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To B(ifurcate) or Not To B — That Is Your Option

FASB Simplifies Accounting for Hybrid Financial Instruments

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Last week, the FASB issued Statement No. 155, *Accounting for Certain Hybrid Financial Instruments* — an amendment of FASB Statements No. 133[1] and 140.[2] Key concepts in Statement 155 are summarized below. Additional information, in question and answer format, is included in the Appendix.

See Question 1 in the Appendix for a brief explanation of hybrid financial instruments and their current accounting treatment under Statement 133.

Summary of Statement 155 Provisions

Fair Value Measurement Election

Statement 155 provides entities with relief from having to separately determine the fair value of an embedded derivative **that would otherwise be required to be bifurcated** from its host contract in accordance with Statement 133. Statement 155 allows an entity to make an **irrevocable election** to measure such a hybrid financial instrument at fair value in its entirety, with changes in fair value recognized in earnings. The election may be made on an instrument-by-instrument basis (see Question 7 in the Appendix) and can be made only when a hybrid financial instrument is initially recognized or when certain events occur that constitute a remeasurement (i.e., new basis) event for a previously recognized hybrid financial instrument. See Question 8 in the Appendix for examples of remeasurement events. An entity must document its election to measure a hybrid financial instrument at fair value, either concurrently or via a preexisting policy for automatic election. Once the fair value election has been made, that hybrid financial instrument may not be designated as a hedging instrument pursuant to Statement 133.

[1] FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.
[2] FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*.

Interests in Securitized Financial Assets

Statement 155 also eliminates the temporary exemption for interests in securitized financial assets provided by Statement 133 Implementation Issue D1.[3] (Note this is a prospective elimination; the guidance in Implementation Issue D1 remains effective for instruments recognized prior to the effective date of Statement 155.) As a result, a holder of an interest in securitized financial assets must determine if its interest is a freestanding derivative or a hybrid financial instrument that may be subject to the bifurcation requirements of Statement 133.[4] Because securitization provides an infinite number of ways to redistribute to investors the cash flows of the underlying assets, the potential exists for many securitization interests to be hybrid financial instruments.

When is an interest in securitized financial assets a hybrid? It's a complicated analysis, beyond the scope of this *Heads Up*. According to Statement 155, the contractual terms of an interest, such as its payoff structure and payment priority, should provide sufficient information to determine whether an embedded derivative exists in the interest. See Question 4 in the Appendix for more information. When determining if an interest in securitized financial assets is a hybrid financial instrument, it is important to note that Statement 155 does not consider a concentration of credit risk in the form of subordination of one interest in securitized assets to another to be an embedded derivative.

Example

A securitization vehicle owns a portfolio of below-investment-grade, fixed-rate bonds. The vehicle issues two fixed-rate classes of interests: a senior class (with an investment-grade rating) and a subordinate class. The cash flows from the bonds are passed through to the interest holders. Credit losses on the bonds in the portfolio are first allocated to the subordinate class. Neither the investors in the senior class nor the investors in the subordinate class would need to consider the subordination of credit risk to be an embedded derivative.

Had Statement 155 concluded that redistributed credit risk constituted an embedded derivative, the vast majority of securitizations would have been affected.

Editor's Note: Statement 133 contains a practicability exception, which states that if an entity is unable to reliably identify and measure an embedded derivative that must be bifurcated, then the entire contract must be measured at fair value with changes in fair value recognized in earnings. While the Exposure Draft had proposed eliminating the practicability exception, the final statement reversed course. Although the exception has been used rarely in the past, respondents noted that it may be used more frequently in the future due to the complexity of instruments that will no longer receive the temporary exemption provided by Implementation Issue D1.

Amendments to Interest-Only and Principal-Only Strip Exemption From Statement 133

Statement 155 tightens up the language regarding interest-only (IO) and principal-only (PO) strips that are excluded from the requirements of Statement 133. Which IO and PO strips are still exempt? See Question 12 in the Appendix.

