The guidance on Statement 133 implementation issues outlined below includes both tentative conclusions and conclusions that have been formally cleared by the Board. The issues that have been cleared are distinguished in the following index with an asterisk (*) placed between the issue number and the issue title. The index also indicates the date cleared by the Board or, for uncleared issues, the date the guidance was released. Constituents may submit their comments on the tentative conclusions within 35 days after an issue is initially posted to the web site. Each issue that has not been cleared indicates in its endnote the date by which constituents should submit any comments regarding that tentative conclusion.

Those issues cleared by the Board have been authored by the FASB staff and represent the staff's views. Official positions of the FASB are determined only after extensive due process and deliberation.

Statement 133 Implementation Issues
Index of All Issues
As of June 12, 2009

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Issue C14	[Number not used. Staff's previous tentative conclusions withdrawn on June 29, 2001.]	
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Issue C17	[Number not used. Staff's previous tentative conclusions withdrawn on February 16, 2006, and incorporated into Statement 155.]	
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Issue C19	[Number not used. Staff's previous tentative conclusions withdrawn on March 26, 2003, and incorporated into Statement 149.]	
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Issue C21	[Number not used. Staff's previous tentative conclusions withdrawn on June 25, 2008 because the issue was resolved by the consensus in EITF Issue No. 07-5, "Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity's Own Stock."]	
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Issue E21		[Number not used. Staff's previous tentative conclusions withdrawn on March 26, 2003.]	
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Issue G3	*	Discontinuation of a Cash Flow Hedge	Cleared 03/31/99; Revised 09/25/00
Issue G4	*	Hedging Voluntary Increases in Interest Credited on an Insurance Contract Liability	Cleared 07/28/99; Revised 09/25/00
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Issue G6	*	Impact of Implementation Issue E1 on Cash Flow Hedges of Market Interest Rate Risk	Superseded
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Issue G15 *	Combinations of Options Involving One Written Option and Two Purchased Options	Cleared 12/06/00
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Issue G23 *	Hedging Portions of a Foreign-Currency-Denominated Financial Asset or Liability Using the Cash Flow Model	Cleared 09/19/01
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Issue H9 *	Hedging a Net Investment with a Compound Derivative That Incorporates Exposure to Multiple Risks	Cleared 12/13/00
Issue H10 *	Hedging Net Investment with the Combination of a Derivative and a Cash Instrument	Cleared 05/17/00

Issue H11 *	Designation of a Foreign-Currency-Denominated Debt Instrument as both the Hedging Instrument in a Net Investment Hedge and the Hedged Item in a Fair Value Hedge	Cleared 06/28/00
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Issue H16 *	Reference in Paragraph 40(e) about Eliminating All Variability in Cash Flows	Cleared 09/19/01
Issue H17	[Number not used. Staff's previous tentative conclusions withdrawn on March 21, 2007.]	

Section I: Disclosures

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Issue I2 *	Near-Term Reclassification of Gains and Losses That Are Reported in Accumulated Other Comprehensive Income	Cleared 06/27/01 Revised 09/15/06

Section J: Transition Provisions

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Issue J3 *	Requirements for Hedge Designation and Documentation on the First Day of Initial Application	Cleared 07/28/99
Issue J4 *	Transition Adjustment for Option Contracts Used in a Cash-Flow-Type Hedge [Conclusions incorporated into Issue J15.]	Superseded
Issue J5 *	Floating-Rate Currency Swaps	Cleared 11/23/99; Revised 09/25/00
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Issue J12 *	Intercompany Derivatives and the Shortcut Method	Superseded

Issue J13 *	Indexed Debt Hedging Equity Investment	Cleared 12/06/00
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Issue J18 *	Foreign-Currency-Denominated Transactions Accounted for under EITF Issue 88-18	Cleared 06/27/01
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Section K: Miscellaneous

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Issue K2 *	Are Transferable Options Freestanding or Embedded?	Cleared 05/17/00
Issue K3 *	Determination of Whether Combinations of Options with the Same Terms Must Be Viewed as Separate Option Contracts or as a Single Forward Contract	Cleared 05/17/00; Revised 05/27/03
Issue K4 *	Income Statement Classification of Hedge Ineffectiveness and the Component of a Derivative's Gain or Loss Excluded from the Assessment of Hedge Effectiveness	Cleared 12/06/00 Revised 03/19/08
Issue K5 *	Transition Provisions for Applying the Guidance in Statement 133 Implementation Issues	Cleared 06/27/01; Revised 06/01/05

Title:	Definition of a Derivative: Initial Net Investment
Paragraph references:	6(b), 8, 12, 57(b), 255–258
Date cleared by Board:	June 23, 1999
Date latest revision posted to website:	March 14, 2006
Affected by:	FASB Statements No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities,* and No. 155, *Accounting for Certain Hybrid Financial Instruments* Revised February 16, 2006

QUESTION

If an entity enters into a forward contract that requires the purchase of 1 share of an unrelated company's common stock in 1 year for $110 (the market forward price) and at inception the entity elects to prepay the contract pursuant to its terms for $105 (the current price of the share of common stock), does the contract meet the criterion in paragraph 6(b) related to initial net investment and therefore meet the definition of a derivative for that entity? If not, is there an embedded derivative that warrants separate accounting?

RESPONSE

Paragraph 6(b) of Statement 133 specifies that a derivative requires either no initial net investment or a smaller initial net investment than would be required for other types of contracts that would be expected to have a similar response to changes in market factors. If no prepayment is made at inception, the contract would meet the criterion in paragraph 6(b) because it does not require an initial net investment but, rather, contains an unexercised election to prepay the contract at inception. Paragraph 8 further clarifies paragraph 6(b) and states that a derivative instrument does not require an initial net investment in the contract that is equal to the notional amount or that is determined by applying the notional amount to the underlying. If the contract gives the entity the option to "prepay" the contract at a later date during its 1-year term (at $105 or some other specified amount), exercise of that option would be accounted for as a loan that is repayable at $110 at the end of the forward contract's 1-year term.

If, instead, the entity elects to prepay the contract at inception for $105, the contract does not meet the definition of a freestanding derivative. Paragraph 8, as amended, indicates that if the initial net investment of the contract (after adjustment for the time value of money) is less, by more than a nominal amount, than the initial net investment that would be commensurate with the amount that would be exchanged to acquire the asset related to the underlying, the characteristic in paragraph 6(b) is met. The initial net investment of $105 is equal to the initial price of the 1 share of stock being purchased under the contract and therefore is equal to the investment that would be required for other types of contracts that would be expected to have a similar response to changes in market factors. That is, the initial net investment is equal to the amount that would be exchanged to acquire the asset related to the underlying.

However, the entity must assess whether that nonderivative instrument contains an embedded derivative that, pursuant to paragraph 12, requires separate accounting as a derivative unless a fair value election is made pursuant to Statement 155. (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 hedging instrument in a Statement 133 hedging relationship.) In this example, the prepaid contract is a hybrid instrument that is composed of a debt instrument as the host contract (that is, a loan that is repayable at $110 at the end of the forward contract's 1-year term) and an embedded derivative based on equity prices. The host contract is a debt instrument because the holder has none of the rights of a shareholder, such as the ability to vote the shares and receive distributions to shareholders. (Refer to paragraph 60 of Statement 133.) Unless the hybrid instrument is remeasured at fair value with changes in value recorded in earnings as they occur, the embedded derivative must be separated from the host contract because the economic characteristics and risks of a derivative based on equity prices are not clearly and closely related to a debt host contract, and a separate instrument with the same terms as the embedded derivative would be a derivative subject to the requirements of Statement 133.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Definition of a Derivative: Existence of a Market Mechanism That Facilitates Net Settlement
Paragraph references:	6(c), 9(b), 57(c)(2), 261
Date cleared by Board:	February 17, 1999
Superseded by:	Clearance of Issue A21

Title: Definition of a Derivative: Impact of Market Liquidity on the Existence of a Market Mechanism
Paragraph references: 6(c), 9(b), 57(c)
Date cleared by Board: February 17, 1999

QUESTION

Does the liquidity of the market for a group of contracts affect the determination of whether there is a market mechanism that facilitates net settlement under paragraph 9(b)? For example, assume a company contemporaneously enters into 500 futures contracts, each of which requires delivery of 100 shares of an exchange-traded equity security on the same date. The contracts fail to meet the criterion in paragraph 9(a) because delivery of an asset related to the underlying is required. The futures contracts trade on an exchange, which constitutes a market mechanism under which the company can be relieved of its rights and obligations under the futures contracts. However, the quantity of futures contracts held by the company cannot be rapidly absorbed in their entirety without significantly affecting the quoted price of the contracts.

RESPONSE

No. The lack of a liquid market for the group of contracts does not affect the determination of whether under paragraph 9(b) there is a market mechanism that facilitates net settlement because the test in paragraph 9(b) focuses on a singular contract. The exchange offers a ready opportunity to sell each contract, thereby providing relief of the rights and obligations under each contract.

Paragraph 57(c)(2) elaborates on the phrase *market mechanism that facilitate net settlement* and states that "any institutional arrangement or other agreement that enables either party to be relieved of all rights and obligations under the contract and to liquidate its net position without incurring a significant transaction cost is considered net settlement." The possible reduction in price due to selling a large futures position is not considered to be a *transaction cost* under that paragraph.

Whether the number of shares deliverable under the group of futures contracts exceeds the amount of shares that could rapidly be absorbed by the market without significantly affecting the price is not relevant to applying the criterion in paragraph 9(b).

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Title: Definition of a Derivative: Penalties for Nonperformance That Constitute Net Settlement
Paragraph references: 6(c), 9(a), 57(c)(1)
Date cleared by Board: November 23, 1999

QUESTION

Does a contract contain a net settlement provision under paragraphs 9(a) and 57(c)(1) if it contains both (a) a variable penalty for nonperformance based on changes in the price of the items that are the subject of the contract and (b) a fixed incremental penalty for nonperformance that is sufficiently large to make the possibility of net settlement remote?

BACKGROUND

Certain contracts may require payment of (a) a variable penalty for nonperformance based on changes in the price of the items that are the subject of the contract and (b) an incremental penalty for nonperformance stated as a fixed amount or fixed amount per unit. The contract may or may not characterize the incremental payment upon nonperformance as a penalty.

