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Accounting for Financial Instruments: Difficulties with Fair Value Measurement and Reporting

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Accounting for Financial Instruments:
Difficulties with Fair Value Measurement and Reporting

Lindsey Byrne

ADMN 799 Honor's Thesis in Accounting

Dr. Le (Emily) Xu

Fall 2013

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I. Introduction to Financial Instruments

a. Definition/Scope

U.S. Generally Accepted Accounting Principles (GAAP) defines financial instruments as “cash, evidence of an ownership interest in a company or other entity, or a contract that does both of the following: 1. Imposes on one entity a contractual obligation either A. to deliver cash or another financial instrument to a second entity or B. to exchange other financial instruments on potentially unfavorable terms with the second entity, and 2. Composes to the second entity a contractual right either A. to receive cash or another financial instrument from the first entity or B. to exchange other financial instruments on potentially favorable terms with the first entity (“Accounting for Financial Instruments (AFI)”.)” They can also be referred to as financial assets. This definition encompasses a wide array of business transactions that are grouped into three main categories: equity-based financial instruments, debt-based financial instruments, and other/foreign exchange instruments (“Financial”). They are classified based on two criteria: “the liquidity of the asset and the legal characteristics that describe the form of the underlying creditor/debtor relationship (“Classification”).”

Equity-based instruments represent the company’s ownership of an asset, whether it’s an investment in another company or an obligation owed to them (“Financial”). Included in this classification are mutual funds, money market mutual funds, reinvested earnings, and common and preferred stock (“Classifications: Instruments”). Debt-based instruments are loans made by an investor to an issuing entity (“Financial”). Long-term and short-term securities, such as bonds, long-term notes, installment notes, leases, accounts on credit, trade notes, currency and deposits, credit lines, noninterest-bearing notes, loans, commercial paper, and the debt portion of convertible loans/bonds are all classified as debt-based financial instruments (“Classifications:

Instruments”). Other/foreign exchange instruments are financial instruments that lack a corresponding liability and are therefore placed into a separate category because they do not qualify as debt or equity (“Classification”). This classification is comprised of monetary gold, special drawing rights (SDRs), financial derivatives, forwards, options, employee stock options, and net equity in insurance technical reserves and pension funds (“Classifications: Instruments”). Usually they are “contingent or conditional upon the occurrence of uncertain future events,” which exceeds the scope of normal financial instruments (“Classification”).

Financial instruments have been of particular interest to the accounting industry in recent years, especially to the two main accounting standards Boards, the U.S. Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB). Financial statement users, such as investors, preparers, and auditors, have continuously had difficulties with accounting for financial instruments, especially complex derivatives whose popularity increased dramatically in recent years (Alexopoulos). The standards for derivatives can be extensive and confusing to many users. It is also incredibly difficult to measure the fair value of financial instruments and to determine when recognition of impairment losses is appropriate. The financial instruments’ substantial influence on the 2008 financial crisis further highlighted that the current accounting standards for financial instruments are “inadequate for today’s complex economic environment (“Focus” 2010).”

b. Financial Instrument Standards and the Global Financial Crisis of 2008

It was the magnitude of derivatives’ role in the global economic crisis that indicated to the two Boards that the accounting standards for financial instruments needed a much more extensive remodeling. After the financial crisis hit, the Financial Crisis Inquiry Commission (FCIC) held a hearing entitled “The Role of Derivatives in the Financial Crisis” in which it was

determined that derivatives “substantially aggravated” the financial crisis (Alexopoulos). The commission discussed the unregulated over-the-counter (OTC) derivatives trades backed by subprime mortgage securities that the members deemed to be a substantial participant in the crisis (Alexopoulos). Large financial institutions had invested in trillions of dollars of OTC mortgage derivatives trades which would generate a payout in the event of a default, also known as credit default swaps (CDS) (Alexopoulos). The payout posed as a sort of “insurance” to the investors of the CDS’s, which provided them with a false sense of security that they would not lose money (Alexopoulos). Ultimately, this encouraged more risk-taking and demand for these securities in the investing community (Alexopoulos). A large amount of investors invested in “naked” CDS’s, which “bet” that non-creditworthy homeowners wouldn’t pay their mortgages (Alexopoulos). Essentially, these “naked” CDS’s were the opposite of the original CDS’s (Alexopoulos). Then the mortgage crisis occurred in 2007 which was due, in part, to the U.S. government’s ongoing push for increased homeownership since the early 1990’s (Carney). Favorable government policies mandated for mortgage lenders to provide “affordable housing” to homebuyers with median or below median income (Carney). When the initial period for favorable lending rates ended in 2007, the resulting descent in housing prices and slowing appreciation rates prevented homeowners from refinancing (Alexopoulos). Troubled homeowners were unable to pay their mortgages and the CDS’s rapidly declined in value. Large investing companies, like American International Group (AIG) and many large U.S. banks, lost billions of dollars from the mortgage crisis and would have failed, had there not been a U.S. Treasury bailout (Alexopoulos). The U.S.’s financial crisis eventually triggered a global economic crisis and lawmakers demanded a financial regulatory reform (Alexopoulos).

FASB came under great scrutiny from investors after the financial crisis. Banks and financial institutions had to account for large losses during that time and claimed that FASB's standards amplified their financial troubles (Nelson). Although it was hardly FASB's fault for the financial crisis, the Board recognized that there were gaps and inconsistencies in the standards, such as impairment of debt investments and estimating fair value of investments, which aggravated the existing predicament (Nelson).

c. FASB/IASB's Recognition for Convergence on Financial Instruments Standards

Prior to the financial crisis in 2008, the FASB and the IASB had discussed their intentions of amending the reporting requirements for financial instruments. The Boards held two meetings, in April and October of 2005, in which the members outlined three long-term objectives to improve, simplify, and converge the complicated financial instruments accounting standards ("Joint Project" Sept. 2013). The objectives were to 1. measure financial instruments at fair value with realized and unrealized gains/losses being reported in the period in which they occur, 2. simplify or eliminate the need for special hedging requirements, and 3. improve the standard for de-recognition of financial assets ("Joint Project" Sept. 2013).

Following the financial crisis, the Boards met in October 2008 to decide on a vastly different approach to the development of new financial instruments standards ("Joint Project" Sept. 2013). Their first order of business was to establish the Financial Crisis Advisory Group (FCAG) which was requested to identify the critical financial instrument accounting issues that required immediate deliberation as well as the issues that would require long-term consideration ("Joint Project" Sept. 2013). The FCAG published a Final Report on July 28, 2009 citing the obscurity of multiple impairment approaches and the delayed recognition of losses related to financial instruments as the underlying sources of accounting issues during the financial crisis

("Focus" 2012). They believed the threshold required to record credit impairments was much too high and that it resulted in the delayed losses ("Focus" 2010). The Boards agreed to take immediate, separate action on those issues, but emphasized the need for a common, long-term solution in the end ("Joint Project" Sept. 2013). Thus, they added the joint project "Accounting for Financial Instruments" to their list of convergence efforts. However, due to different reporting requirements, leases, equity in insurance, and pension obligations will be exempt from the new financial instruments reporting standards ("Focus" 2010). The Boards have both of those topics listed as independent convergence projects. The financial instruments project objectives are to create a common accounting standard that would reduce complexity, significantly improve decision usefulness, and provide greater transparency and consistency ("Joint Project" Sept. 2013). The standard will also deliver a more timely depiction of an entity's exposure to risk in the accounting of financial instruments ("Joint Project" Sept. 2013). The Boards hope to complete the project in an expedient manner. They expect this project to result in an increased convergence of financial instruments standards and a reevaluated measurement and recognition of financial instruments ("Joint Project" Sept. 2013). They also anticipate that the issues relating to impairment and hedging will be completely managed ("Joint Project" Sept. 2013). Specifically for hedging, they hope to; "1. simplify and resolve practice issues in accounting for hedging activities, 2. improve the financial reporting of hedging activities to make the accounting model and associated disclosures easier to understand for users of financial statements, and 3. address differences in the accounting for derivative instruments and hedged items or transactions ("Joint Project" Sept. 2013)." This project will bring the Boards much closer to accounting standards convergence.

II. FASB/IASB Convergence Project Background

The path towards accounting standards convergence between the IASB and the FASB began in the late 1990's. In 1999, the two standards Boards expressed interest in both converging and improving the International Financial Reporting Standards (IFRS) and the U.S. Generally Accepted Accounting Principles (GAAP) ("International"). The objectives of the two were conveyed through FASB's publication *International Accounting Standard Setting: A Vision for the Future*, in which it described its vision of the "ideal international financial reporting system" with a single set of accounting standards and a single, international standard setter ("International"). The Boards' objective was to significantly improve the decision usefulness of financial reporting for users of financial statements. However, the plan wasn't formalized until they held a meeting in Norwalk, Connecticut on September 18, 2002 with other national and regional bodies ("International"). It was there that they issued their first joint document; the Norwalk Agreement ("International").

