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Financial Accounting Series

Statement of Financial Accounting Standards No. 159

The Fair Value Option for Financial Assets
and Financial Liabilities

Including an amendment of FASB Statement No. 115



Financial Accounting Standards Board
of the Financial Accounting Foundation

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Summary

Why Is the FASB Issuing This Statement?

This Statement permits entities to choose to measure many financial instruments and certain other items at fair value. The objective 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. This Statement is expected to expand the use of fair value measurement, which is consistent with the Board's long-term measurement objectives for accounting for financial instruments.

What Is the Scope of This Statement—Which Entities Does It Apply to and What Does It Affect?

This Statement applies to all entities, including not-for-profit organizations. Most of the provisions of this Statement apply only to entities that elect the fair value option. However, the amendment to FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, applies to all entities with available-for-sale and trading securities. Some requirements apply differently to entities that do not report net income.

The following are eligible items for the measurement option established by this Statement:

1. Recognized financial assets and financial liabilities except:
 - a. An investment in a subsidiary that the entity is required to consolidate
 - b. An interest in a variable interest entity that the entity is required to consolidate
 - c. Employers' and plans' obligations (or assets representing net overfunded positions) for pension benefits, other postretirement benefits (including health care and life insurance benefits), postemployment benefits, employee stock option and stock purchase plans, and other forms of deferred compensation arrangements, as defined in FASB Statements No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, No. 87, *Employers' Accounting for Pensions*, No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, No. 112, *Employers' Accounting for Postemployment Benefits*, No. 123 (revised December 2004), *Share-Based Payment*, No. 43, *Accounting for Compensated Absences*, No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*, and No. 158, *Employers' Accounting for Defined Benefit*

Pension and Other Postretirement Plans, and APB Opinion No. 12, *Omnibus Opinion—1967*

- d. Financial assets and financial liabilities recognized under leases as defined in FASB Statement No. 13, *Accounting for Leases* (This exception does not apply to a guarantee of a third-party lease obligation or a contingent obligation arising from a cancelled lease.)
 - e. Deposit liabilities, withdrawable on demand, of banks, savings and loan associations, credit unions, and other similar depository institutions
 - f. Financial instruments that are, in whole or in part, classified by the issuer as a component of shareholder's equity (including "temporary equity"). An example is a convertible debt security with a noncontingent beneficial conversion feature.
2. Firm commitments that would otherwise not be recognized at inception and that involve only financial instruments
 3. Nonfinancial insurance contracts and warranties that the insurer can settle by paying a third party to provide those goods or services
 4. Host financial instruments resulting from separation of an embedded nonfinancial derivative instrument from a nonfinancial hybrid instrument.

How Will This Statement Change Current Accounting Practices?

The fair value option established by this Statement permits all entities to choose to measure eligible items at fair value at specified election dates. A business entity shall report unrealized gains and losses on items for which the fair value option has been elected in earnings (or another performance indicator if the business entity does not report earnings) at each subsequent reporting date. A not-for-profit organization shall report unrealized gains and losses in its statement of activities or similar statement.

The fair value option:

1. May be applied instrument by instrument, with a few exceptions, such as investments otherwise accounted for by the equity method
2. Is irrevocable (unless a new election date occurs)
3. Is applied only to entire instruments and not to portions of instruments.

How Does This Statement Contribute to International Convergence?

The fair value option in this Statement is similar, but not identical, to the fair value option in IAS 39, *Financial Instruments: Recognition and Measurement*. The international fair value option is subject to certain qualifying criteria not included in this standard, and it applies to a slightly different set of instruments.

What Is the Effective Date of This Statement?

This Statement is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. Early adoption is permitted as of the beginning of a fiscal year that begins on or before November 15, 2007, provided the entity also elects to apply the provisions of FASB Statement No. 157, *Fair Value Measurements*.

No entity is permitted to apply this Statement retrospectively to fiscal years preceding the effective date unless the entity chooses early adoption. The choice to adopt early should be made after issuance of this Statement but within 120 days of the beginning of the fiscal year of adoption, provided the entity has not yet issued financial statements, including required notes to those financial statements, for any interim period of the fiscal year of adoption.

This Statement permits application to eligible items existing at the effective date (or early adoption date).

Statement of Financial Accounting Standards No. 159

The Fair Value Option for Financial Assets
and Financial Liabilities

Including an amendment of FASB Statement No. 115

February 2007



Financial Accounting Standards Board
of the Financial Accounting Foundation

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CONTENTS

	Paragraph Numbers
Objective.....	1–2
Standards of Financial Accounting and Reporting:	
The Fair Value Option.....	3–5
Key Terms	6
Applying the Fair Value Option	7–14
Scope of Eligible Items	7
Recognized Financial Assets and Liabilities That Are Not Eligible Items	8
Election Dates.....	9–11
Instrument-by-Instrument Application.....	12–14
Presentation of Items Measured at Fair Value under This Statement ...	15–16
Statement of Financial Position	15
Cash Flow Statement	16
Disclosures Applicable to This Statement and Statement 155.....	17–22
Required Disclosures as of Each Date for Which an Interim or Annual Statement of Financial Position Is Presented.....	18
Required Disclosures for Each Period for Which an Interim or Annual Income Statement Is Presented.....	19–20
Other Required Disclosures	21–22
Application by Not-for-Profit Organizations	23
Effective Date	24–30
Application to Eligible Items Existing at the Effective Date.....	25–27
Available-for-Sale and Held-to-Maturity Securities	28–29
Early Adoption.....	30
Appendix A: Background Information and Basis for Conclusions	A1–A54
Appendix B: Illustrative Fair Value Disclosures.....	B1–B9
Appendix C: Amendments to Existing Pronouncements.....	C1–C7

Statement of Financial Accounting Standards No. 159

The Fair Value Option for Financial Assets and Financial Liabilities

Including an amendment of FASB Statement No. 115

February 2007

OBJECTIVE

1. This Statement permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. The objective 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. This Statement is expected to expand the use of fair value measurement, which is consistent with the Board's long-term measurement objectives for accounting for financial instruments. In addition, it is similar to a measurement choice permitted in International Financial Reporting Standards.

2. This Statement also establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. This Statement does not affect any existing accounting literature that requires certain assets and liabilities to be carried at fair value. This Statement does not establish requirements for recognizing and measuring dividend income, interest income, or interest expense. This Statement does not eliminate disclosure requirements included in other accounting standards, including requirements for disclosures about fair value measurements included in FASB Statements No. 157, *Fair Value Measurements*, and No. 107, *Disclosures about Fair Value of Financial Instruments*.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

The Fair Value Option

3. This Statement permits all entities to choose, at specified election dates, to measure eligible items at fair value (the "fair value option"). A business entity shall report unrealized gains and losses on items for which the fair value option has been elected in earnings (or another performance indicator if the business entity does not report

earnings) at each subsequent reporting date. Upfront costs and fees related to items for which the fair value option is elected shall be recognized in earnings as incurred and not deferred.

4. The requirements related to earnings and some of the other requirements of this Statement apply differently to not-for-profit organizations. Paragraph 23 explains the differences.

5. The decision about whether to elect the fair value option:

- a. Is applied instrument by instrument, except as discussed in paragraph 12
- b. Is irrevocable (unless a new election date occurs, as discussed in paragraph 9)
- c. Is applied only to an entire instrument and not to only specified risks, specific cash flows, or portions of that instrument.

Key Terms

6. The following terms are used in this Statement with the following definitions:

- a. **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.
- b. **Financial asset**—Cash, evidence of an ownership interest in an entity, or a contract that conveys to one entity a right (1) to receive cash or another financial instrument from a second entity or (2) to exchange other financial instruments on potentially favorable terms with the second entity.
- c. **Financial liability**—A contract that imposes on one entity an obligation (1) to deliver cash or another financial instrument to a second entity or (2) to exchange other financial instruments on potentially unfavorable terms with the second entity.
- d. **Firm commitment**—An agreement with an unrelated party, binding on both parties and usually legally enforceable, with the following characteristics:
 - (1) The agreement specifies all significant terms, including the quantity to be exchanged, a fixed price, and the timing of the transaction. The fixed price may be expressed as a specified amount of an entity's functional currency or of a foreign currency. It may also be expressed as a specified interest rate or specified effective yield.
 - (2) The agreement includes a disincentive for nonperformance that is sufficiently large to make performance probable.

Applying the Fair Value Option

Scope of Eligible Items

7. All entities may elect the fair value option for the following items (eligible items):
 - a. A recognized financial asset and financial liability, except any listed in paragraph 8
 - b. A firm commitment that would otherwise not be recognized at inception and that involves only financial instruments (An example is a forward purchase contract for a loan that is not readily convertible to cash. That commitment involves only financial instruments—a loan and cash—and would not otherwise be recognized because it is not a derivative instrument.)
 - c. A written loan commitment
 - d. The rights and obligations under an insurance contract that is not a financial instrument (because it requires or permits the insurer to provide goods or services rather than a cash settlement) but whose terms permit the insurer to settle by paying a third party to provide those goods or services
 - e. The rights and obligations under a warranty that is not a financial instrument (because it requires or permits the warrantor to provide goods or services rather than a cash settlement) but whose terms permit the warrantor to settle by paying a third party to provide those goods or services
 - f. A host financial instrument resulting from the separation of an embedded nonfinancial derivative instrument from a nonfinancial hybrid instrument under paragraph 12 of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, subject to the scope exceptions in paragraph 8. (An example of such a nonfinancial hybrid instrument is an instrument in which the value of the bifurcated embedded derivative is payable in cash, services, or merchandise but the debt host is payable only in cash.)

Recognized Financial Assets and Financial Liabilities That Are Not Eligible Items

8. No entity may elect the fair value option for the following financial assets and financial liabilities:
 - a. An investment in a subsidiary that the entity is required to consolidate
 - b. An interest in a variable interest entity that the entity is required to consolidate
 - c. Employers' and plans' obligations (or assets representing net overfunded positions) for pension benefits, other postretirement benefits (including health care and life insurance benefits), postemployment benefits, employee stock option and stock purchase plans, and other forms of deferred compensation arrangements, as defined in FASB Statements No. 35, *Accounting and Reporting*

by *Defined Benefit Pension Plans*, No. 87, *Employers' Accounting for Pensions*, No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, No. 112, *Employers' Accounting for Postemployment Benefits*, No. 123 (revised December 2004), *Share-Based Payment*, No. 43, *Accounting for Compensated Absences*, No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*, and No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*, and APB Opinion No. 12, *Omnibus Opinion—1967*

- d. Financial assets and financial liabilities recognized under leases as defined in FASB Statement No. 13, *Accounting for Leases* (This exception does not apply to a guarantee of a third-party lease obligation or a contingent obligation arising from a cancelled lease.)
- e. Deposit liabilities, withdrawable on demand, of banks, savings and loan associations, credit unions, and other similar depository institutions
- f. Financial instruments that are, in whole or in part, classified by the issuer as a component of shareholder's equity (including "temporary equity"). An example is a convertible debt security with a noncontingent beneficial conversion feature.