Paragraph 57(c)(1) elaborates on the criterion in paragraph 6(c) regarding whether the terms of a contract require or permit net settlement, which is discussed in paragraph 9(a). Paragraph 57(c)(1) states:

> Its terms implicitly or explicitly require or permit net settlement. For example, a penalty for nonperformance in a purchase order is a net settlement provision if the amount of the penalty is based on changes in the price of the items that are the subject of the contract. Net settlement may be made in cash or by delivery of any other asset, whether or not it is readily convertible to cash. A fixed penalty for nonperformance is not a net settlement provision.

RESPONSE

No. A contract that contains a variable penalty for nonperformance based on changes in the price of the items that are the subject of the contract does not contain a net settlement provision under paragraphs 9(a) and 57(c)(1) if it also contains an incremental penalty of a fixed amount (or fixed amount per unit) that would be expected to be significant enough at all dates during the remaining term of the contract to make the possibility of nonperformance remote. If a contract includes such a provision, it effectively requires performance, that is, requires the party to deliver an asset that is associated with the underlying. Thus, the contract does not meet the criterion for net settlement under paragraphs 9(a) and 57(c)(1) of Statement 133. The assessment of the fixed incremental penalty in the manner described above should be performed only at the contract's

inception. The magnitude of the fixed incremental penalty should be assessed on a standalone basis as a disincentive for nonperformance, not in relation to the overall penalty.

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Title: Definition of a Derivative: Notional Amounts of Commodity Contracts
Paragraph references: 6(a), 7, 251, 540
Date cleared by Board: November 23, 1999
Revised December 6, 2000

QUESTION

How does the lack of specification of a fixed number of units of a commodity to be bought or sold affect whether a commodity contract has a notional amount? Specifically, does each of the illustrative contracts below have a notional amount as discussed in paragraph 6(a) to meet Statement 133's definition of *derivative instrument*?

BACKGROUND

Paragraph 540 of Statement 133 defines *notional amount* as:

> A number of currency units, shares, bushels, pounds, or other units specified in a derivative instrument.

Many commodity contracts specify a fixed number of units of a commodity to be bought or sold under the pricing terms of the contract (for example, a fixed price). However, some contracts do not specify a fixed number of units. For example, consider the following four contracts that require one party to buy the following indicated quantities:

Contract 1: As many units as required to satisfy its actual needs (that is, to be utilized or consumed) for the commodity during the period of the contract (a requirements contract). The party is not permitted to buy more than its actual needs (for example, the party cannot buy excess units for resale).

Contract 2: Only as many units as needed to satisfy its actual needs up to a maximum of 100 units. The party is not permitted to buy more than its actual needs (for example, the party cannot buy excess units for resale).

Contract 3: A minimum of 60 units and as many units needed to satisfy its actual needs in excess of 60 units. The party is not permitted to buy more than its actual needs (for example, the party cannot buy excess units for resale).

Contract 4: A minimum of 60 units and as many units needed to satisfy its actual needs in excess of 60 units up to a maximum of 100 units. The party is not permitted to buy more than its actual needs (for example, the party cannot buy excess units for resale).

This issue solely focuses on whether the contracts under consideration have a notional amount pursuant to the definition in Statement 133. These types of contracts may not satisfy certain of the other required criteria in Statement 133 in order for them to meet the definition of a derivative instrument.

RESPONSE

Generally, the anticipated number of units covered by a requirements contract is equal to the buyer's needs. When a requirements contract is negotiated between the seller and buyer, both parties typically have the same general understanding of the buyer's estimated needs. Given the buyer's often exclusive reliance on the seller to supply all its needs of the commodity, it is imperative from the buyer's perspective that the supplier be knowledgeable with respect to anticipated volumes. In fact, the pricing provisions within requirements contracts are directly influenced by the estimated volumes. The conclusion that a requirements contract has a notional amount as defined in Statement 133 can be reached only if a reliable means to determine such a quantity exists. Application of this guidance to specific contracts is provided below.

Contract 1—Requirements Contract

It depends. If the requirements contract contains explicit provisions that support the calculation of a determinable amount reflecting the buyer's needs, then that contract has a notional amount pursuant to the definition in Statement 133. One technique to quantify and validate the notional amount in a requirements contract is to base the estimated volumes on the contract's settlement and default provisions. Often the default provisions of requirements contracts will specifically refer to anticipated quantities to utilize in the calculation of penalty amounts in the event of nonperformance. Other default provisions stipulate penalty amounts in the event of nonperformance based on average historical usage quantities of the buyer. If those amounts are determinable, they should be considered the notional amount of the contract. The identification of a requirements contract's notional amount may require the consideration of volumes or formulas contained in attachments or appendices to the contract or other legally binding side agreements. The determination of a requirements contract's notional amount must be performed over the life of the contract and could result in the fluctuation of the notional amount if, for instance, the default provisions reference a rolling cumulative average of historical usage. In circumstances where the notional amount is not determinable, making the quantification of such an amount highly subjective and relatively unreliable (for example, if a contract does not contain settlement and default provisions that explicitly reference quantities or provide a formula based on historical usage), such contracts are considered not to contain a notional amount as that term is used in Statement 133.

Contract 2—Requirements Contract with a Specified Maximum Quantity

It depends. The same considerations discussed above with respect to Contract 1 also apply to Contract 2; however, the notional amount cannot exceed 100 units.

Contract 3—Requirements Contract with a Specified Minimum Quantity

Yes. The same considerations discussed above with respect to Contract 1 also apply to Contract 3; however, the notional amount of Contract 3 cannot be less than 60 units. A contract that specifies a minimum number of units always has a notional amount at least equal to the required minimum number of units. Only that portion of the requirements contract with a determinable notional amount would be accounted for as a derivative instrument under Statement 133.

Contract 4—Requirements Contract with a Specified Minimum and Maximum Quantities

Yes. The same considerations discussed above with respect to Contract 1 also apply to Contract 4; however, the notional amount of Contract 4 cannot be less than 60 units or greater than 100 units. A contract that specifies a minimum number of units always has a notional amount at least equal to the required minimum number of units. Only that portion of the requirements contract with a determinable notional amount would be accounted for as a derivative instrument under Statement 133.

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Title:	Definition of a Derivative: Effect of Contractual Provisions on the Existence of a Market Mechanism That Facilitates Net Settlement
Paragraph references:	9(b), 57(c)(2), 261
Date cleared by Board:	November 23, 1999
Date revision posted to website:	May 1, 2003
Affected by:	FASB Statement No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities* FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* Revised March 26, 2003

QUESTION

Does the existence of a contractual requirement that one party obtain the other's permission to assign rights or obligations to a third party under a contract, in and of itself, preclude a contract from meeting the definition of a derivative because it would not possess the net settlement characteristic described in paragraph 9(b) of Statement 133 as a market mechanism?

For the purposes of this question, assume that if the contract did not contain an assignment clause, an established market mechanism that facilitates net settlement outside the contract exists.

BACKGROUND

Some commodity contracts contain a provision that allows one or both parties to a contract to assign its rights or obligations to a third party only after obtaining permission from the counterparty. Under the assignment clause addressed in this issue, permission shall not be unreasonably withheld. The primary purpose of an assignment clause is to ensure that the non-assigning counterparty is not unduly exposed to credit or performance risk if the assigning counterparty is relieved of all of its rights and obligations under the contract. Accordingly, a counterparty could withhold consent only in limited circumstances, such as when the contract would be assigned to a third-party assignee that has a history of defaulting on its obligations or has a lower credit rating than the assignor.

Paragraph 9(b) of Statement 133 indicates that the net settlement characteristic of the definition of a derivative may be satisfied if "one of the parties is required to deliver an asset of the type described in paragraph 9(a), but there is a market mechanism that facilitates net settlement, for example, an exchange that offers a ready opportunity to sell the contract or to enter into an offsetting contract." Paragraph 57(c) of Statement 133, as amended, elaborates on that notion. It states:

> A contract that meets any one of the following criteria has the characteristic described as net settlement [in paragraph 9(b)]….(2) There is an established market mechanism that facilitates net settlement outside the contract. The term *market mechanism* is to be interpreted broadly. Any institutional arrangement or other agreement that enables either party to be relieved of all rights and obligations under the contract and to liquidate its net position without incurring a significant transaction cost is considered net settlement. The evaluation of whether a market mechanism exists and whether items to be delivered under a contract are readily convertible to cash must be performed at inception and on an ongoing basis throughout a contract's life.

RESPONSE

No. The existence of an assignment clause does not, in and of itself, preclude the contract from possessing the net settlement characteristic described in paragraph 9(b) as a market mechanism. Once the determination is made that a market mechanism that facilitates net settlement outside of the contract exists, then an assessment of the substance of the assignment clause is required in order to determine whether that assignment clause precludes a party from being relieved of all rights and obligations under the contract through that existing market mechanism. Although permission to assign the contract shall not be unreasonably withheld by the counterparty in accordance with the terms of the contract, the assignment feature cannot be viewed simply as a formality because it may be invoked at any time to prevent the non-assigning party from being exposed to unacceptable credit or performance risk. Accordingly, the existence of the assignment clause may or may not permit a party from being relieved of its rights and obligations under the contract.

If it is *remote* that the counterparty will withhold permission to assign the contract, the mere existence of the clause should not preclude the contract from possessing the net settlement characteristic described in paragraph 9(b) as a market mechanism. Such a determination requires assessing whether a sufficient number of acceptable potential assignees exist in the marketplace such that assignment of the contract would not result in imposing unacceptable credit risk or performance risk on the non-assigning party. Consideration should be given to past counterparty and industry practices regarding whether permission to be relieved of all rights and obligations under similar contracts has previously been withheld. However, if it is *reasonably possible* or *probable* that the counterparty will withhold permission to assign the contract, the contract is precluded from possessing the net settlement characteristic described in paragraph 9(b) as a market mechanism. If the contract meets the definition of a derivative, each party to the contract needs to determine whether the normal purchases and normal sales exception under paragraph 10(b) applies to the contract.

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Title:	Definition of a Derivative: Asymmetrical Default Provisions
Paragraph references:	6(c), 9(a), 57(c)(1)
Date cleared by Board:	November 23, 1999
Date revision posted to website:	May 1, 2003
Affected by:	FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* Revised March 26, 2003

QUESTION

Does an asymmetrical default provision, which provides the defaulting party only the obligation to compensate its counterparty's loss but not the right to demand any gain from its counterparty, give a commodity forward contract the characteristic of net settlement under paragraph 9(a) of Statement 133?