Included in the Norwalk Agreement was the Memorandum of Understanding (MoU), an agreement that states the Boards' intent to eliminate the differences between the international standards and the U.S. GAAP ("Convergence"). This outlined their goals to create a set of standards that incorporates both their persistence for high quality and their desire for universal transparency. They pledged to "use their best efforts to (a) make their existing financial reporting standards fully compatible as soon as is practicable and (b) to coordinate their future work programs to ensure that once achieved, compatibility is maintained ("Memorandum")." In order to achieve this, they outlined a set of broad actions they would take within the upcoming years. This included undertaking a short-term project intended to remove a variety of minor differences between the U.S. GAAP and the IFRS before January 1, 2005, as well as drafting a timeline

based on the anticipated completion of removing substantial differences that remain after 2005 (“Memorandum”). They planned on continuing joint projects that had already been undertaken at the time and encouraged collaboration as well as coordination of activities (“Memorandum”). They agreed to commence those projects expediently and issue an exposure draft of proposed changes during 2003 (“Memorandum”). Time was of the essence due to the impending expansion of IFRS into several jurisdictions on January 1, 2005 (“Memorandum”). Some of the minor disparities, such as share-based payments, inventory accounting, non-monetary assets and other accounting topics, they were able to complete by 2005 (“Joint”). The rest would be set aside for completion in later years.

FASB and IASB reaffirmed their commitment towards convergence at their meetings in April and October of 2005 (“A Roadmap”). At the first meeting, the SEC Chief Accountant proposed a “Roadmap” that outlined the steps it would take to eliminate the requirement that foreign private issuers reconcile their reported net income from the IFRS to U.S. GAAP, also known as the 20-F filing (“International”). Since 1996, the SEC had been working towards accepting the IASB-based financial reports issued by foreign companies and removing the required 20-F reconciliation (“International”). They believed this would greatly improve transparency and open up U.S. investing into foreign markets by providing secure, financial information. The “Roadmap” urged the necessity for convergence between IASB and FASB standards, as the elimination of the IFRS reconciliation heavily relied upon it (“International”). Basing their approach off of the SEC’s proposal, IASB and FASB issued the “Memorandum of Understanding; A Roadmap for Convergence between IFRS and U.S. GAAP in 2006 (“International).”

Under the MoU, FASB and IASB created guidelines for their project; 1. “convergence of accounting standards can best be achieved through the development of high quality, common standards over time,” 2. “a new common standard should be developed that improves the financial information reported to investors,” and 3. “serving the needs of investors means that the Boards should seek to converge by replacing weaker standards with stronger standards (“A Roadmap”). IASB and FASB summarized their short-term and long-term goals within the MoU. By 2008, the two Standards Boards’ hoped to complete or substantially complete the work needed to eliminate the differences in standards of the trivial accounting areas. This would be achieved either through one or more short-term standard setting projects between 2006 and 2008 (“A Roadmap”). These small tasks, which they previously intended to complete before 2005, included the fair value option, borrowing costs, business combinations and non-controlling interests (“Joint”). They successfully reduced the number of minor projects by 2008 in order to allot more time to focusing on the imperative convergence topics in meetings. FASB and IASB outlined 11 complex topics in their Conceptual Framework project that they regarded as long-term. These included convergence in accounting standards of business combinations, consolidations, fair value measurement guidance, liabilities and equity distinctions, performance reporting, post-retirement benefits, revenue recognition, de-recognition, financial instruments, intangible assets, and leases (“A Roadmap”). They intended to make progress on these extensive joint projects through research, deliberation, and consultation, but found it would be impractical to aim for their completion by 2008. Instead, their aim was to make substantial headway so as to allow for the IFRS reconciliation phase-out by 2009 (“A Roadmap”).

In September of 2008, FASB and IASB met to complete the Memorandum of Understanding and to evaluate the progress of both their short-term and long-term projects

("Completing"). The SEC, by 2007, removed the reconciliation requirement for non-U.S. companies registered in the United States using IFRS due to the headway made by both Standards Boards ("Completing"). FASB, with IASB's assistance, was able to amend and issue new standards for research and development assets acquired in a business combination, the fair value option, borrowing costs and segment reporting. However, FASB had to reevaluate and change its strategy for convergence in 2008 due to the possibility that the SEC might require U.S. companies to adopt IFRS standards at a future date ("Completing"). It had to decide on the effectiveness of undertaking new projects, such as convergence in accounting for taxes, investment properties, and research and development ("Completing"). In addition to discussion on short-term projects at the meeting, the two Standards Boards assessed and projected the future progress of major joint projects. By the 2008 meeting, the two Boards had substantially completed 7 out of the 11 complex, long-term standards projects ("Completing"). For the financial instruments convergence project, IASB issued a discussion paper in 2008 that the Board invited FASB to comment on ("Completing"). Similarly, FASB issued an exposure draft in 2008 on financial instruments that focused on the simplification of hedge accounting ("Completing"). The Boards developed individual approaches to address the four topics they were not able to proceed on (consolidations, de-recognition, fair value measurement, and post-employment benefits) ("Completing"). However, both made certain to monitor each other's research progress and developments in order to minimize the differences when developing common standards in the future. With the major joint projects taking priority of upcoming convergence efforts, the Boards' members were able to set milestones that they hoped to achieve by 2011 for financial statement presentation, leases, liabilities and equity distinctions, revenue recognition, and post-employment benefits ("Completing"). If these milestones were to be

achieved by then, the use of IFRS standards by U.S. companies could be mandatory 2015 (“One world”)

The original arrangement was to complete or substantially complete convergence by June 30, 2011 (Taub). By April 2011, however, three major MoU projects remained significantly incomplete; leasing, accounting for revenue recognition, and financial instruments (Paraiso). In addition, the Boards decided to re-expose lease proposals due to financial reporting concerns raised by global financial statement users (“Joint”). With these key assignments outstanding and the deadline for IFRS adoption approaching, the SEC decided to outline a method of incorporating IFRS into the U.S. financial reporting system. Deputy Chief Accountant Paul Beswick of the SEC proposed the “condorsement” approach; “it established an endorsement protocol which gave FASB the authority to modify IFRS before incorporating standards into U.S. GAAP (Paraiso).” The intention was to eliminate significant differences between U.S. GAAP and IFRS so as to allow U.S. issuers to uphold compliance with both sets of standards after the defined transition period (Paraiso). Yet, many wondered if this approach would prove to be successful. By that time, the two Boards had reached different conclusions on certain MoU topics, namely financial instruments, consolidation, and balance sheet offsetting (Paraiso). Because of the substantial disagreements between the Boards, it was questionable whether they would ever fully eliminate the differences in standards. The Boards did, however, manage to successfully issue considerably converged requirements for “Fair Value Measurement and Disclosure” relating to the fair value measurement project, which provided hope for financial statement users (“Year in Review-2011”).

There was an increased global awareness of regulatory and compliance issues in 2012, with great emphasis on professional skepticism, professional competency, and ethics (Orrell and

Jiaojiao). The Boards' issued a joint progress report in April 2012 highlighting the significant developments made over the almost decade-long convergence project ("Joint"). The report featured the proposed changes made to the joint credit loss impairment and classification and measurement subprojects concerning the convergence on financial instrument standards ("Convergence"). The Boards' members acknowledged stakeholders' uneasiness towards the sluggish pace at which accounting convergence was being completed and reassured them that the delays were necessary to ensure quality improvements to the current standards ("Joint"). During 2012, the Boards were able to re-deliberate the revenue exposure draft ("Year in Review-2012"). In addition, they arranged to make considerable headway on the leases, financial instruments, and insurance projects, and expected to release their final standards by the end of 2013 ("Joint").

Much to the stakeholders' dismay, the Boards were unable to finalize the standards for these projects in 2013 due to what the members described as "challenges" ("Meeting"). This is especially true of the Impairment and Insurance Contracts projects ("Meeting"). They did, however, make significant progress on most of the joint projects in 2013. The Boards were able to discuss the feedback posed for the proposed lease standard and re-deliberated the joint revenue recognition Exposure Draft ("Year in Review-2013"). They expect to issue final standards on revenue recognition, as well as the financial instruments' classification and measurement and impairment phases in the first half of 2014 ("Project").

III. Financial Instruments: Current Accounting Principles

a. Equity Securities

Equity-based financial instruments consist of mutual funds, money market mutual funds, reinvested earnings, and common and preferred stock. Mutual funds include equity investments in real estate, money markets, mixed investments and stock ("Classifications: Instruments").

Money market mutual funds are uninsured mutual funds invested in high-quality, short-term debt issued by corporations, municipal entities, and the government (Waggoner). Reinvested earnings are the earnings retained by a company that are invested back into the company instead of being distributed as dividends (“Retained”). A company, individual investor, or mutual fund can invest in a company’s common or preferred stock, which represents ownership of the outstanding capital of a company. Investments made in a company are usually done so for three reasons: to receive dividends, to realize a gain on the appreciation of the investment, or to signify an affiliation between two companies (Nelson).

