



Deloitte Foundation/FSA Faculty Consortium

FASB Due Process and The Role of Professors in
Standard Formulation

A Case Study via Financial Instruments

May 14, 2010

The set up...

Key Events

- 2002 - FASB & IASB begin process to converge US GAAP & IFRS
- 2006 – FASB & IASB issue an updated Memorandum of Understanding for convergence
- 2008 – SEC issues Roadmap for evaluating role of IFRS in US
- 2009 – G20 requests international accounting bodies to redouble their efforts to achieve a single set of high quality accounting global standards (goal of June 2011)
- 2010 – SEC issues statement:
 - Continued support for a single set of high-quality globally accepted accounting standards
 - IFRS is best positioned to be the single set
 - Expect decision in 2011; first reporting could be 2015

The set up...

Does this mean we can wait until SEC makes a decision re:
IFRS?

Does this mean we shouldn't expect major changes in US
financial reporting until US adopts IFRS?

Even if FASB changes US GAAP, it will be to become the same
as IFRS, right?

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No.

The Tidal Wave of accounting change is starting now!

Agenda

FASB's Agenda – the Wave of Standards

Some of the major changes in revenue recognition, leasing, and financial statement presentation

Financial Instruments

Some Thoughts

Case Study: Financial Instruments with Characteristics of Equity

FASB Agenda - Joint Projects with IASB

	2010 2Q	2010 3Q	2010 4Q	2011 1H	2011 2H
Accounting for Financial Instruments (AFI)	ED	R		F	
Financial Instruments w/ Char. Of Equity (FICE)	ED	R		F	
Financial Statement Presentation	ED	R		F	
Statement of Comprehensive Income	ED			F	
Reporting of Discontinued Operations	ED				
Revenue Recognition	ED	R		F	
Leases	ED	R		F	
Consolidation	ED	R		F	
Fair Value Measurement	ED	R	F		
Insurance Contracts	ED	R		F	
Balance Sheet Offsetting		ED		F	
Also – FI Derecognition, Emissions Trading Schemes, EPS, Income Taxes, Pensions, & Conceptual Framework					

What does all this mean?

FASB will be issuing numerous Exposure Drafts over the next two quarters. Considerations?

- Why the rush? When will final standards be effective?
- What is FASB's due process? How will this volume effect due process? Will it affect quality?
- FASB and IASB proposals are not the same – does this mean that final standards will not be same? If not the same, what does this mean for US?
 - Convergence - a process or a result?

Other IFRSs and level of convergence

Similar:

- IFRS 2 – Share-based Payment
- IFRS 3 – Business Combinations
- IFRS 6 – Extractive
- IFRS 8 – Operating Segments
- IAS 7 – Statement of Cash Flows
- IAS 8 – Accounting Policies...
- IAS 21 – Foreign Exchange Rates
- IAS 23 – Borrowing Costs
- IAS 33 – Earnings per Share

Little similarity:

- IFRS 1 – First-Time Adoption of IFRS
- IFRS 9 – Financial Instruments
- IAS 20 – Accounting for Government Grants
- IAS 29 – Hyperinflationary Economies
- IAS 32 – Financial Instruments – liab & equity
- IAS 36 – Impairment of Assets
- IAS 38 – Intangible Assets
- IAS 40 – Investment Property
- IAS 41 – Agriculture

Some similarity:

- IFRS 5 – Discontinued Operations
- IFRS 7 – Cash Flows
- IAS 1 – Presentation
- IAS 2 – Inventories
- IAS 10 – Events After the Reporting Period
- IAS 11 – Construction Contracts
- IAS 12 – Income Taxes
- IAS 16 – Property, Plant and Equipment
- IAS 17 – Leases
- IAS 18 – Revenue Recognition
- IAS 19 – Employee Benefits
- IAS 24 – Related Party Disclosure
- IAS 27 – Consolidations
- IAS 28 – Investments in Associates
- IAS 34 – Interim Financial Reporting
- IAS 37 – Contingencies
- IAS 39 – Financial Instruments

What does all this mean?

