

2012

FINANCIAL INSTRUMENTS

**A Comprehensive Guide to
Accounting and Reporting**

ROSEMARIE SANGIUOLO

SCOTT A. TAUB, CPA

LESLIE F. SEIDMAN



CCH

a Wolters Kluwer business

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Financial Instruments

by Rosemarie Sangiuolo, Scott A. Taub, CPA, and Leslie F. Seidman

Highlights

CCH's *Financial Instruments* is a comprehensive reference manual on accounting for financial instruments, including loans, securities, securitizations, and derivatives. It integrates and analyzes all of the existing accounting literature on this topic into one volume, and provides analysis and explanation of that guidance.

Author's Observation

Over the past year, the Financial Accounting Standards Board (FASB) continued to pursue the goal of improving the accounting model for financial instruments, which has historically been one of the most complicated and fragmented areas of U.S. GAAP. The financial crisis affecting the United States and global financial markets brought to the forefront some of the shortcomings of the accounting model for financial instruments and highlighted a number of areas requiring immediate improvement. In response, over the past few years, the FASB has issued clarifying guidance in certain areas and has increased disclosure requirements related to financial instruments to improve the accounting and increase transparency surrounding these instruments.

Despite those improvements, most agree that further improvement to financial instrument accounting continues to be needed. Companies that engage in financial instrument transactions report results that can be difficult to understand and compare due to the nature of the transactions and the potential different accounting measures that can be applied today. There are still five or more measurement models that, depending upon the circumstances, could apply to the same financial instrument. Further, certain areas of the accounting guidance, such as hedge accounting rules, are extremely detailed and complex. Structuring opportunities to take advantage of the financial instrument accounting standards continue to exist. For these reasons, the accounting for financial instruments remains a high priority area in the standard setting arena both in the U.S. and internationally.

Currently, the FASB and IASB are both focusing on longer-term solutions to achieve greater transparency and reduce complexity in the accounting for financial instruments. While there has been progress, more work remains for both boards. The IASB has issued a final standard on the recognition and measurement of financial instruments, but required adoption of that standard is likely to be pushed back until 2015 to allow for other parts of the financial instruments project to be completed. The FASB's standard remains under development in all areas. The solutions being developed independently by the FASB and IASB diverge significantly, although the boards continue to state that they expect eventually to converge in this important area. In addition, the boards are working jointly toward developing a new accounting model related to impairment of

financial assets, a key area flagged as needing to be revamped after the financial crisis. This joint effort is expected to result in new guidance for companies holding financial assets that will address when and by how much such assets must be written down to reflect expected credit losses. Information on this project, as well as all of the FASB's technical project activities and initiatives, including international convergence projects, is updated on a regular basis on its website—<http://www.fasb.org>. Information about the IASB and its standard-setting agenda can be found on <http://www.iasb.org>.

2012 Edition

This edition covers various new accounting standards in the area of financial instruments, including:

1. FASB Accounting Standards Update 2011-01, *Receivables (Topic 310): Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings in Update No. 2010-20*
2. FASB Accounting Standards Update 2011-02, *Receivables (Topic 310): A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring*
3. FASB Accounting Standards Update 2011-03, *Transfers and Servicing (Topic 860): Reconsideration of Effective Control for Repurchase Agreements*
4. FASB Accounting Standards Update 2011-04, *Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*
5. New SEC staff guidance, including several positions communicated by members of the SEC staff in speeches

Numerous other accounting developments are reflected in this edition.

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Preface

Accounting for financial instruments is an area of U.S. GAAP that has undergone significant and ongoing change over many years. Some changes were needed to keep pace with developments in financial markets as well as the increasing complexity of financial instruments and structured finance transactions. Others were precipitated by accounting scandals or financial reporting crises. As each recent financial reporting crisis arose, immediate solutions were needed and were developed separately in a piecemeal fashion. Currently, the accounting model for financial instruments is largely instrument-specific and characterized by detailed rules, numerous interpretations of those rules, and many carve-outs and exceptions. The current model for financial instruments can best be described as a mixed-attribute model with a fair value option “overlay,” where companies have significant latitude to decide which subsequent measurement attribute to apply. In addition to a fair value election, the instrument-specific guidance is often complex and fragmented, having originated in pronouncements issued through the years by the FASB, the Emerging Issues Task Force (EITF), the American Institute of Certified Public Accountants (AICPA), and, depending on the circumstances, by the Securities and Exchange Commission and other regulators. Given this complicated landscape, accountants and others (including bankers, analysts, and lawyers) who deal with the accounting for financial instruments in their professions face a difficult task.