There are four ways that an equity security could be accounted for, depending on the nature of the investment and the how the investor wants to account for it (Nelson). If the investor lacks significant influence, meaning they hold less than 20% of the outstanding voting stock, the equity investment can be labeled as a trading security (TS) or as an available-for-sale security (AFS) (Nelson). The accounting method for investments without significant influence will vary based on four critical event; 1. Purchasing the investment, 2. Recognizing the investment revenue, which is typically dividends for equity and interest for debt, 3. Holding the investment during period’s in which its fair value changes, and 4. Selling the investment (Nelson). If the investor holds between 20-50% of the voting stock, the investor is said to have “significant influence” which is accounted for using the equity method (Nelson). If the investor possesses 50% or more of the voting stock, the investor is considered to have control over the company and the accounting treatment is to consolidate both the subsidiary and parent companies’ financial statements. However, FASB does not classify equity assets with control as financial instruments and it is not included in the financial instruments convergence project. Therefore, it will not be discussed further in this paper.

i. Securities without Significant Influence

Equity securities purchased by an investor who lacks significant influence is permitted by U.S. GAAP to account for them in one of two ways: they can be reported as a trading security or an available-for-sale security (Nelson). The differences between these two accounting methods pertain to the way the investor accounts for unrealized holding gains or losses (Nelson). The FASB requires that they are to be accounted for differently because of decision-usefulness and relevance; it all depends on how important the information is to stakeholders and investors (Nelson). For example, if a company decides they would like to hold an investment over multiple periods, day-to-day fluctuations may not be important or relevant information because the security won't be sold for a while.

Trading securities (TS) are financial instruments that an investor acquires and intends to sell in a short duration (Nelson). They can be debt or equity, but the equity security will be focused on for the purpose of this section. They are typically labeled as current assets that are initially recorded at the amount the investor paid for them, including brokerage fees (Nelson). An investment asset account is debited and cash or a payables account is credited. The purpose of these securities is to profit from the short-term price changes, thus they are actively managed, usually on a day-to-day basis, by the investor (Nelson). Managing these securities means “marking them to market,” which is writing the security up or down to the fair value as determined by the market (Nelson). If the value of the security falls, the investor will record an unrealized holding loss. If the value of the security rises, the investor will record an unrealized holding gain. The “fair value adjustment” account is recorded as the other side of the transaction, instead of increasing or decreasing the investment account (Nelson). Unrealized holding gains and/or losses are recorded directly in net income on each reporting date in the period in which

the fair value changes (Nelson). These short-term fluctuations are recorded because the security is anticipated to be held for a very short time; consequently, any temporary changes in the investment are relevant to the investor/stakeholders (Nelson). When the investor sells the investment, they must remove all accounts on the balance sheet associated with that investment and record a realized gain or loss (Nelson). This is determined by removing the investment and “closing out” the “fair value adjustment” account associated with the unrealized gain/loss of that investment to retained earnings. The difference between the cash and the carrying value of the investment is the realized gain or loss that is included in net income (Nelson).

An investment that is not intended to be actively traded (or held to maturity if it is a debt security), but the investor is willing to sell it when the market conditions are desirable, is considered an available-for-sale (AFS) security (Nelson). This type of investment contains almost all of the same characteristics as a TS security, except for a few differences. The journal entry at the time of purchase is the same, but AFS securities can be labeled as current or noncurrent assets (Nelson). Like TS securities, dividend income is recorded by crediting investment revenue and debiting cash (Nelson). It is also carried at fair value in the balance sheet, but, unlike a TS security, unrealized holding gains and losses of an AFS security are not included in net income (Nelson). Instead, they are reported in the statement of comprehensive income under “Other Comprehensive Income (OCI)” at the end of each period (Nelson). Only the realized gains or losses are reported in net income. This is done to avoid making net income seem more volatile than it really is (Nelson). If the investor intends to hold it until market conditions are just right, then recording day-to-day fluctuations may be important, but not as important as for TS securities. Their intention isn’t to actively trade it, but to hopefully hold it long enough for it to become profitable. It is also possible that, if the security is held long

enough, the unrealized gains and losses will eventually offset each other (Nelson). There is, however, a “fair value option” offered for investors who hold AFS securities. This method, offered as an election only at the time of purchase, allows the investor to account for AFS securities as though they were TS securities (Nelson). This means that the investor will record all of the AFS security journal entries like they would if it were a TS security. The only difference between the TS security accounting method and the fair value option is that the purchase and sale of an investment is considered an investing activity under the Statement of Cash Flows, rather than classifying it as an operating activity (Nelson). Just like TS securities, all accounts related to the investment are removed when the AFS security is sold. On the contrary, the amount of the “fair value adjustment” account associated with the particular investment is closed out to Accumulated Other Comprehensive Income (AOCI) instead of retained earnings (Nelson).

If the fair value of an AFS security falls below the cost of the investment, and that drop in value is estimated to be “other-than-temporary” (OTT), the company might have to recognize an OTT impairment loss in net income (Nelson). There is a three step process to determine an OTT impairment loss; 1. The investor must determine if the investment is impaired, 2. The investor must determine if any of the impairment is OTT, and 3. If there is an OTT impairment, the investor must determine where to report the OTT impairment (Nelson). This rule does not apply to TS securities whose changes in fair value are already recognized in earnings (Nelson). The measurement of an OTT impairment is different for debt and equity instruments. If the company has the ability to hold an equity AFS security to the point where the fair value recovers, then they should not record an OTT impairment loss (Nelson). If that is not an option for the company, then the company reduces the carrying value of the investment in the balance sheet to the new fair value and the OTT impairment loss is recognized in net income (Nelson).

By recognizing the OTT impairment, the investor must reclassify amounts out of the OCI that were previously recorded as unrealized gains or losses (Nelson). The reversal of any impairment is disallowed according to U.S. GAAP (Nelson).

ii. Securities with Significant Influence

As stated earlier, when an investor/company has 20-50% equity ownership, they are considered to have significant influence over the investee company (Nelson). This does not imply ownership; however, the investor can influence financial and operating policies by utilizing its voting shares (Nelson). There are two ways to account for an equity instrument in which the investor can influence the investee company; the equity method or the fair value option (Nelson). The fair value option has been previously outlined in this paper. If the investor elects to use the equity method, they must report their share of equity interest in the investee company into a separate investment account (Nelson). This requires consolidating everything in the investee's assets into a separate, total line equal to the investors' share of those assets on the investor's balance sheet (Nelson). This produces the same results as if the investor had control over the company, except the equity method views the investor company and the investee company as a special type of single entity (Nelson). At the end of the period, the investor company recognizes investment income equal to its percentage share multiplied by the net income earned by the investee company (Nelson). The journal entry is recorded as crediting a revenue account and debiting the investment account (Nelson). If the investee company experiences a net loss for the period, the journal entry is the opposite of the one stated before. The investor must also reduce their investment account by their percentage ownership of dividends paid out by the investee company (Nelson). The investment account is reduced because the dividends are seen as a distribution of net assets, essentially returning the investor's

investment (Nelson). If the investment is eventually sold, the company removes it from its balance sheet and records a gain/loss if the amount received is over/below the carrying value of the investment (Nelson).

b. Debt Securities

Debt-based securities include bonds, long-term notes, installment notes, accounts on credit, trade notes, currency and deposits, credit lines, noninterest-bearing notes, loans, commercial paper, and the debt portion of convertible loans/bonds. They can be long-term or short-term debt. Bonds and notes are typically classified as long-term, noncurrent debt, whereas currency, deposits, accounts on credit, credit lines, loans and commercial paper are considered short-term debt. Liabilities “signify creditors’ interests in a company’s asset” and are considered a financial instrument because they are “evidence of interest ownership (Nelson).”

A liability is regarded as “long-term” if it exceeds one year or the firm’s operating cycle, whichever is longer (Nelson). Long-term liabilities are recorded in the balance sheet at their present value, which is the present value of the related cash flows discounted using the effective interest rate at the time of issuance (Nelson). Bonds obligate the issuing company to make specified, period interest payments between the issue date and maturity and to then repay the principal borrowed amount at the maturity date (Nelson). A long-term note is a formal credit arrangement between a creditor and debtor that involves the debtor signing a promissory note (Nelson). This type of long-term debt can also be exchanged for assets or services. In this case, the value of the asset or the service determines the market value of the note (Nelson). Installment notes are notes in which the borrowing company makes equal installment payments for a specified period of time (Nelson). Each payment contains an amount that represents interest and an amount that denotes the repayment of the principal borrowed amount (Nelson).