FASB will be issuing numerous Exposure Drafts over the next two quarters. Considerations?

- Contributing to the discussion
 - Writing comment letters
 - Research that FASB should be made aware of
 - Suggestions for future research
- The effect on education?
 - Use of ED's in class
 - When will final standards need to be incorporated into curriculum?

Major FASB Projects

OK, FASB has a lot of projects. But are the changes to be proposed really that major?

Revenue Recognition

Summary of the Proposed Model

Overview

Steps in the model	Key concepts
Identify the contract with the customer	Combine contracts – prices of contracts are interdependent Segmentation – goods/services in contracts priced independently Contract modification - treat as a separate contract if pricing is independent
Identifying the performance obligations	A good/service is distinct if: <ul style="list-style-type: none">• it is indentified separately in contract• has distinct profit margin• has a distinct function• transferred to customer at a different time
Determine and allocate the transaction price	Initial measurement , consider: <ul style="list-style-type: none">• variable consideration• collectibility• time value of money• noncash consideration Subsequent measurement , consider: <ul style="list-style-type: none">• Onerous performance obligations
Recognize revenue when performance obligations are satisfied	Indicators of control <ul style="list-style-type: none">• has an unconditional obligation to pay• has legal title• has physical possession• specifies the design or function of the good/service

Implementation Guidance – Major Changes

- Single model for all transactions (eliminate industry guidance)
- Control Model-
 - Not same as for consolidation, FI derecognition
 - Affect on construction, software
- Identification of Performance Obligations vs. Deliverables
 - Treatment of warranties and sales returns
- Allocation of consideration
 - variable consideration
- Onerous Contracts
- Cost recognition
 - Is matching concept dead?

Leasing

Leases – They are going on balance sheet

No more operating leases

New Model

Lessee:

Asset – Right to use an asset during the lease term

Liability – PV of obligation to pay rentals

Lessor: (performance obligation model)

Asset – PV of right to receive rent (receivable)

Liability – Performance obligation to let lessee use asset

[And lessor retains underlying asset on its balance sheet]

Leasing Issues

Lessees:

- Lease term (how many years should you use to calculate rent when there are renewal options?)
 - The longest possible term that is “more likely than not to occur”
- Contingent Rent
 - Include in balance sheet amounts using an expected outcome approach
- Impact of recording leases on balance sheet

Lessor:

- Which Model?
 - Performance obligation – two assets/ one liability?
 - Derecognition – lose part of fixed asset?

Financial Statement Presentation

Core Principles

- Flaws with the current presentation model:
 - Multiple presentation alternatives are permitted.
 - Financial information is inconsistently presented on an entity's financial statements.

Core Principle #1: A reporting entity presents a **cohesive** set of financial statements.

- Insufficient guidance regarding the level of aggregation of financial statement information exists.

Core Principle #2: A reporting entity **disaggregates** financial information of an item based on the item's function, nature, and measurement basis.

Statement of Financial Position

Significant Changes

Classification

- Classification of items is based on management's view of an entity's functional activities.
- Assets and liabilities shown together in sections and categories.
- Assets and liabilities are classified as short-term or long-term (or in order of liquidity if management believes it to be more relevant).

Disaggregation

- Management determines whether to disaggregate by function, nature, or measurement basis.

Proposed Statement of Financial Position

Business Section

- Operating Category
 - Operating Finance Subcategory
- Investing Category

Income Tax Section

Discontinued Operation Section

Financing Section

- Debt Category
- Equity Category

Statement of Comprehensive Income

Significant Changes

Classification

- Classification of income and expense items is consistent with the classification of the related assets and liabilities in the statement of financial position.
- The effects of an acquisition/disposal are reflected in a multi-category transaction section.
- [OCI project would append OCI to NI]

Disaggregation

- Disaggregate by function on the face of the financial statement.
- Disaggregate by nature in the footnotes.

