NORTHERN ILLINOIS UNIVERSITY

The FASB's Project on Financial Instruments

A Thesis submitted to the
University Honors Program

In Partial Fulfillment of the
Requirements of the Baccalaureate Degree
With University (Upper Division) Honors

Department of Accountancy

by

David E. Czerniewski

DeKalb, Illinois

August, 1991 (Graduation Date)
AUTHOR: David Czerniewski

THESIS TITLE: The FASB's Project on Financial Instruments

ADVISOR: Patrick R. Delaney

ADVISOR'S DEPT: Accountancy

DISCIPLINE: Accounting/Business

YEAR: Senior

HONORS PROGRAM: Northern Illinois University - Honors Program

NAME OF COLLEGE: Northern Illinois University

PAGE LENGTH: 15

BIBLIOGRAPHY (YES OR NO): Yes

ILLUSTRATED (YES OR NO): No

PUBLISHED (YES OR NO): No

IF YES, LIST PUBLICATION:

COPIES AVAILABLE (HARD COPY, MICROFILM, DISKETTE): Yes

SUBJECT HEADINGS: (Choose 5 key words or phrases by which a reader could find your thesis)

Financial Instruments
Emerging Issues Task Force
Building Block Approach

Financial Accounting Standards Board Accounting

ABSTRACT (100-200 WORDS): The work contains analyses and evaluation of the FASB's Project on Financial Instruments. Emphasis is placed on the disclosure, as well as the recognition and measurement phases of the long-term project. Each section of the long-term project is evaluated on a cost-benefit approach. In particular, the advantages of the FASB's "building block" approach to recognition and measurement are compared to its disadvantages. Problems concerning the implementation of the FASB's proposed solution are also discussed. The role of the Emerging Issues Task Force in dealing with financial instruments is also examined.

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THESIS NO: ____________________________
Approved: Patrick R. Delaney

Department of: Accountancy

Date: 7-29-71
In the past five years, there has been an outbreak in the number of innovative financial instruments that have created new accounting issues. These issues arise because: 1) the accounting literature provides no guidance or conflicting guidance for the financial instruments, and 2) the financial instruments may be designed to exploit loopholes in the accounting literature.¹

In response to pressures from the American Institute of CPAs task force on financial instruments and the Securities and Exchange Commission, the Financial Accounting Standards Board (FASB), in May of 1986, added to its agenda an extensive project on financial instruments and off-balance sheet financing.

In this paper, I will explain the steps in the FASB's long-term project on accounting for financial instruments and on dealing with off-balance sheet financing issues. I will then evaluate the contributions of the Emerging Issues Task Force (EITF) in dealing with financial instruments.

The FASB- The Project on Financial Instruments

Since the financial instruments project was added in 1986, the FASB has decided to break down the project into seven distinct segments:

1) Disclosure of additional information about financial assets and liabilities on balance sheets.
2) Disclosure of additional information about items that are off-balance sheets.
3) When financial assets and liabilities should be removed from or shouldn't appear on balance sheets.
4) How to account for financial instruments that transfer market and/or credit risk.

5) On what basis should financial assets and liabilities be measured.

6) How to account for instruments with both debt and equity characteristics.

7) Whether creation of separate legal entities affects the resolution of the preceding issues.²

(Numbers 4, 6, and 7 have yet to be addressed by the FASB)

**Off-balance sheet financing disclosures.**

In March 1990, the FASB addressed the off-balance sheet disclosure segment (number two above) through the issuance of SFAS 105: Disclosure of Information about Financial Instruments with Off-Balance Sheet Risk and Financial Instruments with Concentrations of Credit Risk. SFAS 105 is important for two reasons. First, the statement provides a GAAP endorsed definition of a financial instrument:

"A financial instrument is cash, evidence of an ownership interest in an entity, or a contract that both:

a. Imposes on one entity a contractual obligation to (1) deliver cash or another financial instrument to a second entity or (2) to exchange financial instruments on potentially unfavorable terms with the second entity.

b. Conveys to that second entity a contractual right
to (1) receive cash or another financial instrument from the first entity or (2) to exchange other financial instruments on potentially favorable terms with the first entity."³

The statement states that certain instruments recognized as assets or liabilities on the balance sheet may have a risk of accounting loss that exceeds the amounts recognized on the balance sheet. These financial instruments are off-balance sheet risks.⁴

Secondly, the statement defined the disclosure requirements for financial instruments with off-balance sheet risk as follows:
A) "The face, contract, or notional principal amount
B) The nature and terms of the instruments and a discussion of their credit and market risks, cash requirements, and related accounting policies
C) The accounting loss the entity would incur if any party to the financial instrument failed completely to perform according to the terms of the contract and the collateral or other security, if any, for the amount due proved to be of no value to the entity
D) The entity's policy for requiring collateral or other security on financial instruments it accepts and a description of collateral on instruments presently held."⁵

John E. Stewart, a technical services partner at Arthur Andersen & Co., supports the statement, but feels that SFAS 105 is deficient in that it fails to supplement the required disclosures
for complex long-term issues such as leases and insurance contracts. Stewart feels that the pronouncements related to these areas, such as SFAS 13, are deficient in disclosing information about matters such as market values and collateral to investors, and that the FASB shouldn't have exempted these areas when issuing SFAS 105.

