

THE FUNDAMENTAL FINANCIAL INSTRUMENT APPROACH

Identifying the building blocks.

**by Halsey G. Bullen, Robert C. Wilkins
and Clifford C. Woods III**

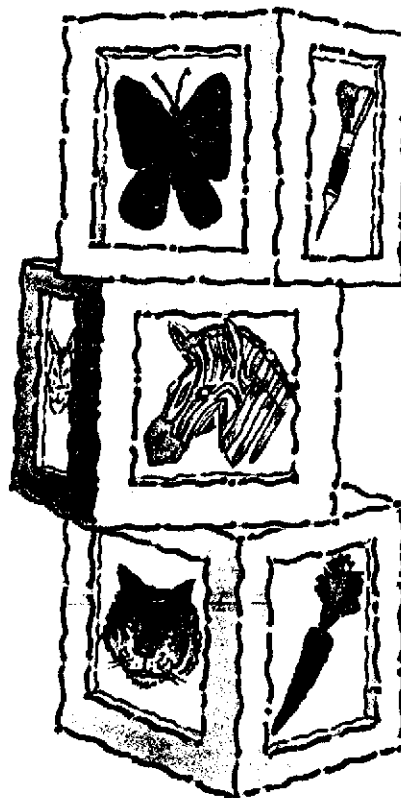
Because of the seemingly endless complexity and diversity of innovative financial instruments, the Financial Accounting Standards Board is taking the approach of breaking down these instruments to resolve the numerous recognition and measurement issues associated with them.

The approach is based on the premise that all financial instruments are made up of a few different "building blocks"—fundamental financial instruments—and that determining how to recognize and measure those fundamental instruments is the key to reaching consistent solutions for the accounting issues raised by other, more complex instruments and by various relationships between instruments.

continued on page 72

HALSEY G. BULLEN and ROBERT C. WILKINS, CPA, are project managers and CLIFFORD C. WOODS III is a research analyst at the Financial Accounting Standards Board, Norwalk, Connecticut.

Expressions of individual views by the members of the FASB and its staff are encouraged. The views expressed in this article are those of Messrs. Bullen, Wilkins and Woods. Official positions of the FASB are determined only after extensive due process and deliberation.



IDENTIFYING FUNDAMENTAL FINANCIAL INSTRUMENTS

To identify which instruments are fundamental, the FASB turned first to its definition of a financial instrument (see exhibit 1, at right). The definition the FASB has established distinguishes between instruments that entail one party's right to receive and another party's obligation to deliver and those that entail rights and obligations to exchange.

If a financial instrument obligates one party to deliver cash or other instruments, that party has a liability—a payable in the broadest sense—and the other party has an asset—a receivable. A right to receive or an obligation to deliver entails a one-way transfer; this transfer would involve no further quid pro quo.

In contrast, a financial instrument that entails a right or obligation to exchange looks to a further transaction that will, if it occurs, consist of a two-way flow of cash and other financial instruments—an exchange. Whether a contract to exchange gives rise to an asset, a liability or perhaps both is determined by the potential for a favorable or unfavorable result. To be an asset, such a contract must entitle a party to exchange on terms that are at least potentially favorable. (For example, a call option to buy a bond next month for \$1,000 has the potential to become favorable to its holder—the market price of the bond could rise above \$1,000 by then.) Likewise, to be a liability, such a contract must obligate a

EXHIBIT 1

What's a financial instrument?

The FASB's July 1989 revised exposure draft, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*, defines a financial instrument as cash, evidence of an ownership interest in an equity or a contract that is both

■ A (recognized or unrecognized) contractual right of one entity to (1) receive cash or another financial instrument from another entity or (2) exchange other financial instruments on potentially favorable terms with another entity.

■ A (recognized or unrecognized) contractual obligation of another entity to (1) deliver cash or another financial instrument to another entity or (2) exchange financial instruments on potentially unfavorable terms with another entity.

That definition includes traditional instruments such as receivables, payables, debt securities and common stock, as well as more innovative financial instruments such as financial futures and forward contracts, interest rate swaps and caps, collateralized mortgage obligations and financial guarantees. It excludes contracts for the purchase or sale of commodities or other goods, services, inventories, property, plant and equipment, as well as tax obligations.

party to exchange on terms that are at least potentially unfavorable.

