest on the principal amount outstanding as long as the interest payments reflect only consideration for the time value of money and for the credit risk associated with the instrument during the term of the instrument.

> > > Instrument D: Collateralized Full Recourse Loan

825-10-55-54 Instrument D is a full recourse loan that is secured by collateral.

825-10-55-55 Whether a full recourse loan is collateralized does not in itself affect the analysis of whether the contractual cash flows are solely payments of principal and interest on the principal amount outstanding.

> > > Instrument E: Convertible Bond

825-10-55-56 Instrument E is a bond that is convertible into equity instruments of the issuer.

825-10-55-57 The holder would analyze the convertible bond in its entirety. The contractual cash flows are not payments of principal and interest on the principal amount outstanding because the interest rate does not reflect only consideration for the time value of money and the credit risk. The return also is linked to the value of the equity of the issuer.

> > Instrument F: Inverse Floater

825-10-55-58 Instrument F is a loan that pays an inverse floating interest rate, that is, the interest rate has an inverse relationship to market interest rates.

825-10-55-59 The contractual cash flows are not solely payments of principal and interest on the principal amount outstanding because the interest amounts are not consideration for the time value of money on the principal amount outstanding.

> > Instrument G: Perpetual Instrument

825-10-55-60 Instrument G is a perpetual instrument with cash flows on specified dates, but the issuer may call the instrument at any point and pay the holder the par amount plus accrued interest due. Furthermore, Instrument G pays a market interest rate, but payment of interest cannot be made unless the issuer is able to remain solvent immediately afterward. Deferred interest does not accrue additional interest.

825-10-55-61 The contractual cash flows are not solely payments of principal and interest on the principal amount outstanding because the issuer may be required to defer interest payments, and additional interest does not accrue on those deferred interest amounts. As a result, interest amounts are not consideration for the time value of money on the principal amount outstanding. However, the contractual cash flows could be payments of principal and interest on the principal amount outstanding if interest is accrued on the deferred amounts.

825-10-55-62 The fact that Instrument G is perpetual does not in itself mean that the contractual cash flows are not solely payments of principal and interest on the principal amount outstanding. A perpetual instrument has continuous (multiple) extension options. Those options may result in contractual cash flows that are solely payments of principal and interest on the principal amount outstanding if interest payments are mandatory and must be paid in perpetuity.

825-10-55-63 Similarly, because Instrument G is callable does not in itself mean that the contractual cash flows are not payments of principal and interest on the principal amount outstanding unless the instrument is callable at an amount that does not substantially reflect payment of the outstanding principal and interest on that principal. Even if the callable amount includes an amount that compensates the holder for the early termination of the instrument, the contractual cash flows could be solely payments of principal and interest on the principal amount outstanding (see paragraph 825-10-55-21).

> > Example 2: Application of Contractual Cash Flow Characteristics to Beneficial Interests in Securitized Financial Assets

825-10-55-64 The following Cases illustrate the application of the contractual cash flow characteristics assessment to beneficial interests in securitized financial assets:

- a. Securitization involving subordination and fixed-rate tranches (Case A)
- b. Fully funded synthetic collateralized debt obligation with multiple tranches (Case B).

> > > Case A: Securitization Involving Subordination and Fixed-Rate Tranches

825-10-55-65 A special-purpose entity that holds only prepayable fixed-rate loans issues all of the following three tranches:

- a. A senior, fixed-rate financial instrument that is entitled to receive fixed-rate interest payments and all the prepayments and repayments of principal amounts received from debtors (with a limited exposure to credit losses on the fixed-rate loans)
- b. A subordinated, fixed-rate financial instrument that is entitled to receive fixed-rate interest payments and the prepayments and repayments of principal amounts received from the debtors only after the holders of the senior financial instrument have been paid in full (with a limited exposure to credit losses on the fixed-rate loans)
- c. A residual financial instrument that is entitled to the remainder of the fixed-rate interest payments from the loans and the prepayments and repayments of principal amounts received from the debtors only after the holders of both the senior financial instrument and the subordinated financial instrument have been paid in full. All credit losses on the fixed-rate loans are absorbed first by the holders of the residual financial instrument.

825-10-55-66 An entity would assess each tranche it holds to determine whether it meets the contractual cash flow characteristics assessment by applying the implementation guidance in paragraph 825-10-55-26. All three tranches would meet the condition in paragraph 825-10-55-26(a) if the contractual term of the tranche, without looking through to the underlying pool, gives rise to cash flows that are solely payments of principal and interest. Similarly, in assessing the conditions in paragraph 825-10-55-26(b), an entity determines by looking through to the underlying pool of instruments that the underlying pool only contains prepayable, fixed-rate loans that have contractual cash flows that are solely payments of principal and interest on the principal amount outstanding, thus satisfying the condition in paragraph 825-10-55-26(b).

825-10-55-67 In assessing whether the condition in paragraph 825-10-55-26(c) is met, an entity would consider whether the exposure to the credit risk inherent in the tranche is equal to or less than the exposure to the credit risk of the underlying pool of instruments. The entity may determine that the senior tranche meets the condition in paragraph 825-10-55-26(c) because the first dollar loss is borne by the residual tranche and then by the subordinated tranche. Similarly, an entity may determine that the credit exposure of the residual tranche is greater than the credit exposure of the underlying pool of instruments because the residual tranche bears the first dollar loss. However, in determining whether the subordinated tranche meets the condition in paragraph 825-10-55-26(c), an entity would need to perform additional analysis to determine the level of the credit exposure of the tranche compared to the underlying pool of instruments.

> > Case B: Fully Funded Synthetic Collateralized Debt Obligation with Multiple Tranches

825-10-55-68 A special-purpose entity that holds securities issued by AA-rated Entity A and that wrote a credit default swap on a referenced credit (BBB-rated Entity B) to a third party issues various tranches of credit-linked beneficial interests to investors that differ in terms of priority for the distribution of cash flows from the special-purpose entity. The assets in the special-purpose entity are sufficient to fund any losses on the credit default swap. The investor is exposed to a potential reduction in its future cash flows, which is the effect of the credit risk related to the credit default swap. That reduction in future cash flows is allocated among the tranches by the subordination of one tranche to another.

825-10-55-69 An entity (that is, the investor in the tranche) would assess each tranche it holds to determine whether it meets the contractual cash flow characteristics. The fact that the underlying pool contains a written credit default swap that increases rather than reduces the cash flow variability of the AA-rated assets in the underlying pool would result in contractual cash flows that are not solely payments of principal and interest in accordance with paragraph 825-10-55-26(b)(2).

> > Identifying the Business Model

825-10-55-70 The following Examples illustrate the application of the guidance in paragraph 825-10-25-25 on identifying the business model within which financial assets are managed. Examples 3 through 6 illustrate the guidance on the amortized cost business model. Examples 7 through 9 illustrate the guidance on the fair value through other comprehensive income business model.

> > Example 3: Held-to-Collect Contractual Cash Flows

825-10-55-71 A nonfinancial entity holds investments to collect contractual cash flows. Its funding needs are predictable, and the maturity of the financial assets is matched with its estimated funding needs. Previous sales have occurred when the financial assets have significantly deteriorated in credit quality such that the

entity has sold the assets to maximize the collection of contractual cash flows through sales rather than cash collection. Furthermore, reports to key management personnel focus on the credit quality of the financial assets.

825-10-55-72 The entity's objective is consistent with holding investments to collect contractual cash flows. Sales due to a significant deterioration in the credit quality of the issuer are consistent with that objective.

> > > Example 4: Held-to-Collect Contractual Cash Flows

825-10-55-73 An entity's strategy is to purchase portfolios of financial assets, such as loans. Those portfolios may or may not include financial assets with incurred credit losses. If payment on the loans is not made on a timely basis, the entity would attempt to extract the contractual cash flows through various means, for example, by making contact with the debtor by mail, telephone, or other methods. The entity also may enter into interest rate swaps or other cash instruments as part of its entity-wide risk management strategy.

825-10-55-74 The objective of the entity's business model is to hold the financial assets and collect contractual cash flows. The entity does not purchase the portfolio to make a profit by selling the assets. Similar analysis would apply even if the entity does not expect to receive all the contractual cash flows because some of the assets have incurred credit losses. Furthermore, including held-to-collect instruments as part of an entity-wide risk management strategy would not invalidate the objective of a held-to-collect business model if the entity does not sell those assets as part of its strategy.

> > > Example 5: Held-to-Collect Contractual Cash Flows

825-10-55-75 An entity's business model is to originate loans to customers and subsequently to sell those loans to a securitization vehicle. The securitization vehicle issues instruments to investors. The originating entity controls the securitization vehicle and, thus, consolidates it. The securitization vehicle collects the contractual cash flows from the loans and passes them on to its investors. The Example assumes that the loans continue to be recognized in the consolidated statement of financial position because they are not derecognized by the securitization vehicle.

825-10-55-76 The consolidated group originated the loans with the objective of securitizing them with transfers that would not meet the requirements for sales accounting in Topic 860. Because the loans would continue to be included in the reporting entity's consolidated financial statement, its business model would be consistent with the primary objective of amortized cost classification.

> > > Example 6: Held-to-Collect Contractual Cash Flows

825-10-55-77 A financial entity holds financial assets to meet liquidity needs in a stress-case scenario (for example, run on the bank's deposits). The entity does not anticipate selling those assets except in those scenarios. Furthermore, the

entity monitors the credit quality of the financial assets, and its objective in managing the financial assets is to collect contractual cash flows. However, the entity also monitors the fair value of the financial assets from a liquidity perspective to ensure that the cash amount that would be realized if an entity needed to sell assets would be sufficient to meet the entity's liquidity needs in a stress-case scenario.

825-10-55-78 If the entity is required by its regulator to sell financial assets either to demonstrate that the assets are liquid or to comply with a regulatory requirement that affects the entity (and not the industry) consistent with paragraph 825-10-55-32(d), the business model for those financial assets is not to hold them to collect contractual cash flows.

> > > Example 7: Held-to-Collect Contractual Cash Flows and Sell

825-10-55-79 A nonfinancial entity anticipates capital expenditure in a few years. The entity invests its excess cash in financial assets to fund the expenditure when the need arises. The entity's objective for managing the financial assets is to maximize the return on those financial assets. Accordingly, the entity would sell financial assets and reinvest the cash in financial assets with a higher yield when an opportunity arises. Furthermore, the managers responsible for the portfolio would be remunerated on the basis of the return generated by the financial assets.

825-10-55-80 The entity's business model is to manage assets both to collect contractual cash flows and to sell them. The entity makes the decision on an ongoing basis about whether collecting cash flows or selling financial assets will maximize the return on those financial assets until the need for the invested cash arises. That strategy is consistent with a fair value through other comprehensive income classification.

825-10-55-81 In contrast, consider an entity that anticipates a cash outflow in five years to fund capital expenditure and invests excess cash in short-term financial assets with the objective of holding the assets to collect contractual cash flows. When the investments mature, the entity would reinvest the cash into new short-term financial assets. The entity would follow this strategy until the funds are needed, at which time it would use the proceeds from the maturing financial assets to fund most of the capital expenditures. That strategy is consistent with the objective of holding financial assets to collect contractual cash flows.

> > > Example 8: Held-to-Collect Contractual Cash Flows and Sell

825-10-55-82 A financial entity holds financial assets to meet its everyday liquidity needs. The entity seeks to minimize the costs of managing its liquidity needs and, therefore, actively manages the contractual yield on the financial assets. The entity monitors the contractual yield and holds some financial assets to collect contractual cash flows and sell other financial assets to reinvest in higher yielding financial assets or to better match the duration of its liabilities.

825-10-55-83 The entity's business model is to manage assets both to collect contractual cash flows and to sell them. Both holding and selling are integral to the objective of maximizing the yield on the financial assets while meeting the liquidity needs of the entity.

> > Example 9: Held-to-Collect Contractual Cash Flows and Sell

825-10-55-84 An insurer holds financial assets to fund insurance contracts liabilities. The insurer uses proceeds from the contractual cash flows on the financial assets to settle insurance contracts liabilities as they come due. The insurer also undertakes significant buying and selling activity to rebalance the portfolio of financial assets on a regular basis as estimates of the expected cash flows needed to fulfill the changes in the insurance contracts liabilities to ensure that the contractual cash flows from the financial assets are sufficient to settle those liabilities.

825-10-55-85 The insurer's objective is to fund insurance contract liabilities. Both collecting contractual cash flows to fund liabilities as they become due and selling financial assets to maintain the desired profile of the asset portfolio are integral to achieving that objective. Accordingly, the insurer's business model is to manage financial assets both to collect contractual cash flows and to sell them.

> > Changes in the Business Model

825-10-55-86 The following are Examples of a change in an entity's business model:

- a. An entity has a portfolio of commercial loans that it holds to sell in the short term. The entity acquires a company that manages commercial loans and has a business model that holds the loans to collect the contractual cash flows. The portfolio of commercial loans is no longer for sale, and the portfolio is now managed together with the acquired commercial loans and all are held to collect the contractual cash flows.
- b. A financial services entity decides to close its retail mortgage business. That business no longer accepts new business and the financial services firm is actively marketing its mortgage loan portfolio for sale.

825-10-55-87 The following are Examples that do not constitute a change in an entity's business model:

- a. A change in intention related to particular financial assets (even in circumstances of significant changes in market conditions)
- b. The temporary disappearance of a particular market for financial assets
- c. A transfer of financial assets between parts of the entity with different business models.

Transition and Open Effective Date Information

> Transition Related to Accounting Standards Update No. 2013-XX, *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*

825-10-65-2 The following represents the transition and effective date information related to Accounting Standards Update No. 2013-XX, *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*:

- a. The pending content that links to this paragraph shall be effective for fiscal years, and interim periods within those fiscal years, beginning on or after [date to be inserted after exposure].
- b. An entity shall apply the pending content that links to this paragraph by means of a cumulative-effect adjustment to the statement of financial position as of the beginning of the first reporting period in which the guidance is effective.
- c. Except as indicated in (d), earlier application of the pending content that links to this paragraph is prohibited.
- d. An entity may adopt the presentation guidance in paragraphs 825-10-45-17 through 45-18 upon issuance of [the final Update]. However, early adoption of the presentation requirement only applies to those hybrid financial liabilities that would qualify and be measured at **fair value** with changes in fair value recognized in net income as if an entity had elected the fair value option in paragraphs 825-30-15-2 through 15-3.
- e. An entity shall provide the following disclosures, consistent with Subtopic 250-10, in the period that the entity adopts the pending content that links to this paragraph:
 1. The nature of and reason for the change in accounting principle, including an explanation of the newly adopted accounting principle.
 2. The method of applying the change.
 3. The effect of the adoption on any line item in the statement of financial position, if material, as of the beginning of the first period for which the guidance is effective. Presentation of the effect on financial statement subtotals is not required.
 4. The cumulative effect of the change on retained earnings or other components of equity in the statement of financial position as of the beginning of the first reporting period for which the guidance is effective.
 5. An entity that issues interim financial statements shall provide the disclosures in (1)–(4) in each interim financial statement of the year of change and the annual financial statement of the period of the change.

Subtopic 825-30

Financial Instruments—Fair Value Option

Overview and Background

825-30-05-1 This Subtopic provides guidance on financial instruments for which an entity has elected the fair value option.

Objectives

825-30-10-1 The objective of the guidance in this Subtopic is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently.

Scope and Scope Exceptions

> Overall

825-30-15-1 The Scope guidance in paragraphs 825-30-15-2 through 15-5 applies to financial instruments in the scope of Section 825-10-15.

> Instruments in the Scope of Subtopic 825-10

> > Fair Value Option

825-30-15-2 All entities may apply the **fair value** option to a group of financial assets and financial liabilities for which both of the following conditions are met:

- a. The entity manages the net exposure relating to the financial assets and financial liabilities (which may be **derivative instruments** subject to Topic 815) on a fair value basis.
- b. The entity provides information on a net exposure basis to its management.

825-30-15-3 All entities may apply the fair value option to a hybrid financial liability provided that neither of the following conditions exists:

- a. The **embedded derivative** or derivatives do not significantly modify the cash flows that otherwise would be required by the contract.
- b. It is clear with little or no analysis when a similar **hybrid instrument** is first considered that separation of the embedded derivative or derivatives is prohibited.

825-30-15-4 All entities may apply the fair value option to a financial asset that meets the contractual cash flow characteristics in paragraph 825-10-25-17 and is managed together with other financial assets within a distinct business model in accordance with paragraph 825-10-25-25(b).

825-30-15-5 All entities may apply the fair value option to a nonfinancial hybrid liability provided that an entity determines that the hybrid nonfinancial liability contains an embedded derivative subject to bifurcation and separate accounting in accordance with Subtopic 815-15. If an entity elects not to use the fair value option for a hybrid nonfinancial liability, the financial liability host contract that results from the separation of the nonfinancial embedded derivative shall be accounted for in accordance with the guidance in paragraph 825-10-35-10.

Recognition

> Fair Value Option

825-30-25-1 This Subtopic permits all entities to choose to measure eligible items at **fair value** with changes in fair value recognized in net income (except as required by paragraph 825-10-45-17).

825-30-25-2 The decision about whether to elect the fair value option shall be:

- a. Applied instrument by instrument, except as discussed in paragraph 825-30-25-3
- b. Made when an entity first recognizes the eligible item
- c. Irrevocable
- d. Applied only to an entire instrument and not only to specified risks, specific cash flows, or portions of that instrument.

825-30-25-3 For financial assets and financial liabilities that constitute a group, an entity shall elect the fair value option in accordance with paragraph 825-30-15-2 for all financial assets and financial liabilities within that group.

Subtopic 323-10

Investments—Equity Method and Joint Ventures—Overall

Scope and Scope Exceptions

323-10-15-4 The guidance in this Subtopic does not apply to any of the following:

- a. An investment accounted for in accordance with Subtopic 815-10
- b. An investment in common stock held by a nonbusiness entity, such as an estate, trust, or individual

1. Subparagraph superseded by Accounting Standards Update No. 2012-04.
 2. Subparagraph superseded by Accounting Standards Update No. 2012-04.
 3. Subparagraph superseded by Accounting Standards Update No. 2012-04.
- c. An investment in common stock within the scope of Topic 810
 - d. An investment in common stock accounted for at fair value in accordance with the specialized accounting guidance in Topic 946
 - e. An equity investment that an investor holds for sale in accordance with paragraph 323-10-15-20. Such an investment is subject to the guidance in Subtopic 825-10.

> Other Considerations

> > Held for Sale

323-10-15-20 Upon the initial qualification of an investment for the equity method of accounting, an investor shall evaluate whether it holds the investment for sale. An investor shall consider an investment for which both of the following indicators are present to be held for sale:

- a. The investor has identified potential exit strategies even though it may not yet have determined the specific method of exiting the investment.
- b. The investor has defined the time at which it expects to exit the investment, which may be either an expected date or range of dates or a time defined by specified facts or circumstances, such as achieving specified milestones or the stated investment objectives of the investor.

323-10-15-21 Once an investor has classified an investment as held for sale, the investor shall not subsequently change the classification of the investment.

Subsequent Measurement

> Decrease in Investment Value

323-10-35-31A An investment in an equity method investee is impaired if it is more likely than not that the fair value of the investment is less than its carrying value. At each reporting date, an equity method investor shall make a qualitative assessment considering impairment indicators to evaluate whether the investment in an investee is impaired. Impairment indicators that an entity should consider include the following:

- a. A significant deterioration in the earnings performance, credit rating, asset quality, or business prospects of the investee
- b. A significant adverse change in the regulatory, economic, or technological environment of the investee
- c. A significant adverse change in the general market condition of either the geographic area or the industry in which the investee operates
- d. A bona fide offer to purchase, an offer by the investee to sell, or a completed auction process for the same or similar investment for an amount less than the cost of that investment
- e. Factors that raise significant concerns about the investee's ability to continue as a going concern, such as negative cash flows from operations, working capital deficiencies, or noncompliance with statutory capital requirements or debt covenants.

323-10-35-31B If an investment in an investee is impaired, the impairment loss shall be recognized.

The amendments in this proposed Update were approved for publication by five members of the Financial Accounting Standards Board. Messrs. Linsmeier and Siegel voted against publication of the amendments. Their alternative views are set out at the end of the basis for conclusions.

Members of the Financial Accounting Standards Board:

Leslie F. Seidman, *Chairman*
Daryl E. Buck
Russell G. Golden
Thomas J. Linsmeier
R. Harold Schroeder
Marc A. Siegel
Lawrence W. Smith

Amendments to the *FASB Accounting Standards Codification*[®]

1. The proposed amendments to the Accounting Standards Codification will be exposed during the comment period of this proposed Update.

Background Information, Basis for Conclusions, and Alternative Views

Introduction

BC1. The following summarizes the Board's considerations in reaching the conclusions in this proposed Update. It includes reasons for accepting certain approaches and rejecting others. Individual Board members gave greater weight to some factors than to others.

BC2. The Board decided that the objective of the amended guidance should be to significantly improve the decision usefulness of an entity's reporting about its financial instruments. The guidance establishes a model that links the measurement of financial assets to the way in which the entity expects to benefit from the cash flows embedded in the assets. The proposed guidance on measuring financial liabilities also is related to the way in which the embedded cash flows affect the entity and the variability of those cash flows. The proposals also would clarify the guidance and improve its accessibility, which would help to simplify it.

BC3. The guidance in this proposed Update covers the recognition, classification, measurement, and presentation of financial instruments. Separately, the Board issued a proposed Update on credit losses on debt instruments in December 2012.

Background Information

Need for the Project

BC4. Over time, financial instruments have increased in complexity, risks, and volume. Some stakeholders believe that accounting models have not been appropriately modified to reflect those complexities and risks in the financial statements. As a result, increases in risk, and the effect of an entity's risk management strategies on that risk, are not adequately captured by or disclosed in the financial statements.

BC5. Since 2005, the FASB and the IASB have had a long-term objective to improve and simplify the reporting for financial instruments. In March 2006, the Boards further clarified their intentions to work together to improve and achieve convergence of financial reporting standards by issuing a Memorandum of Understanding, *A Roadmap for Convergence between IFRSs and US GAAP—2006–2008*. As part of the Memorandum of Understanding, the Boards worked

jointly on a research project to reduce the complexity of the accounting for financial instruments. This joint effort resulted in the IASB's issuance of the March 2008 Discussion Paper, *Reducing Complexity in Reporting Financial Instruments*, which the FASB also published for comment by its stakeholders. That Discussion Paper contained the main causes of complexity in reporting financial instruments and possible intermediate and long-term approaches to improve financial reporting and reduce complexity. The Boards received 162 comment letters. In the discussions leading to this proposed Update, the Board considered relevant recommendations and suggestions about classification and measurement from those comment letters.

BC6. On multiple occasions, the Board also was asked to address numerous issues on many aspects of hedge accounting. As a result, in January 2007, the Board directed the staff to research (a) issues that were impeding the application of hedge accounting and (b) potential approaches to accounting for hedging activities. On June 6, 2008, the Board issued the Exposure Draft, *Accounting for Hedging Activities*, to address the identified issues. The Board received 127 comment letters and considered respondents' concerns in its deliberations on hedge accounting.

BC7. In October 2008, as part of a joint approach to dealing with the accounting and reporting issues arising from the global financial crisis, the FASB and the IASB established the Financial Crisis Advisory Group (FCAG), comprising senior leaders with broad international experience in financial markets. The FCAG was asked to consider how improvements in financial reporting could *enhance investors' confidence* in financial markets. The advisory group was asked to identify any accounting issues that require the Boards' urgent and immediate attention, as well as issues for longer term consideration.

BC8. The FASB and the IASB also organized three roundtable meetings—one each in London, England (November 14, 2008), Norwalk, Connecticut, United States (November 25, 2008), and Tokyo, Japan (December 3, 2008). The purpose of the roundtables was both to:

- a. Receive input from a wide range of stakeholders, including users, preparers, and auditors of financial statements, regulators, and others
- b. Identify accounting issues to enhance investors' confidence in financial markets.

BC9. Participants in the roundtables made general comments about the importance of both of the following:

- a. Achieving convergence of U.S. GAAP and IFRS
- b. Allowing sufficient due process before the Boards make any changes to existing guidance.

BC10. Participants also commented on the following specific issues:

- a. Credit losses
- b. Fair value option
- c. Fair value as a measurement attribute
- d. Clarification of the interaction between conflicting accounting standards
- e. Clarification for investments in collateralized debt obligations.

BC11. In addition to considering the potential for short-term responses to the credit crisis, both Boards emphasized their commitment to working jointly to provide greater transparency and reduce complexity in the accounting for financial instruments.

BC12. In November 2008, the IASB added to its agenda a project on accounting for financial instruments, with the understanding that the FASB would soon consider adding a related project to its technical agenda. In December 2008, the FASB added such a project to its agenda. This proposed Update has been issued as part of that project.

BC13. The IASB decided to complete its deliberations on the project in three phases:

- a. Phase 1: Classification and measurement—In November 2009, the IASB issued IFRS 9 for financial assets in time to allow, but not require, early adoption for 2009 calendar year-end financial statements. In October 2010, the IASB added to IFRS 9 the requirements for classification and measurement of financial liabilities, carrying forward most of the requirements from IAS 39, but making some changes to the fair value option to address the presentation of changes in the fair values of financial liabilities related to changes in instrument-specific credit risk.
- b. Phase 2: Impairment—The IASB issued an Exposure Draft, *Financial Instruments: Amortised Cost and Impairment*, in November 2009. The comment period ended on June 30, 2010. Subsequently, the IASB considered impairment issues jointly with the FASB, but the two Boards were unable to decide on a joint impairment model. The FASB reexposed its proposed guidance on accounting for credit losses on financial assets during the fourth quarter of 2012 and the IASB plans to expose its proposal in the first quarter of 2013.
- c. Phase 3: Hedge accounting—In September 2012, the IASB issued a draft of Chapter 6 of IFRS 9 on general requirements for hedge accounting; it plans to finalize the proposed requirements in the first quarter of 2013. The IASB also plans to issue a Discussion Paper on accounting for macro hedging in 2013. The FASB plans to consider hedge accounting at a later date.

