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Financial Accounting Series

Statement of Financial Accounting Standards No. 155

Accounting for Certain Hybrid Financial Instruments

an amendment of
FASB Statements No. 133 and 140

Financial Accounting Standards Board
of the Financial Accounting Foundation

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Summary

This Statement amends FASB Statements No. 133, *Accounting for Derivative Instruments and Hedging Activities,* and No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.* This Statement resolves issues addressed in Statement 133 Implementation Issue No. D1, "Application of Statement 133 to Beneficial Interests in Securitized Financial Assets."

This Statement:

a. Permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation
b. Clarifies which interest-only strips and principal-only strips are not subject to the requirements of Statement 133
c. Establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation
d. Clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives
e. Amends Statement 140 to eliminate the prohibition on a qualifying special-purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument.

Reasons for Issuing This Statement

In January 2004, the Board added this project to its agenda to address what had been characterized as a temporary exemption from the application of the bifurcation requirements of Statement 133 to beneficial interests in securitized financial assets.

Prior to the effective date of Statement 133, the FASB received inquiries on the application of the exception in paragraph 14 of Statement 133 to beneficial interests in securitized financial assets. In response to the inquiries, Implementation Issue D1 indicated that, pending issuance of further guidance, entities may continue to apply the guidance related to accounting for beneficial interests in paragraphs 14 and 362 of Statement 140. Those paragraphs indicate that any security that can be contractually prepaid or otherwise settled in such a way that the holder of the security would not recover substantially all of its recorded investment should be subsequently measured like investments in debt securities classified as available-for-sale or trading under FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities,* and may not be classified as held-to-maturity. Further, Implementation Issue D1 indicated that holders of beneficial interests in securitized financial assets that are not subject to paragraphs 14 and 362 of Statement 140 are not required to apply Statement 133 to those beneficial interests until further guidance is issued.

How the Changes in This Statement Improve Financial Reporting

This Statement improves financial reporting by eliminating the exemption from applying Statement 133 to interests in securitized financial assets so that similar instruments are accounted for similarly regardless of the form of the instruments. This Statement also improves financial reporting by allowing a preparer to elect fair value measurement at acquisition, at issuance, or when a previously recognized financial instrument is subject to a remeasurement (new basis) event, on an instrument-by-instrument basis, in cases in which a derivative would otherwise have to be bifurcated. Providing a fair value measurement election also results in more financial instruments being measured at what the Board regards as the most relevant attribute for financial instruments, fair value.

Effective Date and Transition

This Statement is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006. The fair value election provided for in paragraph 4(c) of this Statement may also be applied upon adoption of this Statement for hybrid financial instruments that had been bifurcated under paragraph 12 of Statement 133 prior to the adoption of this Statement. Earlier adoption is permitted as of the beginning of an entity's fiscal year, provided the entity has not yet issued financial statements, including financial statements for any interim period for that fiscal year. Provisions of this Statement may be applied to instruments that an entity holds at the date of adoption on an instrument-by-instrument basis.

At adoption, any difference between the total carrying amount of the individual components of the 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. An entity should separately disclose the gross gains and losses that make up the cumulative-effect adjustment, determined on an instrument-by-instrument basis. Prior periods should not be restated.

Statement of Financial Accounting Standards No. 155

Accounting for Certain Hybrid Financial Instruments

an amendment of
FASB Statements No. 133 and 140

February 2006

Financial Accounting Standards Board
of the Financial Accounting Foundation
401 MERRITT 7, PO BOX 5116, NORWALK, CONNECTICUT 06856-5116

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February 2006

OBJECTIVE

1. FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities,* establishes, among other things, the accounting for certain derivatives embedded in other financial instruments. (This combination is referred to as a hybrid financial instrument.)

2. The primary objectives of this Statement with respect to Statement 133 are to:

   a. Simplify accounting for certain hybrid financial instruments by permitting fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation
   b. Eliminate the interim guidance in Statement 133 Implementation Issue No. D1, "Application of Statement 133 to Beneficial Interests in Securitized Financial Assets," which provides that beneficial interests in securitized financial assets are not subject to the provisions of Statement 133.

3. The primary objective of this Statement with respect to FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,* is to eliminate a restriction on the passive derivative instruments that a qualifying special-purpose entity (SPE) may hold.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Amendments to Statement 133

4. Statement 133 is amended as follows: [Added text is <u>underlined</u> and deleted text is ~~struck out~~.]

a. Paragraph 14:

However, interest-only strips and principal-only strips are not subject to the requirements of this Statement provided those strips~~they~~ (a) ~~initially resulted from separating~~represent the right~~s~~ to receive only a specified proportion of the contractual interest cash flows of a specific debt instrument or a specified proportion of the contractual principal cash flows of that debt instrument~~of a financial instrument that, in and of itself, did not contain an embedded derivative that otherwise would have been accounted for separately as a derivative pursuant to the provisions of paragraphs 12 and 13~~ and (b) do not incorporate any terms not present in the original ~~financial~~debt instrument ~~described above~~. An allocation of a portion of the interest or principal cash flows of a specific debt instrument as reasonable compensation for stripping the instrument or to provide adequate compensation to a servicer (as defined in Statement 140) would meet the intended narrow scope of the exception provided in this paragraph. However, an allocation of a portion of the interest or principal cash flows of a specific debt instrument to provide for a guarantee of payments, for servicing in excess of adequate compensation, or for any other purpose would not meet the intended narrow scope of the exception.

b. Paragraphs 14A and 14B are added as follows:

14A. The holder of an interest in securitized financial assets (other than those identified in paragraph 14) shall determine whether the interest is a freestanding derivative or contains an embedded derivative that under paragraphs 12 and 13 would be required to be separated from the host contract and accounted for separately. That determination shall be based on an analysis of the contractual terms of the interest in securitized financial assets, which requires understanding the nature and amount of assets, liabilities, and other financial instruments that compose the entire securitization transaction. A holder of an interest in securitized financial assets should obtain sufficient information about the payoff structure and the payment priority of the interest to determine whether an embedded derivative exists.

