

# **Financial Instruments – The New Model!**

**Tom Canfarotta**

**Russ Golden**

**Greg Jonas**

**Richard Levy**

**Bob Uhl**

## Today's Model – Too Complex!

Loans (e.g., long term mortgages) – Impairment-allowance for bad debts

Investments (and impairment issues):

Trading – Fair Value thru income

Available for sale – FV thru OCI

Hold to maturity – Historical cost

Significant influence – equity method

Cost method – own small % - non public co.

Debt – historical cost

And there's the fair value option and derivatives



# IS THIS MODEL BROKEN?

**What's the matter with it?**

**Is it really too complicated?**

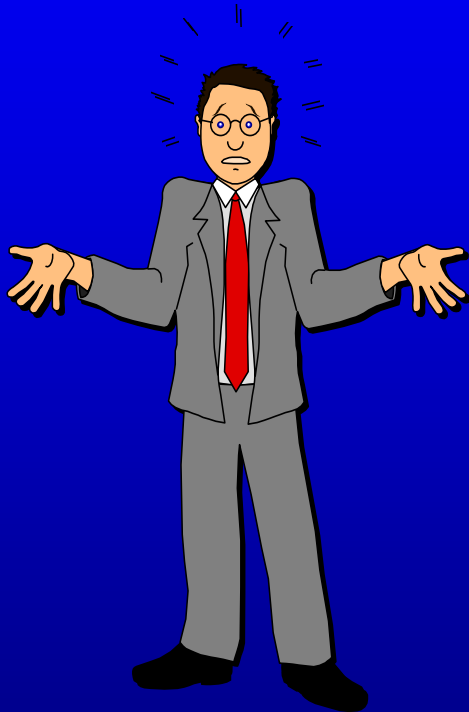
**Do we need more fair value?**

**Should all financial instruments  
be carried at fair value?**

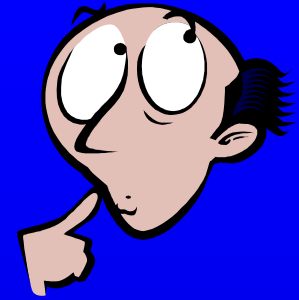
**Do users really want more fair  
value?**

**What about Preparers? Auditors?**

**Will there be convergence with IASB?**



# LOANS



Example - \$10 M mortgage – 6% due in 15 years

Carry at *fair value* (e.g., rates go to 7% FV goes down)

Change in FV thru income *unless*:

Business strategy is to hold and collect, then  
record changes in value thru OCI

Exception – no change for trade receivables due in  
less than one year.

# INVESTMENTS

Equities – Fair value thru income (not OCI)

Available for sale category – Gone!

*Equity method* still OK if there's significant influence AND investee is in similar business

Debt – Fair value thru income unless business strategy is to hold – then thru OCI

Hold to maturity category – Gone!



# Business Strategy



Based on how entity manages its financial instruments

NOT based on intent for individual instruments

Hold instruments for *collections* of contractual cash flows rather than to sell or settle with 3<sup>rd</sup> party

Demonstrate that entity holds a high proportion of these instruments for a long period of time

Make decision (its an election) at inception – can't change later (changes in FV thru income or OCI)

*Operational? Preparers? Auditors? Users?*

# How to Recognize Impairment



If change in fair value went thru OCI,  
determine if a credit loss exists. This means:  
Unable to collect all principal and interest!

Decision based on past and current events  
(not future) – do *not* assess probability

Record losses thru income – no write-ups

# Long Term Debt



Carry at Fair Value – changes thru income  
unless:

Business strategy – hold to pay it off – then  
carry at FV thru OCI (like financial assets)

OR carry at historical cost IF carrying at fair  
value would create a “mismatch”

*Operational? Relevant?*

## Hedging (FAS 133) needs fixing too

Yes! Just too hard – too many restatements.

Under the Financial Instrument proposal:

- Assess ineffectiveness qualitatively
- On-going effectiveness testing if there are indicators
- No more short-cut method or critical terms matching

However, “bifurcation by risk” will still be OK

Will this be enough to fix FAS 133?

# How the new model will be presented

**One statement of financial performance**  
**Net income followed by OCI items**

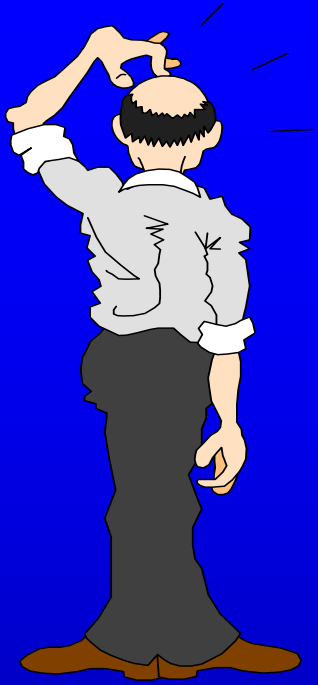


**Balance sheet**

**Display depends on whether changes in  
fair value go thru income or OCI**

**Does historical cost still get disclosed?**

**Will we have greater transparency?**



# Other Issues

Transaction costs and fees – can these still be deferred on the balance sheet and spread?

What is the impact of the new model on:

Allowance for bad debts

Interest income and expense

Realized gains & losses

**Make sense?**

## What about Convergence?

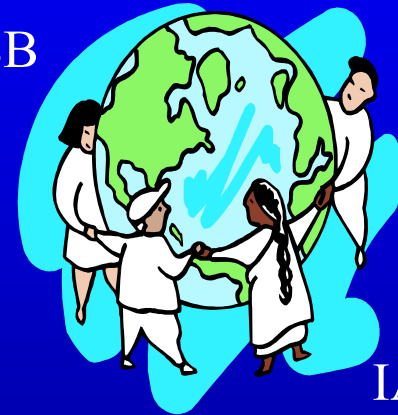
The IASB is well along in developing their own new model

Does it look like ours?

NO! - They like historical cost more than FASB does, plus an “expected” loss approach, no recycling, “hold for sale” for equity investments still OK, statement of financial performance – optional

**How will we converge? Is this approach logical?**

FASB



IASB

# Summary Views



**Is the proposal heading in the right direction?**

**What should be done differently?**

**Users, preparers, auditors – how will they react to the proposal?**

**When might it be adopted?  
Effective date, transition?**