IMPORTANT NOTICE: FASB’s COMPREHENSIVE FINANCIAL INSTRUMENTS PROJECT

In May 2010, the FASB issued an Exposure Draft of a proposed Accounting Standards Update (ASU), *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*. The Exposure Draft proposed an accounting model for financial instruments primarily based on fair value measurement. In 2011, after considering feedback on the Exposure Draft pursuant to its due process requirements, the FASB began to readdress the accounting model for financial instruments. The most significant revision to the model is elimination of the requirement for all loans to be measured at fair value. Instead, the model will require loans not held for sale that meet certain qualifying criteria to be measured at amortized cost. Significant decisions reached to date are outlined below.

Classification and Measurement

- All financial assets and financial liabilities would be required to be classified in one of the following categories:

—*FV-NI*: Financial instruments in this category would initially and subsequently be measured at fair value and all changes in fair value would be recognized in net income. Financial assets (e.g., loans and debt securities) that are held for sale at acquisition would be required to be included in this category. Loan commitments (e.g., certain mortgage loan commitments), revolving lines of credit, and standby letters of credit would be

included in this category if the business strategy for the underlying loans is to hold them for sale. Financial liabilities that (1) are held for transfer at issuance or incurrence and for which the entity has the ability to transact at fair value and (2) relate to short sales would be included in this category.

—*FV-OCI*: Financial instruments in this category would initially be measured at transaction price and most changes in fair value would be recognized in other comprehensive income (impairment charges and interest income/expense would continue to be recognized in net income, not OCI). Only investments in “plain vanilla” debt instruments that are not held for sale at acquisition for which the company’s business strategy is to invest in the instrument either to maximize total return (either by collecting contractual cash flows or selling the asset) or to manage the interest rate or liquidity risk of the entity would qualify for this category.

—*Amortized cost*: Financial assets in this category would initially be measured at transaction price and subsequently measured at amortized cost. This category would include “plain vanilla” assets not held for sale at acquisition for which the company’s business strategy is customer financing or lending, focusing on collection of cash flows from the borrower and where the credit risk of the instrument would be managed through negotiation with the counterparty. Most financial liabilities would be included in this category.

- The classification model would result in the following:
 - Loans and receivables would generally be measured at amortized cost.
 - Investments in debt securities would be measured at fair value in the balance sheet, but certain changes in fair value could be recognized in OCI rather than in net income if qualifying criteria are met.
 - Investments in equity instruments (except for equity method investments) would be marked to fair value through net income. However, nonpublic entities would have a practicability exception to fair value measurement for investments in nonmarketable equity securities permitting measurement at cost less any impairment plus upward adjustments in fair value when information about a change in price is observable.
 - Most financial liabilities would be carried at amortized cost
 - Hybrid financial instruments would continue to be evaluated and bifurcated if required by Subtopic 815-15 (FAS-133).

Impairment

- Receivables, loans, and investments in debt securities measured at amortized cost or FV-OCI would be subject to an impairment evaluation. The current impairment models based on a probable incurred loss (loans) is expected to be eliminated. The amount of impairment to be recognized would be based on expected losses. As this book went to press, details of the impairment model were not fully developed as the FASB and IASB were in early discussions of an approach based on the level of credit risk inherent

in the financial instrument which would reflect the pattern of credit deterioration. Under that approach, entities would be required to recognize a full lifetime expected loss for those financial assets with a heightened level of credit risk or significant deterioration of credit quality since acquisition or origination.

- A different impairment model would apply to loans that initially qualify for the amortized cost category but that are subsequently deemed to be held for sale. Such loans would continue to be measured at amortized cost; however, impairment losses would be recognized in net income based on the difference between the amortized cost basis and its fair value of the asset.
- For a nonmarketable equity security not measured at fair value due to the practicability exception discussed above, entities would be required to assess impairment indicators to determine whether it is “more likely than not” that the security is impaired and, if so, an impairment loss would be recognized in earnings based on the entire difference between the investment’s carrying value and its fair value.

Equity Method Investments

- Equity investments that otherwise would qualify for the equity method of accounting would be measured at fair value with changes in fair value recognized in net income if the investment is held for sale. The held for sale determination would be made upon the investment’s initial qualification for the equity method of accounting and could not be changed subsequently.

Fair Value Option

- The general fair value option for financial instruments would be significantly narrowed. The fair value option would be permitted for (1) hybrid financial assets and liabilities that are required to be bifurcated and (2) groups of financial assets and liabilities for which the company manages the net exposure relating to those financial assets and liabilities (including derivatives) and provides information on that basis to management.