Proposed Statement of Comprehensive Income

Business Section

- Operating Category
 - Operating Finance Subcategory
- Investing Category

Financing Section

- Debt Category

Multi-category Transaction Section

Income Tax Section

Discontinued Operation Section

Other Comprehensive Income, net of tax

Statement of Cash Flows

Significant Changes

Classification

- Classification of cash flows consistent with the classification of the related assets and liabilities in the statement of financial position.
- **Direct method of presentation.**

Big Deal

Disaggregation

- Management determines whether to disaggregate similar items based on the usefulness of such information.

Proposed Statement of Cash Flows

Business Section

- Operating Category
- Investing Category

Financing Section

- Debt Category
- Equity Category

Multi-category Transaction Section

Income Tax Section

Discontinued Operation Section

Consolidated Financial Statements

Statement of Financial Position

Business Section

- Operating Category
 - Operating Finance Subcategory
- Investing Category

Income Tax Section

Discontinued Operation Section

Financing Section

- Debt Category
- Equity Category

Statement of Comprehensive Income

Business Section

- Operating Category
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Financing Section

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Multi-category Transaction Section

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Other Comprehensive Income, net of tax

Statement of Cash Flows

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Multi-category Transaction Section

Income Tax Section

Discontinued Operation Section

Financial Statement Footnotes

Proposed disclosures include:

- Management's judgments used in classifying assets and liabilities
- Indirect reconciliation of operating income to operating cash
- Analysis of "select" line items, disclosing changes resulting from:
 - Cash transactions
 - Non-cash transactions (e.g., interest expense)
 - Accounting allocations (e.g., depreciation)
 - Accounting allowances or reserves (e.g., bad debt)
 - Remeasurements (e.g., fair value changes)

Financial Instruments

Financial Instruments – Today's Model for C&M

Equity Instruments –

1. Have significant influence? Yes - Equity Method
2. Fair value readily determinable? No – Cost (w/ OTTI)
3. Intend to sell soon (or FVO)? Yes - Trading/ FV thru NI
4. All others AFS/ FV in B/S, unrealized G/L in OCI except OTTI

Debt Instruments -

Securities

5. Intend to sell soon (or FVO)? Yes – Trading
6. Intend to hold to maturity? Yes – HTM, Amortized cost (OTTI)
7. Others – AFS/ FV in B/S, unrealized G/L in OCI except OTTI

Loans

8. Intend to sell in foreseeable future? Yes – HFS/ LoCOM
9. Others – Amortized cost with Allowance for credit impair

Different methods for interest recognition

Classification and Measurement

- All equities
- All derivatives
- Many hybrids

Default category:

All financial instruments

Classification

Fair value through earnings

Measurement

Initial: Fair value
Subsequent: Fair Value

Option to record:

Debt instruments:
Business strategy & no
NCCR derivatives

Portion of the
change in fair value
through OCI

Initial: Transaction
price (exception apply)
Subsequent: Fair Value

Option to record:

Own Debt: Business
strategy + measure
attribute mismatch

Amortized cost

Amortized cost

Equity Method – Significant influence & related operations

Business Strategy-

- Based on how the entity manages its financial instruments
- Not based on intent for individual instruments
- To qualify – ***demonstrate*** that entity ***holds a high proportion*** of these instruments for a ***long period of time*** relative to contractual term
- Decision is at inception – no reclassifications

Impairment

FASB's tentative decisions

	Tentative decisions
Scope	Financial assets accounted for at fair value through other comprehensive income
Trigger for impairment	No trigger
Impairment measurement	Based on expected future cash flows; all available information relating to past events and existing conditions is considered. A present value technique is used if there is enough information about the amount and timing of cash flows not to be collected
Initial recognition of a loss	Recognition of a loss on initial recognition is generally precluded. However, when impairment is assessed for a pool of assets, a loss may be recognized as of the first reporting date (e.g., by applying a loss rate to pool)
Effective interest rate (EIR)	Rate that equates the present value of the contractual cash flows (expected CF if purch w/ credit discount), adjusted for any net deferred loan fees or costs, or discounts
Interest recognition	Calculated as EIR times (amortized cost less credit allowance)

Own Debt

Four classifications

1. Default – Fair Value with changes in NI
2. Fair value with unrealized g/l in OCI
 - No embedded derivatives requiring bifurcation
 - Business strategy is not to transfer to 3rd party
3. Amortized cost
 - Meet category 2 requirements, and
 - Measuring at fair value would create accounting mismatch with assets
4. Core Deposit liabilities
 - Present Value
 - Non-core deposits in category 1 or 2

Should changes in own credit be recognized in NI or equity?