There are complex instruments that are considered both debt and equity, such as convertible bonds/loans and bonds with detachable warrants. Convertible bonds/loans are initially classified and accounted for as regular debt securities until the holder exercises their option to convert the bonds (Nelson). Once converted, the embedded derivatives may have to be accounted for separately from the bond. There are three instances in which they will have to be individually accounted for; “1. The economic characteristics of the embedded derivative are not clearly and closely related to the economic characteristics of the host, 2. The hybrid instrument is not re-measured at fair value under otherwise applicable GAAP, with changes in fair value reported in earnings, and 3. A freestanding instrument with the same terms as the embedded derivative is subject to guidance on derivative instruments and hedging (Gleim).” If any of these three conditions are met, the bond will have to be removed from the books and the embedded derivative will have to be accounted for using the accounting standards for derivatives and hedging, which will be discussed later in this paper. A detachable warrant is similar to a convertible bond, but the warrants that give the option to purchase shares/financial assets can be separated from the bond (Nelson). The market price for bonds with detachable warrants is usually allocated to the bond and the warrants based on their relative fair values (Nelson).

Short-term, or current liabilities, are those liabilities that are due within a year or within the company’s operating cycle, whichever is longer (Nelson). Accounts payable are debts owed to suppliers of merchandise or services that are purchased on an open account (Nelson). They typically are non-interest bearing and are reported at face value (Nelson). Trade notes payable are comparable to accounts payable, except for that they are formally recognized with a promissory note and are usually interest-bearing (Nelson). In the case of noninterest-bearing notes, the interest is deducted from the face amount to determine the cash outlaid to the debtor at

the inception of the note (Nelson). A credit line permits a company to borrow cash from a bank without having to go through the formal loan procedures (Nelson). Commercial loans are short-term loans, typically issued by large corporations, which require payment within 270 days or less (Nelson). Cash can include both cash and cash equivalents, there is no distinction made between the two for accounting treatment purposes (Nelson). Cash and cash equivalents include currency/coins, items for deposit, money market funds, treasury bills, balances in checking accounts, commercial paper and sometimes debit/credit card receivables (Nelson).

Debt securities are accounted for differently depending on three classifications; they can be classified as held-to-maturity securities (HTM), trading securities (TS), or available-for-sale securities (AFS) (Nelson). The accounting methods for TS securities and AFS securities were outlined previously in this paper. Likewise, debt instruments can be accounted for using these methods. There are some minor differences in the journal entries between the two types of securities. When a debt security is purchased, the accounting entry is similar to that of an equity security's entry, except that a discount or premium must be recorded for a bond that is sold below/above market price (Nelson). In addition, when interest is received, the discount or premium is amortized to restore the bond to its proper carrying value (Nelson). An investor can also elect the "fair value option" at the time of purchase and report the fair value changes in the income statement (Nelson). Under the fair value option, the investor is required to record the unrealized holding gains and losses on the debt security (Nelson).

The distinct difference between accounting for debt instruments and accounting for equity instruments is that debt can be accounted for as a held-to-maturity (HTM) security. As implied in its name, an HTM security receives periodic interest payments on specified interest dates up to the maturity date where the investor receives the stated principal amount (Nelson).

Equity securities do not have an identifiable maturity date, so they cannot be classified as HTM (Nelson). The security, on the date of inception, is valued at the present value of intended future cash flows at the existing market rate (Nelson). If the investee's stated rate is less than the market rate, the security can be sold at a discount, or less than the stated face amount of the debt (Nelson). If the stated rate is more than the market rate, the security can be sold at a premium, or more than the stated face amount (Nelson). Because an HTM debt instrument will be held to the maturity date, fluctuations in the market value of the debt are not very relevant to the investor or stakeholders. Accordingly, HTM securities are reported at their amortized cost on the balance sheet and any unrealized holding gains or losses are not recognized (Nelson). Interest is recorded using the effective interest method, where the market rate is multiplied by the outstanding balance of the investment to calculate interest receivable (Nelson). Any difference between the interest cash received and the interest receivable is recorded as an amortization of the remaining discount or premium (Nelson). The security can still be sold by the investor if they no longer want to hold it to maturity. In that respect, the gain or loss on the sale of the debt investment is recorded if the amount received is above or below the carrying value of the debt (Nelson).

Like an equity security, a debt security can become impaired if the fair value of the investment declines below the its amortized cost (Nelson). However, investors must use a different process in the determination of the OTT impairment loss for debt securities. There are three instances in which an OTT loss is recorded for a debt investment; "if the investor 1. intends to sell the investment, 2. believes it is 'more likely than not' that the investor will be required to sell the investment prior to recovering the amortized cost of the investment, less any current-period credit loss, or 3. has incurred credit losses and the cash flows won't be enough to recover

amortized cost (Nelson).” If there is a credit loss due to the first and second instances, the investor will write the investment down to fair value in the balance sheet and record an OTT impairment loss in net income (Nelson). Any unrealized holding gains or losses amounts that were previously recorded in OCI for an AFS security will have to be reclassified as a result of the impairment loss (Nelson). If it is established that there is an impairment due to the third instance, it is necessary to separate that impairment amount into credit and noncredit losses (Nelson). Credit losses “reflect expected reductions in future cash flows from anticipated defaults on interest or principal payments (Nelson).” They are calculated by subtracting the present value of expected cash flows from the amortized cost of the debt investment (Nelson). The credit loss portion of the impairment is recorded in net income because it is assumed that this amount won’t be recovered (Nelson). Noncredit losses are reductions in fair value as a result of other factors such as those due to the changes in the economic environment (Nelson). The noncredit losses are calculated by subtracting the credit loss portion from the total impairment and they are recorded in OCI in hopes that the amount may be recovered (Nelson). The methods used to determine OTT impairment losses on debt instruments can be used for both HTM and AFS securities. U.S. GAAP requires that an investor holding a HTM investment that incurs an impairment loss to gradually reverse any of the investment-related amounts in OCI over the remaining life of the investment (Nelson). This is done by debiting the fair value adjustment account and crediting the OCI at the end of each period (Nelson). The reason for doing so is to rid the OCI of the HTM security’s loss, since HTM unrealized gains/losses are not normally recorded in OCI (Nelson).

c. Other Securities/Derivatives/Hedging

Monetary gold, special drawing rights (SDRs), financial derivatives, forwards, options, employee stock options, and net equity in insurance technical reserves and pension funds comprise the “other securities” financial instruments classification (“Classifications: Instruments”). This paper will elaborate on all of the “other securities” except for employee stock options and net equity in insurance technical reserves and pension funds, since employers’ and plans’ obligations are exempt from the FASB/IASB financial instruments convergence project (“Summary”).

i. Monetary Gold and SDRs

Monetary gold is the bullion owned by the U.S. Treasury that is held as custodial reserves by the Mint offices (“Chapter”). It is a financial asset that is typically issued by the International Monetary Fund (IMF) (“Classification”). The central bank records the purchase of monetary gold as an increase in assets and its counterpart is shown as a decrease in the assets of the rest of the world (“Classification”). Special drawing rights (SDRs) “are international reserve assets created by the IMF and allocated to members to supplement existing official reserves (“Classification”).” These types of holdings “represent unconditional rights to obtain foreign exchange or other reserve assets from other IMF members” and are held by a very limited amount of IMF member countries and international financial institutions (“Classification”). SDRs and monetary gold are financial assets that do not have corresponding liabilities (“Classification”).

ii. Financial Derivatives

There are various financial instruments that are grouped under financial derivatives. The four most popular derivatives include financial futures, forward contracts, options and interest

rate swaps (Gleim). Derivatives are “financial instruments that ‘derive’ their values or contractually required cash flows from some other security index” and are typically used to manage risk (Nelson). Derivatives are contracts that allow an investor to purchase an asset on a specific date at a prearranged price (Nelson). The value of a derivative is determined from the forecasted and actual fluctuations of the asset’s price (Nelson). Its purpose is to manage three types of risk exposure: cash flow risk, foreign currency risk and fair value risk (Nelson). The process of managing these types of risk is called “hedging.” Hedging involves exposing the company to a particular type of risk exposure that is the exact opposite of the actual risk that they were already exposed to from an investment they own (Nelson). The intention is to create a relationship by partially or wholly counterbalancing losses on one position with a position in another market (Gleim). A derivative is considered a hedging instrument if it attempts to reduce the risk of; 1. an unrecognized firm commitment, 2. a recognized asset or a liability, or 3. a forecasted (anticipated) transaction (Gleim). U.S. GAAP permits hedge accounting only if the following three conditions are met; 1. the derivative is used to hedge either a fair-value exposure or a cash flow exposure, 2. the derivative is successful in counterbalancing the fair value or cash flows related to the hedged item, and 3. the relationship between the hedged item and the derivative is properly documented (Doupnik). The formal documentation must state the hedging instrument, the hedged item, the nature of the risk being hedged, how the instrument’s effectiveness will be evaluated, and the risk management strategy and objective for the hedge (Doupnik). They must also establish a measurement approach that they will use to assess the ineffective portion of the hedge (Doupnik). Any ineffective portion of the hedge is reported directly in earnings (Doupnik). If a hedging relationship is later deemed as ineffective, U.S. GAAP requires that company must cease accounting for that instrument as a hedge (Doupnik).