14B. Changes in cash flows attributable to changes in the creditworthiness of an interest resulting from securitized financial assets and liabilities (including derivative contracts) that represent the assets or liabilities that are held by the issuing entity shall not be considered an embedded derivative under this Statement. The concentration of credit risk in the form of subordination of one financial instrument to another shall not be considered an embedded derivative under this Statement.

c. Paragraph 16:

In subsequent provisions of this Statement, both (a) a derivative instrument included within the scope of this Statement by paragraphs 6–11 and (b) an embedded derivative instrument that has been separated from a host contract as required by paragraph 12 are collectively referred to as derivative instruments. If an embedded derivative instrument is separated from its host contract, the host contract shall be accounted for based on generally accepted accounting principles applicable to instruments of that type that do not contain embedded derivative instruments. If an entity cannot reliably identify and measure the embedded derivative instrument that paragraph 12 requires be separated from the host contract, the entire contract shall be measured at fair value with gain or loss recognized in earnings, but it may not be designated as a hedging instrument pursuant to this Statement. An entity that initially recognizes a hybrid financial instrument that under paragraph 12 would be required to be separated into a host contract and a derivative instrument may irrevocably elect to initially and subsequently measure that hybrid financial instrument[6bb] in its entirety at fair value (with changes in fair value recognized in earnings). The fair value election shall be supported by concurrent documentation or a preexisting documented policy for automatic election. That recognized hybrid financial instrument could be an asset or a liability and it could be acquired or issued by the entity. That election is also available when a previously recognized financial instrument is subject to a remeasurement (new basis) event[6bbb] and the separate recognition of an embedded derivative. However, that recognized hybrid financial instrument may not be designated as a hedging instrument pursuant to this Statement. This election may be made on an instrument-by-instrument basis.

[6bb]This election shall not be applied to the hybrid instruments described in paragraph 8 of FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*.

[6bbb]For purposes of this Statement, a remeasurement (new basis) event is an event identified in other authoritative accounting literature, other than the recognition of an other-than-temporary impairment, that requires a financial instrument to be remeasured to its fair value at the time of the event but does not require that instrument to be reported at fair value on a continuous basis with the change in fair value recognized in earnings. Examples of remeasurement events are business combinations and significant modifications of debt as defined in EITF Issue No. 96-19, "Debtor's Accounting for a Modification or Exchange of Debt Instruments."

d. Paragraph 16A is added as follows:

Any difference between a transaction price and the estimated fair value at the inception of a hybrid financial instrument for which the fair value election is applied shall not be recognized in earnings unless that estimated fair value is (a) obtained from a quoted market price in an active market, or (b) is evidenced by comparison to other observable current market transactions, or (c) is based on a valuation technique incorporating observable market data.

e. Paragraphs 44A and 44B are added as follows:

44A. In each statement of financial position presented, an entity shall report hybrid financial instruments measured at fair value under the election and under the practicability exception in paragraph 16 of this Statement in a manner that separates those reported fair values from the carrying amounts of assets and liabilities subsequently measured using another measurement attribute on the face of the statement of financial position. To accomplish that separate reporting, an entity may either (a) display separate line items for the fair value and non-fair-value carrying amounts or (b) present the aggregate of those fair value and non-fair-value amounts and parenthetically disclose the amount of fair value included in the aggregate amount.

44B. An entity shall provide information that will allow users to understand the effect of changes in the fair value of hybrid financial instruments measured at fair value under the election and under the practicability exception in paragraph 16 on earnings (or other performance indicators for entities that do not report earnings).

f. Paragraphs 200A–200D and the related heading are added as follows:

Section 2A: Examples Illustrating Application of Paragraphs 14A and 14B Relating to Embedded Derivatives in Securitized Financial Assets

200A. **Example 35: A Dollar-Denominated Floating-Rate Interest Issued by an SPE That Holds Yen-Denominated Floating-Rate Bonds and a Cross-Currency Swap to Pay Yen and Receive Dollars.** If the floating rate reflects a current market rate and the notional amounts of the bonds and the swap correspond to the notional amount of the interests issued, the dollar-denominated floating-rate interest would *not* have an embedded derivative requiring bifurcation because the terms of the beneficial interest do not indicate an embedded derivative and the financial instruments held by the entity provide the necessary cash flows.

200B. **Example 36: A Variable-Rate Interest Issued by an SPE That Holds Fixed-Rate Bonds and a Pay-Fixed, Receive-Variable Interest Rate Swap.** The variable-rate interest would *not* have an embedded derivative requiring bifurcation because the terms of the beneficial interest do not indicate an embedded derivative and the financial instruments held by the entity provide the necessary cash flows. However, if the notional amounts of the fixed-rate bonds and the variable interest rate swap do not match, the variable-rate interest would have to be evaluated for an embedded derivative under paragraph 13 because the financial instruments held by the entity might not provide the necessary cash flows.

200C. **Example 37: A Securitization Involving Subordination.** An SPE that holds fixed-rate bonds issues (a) a senior, floating-rate financial instrument, (b) a subordinated financial instrument that is entitled to 90 percent of the difference between the fixed rate received and the floating rate paid to the senior financial instrument, and (c) a residual financial instrument that is entitled to the remainder of the fixed-rate payment from the bonds after any credit losses. The subordinated financial instrument could be a hybrid financial instrument with an embedded interest rate derivative requiring bifurcation because the terms are floating rate, but the entity does not hold assets that bear a floating rate. This analysis considers the structure as a whole including the related liabilities. Therefore, there could be a shortfall of cash flow after the senior interest holders are paid, due to adverse changes in interest rates, and the investor in the subordinated interest might not recover substantially all of its initial recorded investment in the interest (see paragraph 13(a)). The residual financial instrument would not have an embedded derivative for the concentration of credit risk as discussed in paragraph 14B, because the concentration of credit risk relates to the financial instruments held by the entity, but the residual instrument would have an embedded interest rate derivative.