Statement 140 Amendments

Under the existing guidance in Statement 140, a qualifying special-purpose entity (QSPE) is prohibited from holding a derivative financial instrument that pertains to a beneficial interest that is itself a derivative financial instrument, or which includes an embedded derivative. That prohibition was necessary to prevent an entity from circumventing the requirements of Statement 133 by transferring a derivative into a QSPE and taking back an interest in securitized financial assets that embodies the risks of the derivative without accounting for the interest as a derivative (due to the temporary exemption provided by Implementation Issue D1). Statement 155 eliminated this prohibition because the elimination of the temporary exemption provided by Implementation Issue D1 will force each holder of an interest recognized after the effective date of the Statement to assess whether its interest contains an embedded derivative that requires bifurcation under Statement 133.

[3] Statement 133 Implementation Issue No. D1, "Application of Statement 133 to Beneficial Interests in Securitized Financial Assets."
[4] See paragraphs 12 and 13 of Statement 133.

Disclosures

The final Statement includes disclosure requirements (not included in the Exposure Draft) that are intended to highlight an entity's use of the fair value measurement election and the practicability exception. The disclosure requirements were added to address concerns regarding comparability and consistency as a result of the elective fair value measurement methodology. See Question 13 in the Appendix for the specific disclosure requirements.

Effective Date and Transition

Statement 155 is effective for all financial instruments acquired, issued, or subject to a remeasurement (new basis) event occurring after the beginning of an entity's first fiscal year that begins after September 15, 2006. Upon adoption, an entity may elect fair value measurement for existing financial instruments with embedded derivatives that had previously been bifurcated pursuant to Statement 133. Early adoption is permitted as of the beginning of an entity's fiscal year provided that no financial statements have been issued for any interim period of that fiscal year. Prior periods cannot be restated. See Questions 15 and 16 in the Appendix for additional effective date and transition guidance.

Editor's Note: The Exposure Draft had prohibited application of Statement 155 to instruments held by an entity at the effective date. In redeliberations, the FASB decided to allow the fair value election for existing financial instruments that had previously been bifurcated, as long as the bifurcated embedded derivative is not being used in a qualifying Statement 133 hedging relationship.

On the Horizon

Statement 155 includes only minor amendments to Statement 140; however, the FASB is currently putting the finishing touches on another project that will significantly change the accounting for the rights to service financial assets. That project is expected to be finalized in early March — look for a *Heads Up* shortly after the release of the final Statement. The FASB also is redeliberating another project that will significantly change the accounting for transfers of financial assets. According to the FASB's technical plan, that project is expected to be finalized some time in the second quarter of 2006.

The Board also recently issued an Exposure Draft for a proposed statement, *The Fair Value Option for Financial Assets and Financial Liabilities*, which would create a fair value option under which an entity may irrevocably elect fair value as the initial and subsequent measurement attribute for certain financial assets and financial liabilities on a contract-by-contract basis, with changes in fair value recognized in earnings as those changes occur.

As the issuance dates for these projects draw near, look to our publications for more information.

Appendix: Questions and Answers Related to Statement 155

Scope

1. What is a hybrid financial instrument? How are hybrid financial instruments currently accounted for under Statement 133?

In a nutshell, hybrid financial instruments result from embedding certain derivatives into financial instruments, usually debt or equity "hosts."

Under Statement 133, if certain conditions specified in paragraphs 12 and 13 of that Statement exist, an entity is required to account for its hybrid financial instrument by splitting out the embedded derivative from its host contract and separately accounting for the host and derivative components of the contract. This is known as *bifurcating* the derivative from its host contract. The bifurcated embedded derivative is required to be marked to market each accounting period and accounted for as a derivative in accordance with Statement 133. The host contract, exclusive of the embedded derivative, must be accounted for pursuant to the accounting principles generally accepted for that type of contract.

Example

A bank issues a five-year certificate of deposit. At maturity, the investor is entitled to receive par plus the positive return, if any, of the Standard & Poor's 500 index. This is considered a hybrid financial instrument because the host contract (i.e., the certificate of deposit) contains an embedded derivative (the written equity index option). Because the return on an equity index is not clearly and closely related to the economic characteristics of the host debt instrument, Statement 133 requires the bank to separate (bifurcate) the written equity index option from the certificate of deposit. As a result of this bifurcation, the bank must account for the certificate of deposit separately from the written equity index option.