BC14. The FASB also considered beginning work on its project on accounting for financial instruments in several phases and issuing multiple exposure

documents. However, because the issues are interrelated, the Board expected that a comprehensive approach would result in more coherent requirements, thereby making it easier for stakeholders to consider and understand the proposed guidance. For example, the Board considered various models for accounting for credit losses and selected one model for all debt instruments. The Board's decision on credit losses depended on the overall classification and measurement model for financial instruments because the classification and measurement model influences the relevance and the costs and benefits of each model.

The 2010 Proposed Update and Means of Obtaining Stakeholder Feedback on It

BC15. On May 26, 2010, the Board issued a proposed Update on accounting for financial instruments and revisions to the accounting for derivative instruments and hedging activities. The Board undertook extensive outreach to obtain feedback on the guidance in the 2010 proposed Update from all stakeholders, including users, preparers, auditors, and regulators. Stakeholders provided feedback through the following channels:

- a. Public comment letters
- b. Investor questionnaires
- c. In-person meetings and conference calls with investors and other users of financial statements
- d. Field visits and conference calls with preparers
- e. Public roundtable meetings.

BC16. The comment period for the proposed Update ended on September 30, 2010. The Board received 2,814 public comment letters. The investor questionnaires allowed users of financial statements to provide confidential feedback on the guidance in the proposed Update. The Board received completed questionnaires from 28 investors.

BC17. The Board and the staff received feedback from more than 120 investors and other users of financial statements employed by more than 60 firms through in-person meetings and conference calls with individual investors and groups of investors representing a variety of perspectives.

BC18. In addition, the Board and staff completed eight field visits with various entities, on a confidential basis, to discuss the operability and the benefits and costs of the guidance in the 2010 proposed Update. Field visit participants included banking institutions of various asset sizes, nonfinancial entities, and an insurance company. The Board also received feedback on the 2010 proposed Update in 5 public roundtable meetings with more than 65 participants, including users, preparers, regulators, auditors, and others representing various perspectives.

BC19. The 2010 proposed Update would have established fair value as the primary measurement attribute for financial instruments. Amortized cost measurement would have been applied only on an exception basis for a few financial instruments. Little of the feedback received from stakeholders supported measurement of virtually all financial instruments at fair value. Most stakeholders who provided input favored a mixed measurement attribute model and supported retaining more extensive use of amortized cost measurement, for example, for most loans, core deposits, and most financial liabilities. The Board redeliberated the guidance in the 2010 proposed Update, considered the feedback received, and developed a measurement model that would result in amortized cost measurement for some financial assets and many financial liabilities. The feedback received and the Board's responses to it are discussed in more detail beginning in paragraph BC23.

BC20. In addition, after considering the feedback on its 2010 proposed Update, the Board is now taking a phased approach to redeliberating the issues in it. For example, in December 2012, the Board issued a proposed Update on accounting for credit losses. The Board issued proposed guidance on credit losses separately from the classification and measurement issues in this proposed Update largely to expedite the process of receiving input on the proposed guidance on credit losses. The Board coordinated its consideration of stakeholders' feedback on both accounting for credit losses and other classification and measurement issues.

Convergence Efforts to Reduce Key Differences between This Proposed Update and IFRS 9

BC21. The FASB began its redeliberations on the guidance in the 2010 proposed Update in December 2010. During 2011, the FASB reached tentative decisions on most of the issues, some of which differed from the IASB's decisions on the same issues as reflected in IFRS 9. In January 2012, the FASB and the IASB discussed their respective decisions and elected to jointly redeliberate selected aspects of the FASB's tentative decisions on their respective classification and measurement models. The Boards decided to discuss the following key differences:

- a. The contractual cash flow characteristics of a financial instrument
- b. The need and basis for bifurcation of financial instruments
- c. The basis for and scope of a possible third classification category (that is, debt instruments measured at fair value through other comprehensive income)
- d. Any interrelated issues from (a) through (c) above (for example, disclosures or the model for financial liabilities given the financial asset decisions).

BC22. The Boards discussed each issue jointly and the changes, if any, to their separate models that they would propose to incorporate in any resulting Exposure Draft. Those discussions took place in joint FASB-IASB Board meetings from February 2012 through July 2012. The Boards acknowledged the different starting points for their respective classification and measurement models. Nevertheless, they were able to achieve better convergence on the issues noted in paragraph BC21.

Basis for Conclusions

Scope

Entities Included in the Scope

BC23. Although the issues that gave rise to the Board's consideration of the accounting for financial instruments were raised in the context of financial institutions, the Board decided that the amended guidance should not be limited to the accounting by those institutions. The Board's approach to standard setting generally has been to consider the accounting for a specific transaction or financial instrument and to develop an accounting method that can be applied to all industries, particularly considering that the transactions generally are common to many different industries.

BC24. The Board considered whether certain entities should be excluded from the scope of the proposed guidance on the basis of industry, size, or nonpublic status and decided that all entities that transact in financial instruments should apply this comprehensive accounting model for financial instruments. Risks and market forces have blurred the distinctions between industries and have heightened the need for greater comparability in the financial statements of entities in different industries, including the consistency of reported information within an entity's financial statements. Those factors reinforced the Board's belief that all entities with similar financial instruments should account for those instruments in a similar manner. (See paragraphs BC53–BC62 for a discussion of the status of certain specialized industry guidance.)

Financial Instruments Excluded from the Scope

BC25. The Board decided to exclude specified types of financial instruments from the scope of the proposed guidance (see paragraph 825-10-15-8). Many of the excluded financial instruments, such as those stemming from share-based compensation arrangements, would continue to be subject to existing requirements that the Board determined require no reconsideration at this time. Others, including insurance (and related financial guarantees) and lease contracts, are the subject of other projects on the Board's agenda. Still others, such as instruments classified as shareholders' equity in the reporting entity's

financial statements, are not financial assets or financial liabilities, which are the subject of this proposed Update. The following paragraphs discuss the more significant of the other scope exclusions.

Equity method investments

BC26. The Board decided that an investor in equity investments should continue to use the equity method of accounting for investments that satisfy the existing criteria in Topic 323, which require that a reporting entity have significant influence over the investee's operating and financing policies. For those investments, the Board continues to believe that the equity method of accounting provides the most appropriate representation of the underlying economic activity in an investing entity's financial statements.

Criteria for use of the equity method

BC27. The guidance in the 2010 proposed Update would have added to the current significant influence criterion for use of the equity method an additional criterion that the operations of the investee must be considered related to the investor's consolidated operations. Both criteria would have had to be met for the equity method to be used for a particular investment.

BC28. Much of the feedback that the Board received on the equity method guidance in the 2010 proposed Update opposed the addition of a related operations criterion for use of the equity method. Many respondents said that introducing that criterion would result in interpretive and operational issues, especially for large diversified entities. Some users of financial reporting information noted that adding a related operations criterion might create structuring opportunities for entities that hold equity method investments.

BC29. Some respondents other than users said that investments accounted for by the equity method generally are strategic and are held for the long term. They consider an entity's business strategy to be the appropriate criterion for classification and measurement of financial instruments. Those respondents also said that requiring an investee's operations to be related to those of the investor would be inconsistent with the way in which they manage their business.

BC30. Board members generally agreed with the views summarized in paragraphs BC28 and BC29 on the proposed addition of a related operations criterion for use of the equity method of accounting. Although the 2010 proposed Update would have provided guidance for determining whether an investee's operations are related to those of the investor, that guidance necessarily would have reflected a significant degree of subjectivity. Thus, different entities might have reached different conclusions about the extent to which some investees' operations are related to those of the investor, especially for diversified entities

that would have impaired the comparability of the investors' financial statements. In addition, the Board noted that the consolidation criteria in Subtopic 810-10 do not include a requirement to consider whether the operations of the entity being evaluated for consolidation are homogeneous with or similar to the reporting entity's operations. The proposed criterion of related operations would add a condition for use of the equity method that would not be considered in determining whether to consolidate the investee. The Board decided that determining whether to account for an equity investment using the equity method or whether to consolidate the investee should continue to depend on an investor's ability to control or influence the investee's operations.

Should a fair value option be available for equity method investments?

BC31. As discussed further in paragraphs BC316–BC325, the guidance in this proposed Update would eliminate the existing unconditional fair value option for financial instruments within the scope of this proposed Update (with one limited exception for not-for-profit entities, see paragraph BC34). The amended guidance on a fair value option would provide a fair value option only if specified criteria are met. No such option would be available for an investment accounted for by the equity method. Instead, paragraph 323-10-15-20 would establish specified indicators for an equity method investment to be considered held for sale and measured at fair value with all changes in fair value recognized in net income.

BC32. The guidance in the 2010 proposed Update also would have eliminated the fair value option for equity method investments. The feedback that the Board received from users of financial reporting information generally supported eliminating the fair value option for those investments. But some stakeholders, other than users who commented on this issue, noted that they sometimes make an equity investment in an entity in a related industry with the intent to sell the investment in the near future even though the investor has significant influence over the investee's operating and financing policies. Those stakeholders were concerned that eliminating the fair value option would require the investments to be accounted for by the equity method even though they hold the investment for sale.

BC33. The Board decided that it would be preferable to classify such an equity method investment as held for sale and, thus, to measure it at fair value with all changes in fair value recognized in net income than to provide the investor a free choice about whether to account for the investment in that manner. As discussed further in paragraphs BC316–BC325, optional accounting methods impair comparability and, thus, the decision usefulness of the financial statements. Therefore, alternatives such as a fair value option should be avoided if feasible and, if permitted, should be limited to situations in which another approach is not cost effective. Paragraph 323-10-15-20 provides indicators that an investment

that otherwise would be accounted for by the equity method should instead be classified as held for sale. The Board considers it likely that applying those indicators will achieve a reasonable degree of comparability among entities.

BC34. The Board observed that not-for-profit entities (other than healthcare entities) currently are allowed to carry *other investments* within the scope of Section 958-325-35, Not-for-Profit Entities—Investments—Other—Subsequent Measurement, at fair value, a cost-based method, or equity method for qualifying investments. That election to use fair value, commonly known as the portfolio-wide election, predates the instrument-by-instrument fair value option in current U.S. GAAP. The Board decided to propose retaining the guidance on accounting for other investments in Section 958-325-35, which would permit not-for-profit entities to continue to elect a portfolio-wide fair value option for other investments.

A not-for-profit entity's receivables and payables arising from promises to give

BC35. The Board decided to exclude from the proposed guidance in both the 2010 proposed Update and in this proposed Update the receivables and payables of a not-for-profit entity that represent promises to give. The Board noted that Topic 958, Not-for-Profit Entities, currently addresses a not-for-profit entity's accounting for promises to give. At issue is whether any appropriate changes to the guidance for those promises in Topic 958 should be within the scope of the proposed guidance or should be considered after the Board has considered the issues in the context of the overall accounting for a not-for-profit entity. That later consideration would include the effect of any specific attributes or implementation issues related to receivables and payables of a not-for-profit entity arising from promises to give. The Board decided that it would be more efficient to address the accounting for receivables and payables of a not-for-profit entity after the Board has evaluated the nature and extent of any issues with the current guidance that applies to that aspect of financial reporting by a not-for-profit entity. Because the Board may reconsider the accounting by a not-for-profit entity, this scope exception would apply only to a not-for-profit entity's receivable or payable and not to the counterparty's payable or receivable unless that counterparty is a not-for-profit entity.

Registration payment arrangements

BC36. Under the requirements of Subtopic 825-20, Financial Instruments—Registration Payment Arrangements, a registration payment arrangement is considered a separate unit of account and is measured in accordance with the guidance on loss contingencies in Subtopic 450-20, Contingencies—Loss Contingencies. Registration payment arrangements are excluded from the scope of Topic 460, Guarantees, Topic 480, and Topic 815.

BC37. Under the classification and measurement model in this proposed Update, a registration payment arrangement would not qualify for a cost-based measurement but would be measured at fair value. For reasons similar to those noted in Subtopic 825-20, originally issued as FASB Staff Position EITF No. 00-19-2, *Accounting for Registration Payment Arrangements*, the Board also had excluded registration payment arrangements from the scope of the guidance in the 2010 proposed Update, which also would have required fair value measurement. Those reasons include the following:

- a. Concern about the relevance and reliability of using a fair value measurement because similar arrangements are not entered into on a standalone basis
- b. Concern about the ability to reasonably estimate the price that would be paid to transfer the liability under a registration payment arrangement in an orderly transaction between market participants, considering that a key assumption is the entity's ability to obtain (and maintain) an effective registration statement
- c. Concern that the difficulties (costs) of determining fair value, both at inception and subsequently, might outweigh the benefits, particularly in circumstances in which the likelihood of payment is low and the value is insignificant.

Because the Board considers those reasons to remain valid, registration payment arrangements also are excluded from the scope of the guidance in this proposed Update.

Financial guarantees

BC38. The 2010 proposed Update would have excluded specified types of financial guarantees from its scope, including a contract that constitutes a vendor rebate (by the guarantor) based either on the sales revenues of or the number of units sold by the guaranteed party or on the volume of purchases by the buyer. After considering feedback received from stakeholders and the changes to the measurement model, the Board decided that all financial guarantees should be excluded from the scope of the guidance in this proposed Update and should continue to be accounted for in accordance with Topic 460 or other applicable U.S. GAAP as appropriate, such as Topic 815. The Board's project on insurance contracts deals with some financial guarantees. Applying the guidance in this proposed Update to other financial liabilities stemming from financial guarantees would result in measuring them at amortized cost. The Board considers the accounting and disclosure requirements of Topic 460 to be preferable for guarantees that are not subject to Topic 815 or other applicable U.S. GAAP and that will not be affected by the Board's project on insurance contracts.

Contingent consideration arrangements

BC39. Contingent consideration arrangements meet the definition of *financial instrument*, which encompasses all contractual rights and obligations that are financial assets and financial liabilities, including those for which the amount or other outcome is contingent on a specified event. Therefore, all contingent consideration arrangements would have been within the scope of the guidance in the 2010 proposed Update, unless they were specifically excluded.

BC40. Topic 805, Business Combinations, specifies the accounting for contingent consideration by the acquirer in a business combination. Specifically, if contingent consideration is classified as an asset or a liability, Topic 805 requires that it be remeasured to fair value at each reporting date until the contingency is resolved. The changes in fair value are recognized in net income (unless the arrangement is a hedging instrument in a cash flow hedge for which Topic 815 requires the changes to be initially recognized in other comprehensive income). Therefore, the accounting by the acquirer for contingent consideration issued in a business combination would not have changed as a result of the amendments in the 2010 proposed Update.

BC41. Topic 805 eliminated the scope exception in Topic 815 for contingent consideration issued in business combinations. Therefore, contingent consideration arrangements that meet the definition of a derivative are measured at fair value by both the acquirer and the seller with all changes in fair value recognized in net income.

BC42. The Board decided to exclude all contingent consideration arrangements from the scope of the guidance in this proposed Update. In contrast, the guidance in the 2010 proposed Update would have included within its scope only contingent consideration arrangements that are based on an observable market or observable index but not on other types of contingent consideration arrangements. For example, a requirement to make a payment on the basis of the observable share price of the acquirer would have been within the scope of the 2010 proposed Update, but a requirement to make a payment on the basis of a specified level of future sales of a product would have been excluded from the scope. Arrangements not based on an observable market or index were excluded largely for practical reasons. The 2010 proposed Update would have required measurement of contingent consideration arrangements at fair value. Some Board members were concerned about a seller's ability to reasonably estimate the fair value of an arrangement that is not based on an observable market or an observable index because the seller might not have access to the information necessary to make an estimate on a regular basis.

BC43. The guidance in this proposed Update would result in measuring most liabilities at amortized cost. The Board notes that the current measurement requirements for contingent consideration arrangements differ depending on the nature of the arrangement, with some for which fair value can be determined with

reasonable reliability. Thus, the Board decided that continuing to apply current U.S. GAAP to both assets and liabilities under contingent consideration arrangements (as well as to other acquisition-related contracts) would be preferable to accounting for them under the guidance in this proposed Update.

Derivative instruments subject to Topic 815

BC44. The Board decided that derivative financial instruments within the scope of Topic 815 should be excluded from the scope of this proposed Update. In contrast, the scope of the 2010 proposed Update would have included derivative instruments, except for specified types of derivatives that were explicitly excluded from the scope.

BC45. The effect of applying the model in this proposed Update to derivatives that are not hedging instruments in cash flow hedges or hedges of the net investment in a foreign entity would be the same as the effect of the guidance in Topic 815—both result in fair value measurement with all changes in fair value recognized in net income. The Board decided that excluding derivatives that are subject to Topic 815 would simplify its application because an entity would not need to determine which guidance applies to a particular derivative (as would have been necessary under the 2010 Update), but would need only to determine if a derivative is within the scope of Topic 815. If so, it would be outside the scope of Subtopic 825-10. The guidance in this proposed Update would amend the scope of Topic 815 to exclude specified types of derivatives, for example, interest-only and principal-only strips, that the Board decided should be within the scope of Subtopic 825-10.

Regular-way security trades and trade date versus settlement date accounting

BC46. Existing U.S. GAAP does not require an entity to consistently recognize security purchases and sales at either the trade date or the settlement date. Some transfers of securities are recognized as of the trade date—the date the entity agrees to purchase or sell the securities—while others are recognized as of the date the securities are actually transferred and the transaction is settled. Entities operating in certain industries (for example, brokers and dealers in securities and investment companies) are required to recognize security trades as of the trade date.

BC47. The Board decided not to address the issue of the trade date versus the settlement date in developing either the 2010 proposed Update or this proposed Update. Although recognizing the forward contract at the trade date and delivery of the underlying security at the settlement date may be the conceptually preferable alternative, the Board observed that for regular-way security trades, the period between the trade date and the settlement date is very short.

Therefore, the Board decided that settlement date accounting should be permitted for practical reasons. Accordingly, the Board decided to provide a scope exception from the proposed guidance for forward contracts in regular-way security trades. The Board also decided not to require a change to the existing practice of recognizing security trades at either the trade date or the settlement date.

Certain contracts that are not traded on an exchange

BC48. Paragraph 815-10-15-59 provides a scope exception from Topic 815 for certain contracts that are not exchange-traded, for example, a contract in which the underlying (that is, the reference price or index used to compute the gain or loss on the contract) is a climatic or geographical variable. The excluded instruments would meet the definition of a financial instrument if they are settled either in cash (including net cash settlement) or by delivery of another financial instrument, even though the underlying may be nonfinancial in nature. The excluded contracts do not meet the definition of an insurance contract but are similar to insurance contracts, which are excluded from the scope of the proposed guidance. Therefore, the Board decided to provide a scope exception for the instruments excluded from Topic 815.

Derivatives that prevent sales accounting

BC49. Certain derivatives may prevent sales accounting under Topic 860, Transfers and Servicing. For example, a call option that enables a transferor to repurchase transferred financial assets can cause the transfer not to meet a criterion for sales accounting. Accounting for the derivative would, in effect, measure changes in the value of the transferred assets twice because the holder continues to recognize in its financial statements the assets that it has the option to purchase. Therefore, the Board decided to provide a scope exception from the proposed guidance for derivative financial instruments that would prevent sales accounting.

Investments in life insurance

BC50. The Board decided that a policyholder's investment in a life insurance contract or a life settlement contract accounted for under Subtopic 325-30, Investments—Other—Investments in Insurance Contracts, should be excluded from the scope of the proposed guidance because the contracts have an insurance element. Such contracts generally are purchased for funding purposes, for example, to fund deferred compensation agreements or postemployment death benefits, and the entity purchasing the life insurance is either the owner or beneficiary of the contract. The Board decided that it would be inappropriate to address policyholder accounting as part of this project.

BC51. However, the Board notes that life settlement contracts do not have a direct insurance element. The contracts do not involve an insurable interest, and the investor is not a policyholder. The Board decided that life settlement contracts should be included in the scope of this proposed Update. The Board observed that requiring fair value measurement would, in effect, eliminate the option to use the *investment method* described in Subtopic 325-30.

Forward purchase contracts for the reporting entity's shares that require physical settlement

BC52. Forward purchase contracts that require settlement by the reporting entity's delivery of cash in exchange for the acquisition of a fixed number of its equity shares are excluded from the scope of Topic 815. As discussed in paragraph B27 in the basis for conclusions of FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, the Board rejected the view that forward purchase contracts that must be physically settled by delivering cash should be reported like other derivative instruments. Instead, those forward contracts are currently accounted for under Topic 480 on distinguishing liabilities from equity. The Board concluded in Statement 150 that the unconditional obligation should result in recognition of a liability. That liability, like many others that require cash payments, should be subsequently measured at the present value of the full repurchase price if the amounts to be paid and the settlement date are fixed. If the amounts or settlement date can vary, the liability should be measured at the (undiscounted) amounts that would be paid under the conditions specified in the contract if the shares were repurchased at the reporting date. The Board decided that this project should not change the specialized measurement guidance for these forward contracts, which results in accruing to the forward contract amount over the life of the contract. Therefore, the Board decided that such contracts should be excluded from the scope of the guidance in both the 2010 proposed Update and this proposed Update.

Industry Scope and Status of Certain Specialized Industry Guidance

Not-for-profit entities

BC53. The Board also considered exempting from the scope of the proposed guidance not-for-profit entities, such as health and welfare organizations, hospitals, colleges and universities, religious institutions, trade associations, and private foundations. The Board decided that a not-for-profit entity should be subject to the guidance in this proposed Update because the comprehensive model will improve not only the decision usefulness and transparency of financial reporting by not-for-profit entities but also the comparability of their financial statements.

BC54. An entity within the scope of Topic 958 on not-for-profit entities does not report either net income or other comprehensive income, but a not-for-profit entity within the scope of Topic 954 may report a performance indicator that is comparable to net income. The guidance in this proposed Update (see paragraph 825-10-30-7) provides for initially measuring at the transaction price a not-for-profit entity's financial instruments that would be eligible for fair value through other comprehensive income classification, even if the entity does not report net income and other comprehensive income. Paragraph 825-10-35-15 provides related guidance for the application by a not-for-profit entity on subsequent measurement depending on whether the entity does or does not report a performance indicator. The 2010 proposed Update included the same initial and subsequent measurement guidance for a not-for-profit entity. No respondent objected to either aspect of that proposed guidance.

Broker-dealers and investment companies

BC55. Entities in certain industries apply specialized accounting practices that include accounting for substantially all investments in debt and equity securities at fair value, with the changes in those values recognized in net income or changes in net assets. The Board decided that accounting for financial assets of brokers and dealers in securities at fair value with all changes in fair value recognized in net income provides more relevant information for users of their financial statements and, therefore, retained that requirement from Topic 940, Financial Services—Broker and Dealers. The Board believes the proposed guidance would improve the financial reporting for the financial liabilities of brokers and dealers in securities and, thus, decided to include these financial liabilities in the scope of this proposed Update.

BC56. The Board also considered and decided to retain the specialized industry guidance provided in Subtopic 940-20 on both initial and subsequent measurement for financial instruments related to broker-dealer activities, such as fail-to-deliver assets and fail-to-deliver liabilities. Paragraphs 940-20-30-1 through 30-2 require fail-to-deliver assets to be initially measured at the selling price and fail-to-receive liabilities to be initially measured at contract amounts or the fair value of collateral to be returned. The Board notes that those items are essentially short-term receivables and payables. The Board also considers the specialized industry guidance to be generally consistent with the requirements of this proposed Update on financial assets held for collection of contractual cash flows and financial liabilities measured at amortized cost. The Board also retained the guidance in other Subtopics of Topic 940 on measurement of items such as proprietary trading securities (Subtopic 940-320) and financial restructuring transactions (Subtopic 940-325). (See paragraph 825-10-15-9(a) for a list of the specialized industry guidance for brokers and dealers in securities that this proposed Update would retain.)

BC57. Under longstanding U.S. GAAP, investment companies measure their investments at fair value with all changes in fair value recognized as net increase (decrease) in net assets. The Board decided not to change this long-standing practice for investment companies.

BC58. As it did for brokers and dealers in securities, the Board also considered and decided to retain specialized industry guidance for investment companies. That guidance is listed in paragraph 825-10-15-9(b) and pertains to existing guidance in Subtopic 946-320, Financial Services—Investment Companies—Investments—Debt and Equity Securities, Subtopic 946-310 on receivables, and Subtopic 946-830 on foreign currency matters. For example, investment companies would continue to initially measure financial instruments at the transaction price rather than at fair value. The Board saw no compelling reason to change any of the specialized industry guidance in paragraph 825-10-15-9(b) at this time. For financial assets and financial liabilities not addressed in Topic 946, the Board decided to require investment companies to follow the guidance in this proposed Update. The Board also decided that investment companies should apply the relevant presentation and disclosure requirements in this proposed Update. See paragraphs BC298–BC299 for a discussion on specialized industry guidance for investment companies on determining foreign currency gains and losses, which the Board also decided to retain.