BACKGROUND

Paragraph 6(c) of Statement 133 describes the following derivative characteristic:

> Its terms require or permit net settlement, it can readily be settled net by a means outside the contract, or it provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

Paragraph 9(a) provides the following additional guidance regarding the derivative characteristic in paragraph 6(c):

> Neither party is required to deliver an asset that is associated with the underlying and that has a principal amount, stated amount, face value, number of shares, or other denomination that is equal to the notional amount (or the notional amount plus a premium or minus a discount).

Paragraph 57(c) and related subparagraph (1) provide the following additional guidance regarding the derivative characteristic in paragraphs 6(c) and 9(a):

> A contract that meets any one of the following criteria has the characteristic described as net settlement:
>
> (1) Its terms implicitly or explicitly require or permit net settlement. For example, a penalty for nonperformance in a purchase order is a net settlement provision if the amount of the penalty is based on changes in the price of the items that are the subject of the contract. Net settlement may be made in cash or by delivery of any other asset, whether or not it is readily convertible to cash. A fixed penalty for nonperformance is not a net settlement provision.

Many commodity forward contracts contain default provisions that require the defaulting party (the party that fails to make or take physical delivery of the commodity) to reimburse the nondefaulting party for any loss incurred as illustrated in the following examples:

- If the buyer under the forward contract (Buyer) defaults (that is, does not take physical delivery of the commodity), the seller under that contract (Seller) will have to find another buyer in the market to take delivery. If the price received by Seller in the market is less than the contract price, Seller incurs a loss equal to the quantity of the commodity that would have been delivered under the forward contract multiplied by the difference between the contract price and the current market price. Buyer must pay Seller a penalty for nonperformance equal to that loss.
- If Seller defaults (that is, does not deliver the commodity physically), Buyer will have to find another seller in the market. If the price paid by Buyer in the market is more than the contract price, Seller must pay Buyer a penalty for nonperformance equal to the quantity of the commodity that would have been delivered under the forward contract multiplied by the difference between the contract price and the current market price.

For example, Buyer agreed to purchase 100 units of a commodity from Seller at $1.00 per unit:

- Assume Buyer defaults on the forward contract by not taking delivery and Seller must sell the 100 units in the market at the prevailing market price of $.75 per unit. To compensate Seller for the loss incurred due to Buyer's default, Buyer must pay Seller a penalty of $25.00 (that is, 100 units × ($1.00 – $.75)).
- Similarly, assume that Seller defaults and Buyer must buy the 100 units it needs in the market at the prevailing market price of $1.30 per unit. To compensate Buyer for the loss incurred due to Seller's default, Seller must pay Buyer a penalty of $30.00 (that is, 100 units × ($1.30 – $1.00)).

Note that an asymmetrical default provision is designed to compensate the nondefaulting party for a loss incurred. The defaulting party cannot demand payment from the nondefaulting party to realize the changes in market price that would be favorable to the defaulting party if the contract were honored. Under the forward contract in the example, if Buyer defaults when the market price is $1.10, Seller will be able to sell the units of the commodity into the market at $1.10 and realize a $10.00 greater gain than it would have under the contract. In that circumstance, the defaulting Buyer is not required to pay a penalty for nonperformance to Seller, nor is Seller required to pass the $10.00 extra gain to the defaulting Buyer. Similarly, if Seller defaults when the market price is $.80, Buyer will be able to buy the units of the commodity in the market and pay $20.00 less than under the contract. In that circumstance, the defaulting Seller is not required to pay a penalty for nonperformance to Buyer, nor is Buyer required to pass the $20.00 savings on to the defaulting Seller.

RESPONSE

No. A nonperformance penalty provision that requires the defaulting party to compensate the nondefaulting party for any loss incurred but does not allow the defaulting party to receive the effect of favorable price changes (herein referred to as an asymmetrical default provision) does not give a commodity forward contract the characteristic described as net settlement under paragraph 9(a) of Statement 133.

A derivative instrument can be described, in part, as allowing the holder to participate in the changes in an underlying without actually making or taking delivery of the asset related to that underlying. In a forward contract with only an asymmetrical default provision, neither Buyer nor Seller can realize the benefits of changes in the price of the commodity through default on the contract. That is, Buyer cannot realize favorable changes in the intrinsic value of the forward contract except (a) by taking delivery of the physical commodity or (b) in the event of default by Seller, which is an event beyond the control of Buyer. Similarly, Seller cannot realize favorable changes in the intrinsic value of the forward contract except (a) by making delivery of the physical commodity or (b) in the event of default by Buyer, which is an event beyond the control of Seller. However, a pattern of having the asymmetrical default provision applied in contracts between certain counterparties would indicate the existence of a tacit agreement between those parties that the party in a loss position would always elect the default provision, thereby resulting in the understanding that there would always be net settlement. In that situation, those kinds of commodity contracts would meet the characteristic described as net settlement in paragraph 9(a).

In contrast, a contract that permits only one party to elect net settlement of the contract (by default or otherwise), and thus participate in either favorable changes only or both favorable and unfavorable price changes in the underlying, meets the derivative characteristic described in paragraph 6(c) and discussed in paragraph 9(a) for all parties to that contract. Such a default provision allows one party to elect net settlement of the contract under any pricing circumstance and consequently does not require delivery of an asset that is associated with the underlying. That default provision differs from the asymmetrical default provision in the above example contract, since it is not limited to compensating only the nondefaulting party for a loss incurred and is not solely within the control of the defaulting party.

If the commodity forward contract does not have the characteristic of net settlement under paragraphs 9(a) and 9(b) but has the characteristic of net settlement under paragraph 9(c) because it requires delivery of a commodity that is readily convertible to cash, the commodity forward contract may nevertheless be eligible to qualify for the normal purchases and normal sales exception in paragraph 10(b) and, if so, would not be subject to the accounting requirements of Statement 133 for the party to whom it is a normal purchase or normal sale.

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Title:	Definition of a Derivative: Prepaid Interest Rate Swaps
Paragraph references:	6, 9, 13
Date cleared by Board:	May 17, 2000
Superseded by:	Clearance of Issue A23

Title:	Definition of a Derivative: Assets That Are Readily Convertible to Cash
Paragraph references:	6(c), 9(c), footnote 5 (to paragraph 9), 265
Date cleared by Board:	May 17, 2000

QUESTION

Is an asset considered readily convertible to cash, as that phrase is used in paragraph 9(c), if the net amount of cash that would be received from a sale in an active market is not the equivalent amount of cash that an entity would typically have received under a net settlement provision? The net amount of cash that would be received from a sale in an active market may be impacted by various factors, such as sales commissions and costs to transport the asset (such as a commodity) to the delivery location specified for that active market.

BACKGROUND

Paragraph 9(c) of Statement 133 provides that a contract that requires delivery of the assets associated with the underlying has the characteristic of net settlement if those assets are *readily convertible to cash*. Footnote 5 to that paragraph makes explicit reference to the use of the phrase *readily convertible to cash* in paragraph 83(a) of FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises.*

This issue addresses whether a contract has the net settlement characteristic described in paragraph 9(c). This issue presumes there is no net settlement provision in the contract and no market mechanism that facilitates net settlement that would cause the contract to meet the criteria in paragraphs 9(a) and 9(b). A contract that is a derivative solely because it has the net settlement characteristic described in paragraph 9(c) (since the asset to be delivered under the contract is readily convertible to cash) may yet qualify for the normal purchases and normal sales exception under paragraph 10(b) or the other exclusions provided in paragraph 10.

RESPONSE

It depends. An asset (whether financial or nonfinancial) can be considered to be *readily convertible to cash*, as that phrase is used in paragraph 9(c), only if the net amount of cash that would be received from a sale of the asset in an active market is either equal to or not significantly less than the amount an entity would typically have received under a net settlement provision. The net amount that would be received upon sale need not be equal to the amount typically received under a net settlement provision.

In describing *net settlement*, paragraph 6(c) of Statement 133 states, in part, that the contract "…provides for delivery of an asset that puts the recipient in a position *not substantially different* from net settlement" (emphasis added). The basis for conclusions also comments in or the

paragraph 265 that "…the parties generally should be indifferent as to whether they exchange cash assets associated with the underlying," although the term *indifferent* was not intended to imply an approximate equivalence between net settlement and proceeds from sale in an active market. Based on the foregoing Statement 133 references, if an entity determines that the estimated costs that would be incurred to immediately convert the asset to cash are not significant, then receipt of that asset puts the entity in a position not substantially different from net settlement. Therefore, an entity must evaluate, in part, the significance of the estimated costs of converting the asset to cash in determining whether those assets are readily convertible to cash. For purposes of assessing significance of such costs, an entity should consider those estimated conversion costs to be significant only if they are 10 percent or more of the gross sales proceeds (based on the spot price at the inception of the contract) that would be received from the sale of those assets in the closest or most economical active market. The assessment of the significance of those conversion costs should be performed only at inception of the contract.

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Title: Definition of a Derivative: Determination of an Underlying When a Commodity Contract Includes a Fixed Element and a Variable Element
Paragraph references: 7, 29(g)(2), 57
Date cleared by Board: June 28, 2000

Revised September 25, 2000

QUESTIONS

1. Is a commodity contract between two parties to transact a fixed quantity at a specified future date at a fixed price (such as the commodity's forward price at the inception of the contract) a derivative, assuming that the characteristics of notional amount, underlying, and no initial net investment are present and the commodity to be delivered is readily convertible to cash pursuant to paragraph 9(c)?
2. Is a commodity contract between two parties to transact a fixed quantity at a specified future date at whatever the prevailing market price might be at that future date a derivative, assuming that the characteristics of notional amount, underlying, and no initial net investment are present and the commodity to be delivered is readily convertible to cash pursuant to paragraph 9(c)?
3. Commodity contracts commonly have features of both fixed-price contracts and floating-price contracts, such as an agreement to purchase a commodity in the future at the prevailing market index price at that future date plus or minus a fixed "basis differential" set at the inception of the contract. Assume that the characteristics of notional amount, underlying, and no initial net investment are present and the commodity to be delivered is readily convertible to cash pursuant to paragraph 9(c).

    a. Is this type of mixed-attribute contract a derivative?
    b. If this type of mixed-attribute contract is a derivative, can it be designated as the sole hedging instrument in a cash flow hedge of the anticipated purchase or sale of the commodity?

BACKGROUND

An example of a commodity contract containing features of both fixed-price contracts and floating-price contracts is a transaction between a buyer and seller of crude oil. The buyer is a refinery that seeks to use the crude oil in the production of unleaded gasoline. The buyer agrees in January to buy 1,000,000 barrels of a specific type of crude oil in July from the seller at the July 1 West Texas Intermediate (WTI) index price plus $1.00 per barrel. The contract appears to be primarily a floating price contract, but includes a fixed margin above that price. (If the buyer or the seller no longer wants exposure to fluctuations in WTI between January and July, it will separately use the futures market to "fix" the WTI portion of the contract.)

