

An Accounting Alternative for Financial Instruments with Embedded Derivatives

Companies may elect to measure at fair value entire financial instruments containing embedded derivatives that would otherwise have to be accounted for separately, according to new Statement 155.¹ The new Statement also requires companies to identify interests in securitized financial assets that are freestanding derivatives or contain embedded derivatives that would have to be accounted for separately, clarifies which interest- and principal-only strips are subject to Statement 133, and amends Statement 140 to revise the conditions of a qualifying special purpose entity due to the new requirement to identify whether interests in securitized financial assets are freestanding derivatives or contain embedded derivatives.²

Prior to the implementation of Statement 133, the FASB provided temporary implementation guidance that permitted companies not to evaluate whether beneficial interests in securitized financial assets are freestanding derivatives or contain embedded derivatives that would require separate accounting under Statement 133.³ That temporary guidance led to differences in the accounting for economically similar instruments based solely on their form. Statement 155 replaces that temporary guidance with a requirement to identify derivatives in beneficial interests, but it also allows companies to elect to account for those interests at fair value in their entirety if they contain embedded derivatives that Statement 133 would otherwise require be accounted for separately.

The FASB recognized that separately accounting for embedded derivatives in some types of financial instruments, including beneficial interests in securitizations, could be difficult. The fair value election provided by Statement 155 eliminates the burden on companies that avail themselves of that election of having to separately determine the fair value of embedded

The Fair-Value Election	2
Interests in Securitized	
Financial Assets	2
Interest- and Principal-Only Strips	3
Amendment to Statement 140	4
Effective Date and Transition	4

©2001-2006 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. KPMG and the KPMG logo are registered trademarks of KPMG International, a Swiss cooperative. All rights reserved. A20836NYGR

Photo: GettyImages/Victor Boswell/National Geographic ngs0_4160

¹ FASB Statement No. 155, Accounting for Certain Hybrid Financial Instruments, February 2006, available at www.fasb.org.

² FASB Statements No. 133, Accounting for Derivative Instruments and Hedging Activities, June 1998, and No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, September 2000, both available at www.fasb.org.

³ Statement 133 Implementation Issue No. D1, Application of Statement 133 to Beneficial Interests in Securitized Financial Assets, June 2000, available at www.fasb.org.

derivatives that Statement 133 would otherwise require be accounted for separately. The fair value election in Statement 155 covers some of the financial instruments that would be eligible for the fair value election in the FASB's fair value option project if it is finalized as proposed.⁴ If that happens, the fair value election provided in Statement 155 will no longer be needed as the fair value option proposed statement would allow for fair value measurement of most types of financial assets and liabilities, including those containing embedded derivatives.

The Fair-Value Election

Statement 155's election applies to recognized financial instruments that contain embedded derivatives, which Statement 133 calls "hybrid instruments." The new Statement permits companies to measure at fair value financial instruments containing an embedded derivative instrument if the derivative would otherwise have to be accounted for separately under Statement 133. The fair-value election is irrevocable and must be made on an instrument-by-instrument basis, applied to the entire hybrid financial instrument, and supported by concurrent documentation or by a previously established, documented policy for automatic election. Changes in fair value would be recognized in earnings.

Companies may elect fair-value measurement when the financial instrument is acquired or issued or when a previously recognized financial instrument is subject to a remeasurement (i.e., new basis) event. For purposes of the Statement, a remeasurement event is an event, excluding an other-than-temporary impairment, that triggers a GAAP requirement to remeasure the financial instrument to its fair value at the time of the event. Business

combinations and significant modifications of debt are examples of remeasurement events.

Statement 155 specifies when a difference between the transaction price of an acquired hybrid financial instrument and its estimated fair value upon acquisition may be recognized in earnings. It may be recognized only if the estimated fair value is obtained from a quoted market price in an active market, is evidenced by comparison to other observable current market transactions, or is based on a valuation technique incorporating observable market data. However, this restriction does not apply to hybrid financial instruments previously bifurcated under Statement 133 that a company elects to measure at fair value when Statement 155 is initially adopted.