Hedge accounting

June 2008 Exposure Document

Determination of amounts recorded in other comprehensive income for cash flow hedges	Record at the amount necessary to offset the present value of the cumulative change in expected future cash flows on the hedged transaction
Assumption that hedge is perfectly effective	Neither shortcut nor critical terms matching method permitted
Frequency of hedge effectiveness assessments	Inception only, unless a change in circumstances warrants reassessment
Threshold for hedge accounting	Reasonably effective
Means of assessing effectiveness	Qualitative assessment is required at the inception of the hedging relationship; however, a quantitative assessment may be necessary in certain situations
Designating a hedging relationship	Entity cannot remove hedge designation after it has been established; however, an entity may enter into an offsetting derivative to effectively terminate the hedge

Note:

FASB's proposed Update would retain hedging of risk components (bifurcation-by-risk)

Financial instruments project

Convergence?

	FASB	IASB
Documents	One Exposure Draft	<ul style="list-style-type: none"> • One Standard issued, 3 EDs
Class & Measure	Four measurements : <ul style="list-style-type: none"> • Fair value through earnings • FV through OCI (held & own debt) • Amortized cost (own debt only) • Present value of core deposit liability 	Three Measurements: <ul style="list-style-type: none"> • Fair value through earnings • FV through OCI (held equity only) • Amortized cost (held & own debt)
OCI	<ul style="list-style-type: none"> • Recycle to earnings 	<ul style="list-style-type: none"> • No recycling
Reclass	<ul style="list-style-type: none"> • No reclass after initial recognition 	<ul style="list-style-type: none"> • Reclass if business model changes
Impairment	<ul style="list-style-type: none"> • When don't expect to collect/ based on historical and current information • Based on best estimate 	<ul style="list-style-type: none"> • Expected loss model/ consider future conditions • Use probability weighted scenarios
Hybrids	<ul style="list-style-type: none"> • No bifurcation 	<ul style="list-style-type: none"> • Bifurcate financial liabilities
FV option	<ul style="list-style-type: none"> • Not needed as FV is default 	<ul style="list-style-type: none"> • Permitted only if meet criteria

Financial Instruments with Characteristics of Equity

Classification – Qualifies for Equity

Instrument	Proposed classification
Perpetual instruments (settle only upon distribution of all assets; e.g., common)	Equity
Certain puttable and mandatorily redeemable instruments (narrow except) <ul style="list-style-type: none">•To allow exiting owners to maintain control upon a death or withdrawal•Upon withdrawal if required to hold to transact	Equity
Perpetual preferred convertible into a specified number of equity-classified instruments (e.g. perpetual preferred convertible into common)	Equity
Instruments that require an entity to issue a specified number of equity-classified shares for a specified price (e.g., physical settle forward sale)	Equity

Classification – Split b/w equity & liability

Instrument	Proposed classification
Puttable equity instruments (that don't meet narrow exception)	<ul style="list-style-type: none">• Liability (embedded written put option is a derivative at FV) and• Equity (the remainder)
Share required to be redeemed upon event not certain to occur	<ul style="list-style-type: none">• Liability and• Equity
Debt convertible into a specified number of equity-classified instruments	<ul style="list-style-type: none">• Liability and• Equity
Preferred share convertible into a variable number of equity instruments	<ul style="list-style-type: none">• Liability and• Equity
Equity Instrument that requires a dividend	<ul style="list-style-type: none">• Liability and• Equity
Obligation to repurchase an entity's own shares	<ul style="list-style-type: none">• Gross liability (amount to be paid to redeem the shares) and• Equity (the offsetting entry)