200D. **Example 38: A Securitization That Introduces New Credit Risk.** An entity holds a credit derivative referenced to Company A and high-quality bonds, but issues beneficial interests explicitly referenced to Company B. The beneficial interests would be a hybrid financial instrument with an embedded derivative because the cash flows relating to changes in the credit risk of Company B are not present in the financial instruments held by the entity.

Amendments to Statement 140

5. Statement 140 is amended as follows:

a. Paragraph 35(c)(2):

Passive **derivative financial instruments** that pertain to beneficial interests ~~(other than another derivative financial instrument)~~ issued or sold to parties other than the transferor, its affiliates, or its agents (paragraphs 39 and 40)

b. Paragraph 40:

A derivative financial instrument pertains to beneficial interests ~~(other than another derivative financial instrument)~~ issued only if it:

a. Is entered into (1) when the beneficial interests are issued by the qualifying SPE to parties other than the transferor, its affiliates, or its agents or sold to such other parties after being issued by the qualifying SPE to the transferor, its affiliates, or its agents or (2) when a passive derivative financial instrument needs to be replaced upon occurrence of an event or circumstance (specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds) outside the control of the transferor, its affiliates, or its agents, for example, when the counterparty to the derivative defaults or is downgraded below a specified threshold
b. Has a notional amount that does not initially exceed the amount of those beneficial interests and is not expected to exceed them subsequently
c. Has characteristics that relate to, and partly or fully but not excessively counteract, some risk associated with those beneficial interests or the related transferred assets.

Effective Date and Transition

6. This Statement shall be 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. The fair value election provided for in paragraph 4(c) of this Statement may also be applied upon adoption of this Statement for hybrid financial instruments that had been bifurcated under paragraph 12 of Statement 133 prior to the adoption of this Statement. Earlier adoption

is permitted as of the beginning of an entity's fiscal year, provided the entity has not yet issued financial statements, including financial statements for any interim period, for that fiscal year.

7. At adoption, any difference between the total carrying amount of the individual components of the existing bifurcated hybrid financial instrument and the fair value of the combined hybrid financial instrument shall be recognized as a cumulative-effect adjustment to beginning retained earnings. An entity shall separately disclose the gross gains and losses that make up the cumulative-effect adjustment, determined on an instrument-by-instrument basis. Prior periods shall not be restated.

The provisions of this Statement need not be applied to immaterial items.

This Statement was adopted by the affirmative votes of six members of the Financial Accounting Standards Board. Ms. Schipper dissented.

Ms. Schipper dissents from the issuance of this Statement because she believes that some of its provisions impair comparability and consistency, two desirable qualitative characteristics of financial information in the Board's conceptual framework, and other provisions increase complexity. She believes that neither the increased complexity nor the impairment of comparability and consistency can be justified by a cost-benefit analysis.

Ms. Schipper disagrees with the Board's decision to permit, on an instrument-by-instrument basis, a fair value election for hybrid financial instruments with embedded derivatives that would otherwise require bifurcation. She agrees with the Board's conclusion, expressed in paragraph A14 (as well as elsewhere in other Statements issued by the Board), that fair value is the most relevant measurement attribute for financial instruments, and she believes that the Board's conclusion, expressed in paragraph A14, would support a requirement that fair value be the initial and subsequent measurement attribute for instruments that are eligible for the treatment alternative provided in this Statement. Ms. Schipper reasons that the requirement in Statement 133 to evaluate certain hybrid financial instruments to determine if they contain an embedded derivative that should be accounted for separately from the host contract is one approach to addressing the use of different measurement attributes for derivatives (fair value) and host contracts (sometimes fair value, and sometimes another attribute). A different approach, which she believes is preferable, is to eliminate the use of different measurement attributes for financial instruments whenever it is practicable to do so. She believes that the hybrid instruments that are subject to the scope of the Statement represent such a case.

Ms. Schipper believes that treatment alternatives, such as the one provided in this Statement, are inherently undesirable because they are inconsistent with comparability, a desirable qualitative characteristic of financial information in the Board's conceptual framework. The Board acknowledges, in paragraph A17 of this Statement, that comparability between entities will be impaired by permitting free choice between two different measurement attributes. In addition, because the treatment alternative is applied instrument-by-instrument within an entity, it will probably result in inconsistency, in that different measurement attributes will be applied to economically similar financial instruments within an entity. Ms. Schipper believes that the separate display on the statement of financial position of instruments measured at fair value versus instruments measured using another measurement attribute does little to rectify this inconsistency and noncomparability.

Ms. Schipper also disagrees with the Board's decision to continue to provide an exemption (albeit a narrowed one) from the provisions of Statement 133 for certain interest-only and principal-only strips. She agrees with the Board's reasoning, as described in paragraph A8, that there is no conceptual basis for this exemption and that it impairs comparability because it allows economically similar instruments to be accounted for differently. In addition, the exemption increases complexity because it requires preparers to analyze interest-only and principal-only strips to determine if they qualify for the exemption. The extent of that complexity is illustrated by the fact that the Board found it necessary to include guidance, in paragraph 4(a), with respect to certain instruments that would, and would not, qualify for the exemption.

Members of the Financial Accounting Standards Board:

Robert H. Herz, *Chairman*
George J. Batavick
G. Michael Crooch
Katherine Schipper
Leslie F. Seidman
Edward W. Trott
Donald M. Young

Appendix A

BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

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Appendix A

BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

Introduction

A1. This appendix summarizes considerations that Board members deemed significant in reaching the conclusions in this Statement. It includes reasons for accepting certain views and rejecting others. Individual Board members gave greater weight to some factors than to others.

Background Information

A2. Prior to the implementation of Statement 133, constituents questioned the application of that Statement's definition of a derivative and bifurcation requirements to interests in securitized financial assets. In response to those questions, the Board issued Implementation Issue D1 in June 2000. That Issue provides that entities need not evaluate interests in securitized financial assets for embedded derivatives. Rather, entities may continue to apply the measurement guidance related to accounting for financial instruments in paragraphs 14 and 362 of Statement 140, until further guidance is issued. The scope of Implementation Issue D1 covers transactions involving both qualifying and nonqualifying SPEs.