Hybrid financial instruments that a company elects to measure at fair value may not be designated as hedging instruments. However, a company may preserve its ability to use the embedded derivatives as hedging instruments under Statement 133 by electing to separately account for the embedded derivatives rather than measuring the hybrid financial instruments at fair value in their entirety. In addition, since a company's financial instruments include its debt, Statement 155's fair-value election gives companies the opportunity to carry their debt at fair value if that debt includes an embedded derivative that otherwise would require separate accounting under Statement 133.

Examples of embedded derivatives that an investor may be required to separately account for under Statement 133 if the Statement 155 election is not followed include equity indexed features in debt hosts (e.g., interest affected by the return of an equity index).

Disclosures. Companies that elect to measure hybrid financial instruments at fair value will have to report them in each balance sheet separately from the carrying amounts of assets and liabilities subsequently measured at other than fair value. The information may be presented either parenthetically or as a separate line item on the face of the balance sheet. Information also must be disclosed to enable users of the financial statements to understand the effect on earnings of measuring hybrid financial instruments at fair value.

Interests in Securitized Financial Assets

Statement 155 requires companies to evaluate beneficial interests in securitized financial assets, other than principal- and interest-only strips exempt from Statement 133, in order to identify whether those interests are free-standing derivatives or have embedded derivatives that would have to be accounted for separately. This requirement applies when the holder acquires the beneficial interest through a purchase or through a retained interest in transferred financial assets in a securitization transaction. The requirement also applies to issuers of beneficial interests in securitized financial assets. If a beneficial interest contains an embedded derivative that Statement 133 would otherwise require be accounted for separately, that beneficial interest is eligible for the fair value election provided by Statement 155.

As a result of this new requirement, investors in securitized financial assets will need to obtain information about the payoff structure and the payment priority of the beneficial interest sufficient to determine whether their beneficial interest contains an embedded derivative that would have to be accounted

⁴ FASB Exposure Draft, *The Fair Value Option for Financial Assets and Financial Liabilities*, January 2006, available at www.fasb.org.

for separately. These investors will have to know the nature and amount of the assets and liabilities and other financial instruments making up the securitization transaction.

Evaluations 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 more extensive analysis.

In all cases, Statement 155 requires that the analysis consider whether the assets of the trust, SPE, or other issuer provide the cash flows necessary for the beneficial interest holder to recover substantially all of its initial recorded investment in the interest. If so, the analysis focuses principally on the contractual terms of the beneficial interest. If not, the beneficial interest would likely contain an embedded derivative.

Statement 155 includes guidance on whether credit risk represents an embedded derivative. According to the guidance, credit risk arising from interests in securitized financial assets and liabilities (including derivative contracts) held as the issuing entity's assets or liabilities is not an embedded derivative. The guidance also excludes credit-risk concentration created by subordinating one financial instrument to another from being considered an embedded derivative.

Interest- and Principal-Only Strips

Statement 155 limits the exemption from Statement 133's requirements for interest- and principal-only strips to a narrowly defined set of instruments. Those exempt are interest- and principal-only strips that represent the right to receive a specified pro rata share of all of the contractual interest or principal cash flows of a specific debt instrument and

Examples of the Application of Statement 155

Statement 155 contains several examples of the application of its provisions, three of which are summarized below:

- A securitization structure contains a portfolio of fixed-rate assets and issues variable-rate beneficial interests. The structure also contains a pay-fixed, receive-variable interest rate swap. The variable rate reflects a current market rate, but the notional amount of the swap is less than the notional amount of the assets. The beneficial interest may be a hybrid instrument containing an embedded interest-rate derivative that Statement 133 would require to be analyzed to determine if it requires bifurcation. However, if the example were changed so that the notional amount of the swap matched the notional amount of the assets, there would be no embedded derivative as the financial instruments held by the securitization structure would provide the necessary cash flows for the investors to recover substantially all of their initial recorded investment in the interest.
- A securitization structure contains a portfolio of foreign-currency-denominated floating-rate assets and issues dollar-denominated floating rate beneficial interests. The structure also contains a cross-currency swap to pay the related foreign currency and receive dollars. The floating rate reflects a current market rate, and the notional amount of the assets and the swap correspond to the notional amount of the beneficial interests issued. The dollar-denominated floating-rate beneficial interest would not have an embedded derivative requiring bifurcation for two reasons. First, the economics of the structure result in floating-rate dollar-denominated assets equal to the amount of floating-rate dollar denominated beneficial interests issued. Second, the financial instruments held by the securitization structure provide the necessary cash flows for the investors to recover substantially all of their initial recorded investment in the interest.
- A structure contains a portfolio of fixed-rate financial assets and issues (a) a senior, floating-rate interest, (b) 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 (c) a residual interest that is entitled to the remaining fixed-rate payment from the assets, less any credit losses. The subordinated interest may be a hybrid financial instrument with an embedded interest rate derivative because the terms of the interest are floating rate, but the entity holds only fixed-rate assets. An adverse change in interest rates could create a shortfall in cash flows after the senior interest holders are paid, and the investor in the subordinated interest might not recover substantially all of its initial recorded investment in the interest. The residual interest would not have an embedded derivative for the concentration of credit risk resulting from subordination because the concentration relates to the financial instruments held by the entity. However, the residual interest would have an embedded interest-rate derivative.