iii. Financial Futures

A financial futures contract is “an agreement between a seller and a buyer that requires the seller to deliver a particular commodity at a designated future date, at a predetermined price (Nelson).” The commodity can be a Treasury bond, commercial paper, Treasury bill or a certificate of deposit (Nelson). Investors hedge using financial futures because as interest rates rise, the market price of interest bearing securities falls (Nelson). This means that an investor is exposed to cash flow risk, which is the possibility of having to pay more or to receive less money than was originally agreed upon due to interest rate fluctuations (Nelson). Companies want to make sure that they are managing their risk so that if the price of the commodity does decline, they are able to make up some or all of the loss with the hedged instrument. The seller never has to own the commodity and the buyer doesn’t have to take possession of the commodity (Nelson). They are both trying to take advantage of fluctuations in the interest rates reflected in the change of the commodity price and can close out of their positions at any time by making a purchase in the case of a seller or a sale in the case of a buyer (Nelson). The key to successful hedging is matching the risk with the parallel financial effects created by interest rate movement (Nelson). For example, if the exposure risk is from a short-term investment, the company will want to hedge against it with an instrument that is also short-term. The same goes for long-term investments.

iv. Financial Forwards

Financial forwards contracts are very similar to financial futures contracts. These contracts only differ from futures in three ways; 1. “a forward contract is not usually traded on a market exchange,” 2. “a forward contract calls for delivery on a specific date, whereas futures contract permits the seller to decide later which specific day within the month will be the

delivery date,” and 3. “a forward contract does not call for a daily cash settlement for price changes in the underlying contract (Nelson).” The resulting gains and losses from forward contracts are paid when the transaction is closed out (Nelson). An option, like a forward or futures contract, is used to hedge against the exposure of interest rate risk. However, options give the buyer the right to purchase a commodity at a predetermined price during a specified time period. An interest rate swap is where two debt holders swap their interest rate obligations, using intermediaries/banks to either switch from fixed interest rate to variable interest rate or vice versa (Nelson). This is done without exchanging the principal amounts of the debt. The debtors will continue to make their own interest payments, but will exchange the net cash difference from the swap between payments (Nelson).

v. Foreign Currency Futures/Options

Foreign currency futures and foreign currency options are used to manage a company’s foreign exchange risk linked to business transactions with other companies in foreign countries (Nelson). Companies want to hedge against the foreign currency rate, the price at which foreign currency can be acquired, which can fluctuate over time (Doupnik). The intention is to avoid the risk associated with depreciation of a foreign country’s currency if a company extends credit to a foreign company (Doupnik). It is also used to avoid appreciation in a foreign country’s currency if credit is extended to them by a foreign company (Doupnik). They don’t want to risk getting paid less or having to pay more than what was bargained for. Foreign currency futures act just like regular futures except that the commodity is specifically futures contracts, instead of debt instruments like the regular futures (Nelson). Foreign currency options are similar to regular options where the buyer has the right to trade foreign currency in the future (Doupnik).

vi. Determining Fair Value and Accounting for Derivatives

In order to determine the fair value of a forward contract, a company requires three pieces of information; “1. the forward rate when the forward contract was entered into, 2.the current forward rate for a contract that matures on the same date as the forward contract entered into, and 3. a discount rate- or the company’s incremental borrowing rate (Doupnik).” For an option, it is pertinent to know whether it was traded in an over-the-counter-market or on an exchange to determine the fair value (Doupnik). The fair value of an exchange-traded option is the quoted market price on the exchange whereas the fair value of an over-the-counter-traded option is usually determined by procuring a price quote from an option dealer (Doupnik). The Black-Scholes option pricing model can also be used on over-the-counter-traded options (Doupnik).

The current accounting standards for derivatives are quite extensive and are based on the user’s intended purpose of the derivative. Sometimes derivatives are not used to hedge against risk, but to just profit off of the hedge itself. In this case, the derivative is considered speculative due to high inherent risk and is accounted for in a different way than hedged derivatives, which is explained below (Nelson). Accounting standards for derivatives also treat the effective portion and ineffective portion of an anticipated hedge differently (Nelson). Derivatives are reported in the balance sheet at fair (market) value as either assets or liabilities (Nelson). Any gains or losses in fair value of a derivative that is being used for speculative, not hedging, purposes is recognized immediately in net income (Nelson). Unrealized gains or losses in fair value of hedging derivatives are accounted for in one of two ways; it can be “1. recognized immediately in earnings along with any offsetting loss or gain on the item being hedged or 2. deferred in comprehensive income until it can be recognized in earnings at the same time as earnings are

affected by a hedged transaction (Nelson).” The accounting treatment depends on whether the hedge is a cash flow hedge, a foreign currency hedge, or a fair value hedge (Nelson).

Fair value hedges are used to hedge against the risk of changes in fair value of a liability, asset or firm commitment (Nelson). Some common fair value hedges include futures contracts to hedge fair value in inventory, interest rate swaps to convert fixed-rate debt into floating-rate debt, and futures contracts that are used to hedge fair value of a firm commitment (Gleim). In order to qualify as hedge accounting, the fair-value risk must have the potential to effect the net income of the investing company if it is not hedged (Doupnik). The fair value of the hedged asset or liability is adjusted based on the changes in the spot exchange, which is the current exchange rate (Doupnik). The unrealized gains or losses resulting from the fair value adjustment of both the hedged item and the hedging derivative are included directly in net income (Doupnik). If the hedge is effective, the realized gains or losses from the changes in value of the hedging derivative should offset the realized gains or losses from the changes in value of the hedged item (Doupnik). Since firm commitments are intended future transactions which have not been formally recognized on the financial statements, the recognition of an unrealized gain or loss on the hedging derivative includes debiting an asset and crediting a liability (Gleim).

As described earlier in this section, a cash flow hedge is a derivative used to hedge against exposure to changes in cash outflows or inflows of an asset, liability or a forecasted transaction (Nelson). Cash inflows and outflows usually fluctuate due to floating-rate debt (Doupnik). When an adjustment is made for the changes in fair value of a cash flow hedge, the resulting gain or loss from that adjustment is deferred as a component of OCI (Doupnik). The unrealized gain or loss is later included in net income when the hedged transaction is complete and the resulting revenue affects earnings (Doupnik). Further amounts are deducted from AOCI

to; 1. reflect the current period's amortization of the premium or discount on the forward contract, and 2. show the change in time value of the option (Doupnik). Some common cash flow hedges include interest rate swaps that are used to convert floating-rate debt into fixed-rate debt and futures contracts that are used to hedge the forecasted sale of commodities such as crude oil, natural gas, and other assets (Gleim).

Lastly, foreign currency hedges are the hedges used to avoid the risk exposure of changes in foreign currency (Nelson). The accounting treatment for foreign currency hedges depends on four factors and their various combinations; 1. the type of hedging instrument being used, 2. the type of foreign currency transaction being hedged, 3. the nature of the foreign currency transaction being hedged, and 4. the nature of the hedged risk (Doupnik). A foreign currency hedge is considered an effective hedge if the critical terms of the hedging instrument match the underlying terms of the hedged item, such as the currency amount, the currency type and the settlement date (Doupnik). Foreign currency hedges are typically used to hedge against firm commitments, forecasted transactions, AFS securities, or a company's net investment in a foreign operation (Nelson). A firm commitment is an obligation whereby one company promises to do business with another foreign company in the future. Forecasted transactions are future transactions that a company intends to have with a foreign company but the sale has not been fully established with or communicated to that company. The accounting treatment of foreign currency hedges for firm commitments and AFS securities is to account for them as though they were fair value hedges, which means recognizing gains and losses directly in net income (Nelson). Foreign currency hedges for forecasted transactions and foreign currency assets/liabilities are treated as cash flow hedges, in which the effective unrealized gains or losses are temporarily included in OCI (Nelson). Gains or losses in the fair value of foreign currency

hedges used for a company's net investment in a foreign operation are reported in OCI as part of unrealized gains/losses from foreign currency translation (Nelson).