A3. The Board reconsidered issues relating to Implementation Issue D1 as part of the Exposure Drafts that led to the issuance of Statement 140 and FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*. In both instances, the Board was unable to reach a decision that would have resolved the issues.

A4. In January 2004, the Board decided to add a project to its agenda to reconsider the accounting for interests in securitized financial assets with the objective of replacing the interim guidance in Implementation Issue D1.

A5. The scope of the project was expanded to encompass all hybrid financial instruments (including interests in securitized financial assets) in October 2004.

A6. In August 2005, the Board issued an Exposure Draft, *Accounting for Certain Hybrid Financial Instruments,* for a 60-day comment period. The Board received 24 comment letters on the Exposure Draft. In late 2005, the Board redeliberated the issues identified in the Exposure Draft.

Amendments to Statement 133

Amendments Related to Interest-Only Strips and Principal-Only Strips

A7. This Statement clarifies the scope exception for interest-only strips and principal-only strips provided in paragraph 14 of Statement 133.

A8. The Board considered deleting paragraph 14 of Statement 133 in its entirety, which would have resulted in all interest-only strips and principal-only strips being subject to the requirements of Statement 133, including the embedded derivative provisions. The Board acknowledges that there is no conceptual basis for the exemption provided for interest-only strips and principal-only strips. Some Board members supported deleting paragraph 14 because certain financial instruments whose economic characteristics are similar to those that qualify for the paragraph 14 exemption are ineligible for the exemption because of the form of those financial instruments. Thus, paragraph 14 results in economically similar instruments being accounted for differently.

A9. Rather than deleting paragraph 14 of Statement 133, the Board decided to amend that paragraph to limit its application. The Board acknowledged that paragraph 14 was intended to simplify the application of Statement 133 by exempting from the provisions of that Statement financial instruments that represent the right to receive only a specified proportion of the contractual interest cash flows of a specific debt instrument or a specified proportion of the contractual principal repayment cash flows of that debt instrument. The Board concluded that amending paragraph 14 to apply to a narrow set of financial instruments would retain this simplification.

A10. In deciding to limit the application of the exemption provided in paragraph 14 of Statement 133, the Board also observed that, generally, interest-only strips and principal-only strips in securitized financial assets should not qualify for the exemption from the bifurcation requirements of Statement 133.

A11. During redeliberations, the Board affirmed that it intends the interest-only strip and principal-only strip exemption to apply to only the simplest separations of interest payments from principal payments. The process of separating a debt instrument into its principal and interest components is referred to as stripping an instrument.

A12. The Board acknowledged during its redeliberations that the amendments to paragraph 14 of Statement 133 will result in fewer financial instruments being subject to the scope of FASB Statement No. 134, *Accounting for Mortgage-Backed Securities Retained after the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise.*

Amendments Related to Interests in Securitized Financial Assets

A13. In reconsidering the accounting for interests in securitized financial assets and the application of Statement 133 to those interests, the Board considered several alternatives. The Board considered and rejected making the temporary exemption provided by Implementation Issue D1 permanent, because doing so would have resulted in permanent differences in the accounting for a wide range of similar financial instruments merely based on the form of the financial instrument.

A14. The Board considered requiring that all interests in securitized financial assets be accounted for at fair value with changes in fair value recognized in earnings. This alternative would have reduced complexity and would have resulted in more financial instruments being reported at fair value, which the Board considers to be the most relevant measurement attribute for financial instruments. However, this alternative also would have perpetuated dissimilar accounting for similar financial instruments merely based on the form of the financial instrument.

A15. The Board also considered requiring that all interests in securitized financial assets be accounted for at fair value with changes in fair value recognized in other comprehensive income until realized. Board members acknowledged that this alternative would have also perpetuated dissimilar accounting for similar financial instruments based on the form of the financial instrument. In addition, some Board members believe that allowing the changes in fair value of embedded derivatives to be recognized in other comprehensive income rather than in earnings does not improve financial reporting.

A16. The Board decided to eliminate the exemption from Statement 133 for interests in securitized financial assets provided temporarily by Implementation Issue D1 and to require that those interests be evaluated to determine whether they are freestanding derivatives or whether they contain embedded derivatives. Eliminating this exemption addressed the Board's concern that is expressed in paragraph A13. The Board also decided to permit interests in securitized financial assets that contain embedded derivatives that Statement 133 would otherwise require to be accounted for as a derivative separately from the host contract to be accounted for as a single financial instrument measured at fair value with changes in fair value recognized in earnings. The Board reasoned that this approach results in certain financial instruments being subject to the requirements of Statement 133, regardless of the form of the transaction.

This approach also simplifies the accounting for financial instruments for which fair value measurement is elected. Of the alternatives considered by the Board, this approach results in the greatest degree of convergence with International Accounting Standards.

A17. The Board acknowledged that comparability among entities and consistency within an entity will be impaired as a result of permitting free choice, on an instrument-by-instrument basis, between two different accounting treatments for similar or identical financial instruments. The Board also noted that financial instruments for which fair value measurement is elected would not be eligible to be used as hedging instruments that receive special hedge accounting. However an entity may still elect to separately account for an embedded derivative so that it is eligible as a hedging instrument under Statement 133.

A18. The Board considered whether the accounting for interests in securitized financial assets should distinguish between financial instruments acquired and financial instruments retained by the transferor in a securitization transaction. The Board decided that there should be no distinction in the application of the requirements of Statement 133 based on how the holder acquired the interest, that is, whether the holder of an interest in a securitized financial asset is a purchaser of that interest or whether the holder is a transferor that retains the interest in transferred assets in the securitization transaction.