that contain no terms not present in the original debt. However, an allocation of a portion of a specific debt instrument's interest or principal cash flows as "reasonable compen-

sation" for stripping the instrument or to provide "adequate compensation" to the servicer will continue to be exempt.



This is a publication of KPMG's
Department of Professional
Practice—Audit and Risk Advisory
212-909-5600

Contributing authors:

Kimber K. Bascom
Michael D. Foley
Paul G. Laurenzano
Enrique M. Tejerina
Kurtis R. Kurimsky

Earlier editions are available at:
www.aro.kpmg.com

Defining Issues® is a registered trademark of KPMG LLP. © 2001-2006 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. KPMG and the KPMG logo are registered trademarks of KPMG International, a Swiss cooperative. All rights reserved. A20836NYGR

The FASB considered eliminating the Statement 133 exemption for interest- and principal-only strips in its entirety because it has no conceptual basis. However, the FASB decided for reasons of practicality to continue to exempt a narrow set of the simplest interest- and principal-only financial instruments from the requirements of Statement 133. Interest- and principal-only strips in securitized financial assets will generally not qualify for the exemption.

Amendment to Statement 140

Statement 155 eliminates one of the conditions in Statement 140 that precluded an entity from being a qualifying special purpose entity. The eliminated condition is holding a derivative financial instrument that pertains to a beneficial interest that is itself a derivative financial instrument. The condition had been included in Statement 140 to preclude a qualifying special-purpose entity from holding a derivative that might not be accounted for as a derivative by its beneficial interest holders. The FASB concluded that the condition in Statement 140 is no longer necessary, because Statement 155 requires beneficial interest holders to analyze whether their interest contains an embedded derivative.

The amendment to Statement 140 also clarifies that bifurcation by the issuer in a securitization of embedded derivatives in beneficial interests under the provisions of Statement 133 as required by the new provisions of Statement 155 would not disqualify an otherwise qualifying SPE, regardless of whether those interests are retained by the transferor or held by third parties.

Statement 155 is the first of three planned amendments to Statement 140. The other two amendments will address the accounting for servicing rights and transfers of financial assets (including guidance on the permissible activities of qualifying special-purpose entities). They are expected to be issued later in 2006.

Effective Date and Transition

Statement 155 is effective for all financial instruments acquired, issued, or subject to a remeasurement (new basis) event after the beginning of a company's first fiscal year that begins after September 15, 2006. The fair-value election for financial instruments containing embedded derivatives may also be applied upon adoption to hybrid financial instruments that had been previously bifurcated under Statement 133. Earlier adoption is permitted as of the beginning of a company's fiscal year, provided the company has not yet issued financial statements for that fiscal year or for any interim period in that fiscal year.

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 instrument is recognized as a cumulative-effect adjustment to beginning retained earnings in the period of adoption. Prior periods are not to be restated. Separate disclosure is required of the gross gains and losses making up the cumulative-effect adjustment, determined on an instrument-by-instrument basis.

The descriptive and summary statements above are not intended to be a substitute for the text of FASB Statements 133, 140, or 155, or any other cited, actual, or potential requirements. Nor are any of the cited documents necessarily applicable to any entity's specific circumstances. Those accounting for specific financial instruments and complying with SEC filing requirements should refer to the texts of the applicable documents that set out GAAP and SEC requirements and consult their accounting and legal advisors.