

FASB/IASB PATH TO CONVERGENCE: NEW FINANCIAL INSTRUMENTS PROPOSALS AND WHAT AUDIT COMMITTEES NEED TO KNOW



JUNE 24, 2010

Agenda

- Introduction
- Presentation
 - Linda MacDonald, FTI Consulting
 - Esther Mills, Accounting Policy Plus
 - Michael Young, Willkie Farr & Gallagher, LLP
- Questions and Answers — (*anonymous*)
- Slides — now available on front page of Securities Docket
 - > www.securitiesdocket.com
- Wrap-up



Webcast Series

- Series of webcasts — every other week
- www.securitiesdocket.com/webcasts



Today's Presenters



Linda MacDonald, CPA

Senior Managing Director

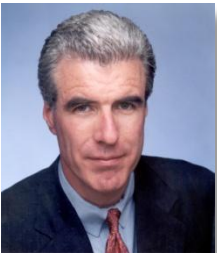
FTI Consulting - Forensic and Litigation Consulting



Esther Mills, CPA

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Today's Agenda

- Overview
- Changes to U.S. GAAP
- Differences between U.S. GAAP and IFRS
- The Audit Committee
- Questions

Overview

Overview

- Financial crisis highlighted need for FASB/IASB to improve and converge U.S. GAAP and IFRS, emphasis on fair value and financial instruments
- FASB/IASB “redoubled” efforts, and converged solutions in process for fair value but not financial instruments
- FASB financial instruments proposal would change U.S. GAAP and create differences between U.S. GAAP and IFRS
- Comment deadline on the proposal September 2010
- Important for audit committees to understand the changes and make sure their organizations are involved