A19. The Board considered how an interest in securitized financial assets should be evaluated for embedded derivatives. The Board decided to require that an evaluation of the terms of the financial instrument be performed and that sufficient evidence be obtained to determine whether the instrument contains an embedded derivative that requires bifurcation. The Board believes sufficient evidence can generally be obtained by analyzing the contractual arrangements that govern the payoff structure and the payment priority of the financial instrument. The Board believes that analysis will require an understanding of the nature and amount of assets and the nature and amount of liabilities and other financial instruments making up a securitization transaction. In securitizations involving the resecuritization of tranches from previous transactions, the analysis might require an understanding of each securitization making up the resecuritization transaction. The Board further believes that in many cases information available to purchasers of financial instruments will be sufficient to perform the analyses required by paragraphs 12 and 13 of Statement 133 to determine whether financial instruments contain embedded derivatives that would require bifurcation. Summarized information may be sufficient in some cases for that determination. However, if summarized information is insufficient for that determination, a purchaser of a financial instrument would be obligated to obtain sufficient detailed information to determine the existence of derivatives or embedded derivatives.

A20. The evaluation of financial instruments for embedded derivatives will vary in complexity depending on the nature of the financial instrument. For example, a senior financial instrument with a market interest rate may require little investigation, whereas a residual financial instrument that absorbs risk disproportionate to other financial instruments will require additional investigation.

A21. The Board also considered whether concentrations of credit risk in subordinated interests in securitized financial assets should be considered embedded derivatives. Some Board members believe that concentrations of credit risk that are created by subordinating one financial instrument to another financial instrument represent, in effect, credit default swaps embedded in the subordinated financial instrument and that such credit default swaps should be identified as embedded derivatives requiring bifurcation. However, the Board decided not to define concentrations of credit risk as embedded derivatives, regardless of how they arise.

A22. The Board decided not to extend the requirements of paragraph 13(b) of Statement 133 for interest rate leverage factors to credit concentrations. Some Board members reasoned that credit concentrations in subordinated interests should not be recognized as embedded derivatives because there is no obligation on the part of the subordinated financial instrument holder to transfer cash or assets. That is, the subordination functions through a cash allocation mechanism in which cash flows that otherwise would have been allocated to the subordinated financial instrument holder instead are allocated to the senior financial instrument holder, to effectively allocate credit losses from the senior financial instrument holder to the subordinated financial instrument holder.

A23. Other Board members reasoned that the purchase price of a subordinated financial instrument reflects the investor's assessment of the cash flows it expects to receive, including the likelihood of default and, therefore, concentrations of credit risk are reflected in the fair value of the subordinated financial instrument. As the credit risk of the subordinated financial instrument is reflected in its fair value, there is no need for separate recognition of credit concentrations.

A24. The Board noted, however, that other aspects of Statement 133 regarding credit risk and the identification of credit risk as an embedded derivative are not affected by the Board's decision on concentrations of credit risk. For instance, the examples in Statement 133 Implementation Issue No. B36, "Modified Coinsurance Arrangements and Debt Instruments That Incorporate Credit Risk Exposures That Are Unrelated or Only Partially Related to the Creditworthiness of the Obligor under Those Instruments," would continue to represent credit risk that is not clearly and closely related to the host contract.

Amendments Related to the Fair Value Election

A25. Having decided to permit fair value measurement for interests in securitized financial assets that contain embedded derivatives that otherwise would be required to be bifurcated, the Board considered how to establish the scope of financial instruments eligible for this election. Financial instruments acquired by a transferor in a securitization transaction would be readily identifiable as interests in securitized financial assets. However, the Board concluded that the fair value election should not be limited to financial instruments created in a transaction accounted for by the transferor as a sale in accordance with Statement 140. The Board considered and rejected definitions that might have specified what financial instruments would be considered interests in securitized financial assets. Likewise, the Board considered and rejected an approach that would have defined interests in securitized financial assets based on the presence of a defined securitization vehicle.

A26. Although the scope of Implementation Issue D1, and the original scope of instruments that would be eligible for the fair value measurement election, is limited to interests in securitized financial assets, the Board decided to extend that election to any recognized hybrid financial instrument that contains an embedded derivative that Statement 133 otherwise would require to be accounted for as a derivative separately from the host contract. The Board believes that this decision eliminates the need to distinguish between interests in securitized financial assets and other hybrid financial instruments and permits many financial instruments other than interests in securitized financial assets to be measured in their entirety at fair value.

A27. The Exposure Draft proposed elimination of the practicability exception in paragraph 16 of Statement 133 because the Board believed that the option to measure hybrid financial instruments at fair value made that exception unnecessary. Many respondents to the Exposure Draft noted that the practicability exception still would be needed in some circumstances because the financial instruments to which the embedded bifurcation analysis would be newly applied as a result of the elimination of Implementation Issue D1 are particularly complex. Those respondents noted that although the practicability exception had rarely been applied in the past, it may be applied more frequently with the elimination of Implementation Issue D1. The Board decided not to eliminate the practicability exception because one objective of the project was to simplify the application of Statement 133 and eliminating the practicability exception would make application more difficult. The Board noted that a financial instrument must be evaluated to determine that it has an embedded derivative requiring bifurcation before the instrument can become a candidate for the fair value election.

A28. The Board decided to limit the election to measure at fair value to hybrid **financial** instruments because it has not yet identified the most relevant measurement attribute for nonfinancial host contracts. The Board also decided to exclude the types of hosts described in paragraph 8 of FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments,* even though some of the hosts described in that paragraph might represent financial instruments. Additionally, the Board decided during its redeliberations to limit the election to measure at fair value to recognized financial instruments. The Board noted that consideration of expanding a fair value option to include nonfinancial items and unrecognized financial instruments will be considered as part of the Board's broader fair value option project.

A29. The Board considered requiring that the election to adopt fair value as the measurement attribute for certain hybrid financial instruments be made as an entity-wide policy decision. The Board noted that that requirement would increase comparability for instruments held by a given entity. However, the Board rejected this approach because it seemed likely to limit the number of entities that would elect fair value measurement. The Board also considered requiring that the election be applied on a type-of-instrument basis. The Board rejected that approach because it would require definitions of types of instruments, thereby introducing additional complexity, and because it would limit the use of fair value. The Board decided to permit application of the fair value election on an instrument-by-instrument basis. The Board reasoned that the hedge accounting elections of Statement 133 are applied on an item-by-item basis and that an instrument-by-instrument application of the fair value election is most consistent with other requirements of Statement 133. In addition, the Board reasoned that an instrument-by-instrument election is the best way to encourage fair value measurement. The Board was also willing to accept a reduction in comparability to achieve increased relevance through expanded use of fair value measurement.

