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FINANCIAL INSTRUMENTS

A Comprehensive Guide to Accounting and Reporting

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CCH
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Financial Instruments

by Rosemarie Sangiuolo and Leslie F. Seidman, CPA

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, including guidance issued by the Financial Accounting Standards Board (FASB), the FASB's Emerging Issues Task Force (EITF) and Derivatives Implementation Group (DIG), as well as accounting guidance issued by the American Institute of Certified Public Accountants (AICPA).

Author's Observation

The past year in accounting standard setting has been characterized by a focus on several interrelated objectives—greater momentum toward international convergence, reducing complexity, and increasing transparency in reported financial information. Accounting obscurity related to off-balance sheet financing and the fallout from the recent subprime crisis has heightened the need for improvement in accounting guidance and, in response, various initiatives have been undertaken.

The areas of financial instrument accounting that have undergone the greatest change in recent years reflect the long-term objective of the FASB and the International Accounting Standards Board (IASB) to measure all financial assets and liabilities at fair value. Various standards related to financial instruments issued in recent years have furthered this goal, including FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments—An Amendment of Statements No. 133 and 140*, FASB Statement No. 156, *Accounting for Servicing of Financial Assets*, FASB Statement No. 157, *Fair Value Measurement*, and FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities.* FAS-157 and FAS-159 became effective in 2008. FAS-157 provides consistent guidance on measuring fair value under U.S. GAAP, and the IASB is currently working on a similar project. FAS-159's introduction of an instrument-by-instrument fair value option for financial instruments aligns with the fair value option permitted by International Financial Reporting Standards (IFRS). Beyond fair value measurement, the FASB and the IASB are also continuing to work toward converging their standards in other areas, consistent with the priorities set in the 2006 "Memorandum of Understanding" between the two boards, with efforts being undertaken to simplify hedge accounting requirements, and to develop a new standard for the derecognition of financial instruments.

The increased focus on clarifying current accounting standards for financial instruments and reducing complexity is visible in the direction being considered in several of the FASB's short-term projects. For example, the FASB is considering a highly simplified "fair value approach" for applying hedge accounting under FAS-133 and eliminating two contentious and heavily interpreted "carve-outs" (the "shortcut method" for certain hedges under FAS-133 and the QSPE concept under FAS-140). Eliminating the QSPE concept in FAS-140 would presumably cause many more securitization entities to be consolidated, thereby increasing the transparency of the risk position of entities involved with such transactions. In turn, this places greater weight on the guidance for consolidation of securitization entities, and the FASB is also considering simplifying those rules. The FASB is still deliberating these projects and all decisions to date are tentative.

In March 2008, the FASB issued an Invitation to Comment, "Reducing Complexity in Reporting Financial Instruments," originally published by the IASB to seek input on whether and how standards for financial instruments should be simplified to assist the boards in setting priorities in this area. Another major effort toward reducing complexity, the FASB's codification and retrieval project, is in its final phase. Once finalized, the codification will be the single authoritative source of U.S. GAAP—one which is fully synthesized with all relevant pronouncements integrated and organized topically. On another front, the SEC's Advisory Committee on Improvements to Financial Reporting, formed in 2007, has issued its recommendations on some overarching issues consistent with the goal of reducing complexity and making reported information more useful and understandable for investors.

Concurrent with the many standard-setting efforts and other initiatives designed to reduce complexity in accounting standards and achieve greater transparency in reported financial information under U.S. GAAP, the movement toward a single set of international accounting standards has accelerated. Recent developments on this front, as further discussed in the Preface to this book, position international convergence and the seemingly inevitable future transition to IFRS as a central issue for U.S. companies and accounting standard setters.

2009 Edition

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

- FASB Statement No. 161, "Disclosures About Derivative Instruments and Hedging Activities"
- FSP FAS-140-3, "Accounting for Transfers of Financial Assets and Repurchase Financing Transactions"
- FSP APB 14-1, "Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement)"
- Amended guidance for consolidations of variable interest entities in FIN-46(R), "Consolidation of Variable Interest Entities," as a result of the issuance of FAS-141(R), "Business Combinations" (revised 2007)
- DIG Issue E23, "Hedging—General: Issues Involving the Application of the Shortcut Method Under Paragraph 68"
- New SEC guidance, including SEC SAB 109, "Written Loan Commitments Recorded at Fair Value Through Earnings," (which supersedes SEC SAB 105 in Topic 5DD) and updated guidance in EITF Topic D-98, "Classification and Measurement of Redeemable Securities," resulting from the issuance of new accounting standards

Numerous other accounting developments are reflected in this edition.

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Accounting Research Manager is the most comprehensive, up-to-date, and objective online database of financial reporting literature. It includes all authoritative and proposed accounting, auditing, and SEC literature, plus independent, expert-written interpretive guidance.