Investments held for the purpose of doing business

BC59. The 2010 proposed Update would have provided special guidance for investments that are not held for capital appreciation and that can only be redeemed with the issuer for a specified maximum amount. Examples given included stock in the Federal Home Loan Bank system, stock in the Federal Reserve Banks, National Credit Union Share Insurance Fund deposits, and investments in certain agricultural cooperatives. One feature of those investments is that the reporting entity must hold them to be able to engage in transactions or to participate in activities with the issuing entity; that is, to do business.

BC60. Without an exception to the subsequent measurement principle, the 2010 proposed Update would have required those investments to be measured at fair value, which would have been difficult to determine because their ownership is restricted and they lack a market. Thus, the Board had proposed measuring those investments at redemption value because that would approximate fair value.

BC61. The Board considered whether to retain or to supersede the existing specialized industry guidance for the following investments held for the purpose of doing business:

- a. National Credit Union Share Insurance Fund deposits of credit unions
- b. Investments in agricultural cooperatives of farmers

- c. Certain exchange memberships of broker-dealers
- d. Federal Home Loan Bank stock and Federal Reserve Bank stock of banks.

BC62. The Board decided that the existing specialized industry guidance should remain in place for all of those instruments. Redemption value is not a valid concept for some of them, and fair value would be difficult to measure in the absence of a market. The reporting entities that hold those investments are familiar with the existing guidance, which provides useful information to investors and other users. Thus, the Board saw no compelling reason to supersede that guidance. The guidance on investments held for the purpose of doing business that would be retained is listed in the appropriate subparagraph of paragraph 825-10-15-9, together with other specialized industry guidance that this proposed Update would retain.

Classification and Measurement of Financial Instruments

BC63. How an entity measures its financial instruments, both initially and subsequently, and where in the statement of comprehensive income changes in the fair values of financial assets subsequently measured at fair value are reported depends on how the entity classifies the instruments when it recognizes them. Classification and subsequent measurement are inextricably linked, and subsequent measurement is a key issue in this proposed guidance—an issue on which much other guidance, such as that on initial measurement, depends. Accordingly, this basis for conclusions discusses the main aspects of the guidance on classification and subsequent measurement before discussing other related issues such as initial measurement.

Measurement Attributes Considered

BC64. The Board believes that many of the reporting issues for financial instruments stem from the nature of the existing mixed-attribute measurement model for financial instruments. That model developed piecemeal over many years, in the context of individual types of financial instruments, such as derivatives, debt and equity securities, loans, and so on. Until the guidance in this proposed Update is implemented, no single classification and measurement model that produces results consistent with both the nature of the instrument and the business models that the entity uses to manage them is available for most financial instruments. The accounting for a financial instrument also sometimes varies solely on the basis of the nature of the entity that holds or owes it.

BC65. In developing the guidance in the 2010 proposed Update, the Board considered the following three measurement attributes to improve the measurement of financial instruments:

- a. Fair value—defined as an exit price in Topic 820
- b. Another remeasurement method—referred to as current value

c. Amortized cost.

In addition, the Board considered two variations of fair value measurement—one in which all changes in fair value are recognized in net income in the period in which the change occurs and another in which qualifying changes in fair value are recognized in other comprehensive income.

BC66. The discussion in paragraphs BC67–BC85 describes the three measurement attributes that the Board considered and their perceived advantages and disadvantages.

Fair value

BC67. In developing the 2010 proposed Update, the Board considered two variations of a fair value measurement basis—one in which all changes in fair value are recognized in net income in the period in which the change occurs and one in which qualifying changes in fair value are recognized in other comprehensive income in the period in which the change occurs. The proposed guidance included both categories for classification of financial instruments, as does this proposed Update. The following paragraphs discuss the perceived advantages and disadvantages of fair value as a measurement attribute for financial instruments, regardless of how the changes in fair value during a period are reported in comprehensive income.

BC68. Fair value measurement has long been highly controversial, and knowledgeable people have differing and strongly held views about fair value as a measurement attribute for financial instruments. Although most stakeholders agree that fair value is a more relevant measure than amortized cost for financial instruments that are part of a trading portfolio or that otherwise are held for sale, views differ about using fair value for financial instruments that are held for collection or payment of contractual cash flows. Critics of fair value for those types of financial instruments argue that it improperly reflects the business strategy or the way in which management runs the business. Critics also charge that fair value results in misleading volatility in reporting and can misstate underlying economic values. They also see issues about operability and auditability, particularly in estimating fair values for nontraded and illiquid items, and about the effects of changes in instrument-specific credit risk on the measurement of financial liabilities. In contrast, some investors, financial analysts, economists, and others have said that fair value is more relevant than amortized cost even if the business strategy does not involve the trading or sale of financial instruments.

BC69. Supporters of fair value state that fair value reflects the underlying economics better than amortized cost, that it enhances relevance and comparability, and that it provides a better starting point for understanding and analyzing credit risks, interest rate risks, duration mismatches, sustainability of net interest margins, and liquidity risks. Some also view fair value as an essential tool in proper risk management of financial institutions and as an early warning

system for problems that are developing at institutions and across the financial system.

BC70. Part A of Section 3 of the Discussion Paper on reducing complexity notes that, for instruments with highly variable cash flows (such as many derivatives), fair value is the only measurement attribute that helps in assessing future cash flows. Because the cash flows of highly variable instruments may be very small at inception or otherwise not highly correlated with the ultimate cash flows of the instrument, a cost-based measure without adjustment has no value in the assessment of future cash flows. The Discussion Paper further states that for instruments with fixed or slightly variable cash flows, a cost-based measure is a feasible measurement attribute if the instruments are held to maturity and it is highly likely that the contractual cash flows will occur. However, there is a risk that the contractual cash flows will not occur, necessitating the need for an impairment model and leading to some of the same complexity that exists in practice today. The fair value of a financial instrument reflects the price that would be received at the measurement date. Fair value information is useful because events and circumstances beyond management's control may create a need to sell a financial instrument. Therefore, even if management has no plans to sell the financial instrument, it is helpful to users of financial statements to know the potential effects of those events and transactions even if management does not consider them to be highly probable.

Current value

BC71. The current value measurement method uses a discounted cash flows technique to calculate the present value of expected future cash flows for a financial instrument that an entity intends to hold. This method excludes other sometimes unidentifiable factors, such as illiquidity risk and market imperfections, thereby addressing some of the concerns about fair value measurements in a dislocated market environment. The value calculated by this method is not based on an exchange price but instead on the cash flows in the instrument that an entity would realize through the collection or payment with the counterparty. This method also would address the shortcomings of the amortized cost model by providing information in current financial reports about both the cash flows and some components of value changes of the financial instrument as well as eliminating the need for guidance on impairment and loan losses.

BC72. Paragraph 25 of FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, states that the only objective of present value when used in accounting measurements at initial recognition and fresh-start measurements is to estimate fair value. However, when Concepts Statement 7 was written, fair value was not defined as an exit price as Topic 820 currently defines it. The purpose of considering current value as a potential measurement attribute for at least some financial instruments was to determine whether the process described in that Concepts Statement to

calculate a value for some financial instruments in periods after initial measurement would provide decision-useful information in certain situations.

BC73. The Board obtained feedback from users, preparers, auditors, and others about the potential operationality and usefulness of a current value measurement method. Although some input supported current value, a majority of the input received was that current value was not sufficiently defined, resulting in widespread confusion about what it was meant to represent. Overall, there was little support for its use as an alternative to either fair value or amortized cost. The Board agreed with those stakeholders that current value is not a feasible or useful alternative measurement attribute. Thus, the Board decided to consider only amortized cost and fair value as potential measurement attributes for financial instruments.

BC74. The Board observed that to implement current value measurement, it would need to develop a robust definition for consistent application, similar to the exercise undertaken in defining fair value in Topic 820. The Board decided not to undertake a project to further define *current value* because of the perceived limited usefulness of current value as an alternate to fair value or amortized cost. Therefore, the Board decided that it would consider only amortized cost as a potential alternative to fair value measurement for financial instruments.

Amortized Cost

Amortized Cost as a Measurement Attribute for Financial Instruments

BC75. Under existing U.S. GAAP, the primary types of financial instruments accounted for at amortized cost are loans not held for sale, other receivables, debt securities classified as held to maturity under Topic 320, an entity's own issued debt, and other liabilities.

BC76. Many stakeholders favor the use of amortized cost for an instrument that an entity intends to hold and realize its benefits through collection of contractual cash flows. For those instruments, amortized cost accounting recognizes reported net interest income as the primary earnings of the entity; it recognizes changes in value in net income only when the entity realizes them. For example, an entity that is in the spread business is concerned about maximizing the interest margin through the collection of interest income and payment of interest expense while minimizing credit losses. Realizing changes in fair value is not the main goal of that business strategy.

BC77. Some stakeholders consider the amortized cost method for financial instruments to be consistent with how a nonfinancial entity recognizes its profit—at the point of realization (sale) of the value added through the manufacturing process rather than as it builds or produces its inventory. In addition, in some situations an entity may be unable to realize changes in value through a mechanism other than collecting or paying the contractual cash flows. For

example, an entity may be unable to transfer some types of its own debt to a third party at fair value or may be restricted to settling it by making the contractual cash payments to the creditor.

BC78. Many contend that reporting volatility in the statement of comprehensive income by recognizing short-term changes in fair value that an entity may never realize is misleading and might create incentives to take short-term actions that are not in an entity's best interest over the long term. They note that use of amortized cost avoids much of that volatility.

BC79. The primary perceived disadvantages of amortized cost can be summarized as follows:

- a. Amortized cost reflects a historical transaction price that is not relevant for current investment decisions. For example, amortized cost does not reflect current market conditions, such as interest rates and market prices. Some argue that an entity that relies entirely on amortized cost measures may not fully understand the risks inherent in its financial instruments and may lose out on certain current opportunities as a result. Fair value would provide information about opportunity cost because it reflects current market conditions.
- b. Under amortized cost, an entity can change its intent and realize in net income short-term changes in value. Some view the use of amortized cost as delaying the recognition of economic gains and losses. An entity could sell assets that are performing favorably and hold on to underperforming assets to meet short-term market expectations.
- c. The use of amortized cost relies on complex impairment models. Estimating impairment losses and using valuation accounts are complicated and subjective and could create opportunities to smooth the recognition of income.
- d. Complex tainting rules may be necessary if some instruments are measured at amortized cost and others are measured at fair value, with management's intentions used to determine which measurement basis should be used for a particular instrument.

Definition of amortized cost

BC80. The term *amortized cost* has not been consistently defined in U.S. GAAP. For example, the Master Glossary in the Codification currently defines amortized cost for loans in the scope of Subtopic 310-30, Receivables—Loans and Debt Securities Acquired with Deteriorated Credit Quality, as follows:

The sum of the initial investment less cash collected less write-downs plus yield accreted to date.

Amortized cost basis currently is defined in the Master Glossary as follows:

The amount at which an investment is acquired, adjusted for accretion, amortization, collection of cash, previous other-than-temporary impairments recognized in earnings (less any cumulative-effect adjustments), foreign exchange, and fair value hedge accounting adjustments.

BC81. Paragraph 9 of IAS 39 includes a definition of *amortized cost* that, unlike the FASB's existing definition, applies to liabilities as well as assets:

The amortised cost of a financial asset or financial liability is the amount at which the financial asset or financial liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount, and minus any reduction (directly or through the use of an allowance account) for impairment or uncollectibility.

BC82. FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, refers to *historical proceeds* as the measurement attribute for liabilities that is comparable to cost for assets. However, in practice, the term *amortized cost* often is applied to both assets and liabilities, and both this project and other recent or current Board projects use the term *amortized cost* for both financial assets and financial liabilities.

BC83. The Board decided that the Master Glossary should include only one definition of amortized cost, which should be consistent with the guidance in this proposed Update. That definition is based on the previous definition of *amortized cost basis*. The Board also decided to clarify that the definition of *amortized cost* applies to both financial assets and financial liabilities.

BC84. In addition, the Board decided to clarify that amortized cost should not be reduced for credit impairments (because the allowance for credit impairments would be shown as a separate line item on the statement of financial position), but would be reduced for writeoffs. The proposed definition of amortized cost refers to *writeoffs* rather than *previous other-than-temporary impairments*.

BC85. The guidance in the 2010 proposed Update would have deleted fair value hedge accounting adjustments from the definition of amortized cost. Those adjustments were in the previous definition because Topic 815 requires them to be included in the amortized cost of the hedged item. The hedge accounting adjustments then are amortized through net income. In the 2010 proposed Update, the measurement attribute for most financial instruments would have been fair value, and fair value hedge accounting would not have been necessary for financial assets or financial liabilities measured at fair value. Because the measurement attribute for some financial instruments in this proposed Update is

amortized cost, the Board reinstated fair value hedge accounting adjustments to the definition of *amortized cost*.

Classification and Measurement in the 2010 Proposed Update

BC86. The guidance in the 2010 proposed Update would have established fair value as the primary or default measurement attribute for all financial instruments. Because fair value would have been the default measurement attribute, a reporting entity would have measured financial instruments at fair value with all changes in fair value recognized in net income. However, an entity would have been permitted to instead measure an asset or a liability at fair value with qualifying changes in fair value recognized in other comprehensive income if specified criteria were met. Limited exceptions to fair value measurement to permit measurement at amortized cost would have been provided for both financial assets and financial liabilities, although the exceptions differed for assets and liabilities. For example, all financial assets except for specified short-term receivables would have been measured at fair value. A reporting entity would have been permitted to measure at amortized cost receivables arising in the normal course of business that are due in customary terms, not exceeding one year.

BC87. The guidance in the 2010 proposed Update would have provided an amortized cost option for financial liabilities that qualified for the other comprehensive income category if measuring those financial liabilities at fair value would create or exacerbate a measurement attribute mismatch of recognized assets and liabilities. That proposed Update included criteria to make that determination and it also would have permitted an entity to measure at amortized cost short-term payables that qualified for the other comprehensive income category.

BC88. Whether changes in the fair value of an instrument measured at fair value were reported in net income or in other comprehensive income would have been determined by applying a classification approach with two criteria—one related to the characteristics of the instrument itself and one related to the business strategy in which the instrument is used.

BC89. Debt instruments with specified characteristics held for collection or payment of contractual cash flows would have qualified for the other comprehensive income category. For qualifying debt instruments for which an entity's business strategy was to hold the instruments for collection or payment of contractual cash flows, both amortized cost and fair value information would have been presented by requiring a reconciliation from amortized cost to fair value on the face of the statement of position. Net income would have reflected an amortized cost measurement model for those instruments because changes in interest accruals and credit impairments would have continued to be recognized in net income at each reporting period. The remaining fair value change would have been recognized in other comprehensive income. In addition, realized gains

and losses on those financial instruments would have been recognized in net income at each reporting period.

Stakeholders' feedback on the proposed classification and measurement requirements

BC90. The following discussion of feedback that the Board received from stakeholders on the 2010 proposed Update's guidance on classification and measurement generally reports the comments of users of financial information separately from those of other stakeholders, including preparers, auditors, regulators, and others (sometimes grouped together and referred to as stakeholders other than users or just as other stakeholders). In addition, the discussion focuses largely on feedback on the proposals for classification and measurement of financial assets. Comments on the proposed classification and measurement of financial liabilities are discussed in paragraphs BC134–BC139, along with the Board's decisions on financial liabilities.

BC91. Almost all stakeholders, users, and others commented on the proposed criteria used to classify and measure financial instruments and how the criteria interact with one another. They noted that derivatives and financial instruments held for trading purposes should be measured at fair value with changes in fair value recognized in net income.

BC92. Users generally supported fair value measurement for all financial assets other than loans that are held for collection of contractual cash flows and for which no readily observable market exists. Almost all stakeholders (users and others) disagreed with establishing fair value as the primary measurement attribute for those loans. They said that measuring those loans at fair value would not appropriately represent the related financial results consistent with the way in which the reporting entity manages them. In the absence of an observable market, fair value measurement also would increase the subjectivity of the reported information for those loans.

BC93. The majority of users consulted said that fair value is relevant and useful for analyzing financial assets. However, many of them consider amortized cost to be significantly more relevant for analyzing loans that an entity intends to hold for collection of cash flows and for which no readily observable markets exist. Thus, they supported amortized cost as the primary measurement attribute for those assets. They said that better information about the risks inherent in those loans (interest rate risk, credit risk, and liquidity risk) would improve financial reporting. However, they do not consider measuring those loans at fair value for recognition in the statement of financial position to be the best way to provide that information. Instead, they favor expanded disclosures about key risks in an entity's financial instruments accompanied by improved disclosures of fair value information.

BC94. A few users supported fair value measurement of all financial instruments, including loans held for collection of contractual cash flows for which a readily observable market does not exist. Those users believe that fair value is more relevant than amortized cost in helping to assess the effect of current economic events on an entity. They highlighted the recent global financial crisis as evidence for the need for more fair value information that could potentially provide earlier warning about loss expectations in the market.

BC95. Most stakeholders other than users who provided feedback on subsequent measurement said that an entity's business strategy should be the primary criterion for the classification and measurement of all financial instruments. They asserted that although some financial instruments have observable markets, financial instruments should be reported in an entity's financial statements in accordance with how the entity manages its business and the underlying risk.

BC96. Many who took that position supported retaining a three-category approach to classification and measurement for financial instruments, similar to the approach in current U.S. GAAP. Those stakeholders noted that most entities employ three business strategies or models for managing financial instruments—a trading portfolio, a portfolio of longer term holdings held for collection or payment of contractual cash flows, and a portfolio held primarily for liquidity purposes that is available for sale as needed. Those stakeholders supported providing a category for assets measured at fair value with changes in fair value reported in other comprehensive income for financial instruments that an entity does not plan to trade in the short term but may need to dispose of in the future to rebalance its portfolio or for liquidity purposes.

BC97. Some stakeholders other than users of financial statements who supported using an entity's business strategy as the primary criterion for classification and measurement supported a model with only two categories—one for instruments measured at fair value with changes in fair value recognized in net income and one for instruments measured at amortized cost. Those stakeholders said that all financial instruments for which an entity's business strategy is to hold the instruments for collection or payment of contractual cash flows should be measured at amortized cost regardless of whether a readily observable market exists for the instruments. They generally said that fair value is not relevant, or is less relevant than amortized cost, in situations in which the entity plans to hold an instrument for collection.

Revised Decisions on Classification and Measurement—before and after Convergence Efforts

BC98. As noted in paragraphs BC21–BC22, early in 2012 the FASB undertook joint deliberations with the IASB on several issues, including classification and measurement of financial instruments, on which the FASB had already reached tentative decisions in its redeliberations on the 2010 proposed Update. The goal

of those joint discussions was to achieve closer convergence of the FASB's tentative decisions and the related guidance in IFRS 9. The following discussion of the FASB's decisions on classification and measurement first covers the Board's initial tentative decisions in response to stakeholders' feedback on the 2010 proposed Update and then discusses the changes to the tentative decisions that resulted from joint redeliberations with the IASB.

Before Joint Convergence Efforts

Characteristics of the instrument

BC99. After considering the input received on the 2010 proposed Update, the Board agreed with respondents that amortized cost would be an appropriate measurement attribute for at least some financial assets. The Board had decided in its redeliberations before joint discussion with the IASB that the measurement of a financial asset should depend on two criteria—the characteristics of the asset and the business strategy that the entity uses to manage the asset.

BC100. The characteristics of a financial asset are important to its classification and measurement because those characteristics determine the variability of the related cash flows and how the entity may realize them. For example, because an equity instrument has no maturity, the only way to realize its value is to sell it. However, an entity can realize the value of a debt instrument by holding it until maturity or for a substantial portion of its life, as the fair value approaches par value. Therefore, the Board decided that only a debt instrument could qualify for measurement at other than fair value with all changes in fair value recognized in net income.

BC101. A principal amount is a critical distinguishing characteristic of a debt instrument. Thus, to satisfy the characteristics of the instrument criterion, the FASB had decided that an amount must be transferred to the debtor (issuer) at inception that will be returned to the creditor (investor) at maturity or other settlement. That amount adjusted by any discount or premium at acquisition would be the principal amount of the contract.

BC102. In its initial redeliberations, the FASB also had decided that financial assets that are subject to significant prepayment risk should be measured at fair value with all changes in fair value recognized in net income because of the potential variability in cash flows. To achieve that result, the classification criteria would have included as a qualifying criterion for measurement at other than fair value through net income that the asset cannot contractually be prepaid or otherwise settled in such a way that the creditor (investor) would not recover substantially all of its initial investment other than through its own choice under the terms of the contract.

Business strategy

BC103. In its initial redeliberations on the 2010 proposed Update, the FASB used the term *business strategy* to refer to how an entity achieves its business purpose—the business activity that the entity uses to manage its financial assets. An entity might manage the same or similar financial assets through different business activities.

BC104. In the FASB's redeliberations before joint convergence efforts, the categories of business strategy and the conditions for each at acquisition (rather than at value realization) of the financial assets would have been as follows:

- a. Customer financing or lending activities, measured at amortized cost—the business activity for financial assets in this category must meet the following conditions:
 1. The entity's business strategy is to manage the assets through customer financing or lending activities, focusing primarily on the collection of substantially all of the contractual cash flows.
 2. The holder of the assets has the ability to manage credit risk by negotiating a potential adjustment of contractual cash flows with the counterparty in the event of a potential credit loss. Sales or settlements would be limited to circumstances that would minimize losses due to deteriorating credit or to exit a particular market for risk management purposes.
 3. At acquisition, the entity does not hold the financial assets for sale.
- b. Investing activities, measured at fair value with qualifying changes in fair value recognized in other comprehensive income—the business strategy for assets in this category must meet the following conditions:
 1. The entity's business strategy is to invest cash either:
 - i. To maximize total return by collecting contractual cash flows or selling the asset
 - ii. To manage its interest rate or liquidity risk by holding or selling the asset.
 2. At acquisition, the assets are not held for sale.
- c. Trading or held-for-sale activities, measured at fair value with all changes in fair value recognized in net income—the business strategy for the assets must meet either of the following conditions:
 1. At acquisition, the entity holds the financial assets for sale.
 2. The entity actively manages the financial assets and monitors them internally on a fair value basis.

BC105. The descriptions of the classification categories and the conditions for each differ as a result of the joint redeliberations of the FASB and the IASB. However, many financial assets would be classified similarly under each set of categories (preconvergence and postconvergence).

Changes to the FASB's initial decisions on classification and measurement of financial assets resulting from convergence efforts

BC106. The FASB's joint redeliberations of selected issues with the IASB led to changes to the FASB's initial decisions on both the characteristics of the instrument criterion and the business strategy criterion as described in paragraphs BC99–BC104.

BC107. This proposed Update uses the terms *contractual cash flow characteristics* and *business model* to refer to the two classification and measurement criteria for financial assets, which are the same terms used in IFRS 9. The meaning of those terms is similar to the meaning of the terms *characteristics of the instrument* and *business strategy* that the FASB used in its initial redeliberations.

BC108. In addition, IFRS 9 applies the business model criterion before the contractual cash flow characteristics criterion, which is the reverse of the order in this proposed Update. The FASB believes that assessing the characteristics of an instrument before assessing the business model in which it is managed is a logical sequence, and neither the FASB nor the IASB think that the order in which the criteria are applied would affect the outcome. See paragraphs BC109–BC133 for a discussion of the criteria in the order they are applied in this proposed Update.

Contractual cash flow characteristics

BC109. To achieve better convergence in accounting for financial instruments, the FASB decided to use the cash flow characteristics criterion in IFRS 9. The FASB considers IFRS 9's focus on whether the contractual terms of a financial asset result in cash flows that are solely payments of principal and interest on the principal amount outstanding to be consistent with the FASB's goal of permitting simple debt instruments to qualify for a measurement category other than fair value through net income.

BC110. As noted in paragraph BC100, the FASB had decided in its initial redeliberations (before joint convergence efforts with the IASB) that because the characteristics of a financial asset determine the variability of the related cash flows, those characteristics are important in deciding how to classify and measure the asset. That is, both the FASB's decisions before joint convergence efforts and IFRS 9 focus on the variability of contractual cash flows. Therefore, the FASB agreed with the IASB that financial assets with contractual cash flows that are solely principal and interest could qualify for a measurement category other than fair value through net income. The FASB also agreed with the principle in IFRS 9 that instruments with features such as an equity or a commodity index are inconsistent with the notion of solely principal and interest. In addition, because the application of the contractual cash flow test would result

in eliminating the bifurcation requirements for financial assets in Subtopic 815-15 (and IAS 39), the FASB and the IASB worked together to address certain issues that stakeholders had raised in applying IFRS 9.

BC111. Both the FASB and the IASB noted that the relationship between principal and interest (that is, consideration for the time value of money and the credit risk in the financial instrument) may be modified by a contractual provision in a way that is inconsistent with the notion of solely payments of principal and interest. For example, an asset may contain a leverage feature or an interest rate that resets or is resettable and the frequency of the reset does not match the term of the interest rate. That feature may result in payments that are not solely principal and interest. Nevertheless, the FASB and the IASB agreed to allow such modified economic relationships to qualify under the contractual cash flow characteristics criterion provided that the feature does not modify the economic relationship between principal and interest by more than an insignificant amount. This proposed Update provides guidance on how that feature affects application of the contractual cash flow characteristics criterion.

Investments in Beneficial Interests

BC112. The Board decided to provide implementation guidance on the application of the contractual cash flow characteristics assessment to beneficial interests in securitized financial assets by looking at certain conditions to determine whether the asset has contractual cash flows that are solely payments of principal and interest. If the beneficial interest does not meet the conditions, the beneficial interest must be measured at fair value through net income. Both the contractual cash flow characteristics test and the conditions for the application of the cash flow test for beneficial interests are aligned with IFRS 9, which meets the Board's goal of reducing differences between U.S. GAAP and IFRS.