A30. The Board decided that the fair value election should be applied irrevocably at initial recognition to impose discipline on an elective accounting method. Otherwise preparers would be able to elect fair value measurement to obtain desired reporting results with the benefit of hindsight.

Amendments Related to Disclosure

A31. During the deliberations that led to the Exposure Draft, the Board decided not to require any additional disclosures for entities electing to measure hybrid financial instruments at fair value pursuant to this Statement. While the Board reasoned that additional disclosures might reduce the effects of noncomparability resulting from the election to measure hybrid financial instruments at fair value, it was sympathetic to constituents' concerns that financial instrument disclosures be developed in a comprehensive rather than a piecemeal manner. Thus, the Exposure Draft did not propose any new disclosures. The Board noted that quantitative and qualitative disclosures about the amounts and methods used to measure financial instruments at fair value under this Statement will be required by the Board's project on fair value measurements. The Board also noted that other applicable disclosure requirements (such as those in FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities,* and Statement 140, among others) continue to apply to hybrid financial instruments under this Statement.

A32. During its redeliberations, the Board decided to require separate display, either parenthetically or as a separate line on the face of the statement of financial position, of amounts measured at fair value as a result of electing fair value measurement under this Statement. The Board reasoned that separating items electively measured at fair value from similar items measured in other ways mitigates the effects of using multiple measurement attributes and that the benefits of that information avoid the drawbacks of promulgating piecemeal disclosures. The Board also decided to require information about the effect on earnings of measuring hybrid financial instruments at fair value. The Board noted that the earnings disclosure is not intended to require quantifying the effect on earnings of accounting for a hybrid financial instrument at fair value instead of accounting for a hybrid financial instrument on a bifurcated basis. That is, the Board does not intend that entities would calculate the difference between accounting for the hybrid financial instrument on a bifurcated basis and accounting for the hybrid financial instrument in its entirety at fair value. The Board decided to require earnings-related disclosures in the form of a general principle and not to prescribe specific disclosures.

Amendments to Statement 140

A33. The Board considered the effect on the requirements for qualifying SPEs of eliminating the Implementation Issue D1 exemption from the bifurcation requirements of Statement 133 and requiring the evaluation of beneficial interests in securitized financial assets to obtain sufficient evidence to determine whether an embedded derivative exists. The Board decided to eliminate the prohibition on a qualifying SPE from holding a derivative financial instrument that pertains to a beneficial interest **other than another derivative financial instrument.** That prohibition was included in Statement 140 to preclude a qualifying SPE from holding a derivative that, because of the Implementation Issue D1 exemption, might not be accounted for as a derivative by the qualifying SPE's beneficial interest holders. Because this Statement eliminates the Implementation Issue D1 exemption, the prohibition is no longer necessary.

A34. Some respondents to the Exposure Draft asked whether bifurcation that would be required in the separate financial statements of a qualifying SPE (if any were issued) would cause the SPE not to qualify under paragraph 35(c) of Statement 140. That is, those respondents questioned whether the requirement to bifurcate a hybrid financial instrument that might not have been bifurcated previously because of Implementation Issue D1 would influence the qualified status of the SPE as a result of this Statement's superseding Implementation Issue D1. The Board amended paragraph 35(c) to clarify that bifurcation of issued interests under the provisions of this Statement would not disqualify an otherwise qualifying SPE, regardless of whether those interests are retained by the transferor or held by third parties.

Effective Date and Transition

A35. During the deliberations that led to the Exposure Draft, the Board decided that the effective date for the amendments to Statement 133 should be consistent with the amendments to Statement 140 on the accounting for servicing rights and the requirements of a qualifying SPE. The Board noted that many financial institutions requested the election to subsequently measure hybrid financial instruments and servicing rights at fair value and that the application of the election would not be burdensome. Based on these two factors, the Board believed that the measurement provisions in the three related projects that amend Statement 140 should be effective close to the expected issuance dates of the final Statements. The Board initially decided that the application of the measurement guidance in all three projects would be effective at the earlier of fiscal years beginning after December 15, 2005, or fiscal years that begin during the fiscal quarter in which the final Statement is issued, if applicable. The Exposure Draft provided that if the final Statement is issued between December 1, 2005, and February 28, 2006, calendar-year reporting entities would apply the Statement as of January 1, 2006, and entities with fiscal years ending on November 30, 2005, would apply the Statement as of December 1, 2005. If a reporting entity's fiscal year ends on June 30, the final Statement would have been effective for fiscal years beginning July 1, 2006.

A36. Some respondents to the Exposure Draft expressed concern that the proposed effective date would not have provided a sufficient period for implementation especially with respect to the elimination of Implementation Issue D1. The Board decided that the effective date should be changed to fiscal years beginning after September 15, 2006, with early adoption permitted as of the beginning of an entity's fiscal year, provided the entity has not yet issued financial statements, including financial statements for any interim period, for that fiscal year. Additionally, the Board decided that the issuance of this Statement and the final servicing rights Statement could precede the issuance of the final Statement that will amend Statement 140 with regard to the requirements of a qualifying SPE.