2. What types of hybrid instruments are not eligible for the fair value option provided by Statement 155?

Hybrid instruments described in paragraph 8 of Statement 107[5] are not within the scope of Statement 155. Therefore, derivatives embedded in the following types of hosts would not be eligible for the fair value measurement election:

- Pension and other postretirement plans, employee stock option and stock purchase plans, and other forms of deferred compensation;
- Insurance contracts, other than financial guarantees and investment contracts;
- Lease contracts;
- Warranty obligations and rights;
- Unconditional purchase obligations;
- Minority interests in consolidated subsidiaries;
- Equity investments in consolidated subsidiaries; and
- Equity instruments issued by an entity and classified in stockholders' equity.

In addition, nonfinancial host contracts are not included in the scope of Statement 155.

3. Are unrecognized financial instruments within the scope of Statement 155?

No. Statement 155 is applicable only for recognized hybrid financial instruments. Unrecognized financial instruments (for example, firm commitments and minimum lease payments under an operating lease) will be considered in the FASB's broader Fair Value Option project, currently under deliberation.

[5] FASB Statement No. 107, *Disclosures About Fair Value of Financial Instruments*.

Identifying Embedded Derivatives

4. How should an entity evaluate an interest in securitized financial assets to determine whether it contains an embedded derivative?

The evaluation of interests for embedded derivatives will vary in complexity depending on the nature of the interest. A holder should obtain an understanding of the nature and amount of assets, liabilities, and other financial instruments that compose the securitization transaction. In some circumstances, sufficient evidence can be obtained from summarized information related to the contractual arrangements that govern the payoff structure and the payment priority of the financial instrument. If the summarized information does not provide sufficient evidence, the holder is obligated to obtain more detailed information.

Examples

Foreign Currency Assets in a Securitization — A company transfers yen-denominated floating-rate bonds to a special-purpose entity (SPE) that issues dollar-denominated floating-rate interests. The SPE holds a cross-currency swap to pay yen and receive dollars. The floating rate reflects a current market rate, and the notional amounts of the bonds and the swap correspond to the notional amounts of the interests issued. In this example, the contractual terms of the interests are consistent with the economic risks of the interests; in other words, the terms of the interests do not indicate an embedded derivative exists. Furthermore, the financial instruments held by the SPE produce the cash flows necessary to pay the interests. The dollar-denominated floating-rate interests issued by the SPE do not contain an embedded derivative.

Subordination in a Securitization — A company transfers fixed-rate bonds to an SPE that issues (1) a senior floating-rate interest, (2) a subordinated interest that is entitled to 90 percent of the difference between the fixed rate received and the floating rate paid to the senior interest, and (3) a residual interest that is entitled to the remaining fixed-rate payment from the bonds, less any credit losses. The subordinated interest may be a hybrid financial instrument with an embedded derivative due to the concentration of interest rate risk (the terms of the interest are floating rate, but the SPE holds fixed rate assets). Since an investor in the subordinated interest may not recover substantially all of its recorded investment if there is an adverse change in interest rates, the embedded derivative may need to be bifurcated under Statement 133. The residual interest would not contain an embedded derivative due to concentration of credit risk because concentration of credit risk is not considered to be an embedded derivative under Statement 155. However, the residual interest may contain an embedded interest-rate derivative.

5. Is the prepayment option in the underlying mortgage loans of a mortgage-backed security considered an embedded derivative?

If the cash flows associated with the prepayment option are passed through proportionately to the investors without modification, the prepayment option would continue to be considered clearly and closely related. Therefore, an embedded derivative would not be separately recognized by the interest holder. However, if the cash flows associated with the prepayment option are disproportionately allocated to different classes of interest holders, then all interests would be subject to the conditions in paragraph 13(b) of Statement 133. Statement 133 Implementation Issue B39[6] was amended to clarify this issue.