BC113. In a structured investment vehicle, the issuer can create a waterfall structure that prioritizes the payments to the holders of the different tranches. Those structures specify the order in which cash flows or shortfalls in cash flows are allocated to the tranches. Thus, the allocation of the cash flows results in creating credit exposure between the tranches.

BC114. In evaluating the application of the cash flow characteristics criterion to beneficial interests, the Board agreed with the IASB that looking solely at the contractual features of the beneficial interest would not capture the economic characteristics of the instrument due to credit risk arising from subordination of one tranche to another. Therefore, the Board decided to provide a look-through approach for assessing the contractual cash flow characteristics of the beneficial interest. The Board noted that if the cash flows of the underlying pool of financial instruments represent solely payments of principal and interest on the principal amount outstanding, the tranche may qualify for a measurement attribute other

than fair value through net income, provided that the tranche is exposed to the same or lower credit risk as the underlying pool of securitized financial instruments. The Board believes that including a credit risk assessment is important to avoid structuring opportunities; otherwise, certain junior tranches may qualify for amortized cost measurement.

Business model

BC115. If a financial asset meets the contractual cash flow characteristics criterion, the entity then would consider the business model in which the asset is managed to determine how to classify and measure the asset.

BC116. In considering how to better align the FASB's business model criterion and the one in IFRS 9, the Boards noted that one primary condition for measurement at amortized cost in both the FASB's redeliberations before the joint convergence efforts and in IFRS 9 (as issued in October 2010) focuses on the collection of contractual cash flows. However, the FASB's business model criterion also would have required other conditions to be met, as described in paragraph BC104.

BC117. The Boards considered several alternatives focusing on the collection of contractual cash flows and the business strategy used to manage the assets as potential conditions for amortized cost measurement of financial assets. The alternatives would include many of the same financial assets in the amortized cost category. The key difference would be in the classification of debt instruments other than loans and receivables. Some alternative conditions would permit debt securities that are held-to-collect contractual cash flows to be measured at amortized cost. The alternative based on the FASB's initial redeliberations would exclude most, if not all, debt securities because it would have required an entity to be able to manage credit risk by negotiating contractual terms with a borrower rather than only selling a security because an issuer's (borrower's) credit quality has deteriorated significantly.

The Amortized Cost Category

BC118. The Boards agreed on a business model for amortized cost measurement that would focus on collection of contractual cash flows but would provide separate implementation guidance on the types of business activities that would be consistent with the objective of collecting contractual cash flows. See paragraphs 825-10-55-30 through 55-34 for the proposed application guidance.

BC119. Some FASB Board members were particularly concerned that an amortized cost business model that focuses solely on collection of contractual cash flows would result in some marketable debt securities with readily determinable fair values to qualify for measurement at amortized cost. The FASB believes that the implementation guidance provided on the held-to-collect

criterion will limit that result by providing guidance on the circumstances in which infrequent sales would be consistent with the objective of amortized cost classification. The FASB also notes that an entity will classify financial assets that it might hold or sell (or hold for a while and then sell) in the fair value through other comprehensive income category. Marketable debt securities often would be classified in that category under the guidance in this proposed Update.

BC120. The FASB considers convergence of accounting and reporting requirements for financial instruments to be vitally important while at the same time providing the most decision-useful information to the users of financial statements. Thus, on balance, the FASB decided to adopt a business model for amortized cost measurement based on the objective of holding financial assets to collect the contractual cash flows, with implementation guidance on the business activities that are consistent with that objective. That decision brings the FASB's and the IASB's business model criteria more in line with each other and thus improves convergence in that area, although differences still may arise on the basis of differences in implementation guidance for applying the condition of held-to-collect contractual cash flows.

The Fair Value through Other Comprehensive Income Category

BC121. The FASB's decisions in its redeliberations before joint convergence efforts included a category for financial assets measured at fair value with qualifying changes in fair value recognized in other comprehensive income (as did the 2010 proposed Update). In contrast, IFRS 9 (as issued in 2010) includes no such category for debt instruments. Accordingly, the FASB and the IASB discussed in their joint convergence efforts the need for and definition of a fair value through other comprehensive income category.

BC122. The FASB continues to consider it important for the business model to include a category that has the objective of both holding financial assets for collection of contractual cash flows and selling financial assets to realize changes in their fair values. Therefore, that category provides a classification for financial assets for which an entity does not know at recognition whether the assets will be held for collection of cash flows or sold to meet specified objectives. For example, an entity might manage its exposure to interest rate risk or maintain a desired yield profile by holding and selling financial assets in accordance with a stated risk management policy. The objective of such a business activity is to manage portfolios of financial assets by holding and selling them as needed to achieve the targeted yield. An entity also might hold and sell financial assets to manage its liquidity.

BC123. The IASB agreed to add to the business model in IFRS 9 a category for financial assets that an entity may hold for an unspecified period and sell. Accordingly, both the amendments in this proposed Update and the IASB's

proposed amendments to IFRS 9 include a fair value through other comprehensive income category.

The Fair Value through Net Income Category

BC124. Both the 2010 proposed Update and the FASB's tentative decisions before joint convergence efforts included a definition for the fair value through net income category. (Paragraph BC104(c) gives the definition of that category in the FASB's initial tentative conclusions.) In IFRS 9, on the other hand, the fair value through net income category is a residual; it includes assets that do not qualify under the conditions for amortized cost measurement.

BC125. Shortly before the FASB undertook joint convergence efforts with the IASB, the FASB and its staff reached out to the Board's stakeholders to obtain their reactions to its tentative conclusions reached to that time. Some of those who commented on the tentative business strategy or model descriptions were concerned that defining all three categories would make applying the requirements overly complex. In particular, they noted that clearly drawing the distinction between the fair value through net income and fair value through other comprehensive income categories may be difficult because both categories include some assets that the entity holds for sale. Respondents suggested that one of the fair value categories should be a residual, and most of those who favored that approach thought that the fair value through net income category should be the residual.

BC126. In this proposed Update, the fair value through net income category is the residual category, containing assets that do not qualify for either of the other two categories.

BC127. Because fair value through net income is the residual category, detailed guidelines about assertions of intent, holding periods, and so forth are not as important as they would be if all three categories were independently defined. Therefore, some of those guidelines may be unnecessary.

Tainting Notion and Sales from the Amortized Cost Category

BC128. The guidance in this proposed Update would not establish a tainting notion like the one in current U.S. GAAP. An entity would be permitted to sell assets from the amortized cost category in specified circumstances. Paragraph 825-10-55-31 indicates that sales of financial assets as a result of a significant deterioration in the issuer's creditworthiness would not be inconsistent with the objective of amortized cost classification if the purpose of those sales is to maximize the collection of contractual cash flows through sales rather than through cash collection. However, sales of financial assets that result from managing credit exposure due to concentrations of credit risk would be inconsistent with the objective of amortized cost classification. Paragraph 825-

10-55-32 identifies other circumstances in which sales from the amortized cost category would not be inconsistent with the objective of holding assets to collect contractual cash flows. That paragraph also indicates that sales resulting from events other than a significant deterioration in the issuer's creditworthiness should be isolated, nonrecurring, and unusual for a reporting entity, resulting from events that the entity could not reasonably have anticipated.

BC129. Current U.S. GAAP for an entity's investments in debt and equity securities is provided in Subtopic 320-10. The three categories for securities set forth in that Subtopic are similar, although not identical, to the three business model categories for financial assets in this proposed Update. Under the guidance in this proposed Update, an entity would classify a debt security and a loan or other receivable into one of the following three categories:

- a. Amortized cost (similar to held to maturity in Subtopic 320-10)
- b. Fair value through other comprehensive income (similar to available for sale in Subtopic 320-10)
- c. Fair value through net income (similar to trading in Subtopic 320-10).

In Subtopic 320-10, those categories apply only to securities and not to other debt instruments held. That Subtopic specifies that for a debt security to qualify for amortized cost measurement, an entity must have a positive intent and ability to hold a security to (or near) its maturity.

BC130. As practice developed under Subtopic 320-10, stakeholders asked the Board to provide additional implementation guidance for the held-to-maturity category, such as circumstances in which sales of financial assets from the held-to-maturity category might be consistent with the objectives of that category. Paragraph 320-10-35-8 provides that a sale from the held-to-maturity category for a reason other than one of several specified reasons or in circumstances other than several that are specified calls into question (taints) an entity's stated intent about all remaining securities in the held-to-maturity category. Those sales also call into question the entity's credibility for similar assertions of intent for future acquisitions of securities.

BC131. The Board recognizes that situations may arise in which an entity's sales of financial assets held in its amortized cost category should call into question the entity's credibility for asserting that it holds financial assets for the primary objective of collecting contractual cash flows. However, the Board asserts that is not a matter appropriately dealt with by an accounting standard to be applied in all of those situations. The guidance in this proposed Update does not include an explicit tainting notion because the appropriate effects of an entity's sales of financial assets that are classified as held-to-collect contractual cash flows are best dealt with by expressing a clear objective and implementation guidance rather than by establishing detailed rules.

BC132. In addition, the Board thinks that an inflexible rule about the effects on an entity's financial statements of sales from the held-to-collect category that are considered to be inappropriate might have unintended consequences that could impair the extent to which an entity's financial statements faithfully represent its business model. For example, an entity might seek to avoid the potential negative effects of the tainting rule on its financial statements by not classifying any financial assets as held-to-collect contractual cash flows even though some of the entity's assets qualify for that classification category.

BC133. The Board recognizes that some of its stakeholders may consider an explicit tainting requirement to be an essential feature of the classification guidance in this proposed Update. Accordingly, the Board included a question for respondents in this proposed Update about the need for an explicit tainting notion.

Subsequent measurement guidance for financial liabilities

BC134. The guidance in this proposed Update would require financial liabilities to be subsequently measured at amortized cost unless certain conditions are met. If those conditions are met, the liabilities would be measured at fair value with changes in fair value recognized in net income. The Board considered several key issues in determining the measurement attribute for financial liabilities, including relevance, whether classification and measurement of financial assets and financial liabilities should be symmetrical, and the effect of changes in instrument-specific credit risk on an entity's financial statements.

BC135. Under the 2010 proposed Update, many financial liabilities would have been measured at fair value through net income. That proposed Update provided a symmetrical model for measurement of financial assets and financial liabilities as an argument for measuring financial liabilities at fair value. For example, one of the arguments for a symmetrical model in the 2010 proposed Update noted that loans, which are funded by an entity's deposits, should be measured similarly (at fair value or a defined remeasurement amount for deposit liabilities) to provide users of financial statements with decision-useful information about how changes in interest rate and refinancing requirements affect the entity's asset-liability management strategies.

BC136. The feedback received on the 2010 proposed Update noted that stakeholders prefer to have financial liabilities measured on a basis that reflects their settlement amounts at maturity, that is, at amortized cost. They said that fair value measurement would be less relevant to users of financial statements in assessing future cash flows because it reflects the amount at which the liability could be transferred to another entity in the market and most liabilities are not transferred but, rather, are settled with the creditor. The stakeholders also were concerned about the increased volatility that would result from fair value measurement and about the potential measurement attribute mismatch between

assets and liabilities if some assets were measured at amortized cost. Furthermore, some stakeholders expressed concern about the feasibility and costs of obtaining the measurement inputs necessary for measuring financial liabilities at fair value.

BC137. Considering the feedback received on the 2010 proposed Update and acknowledging the need to achieve convergence in the area of financial instruments, the Board decided that amortized cost is a relevant measurement attribute because it reflects the settlement amount of the liability. Thus, this proposed Update would require amortized cost measurement of most financial liabilities. However, the Board noted that fair value is the most relevant measurement attribute for financial liabilities that result from short sales or that are issued by broker-dealers in securities (and other entities) for which an entity is able to transact at fair value. Therefore, for those liabilities, the guidance in this proposed Update would continue to require fair value measurement with changes in fair value recognized in net income.

Certain nonrecourse debt

BC138. The Board notes that applying different classification and measurement guidance to financial liabilities and financial assets might in some circumstances result in accounting mismatches unless the guidance provides a method of linking the measurement of a financial liability to the measurement of a related financial asset. For example, an entity may need such a method to avoid an accounting mismatch from the consolidation of a variable interest entity because the financial assets may be measured at fair value but the proposed guidance may require the related financial liabilities to be measured at amortized cost.

BC139. In addressing that issue, the Board first considered providing a targeted fair value option for the situations described in paragraph BC138 to avoid requiring asymmetrical measurement. However, a fair value option, even if conditional or targeted to a particular situation, risks impairing comparability, and the Board has avoided providing such an option wherever feasible. Therefore, for nonrecourse debt linked to specific financial assets, the Board decided that providing an exception to the measurement guidance for liabilities would be preferable. That decision would result in all entities with linked financial assets and nonrecourse debt measuring and reporting the nonrecourse liability in the same way as the linked assets even if the assets are in the fair value through other comprehensive income category, which otherwise does not apply to financial liabilities.

Financial liability issues from the 2010 proposed Update that are no longer pertinent

BC140. The 2010 proposed Update included guidance on two liability-related issues that are not pertinent to the classification and measurement model in this proposed Update.

Amortized cost option for liabilities

BC141. The 2010 proposed Update would have provided an amortized cost option for situations in which measuring a financial liability at fair value would create or exacerbate a measurement attribute mismatch. Because the guidance in this proposed Update would result in amortized cost measurement of most financial liabilities, an amortized cost option similar to the one in the 2010 proposed Update is no longer needed. In addition, the conditional fair value option proposed in Subtopic 825-30 would deal with at least some potential attribute mismatches by permitting an entity that manages the net exposure of a group of financial assets and financial liabilities to measure those assets and liabilities at fair value with changes in fair value recognized in net income.

Core deposit liabilities

BC142. The 2010 proposed Update reflected the Board's decision that, in the context of the proposed classification and measurement model, demand deposits should be split into their core and noncore components. Demand deposits that were not considered core would have been valued at fair value, which the Board thought would be reasonably close to their face amount because of the short-term nature of those deposit liabilities. Core demand deposits would have been remeasured as the present value of the average core deposit amount discounted at the difference between the alternative funds rate and the all-in-cost-to-service rate over the implied maturity of the deposits.

BC143. Most of the stakeholders who provided feedback about the subsequent measurement of core deposit liabilities did not support the proposed remeasurement method. They said that the inputs were too subjective to be useful, which could lead to decreased comparability among entities. Many stakeholders also said that presentation of any amount other than the face amount for core deposits liabilities is misleading and that introducing a new measurement attribute would add complexity to the accounting for financial instruments.

BC144. The guidance on core deposits liabilities in the 2010 proposed Update was developed in the context of a classification and measurement model in which the assets—largely loans receivable—supported by those demand deposits would have been subsequently measured at fair value. In developing

that guidance, the Board considered the earlier comments of many stakeholders that core deposits often are the main source of value for a financial institution. The Board believed that the proposed remeasurement approach would demonstrate how interest rates affected the core demand deposits, which would be useful information for investors in reflecting asset-liability exposure to a duration mismatch.

BC145. In contrast, the classification and measurement model in this proposed Update would result in measuring financial assets used in a bank's lending activities at either amortized cost or fair value depending on the business model in which the assets are managed. In light of that fact, the Board decided that any duration mismatch resulting from measuring demand deposits at their amortized cost (face) amount would be much less significant than under the guidance in the 2010 proposed Update. Therefore, the Board decided that an entity should measure its core deposit liabilities at their face amount.

BC146. Although the Board decided that no different measurement method was needed for core deposit liabilities, it also decided that a reporting entity should disclose certain information about its deposit liabilities. Those disclosures are discussed in paragraphs BC308–BC313.

Initial Measurement

Fair Value or Transaction Price?

BC147. The Board decided that a financial instrument subsequently measured at fair value with all changes in fair value recognized in net income should be initially measured at its fair value. All subsequent changes in the fair value of such an instrument are recognized in net income in the periods in which they occur, and the Board thinks that initial measurement should follow the same principle. Any initial gain or loss also should be recognized in net income.

BC148. The Board notes that the definition of *amortized cost* is based on transaction price. Thus, the proposed guidance on initial measurement would require that financial instruments be measured at their transaction price if they are to subsequently be measured at amortized cost. The Board also decided that a financial instrument that subsequently would be measured at fair value with qualifying changes in fair value recognized in other comprehensive income should be initially measured at its transaction price. That would result in recognizing the difference between a financial instrument's transaction price and its fair value (not attributable to other components of the transaction) in other comprehensive income upon the first remeasurement to fair value. The Board believes that result is more consistent with recognizing subsequent changes in the fair value of those financial instruments in other comprehensive income than reporting an initial difference between transaction price and fair value in net

income but reporting subsequent changes in fair value in other comprehensive income.

If the Transaction Price Includes Consideration for Something Other Than the Financial Instrument

BC149. If part of the consideration given or received for a financial instrument that is measured at either amortized cost or fair value with qualifying changes in fair value recognized in other comprehensive income is for something other than the financial instrument, the Board decided that the financial instrument should initially be measured at its fair value. That would ensure that any other components in the transaction, including any stated or unstated rights or privileges, would be accounted for properly in accordance with other applicable U.S. GAAP.

BC150. Subtopic 835-30, Interest—Imputation of Interest, establishes a general principle for the appropriate accounting if the face amount of a note does not reasonably represent the present value of the consideration given or received in the exchange. Excluding the phrase *customary cash lending activities of financial institutions whose primary business is lending money* from the scope of Subtopic 835-30 results in the potential for situations in which economic losses on lending transactions may not be recognized (paragraph 835-30-15-3(d)). Conceptually, the Board believes that the same principle for unbundling multiple-element transactions that applies to other entities and transactions also should apply to the lending activities of banks and other entities. Therefore, the Board decided to develop a principle that would be broadly applicable to all lending transactions that would require separate recognition of the financial instrument component and any other components if they are bundled together.

BC151. The guidance in the 2010 proposed Update would have required an entity to initially measure a financial instrument at its fair value if the entity had reason to expect that the transaction price of the instrument differed significantly from its fair value and if that difference is attributable to other components of the transaction. The entity also would have had to determine whether reliable evidence indicates that a significant difference between fair value and transaction price does in fact exist.

BC152. Stakeholders said that the 2010 proposed guidance was unclear about when entities would be required to evaluate whether a significant difference between the transaction price and fair value of a financial instrument exists. Many stakeholders were concerned that such an evaluation would need to be made at the inception of every lending transaction. In addition, stakeholders said that the 2010 proposed Update was unclear about how significant a difference between fair value and transaction price needed to be for the entity to be required to measure the financial instrument at fair value and account separately for other components of the transaction. In addition, some stakeholders said that in many circumstances no objective evidence would be available to support

calculating a difference between the transaction price and fair value because, for example, no secondary markets exist for the majority of loans and related commitments.

BC153. The Board acknowledged the difficulty in determining if a difference between the consideration given or received and the fair value of a loan should trigger initial measurement of the loan at fair value and recognition of another component. The Board understands that the pricing of loans by banks involves numerous factors, including consideration of credit spreads, competition, and underwriting, such that different lenders could reasonably charge different interest rates from within a range to the same or similar borrowers. The Board agrees with stakeholders that it often would be extremely difficult to determine the appropriate range of interest rates that should be considered market rates for a particular borrower. For those reasons, the Board decided to take a qualitative rather than a quantitative approach to requiring an evaluation of whether a transaction contains another additional component.

BC154. The Board decided that entities should focus on the terms and structure of lending transactions to determine whether a transaction includes multiple elements. Under such a principle, the parties involved in the financial instrument transactions would evaluate whether a transaction contains multiple components that should be accounted for separately.

BC155. The Board believes that a qualitative approach narrows the population of lending arrangements that would be subject to the multiple component guidance. The Board sought to differentiate the typical loan pricing practices of lending institutions from structured transactions that are priced to convey an explicit benefit to a particular counterparty. The Board understands that it is typical for lenders to offer a wide range of market interest rates to borrowers of a specific credit quality for a particular asset class depending upon their pricing structures. Lenders may offer below-market rates to borrowers for a variety of reasons, for example, when introducing a new loan product or to increase or retain market share for existing products. Those incentives are offered to a broad population of potential borrowers rather than to a specific borrower. Therefore, the Board believes that most lending activities fall within the realm of normal or customary lending activities that would be excluded from application of the guidance in this proposed Update on whether the consideration includes something other than the financial instrument.

BC156. The guidance in this proposed Update on whether the consideration includes something other than the financial instrument describes the terms of a transaction with multiple components as unreasonable to parallel the language in Subtopic 835-30. Subtopic 835-30 does not define terms that are unreasonable, but the Board intends to focus on lending activities that involve intentional structuring such that the price or rate is substantially different from prevailing prices or rates. The Board believes that the qualitative approach in this proposed Update would avoid the cost-benefit concerns with requiring an entity to compare

the fair value and the consideration given or received of every financial instrument it acquires or issues.

Transaction Costs and Fees

BC157. The Board decided that transaction costs and fees related to financial instruments in the fair value through net income category should be recognized as an expense in net income when incurred. Because those costs do not directly affect the fair value of the financial asset or the financial liability, the Board believes that transaction costs should be reflected as current-period expenses rather than capitalized and deferred. Not capitalizing transaction costs as part of an asset's or a liability's fair value is consistent with the guidance in Topic 820.

BC158. The Board decided that certain transaction fees and costs related to financial instruments initially measured at transaction price should be deferred. The deferred fees and costs would be limited to the loan origination fees and direct loan origination costs as defined in Subtopic 310-20. The Board continues to believe the statement in the basis for conclusions of FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, that the fees and costs relating to a loan origination should be recognized over the life of a loan because they are integral to the lending transaction. Accordingly, the Board decided that the recognition of fees and costs for financial assets initially measured at the transaction price should be consistent with current guidance in Subtopic 310-20, which requires those fees and costs to be accreted or amortized as an adjustment of yield over the life of the financial instrument. That accounting for fees and costs would preserve the reported net interest margin for the related financial instruments.

Reclassification of Financial Assets

Reclassification in the 2010 Proposed Update

BC159. The 2010 proposed Update would have prohibited reclassification of financial instruments after the entity initially classified them at the date they were recognized. The Board was concerned about the potential for earnings management if reclassifications were allowed. For example, an entity might reclassify to fair value through net income financial assets that were initially classified as either amortized cost or fair value through other comprehensive income to recognize gains in net income on appreciated financial assets even though previous losses on those assets had not been recognized in net income.

BC160. Feedback on the 2010 proposed Update's prohibition of reclassification generally differed between users of financial statements and stakeholders other than users. Most users of financial statements who commented on the issue agreed with the proposed prohibition of reclassification. Respondents other than users, however, generally favored allowing for reclassifications if the business

model changes. Those respondents also supported classifying financial instruments on the basis of an entity's business model, and they noted that providing reclassification if the business model changes would be consistent with the guidance on initial classification.

BC161. Respondents who supported reclassifying financial instruments when the related business model changes also asked the Board to provide guidance for identifying such a change. Some of them commented favorably on IFRS 9's guidance on determining if the business model has changed. IFRS 9 requires reclassification of financial assets if (and only if) the business model in which they are held and managed changes. IFRS 9 notes that changes in the business model would be very infrequent and requires that those changes be determined by the entity's senior management as a result of external or internal changes. To support reclassification, a change in the business model also must be significant to the entity's operations and demonstrable to external parties.

Reclassification in This Proposed Update

BC162. The FASB agreed with stakeholders who favored reclassifying financial assets upon a change in the business model because to do so would be consistent with initial classification on the basis of the business model. The Board also noted that providing for reclassification in that situation increases convergence because it is consistent with the guidance in IFRS 9.

BC163. This proposed Update also provides the same implementation guidance as IFRS 9 on identifying a change in the business model that should result in reclassification of the related financial assets. As previously noted, stakeholders generally supported that guidance.

BC164. The FASB considered whether reclassification upon a change in the business model should be required or only permitted. The Board noted that one reason for providing for reclassification when the business model changes is to improve comparability among entities that use the same business model for holding and managing financial assets. To make reclassification permissive would impair rather than improve comparability. In addition, IFRS 9 requires rather than only permits reclassification upon a change in the business model. Accordingly, the guidance in this proposed Update would require reclassification of financial assets when the business model changes.

Accounting for a reclassification of financial assets

BC165. Having decided that an entity should reclassify financial assets prospectively when its business model changes, the FASB considered what guidance to provide on how to account for such a reclassification. (The business model in this proposed Update is not assessed on an individual instrument level but, rather, at a higher level of aggregation, such as at a portfolio level. Because reclassification is required only upon a change in the entity's business model, a reclassification would not be expected to affect a single financial asset in

isolation. Nevertheless, for simplicity, the discussion in paragraphs BC166–BC181 is in terms of a single financial asset. The principles are the same for a portfolio of assets as for an individual asset.)

Reclassification date

BC166. The Board considered the following two alternatives for the date as of which to account for a reclassification of financial assets:

- a. The first day of the reporting period immediately following the change in the business model
- b. The last day of the reporting period during which the business model changes.

The guidance in this proposed Update would require alternative (b) above. IFRS 9, in contrast, requires alternative (a).

BC167. The IASB's decision to require accounting for a reclassification as of the first day of the next reporting period after the period in which a change in the business model occurs was based primarily on its view that an entity should be prevented from choosing a reclassification date to achieve a particular accounting result. Under alternative (a), the entity would be required to change its business model before it knows the relative effect of the resulting reclassifications on its financial statements. That is, at the date of a change in its business model an entity does not know its financial results for the next reporting period, which makes it impossible to choose the date of a reclassification to achieve a desired accounting result.

