



Proposal to Permit Companies to Decide Whether to Measure Financial Assets and Liabilities at Fair Value

Companies could elect, on a contract-by-contract basis, to measure most types of financial assets and liabilities at fair value, with changes in fair value recognized in earnings each reporting period, if a proposed FASB Statement is adopted.¹ The proposal contains financial-statement presentation and disclosure requirements for financial assets and liabilities reported under the election.

If adopted, the proposal would enable companies to reduce some of the volatility in reported earnings caused by the fact that under current requirements some financial assets and liabilities must be reported at their fair values and others at cost or some other measure. This mismatch in the “mixed-attribute” accounting model may cause volatility when certain assets or liabilities are reported at fair value but other related assets or liabilities are reported at cost. Under the proposed Statement, companies could reduce this source of earnings volatility by electing to use fair value to measure selected financial assets and liabilities that are currently reported at cost or some other measure where related financial assets and liabilities are also reported at fair value. The proposal would provide some relief for companies that currently use the complex requirements for hedge accounting prescribed by Statement 133 to reduce the volatility caused by the mixed-attribute model.²

Fair-Value Option

Companies would be permitted to elect fair-value measurement when a financial asset or liability is initially recognized or when an event, such as a business combination, triggers a new basis of accounting for that item. The fair-value election would be made on a contract-by-

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¹ FASB Exposure Draft, The Fair Value Option for Financial Assets and Financial Liabilities, January 2006, available at www.fasb.org.

² FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities, June 1998, amended through May 2003, and related interpretations, available at www.fasb.org.

contract basis and would be irrevocable for every contract chosen to be measured at fair value. Companies would need to document that the fair-value election was made when the asset or liability was initially recognized or establish a documented policy to elect fair value at initial recognition for specified financial assets or liabilities.

Changes in the fair value of all contracts subject to the fair-value-measurement election would be recognized in earnings each reporting period. All fair-value measurements made under the election would apply to the entire financial asset or liability. This differs from current requirements for qualifying fair-value hedging relationships. Under fair-value hedge accounting, the amount recorded in earnings for changes in the fair value of the hedged item is limited to changes in fair value that are attributable to selected risks inherent in the item that is being hedged.

Eligibility

The proposed Statement would permit the fair-value election for a large proportion of financial assets and liabilities. For example, companies would be permitted to elect fair-value measurement for their debt instruments, investments accounted for under the equity method, investments in equity securities that do not have readily determinable fair values, insurance and reinsurance contracts that are financial instruments, warranty obligations or warranty rights that are financial instruments, and unconditional purchase obligations that are recorded as liabilities.

The proposed Statement would also permit entities to elect fair-value measurement for unrecognized firm commitments if they have specified characteristics. The unrecognized

firm commitments would have to be binding, legally enforceable agreements with unrelated parties, specify all significant terms (including quantity, a fixed price, and timing), include a disincentive for nonperformance that is large enough to make performance probable, and involve only financial instruments.

The following assets and liabilities would not be eligible for the fair-value election:

- An investment that would otherwise be consolidated,
- Financial liabilities recognized under lease contracts (excluding contingent obligations from cancelled leases and guarantees of third-party lease obligations),
- Written loan commitments that are not accounted for as derivatives,
- Financial liabilities for demand-deposit accounts,
- Current and deferred income-tax assets or liabilities (because such assets and liabilities are not considered financial assets or liabilities for purposes of the proposed Statement), and
- Employers' and plans' financial obligations for pension benefits, other postretirement benefits, postemployment benefits, employee-share-option and share-purchase plans, and other forms of deferred compensation arrangements.

The proposed Statement does not apply to nonfinancial assets and liabilities. However, the next phase of the fair-value-option project, scheduled to begin this year, will consider permitting the fair-value-measurement election for selected nonfinancial assets and liabilities, firm commitments that involve nonfinancial instruments, and financial assets and liabilities identified above that are excluded from the scope of the proposed Statement.

Relationship to Derivative and Hedge Accounting

In some circumstances, the fair-value election would enable companies to report in earnings the offsetting effects of related assets and liabilities that economically hedge each other but may not qualify for hedge accounting under current GAAP. In circumstances where hedge accounting treatment is currently permitted, the fair-value election could enable companies to achieve similar results while avoiding the time, effort, and systems needed to document hedging relationships and to assess their ongoing effectiveness. However, companies will continue to find it necessary or to prefer to apply hedge accounting rules for a significant number of risk-management strategies that hedge various exposures.