Balance Sheet Presentation of Fair Values

- For financial assets and financial liabilities measured at amortized cost (except short-term receivables and payables and demand deposit liabilities), public companies would be required to parenthetically present fair value, consistent with the measurement requirements in ASC 820, on the face of the balance sheet.

Disclosures

- Demand Deposit Disclosures—Public companies that issue demand deposits would be required to disclose in the notes to the financial statements a present value amount for demand deposit liabilities.
- Risk Disclosures—All companies would be required to disclose new information about liquidity risk and financial institutions would be incre-

mentally required to provide new disclosures about interest rate risk, by reportable segment. The proposed disclosures would be required for interim and annual reporting periods, (except for nonpublic, nonfinancial entities, which would be required to provide the liquidity risk disclosures only for annual reporting periods). The following are the key disclosures:

—Qualitative disclosures about the exposure to risks and how they arise, and the company's objectives, policies, and processes for managing the risks and the methods used to measure the risks.

—Liquidity risk disclosures: Disclosure of available liquid funds, which includes unencumbered cash and high-quality liquid assets, and borrowing availability such as lines of credit. Financial institutions would disclose a table based on expected maturities of classes of financial assets, financial liabilities, and off-balance-sheet commitments. Nonfinancial entities would disclose a table of their undiscounted cash obligations, including off-balance-sheet obligations.

—Interest rate risk disclosures: Financial institutions would disclose (1) a table showing when its classes of financial assets and financial liabilities would reprice and their weighted-average yield and duration and (2) a table showing the effect of prospective, hypothetical interest rate shifts on the company's interest-sensitive financial assets and liabilities. A depository institution would disclose a table showing the entity's average rate and average life for insured, uninsured, and brokered time deposits.

Hedge Accounting

- The shortcut method, which assumes no ineffectiveness in a hedging relationship, and the "critical terms match" method would be eliminated.
- In order to designate a fair value or cash flow hedging relationship, the hedge must be expected to be reasonably effective in achieving offset, rather than highly effective as is currently required by ASC 815 (FAS-133). Compliance with this criterion could be demonstrated by a qualitative assessment establishing that an economic relationship exists between the hedging instrument and the hedged item, rather than requiring a quantitative assessment as is currently required.

These tentative decisions, if finalized, would significantly impact numerous chapters in this book, as indicated by an Author's note in those chapters. Timing of a final ASU is uncertain. In addition, the FASB and IASB plan to discuss ways to converge. Readers should monitor the progress of these projects.

PURPOSE OF THIS BOOK

Financial Instruments is written for practicing accountants and other professionals who need to understand the accounting for financial instruments. This book pulls together all of the existing accounting literature on financial instruments into one volume, organizes it logically, and describes the requirements as simply as possible. Given the complexity of the subject matter, there are limits on how "simple" one can make this material. However, this comprehensive, topic-based approach will save practitioners time and effort in researching accounting issues

and provide a comfort level knowing that they have considered all of the relevant guidance. The text includes visual aids whenever possible; observations, such as differences between instrument types; practice pointers; and examples to help readers understand the requirements. The book also includes a cross-reference to the original pronouncements and cites the chapter(s) in which they are discussed, a glossary of terms that includes references to the applicable chapter(s), and a detailed index.

WHAT THIS BOOK COVERS

Financial Instruments is a comprehensive reference manual of generally accepted accounting principles (GAAP) in the United States about financial instruments. A financial instrument is cash, an ownership interest in another entity (such as common stock), or a contract that conveys an obligation and a corresponding right to require delivery of (or exchange) a financial instrument(s). The right may be contingent (such as an option) or unconditional (such as a loan). A financial instrument is ultimately convertible to cash (or stock) and does not involve the delivery of goods or services.

This book includes guidance originally issued by the Financial Accounting Standards Board, and the FASB's Emerging Issues Task Force and Derivatives Implementation Group. It also includes accounting guidance issued by the American Institute of Certified Public Accountants (AICPA), including standards issued by the Accounting Standards Executive Committee (AcSEC), and the audit and accounting guides issued by various committees of the AICPA. It covers accounting requirements for public and private companies and touches on unique aspects of reporting financial instruments by nonprofit organizations. *Financial Instruments* does not cover certain transactions that are technically financial instruments, but that are accounted for under specialized accounting models, including stock compensation and other forms of employee benefits (from the issuer's perspective), most leasing transactions, and insurance contracts. This book does not address the equity method of accounting (for investments that convey significant influence over the investee), consolidation of operating entities (for investments that convey control over the investee), or business combinations. CCH's *GAAP Guide* addresses all of those subjects in detail. However, this book does address consolidation of special-purpose entities that are used to securitize financial assets. This book does not discuss in detail the specialized accounting models used by pension plans, brokers and dealers in securities, and investment companies whereby substantially all of their assets (and certain liabilities) are carried at fair value. This book refers to positions of the SEC staff (and other guidance published by the SEC) when it interprets or elaborates on a financial reporting requirement originally established by the FASB or AICPA. This book does not represent a comprehensive guide to SEC reporting requirements, even for financial instruments.