BC168. The FASB understands the IASB's reasons for IFRS 9's requirement on the date as of which an entity accounts for a reclassification of financial assets. In deciding not to converge with IFRS 9 on that issue, the FASB noted that a change in its business model is sufficiently important that few, if any, entities would make such a change to achieve an accounting result. That seems particularly true under the guidance about the factors that must be present to support that a change in the business model has occurred. The FASB also notes that under alternative (b), reclassification is based on the measurement amount as of the end of the reporting period and not as of the date of the reclassification event. At the date of the reclassification event, the entity will not know its results as of the end of the reporting period, which also would prevent entities from achieving a desired accounting result.

BC169. The FASB decided that a lack of convergence on this issue outweighs the importance of accounting for a change in the business model in the accounting period in which it occurs, especially because both the guidance in this proposed Update and the guidance in IFRS 9 state that a change in the business model should be very infrequent.

Reclassification mechanics

BC170. The mechanics of accounting for reclassification of financial assets includes both of the following:

- a. The new carrying amount of the reclassified assets
- b. The circumstances, if any, in which an entity should recognize a gain or loss in net income if the new carrying amount differs from the previous carrying amount.

BC171. An entity may need to account for any of six potential types of reclassifications. That is, an entity might reclassify financial assets from X to Y, in which X and Y may stand for any of the following three possible business models:

- a. Fair value through net income
- b. Fair value through other comprehensive income
- c. Amortized cost.

BC172. The FASB considered the six potential types of reclassifications in two groups depending on whether the carrying amount of the reclassified assets is fair value both before and after the reclassification or whether the carrying amount changes from (or to) fair value to (or from) amortized cost. If the carrying amount does not change, the first issue in paragraph BC170 is not relevant and no potential gain or loss arises because of a change in carrying amount. It is necessary only to ensure that changes in fair value after the reclassification are recognized either in other comprehensive income or in net income, depending on the classification of the assets after the change in business model.

BC173. In contrast, reclassifying assets either from fair value to amortized cost or vice versa may raise both of the issues in paragraph BC170 because the carrying amount of the assets may (but would not necessarily) change. For example, an entity may reclassify financial assets from the fair value through net income category to the amortized cost category. The asset's carrying amount after the reclassification will be determined by either of the following:

- a. Treating the asset's fair value at the date the change is recognized as its amortized cost for subsequent accounting
- b. Determining the asset's amortized cost at the date it was acquired and using that amount as the basis for subsequent accounting as if the asset had always been classified in the amortized cost category.

BC174. IFRS 9 requires alternative (a) above, and the FASB also decided to require that method. The fair value of the financial asset at the reclassification date becomes its new carrying amount.

BC175. The FASB noted, as did the IASB when it considered this issue, that alternative (b) would be overly complex and impractical. An entity would not be required to separately present interest income and credit losses for an asset

classified as fair value through net income, and that information may not be readily available, especially if the asset has been in the fair value through net income category for several years.

BC176. The FASB decided that the guidance on the carrying amount of assets after reclassification for a change from fair value through other comprehensive income to amortized cost should be the same as for a change from fair value through net income to amortized cost. For both types of reclassification, the new carrying amount of the reclassified assets would be their fair value at the date the entity accounts for the reclassification.

BC177. The Board noted, however, that for financial assets previously classified as fair value through other comprehensive income, an entity's accumulated other comprehensive income will include the total amount of qualifying changes in fair value during the time it was so classified. Because that cumulative amount relates to the previous classification of the asset rather than its current classification, the Board notes that it should not remain in other comprehensive income. Alternatives for the offsetting entry in removing that cumulative amount from other comprehensive income include either net income or the carrying amount of the related assets.

BC178. Including the accumulated amount of changes in fair value in net income at the reclassification date would be consistent with the accounting when an entity has disposed of the assets, which it has not in this situation. Thus, the FASB decided that derecognizing the cumulative amount of qualifying changes in fair value by means of an offsetting entry to the carrying amount of the assets would be preferable. The result will be that the assets will be measured at their amortized cost as though they had been classified in that category from their acquisition.

BC179. The remaining types of reclassification to be discussed are changes from amortized cost to one of the two fair value measurement categories: fair value through net income or fair value through other comprehensive income. The FASB decided that the fair value of the asset at the date the reclassification is accounted for should become the new carrying amount. Because the asset is reclassified to a fair value category, its carrying amount must eventually be fair value.

BC180. Using the fair value of a financial asset at the date of accounting for a reclassification as its new carrying amount raises the issue of how to account for a difference between the old carrying amount (amortized cost) and the new (fair value). Although that difference might, in theory at least, be amortized in some fashion to net income or to other comprehensive income, the FASB rejected that alternative for accounting for a reclassification from amortized cost to fair value through net income, as did the IASB in IFRS 9. Both Boards noted that amortizing the difference between the old and new carrying amount would continue to reflect in an entity's financial statements an amount that is no longer relevant because it pertains to the previous measurement basis of the asset.

Accordingly, both Boards decided that the difference in carrying amount should be included in net income as of the date the reclassification is accounted for if the new classification is fair value through net income.

BC181. Similarly, if the new classification of a financial asset is fair value through other comprehensive income, the difference between old and new carrying amounts would be included in other comprehensive income to be consistent with the new classification of the asset.

Application of Proposed Classification and Measurement Guidance to Particular Financial Instruments

Measurement and Presentation of Debt Instruments Subsequently Identified for Sale

BC182. Although an entity initially classifies particular financial assets (that is, debt instruments) in the amortized cost category because it holds them to collect the contractual cash flows, a sale of the assets may occur in certain circumstances that are discussed in paragraphs 825-10-55-31 through 55-34.

BC183. The guidance in this proposed Update would prohibit reclassifying financial assets after recognition except in the unusual situation of a change in the entity's business model. An entity could not reclassify an individual financial asset or pool of assets solely because it subsequently decides to sell them. Accordingly, reclassifying a financial asset from the amortized cost category to the fair value through net income category is not an alternative for assets subsequently identified for sale.

BC184. The Board considered the following three alternatives for accounting for an entity's subsequent identification for sale of financial assets that initially qualified for amortized cost classification:

- a. Continue to measure the assets at amortized cost (less impairment) and include the gain or loss in net income when the sale is complete.
- b. Measure the assets at the lower of cost or fair value when the decision to sell is made. That requirement would be similar to current U.S. GAAP.
- c. Measure the assets at fair value and present the assets separately from other similar assets (for example, other loans receivable in the fair value through net income category).

BC185. Each of those alternatives has both advantages and disadvantages. On balance, the Board decided to require a modified version of alternative (a) in which the financial assets continue to be measured at amortized cost (less impairment) and any gain is recognized in net income when the sale is complete. To avoid deferring recognition of a known loss, the Board also decided to require

recognition in net income of any impairment, measured as the entire amount of the difference between the asset's amortized cost and its fair value.

BC186. The Board also considered two alternatives for presentation in the statement of financial position of financial assets that an entity has identified for sale after initially classifying them as held-to-collect contractual cash flows.

BC187. The first alternative would require an entity to present financial assets subsequently identified for sale in a separate line item on the statement of financial position. If the fair value of the assets is greater than their net carrying amount, financial assets identified for sale would be reported at cost less an allowance for credit losses, with fair value disclosed parenthetically. If, on the other hand, fair value is less than their net carrying amount, financial assets subsequently identified for sale would be measured at fair value with amortized cost less allowance for credit losses disclosed parenthetically.

BC188. The second alternative would require an entity to present on the statement of financial position a total for the amortized cost balance of financial assets classified in the amortized cost category, with a separate line item showing the total credit allowance. The allowance presented would include the credit impairment for debt instruments held-to-collect contractual cash flows and those subsequently identified for sale.

BC189. The main difference between those two alternatives is whether disaggregated information about financial assets subsequently identified for sale is shown on the face of the statement of financial position or only in the notes. Both alternatives make essentially the same information available; however, the location and detailed manner of presentation differs.

BC190. The Board noted that an entity subsequently deciding to sell financial assets that it initially expected to hold to collect contractual cash flows can be a significant event. Users should be provided with information about that event in the most straightforward and easily accessible manner possible. Thus, the Board decided to require an entity to present disaggregated information about financial assets subsequently identified for sale on the face of the statement of financial position. An entity will supplement that information with more detailed note disclosures about why management departed from its held-to-collect business model.

If an entity decides at recognition to sell part of a pool of financial assets, with individual assets to sell identified later

BC191. The guidance in this proposed Update would require an entity to classify financial assets that satisfy the contractual cash flow criterion on the basis of the business model in which the assets are managed. An entity may originate or purchase a pool of assets (for example, loans) with the plan to sell some of the assets (for example, through securitization) and to hold the others to collect

contractual cash flows, without having yet identified which individual assets it plans to hold and which to sell. In those circumstances, the Board decided that an entity should use its best estimates to determine the appropriate business model for the financial assets by classifying a percentage of the pool into one of the classification categories. An entity would not be precluded from managing identical or similar financial assets through different business models.

Instruments with Embedded Derivatives

Proposals in 2010 and stakeholders' feedback

BC192. Under the classification and measurement model in the 2010 proposed Update, hybrid financial instruments that contain embedded derivatives that otherwise would have required bifurcation and separate accounting would have been measured at fair value in their entirety, with all changes recognized in net income. That was consistent with the proposed use of fair value as the primary measurement attribute for financial instruments. It also would have simplified the measurement for hybrid instruments that no longer would have to be bifurcated. An effect of the elimination of bifurcation, however, would have been that the embedded derivatives would not have qualified for designation as hedging instruments.

BC193. Most of the users who provided feedback on the 2010 proposed Update did not comment on its proposals on embedded derivatives. Most of those who did comment supported fair value measurement for all financial instruments and, thus, also supported the proposed requirement to measure hybrid financial instruments at fair value in their entirety. Those users said that measuring hybrid financial instruments at fair value provides better information about the current economic and interest rate environment, cash flow variability, and risks inherent in these instruments. Users who took that position also said that eliminating the requirement to bifurcate embedded derivatives from the host contract would improve comparability among entities.

BC194. Most respondents other than users of financial statements did not support measuring hybrid financial instruments at fair value in their entirety. They supported continuing to bifurcate embedded derivatives from the host contract on the basis of the current requirements in Subtopic 815-15. That would allow an entity to classify and measure the host contract consistent with management's business strategy based on the general classification and measurement requirements for financial instruments. But some respondents other than users of financial information supported the proposed elimination of the bifurcation of embedded derivatives because they noted that eliminating that requirement would improve comparability and ease implementation.

Different starting points for the FASB and the IASB in working jointly toward converged decisions on bifurcation

BC195. Under the FASB's decisions on classification and measurement reflected in this proposed Update, fair value would not be the primary measurement attribute for financial instruments, and many financial instruments would be subsequently measured at amortized cost. Thus, in redeliberating the 2010 proposals on hybrid financial instruments before the joint convergence efforts, the Board had decided that measurement at fair value of all hybrid instruments that otherwise would have been bifurcated under Subtopic 815-15 would be inappropriate. Rather, the Board had decided to retain the bifurcation requirements in Subtopic 815-15 for hybrid financial instruments. Doing so would have enhanced consistency by applying the same measurement and other requirements to both a hybrid financial asset and a hybrid financial liability.

BC196. The IASB's conclusions on bifurcation of hybrid financial instruments included in IFRS 9 apply different requirements to financial assets and financial liabilities. A hybrid financial asset is not bifurcated. Rather, the entire instrument is subject to the classification guidance for financial assets. Because such an instrument may not meet the contractual cash flow characteristics criterion, the entire contract is included in the fair value through net income category. For financial liabilities, however, IFRS 9 retains the bifurcation requirements of IAS 39.

Guidance on bifurcation resulting from joint convergence efforts

BC197. The proposed requirements for hybrid financial assets in this proposed Update differ from the requirements for hybrid financial liabilities. For a hybrid financial asset, paragraph 825-10-25-26 would require an entity to classify the instrument in its entirety in the fair value through net income category. That is, the entity is prohibited from bifurcating the contract and accounting for the derivative and nonderivative components separately.

BC198. For a hybrid financial liability, paragraph 825-10-25-27 would require an entity to apply the guidance on embedded derivatives in Subtopic 815-15. As a consequence, the derivative feature would be measured at fair value under the requirements of Topic 815, and the entity would separately apply the classification guidance to the host contract. In other words, hybrid financial liabilities would be subject to the bifurcation requirements in Subtopic 815-15.

BC199. The proposed guidance on hybrid financial instruments, that is, financial instruments with a host contract and an embedded derivative, in this proposed Update is the same as that in IFRS 9.

Why did the Boards choose an asymmetrical approach?

BC200. The guidance on bifurcation in this proposed Update, like that in IFRS 9, results in different accounting for hybrid financial assets than for hybrid financial liabilities and, thus, is asymmetrical. As discussed in the paragraphs BC201–BC203, both the FASB and the IASB decided that differing guidance for assets and liabilities is appropriate because methods that work well for assets do not necessarily work well for liabilities and vice versa.

Considerations for Financial Assets

BC201. For financial assets, the FASB decided that, as had the IASB in developing IFRS 9, the bifurcation requirements in Subtopic 815-15 do not work when overlaid on the contractual cash flow characteristics criterion. That criterion looks at whether a financial asset gives rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding. A hybrid financial asset that contains leverage will fail that test if the amount of leverage is more than insignificant. (Paragraph 825-10-55-17 explains application of the contractual cash flow criterion to a financial asset with terms that include leverage.) In contrast, applying the bifurcation requirements in Subtopic 815-15 (for example, the double-double test in paragraph 815-15-25-26) may result in concluding that the embedded derivative is clearly and closely related to the host contract and, thus, does not require bifurcation. That differs from the result of applying the contractual cash flow criterion, and it would permit an entity to classify the hybrid instrument into a category other than fair value with changes in fair value recognized in net income. Therefore, the Board decided to preclude the bifurcation requirements in Subtopic 815-15 from applying to hybrid financial assets. The Board also noted that accounting for the hybrid asset in its entirety retains the instrument's unit of account and enhances comparability for financial statement users.

Considerations for Financial Liabilities

BC202. The FASB, as had the IASB in developing IFRS 9, considered also applying a no-bifurcation approach to financial liabilities but decided not to do so, in part because applying the contractual cash flow test to hybrid financial liabilities would result in more liabilities being measured at fair value through net income. Feedback on the 2010 proposed Update indicated that many stakeholders, including some who supported fair value through net income for most or all financial assets, opposed classifying and measuring financial liabilities in that way. Those stakeholders noted that an entity often cannot or does not settle or transfer its liabilities at fair value before their maturity. Many also were particularly concerned about including in net income the portion of a change in the fair value of a liability resulting from a change in the instrument-specific credit risk. The guidance in this proposed Update addresses that issue by requiring that portion of a change in the fair value of a liability to be separated and recognized in other comprehensive income rather than net income.

BC203. In addition, the FASB considers convergence of financial reporting requirements to be important. Requiring bifurcation of hybrid financial liabilities, but not hybrid financial assets, is consistent with the guidance in IFRS 9. Moreover, the measurement guidance for financial liabilities in this proposed Update largely continues the provisions of U.S. GAAP. The Board notes that bifurcation of hybrid financial liabilities is part of current U.S. GAAP. Thus, it should not add complexity or additional implementation cost. Therefore, the Board decided that the considerations applicable to financial liabilities are sufficiently different from those for financial assets to justify retaining the bifurcation guidance for hybrid financial liabilities.

Considerations for Nonfinancial Hybrid Instruments

BC204. Current U.S. GAAP (paragraph 825-10-15-4(f)) provides a fair value option for a host financial instrument that results from the separation of an embedded nonfinancial derivative and a financial host contract to be measured at fair value with all changes in fair value recognized in net income. That fair value option results in measuring both the host contract and the embedded nonfinancial derivative at fair value. Although the scope of this proposed Update does not include nonfinancial instruments, the proposed guidance would amend the accounting for the host financial contract (asset or liability). Specifically, the host financial asset would have had to be assessed under the classification and measurement guidance in this proposed Update, which could have produced an inconsistent outcome with the model applied to financial hybrid assets. As a result, to achieve symmetry in the accounting for the host financial assets, the Board decided to eliminate the fair value option in paragraph 825-10-15-4(f). Rather, a hybrid nonfinancial asset that contains an embedded derivative that would have required bifurcation and separate accounting under Subtopic 815-15 would be measured in its entirety at fair value (with changes in fair value recognized in net income).

BC205. Similarly, for a hybrid nonfinancial liability, an entity would apply the bifurcation and separate accounting requirements in Subtopic 815-15 and account for the embedded derivative in accordance with Topic 815. The financial host liability that results from separation of the nonfinancial embedded derivative would be subject to the measurement guidance for financial liabilities in this proposed Update. To provide symmetry with the fair value option for hybrid financial liabilities under this proposed Update, the Board decided that an entity would be permitted at recognition to elect to initially and subsequently measure the hybrid nonfinancial liability at fair value with changes in fair value recognized in net income if after applying Subtopic 815-15 the entity determines that an embedded derivative that would have required bifurcation and separate accounting exists.

Exceptions to the Subsequent Measurement Principle

Equity Investments without Readily Determinable Fair Values

BC206. Under the guidance in this proposed Update, an entity would measure its equity investments (other than those that qualify for the equity method of accounting or that result in consolidation) at fair value with all changes in fair value included in net income. Unlike debt instruments, equity investments have no contractual cash flows and, thus, do not meet the contractual cash flows criterion. The only way to realize the changes in the value of an equity investment held is to sell it.

BC207. The Board considered whether to provide an exception to fair value measurement for equity investments that do not have readily determinable fair values and, if so, the nature of the exception and the entities to which it should apply. In considering those issues, the Board took into account, among other factors, the provisions of both current U.S. GAAP and the proposals in the 2010 Update, stakeholders' feedback to the proposals, and the provisions of IFRS 9.

Current U.S. GAAP for equity investments

BC208. In current U.S. GAAP, an equity investment that does not have a readily determinable fair value is measured at cost less any other-than-temporary impairment unless the entity elects the fair value option or the investment qualifies for the equity method.

Guidance in 2010 proposed Update and stakeholders' feedback

BC209. The guidance in the 2010 proposed Update included no exception for equity investments without readily determinable fair values. The guidance in that proposed Update would have required all equity investments held to be measured at fair value with all changes in fair value included in net income. An equity investment could not have qualified for the fair value through other comprehensive income category, which was available only for debt instruments in specified situations.

BC210. The views of users of financial statements who responded to the issue of measurement of equity investments without readily determinable fair values were mixed. Most said that those equity investments should be measured at fair value with all changes in fair value included in net income. However, some supported recognizing changes in the fair value of those investments in other comprehensive income until the investment is sold because of the unavoidable measurement subjectivity and also because the holding periods of those securities usually are relatively long. A few users said that as a result of the significant subjectivity required to determine the fair value of such investments,

they should be measured at cost less impairment with fair value disclosed either in the notes or presented parenthetically on the face of the statement of financial position.

BC211. The views of stakeholders other than users also were mixed. Many favored measuring equity investments without readily determinable fair values at cost less any impairment because, by definition, no observable market exists and information to estimate their fair value may not be available on a timely basis.

Guidance in IFRS 9

BC212. IFRS 9 requires equity investments to be measured at fair value with changes in fair value recognized in profit or loss, but it provides (see paragraph 5.7.5) an option at recognition to present changes in the fair value of an equity investment not held for trading in other comprehensive income. IFRS 9 also indicates that cost may be used as a practical expedient for unquoted equity instruments in limited circumstances (see paragraphs B5.4.14–B5.4.17).

BC213. In summary, both Boards currently require equity instruments to be measured at fair value with all changes in fair value included in net income. However, under U.S. GAAP, equity investments without readily determinable fair values are measured at cost less any impairment. IFRS 9 provides a fair value through other comprehensive income option, and it also includes a practical expedient for unquoted equity instruments.

The FASB's decisions on equity investments without readily determinable fair values

Should a measurement exception be provided and, if so, what should it be?

BC214. The Board decided that the exception from fair value measurement provided in Topic 320 should be continued, at least for some subset of entities. The Board initially provided that exception largely because of the inherent subjectivity and the resulting potential decrease in faithful representation and comparability of the amounts reported in the financial statements for securities whose fair value is not indicated by quoted market prices or similar evidence.

BC215. Instead, the Board considered requiring fair value measurement of all equity investments but reporting qualifying changes in the fair value of equity investments without readily determinable fair values in other comprehensive income until the entity sells the investment. In rejecting that alternative, the Board noted that the reasons for requiring certain debt instruments to be included in the fair value through other comprehensive income category are unrelated to measurement difficulties. The Board also noted that reporting qualifying changes

in fair value in other comprehensive income rather than in net income would not improve the reliability or comparability of the underlying measures of fair value. Accordingly, the Board decided to develop an alternative that more directly addresses the concerns about measures of fair value for equity investments that do not have readily determinable fair values.

BC216. The Board considered the following three alternatives for the alternative measure of investments in equity investments without readily determinable fair values:

- a. Cost less other-than-temporary impairment, which is the requirement in Topic 320
- b. Cost less impairment plus upward adjustments if information about a price change is observable based on transactions in the instrument
- c. Cost less impairment plus upward and minus downward adjustments if information about a price change is observable based on transactions in the instrument.

BC217. If alternative (b) or alternative (c) above is selected, an additional issue arises of whether only observable price changes of identical investments or also observable price changes in similar instruments issued by the same entity should be reflected.

BC218. The Board decided that limiting the adjustments to the cost of the investment to impairment would have provided inadequate information to assist users in evaluating the performance of an entity's equity investment. In the absence of a readily determinable fair value, an investor in equity investments should use all available, reasonably reliable information to adjust cost to develop an alternative measure that is as close to fair value as possible. Thus, the Board rejected alternative (a) in paragraph BC216.

BC219. The Board also rejected the other-than-temporary notion in alternative (a). Deciding how temporary or other than temporary an impairment is requires a significant degree of judgment and little, if any, objective evidence usually is available to guide that judgement. That notion also may delay the recognition of an impairment for too long. The Board decided that an impairment should be recognized as soon as the available, reasonably reliable information indicates that equity investments are in fact impaired without waiting to attempt to determine if the impairment is temporary.

Which observable price changes should be reflected?

BC220. The Board decided that upward as well as downward observable price changes for identical instruments and also for similar instruments issued by the same entity (the investee) should be included in the alternative measure for equity investments without a readily determinable fair value.

BC221. The Board notes that reflecting downward as well as upward price changes is a separate adjustment from reflecting recognized impairments of an investment. Observable price changes would be reflected immediately rather than waiting to determine whether a downward price change is one factor indicating that an impairment should be recognized.

BC222. As indicated in rejecting the alternative of limiting adjustment to cost to impairment (see paragraph BC218), the Board thinks that the alternative measure of an equity investment without a readily determinable fair value should account for all known information about the value of the investment. The Board does not expect an investor to conduct an exhaustive search for potentially observable price changes. However, the Board also does not see a reason to exclude known observable price changes. The Board asserts that the guidance on determining an alternative measure of equity investments without readily determinable fair value will result in relevant and reliable information for users of financial statements without imposing an undue burden on preparers.

What should be the scope of the exception?

BC223. Having decided to provide a practicability exception for equity investments without readily determinable fair values, the Board considered whether the exception should be available only to nonpublic entities or to all entities, both public and nonpublic.

BC224. Supporters of limiting the practicability exception to nonpublic entities noted that the fair value of equity investments provides more relevant information than a cost-based measure for understanding and analyzing the future cash flows and the risks associated with equity investments. Accordingly, they stated that the scope of a practicability exception should be as narrow as possible and that public entities generally have more resources than nonpublic entities for estimating the fair value of equity investments without readily determinable fair values.

BC225. Those who would limit the practicability exception to nonpublic entities also distinguished between the needs of users of financial statements of public and nonpublic entities. The latter often have direct access to the management of the issuer of equity investments, which may enable them to obtain the information necessary to make their own estimates of fair value. Such direct access to management also makes it likely that those users can obtain other information to help them assess the amounts, timing, and uncertainty of future cash flows from the investments. In contrast, investors in public entities are much less likely to have direct access to management.

BC226. The Board understands the rationale discussed in paragraphs BC223–BC225 for limiting a practicability exception for equity investments without readily determinable fair values to nonpublic entities. But the Board also notes that the principal reasons for providing such an exception are the relative lack of objective

evidence to support the judgments needed to estimate the fair value of such investments and the resulting potential decrease in the reliability and comparability of those estimates. Those reasons are not limited to investments held by nonpublic entities. Accordingly, the Board decided to make the practicability exception available to both public entities and nonpublic entities.

How should an investor determine impairment of equity investments without readily determinable fair values?

BC227. The Board considered the following two alternative methods for assessing whether an equity investment without a readily determinable fair value is impaired:

- a. A one-step method in which the investing entity considers impairment indicators to determine if it is more likely than not that the fair value of the investment is less than its carrying amount. If so, an entity would recognize an impairment loss equal to the difference between fair value and carrying amount. That is, the entity would not also assess whether the impairment is other than temporary.
- b. A two-step method in which an entity first makes the same assessment of impairment indicators as in (a) above, but the entity would not recognize an impairment loss unless it determines that the impairment is other than temporary, based on the following two key assessments:
 1. Whether an equity investment will recover in value and, if so, when
 2. Whether the entity has the positive intent and ability to hold the equity investment until the anticipated recovery occurs.

