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What Are My Options?

The FASB Allows a Fair Value Option for Most Financial Assets and Liabilities

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Introduction

On the heels of the FASB's recent standard[1] on **how** entities should measure fair value, FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, expands the scope of **what** companies may carry at fair value. Statement 159 offers an **irrevocable option** to carry the vast majority of financial assets and liabilities at fair value, with changes in fair value recorded in earnings (the fair value option, or FVO). The Statement, which applies to all entities (for-profit and not-for-profit), is effective as of the beginning of a reporting entity's first fiscal year that begins after November 15, 2007. In certain circumstances, earlier application is permitted. (See Effective Date and Transition for more information about early adoption and Appendix B for more information about the scope of Statement 159.)

FASB's Objectives for Statement 159

The FASB has a number of objectives in mind. As shown in the example below, one is to give entities the opportunity to eliminate artificial volatility in reported earnings that occurs when financial assets and liabilities are measured and reported differently in the financial statements. Entities often attempt to mitigate this mismatch by using derivatives and Statement 133[2] hedge accounting. However, because of the stringent hedge accounting criteria in Statement 133, they are frequently unable to achieve the desired result. Because it allows entities to measure virtually all financial assets and liabilities at fair value via earnings, the FVO may eliminate many accounting mismatches. In addition, entities would no longer need to consider and apply the complex hedge accounting rules for derivatives.

Another objective is to expands the use of fair value measurements for financial assets and liabilities. This is in sync with the FASB's long-term goal to have all financial assets and liabilities measured at fair value. While Statement 159 only provides an option, it is a step toward the FASB's longer-term objective.

1 FASB Statement No. 157, *Fair Value Measurements*.
2 FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

Example

Company A funds its operations with fixed-rate debt and has variable-rate assets. To manage the risk of the effect of interest rate variability on the fair value of the debt, Company A enters into a receive-fixed/pay-LIBOR interest rate swap. Because Company A meets the hedge accounting criteria in Statement 133, changes in the fair value of the fixed-rate debt attributable to changes in the benchmark interest rate (LIBOR) and changes in the fair value of the LIBOR-based interest rate swap have been recorded in earnings.

Using the FVO, Company A can instead elect to carry the fixed-rate debt at fair value and achieve a similar (but not identical) reduction in earnings volatility resulting from changes in interest rates without having to address the complex requirements of Statement 133.

But take note. Statement 157 requires Company A to incorporate the effect of changes in its own creditworthiness into changes in the fair value of its fixed-rate debt. Therefore, electing the FVO for the debt introduces a new source of volatility in earnings — the effect of changes in Company A's credit standing. The upshot? Many companies are thinking twice about electing the FVO for liabilities. (See Weighing the Pros and Cons below.)

Instrument-by-Instrument Election

Companies must elect whether to use the FVO on the date an item is initially recognized, with limited exceptions. The election is applied, on an **instrument-by-instrument basis**, to **entire financial assets and liabilities** that are individually transferable in their current form. Companies may also elect the FVO for all items within Statement 159's scope that exist at adoption.

Because the FVO is an instrument-by-instrument election, companies may record identical financial assets and liabilities either at fair value or on another measurement basis permitted by generally accepted accounting principles (GAAP), such as amortized cost.

Example

Company XYZ purchases 100 shares of common stock of Entity X. It can elect the FVO for 50 shares and elect to classify the remaining 50 shares as available-for-sale pursuant to Statement 115.[3] Therefore, changes in the fair value of the first 50 shares would be recorded in earnings. Changes in the remaining 50 shares would be recorded in other comprehensive income.

One exception to the instrument-by-instrument guidance is that for investments that would otherwise fall under equity method accounting, the election must be made for all of the investor's financial interests (equity and debt, including guarantees) in the same entity.

Is Comparability Extinct?