The fixed $1.00 differential is commonly referred to as the "basis" differential, but it reflects multiple factors, such as timing, quality, and location. If not fixed, the basis differential can be

very volatile, because it captures the passage of time (a financing element), changes in relative value of different qualities (or grades) of crude to each other (light v. heavy, sweet v. sour), and changes in the attractiveness of locations from the central pricing hub (Cushing, Oklahoma) relative to each other factor. Supply and demand is a critical factor in influencing the changes in basis due to quality and location; for example, an increase in imports of light crude through the Gulf of Mexico corridor will tend to lower the basis differential for light crude (falling prices due to increased supply) and tend to direct domestic supplies of light crude to northern U.S. locations (because the foreign oil fills southern U.S. demand), lowering the basis differential for contracts calling for delivery at northern points (again due to increased supply in the North). The basis differential therefore is not a simple fixed "transport" charge, but rather a complex and volatile variable in itself. For this reason, energy traders may specialize solely in "trading basis" and seeking the most attractive differential at all times relative to WTI—fixing and unfixing basis by selling contracts back to counterparties or entering into offsetting contracts with third parties.

RESPONSE

Question 1

Yes, the fixed-price commodity contract is a derivative instrument because it meets all the criteria in paragraph 6, including having an underlying (namely, the price of the commodity), as required by paragraph 6(a)(1). The contract's fair value will change as the underlying changes because the contract price is not the prevailing market price at the future transaction date.

A party to this contract would need to determine if the "normal purchases and normal sales" exception in paragraph 10(b) applies to the contract.

Question 2

Yes, the variable-price commodity contract is a derivative instrument because it meets all the criteria in paragraph 6, including having an underlying (namely, the price of the commodity), as required by paragraph 6(a)(1). However, because the contract price is the prevailing market price at the future transaction date, the variable-price commodity contract would not be expected to have a fair value other than zero.

A party to this contract would need to determine if the "normal purchases and normal sales" exception in paragraph 10(b) applies to the contract.

Question 3A

Yes, the whole mixed-attribute contract is a derivative because the basis differential is a market variable in determining the final transaction price under the contract, and this variable has been fixed in the contract, producing an underlying. (If the differential was a market pricing convention that typically would not be expected to change, the contract would be a derivative with very minor, if any, fluctuations in fair value.) The fact that the base commodity price in the contract is a floating variable will help to mute the fluctuations in fair value of the contract as a whole, but there still will be potential changes in fair value of the overall contract because of the

fixed-basis element. A party to this contract would need to determine if the "normal purchases and normal sales" exception applies to the contract.

Question 3B

Typically not. Since that mixed-attribute contract has an underlying related solely to changes in the basis differential, that contract (as a derivative) would generally not be sufficiently effective if designated as the sole hedging instrument in a cash flow hedge of the anticipated purchase or sale of the commodity—a forecasted transaction whose variability in cash flows is based on changes in both the basis differential and the base commodity price.

Because its underlying relates solely to changes in the basis differential, the mixed-attribute contract would essentially be hedging only a portion of the variability in cash flows. The entity is not permitted to designate a cash flow hedging relationship as hedging only the change in cash flows attributable to changes in the basis differential. Paragraph 29(g)(2), as amended by FASB Statement No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*, states that if the hedged transaction is the forecasted purchase or sale of a nonfinancial asset, the designated risk being hedged must be either foreign exchange risk (which does not apply in this example) or "the risk of changes in the cash flows relating to all changes in the purchase price or sales price of the asset reflecting its actual location if a physical asset (regardless of whether that price and the related cash flows are stated in the entity's functional currency or a foreign currency), not the risk of changes in the cash flows relating to the purchase or sale of a similar asset in a different location or of a major ingredient." That paragraph permits no other bifurcation of risk in designating the hedged risk. For an entity to be able to conclude that the hedging relationship proposed in Question 3B (in which the mixed-attribute contract [as a derivative] is the sole hedging instrument in a cash flow hedge of the anticipated purchase or sale of the commodity) is expected to be highly effective in achieving offsetting cash flows, the entity would need to consider the likelihood of changes in the base commodity price as remote or insignificant to the variability in hedged cash flows (for the total purchase or sales price).

However, the mixed-attribute contract may be combined with another derivative whose underlying is the base commodity price, with the combination of those derivatives designated as the hedging instrument in a cash flow hedge of the overall variability of cash flows for the anticipated purchase or sale of the commodity. Such a combination would address the risk of changes in both the basis differential and the base commodity price.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Definition of a Derivative: Impact of Daily Transaction Volume on Assessment of Whether an Asset Is Readily Convertible to Cash
Paragraph references:	9(c), footnote 5 (to paragraph 9)
Date cleared by Board:	June 28, 2000

QUESTIONS

Question 1

An investor holds a convertible bond classified as an available-for-sale security under FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. The convertible bond is not exchange-traded and can be converted into common stock of the debtor, which is traded on an exchange. The convertible bond has a face amount of $100 million and is convertible into 10 million shares of common stock. The bond may be converted in full or in increments of $1,000 immediately or at any time during the next 2 years. If the debt were converted in a $1,000 increment, the investor would receive 100 shares of common stock. The market condition for the debtor's stock is such that up to 500,000 shares of its stock can be sold rapidly without the share price being significantly affected. For purposes of this issue, the embedded conversion option meets the criteria in paragraphs 6(a) and 6(b) but does not meet the criteria in paragraphs 9(a) and 9(b), in part because the option is not traded and it cannot be separated and transferred to another party.

From the investor's perspective, does the convertible bond contain an embedded derivative that must be separately accounted for?

It is clear that the embedded equity conversion feature is not clearly and closely related to the debt host instrument. In determining whether the embedded derivative meets the definition of a derivative, it is not clear whether the equity conversion feature meets the net settlement criteria in paragraph 9(c) because the bond may be converted in $1,000 increments and those increments, by themselves, may be sold rapidly without significantly affecting price, in which case the criteria in paragraph 9(c) would be met. However, if the holder simultaneously converted the entire bond, or a significant portion of the bond, the shares received could not be readily converted to cash without incurring a significant block discount.

Question 2

Would the answer to Question 1 change if, instead, the investor had 100,000 individual $1,000 bonds that each convert into 100 shares of common stock? Assume those bonds are individual instruments but they were issued concurrently to the investor.

BACKGROUND

Paragraph 61(k) of Statement 133 states, in part, the following:

> …for a debt security that is convertible into a specified number of shares of the debtor's common stock or another entity's common stock, the embedded derivative (that is, the conversion option) must be separated from the debt host contract and accounted for as a derivative instrument provided that the conversion option would, as a freestanding instrument, be a derivative instrument subject to the requirements of this Statement. (For example, if the common stock was not readily convertible to cash, a conversion option that requires purchase of the common stock would not be accounted for as a derivative.)

As indicated in footnote 5, the term *readily convertible to cash* refers to assets that "have (i) interchangeable (fungible) units and (ii) quoted prices available in an active market that can rapidly absorb the quantity held by the entity without significantly affecting the price." That footnote also states, "For contracts that involve multiple deliveries of the asset, the phrase *in an active market that can rapidly absorb the quantity held by the entity* should be applied separately to the expected quantity in each delivery."

RESPONSE

Question 1

Yes. From the investor's perspective, the conversion option should be accounted for as a compound embedded derivative in its entirety, separately from the debt host, because the conversion feature allows the holder to convert the convertible bond in 100,000 increments and the shares converted in each increment are readily convertible to cash under paragraph 9(c). The investor need not determine whether the entire bond, if converted, could be sold without affecting the price. Because the $100 million convertible bond is convertible in increments of $1,000, the convertible bond is essentially embedded with 100,000 equity conversion options, each with a notional amount of 100 shares. Each of the equity conversion options individually has the characteristic of net settlement under paragraph 9(c) because the 100 shares to be delivered are readily convertible to cash. Because the equity conversion options are not clearly and closely related to the host debt instrument, they must be separately accounted for. However, because an entity cannot identify more than 1 embedded derivative that warrants separate accounting, the 100,000 equity conversion options must be bifurcated as a single compound derivative. That guidance is consistent with Statement 133 Implementation Issue No. B15, "Separate Accounting for Multiple Derivative Features Embedded in a Single Hybrid Instrument," which concludes that an entity is not permitted to account separately for more than one derivative feature embedded in a single hybrid instrument. There is a substantive difference between a $100 million convertible debt instrument that can be converted into equity shares only

at one time in its entirety and a similar instrument that can be converted in increments of $1,000 of tendered debt; the analysis of the latter should not presume equality with the former.

Question 2

From the investor's perspective, the individual bonds each contain an embedded derivative that must be separately accounted for. Each individual bond is convertible into 100 shares, and the market would absorb 100 shares without significantly affecting the price of the stock. Thus, the form of the financial instrument is important; individual instruments cannot be combined for evaluation purposes to circumvent compliance with the criteria in paragraph 9(c). That guidance is consistent with Statement 133 Implementation Issue No. A3, "Impact of Market Liquidity on the Existence of a Market Mechanism," that concludes that contracts should be evaluated on an individual basis, not on an aggregate-holdings basis.

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Title:	Definition of a Derivative: Whether Settlement Provisions That Require a Structured Payout Constitute Net Settlement under Paragraph 9(a)
Paragraph references:	6(c), 9(a), 57(c)(1)
Date cleared by Board:	December 6, 2000
Date revision posted to website:	May 1, 2003
Affected by:	FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* Revised March 26, 2003

QUESTIONS

Question 1

Upon settlement of a contract, in lieu of immediate net cash settlement of the gain or loss under the contract, the holder may receive a financial instrument involving terms that would provide for the gain or loss under the contract to be received or paid over a specified time period. Does a contract meet the characteristic of net settlement in paragraph 9(a) (and related paragraph 57(c)(1)) of Statement 133 if it provides for a structured payout, rather than immediate payout, of the gain or loss resulting from that contract?

Question 2

Would the answer to Question 1 change if, instead, the holder were required to invest funds in or borrow funds from the other party so that the party in a gain position under the contract can obtain the value of that gain only over time as an adjustment of either the yield on the amount invested or the interest element on the amount borrowed?