Disclosures for balance sheet instruments.

The FASB recently addressed disclosure issues for financial instruments presented on the balance sheet. In April of 1991, the FASB released an exposure draft entitled "Disclosures about Market Value of Financial Instruments." With only minor exceptions, the statement would require "all entities to disclose the market value of all financial instruments, both assets and liabilities on and off balance sheet, for which it is practicable to estimate market value." In the event that market values are not readily available, the entities would need to provide information that is pertinent to estimating those values.

The cost of accumulating and reporting the required market value information would appear to exceed its benefits. Will companies be willing to provide the additional disclosures? John E. Stewart believes that the companies will eventually accept the draft.

"Public companies will give in to peer pressure...if they see their competitors doing it (disclosing market values)...then the market will encourage them to disclose these values."
Stewart also believes that private companies won't feel as much pressure to provide additional disclosures, and therefore, private company disclosures won't be as prevalent.

Recognition, derecognition, and measurement issues.

While SFAS 105 has accomplished much in regard to disclosure, the statement doesn't address recognition and measurement issues. The present accounting literature often provides either conflicting guidance or no guidance on resolving financial instrument recognition issues. A major controversy deals with when to recognize assets and liabilities, and when to derecognize them.

For example, situations that have generated much confusion are sales of assets with recourse to the seller and nonrecourse collateralized borrowings. The relevant literature is SFAS 77, Reporting by Transferors for Transfers of Receivables with Recourse and FASB Technical Bulletin 85-2, Accounting for Collateralized Mortgage Obligations (CMOs).

SFAS 77 allows receivables to be removed from the balance sheet if the transfer "purports to be a sale." Off-balance sheet financing is allowed even though the seller may have to make substantial future payments for credit losses as long as these losses can be reasonably estimated. Consequently, sales are usually not difficult to recognize under SFAS 77.

FASB Technical Bulletin 85-2 allows assets and debt to be removed in a CMO transaction when "cash flows from the assets are irrevocably passed to the creditors and if the borrower cannot be
required to make any future payments to the creditors. If the seller-transferor of the receivables retains a partial interest in the receivables, the technical bulletin does not allow off-sheet treatment. Thus, these two pronouncements can provide conflicting guidance. Receivables transferred may be removed even though there is 100 percent recourse to the seller for future losses (SFAS 77). Also, assets may be removed even if the seller retains a partial interest in the receivables. Under FASB Technical Bulletin 85-2, where a receivables transfer is structured like a borrowing, assets and liabilities may not be removed from the balance sheet, even though there is no recourse to the seller for future losses. Thus, depending on the seller's intentions, a transfer of receivables may be represented two different ways, despite the similarity in economic substance.

FASB - The Building Block Approach

In response to the inconsistencies that have evolved within its own pronouncements, the FASB has decided to create a novel approach to solving the financial instruments dilemmas. The FASB has decided to break down the more complex financial instruments into six basic components. This "building block" approach identifies six basic financial instruments as the components of more complex financial instruments: 1) an unconditional receivable (payable); 2) a conditional receivable (payable); 3) a forward contract, such as futures contracts, etc.; 4) options; 5) guarantee or other conditional exchange; and 6) an equity instrument. By creating recognition and measurement standards
for these "blocks," the FASB can create accounting standards for more complex financial instruments that are consistent with the standards for the "blocks." Thus, a conceptually-sound structure be created that could eliminate disparate accounting for financial instruments.

There are definite advantages to the use of the building block approach. First, the method provides a better understanding of the economic ramifications of an instrument. Take the example of a complex instrument such as callable debt. The instrument is made up of an unconditional payable (debt feature). The issuer is paying more for the call feature through higher interest rates. Thus, an option (the call feature) exists. By splitting instruments into their basic components, accountants will better understand the instruments they are analyzing, and instruments can be conceptually valued.

Secondly, accountants will become better at handling future financial instruments and resolving past conflicts. Take the earlier controversy over sales of receivables with recourse (SFAS 77 vs. FASB Technical Bulletin 85-2). The sale transfers an unconditional receivable to a third party, but the recourse provision acts as a guarantee. Thus, accountants will only be concerned with whether or not a new instrument contains any of the "building block" instruments, and handling the accounting of the overall instrument could easily be determined by the accounting for its parts.

