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Financial Instruments and the Financial Crisis

The global economic crisis is now affecting another segment—regulators and standards setters. The Financial Accounting Standards Board just recently added four short-term projects to its agenda that address practice issues related to financial instruments.

Over the past year, a major new influence on the process of setting accounting standards has emerged: the global financial crisis. Accounting standards setters such as the U.S. Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) are now under considerable pressure to change the accounting standards that have been blamed—rightly or wrongly—for causing or exacerbating our current economic problems. Investors, creditors, regulators, and legislators increasingly expect standards setters to *do* something, and to do it *now*.

Because the present crisis is widely perceived to be linked to certain kinds of financial instruments commonly held by banks and other financial institutions, accounting standards for such financial instruments have been subjected to particular scrutiny. In this column, I'll describe some recent actions of the FASB that illustrate how the Board is quickly changing U.S. Generally Accepted Accounting Principles (GAAP) with regard to financial instruments in response to mounting pressure.

Many New Projects

At its Dec. 15, 2008, meeting, the FASB discussed accounting for financial instruments in light of the global financial crisis. These discussions led to an announcement by FASB Chairman Robert Herz that four short-term projects would be added to the Board's technical agenda. These projects address different practice issues related to financial instruments, specifically:

1. The impairment model of Emerging Issues Task Force (EITF) Issue 99-20, "Recognition of Interest Income and Impairment on Purchased Beneficial Interests and Beneficial Interests That Continue to Be Held by a Transferor in Securitized Financial Assets."

2. Fair-value disclosures about certain financial instruments as required by Statement of Financial Accounting Standards (SFAS) No. 107, "Disclosures about Fair Value of Financial Instruments."

3. Recoveries of other-than-temporary impairments.

4. Clarification of an instrument-scope exception in SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities."

A long-term, comprehensive project on financial instruments to be conducted jointly with the IASB was also added to the FASB's agenda. But rather than attempt to describe everything that the FASB has undertaken with regard to financial-instrument accounting standards, I'll focus on the first two short-term projects to provide a general sense of the nature and pace of the changes that are under way.

EITF 99-20 Impairment Model

The first short-term financial-instruments project addresses impairments of available-for-sale (AFS) and held-to-maturity (HTM) debt securities. Banks and other financial institutions often have substantial holdings of such financial instruments as a result of the widespread practice of *loan securitization*, in which the owner of a portfolio of loans receivable issues securities that give the security holders a *beneficial interest* in the loans, that is, the right to receive principal and/or interest collected on the loans. In particu-

lar, banks and other financial institutions that originate or acquire portfolios of residential-mortgage loans receivable regularly exchange their loans for securities backed by the loans, often via special-purpose entities (SPEs) created solely for the purpose of acquiring the loans, securitizing them, and issuing the securities to the entity from which the loans were acquired. Holding beneficial interests in residential-mortgage loans in the form of debt securities typically provides superior financial and regulatory-compliance flexibility compared to holding the loans directly, so the practice became very popular among banks and other financial institutions over time.

In the past two years, market prices for mortgage-backed debt securities have declined significantly, largely as a result of higher-than-expected default rates among mortgage borrowers. Under U.S. GAAP (specifically, SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities"), if the fair value of an AFS or HTM debt security drops to less than the security's amortized cost basis as of a reporting date, then the asset is considered impaired and the reporting entity is required to determine whether the impairment is "other than temporary." The determination matters in financial reporting because other-than-temporary impairment (OTTI) losses are recognized in earnings, whereas temporary impairment losses aren't.

Until recently, U.S. GAAP had two different models for determining whether the impairment of an AFS or HTM debt security is other than temporary. The first model was found in EITF Issue 99-20 and applied to beneficial interests that aren't of a high credit quality or that can be prepaid or otherwise settled in such a way that the holder wouldn't recover substantially all of its investment. For debt securities that represent beneficial interests in securitized financial assets within the scope of EITF Issue 99-20, an impairment was considered other than temporary if, based on the reporting entity's best estimate of cash flows that a market participant would use in determining the current fair value of the beneficial interest, there was an adverse change in those estimated cash flows.

> On May 14, 2009, Bruce Pounder will present the keynote address at *Portland Business Journal's*, "CFO of the Year Awards" luncheon in Portland, Ore. The topic of the address will be the convergence of U.S. GAAP and International Financial Reporting Standards. For more information, visit www.bizjournals.com/portland/event/5146.

A different impairment model applies to debt securities that aren't within the scope of EITF Issue 99-20. Found in SFAS No. 115, the second model doesn't require exclusive reliance on market participant assumptions regarding future cash flows and permits the use of reasonable management judgment of the probability that the holder will be unable to collect all amounts due.

On Dec. 19, 2008, the FASB issued proposed FASB Staff Position (FSP) EITF 99-20-a, which was intended to make the impairment guidance in EITF Issue 99-20 consistent with that in SFAS No. 115. The comment period on the proposed FSP ended Dec. 30, 2008, and on Jan. 12, 2009, the Board released the final FSP EITF 99-20-1, "Amendments to the Impairment Guidance of EITF Issue No. 99-20." The new FSP is effective for interim and annual reporting periods ending after Dec. 15, 2008; retrospective application to prior interim or annual reporting periods is prohibited.

SFAS NO. 107 Fair-Value Disclosures

SFAS No. 107 was issued in 1991. It requires all public and "large" nonpublic entities to disclose the fair value of those financial instruments for which it is practicable to estimate fair value. If estimating fair value isn't practicable, SFAS No. 107 requires disclosure of descriptive information pertinent to estimating the value of a financial instrument.

On Dec. 24, 2008, the FASB issued proposed FSP FAS 107-a, "Disclosures about Certain Financial Assets: An Amendment of FASB Statement No. 107." The proposed FSP had been developed

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jointly with the IASB, which had issued its own exposure draft proposing a similar set of disclosures. Proposed FSP FAS 107-a was an attempt to require extensive new quantitative and qualitative fair-value disclosures about AFS and HTM debt securities, as well as about certain loans and long-term receivables.

Following a brief comment period that ended on Jan. 15, 2009, the FASB discussed the issues raised by respondents in comment letters and decided to not finalize the proposed FSP (the IASB dropped its proposal as well). Instead, on Jan. 30, 2009, the FASB issued proposed FSP FAS 107-b and APB 28-a, "Interim Disclosures about Fair Value of Financial Instruments." The new proposed FSP would amend SFAS No. 107 so as to require interim-period disclosures about the fair value of financial instruments in addition to the currently required annual disclosures without adding new types of disclosures as the FASB had originally proposed. The proposed FSP would also amend Accounting Principles Board (APB) Opinion No. 28, "Interim Financial Reporting," accordingly.

As proposed, FSP FAS 107-b and APB 28-a would be effective for all interim and annual reporting periods ending after March 15, 2009. It doesn't require disclosures for earlier periods presented for comparative purposes at initial adoption, and, in periods after initial adoption, it requires comparative disclosures only for periods ending subsequent to initial adoption. The comment period ended March 2, 2009, but the FSP hadn't been finalized by the time this column was submitted for publication.

The two financial-instrument projects have been executed in a highly compressed time frame. These examples illustrate how quickly U.S. GAAP is changing during these unprecedented times and underscore how increasingly challenging it is for financial managers to keep up with the changes. **SF**

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