While you may be wondering why the FASB is giving entities an option, remember that optional accounting is not new. Examples under existing standards include the following:

- Under Statement 115, entities can elect different classifications for debt and many equity securities.
- Hedge accounting is optional under Statement 133.
- More recently, Statements 155[4] and 156[5] give entities an option to measure certain hybrid financial instruments and mortgage servicing rights at fair value, with changes in fair value recorded in earnings.
- The IASB has already provided a more limited FVO under IAS 39.[6]

Preparers of financial statements generally have reacted favorably to optional accounting. The breadth of Statement 159 and the relief it provides from the complex and often difficult-to-meet requirements of hedge accounting are particularly welcome.

[3] FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities.*
[4] FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments.*
[5] FASB Statement No. 156, *Accounting for Servicing of Financial Assets.*
[6] IAS 39, *Financial Instruments: Recognition and Measurement.*

However, some financial statement users have concerns about the lack of comparability between financial statements of similar organizations (or even among assets or liabilities held by a single entity) that is likely to result from application of the FVO. The FASB considered these concerns but concluded that the benefits of reducing volatility in financial statements caused by mixed-attribute accounting models and expanded use of fair value outweigh comparability concerns. In addition, the FASB designed Statement 159's extensive disclosure requirements to compensate for the potential lack of comparability.

Disclosure Requirements

The disclosure requirements apply to financial instruments measured at fair value under Statement 159 and to hybrid financial instruments measured at fair value pursuant to paragraph 16 of Statement 133. The objectives of the disclosures are to:

- Help financial statement users understand management's reasons for electing or partially electing the FVO as well as how changes in fair value affect earnings.
- Provide information about (1) certain items that would have been disclosed if the FVO had not been elected and (2) the recorded fair value and the contractual cash payments to help users understand the differences between the two amounts.

See Appendix B for more detail on the required disclosures.

Effective Date and Transition

Statement 159 is effective as of the beginning of the first fiscal year that begins after November 15, 2007. Its provisions may be applied to an earlier period (as of the beginning of the fiscal year) only if the following conditions are met:

- The decision to adopt is made after the issuance of Statement 159 but within 120 days after the first day of the fiscal year of adoption, and no financial statements, including footnotes, for any interim period of the adoption year have yet been issued.
- The requirements of Statement 157 are adopted concurrently with or prior to the adoption of Statement 159.

Example

Company A is a calendar year-end company and will file its March 31, 2007, Form 10-Q on May 5, 2007. Statement 159 was issued on February 15, 2007. Company A may early adopt Statement 159 as of January 1, 2007, if it decides to do so by April 30, 2007, and concurrently adopts Statement 157.

If an entity chooses to elect the FVO for existing items at the date of adoption, the difference between their carrying amount and fair value is included in a cumulative-effect adjustment to the opening balance of retained earnings.

Weighing the Pros and Cons

While the benefits of having the FVO available are fairly apparent, in evaluating whether to use it, preparers should keep some of the following trade-offs in mind:

- For assets and liabilities that are not traded in deep and liquid markets, the challenges that accompany the fair value measurement.
- The comprehensive disclosures required by Statement 159, as well as those required by Statement 157, which emphasize the relative reliability of various fair value measurements.

- Statement 157's requirement to incorporate a company's credit standing into the valuation of its liabilities measured at fair value.
- Statement 159's requirement to recognize up-front costs and fees in earnings rather than permitting deferred recognition (e.g., debt issue costs, deferred loan origination fees and costs).
- The elimination of valuation allowances on items such as loans or accounts receivable when the FVO is elected.
- Statement 159's lack of guidance on accounting for interest and dividend income or interest expense on financial assets and liabilities under the FVO. Statement 159 requires that entities disclose how interest and dividends are measured and where they are reported in the income statement when the FVO is elected. It implies, however, that absent a preexisting policy when the FVO is elected, an entity may either discontinue recognizing interest and dividends (in which case the interest and dividends are subsumed in the change in fair value) or continue to recognize these items separately. This would not be the case, however, for investments in debt and equity securities subject to Statement 115. If the FVO is elected for such securities, Statement 159 requires that they be reported as trading securities under Statement 115, which requires the recognition of dividend and interest income, including amortization of premiums and discounts.