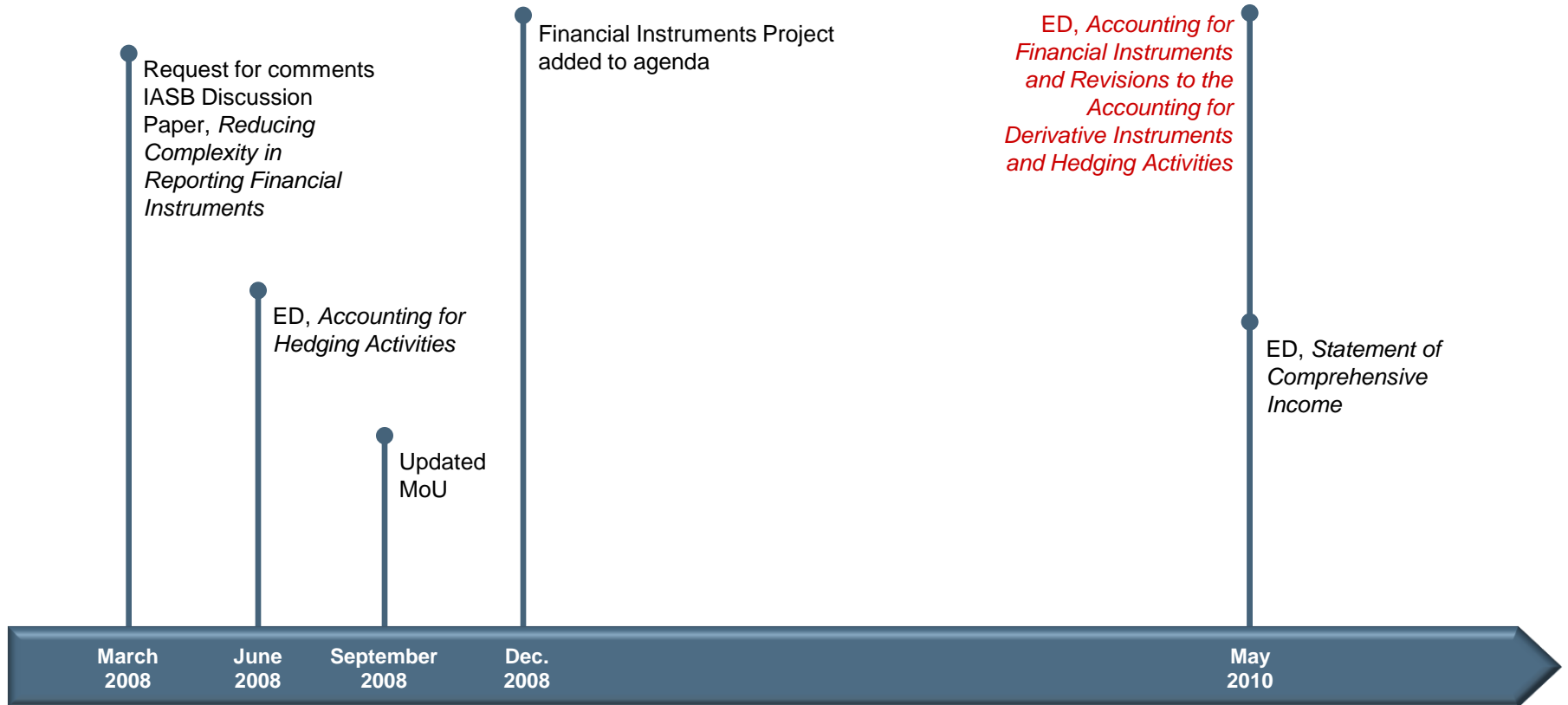
Changes to U.S. GAAP

FASB Financial Instruments Proposal

- Joint FASB/IASB project to improve the decision usefulness of financial instruments reporting for the benefit of users; also to increase comparability globally
- FASB proposal sets out a comprehensive model for financial assets and financial liabilities that addresses issues of:
 - Classification and measurement
 - Presentation
 - Impairment
 - Hedge accounting
 - Transition

Timeline – FASB

FASB



Highlights

- More financial instruments at fair value through net income
- Fair value through other comprehensive income option in specified circumstances, with expanded balance sheet presentation to show both fair value and amortized cost
- New criteria for equity method investments
- Single impairment model for loans and debt securities
- Hedge accounting made simpler
- Deferral for certain nonpublic entities, but partial only
- Is not convergent with IFRS

Classification and Measurement

- More financial instruments at fair value through net income, but fair value through other comprehensive income or amortized cost options in specified circumstances
- Designation on portfolio basis considering entity's business strategy for financial instruments, not instrument-by-instrument basis considering entity's intent for the instrument
- Fair value through other comprehensive income and amortized cost options are irrevocable elections made at inception
- No reclassifications even if entity's business strategy for financial instruments later changes
- No tainting

Fair Value – Net Income

- Fair value through net income unless otherwise specified (*i.e.*, the “default”)
 - Derivatives
 - Equity securities, unless qualify for equity method accounting
- Equity method accounting only if:
 - Investor has significant influence over investee, and
 - Investee’s operations are related to investor’s consolidated operations
- If equity method accounting, use cost (no fair value through net income option)

Fair Value – Other Comprehensive Income

- Fair value through other comprehensive income option for debt instruments if contractual cash flows meet specified criteria and entity's business strategy is to hold the instruments for collection (or payment) for significant portion of their contractual term, not sell (or settle)
 - Many loans
 - Debt securities
- For “qualifying” changes in fair value only
- Amounts recorded in other comprehensive income would go through net income when instrument sold or settled (recycling)

Amortized Cost

- Amortized cost option for financial liabilities that qualify for the fair value through other comprehensive income option if using fair value would create or exacerbate an accounting mismatch
 - Own debt only
- Accounting mismatch if the financial liability is:
 - Contractually linked to asset not at fair value, or
 - Part of an operating segment and less than 50% of segment assets at fair value, or
 - Part of consolidated entity and less than 50% of consolidated assets at fair value

Core Deposit Liabilities

- New “remeasurement” approach for core deposits (deposits without a contractual maturity considered a stable source of funds)
- Present value of the average core deposit amount during the period, discounted at the difference between alternative funds rate and all-in-cost to service rate over implied maturity of the deposits
- Changes in remeasurement amount recorded through net income or through other comprehensive income in specified circumstances

Current State vs. Future State

	Current State			Future State				Change ?
	Fair Value			Fair Value				
	NI	OCI	Cost	NI	OCI	Cost	Other	
Derivatives	✓			✓				No
Financial Assets								
Equity Securities	✓	✓	✓	✓				Yes
Equity Method Investments	✓		✓			✓		Yes
Debt Securities	✓	✓	✓	✓	✓			Yes
Loans	✓		✓	✓	✓			Yes
Financial Liabilities (Non Trading)								
Own Debt	✓		✓	✓	✓	✓		Yes
Core Deposits			✓				✓	Yes

Financial Statement Presentation

Category

Balance Sheet

Income Statement

Fair value -
Net Income



- **Fair value**
- Amortized cost (own debt at fair value)

- Realized and unrealized gains/losses (in aggregate)