BC228. The Board decided that an entity should use the one-step method to determine the need to recognize an impairment. That method would simplify the guidance in effect when the guidance in this proposed Update is issued and, thus, reduce the burden on preparers of financial statements and their auditors and other advisors. It also would eliminate the need to account for two particularly subjective factors. Eliminating that need has the potential to improve the representational faithfulness of the resulting financial statements.

Loan Commitments, Commercial Letters of Credit, and Revolving Lines of Credit

BC229. The scope of this proposed Update, like that of the 2010 proposed Update, includes commitments to originate and purchase loans. Topic 815 requires only loan commitments issued to originate mortgage loans that will be held for sale to be accounted for as derivatives and, thus, measured at fair value. The Board understands that measuring all loan commitments at fair value would be a significant change in practice for many financial institutions.

BC230. In developing the 2010 proposed Update, the Board discussed whether to require an entity that issues loan commitments to recognize changes in its fair values in net income or whether qualifying changes in fair value should be recognized in other comprehensive income if the related funded loan would meet the criteria for that accounting. The Board considered the similarities between loan commitments and written options and whether it would be appropriate to account for both as derivatives under Topic 815. The Board decided that evaluating whether various types of loan commitments meet the definition of *derivative* under Topic 815 not only would create complexity but that it also might result in different outcomes for different types of loan commitments. Therefore, the Board decided not to rely on a broader application of the definition of *derivative* to determine the method of accounting for loan commitments.

BC231. The Board considers a loan commitment to be integral to the lending process that results in the related funded loan. Accordingly, the 2010 proposed Update would have required that a loan commitment be classified on the basis of the business strategy for the underlying loan that would be funded through exercise of the commitment. A commercial letter of credit would have been accounted for in the same way as a loan commitment because a commercial letter of credit and a loan commitment have similar characteristics—both embody an obligation to fund a loan if specified criteria are met. (The remainder of this discussion uses the term *loan commitment* to include commercial letters of credit and revolving lines of credit that meet the definition of *loan commitment* in this proposed Update.)

BC232. The 2010 proposed Update also would have required fees received for a commitment to originate a loan or establish a line of credit to be recognized in net income in a manner generally consistent with the guidance in Subtopic 310-20.

Feedback from stakeholders

BC233. Few respondents to the 2010 proposed Update provided specific feedback on the loan commitment aspects of that proposed Update. Of the few who did, views were mixed. For example, some users of financial reporting information favored measuring all loan commitments at fair value with all changes in fair value recognized in net income on the grounds that a loan commitment is, in substance, a derivative. Other stakeholders, generally those who opposed the overall measurement model in the 2010 proposed Update because of its emphasis on fair value, also opposed extending the measurement of loan commitments and similar instruments at fair value beyond those already measured at fair value under current U.S. GAAP. Those stakeholders generally cited both the integral nature of a loan commitment to the related funded loan and the difficulty of estimating the fair value of loan commitments and commercial letters of credit to support their view. They supported basing the

classification of the commitment on the classification of the related loan when drawn.

The Board's conclusions on loan commitments

BC234. The Board decided that the guidance in this proposed Update should require the issuer of a loan commitment (or a commercial letter of credit or revolving line of credit that meets the definition of a loan commitment) to classify the loan commitment on the basis of the likelihood of its exercise and in accordance with the classification of the related drawn loan; that is, if the loan was drawn, how that loan would have been classified under the guidance in this proposed Update by applying the contractual cash flow characteristics and the business model test to it. The Board considers that accounting to be consistent both with the nature of a loan commitment as an integral part of the process that leads to a loan. Eliminating the reliance on applying Topic 815 to determine if a loan commitment should be accounted for as a derivative and, thus, included in the fair value through net income category also should simplify the accounting for loan commitments.

BC235. The guidance in this proposed Update would require fees received upon issuance of a loan commitment to be accounted for in accordance with Subtopic 310-20. The Board decided that applying that guidance would be consistent with the rationale for the related classification and measurement requirements, namely, that the commitment is an integral part of the lending process rather than a separate service provided to the customer.

Potential scope exceptions

BC236. For practical reasons, the 2010 proposed Update would have provided a scope exception for lines of credit under credit card arrangements. At that time, the Board noted the generally small balances of the associated credit card receivables, the revolving nature of those lines of credit, and the high volume of both the lines of credit and the related receivables that could make the cost of determining their fair value exceed the related benefit. In light of the classification and measurement model in this proposed Update, which would not require all loan commitments to be measured at fair value, that exception is no longer needed. Moreover, as some stakeholders noted in commenting on the 2010 proposed Update, revolving lines of credit under credit card arrangements generally are not legally binding because they are cancellable. Thus, those revolving lines of credit do not meet the definition of *loan commitment* and, even without a scope exception, would not be subject to the guidance in paragraphs 825-10-35-20 through 35-21.

BC237. The Board considered specific implementation challenges that could be encountered by potential borrowers under loan commitments. Conceptually, the

Board believes that the accounting for loan commitments by potential borrowers and potential lenders should be symmetrical. However, the Board understands that it may be impracticable for many borrowers to measure purchased loan commitments at fair value. Therefore, the guidance in this proposed Update would provide a scope exception for holders of loan commitments (potential borrowers).

Deferred Tax Assets

BC238. The guidance in this proposed Update would require an entity to evaluate the need for a valuation allowance for a deferred tax asset related to the change in fair value (unrealized losses) of debt instruments recognized in other comprehensive income separately from the entity's other deferred tax assets. For ease of discussion, that method of evaluating the need for a valuation allowance is referred to as Alternative A.

BC239. The Board decided the opposite in the 2010 proposed Update. That is, the need for a valuation allowance on a deferred tax asset related to the change in the fair values of debt instruments recognized in other comprehensive income would have been determined in combination with an entity's other deferred tax assets (Alternative B). The Board understands that both Alternative A and Alternative B are applied in practice.

Feedback on the 2010 Proposed Update

BC240. The majority of respondents to the 2010 proposed Update commenting on this issue focused on whether an entity has the intent and ability to hold an investment in a debt instrument until recovery of its amortized cost basis. If so, the recovery of the unrealized losses in other comprehensive income and the corresponding reversals of the deferred tax asset can be viewed as the realization of its tax benefit.

BC241. Some respondents to the 2010 proposed Update also supported Alternative B. In providing rationale for its support of Alternative B in the 2010 proposed Update, the Board also said that Alternative B would be consistent with the requirement in Topic 740, Income Taxes, that the ultimate income tax calculation is based on the entity's entire tax position.

Revised Guidance on Deferred Tax Assets

BC242. The guidance in this proposed Update would require an entity to evaluate the need for a valuation allowance for a deferred tax asset related to unrealized losses on debt instruments recognized in other comprehensive income separately from other deferred tax assets, which may result in providing no valuation allowance. The Board decided that a valuation allowance may not be necessary because a deferred tax asset related to such unrealized losses results from the interaction of Topic 740 and Topic 320 and, therefore, is unique. The proposed accounting acknowledges that this issue is a special case

stemming from the interaction of accounting requirements and that the unrealized losses on debt instruments recognized in other comprehensive income are unrelated to other items that give rise to deferred tax assets. Therefore, the need for a valuation allowance should be evaluated separately.

Presentation

BC243. In developing the 2010 proposed Update, the Board decided that it is important for users of financial statements to be able to distinguish between reported amounts for financial instruments on the basis of how they are measured, that is, their measurement category.

BC244. The Board continues to believe that distinguishing financial assets and financial liabilities according to how they are measured will help users to understand an entity's financial position and reported performance for the period. That information has predictive value because it also helps users to develop their own assessments of future cash flows. Therefore, the amendments in this proposed Update, like in the 2010 proposed Update, would require separate presentation of financial assets and financial liabilities depending on their measurement category. Stakeholders commenting on the 2010 proposed Update generally agreed with that requirement.

BC245. The Board also believes that the proposed presentation requirements would address differing needs of different financial statement users and would provide financial statement users with enough information to enable them to include or exclude particular amounts in analyzing financial statements.

Presentation in the Statement of Financial Position

BC246. Once the decision is made to distinguish between financial instruments on the face of the statement of financial position on the basis of their measurement category, the major remaining issue is whether to present on the face of that financial statement an alternative measurement attribute for financial instruments—amortized cost for those measured at fair value and fair value for those measured at amortized cost.

Fair value of financial instruments measured at *amortized cost*

Fair value disclosures in current U.S. GAAP

BC247. Topic 825 currently requires an entity to disclose the fair value of financial instruments either on the face of the statement of financial position or in the notes if it is practicable to estimate that value. Topic 825 specifies that *practicable* means that an estimate of fair value can be made without incurring excessive costs. The Board understands that few entities apply the practicability

exception because they are unable to provide sufficient documentation to justify that it is impracticable to estimate fair value, although some nonpublic entities use that exception for highly illiquid financial instruments and investments in related parties due to the lack of observable market information.

BC248. The Board also understands that entities use different methods to estimate the fair values of loans for disclosure purposes. Some use an entry price calculation to estimate the fair value of their loan portfolio, while others estimate the fair value of their loans using the exit price guidance in Topic 820.

Fair value disclosures in the 2010 proposed Update

BC249. Whether to require presentation of fair value on the face of the statement of financial position was not a significant issue in the 2010 proposed Update because it would have required most financial instruments to be measured at fair value; measurement at amortized cost would have been permitted only in limited circumstances. For example, an entity could have elected to measure financial liabilities that qualified for the fair value through other comprehensive income category at amortized cost if fair value measurement would have exacerbated a measurement attribute mismatch of recognized assets and liabilities. For financial liabilities that an entity elected to measure at amortized cost, the amendments in the proposed Update would have required fair value to be disclosed in the notes to financial statements.

BC250. The guidance in this proposed Update would add an amortized cost category to the two fair value categories in the 2010 proposed Update. Consequently, this proposed Update would significantly expand the number and type of financial instruments that would qualify for measurement at amortized cost. Thus, the Board considered whether to require entities to present the fair value of some or all financial instruments measured at amortized cost on the face of the statement of financial position. The discussion in paragraphs BC257–BC261 pertains to public entities only; presentation of fair value information by nonpublic entities is discussed in paragraphs BC265–BC272.

Feedback Received from Users

BC251. The majority of users of financial information who provided feedback on the 2010 proposed Update favored amortized cost as the primary measurement attribute for financial assets and financial liabilities that an entity holds for collection or payment of cash flows and for which no readily observable markets exist. Some users, however, supported fair value as the primary measurement attribute for those financial instruments.

BC252. Regardless of their views on the primary measurement attribute, many users said that information about fair value is useful and should be provided in the financial statements even if the primary measurement attribute is amortized

cost. Most users who supported disclosure of supplemental fair value information for financial instruments measured at amortized cost prefer that fair value be presented in the notes to financial statements. Many of those users said that presenting fair value on the face of the statement of financial position might be confusing; they noted that fair value is not consistent with an entity's business strategy for financial instruments held for collection or payment of cash flows.

BC253. Other users who provided feedback on the 2010 proposed Update preferred disclosure of fair value on the face of the statement of financial position, in part because they thought that requiring presentation of fair value on the face of the financial statement would increase preparer rigor in determining fair value as well as the auditor's attention to it.

BC254. Most investors and others who use the fair values disclosed today do so to better understand differences in the market's assessment of credit and also to better understand realizable value if liquidity is an issue or if they expect that liquidity may become an issue in the near future. They also compare reported fair value amounts to reported amortized cost amounts across entities in an industry. However, users said that the usefulness of the fair values disclosed today is impaired by the different methods of determining the fair values of loans. As discussed in paragraphs BC262–BC264, some entities report an entry price as consistent with FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, now included in Subtopic 825-10, as a means of estimating fair values of some instruments for which a market price is not available, while others report an exit price as required by Topic 820. Users also said that the fair value amounts are not sufficiently disaggregated by class of instrument. Users think that consistent measurement and greater disaggregation would significantly improve the usefulness of the fair value information and thereby improve the decision usefulness of the financial statements. The Board's decisions on fair value disclosures reached after considering the feedback from users and others are discussed in paragraphs BC257–BC272.

Feedback Received from Other Stakeholders

BC255. Most stakeholders other than users supported a mixed-attribute model; they did not consider fair value and amortized cost to be equally relevant. Those stakeholders supported displaying only the primary measurement attribute on the face of the statement of financial position. They generally said that presentation of another measurement attribute on the face of that financial statement would be confusing and misleading for users of financial statements and could lead to questions about which measurement attribute is most appropriate.

BC256. Stakeholders other than users generally acknowledged that users request fair value information for financial instruments held for collection or payment of contractual cash flows. Most of those stakeholders said that if fair value information is to be provided, it should be presented in the notes to the

financial statements. Some suggested that fair value information disclosed in the notes should be disaggregated by class of financial instrument.

Why public entities should present the fair value of financial instruments measured at amortized cost on the face of the statement of financial position

BC257. The Board decided that a public entity should present the fair values of financial instruments measured at amortized cost on the face of the statement of financial position. (Exceptions for nonpublic entities and for core deposit liabilities are discussed in paragraphs BC265–BC272 and BC273, respectively.) In reaching that decision, the Board weighed the need for both increased prominence of the fair value information and additional rigor in its development against some stakeholders' views that presentation of an alternate measure of financial instruments on the face of the statement of financial position might confuse users.

BC258. The Board understands some users' concerns that fair value information presented in the notes may not be prepared with the same rigor as information presented with more prominence. Regardless of the extent to which those concerns are valid, increasing the prominence of the fair value information seems to be a valid way of attempting to increase the care with which it is developed, particularly if that also helps to achieve other goals. For example, presenting the fair values of financial instruments on the face of the statement of financial position would make it easier for a user to find and use, facilitating a user's comparison of the fair values of financial instruments with other information about those instruments, including their amortized cost.

BC259. The Board believes that concerns about any potential confusion on an alternate measure of financial instruments being included on the face of the statement of financial position can be dealt with by straightforward presentations that clearly label all information presented.

BC260. Some stakeholders who supported presenting the fair value of financial assets measured at amortized cost on the statement of financial position did not hold the same view for financial liabilities. They noted that an entity ordinarily cannot realize changes in the fair values of its financial liabilities that are measured at amortized cost because those liabilities generally are settled at par.

BC261. The Board decided that fair value information is important even for liabilities that will be settled at par because fair value provides information that is helpful in evaluating the overall risk and leverage position of the entity. Net interest rate risk and net credit risk exposure cannot be fully portrayed without fair value information for both assets and liabilities, regardless of whether the liabilities can be effectively settled in the market at fair value. More broadly, assets and liabilities are always interrelated; an entity's assets often depend on

corresponding liability funding, without which the assets would not be available to the entity. Accordingly, users of financial statements need consistent information for both assets and liabilities.

Emphasis on exit values and no practicability exception

BC262. As mentioned in paragraph BC254, some entities disclose entry values whereas others measure fair value in accordance with the exit price notion in Topic 820 because the existing disclosure requirements in Subtopic 825-10 continue to permit use of an entry price notion. The Board emphasizes the focus on exit values for the fair value amounts to be presented on the face of the statement of financial position.

BC263. Also, unlike the existing fair value disclosure requirements, the guidance in this proposed Update would not provide an overriding practicability exception on the basis of presumed excessive costs of developing fair value information. At the time that Statement 107 was issued, no fair value measurement framework like the one in Topic 820 existed. The new parenthetical disclosures would follow the fair value measurement guidance in Topic 820.

BC264. Although the proposed guidance would establish no overriding practicability exception, it excludes receivables and payables due in less than a year from the requirement to disclose fair value parenthetically on the face of the statement of financial position. Because the amortized cost of an asset or a liability due in so short a time should approximate fair value, the Board decided that requiring presentation of their fair value would rarely provide information of sufficient benefit to justify the cost of developing it.

Exemption for nonpublic entities

BC265. The existing fair value disclosure requirements in paragraph 825-10-50-3 apply to a nonpublic entity unless the entity qualifies for the exemption provided for a nonpublic entity that meets both of the following criteria:

- a. The entity's total assets are less than \$100 million on the date of the financial statements.
- b. The entity has no instrument that, in whole or in part, is accounted for as a derivative instrument under Topic 815, other than commitments to originate mortgage loans to be held for sale during the reporting period.

BC266. Most of the users of nonpublic entity financial statements who provided feedback on whether a nonpublic entity should be required to disclose the fair values of financial instruments measured at amortized cost, including regulators of financial institutions, said that they do not use that fair value information in their primary analysis of an entity. However, some users of nonpublic entity

financial statements indicated that they compare the fair values to amortized cost and analyze the differences.

BC267. The majority of preparers and auditors of nonpublic entity financial statements said that presentation of the fair values of financial instruments is not cost beneficial because of the usual lack of observable market data. Determining fair value may require the use of extensive modeling with unobservable inputs, which may be costly to obtain and may result in overly subjective and unreliable valuations. Preparation of fair value estimates often requires a significant amount of management judgment and knowledge, which may create particular difficulties for entities with relatively few employees.

BC268. The Board considered the following alternatives for requiring a nonpublic entity to present on the face of the statement of financial position the fair values of financial instruments measured at amortized cost:

- a. Provide no exemption for nonpublic entities
- b. Exempt all nonpublic entities
- c. Exempt nonpublic entities with less than \$100 million in total consolidated assets at the beginning of the fiscal year
- d. Exempt nonpublic entities that are not financial institutions.

BC269. The Board rejected the first alternative—to provide no exemption for nonpublic entities. It decided instead to exempt all nonpublic entities (the second alternative). Some Board members noted that the fair values of financial instruments always are relevant even if fair value is not the primary measurement attribute. But the Board also considers the cost-benefit concerns pertaining to nonpublic entities summarized in paragraphs BC266 and BC267 to be significant.

BC270. The Board also took into account information obtained during development of its Invitation to Comment, *Private Company Decision-Making Framework—A Framework for Evaluating Financial Accounting and Reporting Guidance for Private Companies*, which was issued for comment on July 31, 2012. That Invitation to Comment discusses how and why the needs of users of private company financial statements differ from the needs of users of public company financial statements and how the cost-benefit considerations of financial reporting vary between private and public companies. The Board understands that relatively few users of financial statements of a nonpublic entity consider fair value information to be significant in their analyses. Users of financial statements of nonpublic entities usually have more access to the entity's management than users of public entities' financial statements. Accordingly, users who want information about the fair values of a nonpublic entity's financial instruments likely can ask management for it (or for information needed to develop their own estimates of fair value).

BC271. The Board also rejected providing an exemption only for smaller nonpublic entities. Any size limit would, of necessity, be arbitrary. The one suggested in alternative (c) in paragraph BC268 has the benefit of being

consistent with the size limit that entities and users of their financial statements are accustomed to, but other than familiarity, no objective evidence supports that particular size limitation.

BC272. A better case might be made for exempting only nonpublic entities that are not financial institutions (alternative (d) in paragraph BC268) than for a size-based exemption. Financial instruments generally are more significant to the business model of a financial institution than to business models of entities in other industries. However, feedback received from regulators of financial institutions indicated that they do not use information about the fair values of financial instruments and do not expect to do so in the future. The Board decided that, on balance, exempting all nonpublic entities would be preferable to drawing a line based on industry.

Exemption for demand deposit liabilities

BC273. The Board decided to exempt demand deposit liabilities from the requirement to present parenthetical information about the fair values of financial liabilities. The Board thinks that the difficulties of determining the fair value of those deposits support not requiring parenthetical disclosure of fair value. The note disclosure requirements for demand deposits are discussed in paragraphs BC308–BC313.

Amortized Cost of Financial Instruments Measured at Fair Value

BC274. In developing the 2010 proposed Update, the Board considered whether the fair value of the relatively few instruments that would have been measured at amortized cost (generally limited to short-term receivables and payables and an entity's own debt that met specified criteria) should be presented either on the face of the statement of financial position or in the notes.

BC275. The guidance in that proposed Update reflected the Board's decision that, with the exception of an entity's own debt, presentation of the amortized cost of financial instruments in the fair value through net income category should not be required, either on the statement of financial position or in the notes. Almost all stakeholders agreed that amortized cost is not a significant factor in the evaluation of instruments that an entity typically holds for capital appreciation or trading purposes. Accordingly, the presentation requirements of this proposed Update for instruments in the fair value through net income category are the same as those in the 2010 proposed Update.

BC276. The guidance in the 2010 proposed Update would have required an entity to present the amortized cost of financial instruments in the fair value through other comprehensive income category on the face of the statement of

financial position. The Board had decided that both fair value and amortized cost information are relevant for debt instruments that an entity holds for collection or payment of contractual cash flows, which would have been included in the fair value through other comprehensive category under that proposed Update. However, the guidance in this proposed Update would require debt instruments that are held-to-collect contractual cash flows to be measured at amortized cost. In light of the guidance in proposed Accounting Standards Update, *Financial Instruments—Credit Losses (Subtopic 825-15)*, issued in December 2012 (see paragraph BC279), the guidance in this proposed Update would not require presentation of the amortized cost of financial assets in the fair value through other comprehensive income category.

Financial Instruments Measured at Fair Value through Other Comprehensive Income

BC277. The guidance in the 2010 proposed Update would have retained the separate presentation of the allowance for loan losses on the face of the statement of financial position. The Board believed that the difference between amortized cost and fair value resulting from estimated credit losses would provide useful information for assessing the amounts, timing, and uncertainty of cash flows. The Board also had decided that a reconciliation from amortized cost to fair value, with credit losses presented in a separate line, would be the best format for that information.

BC278. The Board received mixed views from those who provided feedback on the proposal about presentation of cumulative credit losses on the face of the statement of financial position. Most users of financial information agreed that the proposed presentation would be useful. But most respondents other than users disagreed with the proposed reconciliation of fair value to amortized cost of instruments in the fair value through other comprehensive income category because they thought that it would overcomplicate the statement of financial position.

BC279. The guidance in the proposed Update on credit losses would require the allowance for credit losses to be presented on the face of the statement of financial position, with a reconciliation from amortized cost to fair value presented in the notes.

How should accumulated other comprehensive income be presented?

BC280. The amendments in the 2010 proposed Update would have required an entity to separately present on the face of the statement of financial position the amount of changes in fair value included in accumulated other comprehensive income. Stakeholders provided only limited feedback on the proposed presentation of the equity section of the statement of financial position. Most who

did comment on that issue disagreed with separate presentation of cumulative changes in fair value, generally because they did not consider it appropriate to separately present only one of the components of accumulated other comprehensive income.

BC281. The Board decided that U.S. GAAP provides sufficient disclosures about components of accumulated other comprehensive income and that it is unnecessary to separately present the amount of changes in fair value included in it. In particular, paragraph 220-10-45-14A requires an entity to present, on the face of the financial statements or as a separate disclosure in the notes, changes in the accumulated balances for each component of other comprehensive income. The Board recently considered various aspects of reporting comprehensive income and developed the guidance in Update No. 2011-05, *Comprehensive Income (Topic 220): Presentation of Comprehensive Income*, which was issued in June 2011.

Presentation in the Statement of Comprehensive Income

Instruments in Either the Fair Value through Net Income or the Fair Value through Other Comprehensive Income Category

BC282. The guidance in this proposed Update carries forward without change the proposed requirements in the 2010 proposed Update for presentation in the statement of comprehensive income of information about financial instruments classified in either the fair value through net income category or the fair value through other comprehensive income category. For instruments in the first category, the 2010 proposals would have required separate presentation of an aggregate amount for realized and unrealized gains or losses on the face of the income statement. Almost all of the stakeholders agreed with that proposal.

BC283. Almost all of the stakeholders also agreed with the 2010 proposed requirement for separate presentation in the income statement of the following amounts for financial instruments classified in the fair value through other comprehensive income category:

- a. Current period interest income and expense, including amortization (accretion) of premium (discount) recognized upon acquisition
- b. Credit impairment of financial assets for the current period
- c. Realized gains or losses.

The Board decided to include that presentation requirement in this proposed Update.

Instruments in the Amortized Cost Category

BC284. The guidance in this proposed Update would require separate presentation on the face of the income statement of the following items for instruments measured at amortized cost:

- a. Current period interest income and expense, including amortization (accretion) of premium (discount) recognized upon acquisition
- b. Credit losses on financial assets for the current period
- c. Realized gains or losses.

That presentation is consistent with current U.S. GAAP, which users have said provides helpful information for assessing the amounts, timing, and uncertainty of future cash flows.

Effect of Changes in Instrument-Specific Credit Risk on the Fair Value of Its Liabilities

BC285. A significant concern that stakeholders raised about measuring financial liabilities at fair value relates to changes in fair value that are attributable to changes in instrument-specific credit risk. If those changes are reflected in the fair value of a financial liability, an entity reports a gain from a decrease in instrument-specific credit risk and a loss for an increase in instrument-specific credit risk. Many stakeholders consider recognizing a gain due to a decrease in credit standing to be potentially misleading and, thus, inappropriate because an entity often lacks the ability to realize such gains.

BC286. The amendments in the 2010 proposed Update would have required an entity to separately present on the face of the statement of comprehensive income significant changes in the fair value of financial liabilities that are attributable to changes in instrument-specific credit risk, excluding changes in the price of credit. That proposed requirement reflected the Board's view that the change in fair value attributable to the change in an entity's credit spread does not accurately reflect the change in an entity's own credit standing. The change in an entity's credit spread also measures the change in the price of credit, which affects not just the reporting entity, but also other entities in the industry and the economy. The Board understands that, in practice, changes in instrument-specific credit risk are generally determined on the basis of changes in a reporting entity's own credit spreads or credit default swap spreads but that the method may vary depending on the nature of the liability. The 2010 proposed Update did not provide guidance for determining the amount to be separately presented, but an appendix illustrated two possible methods.