Election Dates

9. An entity may decide whether to elect the fair value option for each eligible item on its election date. Alternatively, an entity may elect the fair value option according to a preexisting policy for specified types of eligible items. An entity may choose to elect the fair value option for an eligible item only on the date that one of the following occurs:

- a. The entity first recognizes the eligible item.
- b. The entity enters into an eligible firm commitment.
- c. Financial assets that have been reported at fair value with unrealized gains and losses included in earnings because of specialized accounting principles cease to qualify for that specialized accounting. (An example is a transfer of assets from a subsidiary subject to the AICPA Audit and Accounting Guide, *Investment Companies*, to another entity within the consolidated reporting entity not subject to that Guide.)
- d. The accounting treatment for an investment in another entity changes because:
 - (1) The investment becomes subject to the equity method of accounting. (For example, the investment may previously have been reported as a security accounted for under either FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, or the fair value option in this Statement.)

- (2) The investor ceases to consolidate a subsidiary or variable interest entity but retains an interest (for example, because the investor no longer holds a majority voting interest but continues to hold some common stock).
- e. An event that requires an eligible item to be measured at fair value at the time of the event but does not require fair value measurement at each reporting date after that, excluding the recognition of impairment under lower-of-cost-or-market accounting or other-than-temporary impairment. (See paragraph 10.)

10. Some of the events that require remeasurement of eligible items at fair value, initial recognition of eligible items, or both, and thereby create an election date for the fair value option as discussed in paragraph 9(e) are:

- a. Business combinations, as defined in FASB Statement No. 141, *Business Combinations*
- b. Consolidation or deconsolidation of a subsidiary or variable interest entity
- c. Significant modifications of debt, as defined in EITF Issue No. 96-19, “Debtor’s Accounting for a Modification or Exchange of Debt Instruments.”

11. An acquirer, parent, or primary beneficiary decides whether to apply the fair value option to eligible items of an acquiree, subsidiary, or consolidated variable interest entity, but that decision applies only in the consolidated financial statements. Fair value option choices made by an acquired entity, subsidiary, or variable interest entity continue to apply in separate financial statements of those entities if they issue separate financial statements.

Instrument-by-Instrument Application

12. The fair value option may be elected for a single eligible item without electing it for other identical items with the following four exceptions:

- a. If multiple advances are made to one borrower pursuant to a single contract (such as a line of credit or a construction loan) and the individual advances lose their identity and become part of a larger loan balance, the fair value option shall be applied only to the larger balance and not to each advance individually.
- b. If the fair value option is applied to an investment that would otherwise be accounted for under the equity method of accounting, it shall be applied to all of the investor’s financial interests in the same entity (equity and debt, including guarantees) that are eligible items.
- c. If the fair value option is applied to an eligible insurance or reinsurance contract, it shall be applied to all claims and obligations under the contract.

- d. If the fair value option is elected for an insurance contract (base contract) for which integrated or nonintegrated contract features or coverages¹ (some of which are called riders) are issued either concurrently or subsequently, the fair value option also must be applied to those features or coverages. The fair value option cannot be elected for only the nonintegrated contract features or coverages, even though those features or coverages are accounted for separately under AICPA Statement of Position 05-1, *Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection With Modifications or Exchanges of Insurance Contracts*.

13. The fair value option need not be applied to all instruments issued or acquired in a single transaction (except as required by paragraph 12(a) or 12(b)). For example, investors in shares of stock and registered bonds might apply the fair value option to only some of the shares or bonds issued or acquired in a single transaction. For this purpose, an individual bond is considered to be the minimum denomination of that debt security. A financial instrument that is legally a single contract may not be separated into parts for purposes of applying the fair value option. In contrast, a loan syndication arrangement may result in multiple loans to the same borrower by different lenders. Each of those loans is a separate instrument, and the fair value option may be elected for some of those loans but not others.

14. An investor in an equity security may elect the fair value option for its entire investment in that equity security, including any fractional shares issued by the investee (for example, fractional shares that are acquired in a dividend reinvestment program).

Presentation of Items Measured at Fair Value under This Statement

Statement of Financial Position

15. Entities shall report assets and liabilities that are measured at fair value pursuant to the fair value option in this Statement in a manner that separates those reported fair

¹AICPA Statement of Position 05-1, *Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection With Modifications or Exchanges of Insurance Contracts*, defines a *nonintegrated contract feature* in an insurance contract. For purposes of applying this Statement, neither an integrated contract feature or coverage nor a nonintegrated contract feature or coverage qualifies as a separate instrument.

values from the carrying amounts of similar assets and liabilities measured using another measurement attribute. To accomplish that, an entity shall either:

- a. Present the aggregate of fair value and non-fair-value amounts in the same line item in the statement of financial position and parenthetically disclose the amount measured at fair value included in the aggregate amount
- b. Present two separate line items to display the fair value and non-fair-value carrying amounts.

Cash Flow Statement

16. Entities shall classify cash receipts and cash payments related to items measured at fair value according to their nature and purpose as required by FASB Statement No. 95, *Statement of Cash Flows* (as amended).

Disclosures Applicable to This Statement and Statement 155

17. The principal objectives of the disclosures required by paragraphs 18–22 are to facilitate comparisons (a) between entities that choose different measurement attributes for similar assets and liabilities and (b) between assets and liabilities in the financial statements of an entity that selects different measurement attributes for similar assets and liabilities. Those disclosure requirements are expected to result in the following:

- a. Information to enable users of its financial statements to understand management’s reasons for electing or partially electing the fair value option
- b. Information to enable users to understand how changes in fair values affect earnings for the period
- c. The same information about certain items (such as equity investments and nonperforming loans) that would have been disclosed if the fair value option had not been elected
- d. Information to enable users to understand the differences between fair values and contractual cash flows for certain items.

To meet those objectives, the disclosures described in paragraphs 18–22 are required for items measured at fair value under the option in this Statement and the option in paragraph 16 of Statement 133 (as amended by FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments*). Those disclosures are not required for securities classified as trading securities under Statement 115, life settlement contracts measured at fair value pursuant to FASB Staff Position FTB 85-4-1, “Accounting for Life Settlement Contracts by Third-Party Investors,” or servicing rights measured at fair value pursuant to FASB Statement No. 156, *Accounting for Servicing of Financial*

*Assets.*² Entities shall provide the disclosures required by paragraphs 18–22 in both interim and annual financial statements. Entities are encouraged but are not required to present the disclosures required by this Statement in combination with related fair value information required to be disclosed by other Statements (for example, Statement 107 and Statement 157).

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

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

- a. Management’s reasons for electing a fair value option for each eligible item or group of similar eligible items
- b. If the fair value option is elected for some but not all eligible items within a group of similar eligible items:
 - (1) A description of those similar items and the reasons for partial election
 - (2) Information to enable users to understand how the group of similar items relates to individual line items on the statement of financial position
- c. For each line item in the statement of financial position that includes an item or items for which the fair value option has been elected:
 - (1) Information to enable users to understand how each line item in the statement of financial position relates to major categories of assets and liabilities presented in accordance with Statement 157’s fair value disclosure requirements³
 - (2) The aggregate carrying amount of items included in each line item in the statement of financial position that are not eligible for the fair value option, if any
- d. The difference between the aggregate fair value and the aggregate unpaid principal balance of:
 - (1) Loans and long-term receivables (other than securities subject to Statement 115) that have contractual principal amounts and for which the fair value option has been elected
 - (2) Long-term debt instruments that have contractual principal amounts and for which the fair value option has been elected

²Those standards include some disclosure requirements that are not affected by this Statement.

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

- e. For loans held as assets for which the fair value option has been elected:
 - (1) The aggregate fair value of loans that are 90 days or more past due
 - (2) If the entity's policy is to recognize interest income separately from other changes in fair value, the aggregate fair value of loans in nonaccrual status
 - (3) The difference between the aggregate fair value and the aggregate unpaid principal balance for loans that are 90 days or more past due, in nonaccrual status, or both
- f. For investments that would have been accounted for under the equity method if the entity had not chosen to apply the fair value option,⁴ the information required by paragraph 20 of APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock* (excluding the disclosures in paragraph 20(a)(3), 20(b), and 20(e) of that Opinion).⁵

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

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

The significance of an investment to the investor's financial position and results of operations should be considered in evaluating the extent of disclosures of the financial position and results of operations of an investee. If the investor has more than one investment in common stock, disclosures wholly or partly on a combined basis may be appropriate. The following disclosures are generally applicable to the equity method of accounting for investments in common stock:

- a. Financial statements of an investor should disclose parenthetically, in notes to financial statements, or in separate statements or schedules (1) the name of each investee and percentage of ownership of common stock, [and] (2) the accounting policies of the investor with respect to investments in common stock. . . .
- d. When investments in common stock of corporate joint ventures or other investments accounted for under the equity method are, in the aggregate, material in relation to the financial position or results of operations of an investor, it may be necessary for summarized information as to assets, liabilities, and results of operations of the investees to be presented in the notes or in separate statements, either individually or in groups, as appropriate. [Footnote reference omitted.]

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

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

- a. For each line item in the statement of financial position, the amounts of gains and losses from fair value changes included in earnings during the period and in which line in the income statement those gains and losses are reported (This Statement does not preclude an entity from meeting this requirement by disclosing amounts of gains and losses that include amounts of gains and losses for other items measured at fair value, such as items required to be measured at fair value.)
- b. A description of how interest and dividends are measured and where they are reported in the income statement (This Statement does not address the methods used for recognizing and measuring the amount of dividend income, interest income, and interest expense for items for which the fair value option has been elected.)
- c. For loans and other receivables held as assets:
 - (1) The estimated amount of gains or losses included in earnings during the period attributable to changes in instrument-specific credit risk
 - (2) How the gains or losses attributable to changes in instrument-specific credit risk were determined
- d. For liabilities with fair values that have been significantly affected during the reporting period by changes in the instrument-specific credit risk:
 - (1) The estimated amount of gains and losses from fair value changes included in earnings that are attributable to changes in the instrument-specific credit risk
 - (2) Qualitative information about the reasons for those changes
 - (3) How the gains and losses attributable to changes in instrument-specific credit risk were determined.

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

Other Required Disclosures

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

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

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

Application by Not-for-Profit Organizations

23. Not-for-profit organizations shall apply the provisions of this Statement with the following modifications:

- a. References to an income statement should be replaced with references to a statement of activities, statement of changes in net assets, or statement of operations. References to earnings should be replaced with references to changes in net assets, except as indicated in paragraph 23(b).
- b. Health care organizations subject to the AICPA Audit and Accounting Guide, *Health Care Organizations*, shall report unrealized gains and losses on items for which the fair value option has been elected within the performance indicator or as a part of discontinued operations, as appropriate.⁷ Consistent with the provisions of FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*, not-for-profit organizations may present such gains and losses

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

⁷Unlike other not-for-profit organizations, organizations subject to the health care Guide present performance indicators analogous to income from continuing operations.

either within or outside other intermediate measures of operations unless such gains or losses are part of discontinued operations.⁸

- c. The disclosure requirements in paragraph 19 shall apply not only with respect to the effect on performance indicators or other intermediate measures of operations, if presented, but also with respect to the effect on the change in each of the net asset classes (unrestricted, temporarily restricted, and permanently restricted), as applicable.

Effective Date

24. This Statement shall be effective as of the beginning of each reporting entity's first fiscal year that begins after November 15, 2007. This Statement should not be applied retrospectively to fiscal years beginning prior to the effective date, except as permitted in paragraph 30 for early adoption.