Fair Value Measurement Election

6. Can the fair value election provided by Statement 155 be applied to all derivatives embedded in other financial instruments?

No. The fair value election can be applied only to financial instruments with embedded derivatives that would be required to be bifurcated from the host contract and accounted for separately under paragraphs 12 and 13 of Statement 133.

Example

An entity holds an interest in securitized financial assets that it has classified as a trading security in accordance with Statement 115;[7] therefore, the interest is measured at fair value with changes in fair value recognized in earnings. Paragraph 12(b) of Statement 133 excludes such an instrument from the bifurcation requirements of Statement 133; therefore, it also would not be eligible for the fair value election.

[6] Statement 133 Implementation Issue No. B39, "Application of Paragraph 13(b) to Call Options That Are Exercisable Only by the Debtor."
[7] FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*.

7. Can an entity make the fair value measurement election on an instrument-by-instrument basis?

Yes. The fair value measurement election may be made on an instrument-by-instrument basis. The FASB considered alternative approaches, such as requiring an entity-wide election or a type-of-instrument election. However, those approaches would have created additional complexity and limited the number of entities that elect fair value measurement. In addition, allowing an instrument-by-instrument approach is more consistent with other aspects of Statement 133, such as hedge accounting elections.

8. Is the recognition of an other-than-temporary impairment considered a remeasurement (new basis) event under Statement 155?

No. A remeasurement (new basis) event is one that is specifically described in authoritative accounting literature that requires a financial instrument to be remeasured at fair value at the time of the event, but does not require subsequent reporting at fair value with changes in fair value reported in earnings. Statement 155 states specifically that an other-than-temporary impairment does not constitute a remeasurement (new basis) event for purposes of the fair value election. Examples of remeasurement (new basis) events provided in Statement 155 include a business combination and significant modifications of debt, as defined in Issue 96-19.[8]

9. How does an entity account for the difference, if any, between the transaction price and the estimated fair value at the inception of a hybrid financial instrument that will be measured at fair value under Statement 155?

If the estimated fair value is (a) obtained from a quoted market price in an active market, (b) evidenced by comparison to other observable current market transactions, or (c) based on a valuation technique incorporating observable market data, then the difference may be recognized in earnings. Otherwise, the difference should be deferred until the criteria listed above have been met or the instrument matures or is settled. This treatment is consistent with the guidance in footnote 3 of Issue 02-3.[9]

Example

A commercial enterprise invests $25 million in a complex, long-term structured note. The note's payoff is linked to a basket of commodity prices. There are no observable forward prices during the term of the note for any of the commodities in the basket. The company's valuation models indicate the fair value of the note at the date of acquisition is $25.3 million.

If the Company elected the fair value option under Statement 155, it would initially recognize the note at $25.3 million. However, it would defer the $300,000 unrealized gain because Statement 155's criteria for initial gain recognition have not been met.

Editor's Note: The FASB is addressing this issue as it (1) reconsiders the provisions of its June 2004 Exposure Draft, *Fair Value Measurements*, and (2) debates the provisions of FASB Staff Position No. FAS 133-a, "Accounting for Unrealized Gains (Losses) Relating to Derivative Instruments Measured at Fair Value Under Statement 133."

[8] EITF Issue No. 96-19, "Debtor's Accounting for a Modification or Exchange of Debt Instruments."

[9] EITF Issue No. 02-3, "Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities."

10. Does the fair value measurement election also apply to issuers of hybrid financial instruments, or is it limited solely to the holders of such instruments?

The FASB clarified in redeliberations that the fair value measurement election applies to hybrid financial instruments that are purchased as well as those that are issued.

Example

Company C issues debt at par that is puttable if the price of the common stock of Company H (an unrelated third party) changes by 20 percent or more. If the debt is put back to company C, the investor will be repaid based on the value of Company H's common stock. The embedded put option is not clearly and closely related to the debt host because the payoff is indexed to an equity price. Under the existing guidance in Statement 133, Company C would be required to bifurcate the embedded derivative from the host contract and account for it separately as a derivative. Under Statement 155, Company C may irrevocably elect to measure the hybrid financial instrument at fair value in its entirety with changes in fair value recognized in earnings.