BACKGROUND

Paragraph 6 of Statement 133 states, in part:

> A derivative instrument is a financial instrument or other contract with all three of the following characteristics…
>
> c. Its terms require or permit net settlement, it can readily be settled net by a means outside the contract, or it provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

Paragraph 9(a) states, in part: "Neither party is required to deliver an asset that is associated with the underlying and that has a principal amount, stated amount, face value, number of shares, or other denomination that is equal to the notional amount…."

Paragraph 57(c)(1) states, in part: "Net settlement may be made in cash or by delivery of any other asset, whether or not it is readily convertible to cash."

RESPONSE

Question 1

Yes. A contract that provides for a structured payout of the gain (or loss) resulting from that contract meets the characteristic of net settlement in paragraph 9(a) (and related paragraph 57(c)(1)) of Statement 133 if the fair value of the cash flows to be received (or paid) by the holder under the structured payout are approximately equal to the amount that would have been received (or paid) if the contract had provided for an immediate payout related to settlement of the gain (or loss) under the contract. The fact that a contract accomplishes settlement by requiring the party in a loss position under the contract to make cash payments over a specified timeframe to the party in a gain position (in lieu of immediate cash settlement of the gain) does not preclude the contract from meeting the characteristic of net settlement in paragraph 9(a). Paragraph 57(c)(1) contemplates that net settlement may be made in the form of cash or any other asset (such as the right to receive future payments), which need not be readily convertible to cash.

Question 2

Generally, yes, the different facts assumed under Question 2 result in a conclusion that differs from the answer to Question 1. The structured payout discussed in Question 1 is substantively different from contractual terms that require one party to the contract to invest funds in or borrow funds from the other party so that the party in a gain position under the contract can obtain the value of that gain only over time as a traditional adjustment of the yield on the amount invested or the interest element on the amount borrowed. A fixed-rate mortgage loan commitment is an example of a contract that requires the party in a gain position under the contract to borrow funds at a below-market interest rate at the time of the borrowing in order to obtain the benefit of that gain. A contract that requires such additional investing or borrowing to obtain the benefits of the contract's gain only over time as a traditional adjustment of the yield on the amount invested or the interest element on the amount borrowed does not meet the characteristic of net settlement in paragraph 9(a).

Contracts that require one party to the contract to invest funds in or borrow funds from the other party so that the party in a gain position under the contract can obtain the value of that gain over time as a *nontraditional* adjustment of the yield on the amount invested or the interest element on the amount borrowed may meet the characteristic of net settlement in paragraph 9(a). A structured payout of the gain on a contract (as discussed in Question 1) could also be described as an abnormally high yield on a required investment or borrowing in which the overall return is related to the amount of that contract's gain, in which case the contract would be considered to have met the characteristic of net settlement in paragraph 9(a). For example, if a contract required the party in a gain position under the contract to invest $100 in the other party's debt

instrument that paid an abnormally high interest rate of 5,000 percent per day for a term whose length is dependent on the changes in the contract's underlying, an analysis of those terms would lead to the conclusion that the contract's settlement terms were in substance a structured payout of the contract's gain (as discussed in the Response to Question 1) and thus that contract would be considered to have met the characteristic of net settlement in paragraph 9(a).

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Title:	Definition of a Derivative: Derivative Treatment of Stock Purchase Warrants Issued by a Company for Its Own Shares of Stock Where the Subsequent Sale or Transfer Is Restricted
Paragraph references:	9(c), footnote 5 (to paragraph 9), 57(c)(3)
Date cleared by Board:	December 6, 2000
Date latest revision posted to website:	May 1, 2003
Affected by:	FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* Revised March 26, 2003

QUESTION

How should stock purchase warrants be evaluated under Statement 133 if those warrants restrict the sale or transfer of the shares received upon exercise of the warrant for a period of time from the exercise date?

BACKGROUND

Paragraph 9(c) of Statement 133 provides that a contract that requires delivery of the assets associated with the underlying has the characteristic of net settlement if those assets are *readily convertible to cash*. Footnote 5 to that paragraph makes explicit reference to the use of the phrase *readily convertible to cash* in paragraph 83(a) of FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises.*

Paragraph 57(c)(3), as amended by Statement 149, states:

> Shares of stock in a publicly traded company to be received upon the exercise of a stock purchase warrant do not meet the characteristic of being readily convertible to cash if both of the following conditions exist: (a) the stock purchase warrant is issued by an entity for only its own stock (or stock of its consolidated subsidiaries) and (b) the sale or transfer of the issued shares is restricted (other than in connection with being pledged as collateral) for a period of 32 days or more from the date the stock purchase warrant is exercised. In contrast, restrictions imposed by a stock purchase warrant on the sale or transfer of shares of stock that are received from the exercise of that warrant issued by an entity for *other* than its own stock (whether those restrictions are for more or less than 32 days) do not affect the determination of whether those shares are readily convertible to cash. The accounting for restricted stock to be received upon exercise of a stock purchase warrant should not be analogized to any other type of contract.

Statement 133 Implementation Issue No. A10, "Assets That Are Readily Convertible to Cash," provides certain guidance that interprets the phrase *readily convertible to cash.* Implementation Issue A10 states the following:

> An asset (whether financial or nonfinancial) can be considered to be *readily convertible to cash*, as that phrase is used in paragraph 9(c), only if the net amount of cash that would be received from a sale of the asset in an active market is either equal to or not significantly less than the amount an entity would typically have received under a net settlement provision.
>
> …an entity must evaluate, in part, the significance of the estimated costs of converting the asset to cash in determining whether those assets are readily convertible to cash. For purposes of assessing significance of such costs, an entity should consider those estimated conversion costs to be significant only if they are 10 percent or more of the gross sales proceeds (based on the spot price at the inception of the contract) that would be received from the sale of those assets in the closest or most economical active market.

Example

A company acquires a warrant to purchase shares of common stock in the publicly traded entity that issued the stock purchase warrant in exchange for cash, goods, services, or other consideration. The stock purchase warrant has no net settlement provision and there is no market mechanism to facilitate net settlement that would cause the warrant to meet the net settlement criteria as described in paragraphs 9(a) and 9(b) of Statement 133. The underlying common stock is publicly traded in an active market and the number of shares to be delivered under the stock purchase warrant is small relative to the daily transaction volume. Under the terms of the stock purchase warrant contract, the shares of common stock to be received upon exercise of the warrant are restricted from sale or transferability for a period of time that begins on the date of exercise, for example, from a one-day period to a several-month period. Once saleable or transferable, costs to deliver the shares to the active market and transaction costs are expected to be negligible.

RESPONSE

In accordance with paragraph 57(c)(3), as amended by Statement 149, newly outstanding shares of common stock in a publicly traded company to be received upon exercise of a stock purchase warrant cannot be considered *readily convertible to cash*, as that phrase is used in paragraph 9(c), if upon issuance of the shares, the sale or transfer of the shares is restricted (other than in connection with being pledged as collateral) for more than 31 days from the date the stock purchase warrant is exercised (not the date the warrant is issued) unless the holder has the power by contract or otherwise to cause the requirement to be met within 31 days of the date the stock purchase warrant is exercised. In contrast, if the sale of an actively traded security is restricted for 31 days or less from the date the stock purchase warrants are exercised, that limitation is *not* considered sufficiently significant to serve as an impediment to considering the shares to be received upon exercise of those stock purchase warrants as *readily convertible to cash*, as that phrase is used in paragraph 9(c). The guidance in this Implementation Issue that a restriction for more than 31 days prevents the shares from being considered *readily convertible to cash* applies only to stock purchase warrants issued by a company for its own shares of stock, in

which case the shares being issued upon exercise are newly outstanding (including issuance of treasury shares) and are restricted with respect to their sale or transfer for a specified period of time beginning on the date the stock purchase warrant is exercised.

However, even if the sale or transfer of the shares is restricted for 31 days or less after the stock purchase warrant is exercised, an entity still must evaluate whether an active market can rapidly absorb the quantity of stock to be received upon exercise of the warrant without significantly affecting the price and whether the other estimated costs to convert the stock to cash are expected to be not significant. The assessment of the significance of those conversion costs should be performed only at inception of the contract. Thus, the guidance in Implementation Issue A10 must be applied to those stock purchase warrants with sale or transfer restrictions of 31 days or less on the shares of stock.

If the shares of an actively traded common stock to be received upon exercise of the stock purchase warrant can be reasonably expected to qualify for sale within 31 days of their receipt, such as may be the case under Rule 144 or similar rules of the SEC, any initial sales restriction is not an impediment to considering those shares as *readily convertible to cash*, as that phrase is used in paragraph 9(c). (However, a restriction on the sale or transfer of shares of stock that are received from an entity other than the issuer of that stock through the exercise of another option or the settlement of a forward contract is not an impediment to considering those shares *readily convertible to cash*, regardless of whether the restriction is for a period that is more or less than 32 days from the date of exercise or settlement.)

The consensus in EITF Issue No. 96-11, "Accounting for Forward Contracts and Purchased Options to Acquire Securities Covered by FASB Statement No. 115," would continue to apply to those warrants that are not derivatives subject to Statement 133 but that involve the acquisition of securities that will be accounted for under FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. However, such warrants are not eligible to be hedging instruments.

EFFECTIVE DATE

The revisions made on April 9, 2002, emphasize that the guidance regarding a 32-day-or-more restriction that prevents the shares that are delivered upon exercise from being considered *readily convertible to cash* applies only to stock purchase warrants issued by a company for its own shares of stock. The effective date of the April 9, 2002 revisions to the implementation guidance in this Issue for each reporting entity is the first day of its first fiscal quarter beginning after April 10, 2002, the date that the revised Board-cleared guidance was posted to the FASB website. The revision made on June 27, 2001, involved the deletion of the penultimate paragraph in the guidance that was cleared on December 6, 2000. The effective date of the June 27, 2001, revised implementation guidance in this Issue was August 1, 2001. That revised implementation guidance applied to all stock purchase warrants issued on or after August 1, 2001. Contracts

entered into prior to August 1, 2001, are not subject to the revisions made on April 9, 2002, and June 27, 2001. Likewise, contracts entered into on or after August 1, 2001, are subject to the revisions made on both April 9, 2002, and June 27, 2001. The revisions made on March 26, 2003 do not affect the effective date.