Classification - Other

Instrument	Proposed classification
Instrument permits or requires cash settlement or net share settlement	Liability (or asset)
Written put options over own equity	Liability (net)
Other instruments not classified as equity or separated	Liability
If at any time the entity does not have enough shares to settle an equity classified instrument	Reclassify from equity to liability (permanent)
Classification of the instrument in the consolidated financial statements	Generally, carry forward from the subsidiary's financial statements

Classification - Examples

Instrument	Current U.S. GAAP	Current IAS 32	Proposed New Classification Model based on Boards' Tentative Decisions
Common share	Equity	Equity	Equity
Perpetual preferred share	Equity	Equity	Equity
Share issued by a subsidiary that is a limited life entity	Equity	Liability ¹	Equity
General partnership interest assuming 1) the general partner takes an active role in the management of the partnership and 2) the instrument must be redeemed if the general partner retires	Equity	Liability ¹	Equity
Ownership instrument that is redeemable at the option of the holder (puttable shares), other than upon retirement or death	Equity (mezzanine equity for public companies)	Liability ¹	Liability (fair value of a put option) and Equity (remainder)
Options, rights issues and warrants settled by exchanging a specified number (fixed number under IAS 32) of shares for a specified price (fixed price under IAS 32)	Liability or Equity (depending on whether the criteria in ASC 815-40-15 (formerly EITF 07-5 and EITF 00-19 are met))	Equity	Equity
Perpetual preferred share convertible into a specified number (fixed number under IAS 32) of ordinary shares	Equity	Equity	Equity
Debt convertible into a specified number (fixed number under IAS 32) of shares	Typically Liability	Liability and Equity	Liability (fair value of debt) and Equity (remainder)
Debt convertible into a "variable" number of shares	Typically Liability	Liability	Liability (in its entirety)

¹Under IAS 32 instruments that are required to be redeemed and that are redeemable at the option of the holder are classified as liabilities, unless they have particular features and meet particular conditions.

Measurement

Instrument	Initial Measurement	Subsequent Measurement
Freestanding liabilities and assets	<ul style="list-style-type: none">Principles developed in the Joint Project on Accounting for Financial Instruments	<ul style="list-style-type: none">Principles developed in the Joint Project on Accounting for Financial Instruments
Freestanding equity instrument	<ul style="list-style-type: none">Transaction price (costs or fees* excluded)	<ul style="list-style-type: none">If not redeemable, do not remeasureIf redeemable, remeasure at the current redemption value
Hybrid instrument	<ul style="list-style-type: none">Liability or asset component at fair valueThe remainder allocated to the equity component	<ul style="list-style-type: none">Principles developed in the Joint Project on Accounting for Financial InstrumentsThe same as freestanding equity instrument

*Transaction costs or fees on issuance should be expensed

Accounting for Exercises of Options and Conversion or Settlement of Convertible Debt

- Shares issued upon exercise of written call options – at FV on the issuance date
 - Equity classified option: $FV \text{ of shares} - (CV \text{ of the option} + \text{Cash received}) = \text{Statement of changes in equity (as transfer of wealth)}$
 - Liability classified option: $FV \text{ of shares} - (CV \text{ of the option} + \text{Cash received}) = \text{Net income}$
- Shares issued upon conversion of convertible debt – at FV on the issuance date
 - $CV \text{ of the liability component} - FV \text{ of the liability component} = \text{Net income}$
 - $FV \text{ of shares} - FV \text{ of the liability component} = \text{Equity}$

Other decisions

- **Scope** – all financial instruments except:
 - Share-based payment awards
 - Interests in subsidiaries, associates, or joint ventures accounted for under other standards
 - Employers' rights and obligations under employee benefit plans
 - Insurance contracts accounted for under other standards
- **Reclassifications** – required under certain circumstances
- **Economic compulsion** - not relevant to classification
- **Fair value option** - not available for the combined instrument
- **Disclosures** – additional disclosures about the nature and terms of the instruments
- **Transition** - limited retrospective application

What does this mean?

Conclusions & Questions

Deloitte.