An entity also had the option to use the "critical terms" method and the "shortcut" method to simplify accounting for hedges. The critical terms method allows for a company to properly conform to the hedge accounting standards by matching the critical terms of the hedged item perfectly with the terms of the hedging instrument ("Critical"). The entity may not have to quantitatively justify that the hedge is effective ("Critical"). In order to use the critical terms method, the entities hedging endeavors must have the following critical terms match; 1. the notional amounts of the derivative and the hedged item, 2. the maturity dates of the hedging instrument and the hedged item, and 3. the underlying of the hedged risk and the derivative ("Critical"). Furthermore, there must not be any change in the counterparty credit risk, the fair value of the derivative must be zero at the inception of the hedge, and the effectiveness of the critical terms must be assessed periodically ("Critical"). The shortcut method is comparable to the critical terms method, except that it involves particular interest rate swaps ("Critical"). Under this method, the hedge is presumed to be completely effective, whereby the entity does not have to report any ineffectiveness nor does it ever have to test the effectiveness of the hedge ("Critical"). There are multiple steps to employing the shortcut method; an entity must 1. "determine the difference between the fixed rate to be received on the swap and the fixed rate to be paid on the debt," 2. "combine that difference with the variable rate to be paid on the swap," 3. "compute and recognize interest expense using that combined rate and the fixed-rate debt's principal amount," factoring in the amortization, premium, or discount on the debt, 4. "determine the fair value of the interest rate swap," and 5. "adjust the carrying amount of the swap to its fair value and adjust the carrying amount of the debt by an offsetting amount ("Guide")." There are few

conditions that must be met to use the shortcut method; the notional value of the swap and the hedged item must match, there cannot be any embedded options, the fixed rate on the swap must remain constant over the life of the swap, and the fair value of the swap has to be zero at the inception date (“Critical”). The problem with these two methods is that they assume that the hedged relationship is perfectly effective just because critical terms are matched. This may not be the case for some hedging transactions and the company could be falsely led to believe that their hedge is effective, when it could be partially ineffective. Using these methods could lead to inaccurate reporting, which is detrimental to both users and preparers of financial statements.

IV. Convergence Project: Accounting for Financial Instruments

a. Financial Instruments Project Progression

One of the three priority projects that remains a challenge for both FASB and IASB is accounting for financial instruments. The Boards’ objective behind converging the standards for financial instruments was to improve the decision usefulness of this reporting topic (Garmong). They wanted to enhance clarity and organization of the financial instruments standards, which would ultimately improve their understandability and accessibility (“Focus” 2013). Convergence decisions regarding this topic, however, have always been met with severe apprehension. Thus, the Boards chose to approach the issue separately. Unfortunately, this led to conflicting judgments in multiple reporting areas, such as the number of classification categories for financial instruments, which ones should be measured at fair value, and where fair value changes should be recognized (Garmong).

During 2009 and 2010, both Boards settled on new rules for financial instruments, but delayed their implementation due to increased opposition (Garmong). FASB even issued an exposure draft in May of 2010 that dealt with the issues surrounding measurement, hedge

accounting, and classification and impairment of financial instruments (Garmong). This, too, was temporarily abandoned due to the fact that issuers were not pleased with the Boards' "divergence" on financial instrument standards. As a result of the negative feedback, the Boards have also decided to separate the project into three phases in order to delve deeper into the issues of accounting for financial instruments. These three phases are accounting for impairment (credit losses), classifying and measuring financial instruments, and accounting for hedging ("Accounting for Financial Instruments (AFI)"). The progress made to these three phases will be explained in detail below.

b. Classification and Measurement

Currently, there are various categories of financial instruments, all with different presentation, measurement and impairment methods ("Focus" 2010). This many accounting standards creates confusion with inconsistent valuation methods and multiple reporting methods. With the conclusion of the classification and measurement topic of the financial instruments convergence, the Boards intend for there to be only two main categories of measurement standards for financial instruments ("Focus" 2010). These categories are; "1. assets/liabilities traded or with variable cash flows, displayed at fair value with changes in net income and 2. assets/liabilities held for collection/payment of principal and interest" with the cost and fair value presented in the balance sheet and the changes reported in net income/comprehensive income ("Focus" 2010).

In May 2010, FASB issued an Accounting Standards Update (ASU) on the overall financial instruments project, stating its intention to further implement the fair value method of measurement for financial assets and liabilities, more so than the current standards demand ("Focus" 2013). However, constituents disagreed with FASB's additional implementation of the

fair value method, arguing that it may not be appropriate for some financial instruments such as deposits, financial instruments that can't be traded, and loans ("Focus" 2013). FASB resolved this issue by requiring that assets held for the collection of cash flows, or financial liabilities, to be measured at amortized cost, since the value is realized over the life of this type of asset ("Focus" 2013). The accounting methods used by an entity for its financial instruments would vary based on the characteristics of the financial instruments and the way in which the assets/liabilities are used in the business ("Focus" 2010). This proposal includes measuring and accounting financial assets with variable cash flows or those assets that are regularly traded at fair value ("Focus" 2010). Financial assets that are retained for the collection of cash, the fair value and amortized cost would be included in the financial statements ("Focus" 2010). An entity would not have the option to measure those instruments that are sold to manage liquidity or interest rate risk at cost ("Focus" 2010). Overall, the measurement accounting standards for financial assets and liabilities would be similar, which would show how the entity manages the instruments together ("Focus" 2010). The ASU would improve the current reporting standards for financial instruments by providing a "consistent, comprehensive framework for classifying those instruments ("Focus" 2013)." The framework established by FASB "would link the measurement of financial assets to the way in which the company expects to benefit from the cash flows embedded in those assets, while the measurement of financial liabilities would be consistent with how the entity expects to settle those liabilities ("Focus" 2013)."

FASB and IASB decided to hold joint re-deliberations in January 2012 that focused on classification and measurement model featured in FASB's 2010 ASU ("Classification" 2014). They also touched upon important aspects of the IASB's measurement guidance IFRS 9, in attempt to reduce the disparities between the two documents ("Classification" 2014). The three

essential differences between the two sets of measurement standards were; “1. the need and basis for bifurcation of financial instruments, 2. the contractual cash flow characteristics of a financial instrument, and 3. the basis for and scope of a possible third classification category, debt instruments measured at fair value through other comprehensive income (“Classification” 2014).”

As a result of the joint meeting, FASB issued a second ASU, “Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities,” in February 2013 with revised proposed standards from the 2010 ASU (“Focus” 2013). This proposal would base classification and measurement on both the cash flow characteristics and the entity’s business model for managing the instrument (“Focus” 2013). An entity would no longer classify its instruments by their legal forms, such as whether an asset is a security or a loan (“Focus” 2013). Financial instruments would be placed into one of three measurement categories; amortized cost, fair value through net income, or fair value through OCI (“Focus” 2013). Instruments that would use the amortized cost method are those that are solely payments of principle and interest (SPPI) held for the purpose of collecting the periodic cash flows (“Focus” 2013). However, the fair values of current receivables/payables and deposit liabilities would have to be disclosed parenthetically on the balance sheet (“Focus” 2013). Those instruments classified under fair value through OCI would include financial assets with SPPI that are both for sale and retained for the purpose of collecting periodic cash flows (“Focus” 2013). Finally, the instruments whose fair value would be reported in net income are those financial assets that do not qualify for measurement at amortized cost or fair value through OCI (“Focus” 2013). This means that all equity instruments, except for those accounted for using the equity method, would be measured at fair value with changes reported in the income statement because

they do not satisfy the SPPI test (“Focus” 2013). A practicability election could be made to measure equity instruments “based on any observable price changes in orderly transactions for the identical or a similar investment of the same issuer (“Focus” 2013).” The proposal would also contain a one-step impairment model for equity instruments, which will be explained later in this paper. Financial liabilities would be reported at amortized cost, unless the intention of the entity is to transact with the instrument at fair value or if the liability is from a short sale (“Focus” 2013). For hybrid financial liabilities, the embedded derivative requirements would remain the same as the current standards (“Focus” 2013). The proposal would eliminate the fair value option described earlier in this paper with a conditional fair value option; investments using the equity method of accounting would no longer be eligible for the fair value option (“Focus” 2013). Not-for-profit entities and health care facilities, however, can still account for their equity method investments at fair value (“Focus” 2013). An entity that uses the fair value option for a financial liability would have to report in OCI “the portion of the total change in the fair value of the liability that results from a change in the instrument-specific credit risk (“Focus” 2013).” For equity investments that are normally measured using the equity method and that an entity holds for sale, the entity would measure the investment at fair value with any changes reported in net income (“Focus” 2013).

This proposal would eliminate the TS, AFS, HTM, and equity method classifications for investments, as well as the cost method of accounting, which would greatly reduce complexity in the standards (“Focus” 2013). This would also improve comparability, since the various accounting methods associated with these classifications would also be greatly reduced (“Focus” 2013). The relevance of the information regarding financial liabilities is greatly improved when the changes in fair value relating to instrument-specific credit risk are included in OCI (“Focus”

2013). Accounting for hybrid financial and non-financial assets would also be simplified. The derivative and non-derivative elements would no longer be accounted for separately, but would instead be entirely measured at fair value with changes reported in net income (“Focus” 2013). This would remove the bifurcation process, which is splitting the instrument into two main parts to account for them separately (“Focus” 2013).

In the Summary of Comment Letters for the 2013 ASU, constituents concurred with FASB that the proposed accounting standards should reduce complexity with financial instrument classification and measurement (“Comment” 2013). They admitted that the ASU does provide more decision-useful information and that it was greatly improved from the ASU issued in 2010 (“Comment” 2013). Constituents did favor the classification based on business model and cash flow characteristics, rather than the current classification standards (“Comment” 2013). However, they found that using the SPPI test to test certain financial instruments very challenging and felt that FASB could try to reduce its complexity (“Comment” 2013). It was also recommended that the scope of the classification and measurement project should not include payables/receivables because the cost of measuring them at fair value in OCI instead of amortized cost may outweigh the benefits (“Comment” 2013).