However, there are a number of disadvantages to the
"building block" approach. First, determining whether a given fact situation fits one, if any, of the fundamental instrument classifications is very subjective and complex. Stewart feels that certain instruments may currently be misclassified by the FASB. For example, a repurchase agreement would be treated by the FASB under the "building block" approach as part of forwards. Stewart argues that a repurchase is more of an unconditional receivable/payable. Thus, not all ambiguity will be resolved with the use of this approach.

Second, the costs of using this method can exceed its benefits. For example, assume a manufacturing company purchases a two-year certificate of deposit (CD) as a temporary investment, with an interest payment at the end of year one, and an interest/principal payment at the end of year two. Heretofore, accounting for CDs has been relatively straightforward. However, under the "building block" approach, the company's accountant would make journal entries for two unconditional receivables (the payments at the end of each year). An option would be recorded since you can pay a prepayment penalty for an early return of your investment. Finally, CDs are guaranteed by the FDIC, and thus, an entry is needed to record the guarantee. Would a company that wishes to make a "simple" investment in a CD consider this approach feasible, or have the understanding to make the correct entries? Financial institutions such as banks and insurance companies may have an appropriate accounting system in place capable of handling the "building block" entries. On
the other hand, the manufacturing company may have to upgrade its accounting information system in order to apply this approach.

Another example of how the "building block" approach can become problematic is the use of the credit terms "2/10, net 30". These credit terms have never given accountants many problems in the past. However, the "building block" approach would have accountants splitting the terms into an unconditional payable (receivable) and an option (early payment for the discount). As you can see, once you apply the "building block" approach, there really is no end to it.

Clearly, the "building block" approach should be applied in certain cases, but not in others. John E. Stewart summarizes his viewpoints concerning the "building block" approach.

"(The approach) can create more problems than it solves. I'll admit, in some cases, splitting instruments makes sense. But the FASB hasn't drawn the line on how far to take this approach. I have yet to discover when I would (split instruments) and when I wouldn't. It is possible that the oversimplification of this approach will not eliminate disparate accounting for financial instruments."15

Stewart also claims the ideal situation for use of this approach is in distinguishing debt vs. equity instruments, since changes in the amount of equity affect calculations of net income.16 Thus, new pronouncements resulting from the FASB's Project on Financial Instruments could possibly amend previous pronouncements, such as APB Opinion 14 which stated that
splitting debt and equity instruments for the above purpose is not practicable.

**Alternative solutions.**

Stewart recommends an approach that has an "issue" focus, as opposed to the "instrument" focus of the "building block" approach.

"I would focus on the retaining or passage of substantive risks and rewards rather than on control (SFAS 77). The FASB basically plans to dedicate a chapter on each fundamental financial instrument, which is not timely enough to deal with emerging problems. I think we should stick to issues such as 'When is a sale a sale?' or 'When is a defeasance a defeasance?'

The "issues" focus is much more judgemental than the "instruments" focus. Accountants may need to further develop their conceptual skills in order to deal with these issue areas. However, by focusing on "issues" rather than "instruments", Stewart feels that the FASB could achieve progress earlier than under the current approach, provide conceptually grounded solutions, and lay the groundwork for further improvements.18

**Basis for valuation of financial instruments.**

Under the current accounting model, amortized historical cost is used for those instruments for which the institution has the intent and the ability to hold to maturity. Market value is used for instruments that are designated at acquisition as trading portfolio securities. For those instruments that the
entity does not have the ability and intent to hold to maturity (intends to sell), lower of cost or market is used.\(^{19}\)

The current accounting model for financial instruments is likely to exist in the future in one form or another because of its consistency with the existing conceptual framework. However, some accounting theorists believe that *fair value* is superior for all financial instruments when compared to the bases under the current model.

Some public accounting firms believe market value is the theoretical standard for valuation of all assets and liabilities, and that accountants should continue to strive toward this ideal standard. Stewart explains Arthur Andersen & Co.'s advocacy for market value:

"Ideally we should strive to have the balance sheet at fair value for all items. But we know we'll never get there. Corporations and preparers will resist because of the difficulty of getting that information. I think financial instruments, however, are easier to value than a nonfinancial asset, such as land. Financial instruments have available markets."\(^{20}\)

By having financial instruments on the balance sheet at market value, many of the problems related to the current accounting for financial instruments and the "building block" approach would be eliminated. Some accounting theorists believe that fair value accounting would "remove some of the motivations to take advantage of the inconsistencies (FASB 77 vs. Technical
Bulletin 85-2)... the motivation by the institution to either avoid recognition of a previously unrealized loss or cause recognition of a previously unrealized gain in the asset would disappear.\textsuperscript{21}

Also, when accounting for an investment in a financial instrument, accountants would not need to worry about how to split up the investment into its fundamental instruments and value each component, but merely reflect the investment on the balance sheet at its readily-determinable market (fair) value. Traded securities are valued by the financial community through analysis of such factors as yields, risks, maturity values, marketability, and liquidity. Nontraded instruments can be valued by estimates from industry experts, just as land is valued by appraisal experts. Although the processes are subject to errors, the balance sheet would better reflect the economic substance of an entity's financial position.