Application to Eligible Items Existing at the Effective Date

25. At the effective date, an entity may elect the fair value option for eligible items that exist at that date. The entity shall report the effect of the first remeasurement to fair value as a cumulative-effect adjustment to the opening balance of retained earnings. A not-for-profit organization shall report such cumulative-effect adjustment as a separate line item within the changes in the appropriate net asset class or classes in its statement of activities, outside of any performance indicator or other intermediate measure of operations.

26. The difference between the carrying amount and the fair value of eligible items for which the fair value option is elected at the effective date shall be removed from the statement of financial position and included in the cumulative-effect adjustment. Those differences may include, but are not limited to:

- a. Unamortized deferred costs, fees, premiums, and discounts
- b. Valuation allowances (for example, allowances for loan losses)
- c. Accrued interest, which would be reported as part of the fair value of the eligible item.

⁸This includes intermediate measures of operations presented by not-for-profit organizations other than health care organizations and any additional intermediate measures of operations presented within the performance indicator by not-for-profit health care organizations.

27. An entity that elects the fair value option for items existing at the effective date shall provide the following in its annual and first-interim-period financial statements for the fiscal year that includes the effective date:

- a. A schedule that presents the following by line item in the statement of financial position:
 - (1) The pretax portion of the cumulative-effect adjustment to retained earnings (or appropriate class or classes of net assets) for items on that line
 - (2) The fair value at the effective date of eligible items for which the fair value option is elected and the carrying amount of those same items immediately before electing the fair value option
- b. The net effect on the entity's deferred tax assets and liabilities of electing the fair value option
- c. Management's reasons for electing the fair value option for each existing eligible item or group of similar eligible items
- d. If the fair value option is elected for some but not all eligible items within a group of similar eligible items:
 - (1) A description of those similar items and the reasons for partial election
 - (2) Information to enable users to understand how the group of similar items relates to individual line items on the statement of financial position
- e. The amount of valuation allowances that were removed from the statement of financial position because they related to items for which the fair value option was elected.

Available-for-Sale and Held-to-Maturity Securities

28. Available-for-sale and held-to-maturity securities held at the effective date are eligible for the fair value option at that date. If the fair value option is elected for any of those securities at the effective date, cumulative unrealized gains and losses at that date shall be included in the cumulative-effect adjustment. The amount of unrealized gains and losses reclassified from accumulated other comprehensive income (for available-for-sale securities) and the amount of unrealized gains and losses that was previously unrecognized (for held-to-maturity securities) shall be separately disclosed. If Statement 157 is adopted at the same time that this Statement is adopted, any change in an existing eligible item's recorded fair value at the effective date due to application of the guidance in Statement 157 (such as for an available-for-sale security) shall be included in the cumulative-effect adjustment if the fair value option was elected for that eligible item.

29. If an entity elects the fair value option for a held-to-maturity or available-for-sale security in conjunction with the adoption of this Statement, that security shall be reported as a trading security under Statement 115, but the accounting for a transfer to the trading category under paragraph 15(b) of Statement 115 does not apply. Electing the fair value option for an existing held-to-maturity security will not call into question the intent of an entity to hold other debt securities to maturity in the future.

Early Adoption

30. An entity may adopt this Statement and elect the fair value option for existing eligible items as of the beginning of a fiscal year that begins on or before November 15, 2007, subject to the following conditions:

- a. The choice to adopt early shall be made after issuance of this Statement but within 120 days of the beginning of the fiscal year of adoption.
- b. The entity also adopts all of the requirements of Statement 157 at this Statement's early adoption date (the first day of the fiscal year of adoption) or earlier.
- c. At the time the entity chooses to adopt this Statement early, the entity has not yet issued financial statements, including required notes to those financial statements, for any interim period of the fiscal year that includes the early adoption date.
- d. The choices to apply or not apply the fair value option to eligible items existing at the early adoption date are retroactive to the early adoption date.
- e. For eligible items with an election date (as specified in paragraph 9) occurring after the early adoption date but before the date of the entity's choice to apply early, the election for those items is retroactive to their election date.
- f. All other requirements that would normally apply as of the required effective date also apply as of the early adoption date.

**The provisions of this Statement need
not be applied to immaterial items.**

This Statement was adopted by the affirmative votes of five members of the Financial Accounting Standards Board. Messrs. Linsmeier and Young dissented.

Mr. Linsmeier dissents from issuance of this Statement because he believes a fair value option generally will not result in financial reporting that achieves many of the objectives for issuing this Statement given in paragraph A3. Mr. Linsmeier agrees with

paragraph A3(a)—that the effect on earnings from using mixed measurement attributes under GAAP in the United States may not be representative of the economics of the reporting entity’s activities. In addition, he agrees with paragraph A3(b)—that a fair value option will enable entities to mitigate reporting volatility in earnings that results from using different measurement attributes in reporting related financial assets and financial liabilities. However, providing entities with an instrument-by-instrument option that often will result in the reporting at fair value of only some instruments within the scope of this Statement will not result in reporting that is more representative of entities’ economic exposures and will provide an opportunity for entities to report significantly less earnings volatility than they are exposed to.

Mr. Linsmeier also agrees with paragraph A3(d)—that fair values for financial assets and financial liabilities provide more relevant and understandable information than cost or cost-based measures. However, an instrument-by-instrument option that results in partial adoption of fair values for only some financial (and other) instruments significantly reduces the relevance of the resulting reporting by failing to portray the earnings effects of financial (and other) instruments’ exposures in the same reporting period and increases users’ costs in processing the information by introducing treatment alternatives that reduce the comparability of reported results within and across reporting entities and line items. For these reasons, Mr. Linsmeier does not agree that this Statement represents a cost-beneficial interim step toward measuring all financial instruments at fair value—a long-term goal stated by the Board in Statement 133. Rather, he believes users of financial statements would be better served by accelerating efforts to issue a Statement requiring all financial instruments to be measured at fair value each reporting period with changes in those fair values reported in earnings.

Mr. Young dissents from the issuance of this Statement because it will not improve financial reporting for the following reasons:

1. The provision of an option for fair value is likely to delay the adoption of consistent use of fair value measurement for financial instruments.
2. This Statement introduces a fragmented approach to reporting financial instruments at fair value instead of a conceptually coherent framework. It permits the continued use of non-fair-value measurement of financial instruments that will result in financial statements that are not representationally faithful. It also impairs consistency and comparability, which will reduce understandability of financial statements and increase complexity for users.
3. The application of the fair value option to financial liabilities that are part of an entity’s capital structure, without any qualifying criteria (such as correcting an existing measurement mismatch), can result in misleading financial reporting.
4. While the preparers of financial statements will realize benefits in reduced volatility of reported earnings or reduction in the cost to achieve reduced

volatility, those benefits are not justified by the cost that users will incur from increases in complexity and reduction in understandability.

This Statement does not meet the objective of financial reporting; it reduces understandability and increases costs for users. It provides benefits to preparers in managing volatility in earnings, which is not an objective of financial reporting.

Mr. Young believes the fair value option will further delay a comprehensive fair value measurement requirement for financial instruments. He believes the assumption in paragraph A3(d) cannot be supported by past experience or empirical evidence. He believes the more likely outcome of this Statement is a very limited expansion in the use of fair value for financial instruments and a delay in the broader requirement for fair value for financial instruments.

With more than a decade of preparers' meeting the requirement for disclosure of fair values for financial instruments (Statement 107) and electing the option of trading classification for marketable securities (Statement 115), it is unlikely that any significant incremental preparer experience using fair value will be gained from this Statement that will facilitate adoption of a fair value requirement for financial instruments.

With the fair value option, a preparer can manage volatility that would otherwise exist from the mixed-attribute accounting model. With this benefit secured, there will only be greater resistance from the preparer community to wider adoption of a fair value measurement for financial instruments. Without a fair value option, the preparer community would be more supportive of a fair value measurement requirement for financial instruments. Therefore, the introduction of elective fair value can only result in further delay and resistance to the requirement for fair value measurement of financial instruments.

Mr. Young disagrees with the Board's decision to permit free choice between different initial and subsequent measurement attributes for financial instruments. Mr. Young agrees with the Board's acknowledgment, in the discussion relating the conclusions in this Statement to the conceptual framework, that the Board's decision impairs comparability and consistency, two desirable qualitative characteristics of financial information in its conceptual framework. Mr. Young believes that the disclosures required by this Statement, taken together with disclosure requirements in other GAAP, are not a substitute for consistent and comparable measurement of similar items.

Reporting financial instruments at fair value and including unrealized changes in fair value in earnings would reflect the economic events in the periods in which they occur and faithfully represent the underlying economics—a key objective of the conceptual framework. Providing an "option" to continue the use of historical-cost-based measurement will lead to accounting that potentially misrepresents the underlying economics.

Mr. Young believes that most users do not expect revaluation of the entity's securities (which are part of an entity's overall capital structure) to be a component of operating performance. In his view, the changes in the entity's overall capital structure (both debt capital and equity capital), particularly from the effect of changes in the entity's own creditworthiness, should not be reflected in business performance. Recognizing changes in an entity's own creditworthiness in earnings could mislead users and potentially misrepresent or conceal operating performance issues. At a minimum, eligibility criteria should be required when the fair value option is elected for the debt portion of an entity's capital structure.

Mr. Young disagrees that the fair value option reduces complexity and costs as discussed in paragraph A3(b). Instead, he believes complexity and cost are shifted from the preparer to the user. He believes the user will be required to expend more cost and effort to compare financial statements prepared using the fair value option with financial statements prepared using a different measurement basis. It is not clear that the same level of user understanding can be achieved at any cost.

With regard to the cost-benefit criterion of the Board's conceptual framework, Mr. Young notes that the incremental burden that would be imposed on preparers by a requirement to measure all financial instruments that are within the scope of this Statement at fair value would not be large, given the requirements of existing accounting guidance. Statement 107 already requires certain fair value measurements of financial instruments for disclosure purposes. Therefore, the ability to measure many financial instruments at fair value should already be in place. Mr. Young believes a far greater benefit to financial reporting at a much lower cost to users and preparers would result from a requirement to measure financial instruments, as defined in the scope of this Statement or the scope of Statement 107 or Statement 115, at fair value.

Members of the Financial Accounting Standards Board:

Robert H. Herz, *Chairman*
George J. Batavick
G. Michael Crooch
Thomas J. Linsmeier
Leslie F. Seidman
Edward W. Trott
Donald M. Young

Appendix A

BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

CONTENTS

	Paragraph Numbers
Introduction	A1
Background Information.....	A2
Basis for Conclusions	A3–A54
Reasons for Permitting a Fair Value Option	A3
Scope.....	A4–A11
Election of the Fair Value Option.....	A12–A22
Qualifying Criteria	A20–A21
Documentation Requirements.....	A22
Use of Non-Fair-Value Measures.....	A23–A27
Financial Statement Presentation and Disclosures	A28–A41
Cash Flow Reporting	A42–A43
Amendments Related to the Fair Value Election.....	A44
Effective Date and Transition	A45–A50
Similarities and Differences with International Accounting	
Standards	A51–A52
Benefits and Costs.....	A53–A54

Appendix A

BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

Introduction

A1. This appendix summarizes considerations that Board members deemed significant in reaching the conclusions in this Statement. It includes reasons for accepting certain views and rejecting others. Individual Board members gave greater weight to some factors than to others.