The extent of the election may vary from company to company. It should not be any surprise, however, that an entity that elects the FVO for a substantial portion of its financial assets and liabilities will have financial statements that look markedly different after adoption.

Appendix A includes examples of reasons the FVO might be elected. Appendix B includes Q&As on the details of Statement 159's provisions.

Join us on March 12, 2007, for a *Dbriefs* webcast on the FVO. Registration for the webcast will be available soon. (Information about *Dbriefs* webcasts can be found on the back page of this issue.)

Appendix A

Why Elect the FVO?

In addition to the accounting mismatch in the Example under FASB's Objectives for Statement 159, entities may elect the FVO for a variety of reasons, including the following:

Simplification
Transaction description: A depository institution originates multifamily mortgage loans for its portfolio. *Current accounting:* The institution defers and amortizes costs and fees associated with originating the loans in accordance with Statement 91.[7] An allowance for losses is established and monitored in accordance with Statements 114[8] and 5.[9] *Electing the FVO:* If the FVO is elected for these loans, the loans will be recorded at fair value, with changes in fair value recorded in earnings. Loan origination costs and fees would be expensed/recognized as incurred, and no allowance for losses would be established.
Transaction description: An investor holds investments in loans (including debt securities and beneficial interests in securitized financial assets), and the debtor's credit has deteriorated such that it is probable that the investor will not recover the contractually required payments of principal and interest. *Current accounting:* These investments are currently subject to complex impairment requirements. *Electing the FVO:* By electing the FVO, companies no longer have to deal with the complexities associated with applying impairment guidance. Entities can "simply" account for changes subsequent to acquisition as fair value adjustments through earnings.
International Convergence
Transaction description: IAS 39 permits certain categories of financial assets and financial liabilities to be designated as "fair value through profit or loss" (FVTPL). Foreign filers may elect the FVTPL designation for assets or liabilities that cannot be carried at fair value under U.S. GAAP, resulting in a reconciling item on Form 20-F. *Electing the FVO:* Electing the FVO could eliminate the difference between IAS 39 and U.S. GAAP, potentially reducing the number of reconciling items on Form 20-F.

[7] FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated With Originating or Acquiring Loans and Initial Direct Costs of Leases.*
[8] FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*.
[9] FASB Statement No. 5, *Accounting for Contingencies.*

Appendix B

Q&As Related to Statement 159

Click a question below to jump to its related Q&A.

Scope

Initial Adoption

Election Date Issues (Including Adoption Date)

Disclosures

Other

Q&As Related to Statement 159

Scope

1. What is within and what is outside the scope of Statement 159?

The FVO may be elected for the following:

	Definition	Examples
Recognized financial assets	Cash, evidence of an ownership interest in an entity, and contracts that convey a right to receive cash or a financial instrument or a right to exchange a financial instrument with potentially favorable terms to another entity	• Accounts and loans receivable • Debt and equity securities • Equity method investments
Recognized financial liabilities	Contracts that impose an obligation to deliver cash or other financial instrument or to exchange a financial instrument with potentially unfavorable terms to another party	• Accounts payable • Guarantees • Issued debt

Other eligible items:

- Firm commitments that would otherwise not be recognized at inception and that involve only financial instruments (see Question 2).
- Written loan commitments (i.e., those that are not within the scope of Statement 133 or that do not qualify as derivatives).
- Certain rights and obligations under insurance contracts and warranties that are not financial instruments but that can be settled by paying a third party to provide goods and services.
- A financial host contract in a nonfinancial hybrid instrument (see Question 14).