The Role of the Emerging Issues Task Force

In 1984, the FASB identified three key deficiencies in the standard-setting process. First, the FASB's due process prevented it from dealing with the issues promptly. Second, the Board's resources were being diverted from longer-term projects. Third, the FASB's new pronouncements were leading to complaints of standards overload.\textsuperscript{22}

The Emerging Issues Task Force was born in response to these problems. The EITF has addressed over 200 issues since its
inception. More than half of these issues dealt with financial instruments, financial institutions, and off-balance sheet financing.\textsuperscript{23}

Getting an item such as a new financial instrument on the agenda can be accomplished quickly. Since the EITF meetings are only six weeks apart, an item can be added to the agenda at one meeting and be resolved six weeks later.\textsuperscript{24} This process is much faster than the FASB's due process, which could take months or years to resolve.

Plugging the gaps in GAAP.

The EITF has been reasonably successful in freeing up the FASB for more long-term projects. The EITF's consensuses enable the FASB to devote more of its resources to more permanent, long-term projects, like the project on financial instruments.

The EITF recently released Issue No. 88-11, which addresses the sale of receivables controversy discussed earlier. Recall that under SFAS 77, a sale may be recorded although substantially all of the risks of ownership are retained. Under Technical Bulletin 85-2, if any risks are retained, no recording of a sale is allowed.

Issue No. 88-11 helps to eliminate some of the controversy by specifying the accounting for loan receivables (payables). In practice, the interest portion of loans are sold while the principal portion is retained, and vice-versa. Issue No. 88-11 states that the "cost of the loan should be allocated between the portion sold and the portion retained based on their relative
fair values on the date the loan was acquired.25 Thus, a portion of the loan is removed from the balance sheet for the rights/risks that have been transferred, and a portion of the loan is kept on the balance sheet for the retained rights/risks. A trend can be seen in the EITF consensuses toward the "risks and rewards" approach as the future solution for handling financial instrument dilemmas.

In this respect, the EITF is creating temporary solutions until a more permanent solution is reached upon the conclusion of the FASB's PROJECT ON FINANCIAL INSTRUMENTS. EITF consensuses are part of the least authoritative section of the "hierarchy of GAAP". The "hierarchy of GAAP", which was derived from Rule 203 of the Code of Professional Conduct, splits accounting pronouncements into three different levels based on the authority with which the accounting community holds the pronouncements. The most authoritative level consists of FASB Statements of Financial Accounting Standards, APB Opinions, and Accounting Research Bulletins. The second level includes AICPA Statements of Position and FASB Technical Bulletins. The third and least authoritative level includes items such as EITF consensuses. Thus, when the FASB finally issues a SFAS statement on financial instrument recognition and measurement, EITF Consensus No. 88-11 and others will be superseded.

Conclusions

The FASB has invested much time and resources in the Project on Financial Instruments. The disclosure segments of the Project
have been extremely successful, resulting in SFAS 105 and an exposure draft. Most accounting theorists feel these pronouncements have few deficiencies and will result in better information for investors.

The recognition and measurement phases of the Project are currently in progress. The FASB plans to stick with its "building block" approach. The approach has shown some advantages, such as being conceptually grounded. However, the approach as demonstrated could be costly (if not impossible) to apply in the rapid business environment, even for entities with infrequent involvement with financial instruments or simple accounting information systems. The approach is too subjective, too complex, and will not work unless the FASB provides preparers with a detailed list of transactions that are exempt from the "building block" approach.

While the lengthy PROJECT ON FINANCIAL INSTRUMENTS is in progress, the EITF has helped the FASB by providing temporary solutions to financial instrument dilemmas, pending the outcome of the Project.

Perhaps the FASB will never resolve the dilemmas behind financial instruments until the focus of the solution relates to the issues underlying the transactions, instead of the instruments involved. If transactions are reported on the balance sheet at market values with an "issue" focus for recognition, investor interests will be maximized, and accountants will be left with fewer headaches.
ENDNOTES


5. Ibid, pages 7-8.


10. Ibid, page 104.


14. Ibid.

15. Ibid.

16. Ibid.

17. Ibid.

18. Ibid.


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