Feedback received

BC287. The feedback from preparers and auditors who addressed the application of the 2010 proposal was nearly uniform in suggesting that all changes in the fair value of derivative liabilities, as well as liabilities that are traded, should be recognized in net income.

BC288. Preparers and auditors overwhelmingly opposed the proposal to separate the total change in the fair value of a liability attributable to changes in instrument-specific credit risk into two components: changes attributable to the entity's own nonperformance risk and changes due to other credit risks, such as changes in the price of credit. Although many preparers and auditors agreed with separately presenting the change in the fair value of a liability that is attributable to changes in the entity's credit standing, they said that bifurcating that change into components would be costly, complex, and arbitrary.

BC289. Most users of financial information who commented on the issue supported separate presentation of changes in fair value attributable to changes in an entity's credit standing, but most did not indicate that separating that amount further into changes in nonperformance risk and other credit market risks such as changes in the price of credit would be particularly important.

Guidance on measuring and presenting the change in fair value attributable to instrument-specific credit risk

BC290. The guidance in this proposed Update would require most financial liabilities to be measured at amortized cost requiring only liabilities expected to be settled at fair value, including obligations from short sales, to be measured at fair value with all changes in fair value recognized in net income. The guidance in this proposed Update also provides a limited fair value option, and electing it would result in measuring some liabilities at fair value and recognizing changes in fair value in net income.

BC291. Noting stakeholders' concerns, the Board decided to require that changes in instrument-specific credit risk for financial liabilities for which a fair value option has been elected should be separately presented in other comprehensive income. The Board observed that because those liabilities are typically settled with the creditor rather than through a transfer or settlement with a third party at fair value, changes in their fair value as a result of changes in the instrument-specific credit risk usually are not realized. In addition, the Board noted that the gain or loss recognized in accumulated comprehensive income would be reclassified to earnings upon the settlement of the liability. In light of the feedback from stakeholders and the computational difficulties, the Board also decided to require that the entire risk in excess of the base market risk (for example, a risk-free interest rate) should be considered as the instrument-specific credit risk, but an entity would be able to use an alternative method that it

deems to result in a more faithful measurement of the fair value change attributable to changes in instrument-specific credit risk. Those presentation requirements are similar to those in IFRS 9, although certain differences exist. For example, under IFRS 9 an entity is prohibited from reclassifying changes in fair value attributable to instrument-specific credit risk recognized in other comprehensive income from being reclassified to net income upon the settlement of the liability. Furthermore, IFRS 9 requires changes in instrument-specific credit risk to be presented in net income if recognizing those changes in other comprehensive income exacerbates an accounting mismatch.

Transaction Gains and Losses on Instruments Denominated in a Foreign Currency

BC292. The total change in the fair value of a foreign-currency-denominated financial instrument may be made up of the following two components:

- a. A change in the price of the instrument in the currency in which it is denominated
- b. A change in the exchange rate between the currency of denomination and the functional currency, which the guidance on foreign currency matters in Topic 830 refers to as a transaction gain or loss.

In addition, if the functional currency and the reporting currency differ, changes in the exchange rate between the two currencies would result in a translation adjustment, which is reported in other comprehensive income. This discussion focuses only on transaction gains and losses.

BC293. Topic 830 requires transaction gains and losses on foreign-currency-denominated assets and liabilities to be recognized in net income. However, paragraph 320-10-35-36 requires that the entire change in the fair value of a foreign-currency-denominated available-for-sale debt security be reported in other comprehensive income. That is, the portion of the fair value change attributable to a transaction gain or transaction loss is not recognized separately in net income. The guidance in the 2010 proposed Update would have applied the same reporting requirement.

Feedback received on the 2010 proposed Update

BC294. Auditors and preparers supported including such transaction gains or losses in net income rather than in other comprehensive income. They noted that including the gain or loss in other comprehensive income is inconsistent with the requirements of Topic 830 for other transaction gains or losses. Auditors and preparers also pointed out that changes in foreign currency exchange rates would result in realized gains and losses if the entity holds the debt instrument on which they arise to contractual maturity, while other unrealized gains and losses excluded from net income usually would reverse if the debt instrument is held to contractual maturity. Therefore, those stakeholders supported recognizing

transaction gains or losses on foreign-currency-denominated debt securities in net income in the reporting period in which the gain or loss occurs.

BC295. Users of financial statements also generally supported including in net income transaction gains and losses on foreign-currency-denominated debt instruments for which qualifying changes in fair value are recognized in other comprehensive income. Like preparers and auditors, users noted that holding a debt instrument to collect its contractual cash flows does not mean that the entity will not realize the effect of changes in foreign currency exchange rates.

Measuring transaction gains and losses and including them in net income

BC296. The Board generally agreed with the reasons given by stakeholders (summarized in paragraphs BC294–BC295) for supporting recognition in net income of transaction gains or losses on debt securities in the fair value through other comprehensive income category. The Board also noted that recognizing those gains or losses in net income converges with the IASB’s requirements.

BC297. The Board considered several methods in deciding what guidance to give on how to separate the transaction gain or loss from other components of the change in fair value of a debt security denominated in a foreign currency.

BC298. Investment companies follow specialized guidance for reporting foreign currency gains and losses on debt instruments. For investment companies that elect to separately report transaction gains and losses on foreign currency denominated debt investments measured at fair value with changes in fair value included in their performance statement, Subtopic 946-830 on foreign currency matters specifies a simplified method that is based on the cost of an instrument for calculating the transaction gain or loss.

BC299. The Board saw no compelling reason to change the method used by investment companies that choose to separately present transaction gains and losses. Therefore, the Board decided to retain the method of determining transaction gains or losses required by Subtopic 946-830. But because that method is based on the cost rather than the fair value of the foreign-currency-denominated instrument, the Board decided not to extend it to other entities. The Board notes that separating a change in a fair value amount into components is a matter of allocation and, like other allocation issues such as the method used to depreciate an asset’s cost, there is no single right answer. Therefore, the Board decided to require an entity to use a fair-value-based method but to permit it to choose which method is appropriate for each currency, provided that the method is used consistently from period to period. For example, the Board understands that many entities use a simplified fair value method for fair value hedge accounting of an available-for-sale debt security; they may want to use that method for this purpose as well.

Disclosures

BC300. The Board sought to develop a set of disclosures to be made in the notes to an entity's financial statements that would provide information that would be useful in analyzing an entity's exposures to risks from financial instruments. The proposed disclosures would augment existing disclosures and were designed to address the changing needs of financial statement users on the basis of the proposed model of accounting for financial instruments.

BC301. In developing the disclosures included in the 2010 proposed Update, the Board considered input from users of financial statements as well as preexisting disclosure requirements. In reconsidering those disclosures, the Board also took into account stakeholders' input on them in response to the 2010 proposed Update. However, the accounting and financial reporting model for financial instruments in this proposed Update is so different from the one issued for comment in 2010 that most of the related disclosures are not pertinent to the revised model. Thus, the following discussion of the more significant of the individual disclosures includes little mention of responses to the 2010 proposals.

BC302. Many users of financial statements who responded to the 2010 proposed Update asked for more information about liquidity and interest rate risk of financial instruments, especially loans and deposits. Rather than considering such disclosures together with other issues in this proposed Update, the Board undertook a separate project on liquidity and interest rate disclosures.

How Fair Values of Instruments Measured at Amortized Cost Were Determined

BC303. The Board considered whether public entities' parenthetical disclosures of fair value should be supplemented by the existing disclosures from Topic 825 about how fair values were determined or by the more extensive disclosures on that matter from Topic 820. Both Topics require disclosure of the method and significant assumptions used to estimate fair values, but Topic 820 also requires more information about, for example, valuation processes in place for all Level 3 measurements and descriptions of the sensitivity of the measures to changes in unobservable inputs to the calculations. The Board decided that not all of the more extensive disclosures from Topic 820 are necessary for items whose primary measurement basis is not fair value. Therefore, the guidance in this proposed Update would require only the disclosures enumerated in paragraph 825-10-50-34 about how the parenthetical disclosures of fair value were determined.

Existing Disclosures in Topic 320 for Held-to-Maturity and Available-for-Sale Securities

BC304. Because two of the measurement categories for financial assets in this proposed Update are similar (though not identical) to two categories currently in Subtopic 320-10, the Board considered using the existing disclosure requirements for held-to-maturity and available-for-sale securities as a starting point. The existing disclosure requirements in Topic 320 for held-to-maturity securities focus entirely on securities, and the classification and measurement model in this proposed Update does not distinguish on the basis of the form of the instrument. In addition, the fair values of most financial assets measured at amortized cost would be presented parenthetically on the face of the statement of financial position under the proposed model. Because of those changes in the information that will be made available, the Board decided not to continue all of the existing required disclosures for held-to-maturity securities. Although the Board decided that the required disclosure of contractual maturities of debt securities should not be continued as part of this project on financial instruments, that disclosure is being considered in the broader project on liquidity and interest rate disclosures.

BC305. The Board decided to continue certain of the existing disclosures for available-for-sale securities to apply to the fair value through other comprehensive income category. In particular, the Board decided to propose continuing the existing disclosures of total gains for financial assets with net gains in accumulated other comprehensive income and total losses for assets with net losses in accumulated other comprehensive income (see paragraph 825-10-50-36).

Sales of Financial Assets from the Held-to-Collect and Held-to-Collect-and-Sale Categories

BC306. An entity may sell financial assets from the held-to-collect category and the held-to-collect-and-sale category. (Paragraphs 825-10-55-31 and 55-32 provide implementation guidance on sales that would be consistent with the objective of the held-to-collect category, and paragraphs 825-10-55-36 and 55-37 provide related guidance for the held-to-collect-and-sale category.) Users of an entity's financial statements need information that helps them to evaluate the effects of such sales on the entity and its financial statements. In addition, the Board thinks that a user of the entity's financial statements needs information to help evaluate the reason for a sale from the held-to-collect category and its appropriateness in the context of the primary objective of that category. The proposed disclosures for sales from those two categories are those that the Board believes would provide information to make such evaluations.

Financial Assets That Have Been Reclassified

BC307. The guidance in this proposed Update would require an entity to reclassify financial assets if the business model in which the assets are held and managed changes and the change satisfies specified conditions. The Board decided that an entity that has reclassified financial assets from one business model to another during the reporting period should disclose sufficient information about the reclassification to enable users of the reporting entity's financial statements to evaluate the appropriateness of the reclassification and its effects on the entity.

Core Deposit Liabilities

BC308. As discussed in paragraph BC273, core deposit liabilities are exempt from the requirement to disclose fair value parenthetically on the face of the statement of financial position. The Board considered what information an entity should disclose about those liabilities.

BC309. The Board first considered requiring a public entity to disclose the present value of its core deposit liabilities, determined in accordance with guidance to be provided. But after considering the feedback received on the 2010 proposed Update (see paragraphs BC142–BC146) and in developing the potential disclosure, including what guidance to provide on determining the amount to be disclosed, the Board decided instead to require only disclosure of the information specified in paragraph 825-10-50-39, which would be part of the underlying data needed to determine a present value amount for core deposits.

BC310. The Board considered requiring disclosure of the key inputs needed to permit users to make their own estimates of the present value of core deposits. The Board observed that to permit users to determine their own present value amounts, disclosure of key inputs would need to be disaggregated by class of deposit, which could result in overly detailed, voluminous disclosures and perhaps also the disclosure of proprietary information. For example, a decay rate by type of deposit would be needed for a user to estimate a present value of core deposits. The Board thus decided to require public entities to disclose certain specified key inputs, disaggregated to the extent that management considers appropriate.

BC311. Because the present value of core deposits generally does not change much over relatively short periods of time, the guidance in this proposed Update would require disclosure of the key inputs to the present value of core deposits only on an annual basis. To gain additional input on that point as well as the other aspects of disclosure of the present value of core deposit liabilities, this proposed Update includes questions about this issue.

BC312. After deciding to require disclosure of certain key inputs, the Board considered whether to exempt nonpublic entities from the requirement to disclose key inputs needed to determine the present value of core deposits.

BC313. Some Board members observed that the Invitation to Comment on decision-making framework for nonpublic entities does not support exempting nonpublic entities from disclosure of information that is particularly pertinent to their industry. Those Board members noted that the disclosures in question are particularly pertinent to the financial services industry. The Board also noted, however, that an investor or other user of a nonpublic entity's financial statements usually can obtain information about the key inputs to an estimate of the present value of core deposits by asking management. The Board also was concerned about the relative cost to a smaller entity of developing such disclosures on a regular basis. Accordingly, the Board decided to exempt a nonpublic entity from the requirement to disclose the specified key inputs to the present value of core deposit liabilities.

Other Disclosures

BC314. The Board considered what additional information an entity should disclose to enable users of a reporting entity's financial statements to understand the reported information about financial assets and financial liabilities and the transactions and other events that change them and decided to require disclosures in the following areas:

- a. The entity's application of the exception from fair value measurement for equity investments without readily determinable fair values
- b. Qualitative and quantitative information about the entity's nonrecourse financial liabilities and the financial assets that will be used to settle them
- c. Information about the effects of the entity's own credit standing and changes in instrument-specific credit risk on the fair values of liabilities that the entity measures at fair value because it has selected the fair value option provided in Subtopic 825-30.

BC315. The Board thinks that users will benefit from the specific disclosures for each of those areas, which are detailed in paragraphs 825-10-50-40 through 50-42. For example, for (a) above, users of the financial statements need to understand the details of how the entity developed the specified alternative measure included in financial statements for equity investments without readily determinable fair values.

Fair Value Option

Currently Available Fair Value Option in U.S. GAAP

BC316. Subtopic 825-10 currently provides a broadly applicable fair value option that permits an entity to elect to measure many financial instruments at fair value with changes in fair value recognized in net income. The stated objective of that fair value option is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions.

BC317. Because the guidance in the 2010 proposed Update would have required most financial assets and financial liabilities to be measured at fair value, it would have eliminated the need for a fair value option for most, if not all, financial instruments within its scope. The guidance in this proposed Update, however, makes much less use of fair value measurement of financial instruments than the guidance in the 2010 proposed Update did; therefore, the Board considered whether to provide a limited fair value option for financial instruments. Accordingly a fair value option for some financial instruments is discussed within the scope of this proposed Update.

Providing Only a Fair Value Option Limited to Specified Conditions

BC318. The Board decided that an unconditional fair value option like that in the existing Subtopic 825-10 should no longer be provided for instruments within the scope of this proposed Update. An optional or alternative provision in U.S. GAAP has the potential to impair comparability and thus to make financial statements less decision useful. The Board also observed that users of financial statements generally prefer to avoid broad, unconditional, optional accounting practices.

BC319. Having decided not to provide an unconditional fair value option for either financial assets or financial liabilities, the Board focused on determining whether providing one or more conditional or targeted fair value options would enhance the usefulness of financial statements in specified situations.

Situations in Which a Fair Value Option Commonly Is Used

BC320. The Board understands that entities commonly elect the fair value option provided in current U.S. GAAP in the following situations:

- a. To minimize asymmetrical measurements for nonrecourse financial liabilities and the assets to be used to settle the liabilities
- b. To avoid having to bifurcate embedded derivatives
- c. To avoid having to apply complex hedge accounting guidance

- d. For investments in unconsolidated limited partnerships and private equity placements that otherwise would be accounted for by the equity method
- e. For liabilities used to fund trading activities or for more general asset-liability-measurement mismatches.

BC321. The amendments in this proposed Update would achieve symmetrical measurement of related financial assets and financial liabilities or would provide a way to achieve fair value measurement with changes in fair value recognized in net income for some of the items listed in the preceding paragraph, making a fair value option unnecessary in those situations.

BC322. However, applying the guidance in this proposed Update in other situations for which entities often use the fair value option in current U.S. GAAP would not result in classification of the related financial assets and liabilities in the fair value through net income category. In most of those situations, the following are reasons for electing the fair value option:

- a. To permit applying a consistent measurement attribute to financial assets and financial liabilities for which an entity manages the net exposure on a fair value basis without having to apply complex hedge accounting provisions
- b. To avoid having to bifurcate embedded derivatives.

BC323. The Board decided that providing a fair value option in those circumstances would result in more faithfully representing the entity's assets, liabilities, and the activities in which they are employed than the financial statements otherwise would provide while lowering implementation costs. Therefore, the Board decided to provide a fair value option for a group of financial assets and liabilities if both of the following conditions are met:

- a. The entity manages the net exposure for the financial assets and financial liabilities on a fair value basis.
- b. The entity provides information on that basis to its management.

BC324. An entity also would be able to elect at recognition to measure a hybrid financial liability at fair value through net income unless the embedded derivative is not considered substantive according to the conditions in paragraph 825-30-15-3. The Board decided that providing a fair value option in that situation would achieve an appropriate balance between avoiding the cost of bifurcating a hybrid financial liability and limiting the fair value option to situations in which an option is necessary to reduce implementation costs.

BC325. The guidance in this proposed Update also would provide a fair value option for financial assets that qualify for measurement at fair value through other comprehensive income. If a financial asset qualifies for measurement at fair value, the Board sees no compelling reason to preclude an entity from recognizing all changes in the asset's fair value in net income.

Effective Date and Transition

Effective Date

BC326. The guidance in the 2010 proposed Update would have given nonpublic entities with less than \$1 billion in consolidated total assets as of the beginning of their fiscal year an additional 4 years after the effective date for all other entities to implement the proposed guidance on measurement of specified loans, loan commitments, and core deposit liabilities. The delay was considered necessary because measuring the specified items at fair value (or the remeasurement amount for core deposits) would represent a significant and potentially difficult-to-implement change in practice for smaller nonpublic entities.

BC327. The amendments in this proposed Update would not require an entity to determine the fair value of the loans, loan commitments, and core deposit liabilities that were of particular concern in developing the effective date guidance in the 2010 proposed Update. Accordingly, the Board decided to include a question about whether nonpublic entities, at least smaller nonpublic entities, would need additional time to implement some or all of the provisions of this proposed Update rather than proposing guidance on delayed effective date provisions for some or all nonpublic entities.

Early Adoption

BC328. To avoid impairing the comparability of financial statements during the early adoption period, the Board generally prohibits early adoption of the guidance in broad, significant amendments to the Codification. For that reason, the Board decided to prohibit early adoption of the guidance in this proposed Update, with one exception.

BC329. The Board decided to permit early adoption of the presentation requirements in paragraphs 825-10-45-17 through 45-18 for the portion of the total change in the fair value of a liability that results from a change in instrument-specific credit risk. An entity could early adopt that presentation provision only for a hybrid financial liability that would qualify for and be measured at fair value with all changes in fair value recognized in net income under the fair value option in paragraphs 825-30-15-2 through 15-3 after the effective date of the related amendments. However, in making this decision the Board noted that the entity would be prohibited from early adopting the classification and measurement guidance in this proposed Update, and, thus, only the separate presentation requirement would be applicable to those hybrid financial liabilities that would qualify for the fair value option under the proposed requirements.

BC330. The Board understands that users often disregard unrealized gains and losses attributable to changes in an entity's credit standing for financial liabilities measured at fair value under the fair value option in current U.S. GAAP in analyzing the entity's financial performance. The Board notes that the effect on

comparability of permitting early adoption of presentation guidance is less significant than the effect of permitting early adoption of recognition or measurement guidance. Therefore, the Board decided to propose early adoption of the presentation guidance in paragraphs 825-10-45-17 through 45-18 and to include a question for respondents about it.

Transition

BC331. The Board decided to require that transition to the amended requirements be effected by a cumulative-effect adjustment to the statement of financial position as of the beginning of the first reporting period in which the guidance is effective. The Board rejected other methods, including methods requiring retrospective transition, although it acknowledged that retrospective transition methods provide the most useful information. However, the Board decided that retrospective application, even if limited to financial instruments held or outstanding at the effective date, would be impracticable to apply because it would require an entity to make significant estimates of amounts and assumptions about how financial assets and financial liabilities would have been classified in prior periods.

Benefits and Costs

BC332. The objective of financial reporting is to provide information that is useful to present and potential investors, creditors, donors, and other capital market participants in making rational investment, credit, and similar resource allocation decisions. However, cost is a pervasive constraint on the information that financial reporting can provide; the benefits of providing information that helps to achieve that objective should justify the related costs. Present and potential investors, creditors, donors, and other users of financial information benefit from improvements in financial reporting, while the costs to implement new guidance are borne primarily by the preparer and, by extension, the preparer's investors. The Board's assessment of the costs and benefits likely to result from issuing new guidance is unavoidably more qualitative than quantitative. Neither objective measurement of the costs to implement new guidance nor quantification of the value of improved information in financial statements is possible.

BC333. Throughout its deliberations that led to this proposed Update, the Board considered whether the expected improvement in the usefulness of the information—improvements in its relevance and the extent to which it faithfully represents what it purports to represent—justifies the costs that stakeholders are likely to incur to prepare and use that information. The Board believes that the proposed guidance would significantly improve financial reporting by establishing a consistent, comprehensive framework for measuring and presenting in financial statements information about an entity's financial assets and financial liabilities. The Board also decided that the expected improvement in financial reporting would be achieved at an acceptable cost. The reasons for the Board's decisions

on benefits and costs, including the expected effect on the complexity of financial reporting, are discussed in the following paragraphs.

Gathering Information about Benefits and Costs

BC334. As part of its due process that led to this proposed Update, the Board conducted extensive outreach activities with investors, creditors, regulators, and other users, as well as preparers and auditors, of financial statements to obtain information about specific deficiencies in the existing accounting guidance for financial instruments. Paragraphs BC5–BC20 outline the nature of the outreach activities conducted at each stage of the financial instruments project that were made to date.

BC335. The Board's outreach activities, for example, field visits with preparers of financial statements (paragraph BC18), also included varying amounts of discussion about the potential costs and feasibility of implementing the Board's proposals for improving the accounting for financial instruments.

Expected benefits of the proposed guidance

BC336. On the basis of the significant input received from users of financial statements, the Board believes that the proposed guidance would provide relevant, transparent, and comparable information that faithfully represents the effects of a reporting entity's involvement in financial instruments on its financial position and financial performance. As a result, the information provided about an entity's exposure to financial instruments would be more decision useful than the information provided under today's accounting guidance.

BC337. The Board believes that the most significant increases in decision usefulness would result from the following provisions:

- a. Align the measurement of financial assets with the way in which an entity expects to benefit from the cash flows embedded in them and the business model within which the entity manages a financial asset.
- b. Enhance comparability by applying the same measurement method to all debt instruments that an entity holds regardless of their legal form.
- c. Measure equity investments with readily determinable fair values at fair value through net income, thereby eliminating the recognition of changes in the fair value of an equity investment in other comprehensive income.

BC338. The proposed guidance also would provide other benefits. Regardless of the relative importance of the first three means of improving decision usefulness, the following aspects of the proposed guidance also would make significant contributions to improved decision usefulness:

- a. Enhance comparability by replacing for financial instruments within its scope the unconditional fair value option in current U.S. GAAP with a

- limited, conditional fair value option directed toward eliminating potential measurement attribute mismatches in specified situations.
- b. Recognize in other comprehensive income, rather than in net income, changes in the fair value of a liability for which the limited fair value option is elected that are attributable to changes in instrument-specific credit risk.
 - c. For a public entity, parenthetically present fair value on the face of the statement of financial position for financial assets and financial liabilities measured at amortized cost.
 - d. Reduce the explicit focus on an entity's intended means of disposing of a financial asset in favor of an increased focus on the business model within which the entity manages the asset.
 - e. Provide a practicability exception to measurement of equity investments without readily determinable fair values that recognizes in net income any observable price changes, both upward and downward, in the period in which the change occurs.
 - f. Simplify the impairment method for equity method investments and equity investments without a readily determinable fair value by eliminating the other-than-temporary impairment model in current U.S. GAAP, which also provides for more timely recognition of any impairment.
 - g. Improve period-to-period consistency by providing for a reclassification of a financial asset only when an entity changes the business model within which it manages the asset, which the Board expects will happen very infrequently. In addition, an entity would be required to explain the change in business model and its effects.
 - h. Provide a single unit of account for all financial assets by eliminating the bifurcation requirement for hybrid financial assets in current U.S. GAAP and, instead, account for such assets in their entirety.
 - i. Improve convergence of U.S. GAAP and IFRSs by reducing key differences in the accounting for financial instruments.

Expected costs of implementation, including effects on complexity

BC339. The Board expects that most of the direct costs of applying the proposed guidance are likely to be the costs of the systems changes incurred to implement the guidance (at the effective date of a final Accounting Standards Update). Many entities also will incur initial costs to educate employees about how to comply with the new requirements, as well as explain the effects of the changes in accounting for financial instruments on the entity's financial statements to analysts who follow the company and other users of its financial statements. Once those systems changes are made and the related education and explanation has been accomplished, the Board believes that for most entities the ongoing costs of providing the information that the proposed guidance would require are unlikely to be significantly higher than the costs of complying with current U.S. GAAP. For some, including nonpublic entities, the ongoing costs are

likely to be less than the cost of complying with current requirements, mainly because a nonpublic entity no longer would have to disclose the fair value of its financial instruments measured at amortized cost.

BC340. The Board recognizes that the initial costs of preparing to comply with the guidance in this proposed Update are likely to be significant for many entities, especially financial institutions and other entities that make loans to their customers. For some entities, depending on their individual situations and the way in which they manage and use financial instruments, the ongoing costs may be somewhat higher than complying with current U.S. GAAP.

