Purpose of this paper

1. As described in the cover note, this paper summarizes the FASB’s discussions to date related to classification and measurement of financial liabilities.

Tentative decisions reached to date

Overall classification and measurement of financial liabilities

2. At the July 15, 2009 FASB Board meeting, the FASB tentatively decided that all financial liabilities would be recognized at fair value with certain exceptions. For financial liabilities recognized at fair value, subsequent changes in fair value would be recognized in net income (FV-NI) or other comprehensive income (FV-OCI) using the same criteria used to determine the accounting for subsequent changes in the fair value of financial assets. That is, changes in the fair value of a financial liability may be recognized in other comprehensive income if the financial liability meets both of the following conditions:

(a) The entity’s business strategy is to hold the financial liability with principal amounts for payment(s) of contractual cash flows rather than to settle the financial liability with a third party.

(b) The financial liability is not a hybrid instrument that is required to be bifurcated under FASB Accounting Standards Codification™ Subtopic
815-15 on embedded derivatives (originally issued as FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*).

3. An entity’s own debt would be eligible to be recognized at amortized cost if, in addition to meeting the qualifying criteria for recognizing fair value changes in other comprehensive income, measurement of the liability at fair value would *create or exacerbate* an accounting mismatch. The election would be optional and, therefore, would not preclude an entity from measuring financial liabilities at fair value.

**Core deposits**

4. At the November 24, 2009 FASB Board meeting, the FASB tentatively decided that core deposits should be measured using the following approach:

   (a) The value of the core deposit liability would be determined using a present value of the average core deposit amount discounted by the difference between the alternative funds rate and the all-in-cost-to-service rate over the implied maturity.

   (b) The core deposit liability amount that would be subject to remeasurement would be determined as an average amount over the implied maturity time period, which would result in the consideration of future deposits. Considering and valuing future deposits would result in an intangible asset being reflected in the valuation.

5. The FASB agreed that core deposits would qualify for remeasurement changes to be recognized in other comprehensive income.

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1 A measurement attribute mismatch does not refer to economic mismatches or duration mismatches of assets and liabilities. Instead, it refers to the difference in how assets and liabilities are measured for balance sheet purposes
Presentation

6. At the August 13, 2009 FASB Board meeting, the FASB tentatively decided that financial instruments would be displayed separately on the face of the statement of financial position depending on whether changes in their fair value are recognized in net income or in other comprehensive income.

7. An entity would be required to present on the face of the statement of financial position only the fair value amount of financial instruments whose changes in fair value are recognized in net income, except for the entity’s own debt. The entity would be required to present the amortized cost of its own debt in the statement of financial position. An entity that so chooses may also present, either in the statement of financial position or in the notes to the financial statements, both the amortized cost and the amount needed to adjust the amortized cost to arrive at fair value for financial instruments whose changes in fair value are recognized in net income.

8. An entity would be required, at a minimum, to present separately on the face of the performance statement an aggregate amount for realized and unrealized gains or losses of financial liabilities whose changes in fair value are recognized in net income. An entity that so chooses may also present current period interest expense accruals (including amortization/accretion of premium/discount upon acquisition), or dividend expense accruals, as separate line items in the performance statement. However, separate presentation of those items would not be required for financial liabilities whose changes in fair value are recognized in net income.

9. For financial liabilities whose changes in fair value are recognized in other comprehensive income, an entity would be required to present as separate line items in the statement of financial position the amortized cost and the amount needed to adjust amortized cost to arrive at fair value.

10. An entity would be required, at a minimum, to present separately on the face of the performance statement current period interest expense accruals (including amortization/accretion of premium/discount upon acquisition) and realized gains or
losses of financial liabilities whose changes in fair value are recognized in other comprehensive income.

11. An entity would not be required to present foreign currency transaction gains or losses on a financial liability denominated in a foreign currency as a separate line item in the performance statement. Those changes in fair value would continue to be presented in other comprehensive income together with other changes in fair value of financial liabilities whose changes in fair value are recognized in other comprehensive income.

12. For an entity’s own debt for which the amortized cost option is elected, the entity would be required to present separately in the performance statement both the current period interest accruals (including amortization/accretion of premium/discount upon acquisition) and realized gains or losses.

**Additional discussions**

13. At the November 24, 2009 FASB Board meeting, the FASB discussed the amortized cost option for an entity’s own debt. The FASB staff has identified some implementation issues related to the requirement that an entity’s own debt only be measured at amortized cost if measurement of the liability at fair value would create or exacerbate an accounting mismatch. The staff identified three alternatives for the FASB Board to consider. However, the FASB did not reach any tentative decisions on this issue. The alternatives discussed are summarized below.

*Alternative 1: amortized cost option based on an accounting mismatch*

14. This alternative is consistent with the FASB’s discussion at the July 15, 2009 Board meeting. This alternative would permit financial liabilities that qualify for FV-OCI to be eligible for the amortized cost election if measuring the financial liability at fair value would create or exacerbate a measurement attribute mismatch.
15. Under this alternative, the FASB staff recommends that the FASB address the level at which an entity should determine whether a measurement attribute mismatch exists (for example, consolidated entity, reporting unit, business unit, operating segment, or instrument-by-instrument). Additionally, if an entity level or business unit approach is selected, the FASB may wish to clarify whether specific identification of a measurement mismatch would be permitted in situations in which a financial liability is issued for the purpose of financing the purchase of a specific asset that will be measured at amortized cost. At the November 24, 2009 meeting, the FASB staff recommended against allowing for specific identification of a measurement mismatch in those situations because of potential structuring opportunities that could result if such transactions are considered in isolation (for example, if an entity issues debt for the purchase of a specific asset and then subsequently sells the asset or enters into a sale leaseback of the asset while retaining the debt).

Alternative 2: amortized cost option based on eligibility for FV-OCI category

16. This alternative would provide an option to measure financial liabilities that qualify for FV-OCI at amortized cost. The alternative would be available to all entities and all qualifying financial liabilities. It would broaden the eligibility of financial liabilities for which amortized cost could be elected.

Alternative 3: amortized cost option for most financial liabilities

17. This alternative would permit amortized cost measurement for most financial liabilities, with some exceptions. Most financial liabilities, regardless of whether the classification guidance would cause them to fall into the FV-NI or FV-OCI category, would be eligible to be measured at amortized cost. However, to preserve current practice, derivative liabilities and obligations to return securities sold short (short sales) would not be permitted to be measured at amortized cost.
18. Under this alternative, the FASB staff recommends that the FASB reconsider retaining the requirement to bifurcate hybrid financial liabilities such that an embedded derivative would continue to be measured at fair value and the host debt instrument would be measured at amortized cost.