A37. During the deliberations that led to the Exposure Draft, the Board considered whether the election to measure hybrid financial instruments that otherwise would require separation into a host contract and a derivative instrument measured at fair value should be applied on a prospective basis for new instruments or on a prospective basis for new instruments *and* for existing instruments with a cumulative-effect adjustment recorded to reflect the measurement of existing hybrid financial instruments at fair value. Some Board members suggested that an entity be allowed to apply the fair value election to existing hybrid financial instruments that are currently being separated into a derivative and a host contract to ease application of Statement 133. During the deliberations that led to the Exposure Draft, the Board believed that if the fair value election were made applicable to existing hybrid financial instruments, the fair value election should be applied to *all* hybrid financial instruments, rather than to only certain bifurcated hybrid financial instruments selected by the reporting entity. However, the Board concluded that application on an all-or-none basis would not be practical because some derivatives from bifurcated hybrid financial instruments could be hedging instruments under Statement 133, and combining the derivative with the host into a hybrid financial instrument measured at fair value would eliminate the opportunity to use the embedded derivative as a hedging instrument. The Board also rejected that alternative because of complexities associated with recognition of gains or losses on host contracts. The Board also considered requiring application of the requirements of this Statement to all existing instruments. The Board rejected that alternative because it would require preparers to perform a bifurcation evaluation on interests that previously had not been subject to Statement 133 because of the Implementation Issue D1 exemption. Instead, the Board initially decided that the election should be applied on a prospective basis for new instruments and that existing instruments would not be eligible for this election.

A38. Many respondents to the Exposure Draft suggested that the scope of the fair value election be expanded to include all hybrid financial instruments that were previously separated into a derivative and a host contract at initial application. Those respondents noted that financial reporting and operational benefits would be realized from having consistent accounting for similar financial instruments. The Board agreed with these respondents and decided to allow an instrument-by-instrument election for existing bifurcated hybrid financial instruments in which the bifurcated embedded derivative is not being used in a qualifying Statement 133 hedging relationship. The Board further noted similar transition provisions being promulgated as part of the servicing rights and the life settlements projects that also provide a fair value election for existing assets.

A39. Having decided to expand the transition provisions to include existing bifurcated hybrid financial instruments, the Board considered how any difference between the carrying amount of the separate components of the bifurcated hybrid financial instrument and the fair value of the combined hybrid financial instrument should be recognized. The Board considered delaying the effective date of this Statement to coincide with the adoption of the Board's final Statement on fair value measurements and the related FASB Staff Position (FSP) FAS 133-a, "Accounting for Unrealized Gains (Losses) Relating to Derivative Instruments Measured at Fair Value under Statement 133." The Board decided against requiring early adoption of the fair value measurements Statement and the related FSP as part of this Statement. The Board decided that at transition any difference between the carrying amount of the bifurcated hybrid and the fair value of the combined hybrid should be recognized as an adjustment to beginning retained earnings.

A40. For hybrids entered into subsequent to adoption of this Statement for which the fair value measurement attribute is elected, the Board believes that guidance currently exists in 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," that could be utilized in the interim and that a delay in the effective date of this Statement would reduce the benefits to be derived from the simplification offered by this Statement. The Board acknowledges that utilizing Issue 02-3 in this manner effectively expands the scope of footnote 3 in the consensus to include embedded derivatives in hybrid financial instruments electing the fair value measurement attribute. The Board does not intend that the guidance in footnote 3 of Issue 02-3 be applied to transfers accounted for as sales under the provisions of Statement 140. That is, the Board does not intend that the gain on sale resulting from a securitization transaction be deferred as a result of the existence of an embedded derivative in a retained interest that might not meet the observability criteria of Issue 02-3.

Benefits and Costs

A41. The mission of the FASB is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including preparers, auditors, and users of financial information. In fulfilling that mission, the Board endeavors to determine that a proposed standard will fill a significant need and that the costs imposed to meet that standard, as compared with other alternatives, are justified in relation to the overall benefits of the resulting information. Although the costs to implement a new standard may not be borne evenly, investors and creditors—both present and potential—and other users of financial information benefit from improvements in financial reporting, thereby facilitating the functioning of markets for capital and credit and the efficient allocation of resources in the economy.

A42. The Board's assessment of the benefits and costs of amending Statements 133 and 140 with respect to the accounting for hybrid financial instruments was based on input received from preparers and users of financial statements.

A43. The Board concluded that a fair value measurement election should be provided for certain hybrid financial instruments that otherwise would require bifurcation. The Board reasoned that providing this election would decrease the burden associated with applying Statement 133 to hybrid financial instruments. The Board concluded that the expected benefits of both improved financial reporting resulting from consistent application of Statement 133 to different financial instruments with similar economic characteristics and simplification in financial reporting achieved through permitting fair value measurement for certain hybrid instruments would outweigh the decreased comparability in financial statements and the costs associated with implementing this Statement. Although fair value measurement is elective under this Statement, the Board concluded that providing a fair value election will expand the use of fair value for financial instruments and that such an expansion is consistent with the Board's belief that fair value is the most relevant measurement attribute for financial instruments.

A44. The Board concluded that eliminating the Implementation Issue D1 exemption would improve financial reporting by requiring all financial instruments, including those in the form of interests in securitized financial assets, to be subject to the Statement 133 bifurcation requirements. As a result of eliminating the Implementation Issue D1 exemption, the Board was able to simplify the qualifying SPE criteria by deleting the parenthetical phrase *other than another derivative financial instrument* in paragraphs 35(c) and 40 of Statement 140. Removing this restriction on qualifying SPEs and eliminating the Implementation Issue D1 exemption will result in increased consistency in the application of the bifurcation requirements of Statement 133 and will result in either the identification of more derivatives in interests in securitized financial assets or accounting for these interests in their entirety at fair value.

Appendix B

IMPACT ON EITF ISSUES AND STATEMENT 133 IMPLEMENTATION ISSUES

B1. This appendix addresses the impact of the provisions of this Statement on the consensuses reached on EITF Issues and the responses to Statement 133 Implementation Issues through December 14, 2005. This appendix does not address the impact of this Statement on other authoritative accounting literature included in categories (b), (c), and (d) in the GAAP hierarchy as discussed in AICPA Statement on Auditing Standards (SAS) No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles.