Expected Effects on Complexity of Financial Reporting about Financial Instruments

BC341. Financial reporting complexity also contributes to the cost to prepare, audit, and use financial reporting information. Throughout its deliberations the Board considered the potential effects on complexity in financial reporting about financial instruments. In addition, after reaching tentative decisions on all of those issues, the Board and its staff conducted an analysis of the cumulative effect of the resulting proposed guidance on the complexity of financial reporting about financial instruments. The Board discussed that analysis in a public Board meeting before issuing this proposed Update.

BC342. The Board's view of how the guidance in this proposed Update would affect the complexity of financial reporting is discussed in the following paragraphs in the context of the specific features of accounting guidance that often result in complexity.

Different accounting for economically similar transactions or events

BC343. The guidance in this proposed Update would continue the use of a mixed-attribute measurement model for financial assets. The main reason for the continuance of a mixed-attribute measurement model is the Board's agreement with users and other stakeholders who noted in their feedback on the 2010 proposed Update that amortized cost would provide more relevant information about some financial instruments, while fair value would provide more relevant information about others. The mixed-attribute measurement model is appropriate because how an entity manages financial instruments would affect the entity's future cash flows and, thus, the measurement should be linked accordingly. Moreover, under the proposed guidance, the measurement of a financial asset no longer would depend on its legal form, which not only would improve the relevance but also would reduce complexity compared with the existing guidance.

BC344. In addition to proposing a mixed-attribute measurement model for both financial assets and financial liabilities, the measurement model for financial assets is not the same as the one for financial liabilities. As a result, the accounting for issuers and holders of the same financial instrument would not be

symmetrical. In addition, hybrid financial assets and hybrid financial liabilities would be subject to different bifurcation requirements, with bifurcation and separate accounting not permitted for hybrid financial assets, while hybrid financial liabilities would be subject to the existing guidance that permits such separate accounting. Some may view this lack of symmetry as increasing complexity.

BC345. Replacing the unconditional fair value option in current U.S. GAAP with a limited, conditional fair value option also would reduce the complexity resulting from alternative measurement methods for economically similar financial instruments, while at the same time enhancing the comparability of different entities' financial statements.

Brightline or percentage tests

BC346. The guidance in this proposed Update does not depend on brightline or percentage tests. In particular, accounting for hybrid financial assets in their entirety, as discussed in paragraph BC344, makes it unnecessary to apply to them the current "double-double test" for assessing the degree of leverage in embedded interest rate instruments. That reduces the complexity of the accounting guidance for financial assets.

Insufficient or overly detailed application guidance

BC347. In developing the proposed implementation guidance in Section 825-10-55, the Board sought to strike an appropriate balance between:

- a. Insufficient guidance that might result in differing judgments in economically similar circumstances, thereby reducing comparability (or consistency) and making it more difficult for users to make meaningful comparisons
- b. Overly detailed application guidance that can contribute to complexity by making the requirements more difficult to understand or by becoming a set of de facto rules that preclude an entity from using its judgment to apply the requirements in ways that best represent the transaction or event.

BC348. The proposed application guidance explains how the classification framework presented in it leads to decisions about how to account for specific financial instruments in specified situations, which will help stakeholders apply the framework to other instruments or in other situations. Therefore, the application guidance in this proposed Update differs in degree of detail as compared with the application guidance in current U.S. GAAP. Considered on an overall basis, the Board believes that the proposed application or implementation guidance would contribute to a reduction in complexity.

Excessive or overly prescriptive presentation or disclosure requirements

BC349. The proposed guidance would require an entity to separately present on the face of the statement of financial position financial assets and financial liabilities by classification category. For example, financial assets measured at fair value through net income would be presented separately from assets measured at fair value through other comprehensive income. That proposed presentation requirement would reduce complexity for users of the financial statements, making it unnecessary for them to search through the notes to understand how an entity measures its financial instruments, without increasing complexity for preparers of financial statements.

BC350. The Board also sought to reduce the complexity and costs for public entities that are required to disclose information about fair values of instruments measured at amortized cost (as discussed in paragraph BC352, nonpublic entities would not be required to disclose those fair values). An entity would be required to disclose only specified information about how it determined the disclosed fair values, which is less than the information that Topic 820 currently requires for financial instruments measured at fair value.

Differential reporting for nonpublic entities

BC351. Different reporting requirements for nonpublic entities than for public entities sometimes are necessary to meet the informational needs of users of nonpublic entity financial statements or to reduce the cost of application in light of the perceived benefits of the reported information. Although such differences potentially benefit users, preparers, or both, they also can increase the cost of application if they make the overall guidance more difficult to read and understand.

BC352. The amendments in this proposed Update would result in different guidance for nonpublic entities in both the requirement to disclose the fair values of financial assets measured at amortized cost and the requirement to disclose information about core deposit liabilities, neither of which would apply to a nonpublic entity. The Board decided that those differential requirements are necessary for the purposes discussed in paragraph BC351. Because that proposed guidance is clearly described, its inclusion should increase neither the cost of compliance nor the overall complexity of the guidance. Rather, it should decrease costs and complexity for nonpublic entities.

Differences between U.S. GAAP and IFRSs

BC353. The proposed guidance would converge more with the IASB's requirements for financial instruments in its proposed amendments to IFRS 9, as a result of joint deliberations between the FASB and the IASB. However, a few differences would remain. The FASB decided that the remaining differences are

necessary to achieve appropriate accounting in the pertinent areas as well as to provide adequate guidance to help entities transition to the proposed guidance when finalized. Considered on an overall basis, the Board believes that the improved convergence of U.S. GAAP and IFRS 9 would decrease complexity.

Alternative Views

BC354. Two Board members disagree with the issuance of the proposed guidance.

Summary

BC355. Messrs. Linsmeier and Siegel believe that the proposed Update does not meet the objectives of increased decision-useful information and a reduction in complexity as set forth in the Summary and Questions for Respondents section of this proposed Update. In terms of decision-useful information, they note that some stakeholders speculate that this proposed Update will produce no significant differences in classification and measurement decisions for debt instruments and, therefore, is not an improvement. Furthermore, they believe that, if anything, the proposed Update would be more lenient than current U.S. GAAP because it would permit a greater use of the amortized cost measurement attribute for certain financial instruments that meet the contractual cash flow characteristics criteria and the held-to-collect contractual cash flows business model assessment. Additionally, they believe that both amortized cost information and fair value are relevant for all nontrading financial instruments. However, they are concerned that the proposed Update does not achieve this, particularly for nonpublic financial institutions, because the requirement to disclose fair value information would be removed for all nonpublic entities. Finally, they believe that the proposed Update provides both an implicit option through choice of business model to measure financial assets at fair value through other comprehensive income and an explicit option to measure at fair value through net income financial assets that qualify for measurement at fair value through other comprehensive income. They believe that those broad options create noncomparability for users.

BC356. In terms of complexity, Messrs. Linsmeier and Siegel assert that while the proposed Update contains some simplifications, it also adds or unnecessarily maintains areas of complexity. They note that the proposed model would make no accounting distinction based on the legal form of the instrument, which they believe is an improvement. Similarly, under the guidance in the proposed Update, equity investments with readily determinable fair values would be measured at fair value with changes recognized in net income. They consider this to be an improvement because it would eliminate the need for a complex and confusing other-than-temporary impairment model. However, they are concerned that complexities were added to the proposed model in creating a practicability exception for measuring fair value for equity investments without readily determinable fair values and in creating three different models for accounting for

embedded derivatives on the basis of instrument type. They also believe that complexities were retained because the proposed Update focuses on value realization in the business model assessment, which would create a need for implementation guidance on reclassifications and subsequent sales of financial assets carried at amortized cost.

Issues with Decision Usefulness of the Proposed Update

BC357. Messrs. Linsmeier and Siegel believe that some financial institution stakeholders already have indicated that the proposed Update will not result in significantly different classifications and measurement outcomes as compared with those in place today. Therefore, they are concerned that the benefits of making wholesale changes to the classification and measurement requirements may not justify the costs of assessing and transitioning to the new Update. Notwithstanding the feedback above about the magnitude of changes that might ensue, they are concerned that the proposed guidance is less restrictive than current U.S. GAAP about which instruments would qualify for amortized cost measurement. Paragraph 320-10-25-1(c) states that to qualify for amortized cost measurement under current U.S. GAAP, “. . . investments in debt securities shall be classified as held-to-maturity only if the reporting entity has the positive intent and ability to hold those securities to maturity.” Proposed paragraph 825-10-25-25(a) states that to qualify for amortized cost measurement, “the asset is held and managed within a business model that has the objective of holding the assets to collect contractual cash flows.” They believe that this proposed guidance could permit a much broader application of amortized cost to debt securities than exists today. They believe that unless these instruments are held until maturity to collect contractual cash flows, fair value would be the most relevant measurement attribute for the balance sheet with net income information being driven based on amortized cost (a fair value through other comprehensive income approach).

BC358. Messrs. Linsmeier and Siegel believe that for nontrading financial assets, financial statement users need both fair value and cost information. Therefore, they particularly are concerned that the proposed Update would not require nonpublic financial institutions to disclose fair value information for any financial instruments measured at amortized cost. They believe that the proposed amortized cost measurement would not provide adequate transparency about the key risks inherent in those instruments, such as credit risk, interest rate risk, and liquidity risk. As noted in paragraph BC93 of this proposed Update, investors have requested more transparency about these risks. They believe that discarding the current U.S. GAAP requirement for disclosure of the fair value of these instruments would eliminate extremely relevant information necessary for the users of these financial statements because the fair value estimate reflects all the underlying risks at a given point in time. They note that fair value information has been shown in academic research to provide the most decision-useful information about the credit and interest rate risks of banking institutions and also has been shown to be the best predictor of future failure of those institutions.

Issues with Complexity of the Proposed Update

BC359. Messrs. Linsmeier and Siegel believe that this proposed Update would add, in at least two areas, complexities to U.S. GAAP. First, they are concerned that while eliminating bifurcation of hybrid financial assets can be seen as a simplification, the proposed Update creates three separate models for analyzing similar embedded derivative features. The proposed Update would require hybrid financial assets and hybrid nonfinancial assets to be analyzed under two different sets of criteria (principal and interest for hybrid financial assets versus clearly-and-closely-related guidance in Subtopic 815-15 for hybrid nonfinancial assets) while hybrid financial liabilities would be assessed for bifurcation or separation using the provisions in Topics 815, 470, and 480, which is asymmetrical with the analysis of hybrid financial assets. Second, they note that this proposed Update would create a new practicability exception for equity instruments without readily determinable fair values by permitting such investments to sometimes be measured at an attribute other than fair value. They believe that the addition of this exception could diminish comparability and consistency because not all equity investments would be measured at fair value with fair value changes recognized in net income.

BC360. Messrs. Linsmeier and Siegel believe that both the current guidance on classification and measurement and the proposed Update unnecessarily require judgments based on how reporting entities expect to realize future value from financial instruments. They believe that judgments about future value realization would increase complexities because additional guidance would be required to address changes in those judgments. For example, they believe that value realization as a driver of classification necessitates the retention of guidance on reclassifications, which does not simplify the judgments regarding the business model assessment. Additionally, they are concerned that while this proposed Update would eliminate the notion of “tainting” a portfolio of financial assets measured at amortized cost, practice issues may arise about just how many sales of amortized cost financial assets can occur without calling into question future classifications of a held-to-collect contractual cash flows business model. Proposed paragraph 825-10-55-32 states that sales that result from reasons other than managing credit exposures should be very infrequent, and paragraph 825-10-55-33 instructs an entity to consider historical sales of financial assets and the reasons for them. They are concerned that these proposed requirements will not improve current U.S. GAAP and will not be operable.

BC361. Messrs. Linsmeier and Siegel note that the basis for conclusions cites the desire to converge with IFRS as a significant basis for some of the decisions made in this proposed Update. However, they are concerned that while many of the key principles are converged, the application guidance included in this Update will result in different outcomes in a number of fact patterns. They believe that if these differences are finalized and if investors are unaware of these differences, they will be misled when comparing an entity that would apply this proposed Update with one that would apply the proposed amendments to

IFRS 9. Specifically, they note that in order to reach the same classification and measurement conclusions, Example 3 in the proposed Update (paragraphs 825-10-55-71 through 55-72) is worded differently from Example 1 in the proposed amendments to IFRS 9. If the wording in the proposed Update was the same as in the proposed amendments to IFRS 9, the conclusions reached would be different because this proposed Update includes guidance on the frequency of sales out of the amortized cost business model. Similarly, they note that classification and measurement conclusions are not the same for Example 6 in this proposed Update and Example 4 from the proposed amendments to IFRS 9 because the proposed amendments to IFRS 9 would allow for the possibility that a portfolio as described would be consistent with amortized cost classification, whereas Example 6 concludes that amortized cost classification would be inappropriate. Finally, they believe that because the terms for Instrument G differ in the proposed Update (paragraph 825-10-55-60 through 55-63) and the proposed amendments to IFRS 9 that it may be possible for conclusions to differ. Instrument G in this proposed Update is a perpetual instrument with cash flows on specified dates. Because the terms for Instrument G in the proposed amendments to IFRS 9 make no reference about whether its payments are on specified dates, they believe the conclusions could differ because having required payments on specified dates is an important consideration in determining that an instrument passes the contractual cash flow characteristics criterion and, therefore, is eligible to be classified and measured at amortized cost under a held-to-collect contractual cash flows business model.

Conclusion

BC362. Messrs. Linsmeier and Siegel believe that, in contrast to the model in this proposed Update, the model that the Board had deliberated and agreed upon before the joint convergence efforts (as described in paragraphs BC99–BC105) generally would represent a significant improvement to current U.S. GAAP and would provide investors with decision-useful information. They note that under all three of the business models in the proposed Update, management would be permitted on the basis of future economic conditions either to hold a financial asset or to sell it before maturity. As a result, the proposed model provides additional guidance on the extent of and acceptable reasons for subsequent sales within two of the business models. They believe that basing classification of debt instruments that pass the cash flow characteristics criteria on whether and to what extent instruments will be subsequently sold creates a model that is not auditable because there can be no verification on the extent and reason for selling financial instruments until the time of sale. This also means that the proposed model will be subject to significant second-guessing after the instruments are sold, especially for instruments classified under the held-to-collect contractual cash flows business model. In contrast, the model described in paragraphs BC103–BC105 bases classification of debt instruments that pass the cash flow characteristics criteria on the business activity that an entity uses to manage its assets at acquisition: customer financing/lending, investing, or

trading/held for sale. They believe that the business strategy conditions in paragraphs BC103–BC105 would be based on an ex-ante analysis of the activities that gave rise to the financial asset, with much less reliance on judgment about how management intends and expects to realize value from the asset when it matures or is sold. Because that model does not include judgments about the ultimate value realization of financial assets, they believe that it would be easier to implement and would eliminate the need for any guidance about reclassifications and detailed implementation examples about subsequent sales of assets measured at amortized cost.

BC363. Messrs. Linsmeier and Siegel also believe that in order for the proposed model to improve U.S. GAAP, it should not require the asymmetric treatment of hybrid financial assets and hybrid financial liabilities by introducing the new and complicated solely interest and principal classification criteria for hybrid financial assets while retaining the extremely complicated and voluminous clearly-and-closely-related bifurcation and classification criterion for financial liabilities. Rather, they support an alternative approach that would require symmetrical treatment of both hybrid financial assets and hybrid financial liabilities under either the solely principal and interest no bifurcation classification model or the clearly-and-closely-related bifurcation and measurement model because it would represent an improvement to current U.S. GAAP. Finally, they believe that both fair value information and amortized cost information are equally important to understanding the potential risks and rewards of nontrading financial instruments. Therefore, they also believe that fair value information should be required to be presented either on the face of the financial statements or in the footnotes for all financial instruments (excluding core deposits) of nonpublic entities (particularly financial institutions) that are measured at amortized cost on the face of the statement of financial position and that the inputs for measuring the current value of core deposit liabilities of these entities also should be disclosed.

BC364. Messrs. Linsmeier and Siegel believe that if their alternative model cannot be supported, a more cost-beneficial improvement would be to make only targeted changes to current U.S. GAAP by (a) replacing the current broad fair value option with the three conditional targeted fair value options in this proposed Update, (b) making the changes in this proposed Update to equity instruments' classification and impairment, and (c) requiring the presentation or disclosure of fair value information for instruments measured at amortized cost on the statement of financial position.

Appendix: Comparison of the FASB's and the IASB's Proposed Classification and Measurement Models

A1. The table provides a side-by-side comparison of the FASB's and the IASB's proposed models for financial instruments. For a complete description of the IASB's model, see (a) IFRS 9 for the finalized requirements for classifying and measuring financial assets and (b) the IASB's Exposure Draft, *Classification and Measurement: Limited Amendments to IFRS 9* (issued November 2012).

	Amendments in the FASB's Proposed Update	IFRS 9 for Financial Instruments and the IASB's Proposed Amendments to IFRS 9
Scope	<ul style="list-style-type: none"> All financial instruments (except those for which a specific scope exception has been provided). 	<ul style="list-style-type: none"> Items within the scope of IAS 39.
Classification and Measurement Categories for Financial Assets	<ul style="list-style-type: none"> Fair value through net income (FV-NI). Fair value through other comprehensive income (FV-OCI). Amortized cost. 	<ul style="list-style-type: none"> Fair value through profit or loss (FVTPL). Fair value through other comprehensive income (FV-OCI). Amortized cost.
Classification and Measurement Categories for Financial Liabilities	<ul style="list-style-type: none"> FV-NI. Amortized cost. 	<ul style="list-style-type: none"> FVTPL. Amortized cost.
Contractual Cash Flow Characteristics Assessment	<ul style="list-style-type: none"> A financial asset would be eligible for a measurement category other than FV-NI if its contractual terms give rise on specified dates to cash flows that are solely payments of principal and interest on the 	<ul style="list-style-type: none"> A financial asset would be eligible for a measurement category other than FVTPL if its contractual terms give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

	Amendments in the FASB's Proposed Update	IFRS 9 for Financial Instruments and the IASB's Proposed Amendments to IFRS 9
	principal amount outstanding.	
Amortized Cost Classification Criteria for Financial Assets	<ul style="list-style-type: none"> • To be classified and measured at amortized cost, a financial asset must: <ol style="list-style-type: none"> 1. Pass the contractual cash flow characteristics criterion 2. Be managed within a business model whose objective is to hold the assets to collect contractual cash flows. • Detailed implementation guidance on when sales are permitted from the amortized cost category. 	<ul style="list-style-type: none"> • To be classified and measured at amortized cost, a financial asset must: <ol style="list-style-type: none"> 1. Be held within a business model whose objective is to hold assets to collect contractual cash flows 2. Have contractual terms that give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.
FV-OCI Classification Criteria for Financial Assets	<ul style="list-style-type: none"> • To be classified and measured at FVO-CI, a financial asset must: <ol style="list-style-type: none"> 1. Pass the contractual cash flow characteristics criterion 2. Be managed within a business model that has the objective of both holding financial assets to collect contractual cash flows and selling financial assets. 	<ul style="list-style-type: none"> • To be classified and measured at FV-OCI, a financial asset must: <ol style="list-style-type: none"> 1. Be held in a business model in which assets are managed both to collect contractual cash flows and for sale 2. Have contractual terms that give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

	Amendments in the FASB's Proposed Update	IFRS 9 for Financial Instruments and the IASB's Proposed Amendments to IFRS 9
FV-NI Classification Criteria for Financial Assets	<ul style="list-style-type: none"> • Residual measurement category for financial assets under the business model assessment. • Required category for instruments that fail the contractual cash flow characteristics criterion. • Required measurement category for equity investments unless the practicability exception is elected for equity investments without a readily determinable fair value. 	<ul style="list-style-type: none"> • Residual measurement category for financial assets under the business model assessment. • Required category for instruments that fail the contractual cash flow characteristics criterion. • Required measurement category for equity investment. However, an irrevocable election at initial recognition is provided for investments in equity instruments (that are not held for trading) to present changes in fair value in other comprehensive income.
Classification Criteria for Financial Liabilities	<ul style="list-style-type: none"> • FV-NI required for: <ol style="list-style-type: none"> 1. If the entity's business strategy at incurrence of the liability is to subsequently transact at fair value. 2. Short sales obligations. • Amortized cost required for other financial liabilities. • Specific measurement guidance for certain nonrecourse financial liabilities. 	<ul style="list-style-type: none"> • FVTPL required for trading and derivative liabilities. • Amortized cost required for other financial liabilities (except when certain exceptions are met).
Hybrid Financial Contracts	<ul style="list-style-type: none"> • Hybrid financial assets measured in their entirety. Embedded derivatives are not bifurcated and accounted for separately. 	<ul style="list-style-type: none"> • Hybrid financial assets measured in their entirety. Embedded derivatives are not bifurcated and accounted for separately. • Embedded derivative

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	<ul style="list-style-type: none"> • Embedded derivative guidance in Subtopic 815-15 applies to hybrid financial liabilities. 	<p>guidance in IAS 39 applies to hybrid financial liabilities.</p>
Fair Value Option	<ul style="list-style-type: none"> • Financial assets: Irrevocable election at initial recognition for financial assets that meet the contractual cash flow characteristics criterion and the business model for FV-OCI classification. • Financial assets and liabilities: Irrevocable election at initial recognition if an entity manages the net exposure of a group of financial assets and financial liabilities on a fair value basis and information is provided to management on that basis. • Financial liabilities: The liability contains one or more separable embedded derivatives and the entity elects to account for the hybrid contract in its entirety. 	<ul style="list-style-type: none"> • Financial assets: Irrevocable election available at initial recognition if measuring at fair value eliminates or significantly reduces a measurement or recognition inconsistency (an accounting mismatch) for financial assets classified at amortized cost and FV-OCI. • Financial liabilities: Irrevocable election would be available at initial recognition if: <ol style="list-style-type: none"> 1. Measuring at fair value eliminates or significantly reduces an accounting mismatch. 2. An entity manages and evaluates a group of instruments on a fair value basis. 3. The liability contains one or more separable embedded derivatives, and the entity elects to account for the hybrid contract in its entirety.
Core Deposit Liabilities	<ul style="list-style-type: none"> • Measured at amortized cost. 	<ul style="list-style-type: none"> • No special measurement guidance; generally measured at amortized cost.
Unconsolidated Equity Investments	<ul style="list-style-type: none"> • An entity would perform a held-for-sale evaluation 	<ul style="list-style-type: none"> • Not within the scope of IFRS 9; accounted for

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	<p>upon an investment's initial qualification for the equity method of accounting. If an investment is determined to be held for sale, it would be classified and measured at FV-NI, and an entity could not subsequently change that classification. If not held for sale, the investment would be accounted for under Topic 323.</p> <ul style="list-style-type: none"> • The cost method would be eliminated. 	<p>under IAS 28.</p>
Loan Commitments	<ul style="list-style-type: none"> • The potential creditor would measure a loan commitment based on the likelihood of exercise of the loan commitment: <ol style="list-style-type: none"> 1. Not remote: measure the loan commitment consistently with the measurement of the underlying loan under the tentative model. 2. Remote: recognize any commitment fee received as fee income over the commitment period in accordance with Subtopic 310-20. 	<ul style="list-style-type: none"> • Only some loan commitments are within the scope of IFRS 9 and IAS 39. • For those within the scope, subsequent measurement would depend on the terms of the instrument and the entity's circumstances.
Recognition of Realized Gains and Losses	<ul style="list-style-type: none"> • Debt instruments: Amounts in accumulated other comprehensive income are reclassified upon sale, settlement, or 	<ul style="list-style-type: none"> • Debt instruments: For financial assets classified at FV-OCI, gains and losses are reclassified to profit or loss when the

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	impairment to net income.	instrument is derecognized or impaired. <ul style="list-style-type: none"> • Equity investments: For equity investments for which FV-OCI has been elected, changes recognized in other comprehensive income are not reclassified to profit or loss.
Tainting	<ul style="list-style-type: none"> • No tainting. 	<ul style="list-style-type: none"> • No tainting.
Reclassifications	<ul style="list-style-type: none"> • Required prospectively for financial assets if the entity's business model for managing its financial assets changes. • Prohibited for financial liabilities. • Reclassified on the last day of the reporting period in which an entity's business model changes. 	<ul style="list-style-type: none"> • Required prospectively for financial assets if the entity's business model for managing its financial assets changes. • Prohibited for financial liabilities. • Reclassified on the first day of the first reporting period following an entity's change of business model.
Presentation of Changes in Instrument-Specific Credit Risk	<ul style="list-style-type: none"> • For financial liabilities designated under the fair value option, an entity would present separately the portion of the change in fair value attributable to changes in instrument-specific credit risk in other comprehensive income. • Cumulative gains and losses recognized in other comprehensive income would be recognized in net income upon settlement of the liability. 	<ul style="list-style-type: none"> • For financial liabilities designated under the fair value option, an entity would present the portion of the change in fair value attributable to changes in instrument-specific credit risk in other comprehensive income. • This amount would not be reclassified to profit or loss when these liabilities are derecognized. However, an entity may transfer the cumulative gain or loss within equity.

Amendments to the XBRL Taxonomy

The provisions of this Exposure Draft, if finalized as proposed, would require changes to the U.S. GAAP Financial Reporting Taxonomy (UGT). We welcome comments on these proposed changes to the UGT at the ASU Taxonomy Changes provided at www.fasb.org. After the FASB has completed its deliberations and issued a final Accounting Standards Update, proposed amendments to the UGT will be made available for public comment at www.fasb.org and finalized as part of the annual release process.