Background Information

A2. In Statements 155 and 156 and FSP FTB 85-4-1, the Board decided to permit entities to elect fair value as the subsequent measurement attribute with changes in fair value included in earnings for certain hybrid instruments, servicing rights, and life settlement contracts, respectively. The Board received requests from constituents to explore creating a more broadly applicable fair value option. In May 2004, knowing that the IASB had incorporated a fair value option in IAS 39, *Financial Instruments: Recognition and Measurement*, the Board added a project to its agenda to consider whether entities should be permitted a one-time election, at the initial recognition of an item, to report financial instruments, and perhaps certain nonfinancial instruments that are similar to financial instruments, at fair value with the changes in fair value included in earnings. Work on this project was initially deferred until the IASB concluded its reconsideration of possible modifications to the fair value option in IAS 39. In June 2005, the IASB issued *The Fair Value Option*, an amendment to IAS 39. In January 2006, the Board issued an Exposure Draft, *The Fair Value Option for Financial Assets and Financial Liabilities*, for a 75-day comment period. Approximately 80 organizations and individuals responded to the Exposure Draft.

Basis for Conclusions

Reasons for Permitting a Fair Value Option

A3. The Board decided to permit entities to elect a fair value option for financial assets and financial liabilities for the following reasons:

- a. A fair value option would enable entities to mitigate the volatility in earnings that results from using different measurement attributes in reporting related financial assets and financial liabilities. The effect on earnings from using mixed

measurement attributes under GAAP in the United States may not be representative of the economics of the reporting entity's activities. Although special hedge accounting under Statement 133 compensates in part for the mismatch of measurement attributes, only certain hedging relationships can qualify for hedge accounting and only derivatives can be used as the hedging instrument under Statement 133.

- b. A fair value option would enable entities to achieve consistent accounting and, potentially, an offsetting effect for the changes in the fair values of related assets and liabilities without having to apply complex hedge accounting provisions, thereby providing greater simplicity in the application of accounting guidance. A fair value option would enable entities to avoid the time, effort, and systems needed to document fair value hedging relationships and demonstrate their effectiveness to qualify for continued hedge accounting. That is, rather than designating a fair value hedging relationship under Statement 133, entities could elect to apply the fair value option to the hedged item at its inception. However, the offset resulting from the application of the fair value option is based on the fair value of the entire financial asset or liability and not selected risks inherent in those financial assets or financial liabilities.
- c. A fair value option would achieve further convergence with the IASB, which has incorporated a fair value option for financial instruments in IAS 39.
- d. A fair value option would expand the use of the fair value measurement attribute for financial instruments. The Board believes fair values for financial assets and financial liabilities provide more relevant and understandable information than cost or cost-based measures. The Board considers fair value measurements of financial instruments to be more relevant to financial statement users than cost-based measurements because fair value reflects the current cash equivalent of the entity's financial instruments rather than the price of a past transaction. The Board also believes that, with the passage of time, historical prices become irrelevant in assessing an entity's current financial position.

Some respondents to the Exposure Draft, primarily users of financial statements, objected to the elective nature of this Statement and urged the Board to require, rather than permit, fair value accounting for all financial instruments. The Board continues to believe that fair value is the most relevant measurement attribute for financial instruments. However, the Board concluded that it has more work to do before fair value measurement can be required for all financial instruments. There are several unresolved issues, including how to measure fair value (which has been addressed through the issuance of Statement 157), what is included in the scope, how to present changes in fair value, whether to continue to permit hedge accounting for forecasted transactions, whether additional disclosures should be required, and the relationship with the existing Statement on transfers and extinguishments of financial instruments.

Those issues are being addressed as part of the Board's research project on financial instruments, which is being conducted jointly with the IASB. The Board views the fair value option as an interim step that can mitigate existing reporting issues and expand the use of fair value measurements for financial instruments.

Scope

A4. In undertaking the fair value option project, the Board initially planned to address not only financial assets and financial liabilities but also certain nonfinancial assets and nonfinancial liabilities that are similar to financial items. However, the Board decided that additional input was needed from constituents about the use of fair value in accounting for nonfinancial assets and nonfinancial liabilities. The Board decided to split the project into two phases and use the notice for recipients in the Exposure Draft for Phase 1 to solicit information about the potential application of the fair value option to nonfinancial assets and nonfinancial liabilities. Consequently, Phase 1 addresses the fair value option for certain financial assets and financial liabilities, and Phase 2 will consider permitting the fair value option to be elected for certain nonfinancial assets, nonfinancial liabilities, and some of the financial assets and financial liabilities excluded from the scope of Phase 1.

A5. Some respondents questioned whether insurance contracts are financial instruments. Some insurance contracts require the payment of cash to settle a claim (and thus are financial instruments in the scope of this Statement), whereas others may permit settlement of a claim by either a cash payment or the provision of goods or services (by the insurance company or by a third party that is compensated by the insurance company), in which case the insurance contract would not meet the definition of a financial instrument. Some respondents noted that scrutinizing individual contracts to determine whether they are financial instruments would be quite burdensome, as would be the case in determining whether warranty rights and obligations meet the definition of a financial instrument. The Board decided to expand the scope of this Statement slightly by including insurance and reinsurance contracts as well as warranty rights and obligations that permit or require settlement of a claim by providing goods or services if settlement of the related obligation is permitted by payment to a third-party provider of goods or services rather than only by the insurer's or warrantor's providing goods or services directly to the insured or other claimant.

A6. The Board also considered the case of a hybrid nonfinancial instrument for which bifurcation of an embedded derivative would be required by paragraph 12 of Statement 133. If that bifurcation results in the nonfinancial features of the hybrid instrument being included entirely in the embedded derivative, the resulting host contract would be a financial instrument that would be accounted for separately. The Board decided that

in that case, the host financial instrument would be eligible for election of the fair value option subject to the scope exceptions in paragraph 8 of this Statement.

A7. The Board discussed whether the fair value option should be permitted for financial assets and financial liabilities that would otherwise not be recognized at inception under existing GAAP. The Board determined that under Phase 1 of the project, the fair value option should be permitted at inception for unrecognized firm commitments that involve only financial instruments. This Statement uses the definition of *firm commitment* as set forth in Statement 133, which requires that the terms of the agreement include a disincentive for nonperformance that is sufficiently large to make performance probable. The Board notes that Statement 133 Implementation Issue No. F3, “Firm Commitments—Statutory Remedies for Default Constituting a Disincentive for Nonperformance,” clarifies that the binding provisions of a firm commitment are regarded to include those legal rights and obligations codified in the laws to which such an agreement is subject.

A8. The Board considered whether the fair value option should not be permitted for certain financial assets and financial liabilities. The Board’s discussions focused on items that have historically been excluded from pronouncements that address financial instruments broadly, particularly the scope exceptions in Statement 107. The Board supported a broad application of the fair value option and decided to keep scope exceptions to a minimum. The Board decided to exclude from the scope of this Statement the following financial assets and financial liabilities for the reasons indicated:

- a. An interest in an entity (principally an investment in a subsidiary or a primary beneficiary’s variable interest in a variable interest entity) that would otherwise be consolidated. The Board believes the fair value option project should not be used to make significant changes to consolidation practices.
- b. Employers’ and plans’ financial obligations (or assets representing net overfunded positions) for pension benefits, other postretirement benefits (including health care and life insurance benefits), postemployment benefits, employee stock option and stock purchase plans, and other forms of deferred compensation arrangements as defined in Statements 35, 87, 106, 112, 123(R), 43, 146, and 158 and Opinion 12. The Board believes that any modifications should be part of a reconsideration of those individual areas. (The Board revised this scope exception to clarify that the fair value option is not available for the asset or liability that represents the net overfunded or underfunded status of a benefit plan.)
- c. Financial assets and financial liabilities recognized under lease contracts as defined in Statement 13. (This exclusion does not include a contingent obligation arising out of a cancelled lease and a guarantee of a third-party lease obligation.) The

Board believes that lease accounting provisions should not be changed by the fair value option project without a comprehensive reconsideration of the accounting for lease contracts.

- d. Deposit liabilities, withdrawable on demand, of banks, savings and loan associations, credit unions, and other similar depository institutions. The Board will include those liabilities in the deliberations of Phase 2 because the fair value of those liabilities are often significantly affected by nonfinancial components.
- e. Financial instruments that are, in whole or in part, classified by the issuer as components of shareholder's equity (including "temporary equity"). The changes in the fair value of any contract that, for whatever reason, is reported in shareholders' equity, in whole or in part, should not affect earnings. The current standard for convertible debt with noncontingent beneficial conversion features requires separate recognition as part of additional paid-in capital (in the shareholders' equity section of the statement of financial position) of the intrinsic value of the embedded beneficial conversion features.

A9. The scope of the Exposure Draft excluded written loan commitments that are not accounted for as derivatives under Statement 133. Consideration of those loan commitments had been deferred to Phase 2 of the fair value option project. Many respondents disagreed with that scope exception, noting that there is no substantive difference between those loan commitments currently in the scope of Statement 133 and those excluded from Statement 133's fair value accounting requirement. The Board agreed with those observations and decided that written loan commitments that are not accounted for as derivatives under Statement 133 should be included within the scope of Phase 1 and removed the scope exception.

A10. The Board also affirmed that the election of the fair value option is not permitted for current or deferred income tax assets or liabilities because those assets and liabilities are not contractual. Thus, they are not financial assets or financial liabilities.

A11. The Board discussed whether the fair value option election should be prohibited for nonpublic entities that have elected the exception under FASB Statement No. 126, *Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities*, from having to disclose fair values under Statement 107. The Board noted a significant difference between a nonpublic company's election not to be subject to Statement 107, which requires fair value disclosures of **all** of an entity's financial assets and liabilities (if practicable), and a nonpublic company's desire to elect the fair value option for selected financial assets and financial liabilities. Because the fair value option may be applied on an instrument-by-instrument basis, the Board believes that the fair value option should be available to nonpublic entities that have elected the Statement 126 exception.

Election of the Fair Value Option

A12. The Exposure Draft indicated that the election of the fair value option should be made at initial recognition of the financial asset or financial liability or upon a remeasurement event that gives rise to new-basis accounting at fair value for that item. The Board noted that an election after initial recognition would permit entities to recognize gains or losses in earnings after those gains and losses had occurred and, consequently, is not permitted.

A13. A few respondents to the Exposure Draft requested that the Board modify that provision to permit the fair value option election when (a) the legal form and substance of the item changes or (b) a change in risk management strategy occurs. However, those respondents did not provide the Board with any information that had not been considered in the Board's deliberations prior to the Exposure Draft; therefore, the Board did not add those two suggested events as circumstances that would permit a new choice about whether to elect the fair value option.

A14. The Board also discussed whether an entity may elect the fair value option for financial assets that have been reported at fair value (with changes included in earnings) under specialized accounting principles but, at a point in time, become no longer subject to that required reporting because they no longer qualify for those specialized accounting principles. The Board decided that, consistent with the reasons in paragraph A3, the consolidated reporting entity should be able to continue its reporting at fair value (with changes included in earnings). Consequently, the Board decided that an entity may elect the fair value option in that circumstance even though the election would not be made at the date of initial recognition.