Fair-Value Election When Hedge

Accounting Is Not Permitted. The proposed Statement would enable companies to achieve an accounting offset for changes in the fair value of related financial assets and liabilities in some circumstances that would not qualify for fair-value hedge accounting under current guidance. Here are two examples:

- Under the proposed Statement, companies could achieve accounting offset for related financial assets and liabilities that currently would not qualify for fair-value hedge accounting because the hedging instrument is not a derivative.
- Under the proposed Statement, companies would be permitted to elect fair-value measurement for investments accounted for under the equity method. Such investments are not now eligible to be designated as the hedged item in a fair-value hedging relationship.

Another example is a portfolio of similar assets or liabilities, such as a bond portfolio. To qualify for hedge accounting, the individual assets or liabilities in the portfolio must share the risk exposure for which they are designated as being hedged. Moreover, the change in fair value attributable to the hedged risk for each individual item in the hedged portfolio must be expected to respond in a generally proportionate manner to the overall change in the fair value of the aggregate portfolio that is attributable to the hedged risk. Under the proposed Statement, an entity could elect fair-value measurement when initially recognizing each financial asset or liability within a portfolio without having to demonstrate that each individual item is expected to respond in a proportionate manner to the overall change in the fair value of the aggregate portfolio that is attributable to the hedged risk.

Hedging Strategies Not Affected by the Fair-Value Option. By permitting companies to report the offsetting effect of changes in the fair values of related assets and liabilities, the extent to which such items are economically hedged would be reflected in earnings. However, risk-management strategies are often designed to minimize risks other than changes in the total fair value of an asset or liability. In those circumstances, the proposed Statement would not provide an alternative to the current hedge accounting requirements. The proposed Statement would have no effect on these hedges:

- All hedges of the exposure to variability in future cash flows (i.e., cash-flow hedges).
- Fair-value hedges of the exposure to changes in the fair value of a nonfinancial asset or liability or certain unrecognized firm commitments that do not involve

financial assets or liabilities.

- Fair-value hedges of the exposure to changes in an identified portion of a financial asset or liability that is attributable to selected risks inherent in the hedged item.
- Hedges of a net investment in a foreign operation using either a derivative or a nonderivative instrument as the hedging instrument.

Lower Volatility from Hedge Accounting. In some cases, derivative contracts are used to hedge exposure to fair-value changes in a portion of a financial asset or liability that is attributable to specified risks. In those circumstances, the accounting offset associated with the election would be based on changes in the entire fair value of the financial asset or liability, whereas the accounting offset for a qualifying fair-value hedging relationship would be limited to selected risks inherent in the item that is being hedged. Therefore, companies may in some cases continue to apply the requirements for fair-value hedge accounting.

Embedded Derivatives. Companies are required to evaluate contracts that do not meet the definition of a derivative instrument in their entirety to identify “embedded” derivative instruments that may require separate accounting. However, the requirement to identify embedded derivatives does not apply to a contract that is remeasured at fair value with changes in fair value reported in earnings each reporting period. The proposed Statement would thereby contribute to simplifying the application of accounting requirements because companies would not be required to identify and separately account for derivatives that are embedded in a financial asset or liability for which fair-value measurement has been elected.

Presentation and Disclosures

Companies that choose to elect fair-value measurement would be required to report the financial assets and liabilities that are measured at fair value under the election separately from the reported carrying amounts of assets and liabilities that are subsequently measured at cost or some other measure. These companies would either display separate line items for the fair-value and non-fair-value carrying amounts or aggregate the fair-value and non-fair-value amounts and parenthetically disclose on the balance sheet the carrying amounts of financial assets and liabilities for which fair-value measurement has been elected. Cash receipts and cash payments related to financial assets and liabilities for which fair-value measurement has been elected would be classified in the statement of cash flows based on the nature and purpose for which the related financial assets and liabilities were acquired or incurred.

The following disclosures would be required about financial assets and liabilities to which the fair-value-measurement election had been applied:

- The difference between the carrying amount of any financial liabilities reported at fair value due to the election and the aggregate principal amounts.
- Information sufficient to allow users of financial statements to understand the effect on earnings of changes in the fair values of the financial assets and liabilities that are subsequently measured at fair value as a result of a fair-value election.
- Quantitative information by line item communicating where the income statement reports gains and losses from changes in the fair values of the financial

assets and liabilities for which fair-value measurement has been elected.

- A description of how interest and dividends are measured and reported in the income statement.