This book contains cross-references to the Accounting Standards Codification so that readers can carefully review the full text and other relevant material. In certain instances, references to the Codification are not included (e.g., tentative guidance, effective date and transition guidance for standards that are already fully effective, standards that are superseded, content from the basis for conclu-

sions of accounting pronouncements). In addition, this book contains references to sources that are outside the scope of the Codification, including FASB Concepts Statements, auditing standards, rulings of the Internal Revenue Service, and regulatory principles developed by the federal banking agencies and the National Association of Insurance Commissioners. Those references are intended to provide context and depth to the discussion of the topic being discussed. However, any accounting literature not included in the Codification is considered nonauthoritative.

This book also includes a high-level discussion of the relevant International Financial Reporting Standards (IFRS) for financial instruments covered in each chapter. “IFRSs” consist of pronouncements issued by the International Accounting Standards Board (IASB) and standards and interpretations issued and approved by the IASB’s predecessor Board, the International Accounting Standards Committee (IASC).

HOW THIS BOOK IS ORGANIZED

Financial Instruments is organized into five parts:

- Part I: Financial Assets, including cash, securities, loans, and servicing rights
- Part II: Financial Liabilities, including debt, securities lending arrangements, and convertible debt
- Part III: Derivative Instruments, including hedging activities
- Part IV: Equity Instruments, including various forms of stock and contracts indexed to a company’s own stock
- Part V: Pervasive Issues, such as offsetting and fair value measurement and disclosures

Within each part, the chapters are organized by instrument type in the order in which they typically appear in a company’s balance sheet. Each chapter integrates all of the available guidance for that type of instrument and alerts the reader to potential changes in accounting (such as an outstanding FASB Exposure Draft or an EITF Issue under discussion). Each chapter covers the relevant accounting questions for that type of instrument, including:

- When and how to initially recognize the instrument in the balance sheet.
- How to present the instrument in the financial statements.
- How to measure the instrument in subsequent periods (e.g., cost or fair value).
- How to recognize income or expense.
- When and how to recognize impairment.
- When to remove the instrument from the balance sheet (and whether to recognize a gain or loss).
- What to disclose in the footnotes.

Each chapter also highlights any interesting aspects of regulatory reporting for certain institutions and areas of audit risk that stem from the financial reporting requirements. Certain positions of the Securities and Exchange Commission (and its staff) are included when they relate directly to information that must be included in the audited financial statements of a public company. To facilitate additional research, *Financial Instruments* includes references to pertinent paragraphs of the Accounting Standards Codification. Readers who are familiar with a specific pronouncement can locate that pronouncement in the cross-reference section (21,001) and then refer to the chapter(s) in which it is discussed. The glossary and index can also be used to locate guidance on specific instruments and accounting topics. This edition reflects authoritative guidance that pertains to financial instruments through the standard number or date indicated below:

- FASB Accounting Standards Update 2011-04, *Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*
- AICPA Audit and Accounting Guides, 2010 editions (or the latest edition available)
- SEC SAB 111, "Other Than Temporary Impairment of Certain Investments in Debt and Equity Securities"
- Statement on Auditing Standards No. 101, "Auditing Fair Value Measurements and Disclosures"
- PCAOB Staff Audit Practice Alert No. 4, "Auditor Considerations Regarding Fair Value Measurements, Disclosures, and Other-Than-Temporary Impairments"

Establishing a "cut-off" for this book was difficult, given the dynamic nature of this subject and the lead-time necessary to publish a book of this length. Readers should understand that the accounting standard-setters continuously address new issues and interpret and amend existing standards. There are inevitable time delays between the promulgation of new standards and their inclusion in this or future editions of this book. Readers may find the following websites useful to monitor accounting developments:

- FASB website: www.fasb.org (includes Accounting Standards Codification and pre-codification standards issued by the FASB, EITF, DIG, and AICPA)
- AICPA website: www.aicpa.org (includes Audit and Accounting Guides)
- U.S. Securities and Exchange Commission website: www.sec.gov (includes guidance from the Office of the Chief Accountant and the Division of Corporation Finance)

The author and publisher welcome your suggestions to improve future editions of this book. Please send your comments to Elizabeth Murphy, Developmental Editor, at elizabeth.murphy@wolterskluwer.com.