11. If an entity holds a potential hybrid financial instrument, must it evaluate whether the instrument is truly a hybrid financial instrument in order to elect the fair value measurement method?

Yes. To qualify for the fair value measurement election under Statement 155, a potential hybrid financial instrument must be fully evaluated to determine whether an embedded derivative that would require bifurcation exists. Refer to Question 4 for guidance in determining whether an embedded derivative exists. Note that the FASB recently issued an Exposure Draft for a proposed Statement, *The Fair Value Option for Financial Assets and Financial Liabilities*, that is much broader in scope than Statement 155. Under the guidance in that Exposure Draft, an entity would be able to elect fair value measurement for most financial instruments, regardless of whether they contain an embedded derivative that would require bifurcation.

IO and PO Strip Exemption

12. Which IO and PO strips still are excluded from the requirements of Statement 133?

Only the simplest IO and PO strips are eligible for the exemption provided in paragraph 14 of Statement 133. Those strips should represent the right to receive only a specified proportion of the contractual cash flows of a specific debt instrument and should not contain any terms that were not present in the original debt instrument. In other words, there can be no modifications to the strips, such as incremental servicing fees, guarantee fees, or any change in the terms.

Example

An IO strip contains a contingent feature that would reallocate a portion of the future principal payments on the original financial instrument to holders of the interest-only strip if interest rates decline by a specified amount (e.g., 100 basis points). As the IO and PO strips both contain contingent features that were not present in the original financial instrument, the provisions of Statement 133 would have to be applied to determine whether (1) the contingent feature meets the definition of a derivative or (2) the IO and PO strips contain an embedded derivative that must be separated from the host and accounted for as a derivative.

Disclosures

13. What disclosures are required by Statement 155?

The table below illustrates the disclosure requirements:

For Each Period in Which the Indicated Statement Is Presented	Required Disclosure
Balance Sheet	The fair values of hybrid financial instruments measured at fair value (either due to the fair value election or use of the practicability exception) should be reported separately from the carrying amounts of items measured using another measurement attribute (e.g., present separate line items on the balance sheet for fair value and other carrying amounts, or present a single line item aggregating all amounts with a parenthetical disclosure of the fair value amounts included in the aggregate amount).
Income Statement	The impact on earnings of changes in the fair value of hybrid financial instruments measured at fair value.

14. Is an entity required to quantify the effect of measuring hybrid financial instruments at fair value compared to what would have been recorded absent the fair value election?

No. An entity is required to disclose only the impact on earnings of changes in the fair value of hybrid financial instruments that are measured at fair value due either to the fair value election or to the use of the practicability exception. The income statement disclosures are not intended to provide a quantification of the effect on earnings of accounting for hybrid financial instruments at fair value compared to accounting for hybrid financial instruments on a bifurcated basis.

Effective Date and Transition

15. Can a calendar-year-end entity adopt Statement 155 in fiscal 2006?

Yes. Statement 155 may be early adopted as of January 1, 2006, for calendar-year-end entities, provided that the entity has not yet issued financial statements for any interim period of 2006. SEC registrants should consider the disclosure requirements of SAB 74[10] for their December 31, 2005, financial statements.

16. If, upon adoption of Statement 155, an entity elects to measure an existing bifurcated hybrid financial instrument at fair value, how does it account for the difference between the carrying amount of the individual components and the fair value of the combined hybrid?

Any difference between the carrying amount of the individual components of an existing bifurcated hybrid financial instrument and the fair value of the combined hybrid financial instrument should be recognized as a cumulative-effect adjustment to beginning retained earnings of the period of adoption. An entity is also required to separately disclose the gross amount of gains and losses making up the cumulative-effect adjustment, calculated on an instrument-by-instrument basis.

[10] SEC Staff Accounting Bulletin Topic 11.M (SAB 74), "Disclosure of the Impact That Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant When Adopted in a Future Period."

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