FASB held a meeting on December 18, 2013 to re-deliberate on the SPPI model introduced in the 2013 ASU (“Classification” 2014). They decided it was too complex and opted to discard the SPPI model for assessing contractual cash flow characteristics of a financial instrument (“Classification” 2014). Because of this, the Board decided to reinstate in the proposal the bifurcation process requirements for accounting for hybrid financial assets (“Classification” 2014). The Board instructed its staff to evaluate if they should create a new cash flow characteristics assessment approach to classify and measure regular and hybrid

financial instruments (“Classification” 2014). The analysis of a new cash flow characteristics assessment model will be presented at a future meeting (“Classification” 2014). They will also evaluate the proposed business model assessment and come up with possible alternatives (“Classification” 2014). Together, FASB and IASB will consider the feedback received for FASB’s 2013 ASU and IASB’s 2012 Exposure Draft on classification and measurement and will make an effort to issue a Final Draft in the first half of 2014 (“Classification” 2014).

c. Credit Impairment

FASB and IASB acknowledged the necessity for improved financial instruments credit impairment standards after the credit crisis in 2008. In the wake of the crisis, the Boards established the Financial Crisis Advisory Group to help pinpoint the accounting issues that may have adversely affected the market’s impending problem. When they issued their Final Report, the FCAG identified the credit impairment as one of the critical financial instrument accounting issues that needed both immediate attention and a long-term solution. The current accounting standards for credit impairment, outlined in earlier paragraphs, are different depending on the category and instrument type (“Focus” 2010). In addition, current guidance does not require timely recognition of expected credit losses, which was made very clear during the financial crisis (“Focus” 2011). There is a lot of tension surrounding the existing “probable loss” thresholds for impairment (“Focus” 2010). Current standards only allow for credit losses to be accounted for when there is a significant indication that a portfolio/loan will not be paid in full (“Focus” 2011). FASB intended that the new approach would eliminate the need for the “probable loss” threshold and only instruments held for collection or payment would be tested for impairment (“Focus” 2010).

In the early stages of the impairment project, IASB and FASB decided to address the matter independently, issuing separate impairment models in 2009 and 2010. IASB focused on a cash flow approach relating to credit loss expectations whereas FASB proposed eliminating the “probable loss” threshold and instating a recognition of lifetime expected losses at the date of the asset’s acquisition (“Credit” Dec. 2013). Due to their constituents’ concern for “divergence,” FASB and IASB began joint re-deliberations on credit impairment in November 2010 (“Credit” Dec. 2013). On January 31 of the following year, the Boards proposed a converged solution in the Supplementary Document (SD) “Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities—Impairment” (“Credit” Dec. 2013).

From the feedback they received, the Boards decided to pursue a “three-bucket approach” which would assess the deterioration in the credit quality of a financial asset using three categories of assets (“Credit” Dec. 2013). The recognition and measurement of impairment losses would be based on forward-looking expected, not incurred, losses for open portfolios (“Credit” Dec. 2013). For assets in “Bucket 1,” an entity would recognize lifetime expected losses for financial instruments that are expected to experience a “loss event” within the next 12 months (“Focus” 2012). The entity would recognize all lifetime expected losses for instruments in Buckets 2 and 3 (“Focus” 2012). There are two transfer criteria that requires financial assets to be reassigned from Bucket 1 to Bucket 2 or Bucket 2 to Bucket 3; 1. there has been a more than insignificant deterioration in credit quality and 2. it is at least reasonably possible that some or all of the contractual cash flows may not be collected (“Focus” 2012). For this approach, an entity would record credit losses equal to the higher of; “(a). the time-proportional (TPA) expected credit losses of the portfolio, which seeks to align the recognition of interest income with credit

losses, or (b). credit losses expected to occur within the foreseeable future (FFP), called “the floor,” which is no less than 12 months after an entity’s reporting date (“Focus” 2011).” This approach allows for entities to forecast future economic conditions when determining asset impairment losses and to recognize the total amount of credit losses expected for an asset when collectability of payments becomes uncertain (“Focus” 2011).

Constituents of the Boards’ were very pleased with Boards’ improvements from their individual impairment models and their effort towards convergence displayed in the SD (“Comment” 2011). Most of them agreed that this proposal would address the issue with delayed recognition of credit losses, however many were concerned with the calculations involving the TPA and the FFP (“Comment” 2011). The TPA involves calculating the weighted average age and the weighted average life of a portfolio, a process that constituents found challenging for revolving credit instruments such as credit cards (“Comment” 2011). They felt more guidance and examples were needed. In addition, respondents were worried that the floor would be higher than the amount of the TPA (“Comment” 2011). They argued that either the floor should be the sole basis for establishing loss allowance or it should be eliminated from the model altogether (“Comment” 2011). U.S. stakeholders had significant concerns of their own regarding the “three-bucket” impairment model. FASB received a considerable amount of negative feedback relating to that model, all of which argued that the approach would not be “understandable, auditable, or operable (“Focus” 2012).

Due to the abundance of negative reactions towards the “bucket” approach, FASB chose not to pursue this model. Instead, the members opted to amend the proposal and simplify the measurement objective (“Focus” 2012). On December 20, 2012, FASB issued a proposed Accounting Standards Update (ASU) “Financial Instruments—Credit Losses (Subtopic 825-15)”

which featured a new, forward-looking model based on expected credit losses (“Focus” 2012). This model, called the “current expected credit loss” (CECL) model, features a single measurement objective for the allowance of credit loss, instead of three like the “bucket” model (“Focus” 2012). This would replace the multiple impairment models for OTT credit losses that are currently instated by U.S. GAAP. The allowance for expected credit losses under the CECL model requires manager’s to estimate the contractual cash flows that the entity does not anticipate to collect based on their assessment of credit risk as of the reporting date (“Focus” 2012). It must also reflect both the possibility that no credit loss results and that a credit loss will result (“Focus” 2012). The result of this model is to extend the amount of information an entity will have to consider when estimating their credit lost. They would evaluate the loss using information from “past events, current conditions, and reasonable and supportable forecasts that affect the expected collectability of the... contractual cash flows (“Focus” 2012).” The current OTT impairment model only considers the past and the current conditions. The income statement under the CECL method would show credit deterioration/improvement from the changes in the estimate of expected credit losses (“Focus” 2012). These losses are a result of changes in condition from the previous reporting date, changes in the credit risk of asset held, and changes in reasonable forecasts about the future (“Focus” 2012). The balance sheet would contain the current estimate of the expected credit losses at the reporting date (“Focus” 2012).

The CECL model is similar to the “three-bucket” approach in a few ways; 1. they both require expected credit losses to be “estimated based on past events, current conditions, and reasonable and supportable forecasts about the future,” 2. they both require expected credit losses to “reflect both the possibility that a credit loss results and the possibility that no credit loss results”, and 3. “they both reflect the time value of money” (“Focus” 2012). The major

difference is the elimination of the transfer criteria “trigger” of the “three-bucket” model (“Focus” 2012). Full recognition of expected credit losses under the “three-bucket” model would be deferred until the “trigger” is met (“Focus” 2012). This “trigger”, or threshold, was deemed to be inoperable by the Boards’ constituents and was said to resemble the current “threshold” that inhibited the timely recognition of credit losses during the financial crisis (“Focus” 2012). On the other hand, the CECL model requires that an allowance for all expected credit losses be recognized, even if the predicted loss event is beyond a year (“Focus” 2012).