The following are not eligible for the FVO:

- Nonfinancial assets and liabilities.
- An investment in a consolidated entity.
- Employers' and plans' financial obligations for items such as pension benefits and other forms of deferred compensation arrangements.
- Income tax assets and liabilities.
- Financial assets and liabilities recognized under lease contracts as defined in Statement 13.[10]
- Deposit liabilities, withdrawable on demand, of banks, savings and loan associations, credit unions, and other similar depository institutions.
- Financial instruments that are, in whole or in part, classified in shareholders' equity by the issuer. An example is a convertible debt security with a noncontingent beneficial conversion feature.

[10] FASB Statement No. 13, *Accounting for Leases.*

2. What is an example of a firm commitment for which the FVO could be elected?

A firm commitment is an agreement that is usually legally enforceable, is binding on both parties, specifies all significant terms, and includes a disincentive for nonperformance that is significant enough to make performance probable. Statement 159 applies to firm commitments that would not otherwise be recognized at inception (pursuant to Statement 133) and that involve only financial instruments. An example is a forward purchase contract for a loan, such as a privately placed debt instrument, that is not readily convertible to cash. The forward is a commitment that involves only financial instruments — a loan and cash — and would not otherwise be recognized because it is not a derivative instrument.

3. Can the FVO be applied to a portion of an instrument?

No. The FVO must be applied to an entire instrument. An entity may not apply the FVO to specific risks, specific cash flows, or other portions of items. An "entire instrument" is one that is individually transferable in its current form.

Initial Adoption

4. Can an entity elect the FVO for available-for-sale and held-to-maturity securities that it holds on adoption of Statement 159?

Yes. The FVO may be elected for available-for-sale and held-to-maturity investments upon adoption of Statement 159, and the election would not be considered a prohibited transfer between categories of investments under Statement 115. Entities should include unrealized gains and losses on such available-for-sale or held-to-maturity securities in the cumulative-effect adjustment to beginning retained earnings in the period of adoption.

5. Can an entity early adopt Statement 159 if it has issued an earnings release or filed a regulatory report for an interim period within 120 days after the beginning of the fiscal year of proposed adoption?

Generally, yes. Paragraph 30(c) of Statement 159 prohibits early adoption for an entity that has issued financial statements, including required footnotes, for any interim period of the fiscal year that includes the date of adoption. Although earnings releases and regulatory reports (such as bank call reports and broker-dealer focus reports) may contain some information that is compliant with U.S. GAAP, they generally do not constitute full U.S. GAAP financial statements[11] with footnotes. Unless the entity has issued an earnings release or filed a regulatory report for an interim period that contains full U.S. GAAP compliant financial statements and footnotes within 120 days of proposed adoption, it may early adopt Statement 159.

Example

On April 29, 2007, Bank A determined that it would like to early adopt Statement 159 for its year ended December 31, 2007.

On April 25, 2007 (within 120 days of proposed early adoption), Bank A filed its call report for the quarter ended March 31, 2007. The call report includes a balance sheet, an income statement, and a statement of changes in equity, but not a statement of cash flows. Moreover, although the call report contains some supplemental information, it does not include all footnote disclosures required by U.S. GAAP.

Since the call report is not fully compliant with U.S. GAAP, it does not constitute the issuance of financial statements with footnotes. Therefore, Bank A may early adopt Statement 159.

6. Upon initial adoption of Statement 159, if an entity elects the FVO for an existing instrument, how should associated deferred costs and fees, valuation allowances and premiums and discounts, and accrued interest be treated?

Under existing GAAP, many items eligible for the FVO have deferred costs and fees, allowances, accrued interest, and other basis adjustments associated with them. When the FVO is elected, these items should be removed from the statement of financial position and included in the cumulative-effect adjustment in the year of adoption.

[11] See EITF Topic No. D-86, "Issuance of Financial Statements," for additional information.

Election Date Issues (Including Adoption Date)

7. Besides the adoption date of Statement 159 or the date when an entity first recognizes an eligible item, are there other dates on which an entity may elect the FVO?