A15. When a contract is modified (or a rider added to it) after it has been initially recognized, the question arises as to whether that modification would permit election of the fair value option for the related asset or liability. The Board decided that the availability of the fair value option should be based on whether, under GAAP, the modification is accounted for as the continuation of the original contract or as the termination of the original contract and the origination of a new contract. If the modification is considered the origination of a new contract, the fair value option could be elected on the date of its initial recognition. Otherwise, the entity's previous decision about electing the fair value option for the original contract would govern the accounting for the continuation of that original contract.

A16. The Board also decided that an entity may elect the fair value option at the time that an entity becomes subject to the equity method of accounting, even though that point in time is not necessarily the date of initial recognition of the investment in the investee.

A17. A respondent requested that the Board clarify whether the fair value option should be elected at the trade date or the settlement date of an asset or liability. The Board considered that request and noted that an entity would elect the fair value option at the time of initial recognition, which could occur at the trade date or the settlement date depending on relevant GAAP. For example, if an entity was required to initially recognize a contract on the trade date, the fair value option would also need to be elected on the trade date and not the settlement date.

A18. The Exposure Draft permitted the election of the fair value option on a contract-by-contract (that is, instrument-by-instrument) basis. Some respondents supported a contract-by-contract election, noting that entities could better align their accounting practices with their risk management activities. They noted that this accounting symmetry would allow preparers to mitigate some of the earnings volatility associated with a mixed-attribute model. Many respondents expressed concerns about permitting a contract-by-contract election. One concern was that having the contract as the unit of account would unduly constrain the determination of fair value. (Statement 157, which was issued after the Exposure Draft, provides guidance on determining fair value; under that Statement, the unit of valuation need not be the unit of account.) Another concern was that such an election approach would allow for abuse in applying the rules in order to obtain a desired outcome. Moreover, that technique could exacerbate noncomparability in reporting between similar entities. Some respondents suggested either an entity-wide election for all financial assets and financial liabilities or an option to measure all or none of a category or type of asset or liability at fair value (an election by type).

A19. The Board believes that the election of the fair value option on an instrument-by-instrument basis is more consistent with the reasons in paragraph A3 for permitting a fair value option than either an entity-wide election or an election by type. Because entities typically use their hedging activities to mitigate a portion of their risks rather than eliminate all their risks, an instrument-by-instrument election is consistent with this Statement's objective to achieve an offsetting accounting effect for the changes in the fair values of related financial assets and financial liabilities without having to apply complex hedge accounting provisions of Statement 133. An instrument-by-instrument election also accomplishes further convergence with the IASB's fair value option for financial instruments in IAS 39. To provide entities with greater flexibility in obtaining benefits from the fair value option, the Board decided to permit election on an

instrument-by-instrument basis. To minimize the potential for abuse, the Board decided that once an entity elects the fair value option for an asset or liability, it could not subsequently discontinue the use of the fair value measurement treatment for reporting that asset or liability.

Qualifying Criteria

A20. To provide entities with greater flexibility in obtaining the benefits of the fair value option, the Board decided not to impose any eligibility requirements in the Exposure Draft. Respondents generally agreed with that decision. However, several respondents recommended that the Board incorporate eligibility requirements that are the same or similar to the eligibility requirements in IAS 39. They asserted that the suggested modification would provide further convergence with international standards and result in more relevant information.

A21. The Board concluded that the absence of those eligibility requirements would not lead to substantive divergence with international standards. Furthermore, the Board concluded that including eligibility requirements for the fair value option would conflict with the objectives of this Statement. That is, it would reduce the use of the fair value measurement attribute for financial instruments, increase complexity, and hinder entities' ability to mitigate accounting mismatches through the use of a flexible and easy-to-implement fair value option. However, the Board was mindful of those respondents' concerns as it reconsidered the disclosure requirements.

Documentation Requirements

A22. Respondents to the Exposure Draft stated that documentation of the fair value option was an internal control matter and did not require accounting guidance from the Board. Those respondents also stated that the Board's documentation requirements set forth in the Exposure Draft were overly burdensome and detracted from the benefits of the fair value option election, mainly, its simplicity. In its redeliberations, the Board decided that it is sufficient for this Statement to indicate the timing of requirements for making the election and provide an acknowledgment that an entity could establish a policy to elect the fair value option for specified classes of assets or liabilities. The Board agreed that maintaining evidence of compliance with the requirements of this Statement is a matter of internal control and decided not to prescribe how that evidence should be created and maintained.

Use of Non-Fair-Value Measures

A23. In its initial deliberations, the Board discussed whether entities should be permitted to elect (outside of the hedge accounting provided in Statement 133) to recognize in earnings the change in an asset's or liability's fair value attributable to only certain selected risks (rather than the total change in fair value). The Board rejected recognizing the fair value changes that are attributable to only selected risks because that would be inconsistent with expanding the use of the fair value measurement attribute and international convergence. Moreover, the resulting measurement would not represent the fair value of the asset or liability as a whole.

A24. The Board also considered whether to curtail the debtor's recognizing in earnings the effect of changes in its creditworthiness in reporting liabilities at fair value when the fair value option has been elected. For example, the debtor might exclude the effects of the change in its creditworthiness from the liability's carrying amount, resulting in a non-fair-value measure. The Board agreed that liability remeasurements at fair value should include the effect of changes in creditworthiness so that the estimate reflects the amount that would be observed in an exchange between willing parties of the same credit quality. The Exposure Draft provided no special treatment for the effect of changes in the debtor's creditworthiness in reporting the debtor's liabilities when the fair value option is elected.

A25. Some respondents disagreed with reporting the effect of changes in the issuer's own creditworthiness as gains and losses in the issuer's financial statements. Some respondents suggested the change in fair value should be split: the change in fair value attributable to changes in the debtor's creditworthiness should be reported in other comprehensive income (until realized) and the remaining change in fair value should be reported in earnings. Under that suggestion, the assets or liabilities would still be reported at fair value. Other respondents objected to including the change in fair value attributable to changes in the debtor's creditworthiness in other comprehensive income, which they stated would misstate shareholders' equity. Under that suggestion, liabilities would be reported at a non-fair-value measure. The Board concluded that there is no justification, conceptual or otherwise, for curtailing the debtor's recognizing in earnings the effect of changes in its creditworthiness in reporting liabilities at fair value. However, the Board decided to require additional disclosures that would help users of financial statements understand the related reporting. The Board decided to focus on the effect of changes in instrument-specific credit risk on fair value, rather than on the effect of changes in the debtor's creditworthiness. If, in any period presented, changes in instrument-specific credit risk cause significant changes in the fair values of financial liabilities for which the fair value option has been elected, the entity must disclose its estimate of the portion of the change in fair value of those liabilities that is due to

changes in instrument-specific credit risk. The entity also must disclose qualitative information about the reasons for those changes (which are included in current-period earnings), as discussed in paragraph A36.

A26. Some respondents to the Exposure Draft suggested that to meet some of the Board's stated objectives for this Statement, the fair value option should be permitted for a portion of an asset or liability. Those respondents stated that electing the fair value option for a portion of an asset or liability would enable them to (a) mitigate volatility in reported earnings that is caused by an accounting model that uses multiple measurement attributes and (b) achieve an offset accounting effect for the changes in the fair values of related financial assets and financial liabilities without having to apply complex hedge accounting provisions.

A27. As discussed above, the Board rejected recognizing fair value changes that are attributable to only selected risks and fair value changes that exclude the effects of an entity's own creditworthiness. The Board views permitting a fair value option election for only a portion of an asset or a liability as similar to those other issues. The Board believes that a fair value election for only a portion of an asset or a liability would not meet its objectives of expanding the use of fair value measurement for financial instruments and international convergence. Therefore, the Board rejected respondents' requests to permit election of the fair value option for only a portion of an asset or a liability.

Financial Statement Presentation and Disclosures

A28. The Board observed that several accounting pronouncements permit an entity to elect to measure certain items at fair value. The Board determined that an entity that elects the fair value option under Statement 155's amendment of paragraph 16 of Statement 133 should provide the disclosures required by this Statement for those elections. The Board determined that the disclosures required by this Statement are not required to be applied to securities classified as trading securities under Statement 115, life settlement contracts that are accounted for under the fair value method under FSP FTB 85-4-1, or servicing assets or liabilities measured at fair value under Statement 156.

A29. The Board considered whether any special display guidance for the statement of financial position or income statement or additional disclosures were needed to compensate for the lack of comparability that will arise from the use of the fair value option. The Board decided that special display guidance is needed on the statement of financial position with respect to the elective use of fair values. Assets and liabilities that are subsequently measured at fair value pursuant to the election of the fair value

option under this Statement should be reported separately from the carrying amounts of assets and liabilities subsequently measured using another measurement attribute on the face of the statement of financial position. To accomplish that separate reporting, an entity may either (a) display separate line items for the fair value and non-fair-value carrying amounts or (b) present amounts that aggregate those fair value and non-fair-value amounts and disclose parenthetically the amount of fair value included in the aggregate amount for that line item.

A30. The Board considered the interaction between the fair value option project and its project on financial statement presentation and decided not to specify how an entity should report in its income statement the changes in the fair values of assets and liabilities subsequently measured at fair value as a result of electing the fair value option. The Board determined that an entity should disclose, by line item in the statement of financial position, the amounts of gains and losses included in earnings during each period and in which line item in the income statement those gains and losses are reported. The Board determined that the above disclosure is required for items for which the fair value option has been elected but emphasized that this Statement does not preclude an entity from satisfying that requirement by disclosing amounts of gains and losses that include gains and losses for other items measured at fair value, such as items that are required to be measured at fair value under GAAP. The Board believes that presenting such disclosures using a tabular format will be more easily understood. The Board, however, did not require tabular presentation.

A31. The Board observed that several accounting pronouncements require disclosures about fair value measurements for financial instruments. The Board encourages entities to combine the fair value information disclosed under this Statement with the fair value information disclosed under other pronouncements, where meaningful. The Board concluded that having those disclosures in one place would enhance users' understanding about fair value and the use of fair value in financial reporting, although the Board did not mandate that presentation.

A32. The Board deliberated whether a reporting entity should disclose quantitative information about the extent to which (a) fair value is used to subsequently measure assets and liabilities, (b) the fair value option has or has not been elected, and (c) items were or were not eligible for the fair value option. The Board determined that this Statement's requirement to separately display elective fair value amounts in the statement of financial position and Statement 157's requirement to disclose fair value measurements by level within the fair value hierarchy would provide meaningful information to users. The Board also determined that if a line item in the statement of financial position includes an item or items for which the fair value option has been elected and includes an item or items that were not eligible for the fair value option at

initial recognition or upon the occurrence of an election event specified in paragraphs 9(d) and 9(e), an entity must disclose the carrying amount of those ineligible items as of the reporting date. The Board noted that Statement 157's fair value hierarchy disclosures must be presented by major category of assets and liabilities. The Board determined that for each line item in the statement of financial position that includes an item or items for which the fair value option has been elected, an entity must disclose information to enable users to relate the line item in the statement of financial position to the major categories of assets and liabilities presented in accordance with Statement 157's fair value disclosure requirements. The Board considered fair value disclosures required by Statement 107 and noted that Statement 107 already requires an entity to relate amounts disclosed pursuant to that Statement's disclosure requirements to what is reported in the statement of financial position.