The Board’s Feedback Summary from its constituents conveyed very conflicting views over this new approach. Investors who commented supported the single model credit impairment and regarded it as a substantial improvement from the OTT impairment loss guidelines (“Feedback”). They were pleased with a model that reports all expected credit losses, as opposed to a model that contains a “threshold” condition (“Feedback”). However, preparers of financial statements (entities) are not so pleased with the new CECL model. They are very opposed to the full recognition of expected credit losses. Preparers prefer a model that contains a “threshold” requirement or one that requires reporting only some of the expected credit losses (“Feedback”). In addition, they believe that CECL model will result in understating the net instrument value of a financial instrument measured at amortized cost on the day of acquisition because expected credit losses will already have to be reflected in the purchase price of the asset (“Feedback”). Critics also argue that the matching principle will be violated, since the time of credit loss expense recognition will not “match” the timing of compensation recognition for those credit losses (“Feedback”). Both sides have compelling arguments and the Boards intend to continue their re-deliberations on the CECL model (“Credit” 2013). They will assess the feedback

received from the comment letters on FASB's 2012 ASU and IASB's 2013 Exposure Draft and they expect to issue the Final Document in the first half of 2014 ("Credit" 2013).

d. Hedge Accounting

Accounting for hedged transactions has always been a difficult undertaking for financial statement preparers. Current hedge accounting requirements are inconsistent and they lack transparency ("Focus" 2010). They have complex quantitative requirements in order to qualify as certain hedges ("Focus" 2010). The two Standards Boards' intention with the hedge accounting project is to allow for a "less rigorous qualitative assessment, [that] allow[s] [for] consistent reflection of economic impacts of hedging activities ("Focus" 2010). At a meeting on January 31, 2007, FASB instructed its staff to research the issues that cause the application of hedge accounting to be difficult and the potential approaches the Board could take to improve the hedge accounting standards ("Hedge" 2013). The staff members determined that there were seven issues that severely affect the proper implementation of hedge accounting standards ("Hedge" 2013). These issues include; "1. strict documentation requirements, 2. lack of clarity regarding when de-designation and re-designation is necessary, 3. which hedged items or hedged transactions could be included in a group, 4. how effectiveness should be assessed and what should be included in effectiveness testing, 5. how cash flows and different aspects of the discount rate should be incorporated into the measurement of a hedged item to determine the change in value attributable to an individual hedged risk, 6. how ineffectiveness should be measured in a cash flow hedge and what features should be included in a perfect hypothetical derivative, and 7. what the consequences should be for failing to meet the criteria for hedge accounting ("Hedge" 2013)." FASB issued the Exposure Draft "Accounting for Hedging Activities" in June 2008 to address the issues that were discussed ("Hedge" 2013).

In the Exposure Draft, FASB expressed its intent to eliminate an entity's election to designate individual risks, with two exceptions, as the hedged risk in a cash flow or fair value hedge ("Exposure"). The risk can only be risk associated with the change in fair value or the change in cash flows of a financial instrument in order to qualify as a proper hedge ("Exposure"). There are two instances in which a company can label its individual risks as the hedged risk in a cash flow or fair value hedge; 1. when it's foreign currency exchange risk, and 2. when it is interest rate risk to its own issued debt if it is hedged at inception ("Exposure"). It is only with these two exceptions that a company does not have to report information regarding the risks that an entity chooses not to manage as part of these hedging relationships ("Exposure"). As a result of this amendment, the financial statements will reflect information on the hedging relationship and both the risks of the hedged item that the company chooses to manage and the risks it chooses not to manage ("Exposure"). The proposal also eliminates critical terms matching and the shortcut method, thereby disallowing the entity from presuming that a hedge is highly effective and, as a result, not recognizing the ineffective portion of the hedge in earnings ("Exposure"). This means that an entity would independently have to assess the present value of the aggregate change in expected future cash flows of a hedged transaction and measure the changes in fair value of the hedged item for a fair value hedge ("Exposure"). The proposal establishes that the effectiveness of the hedge must be evaluated at inception, but the effectiveness threshold for hedge accounting would change from "highly effective" to only "reasonably effective" in offsetting the risk of the hedged item ("Exposure"). After inception, the effectiveness of the hedging relationship would only need to be assessed if conditions indicate that the hedge is no longer reasonably effective ("Exposure").

With the elimination of the shortcut and critical terms methods, there will no longer be several ways to account for the same hedging transaction, thus improving the comparability of financial results (“Exposure”). By shrinking the effectiveness requirements of hedge accounting, the ability to utilize hedge accounting is increased which results in more consistent application of the standards (“Exposure”). In addition, by insisting that an entity designate all risk as hedged risk, the outcome “better reflects the economics of the instruments (“Exposure”).” Finally, the income statement would accurately reveal information about the risks it is and isn’t managing (“Exposure”). Although constituents were satisfied with the proposal, they advised the two Boards to simplify, improve, and converge the hedged accounting standards together, not separately like FASB had done (“Hedge” 2013). There was concern that the two Boards were not working together on the hedge accounting standards, which stakeholders felt absolutely required convergence (“Invitation Summary” 2010).

On May 26, 2010, FASB published the ASU “Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities—Financial Instruments (Topic 825) and Derivatives and Hedging (Topic 815),” which featured the 2008 Exposure Draft (“Hedge” 2013). They issued an Invitation to Comment (ITC) for the ASU on February 9, 2011 (“Hedge” 2013). The purpose of this ITC was to gauge the U.S. constituents’ attitudes towards IASB’s hedge accounting Exposure Draft (ED) that was issued in December 2010 (“Invitation” 2011). The proposed revisions to hedge accounting guidance were considerably different than those proposed by FASB in their ASU (“Invitation” 2011). FASB had not discussed or considered the standards proposed in IASB’s document and the Board members wanted to see if U.S. stakeholders felt that the modifications outlined in IASB’s ED was a better starting point than FASB’s 2010 ASU (“Invitation Summary” 2010).

The goal of IASB's ED "Hedge Accounting" was to "a. align hedge accounting more closely with risk management and hence result in more useful information, b. establish a more objective-based approach to hedge accounting, and c. address inconsistencies and weaknesses in the existing hedge accounting model ("Invitation" 2011). The Board expanded the scope of their financial assets able to be designated as hedging instruments to include non-derivative financial assets/liabilities, whose changes in fair value would be reflected in net income ("Invitation" 2011). In FASB's ITC, U.S. stakeholders expressed their disapproval of the objective-based approach proposed by FASB. Instead, they advocated for a more principles-based approach that would align hedge accounting practices more closely with that of risk management strategies ("Invitation Summary" 2010). The current rules-based approach is perceived as "too cumbersome to comply with and understand ("Invitation Summary" 2010)." They also stated that they preferred FASB's approach to reducing the effectiveness threshold and raised concern about IASB's hedge effectiveness testing ("Invitation Summary" 2010). Other apprehensions towards IASB's ED included the increased usage of OCI for fair value hedging and the added burden to provide ample documentation of risk management objectives to auditors and regulators ("Invitation Summary" 2010). U.S. constituents, however, do support the expansion of designated hedging instruments, especially to include cash instruments that are measured at fair value ("Invitation Summary" 2010). They believe that "the nature of the instrument should not preclude it from being used to achieve hedge accounting treatment if it is legitimately part of the entity's risk management practices ("Invitation Summary" 2010)." U.S. stakeholders hope that a joint standard will reduce the volatility in the income statement caused by hedging activities that exceed the scope of the hedge accounting standards ("Invitation Summary" 2010).

At this point in the hedge accounting convergence project, FASB intends to consider the feedback received from its 2010 ASU and its 2011 ITC for IASB’s Exposure Draft to decide on how to approach the hedge accounting re-deliberations (“Hedge” 2013). They will consider IASB’s hedge accounting model when evaluating their position on the subject (“Hedge” 2013). The hedge accounting convergence project is the last of the three topics to be discussed for the overall financial instruments convergence project and they do not expect to issue a document or draft on hedging until the other two topics have been fully addressed (“Hedge” 2013).

The proposed balance sheet presentation for the overall financial instruments convergence project is shown below (“Focus” 2010).

How Loans and Capital Would Look on Balance Sheet

Loans	
Amortized cost	XXX
Allowance for credit losses	(XX)
<u>Residual FV adjustment</u>	<u>(XX)</u>
Fair value	XXX
Capital could be presented as follows	
Common stock	XXX
Retained earnings	XXX
<u>AOCI, excluding fair value changes</u>	<u>XXX</u>
Equity excluding FV changes	YYY
Fair value changes on <u>financial instruments</u>	<u>(XX)</u>
Total comprehensive equity	ZZZ

V. Closing Comments

After researching this convergence project, it is clear to me why FASB and IASB have not reached convergence. The financial instruments convergence project is an incredibly extensive task and it is only one of the many convergence projects that the Boards have on their

agenda. Accounting convergence is important but I don't believe that they will be able to meet their 2015 deadline. It is my prediction, with all of the concerns raised over the latest ASU's, that neither the measurement and classification project nor the credit impairment project explained in this paper will be completed within the first half of 2014.

I find it very hard to make suggestions for the convergence project, since my real world experience with accounting practices is limited. I would, however, like to say that I do agree with the CECL impairment loss model that the Boards presented in their ASU's. To me, FASB and IASB were established to protect the investors and the general population, not businesses. Therefore, I believe a credit impairment should be realized to its full extent and as soon as possible. This may understate companies' investments, but, seeing as what it did during the financial crisis, a timely recognition of a credit impairment loss is necessary. The current credit impairment standards amplified the problems during that time and it is critical for changes to be made to that standard so as to prevent this from repeating in the future.

With that being said, I found this research project to be very interesting and challenging. I obtained a great deal of knowledge from writing this paper and it turns out most of my preconceptions were false. I really enjoyed the out-of-class experience; I learned a lot about the accounting convergence efforts, how the process works, how to navigate the FASB website, and, especially, financial instruments. Prior to this paper, I had no understanding of financial instruments and its scope. Researching for this paper also helped to get me into the routine of reading technical accounting language, which can be very daunting but it is necessary for a career in this industry. In conclusion, I appreciate the challenge that this topic presented, it has had a great impact on my college career.

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