Yes. The FVO may also be elected when:

- An entity enters into an eligible firm commitment that is not otherwise recognized.
- A financial asset or liability previously reported at fair value through earnings no longer qualifies for fair value measurement. One example is an asset transferred from a subsidiary that is within the scope of the AICPA Audit and Accounting Guide, *Investment Companies*, to another entity within the consolidated reporting entity that is not within this guide's scope.
- An investment becomes subject to the equity method of accounting.
- An event represents the initial recognition of the item, requires remeasurement of an eligible item at fair value, or both. Examples include:
    1. The initial recording of financial assets and financial liabilities in a business combination.
    2. The initial consolidation of a subsidiary or variable interest entity.
    3. Deconsolidation of a subsidiary or variable interest entity.
    4. Significant modifications of debt under Issue 96-19.[12]

8. What documentation needs to be in place to support the election of the FVO?

Unlike Statement 133, Statement 159 provides little guidance on the documentation required to support an entity's election of the FVO. Statement 159 simply indicates that the decision to elect the FVO should be made at the date of election for each eligible item. An entity also may establish an automatic election policy for certain eligible items (for example, an entity may document in a written policy that it will elect the FVO for all single-family mortgages that it originates). Although Statement 159 leaves room for discretion regarding documentation, in the absence of a well-developed preexisting policy for election, evidence of the election should be documented concurrently with the recognition or remeasurement (see Question 7) of eligible items.

9. Is the ability to elect the FVO predicated on the reliability of fair value measurements?

No. The FVO may be elected for any eligible instrument within the scope of Statement 159. In Statement 157, the Board rejected a minimum-reliability threshold for items that are carried at fair value (under the FVO or otherwise). That is, the Board decided to allow fair value measurements for items in financial statements even when they are not based on market-observable data. In such circumstances, however, the data used for the measurement must reflect assumptions marketplace participants would use in pricing the asset or liability (including adjustments that marketplace participants demand for the risk associated with the unobservable data or the model used to determine fair value). In addition, Statement 157's disclosures highlight the relative reliability of fair value measurements.

Disclosures

10. Does management have to explain why it elects the FVO?

Yes. Statement 159 requires that management disclose its reasons for electing the FVO for each eligible item, or group of similar items, as of each date for which a statement of financial position is presented (both interim and annual dates). Furthermore, in the initial year of adoption, management must give its reasons for electing the FVO for eligible items **existing** at the effective date. Companies should disclose the reasons for the effective date election in the first-interim-period and annual financial statements for the fiscal year that includes the effective date.

[12] EITF Issue No. 96-19, "Debtor's Accounting for a Modification or Exchange of Debt Instruments."

Statement 159 also requires that if the FVO is elected for some but not all eligible items within a group of eligible items, a description of the similar items and the reason for partial election must be disclosed. Financial statement users must also be able to relate the group of similar items to individual line items on the statement of financial position.

11. An entity must provide management's reasons for electing the FVO for items existing at the effective date (see Question 10). What other disclosures are required in an entity's financial statements in the initial year of adoption?

The following additional disclosures are required for the annual and first-interim-period financial statements in the initial year of adoption of Statement 159:

- A schedule that presents the following by line item in the statement of financial position:
    1. The pre-tax 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 FVO is elected and the carrying amount of those same items immediately before election of the FVO.
- The net effect of the FVO election on the entity's deferred tax assets and liabilities.
- The amount of valuation allowances that were removed from the statement of financial position because they related to items for which the FVO was elected.
- 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) should be separately disclosed.

12. If an entity elects the FVO for a financial asset or liability, does the entity have to disclose the reasons for changes in fair value?

It depends. For most financial assets and liabilities for which the FVO has been elected, disclosure of the reasons for the changes in fair value is not required, although the amounts of gains and losses resulting from changes in fair value included in earnings must be disclosed. However, for liabilities with fair values that have been significantly affected during the reporting period by changes in the instrument-specific credit risk,[13] entities must disclose:

1. The estimated amount of gains and losses attributable to the changes in the instrument-specific credit risk.
2. **Qualitative information about the reasons for the changes.**
3. How gains and losses attributable to changes in instrument-specific credit risk were determined.