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Title:	Definition of a Derivative: Effect of Offsetting Contracts on the Existence of a Market Mechanism That Facilitates Net Settlement
Paragraph references:	9(b), 57(c)(2), 261
Date cleared by Board:	December 6, 2000
Date revision posted to website:	March 8, 2004 Revised March 13, 2002

QUESTION

Does the ability to enter into an offsetting contract, in and of itself, constitute a "market mechanism that facilitates net settlement" as defined by paragraph 9(b) of Statement 133? In other words, is an offsetting contract, by its very nature, viewed as relieving a party of all rights and obligations under the original contract, or does it instead impose a different set of new rights and obligations?

BACKGROUND

Paragraph 9(b) of Statement 133 states that a contract meets the net settlement criteria in paragraph 6(c) if there is a market mechanism that facilitates net settlement, for example, an exchange that offers a ready opportunity to sell the contract or enter into an offsetting contract. Paragraph 57(c)(2) states that the term *market mechanism* is to be interpreted broadly. Any institutional arrangement or other agreement that enables either party to be relieved of all rights and obligations under the contract and to liquidate its net position without incurring a significant transaction cost is considered net settlement.

Statement 133 Implementation Issue No. A21, "Existence of an Established Market Mechanism That Facilitates Net Settlement under Paragraph 9(b)," provides detailed guidance about what constitutes an established market mechanism that facilitates net settlement under paragraph 9(b) of Statement 133. It also identifies the four primary characteristics that an established market mechanism as contemplated by paragraph 9(b) must have. Assume a broker-dealer stands ready to buy and sell a non-exchange-traded commodity forward contract that would relieve either party to the contract of its obligation to make (or right to accept) delivery of the commodity and its right to receive (or obligation to make) payment under the contract by arranging for a broker-dealer to make or accept delivery and paying the broker-dealer a commission plus any difference between the contract price and the current market price of the commodity. That arrangement is considered a market mechanism under paragraph 9(b). In contrast, an agreement whereby the broker-dealer will merely make (or accept) delivery on behalf of an entity is not viewed as a market mechanism that relieves the entity of its rights and obligations under the contract and is thereby not viewed as a market mechanism.

For example, party A contracts to sell a commodity such as iron ore to party B at a fixed price, and B offsets its purchase contract by entering into a separate contract to sell the same

commodity to party C at a different fixed price, instructing A to deliver directly to C. If A fails to deliver to C, C will legally look to B for remedy, not A. Even absent failure to perform, B will still pay A, and C will pay B, even though A may deliver directly to C. Assume the contracts in this series have an underlying and a notional and, therefore, they will at any given point in time have a positive or negative fair value.

For the purposes of this question, assume that the contract would not qualify for the normal purchases and sales exception under paragraph 10(b) (as amended). Also, assume that the asset associated with the underlying is not readily convertible to cash under paragraph 9(c).

RESPONSE

No. Consistent with paragraph 57(c)(2) and the guidance in Implementation Issue A21, the ability to enter into an offsetting contract, in and of itself, does not constitute a market mechanism because the rights and obligations from the original contract survive. The fact that an entity has *offset* its rights and obligations under an original contract with a new contract does not by itself indicate that its rights and obligations under the original contract have been *relieved*. The guidance in this issue applies to contracts regardless of whether the asset associated with the underlying is financial or nonfinancial. In addition, the guidance in this issue applies regardless of whether the offsetting contract is entered into with the same counterparty as the original contract or a different counterparty, unless an offsetting contract with the same counterparty relieves the entity of its rights and obligations under the original contract, in which case the arrangement does constitute a market mechanism.

The example arrangement discussed in the background section does not constitute a market mechanism because party B is not relieved of its rights and obligations from the original contract. The original contract survives and is not actually sold. The offsetting contract carries a new set of legal rights and obligations; however, those rights and obligations generally *offset*, rather than *relieve*, the original contract's set of legal rights and obligations. In contrast, a mercantile exchange that trades futures contracts offers a ready opportunity to enter into an offsetting contract that can precisely cancel the rights and obligations of another futures contract (because the counterparty legally is the futures exchange itself), and thus the mercantile exchange does constitute a market mechanism.

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Title:	Definition of a Derivative: Synthetic Guaranteed Investment Contracts
Paragraph reference:	6
Date cleared by Board:	March 14, 2001
Date posted to website:	April 10, 2001

QUESTION

From the perspective of the issuer of the contract, do synthetic guaranteed investment contracts meet Statement 133's definition of a *derivative instrument*?

BACKGROUND

Definition of a Traditional GIC

Before considering the derivative implications of a synthetic guaranteed investment contract (GIC), a traditional GIC must be understood. In a traditional GIC, the issuer of the contract takes deposits from a benefit plan or other institutional customer and purchases investments that are held in its general account. (Equity investments may also be acquired, although they are less common than fixed income investments.) The benefit plan is a creditor of the issuing company and therefore has credit risk, although generally the GIC issuers have a high credit-quality rating. The issuer is contractually obligated to repay the principal and specified interest guaranteed to the benefit plan. The plan's provisions typically permit the participant to withdraw funds from the fund at book value (also referred to as account or contract value) for specified reasons, such as loans, hardship withdrawals, and transfers to other investment options offered by the plan. A benefit-responsive GIC contains provisions that mirror the plan's participant-directed withdrawal/transfer provisions. Therefore, the issuer is at risk that interest rates could increase, reducing the price of the fixed-income investments backing the GIC liability, while those investments may have to be sold at a loss to cover withdrawals. (Traditional GICs are accounted for based on FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments.)*

Definition of a Synthetic GIC

A synthetic GIC is a contract that simulates the performance of a traditional GIC through the use of financial instruments. A key difference between a synthetic GIC and a traditional GIC is that the policyholder (such as a benefit plan) owns the assets underlying the synthetic GIC. (With a traditional GIC, the policyholder owns only the contract itself that provides the plan with a call on the contract issuer's assets in the event of default.) Those assets may be held in a trust owned by the policyholder and typically consist of government securities, private and public mortgage-backed securities, and other asset-backed securities, and investment grade corporate obligations. To enable the policyholder to realize a specific known value for the assets if it needs to liquidate them, synthetic GICs utilize a "wrapper" contract that provides market and cash flow risk protection to the policyholder. This wrapper or guarantee may be provided in a variety of

structures. In one structure, the issuer provides cash advances to fund the policyholder's cash withdrawal requirements if the invested asset values have decreased. Other structures include:

1. A swap agreement whereby the synthetic GIC issuer exchanges a fixed return for the market value of supporting assets, if needed for benefit payments.
2. An agreement by the issuer to buy assets at book value if a sale is needed to make benefit payments.
3. A payment upon termination of the contract equal to the difference between a hypothetical book value of plan assets and their market value. (Provisions of benefit responsive traditional GICs and synthetic GICs generally prohibit the benefit plan and its sponsor from taking any actions that would encourage participant withdrawals and transfers.)

Synthetic GICs can be viewed as the issuer selling a put option to the policyholder. For many synthetic GICs, the option premium is in the form of a fee charged on the outstanding contract book value. For some forms of synthetic GICs, the option premium for the put option is not explicitly stated but, instead, is embedded in the determination of the investment return guaranteed to the policyholder.

In any of the structures, various methods can be used to limit the synthetic GIC issuer's exposure to net payments under the contract. In the current marketplace, most synthetic GICs pass many of the asset and cash flow related risks to the policyholder. Structures to limit such risk include the following:

- Reset of the crediting rate or maturity date: cash flow volatility (for example, timing of benefit payments) as well as asset underperformance can be passed through to the policyholder through adjustments to future contract crediting rates and/or contract maturities. Formulas are typically provided in the contract which adjust renewal crediting rates to recognize the difference between the fair value and book value of remaining assets in the segregated portfolio.
- Impaired securities may also be excluded directly from book value guarantees.
- Investment guidelines: carefully structured investment policy can limit significantly the cash volatility of assets in the segregated portfolio (for example, limit callable securities, mortgage backed securities, etc.).
- Buffer funds: cash and cash equivalents are maintained and are accessed first in order to fund benefit payments and thus limit the potential for synthetic GIC issuer's assets to be accessed to make benefit payments.
- Liquidation structure of pension plan: pro rata or tiered structures dictate the order of accessing various plan assets, including synthetic GIC assets, for benefit payments.

As with other types of GICs, the specific terms and conditions of synthetic GICs are negotiated on a case-by-case basis. However, those contracts fall into several broad structural categories, as discussed in the attachment.

The following hypothetical example illustrates concepts related to synthetic GICs.

On January 1, 2000, ABC issues a synthetic GIC contract to the XYZ Pension Fund. XYZ has a fixed return plan option that provides participants with a guaranteed 6 percent return for a 3-year period. The plan's invested assets consist of one public, $50 million par value, 6.50 percent, AA-rated, fixed-rate, non-callable, semi-annual payment bond that matures at par on December 31, 2002. (A simplistic assumption that is unrealistic since the plan would diversify its exposure by owning various bonds.) XYZ acquired the bond at par on January 1, 2000. ABC is charging XYZ 12 basis points per year on the $50 million plan balance, or $60,000 per year. Assume that the market yield applicable to this bond immediately increased to 8 percent and caused the following events to occur:

- The bond price decreased to $48,342,000.
- All plan participants requested that their funds be transferred to another plan fund.
- XYZ exercised its put option to transfer the bond to ABC in exchange for a $50 million cash payment.
- ABC honored its synthetic GIC obligation and acquired the bond for $50 million.
- XYZ used the $50 million proceeds to make the transfer of participant funds to the newly selected fund.

(Refer to the attachment for additional background material.)

RESPONSE

Yes. From the perspective of the issuer of the contract, synthetic GICs are derivatives under Statement 133. Paragraph 6 of Statement 133 defines a derivative instrument as a financial instrument or contract with the following three characteristics:

- It has one or more underlyings and one or more notional amounts or a payment provision.
- It requires no initial investment or an initial investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.
- Its terms require or permit net settlement, it can readily be settled net by a means outside the contract, or it provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

Synthetic GICs contain an underlying, the formula by which interest is calculated, and a notional amount. The interplay between the fair value of a portfolio of segregated assets and a notional amount together determine the amount of the settlement(s), if any, due from the contract issuer, after considering all contract terms. Depending on the specifics of the contract, a synthetic GIC requires either no initial investment or the payment of a risk charge or fee (covering

either the entire contract or, more typically, an initial period of the contract). The terms of a synthetic GIC require net settlement since the issuer of the contract makes a payment to the holder equal to the net amount due.