Conditionality of rights and obligations is another characteristic that distinguishes

AT A GLANCE

■ THE FASB IS BREAKING DOWN financial instruments to resolve the issues raised by their seemingly endless complexity and diversity. This fundamental financial instrument approach—based on the way complicated instruments are created and valued in the marketplace—is intended to help answer recognition and measurement questions raised by new as well as traditional instruments.

■ THE BOARD HAS TENTATIVELY identified six fundamental financial instruments. The six are unconditional receivable (payable); conditional receivable (payable); forward contract; option; guarantee or other conditional exchange; and equity instrument. All other financial instruments are compounds, which

can be analyzed as made up of various combinations of these fundamentals. Hedging and other relationships between instruments sometimes have an effect on the accounting answers.

■ NUMEROUS GENERALLY accepted accounting principles will be reconsidered in the financial instruments project and—in view of present inconsistencies—some surely will have to change. The FASB's ultimate goal is to issue statements of financial accounting standards that resolve the accounting issues of financial instruments on a consistent conceptual basis. The board's building-block approach should help CPAs resolve the inevitable issues that will arise involving financial instruments and off-balance-sheet financing.

between fundamental financial instruments. A right to receive or an obligation to deliver cash or another instrument—a one-way transfer—may be either unconditional or conditional on some event. The same is true for a right or obligation to exchange cash and other financial instruments—a two-way exchange.

Conditional exchanges can be further subdivided into

■ Instruments whose rights and obligations are conditional on events within the control of one party to the contract (for example, in an option contract, the conditional event is generally the option holder's decision to exercise).

■ Instruments whose rights and obligations are conditional on events beyond the control of either party to the contract (for example, in a financial guarantee, the conditional event that could take place might be default on some other contract by a third party).

How important that subdivision of conditionality may end up being for accounting recognition and measurement will have to remain to be seen.

Those contractual distinctions between financial instruments helped lead the FASB to its current list of six tentatively identified fundamental financial instruments, which are defined in exhibit 2 below.

continued on page 75

EXHIBIT 2

Six tentatively identified fundamental financial instruments

Unconditional receivable (payable). An unqualified right (obligation) to receive (deliver) cash or another financial asset on or before a specified date or on demand. These contracts entail a future one-way transfer of one or more financial assets. Examples are trade accounts, notes, loans and bonds receivable (payable).

Conditional receivable (payable). A right (obligation) to receive (deliver) cash or another financial asset dependent on the occurrence of an event beyond the control of either party to the contract. These contracts entail a potential one-way transfer of one or more assets. Examples include interest rate caps and floors, insurance contracts without subrogation rights and compensation promised to a third party if a transaction or other event occurs.

Forward contract. An unconditional right and obligation to exchange financial instruments. Examples include forward purchase and sale contracts, futures contracts and repurchase agreements that obligate both

parties to a future exchange of financial instruments. (Forward and futures contracts for the purchase or sale of metals, grain or other goods do not qualify as financial instruments because the items to be exchanged are not both financial instruments.)

Option. A right (obligation) to exchange other financial instruments on potentially favorable (unfavorable) terms that is conditional on the occurrence of an event within the control of one party to the contract. Most commonly, the conditional event is an option holder's decision to exercise the right to demand the exchange. Examples include warrants, loan commitments and exchange-traded and other put or call options. Bonds or stocks with attached warrants, mortgages that allow the borrower to prepay and convertible bonds are examples of compound financial instruments containing options.

Guarantee or other conditional exchange. A right (obligation) to exchange financial instruments on potentially fa-

vorable (unfavorable) terms that is conditional on the occurrence of an event outside the control of either party. Examples include performance bonds, letters of credit and all other contracts for which the obligor, on occurrence of a specified event, would receive the subrogation or other rights to another financial instrument in exchange for its delivery of a financial instrument.

Equity instrument. An ownership interest in an equity. It typically entitles its holder to a pro rata share of any distributions made to that class of holders but only entails a right (obligation) to receive (deliver) cash or other financial instrument assets on the entity's liquidation. Examples include common stock and partnership interests.

This set of fundamental instruments is being reexamined as the recognition and measurement phase proceeds. Some categories might be combined if analysis shows they should be accounted for similarly, while others might have to be divided.

