FASB

Accounting for Financial Instruments and Revisions to Accounting Derivative Instruments and Hedging (Topic 815)
Technical Director: 1810-100
EMAIL : Director @ Fasb.org

By: Dr. Joseph S. Maresca CPA, CISA

Colleagues,
I thank you for the opportunity to critique this Statement.
Details follow:

Background

The Statement applies to all entities except for:
(1) classifications as stockholder equity
(2) equity elements bifurcated
(3) employer plan obligations and related assets
(4) a 944 insurance contract
(5) investments under the equity method qualifying under Topic 323 on the equity method
(6) equity in consolidated subsidiaries or a non-controlling interest
(7) interests in variable interest entity to be consolidated under subtopic 810-10
(8) financial assets or financial liabilities for a lease within the definition of 840 leases
(9) loan commitment and financial standby letters of credit held by the borrower etc.

Embedded derivatives implicit or explicit terms may affect some cash flows or values of other exchanges required by a contract; such as a derivative. Hybrid instruments are contracts which embody embedded derivatives and a host contract. pp. 31

A. Financial assets or liabilities are at fair value if all subsequent changes in the fair value are recognized in net income. pp. 32
B. When the fair value differs significantly from transactions prices recognized in Comprehensive Income.

Guidance on Impairment was explained. Financial assets are at fair value with any changes to fair value reflected in Comprehensive Income.
In determining the amount of impairment to be recognized for a pool of assets, the historical loss may be examined as to the loss rates experienced in the past. Historical loss rates may have important meaning. pp. 44-46

A troubled debt restructuring does not result from a new loan but rather represents part of an entity's ongoing effort to ***recover its original investment or the investment in the original loan.*** The same interest rate used to discount cash flows will apply here.

Critique:

Comment 1:

Embedded derivatives implicit or explicit terms may affect some cash flows or values of other exchanges required by a contract; such as a derivative. Hybrid instruments are contracts which embody embedded derivatives and a host contract. pp. 31

Where other exchanges are involved "materially", accountants may consider intermarket implications. Whenever an embedded derivative is the subject of the contract, the auditee has the most control at the inception of the contract. Therefore, the rights, duties, liabilities and recourse of the various parties and counterparties should be set forth clearly in the host contract so that a Distrct Court can interpret the contract uniformly and consistently. Otherwise, a District Court must resort to "stare decisis" in order to provide guidance to the litigants in an embedded derivative contract.

Embedded terms may meet the definition of a derivative in another contract like the **"host contract**". The host contract's cash flows may be modified when changes in specified underlying market variables occur. The contract that embodies **both** the derivative and the host contract is referred variously as the "hybrid instrument."

Embedded derivatives appear in a variety of contracts, including foreign exchange contracts (sometimes involving foreign bourses) , lease agreements, and insurance contracts . Convertible debt and preferred stock instruments may also contain this complex terminology. When the contract involves subject matter under a foreign jurisdiction, the legal venue for the contract interpretation may be overseas - outside the jurisdiction of American courts. Therefore, contract compliance, language and venue issues should be addressed thoroughly at the inception of the contract and not at the point the contract itself or key provisions become problematic.

Comment 2:

In determining the amount of impairment to be recognized for a pool of assets, the historical loss may be examined as to the loss rates experienced in the past. Historical loss rates may have important meaning. pp. 44-46

Where the subject of the contract or pool of assets impaired involves real estate, past historical experience may be helpful. Real estate recessions tend to last 4 years or slightly more. **Location is the rule in real estate**. And so, some markets may grow or hold their values substantially during a real estate recession while others will experience valuation losses in individual portfolios or pools of real estate assets.

Recessionary trends can impact valuations; however , an uptick in housing starts, an increment in orders, increased bulk shipping activitity, increased consumer spending and an increase in part-time hiring all portend an end or nearing the end of a recession. Such trends can assist the accountant in understanding the forces which drive the valuations of assets.

Another aspect impacts real estate portfolios or pools of assets. Namely, population growth impacts real estate valuations in particular growth areas because this phenomena drives prices upward.
From 1960- now, the USA grew from 180MM people to 300MM people.
From now til 2050, the USA population will grow from 300MM people to 500MM. And so, real estate valuations will increase over time.

Real estate valuations will be subject to the availability of water.
And so, desalination coupled with solar energy and other technologies like the "Artificial Sun" will provide the opportunity for cheaper water to service communities with a paucity of water resources. This is happening in the Middle East , Africa and China right now.

Comment 3

A troubled debt restructuring does not result from a new loan but rather represents part of an entity's ongoing effort to ***recover its original investment or the investment in the original loan.*** The same interest rate used to discount cash flows will apply here.

Pools of loans or groups of loans are subject to the same internal accounting controls as loans made at the inception of a relationship with a borrower. i.e.

Zero interest loans are problematic because there is an admission that the institution is seeking to recover the principal only. When a relationship officer consolidates ALL customer accounts and the result is an overdraft - the net effect is really a loan and not a consolidated overdraft.

Proponents of mixed measure models hold the long term as the most relevant.