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Attachment to No. A16

Synthetic GICs

Synthetic GICs fall into several broad structural categories, as follows:

- *Buy and Hold.* Typically, a "buy and hold" synthetic contract covers a limited class of assets, usually high-quality bonds expected to be held to maturity. There is no stated rate guarantee; instead, the interest rate is reset periodically as specified in the contract, subject to a specified floor—for example, 3 percent or zero percent. The term of the contract generally is consistent with the maturity of the underlying assets. Although buy-and-hold contracts are structured to permit participant withdrawals and transfers at book value, generally no withdrawals are expected. The arrangements between the benefit plan and the wrap provider typically contain provisions outlining operating and investing guidelines for the benefit plan. These guidelines are designed to ensure the availability of other sources of liquidity sufficient to satisfy expected levels of net participant-directed withdrawals and transfers, without the need to access the assets wrapped by the synthetic GIC. While participants can make withdrawals or transfers at book value, in most cases, the benefit plan can terminate the contract at the market value of the assets at any time, but it can withdraw at contract value only at maturity or earlier with a specified notification period.

- *Actively Managed.* With an actively managed synthetic GIC, the assets often are managed by an outside investment manager, but may be managed by the insurer. Generally, the contract is "evergreen"—that is, there is no specified maturity date—and there is no stated rate guarantee; instead, the interest rate is reset periodically as specified in the contract, subject to a specified floor, frequently zero percent and typically not less than zero percent. Participant-directed withdrawals and transfers are made at book value, with future interest returns adjusted to recognize the difference between the fair value and book value of the remaining assets covered by the synthetic GIC, but typically not below a zero interest rate. Benefit plan-initiated withdrawal provisions are similar to those for buy-and-hold GICs.

- *Fixed Rate/Fixed Maturity.* This contract is essentially the same as a traditional general account GIC. The synthetic GIC issuer guarantees a fixed rate for a fixed and certain term and assumes the investment risks and rewards of the assets. If the assets earn less than the guaranteed return, the insurance company absorbs the loss. If the assets earn more than was assumed in pricing, the income recognized by the insurer will be greater than the "wrap fee" assumed in the pricing. Typically, the insurer also will be the investment manager because of the assumption of investment risk.

Note that participant-initiated withdrawals and transfers of fixed-rate/fixed-maturity contracts are permitted at book value but are expected to occur infrequently. Withdrawals initiated by the benefit plan generally are permitted only at the market value of the assets and the guarantee is not activated.

Title:	Definition of a Derivative: Contracts That Provide for Net Share Settlement
Paragraph references:	6(c), 9(a), 57(c)(1)
Date cleared by Board:	March 21, 2001
Date posted to website:	April 10, 2001
Date revision posted to website:	May 1, 2003
Affected by:	FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* Revised March 26, 2003

QUESTION

If an option, warrant, or other contract provides for net share settlement as a settlement alternative, would that provision meet the net settlement criterion in paragraphs 6(c), 9(a), and 57(c)(1) as delivery of "any other asset, whether or not it is readily convertible to cash"?

BACKGROUND

Some contracts contain provisions that provide for net share settlement as a settlement alternative. Under net share settlement of an option or warrant to purchase common stock, the party with a loss delivers to the party with a gain an amount of common shares (which is the asset related to the underlying) with a current fair value equal to the gain. In some instances, the shares delivered in a net share settlement are restricted from sale for a period of at least 32 days.

For example, Company A has a warrant to buy 100 shares of the common stock of Company X at $10 a share. Company X is a privately held company. The warrant provides Company X with the choice of settling the contract on a physical basis (gross 100 shares) or a net share basis. The stock price increases to $20 a share. Instead of Company A paying $1,000 cash and taking full "physical" delivery of the 100 shares, the contract is net share settled and Company A receives 50 shares[1] of stock without having to pay any cash for them. (Net share settlement is sometimes described as a "cashless" exercise.)

Paragraph 6(c) states the net settlement characteristic of a derivative instrument as follows:

> Its terms require or permit net settlement, it can readily be settled net by a means outside the contract, or it provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

[1] Computed as the warrant's $1,000 fair value upon exercise divided by the $20 stock price at that date.

Paragraph 9 states, in part:

> *Net settlement*. A contract fits the description in paragraph 6(c) if its settlement provisions meet one of the following criteria:
>
> a. Neither party is required to deliver an asset that is associated with the underlying and that has a principal amount, stated amount, face value, number of shares, or other denomination that is equal to the notional amount (or the notional amount plus a premium or minus a discount).

RESPONSE

Yes. The net settlement criterion as described in paragraph 6(c) and related paragraphs of Statement 133 is met if the contract provides for net share settlement at the election of either party. Paragraph 57(c)(1) clarifies the definition of net settlement in paragraph 9(a) by stating, in part:

> [The contract's] terms implicitly or explicitly require or permit net settlement.…Net settlement may be made in cash *or by delivery of any other asset, whether or not it is readily convertible to cash.* [Emphasis added.]

Therefore, if either counterparty could net share settle the contract, then it would be considered a derivative, regardless of whether the net shares received were readily convertible to cash as described in paragraph 9(c) or were restricted for more than 31 days. Paragraph 57(c)(1) is explicit in stating that *any* form of net settlement, which would include net share settlement of an option on a nonpublic company's common stock, would satisfy the net settlement requirement of a derivative.

While this conclusion applies to both investors and issuers of contracts, issuers of those net share settled contracts should consider whether such contracts qualify for the scope exception in paragraph 11(a) of Statement 133.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Definition of a Derivative: Application of Market Mechanism and Readily Convertible to Cash Subsequent to the Inception or Acquisition of a Contract
Paragraph references:	6(c), 9(b), 9(c), 57
Date cleared by Board:	September 19, 2001
Date posted to website:	October 10, 2001
Date latest revision posted to website:	June 10, 2003
Affected by:	FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity* Revised May 27, 2003

QUESTIONS

1. Does the evaluation of whether a market mechanism exists (under paragraph 9(b)) and whether items to be delivered under a contract are readily convertible to cash (under paragraph 9(c)) have to be performed only at inception or acquisition of a contract or continuously during the contract's life?
2. If those evaluations must be performed continuously during the contract's life, what is the accounting at the subsequent date when it is determined that the contract then meets, or ceases to meet, the definition of a derivative in Statement 133?

BACKGROUND

Paragraph 57(c)(2), as amended by Statement 149, states, "The evaluation of whether a market mechanism exists and whether items to be delivered under a contract are readily convertible to cash must be performed at inception and on an ongoing basis throughout a contract's life." In addition, the footnote to paragraph 57(c)(3), added by Statement 149, states, "The evaluation of *readily convertible to cash* shall be applied to a contract throughout its life."

Statement 133 Implementation Issue No. A10, "Assets That Are Readily Convertible to Cash," addresses how the significance of transaction costs should be evaluated when determining if an asset is readily convertible to cash in an active market. Implementation Issue A10 establishes a 10 percent threshold but indicates that the threshold should be applied "only at inception of the contract" in determining the significance of transaction costs.

The following examples are relevant to the above two questions:

Example 1

A purchase contract for future delivery of commodity X is entered into and, at the inception of the contract, the market for contracts on commodity X is a relatively thin market, such that

brokers do not stand ready to buy and sell the contracts. As time passes, the market for commodity X matures and broker-dealer networks develop. The existence of the broker-dealer market and the ability of the purchaser to be relieved of its rights and obligations under the purchase contract are consistent with the characteristics of a market mechanism discussed in Statement 133 Implementation Issue No. A21, "Existence of an Established Market Mechanism That Facilitates Net Settlement under Paragraph 9(b)." Accordingly, the purchase contract will have the characteristics of net settlement as defined by paragraph 9(b) of Statement 133 as broker-dealer networks develop.

Example 2

A nontransferable forward contract on a nonpublic company's stock that provides only for gross physical settlement is generally not a derivative instrument because the net settlement criteria are not met. If the company, at some point in the future, accomplishes an initial public offering (IPO) of its shares and the original contract is still outstanding, the shares to be delivered would be considered to be readily convertible to cash (assuming that the shares under the contract could be rapidly absorbed in the market without significantly affecting the price). Question 1 asks whether this subsequent evaluation of the contract should be made, thereby causing a contract that was not previously accounted for as a derivative to meet the definition of a derivative.

Example 3

A nontransferable forward contract on a public company's stock provides for delivery on a single date of a significant number of shares that, at the inception of the contract, would significantly affect the price of the company's stock in the market if sold within a few days. As a result, the contract does not satisfy the readily-convertible-to-cash criterion. However, at some later date, the trading activity of the company's stock increases significantly. Upon a subsequent evaluation of whether the shares are readily convertible to cash, the number of shares to be delivered would be minimal in relation to the new average daily trading volume such that the contract would then satisfy the net settlement characteristic. Question 1 asks whether this subsequent evaluation of the readily-convertible-to-cash-criterion has to be made.

Example 4

A nontransferable forward contract on a public company's stock meets the net settlement criteria in paragraph 9(c) in that, at inception of the contract, the shares are expected to be readily convertible to cash when delivered under the contract. Assume that there is no other way that the contract meets the net settlement criteria. The public company subsequently becomes delisted from the stock exchange, thus causing the shares to be delivered under the contract to no longer be readily convertible to cash. Question 1 asks whether the subsequent evaluation should be made, resulting in the contract ceasing to meet the definition of a derivative.

RESPONSE

Question 1

As required by paragraph 57(c)(3), as amended by Statement 149, the evaluation of whether a market mechanism exists and whether items to be delivered under a contract are readily convertible to cash must be performed at inception and on an ongoing basis throughout a contract's life. If events occur subsequent to the inception or acquisition of a contract that cause the contract to meet the definition of a derivative instrument, then that contract must be accounted for at that later date as a derivative under Statement 133. For example, if a market develops, if a company effects an IPO, or if daily trading volume changes for a sustained period of time, then those events need to be considered in re-evaluating whether the contract meets the definition of a derivative. An entity should refer to the guidance in Implementation Issue A10 when determining whether such a contract meets the definition of a derivative. Similarly, if events occur subsequent to the inception or acquisition of a contract that would cause a contract that previously met the definition of a derivative to cease meeting the criteria (for example, a company becomes delisted from a national stock exchange), then that contract cannot continue to be accounted for under Statement 133. The guidance in Implementation Issue A10 about assessing the significance of transaction costs is not relevant when determining whether such a contract no longer meets the definition of a derivative.