A33. Users of financial statements requested additional information about management's reasons for electing the fair value option and, for instances in which an entity elects the fair value option for only certain instruments within a group of similar instruments, disclosure of management's reasons for only partial election. The Board agreed but decided not to provide guidance on how to define groups of similar instruments. Rather, the Board decided that an entity should provide information to enable users to relate groups of similar items to specific line items in the statement of financial position.

A34. The Exposure Draft required disclosure of (a) information sufficient to allow users of financial statements to understand the effect on earnings of changes in the fair values of assets and liabilities subsequently measured at fair value as a result of a fair value election and (b) quantitative information by line item indicating where in the income statement gains and losses are reported that arise from changes in the fair value of financial assets and financial liabilities for which the fair value option has been elected. Some respondents urged the Board to require entities to disclose the cumulative effect on assets and liabilities of electing the fair value option. Users requested additional information about changes in fair values during the period to enhance their ability to assess the quality of an entity's earnings. Users also requested additional information about an entity's methods and significant assumptions used to estimate fair value. Some respondents questioned whether separate disclosure of unrealized gains or losses was required.

A35. The Board determined that preparers should not be required to maintain two sets of accounting records, one reflecting fair value measurements and one without the effects of the fair value election. The Board considered the disclosure requirements of Statement 157, noting that for assets and liabilities that are measured at fair value on

a recurring basis using significant unobservable inputs (Level 3 measurements), an entity is required by Statement 157 to (a) separately present changes during the period attributable to total gains or losses included in earnings and describe where those gains and losses are reported in the income statement, (b) disclose the valuation techniques used to measure fair value, and (c) disclose information about unrealized gains and losses relating to the assets and liabilities that are still held at the end of a reporting period. The Board believes that those disclosures will provide meaningful information to users. As stated in paragraph A30, the Board determined during its redeliberations that an entity should disclose, by line item in the statement of financial position, the amounts of gains and losses from fair value changes included in earnings during each period and in which line item in the income statement those gains and losses are reported. The Board specified that that requirement applies to fair value changes for all items for which the fair value option has been elected, regardless of the level within the fair value hierarchy. The Board believes that the additional disaggregation of information about changes in fair value during the period will enhance a user's ability to assess the quality of an entity's earnings. The Board determined that the general requirement in the Exposure Draft to provide sufficient information to allow users to understand how changes in fair values of assets and liabilities affect earnings for the period was unnecessary because the disclosure requirements in Statement 157 and this Statement produce that information.

A36. Respondents noted that an entity's deteriorating creditworthiness may reduce the fair value of the entity's debt and increase its earnings, and they questioned the relevance of the reduced value of the debt if it is not realizable due to the entity's liquidity constraints. For long-term debt instruments that have contractual principal amounts and for which the fair value option has been elected, the Board decided to require disclosure of the difference between the aggregate fair value carrying amount and the aggregate unpaid principal amount the entity would be contractually required to pay to the holders of those obligations. This disclosure is similar to one required by the IASB and will give users of financial statements relevant information about the relationship between current value and the related required cash payments. In addition, for liabilities for which the fair value option has been elected and whose fair values have been significantly affected during the reporting period by changes in instrument-specific credit risk, the Board determined that an entity should disclose, by line item in the statement of financial position, the estimated amount of gains and losses included in earnings that are attributable to changes in the instrument-specific credit risk. The Board also decided that qualitative information about the reasons for those changes must be disclosed. The Board decided not to provide (a) guidance about when a change in instrument-specific credit risk is considered significant or (b) detailed computational guidance about how to determine the approximation of the amount of the liabilities' fair value change attributable to the change in instrument-specific credit risk. Rather, the

Board decided to require that an entity disclose how it determines gains and losses attributable to instrument-specific credit risk.

A37. Respondents suggested that disclosure requirements about assets for which the fair value option has been elected should be similar to the disclosure requirements for liabilities for which the fair value option has been elected. The Board determined that for any loans and long-term receivables (other than securities subject to Statement 115) that have contractual principal amounts and for which the fair value option has been elected, an entity must disclose the difference between the aggregate fair value carrying amount and the aggregate unpaid principal amount the entity would be contractually entitled to receive from the issuers of the obligations.

A38. Some respondents to the Exposure Draft requested that disclosures about loans measured at fair value due to election of the fair value option provide the same information as if those loans were measured using an amortized cost method with a corresponding allowance for loan losses. The Board noted that existing accounting guidance about loan charge-offs and the allowance for loan losses is not applicable to loans measured at fair value. The Board reviewed those existing disclosure requirements and determined that the following disclosures about loans measured at fair value due to election of the fair value option would provide useful information to financial statement users: (a) the aggregate fair value of loans that are 90 days or more past due, (b) the aggregate fair value of loans that are in nonaccrual status when the entity's policy is to recognize interest income separately from other changes in fair value, and (c) for loans that are 90 days or more past due, in nonaccrual status, or both, the difference between the aggregate fair value and the aggregate unpaid principal amount the entity would be contractually entitled to receive from the issuers of those obligations through maturity. In addition, for loans and other receivables measured at fair value due to the election of the fair value option, the Board determined that an entity should disclose separately the estimated amount of change in fair value of those assets attributable to changes in instrument-specific credit risk from all other changes in fair value for those assets. The Board decided not to provide guidance on how to determine the approximation of the amount of fair value change attributable to the change in borrower-specific credit risk. Rather, the Board decided to require that an entity disclose how it determines gains and losses attributable to instrument-specific credit risk. The Board considered whether disclosures about loans for which the fair value option has been elected should be provided in a disaggregated manner, such as by major loan type or geographical characteristics. The Board noted that the issue of disaggregating loan disclosure information is not new and should not be addressed in this project.

A39. The Board reviewed the existing disclosure requirements in paragraph 20 of Opinion 18 that apply to equity method investments and decided to continue to require most of those disclosures for investments that would have been accounted for under the equity method if the entity had chosen not to elect the fair value option. The Board decided that the disclosure requirements in paragraphs 20(a)(3), 20(b), and 20(e) of that Opinion should not be required for investments measured at fair value that would otherwise be accounted for under the equity method. The information required by those paragraphs was not necessary for investments reported at fair value.

A40. The Board decided that if an entity elects the fair value option when one of the events described in paragraphs 9(d) and 9(e) occurs, the entity should provide (a) qualitative information about the nature of the event and (b) quantitative information by line item in the statement of financial position about which line items in the income statement include the effect on earnings of initially electing the fair value option for an item.

A41. The Board considered whether to provide guidance on how reported interest should be determined for receivables and payables reported at fair value pursuant to the fair value option. The Board noted that the issue of determining interest when financial assets and financial liabilities are measured at fair value is not new and would best be resolved in a different project. During its redeliberations, the Board affirmed that the fair value option project does not address methods for recognizing and measuring the amount of interest and dividend income and that an entity should provide a description indicating how interest and dividends are measured and reported in the income statement. However, the Board clarified that origination fees and costs related to items for which the fair value option is elected should be expensed as incurred. No amendment to FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, is required because that Statement does not apply to loans measured at fair value with changes reported in earnings.

Cash Flow Reporting

A42. The Board considered whether the cash receipts and cash payments related to financial assets and financial liabilities for which the fair value option has been elected should be classified as operating activities in the statement of cash flows, since that classification is required for trading securities under Statement 115. The Board decided that the required classification as operating activities for trading securities is inappropriate because Statement 115 permits securities to be classified as trading even though they are not being held for sale in the near term. The Board concluded that the cash receipts and cash payments related to trading securities as well as to financial assets and

financial liabilities for which the fair value option has been elected should be classified pursuant to Statement 95 (as amended) based on the nature and purpose for which the related financial assets and financial liabilities were acquired or incurred. The Board decided that Statements 95 and 115 as well as FASB Statement No. 102, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale*, should be amended to reflect those conclusions.

A43. The Board considered amending Statement 95 to require a reconciling line item for changes in fair value when the indirect method is followed in presenting the statement of cash flows, but it decided that amendment would not be necessary because paragraph 29 of Statement 95 requires separate line items for major reconciling items.

Amendments Related to the Fair Value Election

A44. In addition to the amendments to Statements 95, 102, and 115 about the classification of the cash receipts and cash payments related to trading securities discussed in paragraph A42, the Board considered whether other amendments were warranted. The Board decided that the special display requirements for the statement of financial position with respect to the elective use of fair values should apply to the use of the trading category under Statement 115. As a result, two further amendments to Statement 115 are warranted:

- a. To require entities to either display separate line items in an entity's statement of financial position for the fair value and non-fair-value carrying amounts for investments in debt and equity securities or present amounts that aggregate those fair value and non-fair-value amounts provided that the amount of fair value for available-for-sale and trading securities included in the aggregate amount for that line item is separately disclosed parenthetically on the face of the entity's statement of financial position
- b. To revise the phrasing of paragraph 4 about scope to reflect the availability of the fair value option for investments in equity securities that would otherwise be accounted for under the equity method.

A similar amendment of the definition of *related parties* in FASB Statement No. 57, *Related Party Disclosures*, is also warranted. Those modifications of Statement 57 and paragraph 4 of Statement 115 do not change the original definition of *related parties* or the original scope of Statement 115. The Board also decided that a further amendment of Statement 133 is warranted to clarify that a nonderivative financial instrument (such as a foreign-currency-denominated liability) that is reported at fair value cannot be designated as hedging the foreign currency exposure of a net investment in a foreign operation. A foreign-currency-denominated financial asset or liability that is reported at

fair value does not give rise to any foreign currency transaction gain or loss, as that term is used in FASB Statement No. 52, *Foreign Currency Translation*. That clarification of Statement 133 is warranted because the measurement of liabilities at fair value is newly available on a broad basis under this Statement. The definitions of *financial asset* and *financial liability* in this Statement reflect minor clarifying changes to the definitions of those terms in FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, and Statement 141. The Board decided that a formal amendment of Statements 140 and 141 is not necessary because the changes are only editorial.

Effective Date and Transition

A45. The Board initially decided that this Statement should be effective as of the beginning of each reporting entity's first fiscal year that begins after December 15, 2006, with earlier adoption permitted as of the beginning of an entity's earlier fiscal year that begins after issuance of this Statement (thereby resulting in an earlier effective date). Many respondents asked for a delay in the effective date to allow more time to review existing positions and risk management strategies. Some respondents recommended that the Board delay the effective date to be either concurrent with or later than the effective date for Statement 157. The Board decided that this Statement should be effective as of the beginning of each reporting entity's first fiscal year that begins after November 15, 2007, the same effective date as Statement 157.

A46. The Exposure Draft permitted an entity to elect the fair value option for existing financial assets and financial liabilities that are within the scope of this Statement, rather than limit its application to only newly recognized financial assets and financial liabilities. The Board had decided that retrospective application of this Statement to fiscal years preceding the effective date, which would involve restatement of previously issued financial statements, should not be permitted because of the elective nature of this Statement and the benefit of hindsight. Therefore, the effect of the initial adoption of this Statement attributable to the election of the fair value option for selected financial assets and financial liabilities existing at the effective date should be accounted for as a cumulative-effect adjustment of retained earnings as of the effective date, not the beginning of the earliest year presented. Respondents were supportive of those provisions and no changes have been made for that reporting.

