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Regarding: Ed 37 Financial Instruments--Classification Due 7-31-09
By : Dr. Joseph S. Maresca CPA, CISA

Colleagues,

Thank you for the opportunity to critique this extensive presentation on the classification of financial instruments. Detailed comments are set forth below.

Critique: The presentation is complex and it impacts a number of very technical areas.

(1) P. 10 refers to derivatives linked to controlled entities. This is a complex area due to the definition of control, majority and minority interests. The least clear aspect of derivatives is the area of recourse due to the shear number of parties involved in some types of derivative transactions. The USA courts have been unsympathetic to viewing derivative transactions in the same light as consumer transactions with the attendant guarantees.

Instead, the maxim seems to be to "let the buyer beware". Generally, each party to the derivative transaction will have an expert charged with the responsibility of gleaning the rights, duties, responsibilities and recourse inherent in the derivative transaction.

There are other complexities in controlled entities; namely, the quasi-reorganization in bankruptcy transactions and the legal doctrine of "pierce the corporate veil ". Another practical problem is ascertaining the financial disclosure of derivatives subject to variable interpretations of the parties with the ultimate recourse.

Variable interpretations of recourse could have dramatic consequences for contingent liability disclosure. Intercompany derivative transactions could be problematic depending upon the ultimate design of the transaction and the final determination of the parties having recourse by local courts in host countries or USA courts.

(2) P. 17 dictates that the instrument is to be classified in accordance with the substance of the contractual arrangement. Transactions in international trade are not always uniformly clear as to the applicable law or governing precedent. For instance, the official language of the contract may be unclear.

When several countries are bound contractually, there should be a forum selection clause clarifying where any potential disputes will be litigated or settled. A choice of law clause may be helpful to clarify ambiguities between the parties. Force majeure clauses may stipulate specific eventualities which excuse parties from partial or full performance of the legal contract. In some instances, a joint venture or affiliate relationship may be the only form of business organization available to USA companies with manufacturing facilities governed by the host country majority ownership of the entire venture. Investing in foreign nations may have expropriation risk just beneath the threshold of a full confiscation.

(3) #24/Pg. 22 describes the settling of non-financial obligations when there is no particular obligation to settle in cash . There could be circumstances where the settlement presupposes a contingent liability.

(4) The financial assets/liabilities should be ascertainable by readers of the financial statements when net amounts are presented in the Statements. #47/P. 27 #54/P. 29 provides a clarification.

(5) AG 62 P. 46 The receipt of floating payments in a "synthetic instrument" may have implications for additional interest on loans where the customer account is in overdraft position on a consolidated basis. Major overdraft transactions constitute a form of loan with interest imputed.

(6) P. 71 The concept of a "covered call" may apply with renewable options extending into the future and revenue streams associated with the original stock purchase.

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