Financial assets also require additional disclosures when the fair value has been affected by instrument-specific credit risk (see Question 13).

13. What other disclosures are required by Statement 159?

The FASB intended the disclosure requirements of Statement 159 to be robust to compensate for the lack of comparability that may result from electing the FVO. The Board chose not to prescribe the exact form of the disclosures. In addition to the disclosures already discussed, an entity is required to disclose the following as of each date, unless otherwise noted, for which a statement of financial position or an income statement, as applicable, is presented:

[13] Instrument-specific credit risk does not contemplate the risk associated with market conditions such as changes in market interest rates.

When Is Disclosure Required?	What Information Must Be Disclosed?
A line item in the statement of financial position includes an item or items for which the FVO has been elected.	• If the aggregate of fair value and non-fair-value amounts is presented in the same line item (rather than in two line items displaying the fair value and non-fair-value carrying amounts), parenthetical disclosure of the amount measured at fair value. • Information to help users understand how each line item relates to major categories of assets and liabilities presented in accordance with Statement 157's fair value disclosure requirements. • Aggregate carrying amount of items included in each line item that are ineligible for the FVO, if any. • By line item in the statement of financial position, amounts of gains and losses from changes included in earnings during each period presented and in which line item in the income statement those line items are reported. • Methods and significant assumptions used to estimate fair value (in annual periods only).
The financial statements include loans or other receivables for which the FVO has been elected.	• Estimated amount of gains or losses included in earnings during the period attributable to changes in instrument-specific credit risk.[14] • How gains, losses, or both, attributable to changes in instrument-specific credit risk[14] were determined. • Difference between the aggregate fair value and the aggregate unpaid principal balance (if the instrument is long-term). • Aggregate fair value of loans that are 90 days or more past due. • When the entity's policy is to recognize interest income separately from other changes in fair value, disclosure of the aggregate fair value of loans in nonaccrual status.
The financial statements include long-term debt for which the FVO has been elected.	Difference between the aggregate fair value and the aggregate unpaid principal balance. (See Question 12 as it relates to creditworthiness.)
The financial statements include investments that would have otherwise been accounted for under the equity method, but for which the FVO has been elected.	Information required, with certain exceptions, by paragraph 20 of Opinion 18.[15]
One of the events in paragraph 9(d) or 9(e) (a new election date) occurs and an entity elects the FVO.	• Qualitative information about the nature of the event. • 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 FVO for an item.

Questions 10–13 discuss the financial statement disclosure requirements of Statement 159. In addition to these disclosures, public companies should include disclosure in MD&A to help investors understand the effect of adoption of Statement 159 or election of the FVO at a date subsequent to initial recognition of an item (see Question 7), including the impact on the comparability of financial statements from period to period.

[14] See footnote 13.
[15] APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*.

Other

14. Can the host instrument resulting from the separation of an embedded nonfinancial derivative instrument from a nonfinancial hybrid instrument be accounted for using the election of FVO?

It depends. If the separation of the derivative instrument eliminates all nonfinancial features of the hybrid instrument, the resulting host contract is a financial asset or liability and is eligible for the FVO.

15. How should Statement 95[16] be applied with respect to the classification of cash receipts and payments on financial assets and liabilities for which the FVO has been elected?

The FVO clarifies that entities should classify cash receipts and payments related to items measured at fair value according to their nature and purpose. Consistent with this guidance, Statement 159 amends Statements 95, 102,[17] and 115 to remove the current requirement to classify cash flows associated with trading securities as operating activities. The FASB concluded that the cash receipts and cash payments related to trading securities as well as to financial assets and financial liabilities for which the FVO 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.

16 FASB Statement No. 95, *Statement of Cash Flows.*

17 FASB Statement No. 102, *Statement of Cash Flows — Exemption of Certain Enterprises and Classification of Cash Flows From Certain Securities Acquired for Resale.*

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