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Preface

Accounting for financial instruments is an area of U.S. GAAP that has undergone significant and continuous change in recent years. Much of this change has been necessitated by the rapid developments in financial markets. Changes in regulation and increasing volatility in the capital markets inspired innovations in the nature of financial instruments and new ways to bundle them, unbundle them, and modify them. Unfortunately, the accounting rules for financial instruments historically have not kept pace with the increasing complexity of the instruments and structured finance transactions. For many years, most financial instruments such as loans, securities, and derivatives were carried at historical cost in the balance sheet, unless collection was in doubt. Several well-publicized accounting scandals, including gains-trading of securities, unforeseen losses on derivatives, upfront gain recognition on securitizations of subprime loans, inadequately documented loan loss reserves, and off-balance sheet financing, have motivated the ongoing changes in the accounting model.

The Financial Accounting Standards Board (FASB)—the primary accounting standard-setter in the United States—has been attempting to comprehensively address accounting for financial instruments for over 20 years, having commenced its Financial Instruments project in 1986. However, 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. Recently, the trend has been a move toward broader use of fair value measurement, with the initial introduction of a fair value option for specific instruments (servicing, certain hybrids) and then a broader fair value option for most types of financial instruments. 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, fragmented, and spread across 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.

Acknowledging the complexity and fragmentation of many areas of the accounting literature, in 2005, the FASB began a major project to codify U.S. GAAP. The codification will organize existing FASB, AICPA, and SEC accounting literature by topic, fostering easier navigation of all authoritative literature on a given topic in one location. In 2008, the codification was released publicly for a one-year verification period, during which constituents may provide feedback. The final version of the codification is scheduled to be released as early as April 2009, at which time all existing pronouncements will be superseded and the codification will become the single authoritative source of U.S. GAAP. In this edition, the cross-reference table includes references to the relevant topic in the codification for each pronouncement covered.

This edition of *Financial Instruments* 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). IFRSs are considered a "principles based" set of standards because they establish broad rules. They differ from pronouncements issued by the FASB, which are generally more detailed and perceived to be more "rules-based."

In 2006, the FASB and the International Accounting Standards Board (IASB) executed a "Memorandum of Understanding" between the two boards, outlining the broad areas for joint work to achieve convergence. The two boards are in the process of working through various convergence projects. Alongside this effort, there has been discussion in many forums about the potential that U.S. companies may ultimately be required to transition to IFRS. In 2007, the SEC published a concept release discussing this possibility. In August 2008, the SEC announced plans to propose a "roadmap" for possible transition to IFRS by U.S. issuers beginning in 2014, citing the need for a single set of high quality accounting standards due to increasingly integrated global capital markets that require greater comparability and investor confidence in financial reporting.

Information on 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.

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.[1] It includes guidance 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. Over 400 pieces of authoritative literature are referenced in this book.

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 Level A* 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.

[1] 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. (FAS-107, par. 3)

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 established by the FASB or AICPA. This book does not represent a comprehensive guide to SEC reporting requirements, even for financial instruments. This book refers to some guidance that does not represent GAAP, including auditing standards published by the AICPA, 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 merely to provide context and depth to the discussion of the topic being discussed. This book contains cross-references to the source documents so that readers can carefully review the full text and other relevant material.

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 original pronouncements. Readers who are familiar with a specific pronouncement can locate that pronouncement in the cross-reference section (CR.01) 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 Statement No. 161, "Disclosures About Derivative Instruments and Hedging Activities"
- FASB Interpretation No. 46(R), "Accounting for Variable Interest Entities" (Revised December 2003)
- FASB Technical Bulletin No. 01-1, "Effective Date for Certain Financial Institutions of Certain Provisions of Statement 140 Related to the Isolation of Transferred Financial Assets"
- Derivatives Implementation Guidance that has been cleared by the FASB through May 2008
- FASB Staff Positions issued through May 2008
- FASB Staff Implementation Guide, "A Guide to Implementation of Statement 140 on Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities"
- Consensuses of the Emerging Issues Task Force reached through March 2008
- AICPA Statement of Position No. 03-3, "Accounting for Certain Loans or Debt Securities Acquired in a Transfer"
- AICPA Practice Bulletin 15, "Accounting by the Issuer of Surplus Notes"
- AICPA Audit and Accounting Guides, 2007 editions (or the latest edition available)
- SEC SAB 109, "Written Loan Commitments Recorded at Fair Value Through Earnings"
- Statement on Auditing Standards No. 101, "Auditing Fair Value Measurements and Disclosures"
- PCAOB Staff Audit Practice Alert No. 2, "Matters Related to Auditing Fair Value Measurements of Financial Statements and the Use of Specialists"

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 FASB, EITF, and DIG)
- AICPA website: www.aicpa.org (includes proposed Statements of Positions, Practice Bulletins, and 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 Amy Havlan, Developmental Editor, at amy.havlan@wolterskluwer.com.

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About the Authors

Rosemarie Sangiuolo is an independent consultant with background in the financial services industry and accounting standard-setting. She specializes in accounting and reporting for financial instruments. She is currently a member of the project team working on the FASB's codification and XBRL projects. 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.

Leslie F. Seidman is a certified public accountant 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.

PART I:
FINANCIAL ASSETS

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CASH AND CASH EQUIVALENTS

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