A47. Respondents that requested a delay in the effective date also generally favored permitting early adoption of this Statement. Some entities particularly wanted to be able to adopt it at the beginning of fiscal year 2007. To facilitate early adoption as of the beginning of fiscal years beginning after November 15, 2007, the Board decided to change the provision in the Exposure Draft that limited early adoption to the beginning

of an entity's earlier fiscal year that begins after issuance of this Statement. The Board decided that an entity may make the decision to adopt this Statement early (which would necessarily include the decision whether to elect the fair value option for each of its existing eligible assets and liabilities) within 120 days of the beginning of the reporting entity's fiscal year, thereby making that election retroactive to the beginning of the fiscal year (or to the date of initial recognition, if later for certain assets and liabilities). Although the Board prefers not to permit entities to make retroactive elections that can have a significant retroactive effect on earnings of the current year in which the election is made, the Board believes that the early adoption of the fair value option warrants permitting retroactive elections within the first 120 days of the fiscal year. The 120-day retroactive election provision does not apply to entities that do not choose early adoption of this Statement.

A48. Though supportive of permitting such retroactive early adoption, the Board decided that two conditions were important in establishing the 120-day retroactive election provision:

- a. The entity also must adopt all of the requirements of Statement 157 concurrent with or prior to the early adoption of this Statement. The Board's willingness to permit a fair value option under this Statement was implicitly premised on the improved guidance being developed for determining fair value measurements. Now that the guidance in Statement 157 has been finalized, it must be used in applying the fair value option.
- b. At the time it decides to adopt this Statement early, the entity has not yet issued financial statements, including required notes to those financial statements, for any interim period of the fiscal year that includes the early adoption date. The Board had decided that the initial application of this Statement should not involve restatement of previously issued financial statements.

A49. To facilitate users' understanding of how the fair value option was elected at initial adoption with respect to existing assets and liabilities, the Board decided to require a detailed analysis of the cumulative-effect adjustment to the opening balance of retained earnings (or appropriate class or classes of net assets) as of the date of initial adoption, including a comparison of the previous carrying amount and the new fair value carrying amount for the affected assets and liabilities. That cumulative-effect adjustment would include removing from the statement of financial position the difference between the carrying amount and fair value of eligible items for which the fair value option is elected at the effective date. Those differences may include, but are not limited to, any unamortized deferred costs (including deferred acquisition costs for insurance contracts), fees, premiums, discounts, valuation allowances (such as an allowance for loan losses), and accrued interest related to existing assets and liabilities

for which the fair value option has been elected at the initial application of this Statement. To further facilitate users' understanding, the Board also decided to require disclosure of additional information about management's reasons for electing the fair value option, and, for instances in which an entity elects the fair value option for only certain instruments within a group of similar instruments, disclosure of management's reasons for only partial election.

A50. The Board considered whether to permit election of the fair value option for available-for-sale and held-to-maturity securities previously accounted for under Statement 115. The Board decided to permit an entity to elect the fair value option for those securities upon the initial adoption of this Statement, which has the effect of reclassifying those securities into the trading category. However, the Board decided that the amount of the effect of that reclassification into the trading category should be included in the cumulative-effect adjustment of retained earnings and that the amount of the effect of that reclassification should be separately disclosed. The effect of that reclassification into the trading category arising from the initial adoption of this Statement should not be included in current-period earnings as a transfer between categories under Statement 115.

Similarities and Differences with International Accounting Standards

A51. The IASB has included a fair value option for financial instruments in IAS 39. The provisions in IAS 39 are similar to those in this Statement insofar as the fair value options in both pronouncements require that the election:

- a. Be made at the initial recognition of the financial asset or financial liability
- b. Is irrevocable
- c. Results in the changes in fair value being recognized in earnings (referred to as "profit or loss" in IAS 39) as those changes occur.

A52. The differences between the provisions in this Statement and international standards pertain principally to disclosures, scope exceptions, and whether certain eligibility criteria must be met to elect the fair value option.

Benefits and Costs

A53. The mission of the FASB is to establish and improve standards of financial accounting and reporting to provide information that is useful to users of financial statements (present and potential investors, creditors, donors, and other capital market participants) in making rational investment, credit, and similar resource allocation decisions. In fulfilling that mission, the Board endeavors to determine that a proposed

standard will fill a significant need and that the costs imposed to meet that standard, as compared with other alternatives, are justified in relation to the overall benefits of the resulting information. Although the costs to implement a new standard may not be borne evenly, users of financial statements benefit from improvements in financial reporting, thereby facilitating the functioning of markets for capital and credit and the efficient allocation of resources in the economy.

A54. The Board's assessment of the benefits and costs of establishing a fair value option was based on discussions with preparers, auditors, regulators, and users of financial statements. The Board considered the costs associated with decreased comparability as a result of allowing a choice between fair value and the non-fair-value measurement attribute otherwise required by GAAP. The Board also considered the benefits arising from mitigating problems of volatility in reported earnings caused by an accounting model that uses multiple measurement attributes; achieving an offsetting accounting effect for the changes in the fair values of related assets and liabilities without having to apply complex hedge accounting provisions, thereby simplifying the application of accounting guidance; and expanding the use of the fair value measurement attribute for financial instruments. The Board concluded that the financial reporting benefits would outweigh the costs of noncomparability, particularly since the improved disclosures required by this Statement would enable users to compare entities that make different decisions about use of the fair value option.

Appendix B

ILLUSTRATIVE FAIR VALUE DISCLOSURES

B1. The examples below illustrate selected disclosure requirements for items reported at fair value under this Statement and include selected disclosures required by Statements 157 and 107. The examples represent suggested forms for presenting disclosure information. While the suggested forms of presentation illustrate selected required disclosures, the suggested forms of presentation are not mandated by this Statement. Aggregation of related fair value disclosures is encouraged but not required.

B2. The statement of financial position for Company XYZ as of December 31, 2008, after the adoption of this Statement, is provided to assist in understanding the illustrative fair value disclosure examples set forth below:

Company XYZ
Statement of Financial Position
(\$ in 000s)

<u>Description</u>	<u>At December 31, 2008</u>
Assets	
Cash and due from banks	\$ 38
Deposits with banks	22
Fed funds sold and securities purchased under resale agreements	134
Securities borrowed	75
Trading securities	115
Securities available-for-sale	75
Securities held-to-maturity	32
Loans and lease receivables (\$150 at fair value)	\$560
Allowance for loan and lease losses	<u>(10)</u>
Loans, net of allowance for loan and lease losses	550
Derivatives	60
Private equity investments (\$75 at fair value)	125
Premises and equipment	10
Other assets	<u>20</u>
Total assets	<u><u>\$1,256</u></u>
Liabilities	
Non-interest-bearing deposits	\$ 143
Interest-bearing deposits	412
Fed funds purchased and securities sold under repurchase agreements	130
Accounts payable	110
Short-term borrowings	128
Long-term debt (\$60 at fair value)	<u>200</u>
Total liabilities	<u>1,123</u>
Shareholders' equity	
Common stock (authorized 5,000,000 shares; issued 3,550,000 shares)	4
Capital surplus	88
Retained earnings	42
Accumulated other comprehensive income (loss)	<u>(1)</u>
Total shareholders' equity	<u>133</u>
Total liabilities and shareholders' equity	<u><u>\$1,256</u></u>

Example 1—Initial Adoption of Fair Value Option (FVO)

B3. This Statement requires that an entity provide information about the extent to which the fair value option is elected for existing eligible items at the time of initial adoption in a manner that reconciles to the cumulative-effect adjustment to retained earnings. That information might be presented as follows: [Disclosures required by paragraphs 27(a), 27(b), and 27(e) of this Statement are illustrated below.]

(\$ in 000s) Description	Balance Sheet 1/1/08 prior to Adoption	Net Gain/(Loss) upon Adoption	Balance Sheet 1/1/08 after Adoption of FVO
Loans net	\$120	\$(20)	\$100
Private equity investments	50	(10)	40
Long-term debt	(70)	<u>4</u>	(66)
Pretax cumulative effect of adoption of the fair value option		(26)	
Increase in deferred tax asset		<u>8</u>	
Cumulative effect of adoption of the fair value option (charge to retained earnings)		<u><u>\$(18)</u></u>	

The \$20,000 net loss for loans that was recorded as part of the cumulative-effect adjustment to retained earnings upon initial adoption of this Statement includes \$3,000, which was removed from the allowance for loan and lease losses.

B4. An entity might provide the following additional disclosures required by paragraphs 27(c) and 27(d) of this Statement in this same note: (a) management's reasons for electing the fair value option for each existing eligible item or group of similar eligible items and (b) if the fair value option is elected for some but not all eligible items within a group of similar eligible items, (1) a description of those similar items and the reasons for partial election and (2) information to enable users to understand how the group of similar items relates to individual line items on the statement of financial position.

Example 2—Fair Value Measurements and Changes in Fair Values Included in Current-Period Earnings

B5. The objective is to provide information about (a) assets and liabilities measured at fair value on a recurring basis (as required by Statement 157), (b) changes in fair values of assets and liabilities for which the fair value option has been elected in a manner that relates to the statement of financial position (as required by this Statement), and (c) fair value estimates and corresponding carrying amounts for major categories of assets and liabilities that include items measured at fair value on a recurring basis (in accordance with Statement 107).

B6. Table 1 represents the fair value hierarchy table set forth in Statement 157, supplemented to (a) provide information about where in the income statement changes in fair values of assets and liabilities reported at fair value are included in earnings⁹ and (b) voluntarily integrate selected disclosures required annually by Statement 107. [Disclosures required by paragraphs 19(a) and 18(c) of this Statement are illustrated below.]

⁹Paragraph 19(a) of this Statement requires an entity to disclose the amounts of gains and losses included in earnings from fair value changes for assets and liabilities for which the fair value option has been elected but does not preclude an entity from meeting that disclosure requirement by disclosing amounts of gains and losses that include amounts of gains and losses for other items measured at fair value through earnings, such as items required to be measured at fair value.

Table 1
(\$ in 000s)

Description	Total Carrying Amount in Statement of Financial Position 12/31/08 ¹⁰	Statement 107 Fair Value Estimate 12/31/08 ¹¹	Assets/Liabilities Measured at Fair Value 12/31/08	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Changes in Fair Values for the 12-Month Period Ended December 31, 2008, for Items Measured at Fair Value Pursuant to Election of the Fair Value Option				
							Trading Gains and Losses	Other Gains and Losses	Interest Income on Loans	Interest Expense on Long-Term Debt	Total Changes in Fair Values Included in Current-Period Earnings
Trading securities	\$ 115	\$ 115	\$ 115	\$ 105	\$ 10		\$ 10				\$ 10
Available-for-sale securities	75	75	75	75							
Loans, net	400	412	150	0	100	\$ 50	\$ 10				7
Derivatives	60	60	60	25	15	20					5
Private equity investments	125	138	75*	0	25	50					(18)
Long-term debt	(200)	(206)	(60)	(30)	(10)	(20)			13		9

*Represents investments that would otherwise be accounted for under the equity method of accounting.

Loans are included in loans and lease receivables in the statement of financial position. As of December 31, 2008, approximately \$160,000 of lease receivables are included in loans and lease receivables in the statement of financial position and are not eligible for the fair value option.

¹⁰This column discloses carrying amount information required annually by Statement 107 only for major categories of assets and liabilities that include items measured at fair value.