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The authors thank Elizabeth Murphy, Developmental Editor; Mike Lindquist, Manager, Editorial Services; and the staff at CCH Tax and Accounting for their guidance and efforts in bringing this manual to press.

About the Authors

Rosemarie Sangiuolo is an independent consultant specializing in accounting and reporting for financial instruments.. In that capacity, she has consulted on accounting matters for various organizations and is currently involved in standard-setting projects related to financial instrument accounting. Ms. Sangiuolo has authored and served as technical reviewer for various publications including CCH's interpretations on Derivatives and Hedging. For four years, she served as a member of the core project team to develop the FASB Accounting Standards Codification, focusing on the codification of complex areas of GAAP related to transfers and servicing of financial assets, derivatives and hedging, interest income recognition, and loan impairment, among others. She was also the lead technical reviewer in the FASB's project to update the XBRL taxonomy released in 2009 to incorporate referencing of existing accounting standards.

Previously, Ms. Sangiuolo was a project manager at the Financial Accounting Standards Board, where she focused primarily on standard-setting efforts associated with derivatives and hedging, asset transfers, and securitization transactions. In that capacity, she contributed to numerous accounting pronouncements issued by the FASB, the Emerging Issues Task Force, and the Derivatives Implementation Group. Prior to joining the FASB, Ms. Sangiuolo was a Vice President at J.P. Morgan & Co., where she dealt with accounting policy, regulatory, and financial reporting issues relevant to the financial services industry. Ms. Sangiuolo graduated summa cum laude from Fordham University with a major in economics and received her M.B.A. from New York University's Stern School of Business.

Scott Taub is a Managing Director of Financial Reporting Advisors, LLC (FRA), which provides consulting services related to accounting and SEC reporting and litigation support services. FRA specializes in applying generally accepted accounting principles to complex business transactions and also provides litigation support and expert services. Mr. Taub is also a member of the IASB's International Financial Reporting Interpretations Committee.

From September 2002 through January 2007, Mr. Taub was a Deputy Chief Accountant at the Securities and Exchange Commission (SEC) and twice served as Acting Chief Accountant for a total of 14 months. He played a key role in the SEC's implementation of the accounting reforms under the landmark Sarbanes-Oxley Act and was responsible for the day-to-day operations of the Office of the Chief Accountant. Mr. Taub represented the SEC in many venues, including the FASB and IASB's advisory committees, and served as the SEC Observer to the FASB's Emerging Issues Task Force (EITF) and as Chair of the Accounting and Disclosure committee of the International Organization of Securities Commissions (IOSCO).

Prior to September 2002, Mr. Taub was a partner in Arthur Andersen's Professional Standards Group (PSG), where he consulted on complex financial reporting matters, helped to establish and disseminate Andersen's policies regarding financial reporting matters, and represented the firm before various

standards setters, including the FASB, SEC, AICPA, and IASB. Mr. Taub also authored interpretive guidance for Andersen on a wide variety of accounting and reporting issues.

Mr. Taub is a frequent speaker, having addressed numerous audiences sponsored by a variety of organizations, and writes a periodic column for Compliance Week on financial reporting developments. He is a licensed CPA in Michigan and Illinois and is a member of the American Institute of Certified Public Accountants.

Leslie F. Seidman is a certified public accountant (inactive) with extensive experience in the financial services industry and in accounting standard-setting. With an English major from Colgate University and a Masters Degree in accounting from New York University Stern School of Business, Ms. Seidman has a unique combination of writing ability and accounting knowledge.

Ms. Seidman started her career as an auditor for Ernst & Young LLP before joining J.P. Morgan, where she was a Vice President of accounting policy for many years. Ms. Seidman was selected for an industry fellowship at the Financial Accounting Standards Board, where she later served as assistant director of implementation and practice issues. Subsequently, Ms. Seidman had her own financial reporting consulting firm, serving financial institutions, accounting firms, and other organizations. She has authored, reviewed, and edited hundreds of accounting pronouncements of the FASB and AICPA, and contributed to several books and other publications.

Ms. Seidman is a member of the AICPA and the Institute of Management Accountants, where she served on the Financial Reporting Committee.

Subsequent to writing this book, Ms. Seidman was appointed to a three-year term as a member of the Financial Accounting Standards Board. She was reappointed to a five-year term in March 2006.

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