Mortgages and mortgage-backed securities

A typical fixed-rate residential mortgage is a combination of a series of required cash flows—each an unconditional receivable (payable)—and the privilege of prepaying the remaining principal balance at any time—an option written (held). The prepayment option is favorable to the homeowner. If interest rates decline, the borrower can refinance at a lower rate without penalty. And it's that possibility that makes prepayment options unfavorable for banks, thrifts and other mortgage investors; the prepayment option embedded in everyday residential mortgages is the wild card that makes investing in mortgages (and mortgage-backed securities) so much riskier than it might at first seem to be.

Mortgage-backed securities are created by bundling mortgages into a pool and offering (often through a trust) different interests in that pool to different investors. Mortgage-backed securities take several forms. In some, "senior" investors might be entitled to all cash collected from the pool until they recoup their entire investment plus, say, 9% interest; "subordinated" investors might be entitled to whatever remaining cash is collected.

Alternatively, a pool of mortgages might be split into several classes (or "tranches") of securities, each of which entitles investors to different seniority and rates of return—or split into securities entitling investors to only the interest

payments or only the principal payments. Often, financial guarantees are an important part of these securities.

In terms of fundamental instruments, mortgage-backed securities combine unconditional receivables (payables), conditional receivables (payables), guarantees, options and perhaps equity instruments (representing interests in the residual value of a trust). Examining these components to determine which have been transferred to investors or others and which have been retained by the security's sponsor may help in resolving the troublesome "sale or financing" derecognition question that is raised on many occasions when these securities are first created.

RECOGNITION AND MEASUREMENT

Recognition and measurement questions to be answered for each fundamental instrument fall into four categories:

Recognition—Whether and when an asset or liability should initially be recorded in the statement of financial position.

Initial measurement—At what amount an asset or liability should initially be recorded.

Subsequent measurement—At what amount an asset or liability should be reported after recognition and initial measurement; in particular, whether gain or loss should be recognized as a result of some or all changes in market value.

Derecognition—Whether and when an asset or liability should be removed from the statement of financial position—and whether gain or loss should be recognized.

While the recognition and initial measurement of financial instruments are not necessarily easy to resolve, the more difficult issues are in subsequent measurement and derecognition.

COMPOUND FINANCIAL INSTRUMENTS

Financial instruments that do not meet the definition of one of the fundamental financial

instruments can be analyzed as made up of fundamentals in various combinations. Some of these compound instruments may combine only a few fundamental instruments; for example, a callable zero-coupon bond combines (from the issuer's perspective) an unconditional payable and a call option held.

Other compound instruments are more complex. They may contractually link several fundamental instruments. Exhibits 3 (above) and 4 (page 77) show how two kinds of compound instruments—mortgages and mortgage-backed securities and interest rate swaps—can be broken down into fundamental instruments.

The FASB anticipates that the recognition and measurement of various compound instruments can be approached by analyzing them in terms of their fundamental financial instrument components. Determining the accounting for each fundamental instrument should point the way to the accounting for any compound financial instrument. While that may sound challenging, it mirrors the current business practices of many buyers and sellers of mortgages, corporate bonds and other compound financial instruments.

RELATIONSHIPS BETWEEN FINANCIAL INSTRUMENTS

At the same time, the FASB will consider whether some of the contractual and other relationships between financial instruments—whether fundamental or compound—should affect the accounting for one or more of the related instruments. Relationships that raise accounting issues include those between hedging and hedged instruments, assets and liabilities that can be set off against each other, secured debt and securing assets (either with or without recourse to other assets of the borrower), options that are “covered” by particular assets and in-substance defeasances and other dedications of specific assets to the settlement of specific liabilities.

THE GOAL: ACCOUNTING STANDARDS FOR FINANCIAL INSTRUMENTS

Breaking down complex financial instruments into their fundamental components is not a new idea. On the contrary, it often is acknowledged by many investment bankers, financial managers, economists and finance academics (usually in the context of how best to manage financial risks) as the way in which complex financial instruments are created and valued in the marketplace.

Similarly, the FASB’s approach is intended to break down complex financial instruments to determine their economic substance and thereby develop consistent accounting standards.