¹¹This column discloses fair value estimates required annually by Statement 107 only for major categories of assets and liabilities that include items measured at fair value. Statement 107 requires an entity to disclose fair value estimates and related carrying amounts for all financial instruments within the scope of that Statement, if practicable. Footnote 3a of Statement 107 requires that if an entity discloses the fair value of financial instruments in more than a single note, one of the notes shall include a summary table (not presented in this appendix).

¹²This Statement does not require disclosure of this amount, nor does it preclude disclosure of this amount. This amount is shown here for completeness.

¹³Refer to note 12.

B7. An entity might provide the following additional disclosures required by paragraphs 18(a) and 18(b) of this Statement here: (a) management's reasons for electing a fair value option for each eligible item or group of similar eligible items and (b) if the fair value option is elected for some but not all eligible items within a group of similar eligible items, (1) a description of those similar items and the reasons for partial election and (2) information to enable users to understand how the group of similar items relates to individual line items on the statement of financial position.

B8. Table 2 is an alternative illustrative example that does not integrate disclosures required annually by Statement 107 or the additional gain and loss amounts voluntarily displayed in Table 1. Table 2 represents the fair value hierarchy table set forth in Statement 157, supplemented to provide information about where in the income statement changes in fair values of assets and liabilities for which the fair value option has been elected are included in earnings. [Disclosures required by paragraphs 19(a) and 18(c) of this Statement are illustrated below.]

Table 2
(\$ in 000s)

Description	Fair Value Measurements 12/31/08	Fair Value Measurements at December 31, 2008, Using			Changes in Fair Values for the 12-Month Period Ended December 31, 2008, for Items Measured at Fair Value Pursuant to Election of the Fair Value Option			Total Changes in Fair Values Included in Current-Period Earnings
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Other Gains and Losses	Interest Income on Loans	Interest Expense on Long-Term Debt	
Trading securities	\$115	\$105	\$ 10					
Available-for-sale securities	75	75						
Loans	150	0	100	\$ 50	\$ (3)	\$10		\$ 7
Derivatives	60	25	15	20				
Private equity investments*	75	0	25	50	(18)			(18)
Long-term debt	(60)	(30)	(10)	(20)	13		\$(4)	9

*Represents investments that would otherwise be accounted for under the equity method of accounting.

Loans are included in loans and lease receivables in the statement of financial position. As of December 31, 2008, approximately \$160,000 of lease receivables are included in loans and lease receivables in the statement of financial position and are not eligible for the fair value option.

B9. An entity might provide the following additional disclosures required by paragraphs 18(a) and 18(b) of this Statement here: (a) management's reasons for electing a fair value option for each eligible item or group of similar eligible items and (b) if the fair value option is elected for some but not all eligible items within a group of similar eligible items, (1) a description of those similar items and the reasons for partial election and (2) information to enable users to understand how the group of similar items relates to individual line items on the statement of financial position.

Appendix C

AMENDMENTS TO EXISTING PRONOUNCEMENTS

C1. APB Opinion 21, *Interest on Receivables and Payables*, is amended as follows: [Added text is underlined and deleted text is ~~struck out~~.]

- a. Paragraph 16, as amended:

Statement presentation of discount and premium. The discount or premium resulting from the determination of present value in cash or non-cash transactions is not an asset or liability separable from the note which gives rise to it. Therefore, the discount or premium should be reported in the balance sheet as a direct deduction from or addition to the face amount of the note. It should not be classified as a deferred charge or deferred credit. The description of the note should include the effective interest rate; the face amount should also be disclosed in the financial statements or in the notes to the statements.⁹ Amortization of discount or premium should be reported as interest expense. Issue costs should be reported in the balance sheet as deferred charges. This paragraph does not apply to the amortization of premium and discount and the debt issuance costs of liabilities that are reported at fair value.

C2. FASB Statement No. 57, *Related Party Disclosures*, is amended as follows:

- a. Paragraph 24(f):

Related parties. Affiliates of the enterprise; entities for which investments in their equity securities would, absent the election of the fair value option under FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, be required to be ~~are~~ accounted for by the equity method by the enterprise; trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management; principal owners of the enterprise; its management; members of the immediate families of principal owners of the enterprise and its management; and other parties with which the enterprise may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests. Another party also is a related party if it can significantly influence the management or operating policies of

the transacting parties or if it has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

C3. FASB Statement No. 95, *Statement of Cash Flows*, is amended as follows:

a. Paragraph 15, as amended:

Investing activities include making and collecting loans and acquiring and disposing of debt or equity instruments and property, plant, and equipment and other productive assets, that is, assets held for or used in the production of goods or services by the enterprise (other than materials that are part of the enterprise's inventory). Investing activities exclude acquiring and disposing of certain loans or other debt or equity instruments that are acquired specifically for resale, as discussed in Statement 102, ~~and securities that are classified as trading securities as discussed in FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*.~~

b. Paragraph 16, as amended:

Cash inflows from investing activities are:⁵

- a. Receipts from collections or sales of loans made by the enterprise and of other entities' debt instruments (other than cash equivalents; and certain debt instruments that are acquired specifically for resale as discussed in Statement 102, and securities classified as trading securities as discussed in Statement 115) that were purchased by the enterprise
- b. Receipts from sales of equity instruments of other enterprises (other than certain equity instruments carried in a trading account as described in Statement 102, ~~and certain securities classified as trading securities as discussed in Statement 115~~) and from returns of investment in those instruments
- c. Receipts from sales of property, plant, and equipment and other productive assets.

c. Paragraph 17, as amended:

Cash outflows for investing activities are:

- a. Disbursements for loans made by the enterprise and payments to acquire debt instruments of other entities (other than cash equivalents; and certain debt instruments that are acquired specifically for resale as discussed in Statement 102, and securities classified as trading securities as discussed in Statement 115)
- b. Payments to acquire equity instruments of other enterprises (other than certain equity instruments carried in a trading account as described in Statement 102 ~~and certain securities classified as trading securities as discussed in Statement 115~~)
- c. Payments at the time of purchase or soon before or after purchase⁶ to acquire property, plant, and equipment and other productive assets.⁷

d. Footnote 8c, as added, to paragraph 22:

The term *goods* includes certain loans and other debt and equity instruments of other enterprises that are acquired specifically for resale, as discussed in Statement 102, ~~and securities that are classified as trading securities as discussed in Statement 115.~~

C4. FASB Statement No. 102, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale*, is amended as follows:

a. Paragraph 8, as amended:

Banks, brokers and dealers in securities, and other enterprises may carry securities and other assets in a trading account.³ Cash receipts and cash payments resulting from purchases and sales of securities classified as trading securities as discussed in FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, shall be classified pursuant to Statement 95 (as amended) based on the nature and purpose for which the securities were acquired as operating cash flows. Cash receipts and cash payments resulting from purchases and sales of other securities and other assets shall be classified as operating cash flows if those assets are acquired specifically for resale and are carried at market value in a trading account. Cash flows from purchases, sales, and maturities of available-for-sale

securities shall be classified as cash flows from investing activities and reported gross in the statement of cash flows.

C5. FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, is amended as follows:

a. Paragraph 4, as amended:

This Statement does not apply to investments in equity securities that, absent the election of the fair value option under FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, would be required to be accounted for under the equity method nor to investments in consolidated subsidiaries. This Statement does not apply to enterprises whose specialized accounting practices include accounting for substantially all investments in debt and equity securities at market value or fair value, with changes in value recognized in earnings (income) or in the change in net assets. Examples of those enterprises are brokers and dealers in securities, defined benefit pension plans, and investment companies. This Statement applies to cooperatives and mutual enterprises, including credit unions and mutual insurance companies, but does not apply to not-for-profit organizations. FASB Statement No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*, establishes standards for not-for-profit organizations. This Statement does not apply to investments in derivative instruments that are subject to the requirements of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. If an investment would otherwise be in the scope of this Statement and it has within it an embedded derivative that is subject to Statement 133, the host instrument (as described in Statement 133) remains within the scope of this Statement. A transaction gain or loss on a held-to-maturity foreign-currency-denominated debt security shall be accounted for pursuant to FASB Statement No. 52, *Foreign Currency Translation*.

b. Paragraph 17, as amended:

An enterprise shall report its investments in available-for-sale securities and trading securities separately from similar assets that are subsequently measured using another measurement attribute on the face of the statement of financial position. To accomplish that, an entity shall either (a) present the aggregate of those fair value and non-fair-value amounts in the same line item and parenthetically disclose the amount of fair value included in the aggregate amount or (b) present two separate line items to display the fair value and

non-fair-value carrying amounts. An enterprise that presents a classified statement of financial position shall report individual held-to-maturity securities, individual available-for-sale securities, and individual trading securities as either current or noncurrent, as appropriate, under the provisions of ARB No. 43, Chapter 3A, “Working Capital—Current Assets and Current Liabilities.”⁵

c. Paragraph 18:

Cash flows from purchases, sales, and maturities of available-for-sale securities and held-to-maturity securities shall be classified as cash flows from investing activities and reported gross for each security classification in the statement of cash flows. Cash flows from purchases, sales, and maturities of trading securities shall be classified based on the nature and purpose for which the securities were acquired as cash flows from operating activities.

C6. FASB Statement No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*, is amended as follows:

a. Paragraph 6, as amended:

Generally accepted accounting principles other than those discussed in this Statement also apply to investments held by not-for-profit organizations. For example, not-for-profit organizations must disclose information required by FASB Statements No. 107, *Disclosures about Fair Value of Financial Instruments*, ~~and No. Statement 133~~, and FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*.

C7. FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, is amended as follows:

a. Paragraph 42, as amended:

A derivative instrument or a nonderivative financial instrument that may give rise to a foreign currency transaction gain or loss under Statement 52 can be designated as hedging the foreign currency exposure of a net investment in a foreign operation provided the conditions in paragraphs 40(a) and 40(b) are met. (A nonderivative financial instrument that is reported at fair value does not give rise to a foreign currency transaction gain or loss under Statement 52 and, thus, cannot be designated as hedging the foreign currency exposure of a net investment in a foreign operation.) The gain or loss on a hedging

derivative instrument (or the foreign currency transaction gain or loss on the nonderivative hedging instrument) that is designated as, and is effective as, an economic hedge of the net investment in a foreign operation shall be reported in the same manner as a translation adjustment to the extent it is effective as a hedge. The hedged net investment shall be accounted for consistent with Statement 52; the provisions of this Statement for recognizing the gain or loss on assets designated as being hedged in a fair value hedge do not apply to the hedge of a net investment in a foreign operation.

b. Paragraph 44A, as added:

In each statement of financial position presented, an entity shall report hybrid financial instruments measured at fair value under the election and under the practicability exception in paragraph 16 of this Statement in a manner that separates those reported fair values from the carrying amounts of assets and liabilities subsequently measured using another measurement attribute on the face of the statement of financial position. To accomplish that separate reporting, an entity may either (a) display separate line items for the fair value and non-fair-value carrying amounts or (b) present the aggregate of those fair value and non-fair-value amounts and parenthetically disclose the amount of fair value included in the aggregate amount. For those hybrid financial instruments measured at fair value under the election and under the practicability exception in paragraph 16, an entity shall also disclose the information specified in paragraphs 18–22 of FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*.