B2. Even though the provisions of this Statement do not nullify or partially nullify the consensuses in the following EITF Issues, the status section of each of those Issues in *EITF Abstracts* will be updated to state: "Statement 155 amended Statement 133 in February 2006. Statement 155 provides a fair value measurement election for certain hybrid financial instruments with embedded derivatives that otherwise would require bifurcation. Hybrid financial instruments that are elected to be accounted for in their entirety at fair value cannot be used as a hedge instrument in a Statement 133 hedge."

85-9 "Revenue Recognition on Options to Purchase Stock of Another Entity"

85-29 "Convertible Bonds with a 'Premium Put'"

86-15 "Increasing-Rate Debt"

86-28 "Accounting Implications of Indexed Debt Instruments"

90-19 "Convertible Bonds with Issuer Option to Settle for Cash upon Conversion"

96-12 "Recognition of Interest Income and Balance Sheet Classification of Structured Notes"

97-15 "Accounting for Contingency Arrangements Based on Security Prices in a Purchase Business Combination"

98-5 "Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios"

99-20 "Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets"

00-19 "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock"

03-7 "Accounting for the Settlement of the Equity-Settled Portion of a Convertible Debt Instrument That Permits or Requires the Conversion Spread to Be Settled in Stock (Instrument C of Issue No. 90-19)"

B3. Even though the provisions of this Statement do not nullify or partially nullify the consensuses in the following EITF Issue, the status section of that Issue in *EITF Abstracts* will be updated to state: "Statement 155 amended Statement 133 in February 2006. Statement 155 indicates that interest-only and principal-only strips exempt from the bifurcation requirements of Statement 133 are limited to a narrowly defined set of such instruments."

88-11 "Allocation of Recorded Investment When a Loan or Part of a Loan Is Sold"

B4. The provisions of this Statement nullify the response in Statement 133 Implementation Issue No. C4, "Interest-Only and Principal-Only Strips."

B5. Even though the provisions of this Statement do not nullify or partially nullify the responses in the following Statement 133 Implementation Issues, the Implementation Issues will be updated to indicate in the "Affected by" section the following: "FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments,*" and a revision date of February 2006. Further, where appropriate in each of the Issues, the following statement has been included in the body of the Implementation Issue: "Note that Statement 155 was issued in February 2006 and allows for a fair value election for hybrid financial instruments that otherwise would require bifurcation. Hybrid financial instruments that are elected to be accounted for in their entirety at fair value cannot be used as a hedge instrument in a Statement 133 hedge."

A1 "Initial Net Investment"

B1 "Separating the Embedded Derivative from the Host Contract"

B2 "Leveraged Embedded Terms"

B4 "Foreign Currency Derivatives"

B5 “Investor Permitted, but Not Forced, to Settle without Recovering Substantially All of the Initial Net Investment”

B6 “Allocating the Basis of a Hybrid Instrument to the Host Contract and the Embedded Derivative”

B10 “Equity-Indexed Life Insurance Contracts”

B11 “Volumetric Production Payments”

B15 “Separate Accounting for Multiple Derivative Features Embedded in a Single Hybrid Instrument”

B17 “Term-Extending Options in Contracts Other Than Debt Hosts”

B20 “Must the Terms of a Separated Non-Option Embedded Derivative Produce a Zero Fair Value at Inception?”

B23 “Terms of a Separated Non-Option Embedded Derivative When the Holder Has Acquired the Hybrid Instrument Subsequent to Its Inception”

B24 “Interaction of the Requirements of EITF Issue No. 86-28 and Statement 133 Related to Structured Notes Containing Embedded Derivatives”

B29 “Equity-Indexed Annuity Contracts with Embedded Derivatives”

B30 “Application of Statement 97 and Statement 133 to Equity-Indexed Annuity Contracts”

B35 “Application of Statement 133 to a Not-for-Profit Organization’s Obligation Arising from an Irrevocable Split-Interest Agreement”

B36 “Modified Coinsurance Arrangements and Debt Instruments That Incorporate Credit Risk Exposures That Are Unrelated or Only Partially Related to the Creditworthiness of the Obligor under Those Instruments”

B37 “Mandatorily Redeemable Preferred Stock Denominated in either a Precious Metal or a Foreign Currency”

B6. Statement 133 Implementation Issue No. B39, “Application of Paragraph 13(b) to Call Options That Are Exercisable Only by the Debtor,” is amended as follows:

a. The "Comments" section of Example 6 in the chart illustrating the guidance to specific debt instruments:

> ~~Although the related mortgage loans are prepayable, and thus each contain a separate embedded call option, the MBS itself does not contain an embedded call option. The MBS issuer has the obligation (not the option) to pass through cash flows from the related mortgage loans to the MBS investors.~~While the MBS itself does not contain an embedded call option, the Board decided as part of FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments,* that an interest in MBS with underlying assets containing an embedded call feature, for which all of the associated cash flows are proportionately passed through to all the interest holders, will not be subject to the conditions in paragraph 13(b) with respect to that embedded call feature. However, in situations in which the cash flows associated with the embedded call feature are disproportionately allocated to different classes of interest holders, all interests in that MBS would be subject to the conditions in paragraph 13(b) with respect to that embedded call feature.

B7. Statement 133 Implementation Issue No. D1, "Application of Statement 133 to Beneficial Interests in Securitized Financial Assets," is amended as follows:

a. The "Affected by" section:

> ~~FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* **(Revised July 30, 2003)**~~FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments* **(Revised February 14, 2006)**

b. The "Note" section:

> ~~**NOTE:** FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities,* issued in April 2003, does not address issues surrounding the evaluation of beneficial interests issued in securitization transactions under Statement 133. Rather, the FASB plans to resolve those issues in a limited scope interpretation of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.* The FASB staff interim guidance in this Implementation Issue remains effective until the FASB issues new guidance superseding this Issue and that guidance becomes effective.~~

c. The following is added at the end of the Implementation Issue:

EFFECTIVE DATE AND TRANSITION

FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments,* issued in February 2006, addresses issues on the evaluation of beneficial interests issued in securitization transactions under Statement 133. The FASB staff interim guidance in this Implementation Issue remains effective for instruments recognized prior to the effective date of Statement 155.