Fair value -
OCI



- **Fair Value**
- Allowance for credit losses
- Amount to reconcile fair value and amortized cost
- **Amortized cost**

- Interest income/expense
- Credit losses
- Realized gains/losses
- Significant changes in liability fair values attributable to entity's own credit standing

Amortized
Cost



- **Amortized cost**

- Interest expense
- Realized gains/losses

Impairment

- Single credit impairment model for loans and debt securities
- Ongoing assessment of fair value declines below amortized cost due to credit impairment
 - No probability threshold for recognition
 - No OTTI determinations
- Evaluated on individual or pool basis using all available information relating to past events and existing conditions, not potential future events and conditions (modified expected loss approach)
- Reversals if credit impairment situations reverse
- Interest accrual = effective interest rate x (amortized cost - cumulative credit impairment)

Hedge Accounting

- Hedge effectiveness threshold lowered to “reasonably effective,” no longer “highly effective”
- Requires less rigorous qualitative assessment (quantitative assessment might still be necessary in certain circumstances)
- Bifurcation by risk for financial items
- No short cut method or critical terms match method
- No elective de-designation of hedges
 - Discontinue hedge accounting only if criteria no longer met or if instrument expires, is sold, terminated, or exercised

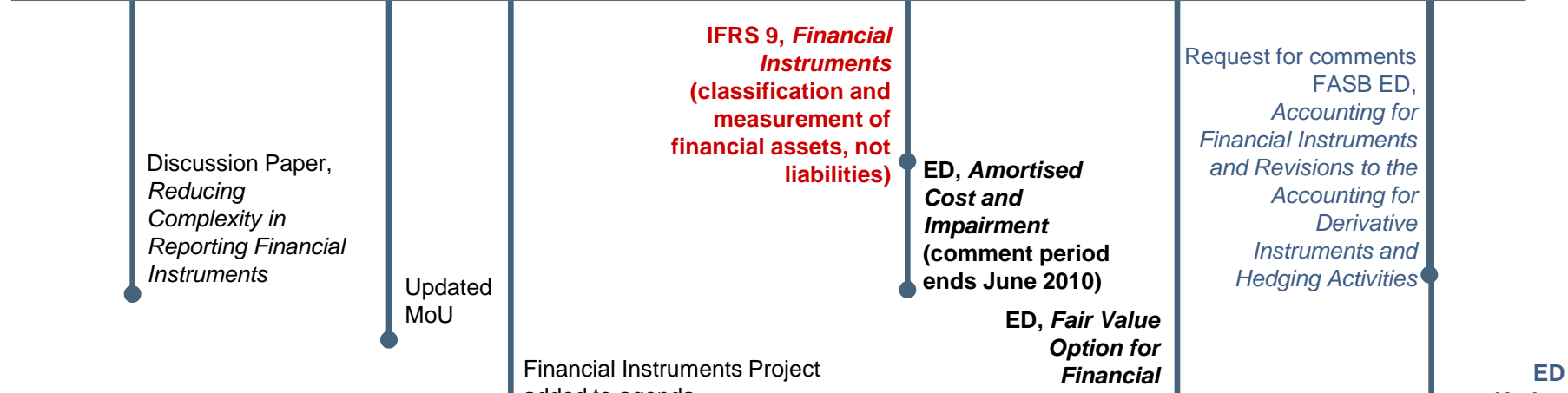
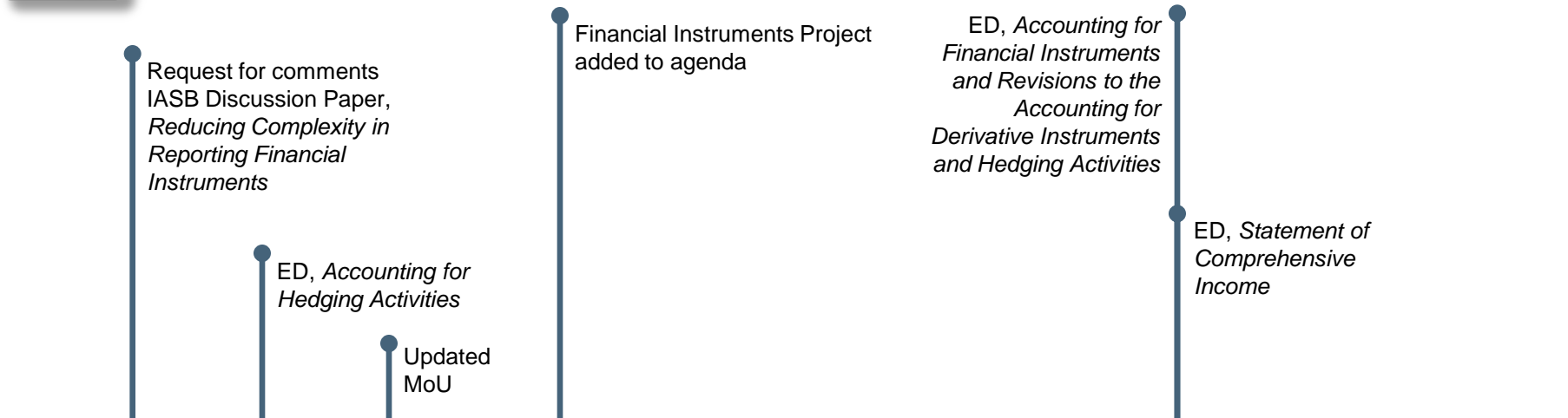
Transition