The FASB added a disclosure to its proposal to address the effect of fair-value measurement of a company's own debt securities. For example, a deterioration in creditworthiness that reduces the fair value of a company's

debt securities would generate current-period gains in the income statement. The proposed Statement would require companies to disclose qualitative information about the reasons for significant changes in the fair values of financial liabilities for which fair-value measurement has been elected.

Comparison to International Accounting Standards

The IASB has adopted a fair-value option for financial instruments.* The adopted provisions are similar to the FASB's proposed Statement. In both cases, fair value is to be elected when the financial asset or liability is initially recognized; the election is irrevocable; and changes in fair value are recognized in earnings as they occur. The differences between international standards and the proposed Statement primarily relate to disclosures, scope exceptions, and whether eligibility criteria must be met to elect fair-value measurement.

Disclosures. International standards require disclosure of the current-period and cumulative amount of change in the fair value of a financial instrument that was caused by changes in credit risk for loans, receivables, and financial liabilities for which the fair-value option has been elected.** The proposed Statement would require the reasons for significant changes in the fair values of financial liabilities to be disclosed, but it would not require quantitative disclosure of the portion of a change in fair value that is attributable to changes in credit risk.

Scope Exceptions. The proposed Statement includes scope exceptions for written loan commitments that are not accounted for as derivatives and for financial liabilities for demand deposits. International standards do not contain those exceptions. However, the FASB will reconsider whether to retain the two exceptions in the next phase of the fair-value-option project.

Eligibility. The proposed Statement contains no eligibility criteria for companies to apply the fair-value option. Under international standards, however, the fair-value option may be applied to financial instruments other than hybrid instruments only when it results in more relevant information. For this purpose, the fair-value information is more relevant if it eliminates or significantly reduces an accounting mismatch that would otherwise arise from non-fair-value measurements of assets or liabilities or if a group of financial instruments is managed and its performance is evaluated on a fair-value basis pursuant to a documented risk management or investment strategy and fair-value information about that group of financial instruments is provided to key management personnel.

* International Accounting Standard 39, Financial Instruments: Recognition and Measurement, as revised in 2005.

** International Accounting Standard 32, Financial Instruments: Disclosure and Presentation, as revised in 2005.

Proposed Transition and Effective Date

As of the date a company initially adopts the final Statement, it would be permitted to elect fair-value measurement for any financial asset or liability within the Statement's scope. The adjustment to reflect the difference between the fair value and the current carrying amount of the financial assets and liabilities for which a company irrevocably elects fair-value measurement would be reported as a cumulative-effect adjustment to retained earnings upon adoption. Retrospective application would not be allowed. The proposed Statement would be effective as of the beginning of a company's first fiscal year that begins after December 15, 2006, with earlier adoption permitted for companies with fiscal years beginning after the Statement is issued.

Pros and Cons

The proposed Statement reports pro and con arguments that were considered. In favor of the fair-value option would be its effect on reducing volatility in reported earnings caused by the fact that under current requirements some financial assets and liabilities must be reported at their fair values and others at cost or some other measure. The accounting for an economic hedging relationship would reduce volatility without the complex hedge-accounting requirements and the implementation difficulties that entails. Reporting financial instruments at fair value



would also eliminate the need to identify and separate embedded derivatives. The fair-value option might in these ways contribute to the goal of simplifying the application of financial-accounting requirements. The FASB also believes the expanded use of fair-value measurement for financial instruments would provide users of financial statements with information more relevant and understandable than would cost-based measures. Finally, the FASB cites in favor of the fair-value option its potential contribution to reducing differences between U.S. and international accounting standards.

The FASB cites as a potential drawback reduced comparability between companies' financial statements. To the extent that some companies measure financial assets and liabilities at fair value and others use historical cost for the same types of assets and liabilities, the accounting is different for similar items and comparability suffers. In addition, because the proposed Statement permits companies to elect fair-value measurement on a contract-by-contract basis, different measures could be applied and reported for similar financial assets and liabilities within a company. The FASB addressed the comparability issue by proposing explanatory disclosures.



The comment period for the proposed Statement ends April 10, 2006. The FASB currently expects to issue the final Statement in the third quarter of 2006.

The descriptive and summary statements above are not intended to be a substitute for the text of the proposed Statement, or any other cited, actual, or potential requirements. Nor are any of the cited documents necessarily applicable to any entity's specific circumstances. Those accounting for specific financial instruments and complying with SEC filing requirements should refer to the texts of the applicable documents that set out GAAP and SEC requirements and consult their accounting and legal advisors.

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