As the FASB’s financial instruments project proceeds, numerous generally accepted accounting principles will be reconsidered and some surely will have to change. Exhibit 5 on page 78 indicates some of the authoritative accounting literature subject to reconsideration in the project. Another indication of the potential for change in current practice may be the FASB’s tentative conclusions on fundamental instruments, which include the tentative decision to measure certain options held or written at their current market values or at estimates of those values based on option pricing models or other techniques, if this is feasible.

The FASB plans to issue an initial discussion document on the recognition and measurement of financial instruments in 1990. As planned, it would present the fundamental financial instrument approach and the issues the project aims to resolve, expressed in terms of accounting for fundamental instruments, compound instruments and hedging and other rela-

EXHIBIT 4

Interest rate swaps

The interest rate swap was invented in the early 1980s to aid companies able to borrow cheaply at floating interest rates but seeking fixed rates and vice versa. It has become an essential tool of finance since its creation.

A straightforward interest rate swap might require one party—the “fixed-rate payer”—to pay a fixed interest rate times a notional principal amount at the end of each of the next five years; the counterparty would be required to pay the floating London interbank offered rate times the same notional principal amount at the same intervals. There are no principal payments and the fixed rate is typically negotiated to eliminate any need for

a cash payment at the outset. For convenience, the parties usually agree that a single net payment be made at each due date.

Interest rate swaps typically are entered into in connection with a borrowing, although the swap counterparty usually is not the lender. Some have described the economic position of a floating-rate borrower/fixed-rate payer in a swap as being the same as that of a fixed-rate borrower, but there is a difference. In an interest rate swap, the borrower is exposed to a credit risk since the swap counterparty might default.

The interest rate swap can be analyzed into fundamental financial instruments in at least two ways:

- As a series of forward contracts (to exchange a floating-rate cash receipt for a fixed payment).

- As a series of variable-rate receivables and a series of fixed-rate unconditional payables to be settled by net payments after setoff.

Which of these analyses is more appropriate for swaps, whether the choice affects the accounting result and whether the relationship between an interest rate swap and a debt incurred at the same time should affect the accounting for either or both instruments are among the questions the financial instruments project is expected to deal with in resolving the diversity in current accounting practice for swaps.

EXHIBIT 5

Authoritative literature that may be affected by the recognition and measurement phase of the financial instruments project

Document	Title	Area that may be affected
Accounting Principles Board Opinion no. 21	<i>Interest on Receivables and Payables</i>	Accounting and scope restrictions.
FASB Statement no. 12	<i>Accounting for Certain Marketable Securities</i>	Entire statement (both debt and equity securities are financial instruments).
FASB Statement no. 15	<i>Accounting by Debtors and Creditors for Troubled Debt Restructurings</i>	Entire statement.
FASB Statement no. 52	<i>Foreign Currency Translation</i>	Forward exchange contract and hedging provisions.
FASB Statement no. 65	<i>Accounting for Certain Mortgage Banking Activities</i>	Mortgage loans, mortgage-backed securities and the sale of loans with servicing retained.
FASB Statement no. 76	<i>Extinguishment of Debt</i>	Entire statement.
FASB Statement no. 77	<i>Reporting by Transferors for Transfers of Receivables with Recourse</i>	Entire statement.
FASB Statement no. 80	<i>Accounting for Futures Contracts</i>	Entire statement.
FASB Statement no. 91	<i>Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases</i>	Initial and subsequent measurement issues.
Various AICPA accounting and audit guides, especially those for banks, savings and loan associations, finance companies, investment companies and brokers and dealers in securities.		Some specialized accounting principles will be reexamined. Areas that may be affected include the distinction between trading and investment accounts, allowances for loan losses and valuing repossessed collateral.

tionships between financial instruments. The document also is expected to provide the FASB's preliminary views on some of those issues. Ultimately, after considering written comments on the discussion document, a public hearing planned for late 1990 and further deliberations and exposure drafts, the project's goal is to issue accounting standards that resolve the accounting issues of financial instruments on a consistent conceptual basis.

The fundamental financial instrument ap-

proach is a tool intended to help resolve the recognition and measurement issues of new as well as traditional financial instruments. The approach should help the FASB resolve today's issues and help practicing accountants answer tomorrow's inevitable accounting questions about innovative financial instruments and off-balance-sheet financing. The approach is still being developed and the FASB welcomes suggestions and supportive or critical comments from all of its constituents.