- 4-year deferral provisions for nonpublic entities with < \$1B total consolidated assets
- For loans and loan commitments that qualify for fair value through other comprehensive income option and for core deposit liabilities that qualify for remeasurement changes in other comprehensive income
 - Measure as currently under U.S. GAAP, but
 - Disclose fair value of the loans
- All other provisions would apply at effective date

Differences Between U.S. GAAP and IFRS

Timeline – FASB / IASB

FASB



IASB



IASB Approach

Same categories as FASB

+

**Similar eligibility criteria, applied to
different categories**

+

Classification by instrument (not portfolio)

=

**Different classification and measurement for
financial instruments**

Classification and Measurement

FASB

Business model is to hold instrument for collection of principal and interest



Fair value through Net Income

Fair value through OCI

Amortised Cost



Loans
Plain vanilla debt securities

IASB

Business model is to hold instrument for collection of principal and interest



Fair value through Net Income

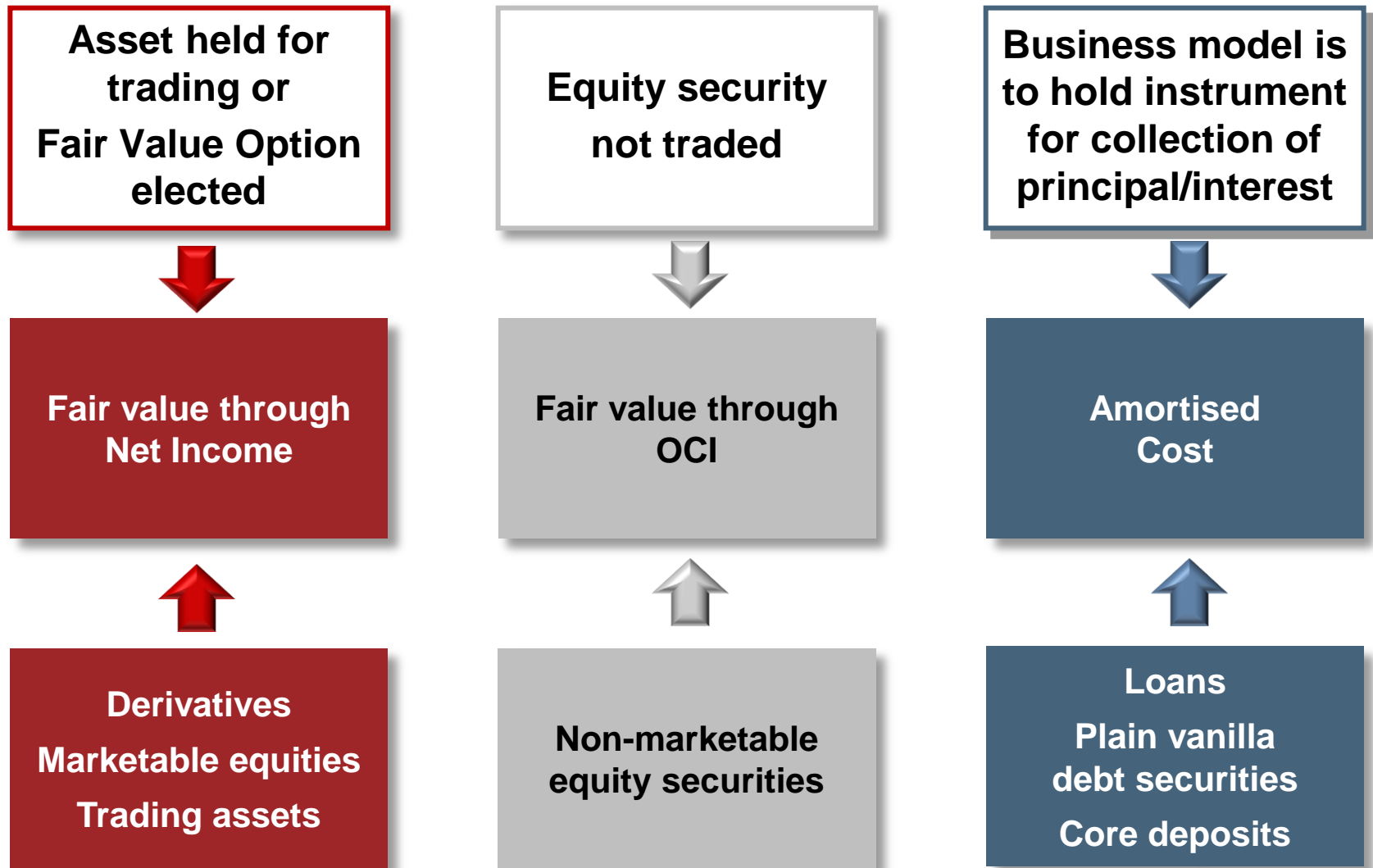
Fair value through OCI

Amortised Cost



Loans
Plain vanilla debt securities

Classification and Measurement – IASB



FASB vs. IASB Proposals

	FASB				IASB			Different?
	Fair Value				Fair Value			
	NI	OCI	Cost	Other	NI	OCI	Cost	
Derivatives	✓				✓			No
Financial Assets								
Equity Securities	✓				✓	✓	✓	Yes
Equity Method Investments			✓		✓		✓	Yes
Debt Securities	✓	✓			✓		✓	Yes
Loans	✓	✓			✓		✓	Yes
Financial Liabilities (Non Trading)								
Own Debt	✓	✓	✓			✓	✓	Yes
Core Deposits				✓			✓	Yes

Classification and Measurement

FASB

IASB

✓ Classification and measurement criteria based on business strategy

✓ Classification and measurement criteria based on business strategy

If criteria are met, classification is optional for each of the categories

If criteria are met, classification is required for each of the categories

Classification is by portfolio of instruments

Classification is by individual instrument

No reclassifications for existing instruments even if strategy changes

Reclassifications permitted in very limited circumstances

Fair value option eliminated

Fair value option remains

Impairment

- Impairment based on all available information relating to past events and current conditions and forecasts of future economic events and conditions
 - FASB model prohibits incorporating future events
- All other changes to impairment model consistent with FASB proposal:
 - Single credit impairment model for loans and debt securities
 - Ongoing assessment required - no probability threshold for recognition
 - May be evaluated on individual or pool basis
 - Reversals if credit impairment situations reverse

Interest Income

- Different pattern of interest income recognition from current approach and from FASB's approach
- Interest revenue is recognized based on cash flows expected at inception, including expected credit losses
 - Expected impairment losses are recognized on a level yield basis over the life of the loan
 - Interest revenue is lower in earlier years as compared to current incurred loss approach
 - Catch up adjustment is recorded to income when expectations about credit losses change
- IASB and FASB forming an Expert Advisory Panel to address operational challenges

Financial Statement Presentation

- For instruments at amortized cost (*e.g.* loans), fair value information disclosed in footnotes rather than on face of balance sheet
- Income statement shows more information about breakdown of net interest revenue and impairment losses
- For own debt at fair value (*i.e.*, fair value option elected): changes in credit spreads presented separately in Other Comprehensive Income
- Extensive new footnote disclosures required

Hedge Accounting

- ED not yet issued
- IASB considering many more changes than FASB
 - Hedging net exposures
 - Hedging non-financial risks

Summary

- Classification and measurement criteria different from FASB proposal
 - Traditional lending activities remain at amortized cost
 - Classification by instrument rather than by portfolio
 - Fair value option for financial assets and liabilities still exists
- Impairment model based on expected losses
 - Results in a different pattern of interest income recognition from both current IFRS approach and FASB proposed approach
- Changes to hedge accounting still under consideration

The Audit Committee

Questions?

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Thank You

Thank you for attending this webcast.