Question 2

In accordance with the provisions of Statement 133, a contract that both meets the definition of a derivative and is subject to Statement 133 must be carried at fair value. Accordingly, if a contract meets the definition of a derivative subsequent to acquisition by an entity, the contract must be immediately recorded at its then-current fair value with the offsetting entry recorded in earnings. (Statement 133 does not provide guidance about the classification in the income statement of a derivative's gains or losses, including the adjustment to fair value for a contract that newly meets the definition of a derivative.) The contract may then be designated as a hedging instrument, provided that the hedge criteria of Statement 133 are met.

During the period in which the contract does not meet the definition of a derivative, that contract cannot be designated as the hedging instrument in any hedging relationship. (However, it should be noted that the contract could potentially be the hedged item in a fair value hedge or its cash flows could potentially be the hedged transactions in a cash flow hedge.) The contingent designation of a hedging relationship in which the hedging instrument is not currently a derivative but may become one cannot justify the application of hedge accounting to fair value changes occurring prior to inception of the hedge; the inception of that hedging relationship would be the date on which the contract meets the definition of a derivative. If an entity had anticipated that a contract that was not a derivative at inception might later meet the definition of a derivative and has made a contingent designation of an "all-in-one" hedging relationship (as discussed in Statement 133 Implementation Issue No. G2, "Hedged Transactions That Arise from Gross Settlement of a Derivative ('All-in-One' Hedges)") to be effective upon the date that the contract meets the definition of a derivative, only the changes in the fair value of

the new derivative contract occurring after the date the contract became a derivative would be recognized in other comprehensive income pursuant to paragraph 30(b). As noted above, when the contract's carrying amount is adjusted to fair value on the date that the contract meets the definition of a derivative, the offsetting entry must be recorded in current period earnings.

If a contract ceases to be a derivative pursuant to Statement 133 and an asset or liability had been recorded for that contract, the carrying amount of that contract becomes its cost basis and the entity should apply other generally accepted accounting principles that are applicable to that contract prospectively from the date that the contract ceased to be a derivative. If the derivative contract had been designated in a cash flow hedging relationship and a gain or loss is recorded in accumulated other comprehensive income, then provisions of paragraphs 31 and 32 of Statement 133 should be applied accordingly.

EFFECTIVE DATE

The effective date of the implementation guidance in this Issue for each reporting entity is the first day of its first fiscal quarter beginning after October 10, 2001, the date that the Board-cleared guidance was posted on the FASB website. The revisions made on March 26, 2003 do not affect the effective date.

REFERENCE

FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, was issued in May 2003. The Statement requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances).

Statement 150 does not impact the responses in this Implementation Issue. Under Statement 150, forward contracts that require physical settlement by repurchase of a fixed number of the issuer's equity shares in exchange for cash are measured initially at the amount of cash that would be paid under the conditions specified in the contract if the exchange occurred immediately. Those contracts are not considered to be derivative instruments of the reporting entity for purposes of Statement 133 (refer to paragraph 11(d), as amended by Statement 150). Therefore, those forward purchase contracts would not be subject to the requirements of Implementation Issue A18.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Definition of a Derivative: Impact of a Multiple-Delivery Long-Term Supply Contract on Assessment of Whether an Asset Is Readily Convertible to Cash
Paragraph references:	9(b), 9(c), footnote 5 (to paragraph 9), 57(c)
Date cleared by Board:	September 19. 2001
Date posted to website:	October 10, 2001

QUESTIONS

1. Does a 5-year commodity supply contract meet the net settlement characteristic in paragraph 9(b) and related paragraph 57(c)(2) of Statement 133 if a forward market for the commodity contract does not exist beyond the next 12 months even though a spot market exists?
2. Does a 5-year commodity supply contract meet the net settlement characteristic in paragraph 9(c) and related paragraph 57(c)(3) of Statement 133 if a forward market for the commodity does not exist beyond the next 12 months even though a spot market exists?

This Issue does not address whether or not the contract would qualify for the "normal purchases and normal sales" scope exception in paragraph 10(b) of Statement 133.

BACKGROUND

An entity has a five-year supply contract that obligates it to deliver at a specified price each month a specified quantity of a commodity that has interchangeable (fungible) units and for which quoted prices are available in an active market. However, the quoted prices that are available are for either a spot sale or a forward sale of the commodity with a maturity of 12 months or less. In other words, the forward market for the commodity beyond the next 12 months does not currently exist and is not expected to develop. There are brokers who are willing to take over the rights and obligations relating to the next 12 months of the supply contract, but not for periods beyond the next 12 months. With respect to the active spot market for the commodity, it can rapidly absorb the quantity specified in the supply contract for each individual month but not the total quantity for the entire five-year period in a single transaction (or in multiple transactions over the course of a day or so).

Paragraph 9 of Statement 133 states, in part:

> *Net settlement*. A contract fits the description in paragraph 6(c) if its settlement provisions meet one of the following criteria:
>
> a. Neither party is required to deliver an asset that is associated with the underlying.…
> b. One of the parties is required to deliver an asset of the type described in paragraph 9(a), but there is a market mechanism that facilitates net settlement, for example,

an exchange that offers a ready opportunity to sell the contract or to enter into an offsetting contract.

c. One of the parties is required to deliver an asset of the type described in paragraph 9(a), but that asset is readily convertible to cash [refer to footnote 5 below]….

Footnote 5 (to paragraph 9) states:

> FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, states that assets that are readily convertible to cash "have (i) interchangeable (fungible) units and (ii) quoted prices available in an active market that can rapidly absorb the quantity held by the entity without significantly affecting the price" (paragraph 83(a)). For contracts that involve multiple deliveries of the asset, the phrase *in an active market that can rapidly absorb the quantity held by the entity* should be applied separately to the expected quantity in each delivery.

Paragraph 57(c)(2) states, in part, that "Any institutional arrangement or other agreement that enables either party to be relieved of all rights and obligations under the contract and to liquidate its net position without incurring a significant transaction cost is considered net settlement."

The supply contract does not contain a net settlement provision as described in paragraph 9(a) and related paragraph 57(c)(1) of Statement 133.

RESPONSE

Question 1

No. The 5-year commodity supply contract does not meet the net settlement characteristic in paragraph 9(b) at its inception because there is no market mechanism to net settle the entire 5-year contract—the forward market exists only for the next 12 months while the contract period is for the next 5 years. Accordingly, there is no market mechanism for the company to settle the entire contract on a net basis. However, if the contract contained contractually separable increments that individually met the net settlement criteria, those contractually separable increments may be embedded derivatives.

In the example, the brokers in the market will not assume the rights and obligations of the entire contract. Note that the market mechanism in the net settlement characteristic in paragraph 9(b) relates to whether a party to the contract can be relieved of its rights and obligations under the entire contract, not merely whether an independent broker in the market stands ready to assume the selected rights and obligations.

The definition of a derivative in Statement 133 must be applied based on the actual terms of the contract, including its maturity date and the total quantity of the underlying. The Statement does not permit bifurcation of a 5-year contract into 5 annual contracts, 60 monthly contracts, or 1,826

daily contracts in an attempt to assert that only a portion of the contract meets the definition of a derivative. To do so would be to disregard one of the critical terms of the contract, that is, the term to the maturity date of the contract. The guidance to Question 2 in Statement 133 Implementation Issue No. A12, "Impact of Daily Transaction Volume on Assessment of Whether an Asset Is Readily Convertible to Cash," also emphasizes the importance of the terms of the individual contract.

Based on the guidance in Statement 133 Implementation Issue No. A18, "Application of Market Mechanism and Readily Convertible to Cash Subsequent to the Inception or Acquisition of a Contract," the five-year commodity supply contract in the example, would, at the beginning of the fifth year, be re-evaluated to determine whether the contract meets the net settlement characteristic in paragraph 9(b) and would likely meet the characteristic because a forward market for the contract would then exist for the remaining term of the contract.

Question 2

Yes. The five-year commodity supply contract meets the net settlement characteristic in paragraph 9(c) of Statement 133. The criterion in paragraph 9(c) is met because an active spot market for the commodity exists today and is expected to be in existence in the future for each delivery date (for example, for quantities to be delivered each day or each month for the next five years) under the multiple delivery supply contract. The spot market can rapidly absorb the quantities specified for each monthly delivery without significantly affecting the price.

The fact that the spot market may not be able to absorb within a few days the quantity specified in the entire five-year contract is irrelevant because the performance of the contract is spread out over a five-year period and, therefore, is not expected to occur within a few days. Footnote 5 indicates that, "for contracts that involve multiple deliveries of the asset, the phrase *in an active market that can rapidly absorb the quantity held by the entity* should be applied separately to the expected quantity in each delivery."

EFFECTIVE DATE

The effective date of the implementation guidance in this Issue for each reporting entity is the first day of its first fiscal quarter beginning after October 10, 2001, the date that the Board-cleared guidance was posted on the FASB website.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Definition of a Derivative: Existence of an Established Market Mechanism That Facilitates Net Settlement under Paragraph 9(b)
Paragraph references:	9(b), 57(c), 260–262
Date cleared by Board:	March 13, 2002
Dated posted to website:	April 10, 2002

QUESTION

What constitutes an established market mechanism that facilitates net settlement under paragraph 9(b) of Statement 133?

BACKGROUND

Paragraph 9 states, in part:

> *Net settlement*. A contract fits the description in paragraph 6(c) if its settlement provisions meet one of the following criteria:…
>
> b. One of the parties is required to deliver an asset of the type described in paragraph 9(a), but there is a market mechanism that facilitates net settlement, for example, an exchange that offers a ready opportunity to sell the contract or to enter into an offsetting contract.

Paragraph 57(c) states, in part:

> A contract that meets any one of the following criteria has the characteristic described as net settlement:…
>
> (2) There is an established market mechanism that facilitates net settlement outside the contract. The term *market mechanism* is to be interpreted broadly. Any institutional arrangement or other agreement that enables either party to be relieved of all rights and obligations under the contract and to liquidate its net position without incurring a significant transaction cost is considered net settlement.

Statement 133's basis for conclusions (paragraphs 260 and 261) states, in part:

> The Board focused in the Exposure Draft on whether there is a mechanism in the market for net settlement because it observed that many derivative instruments are actively traded and can be closed or settled before the contract's expiration or maturity by net settlement in active markets.

Respondents observed that the phrase *mechanism in the market* was unclear and could lead to different interpretations in practice. They asked whether *only* an organized exchange would constitute the type of market mechanism that the Board had in mind, or whether a willingness of market participants to enter into such a contract in the over-the-counter or other markets would require that the contract be viewed as a derivative instrument. This Statement responds to those questions by indicating in paragraph 57(c)(2) that the Board intends *market mechanism* to be interpreted broadly to include any institutional arrangement or side agreement that permits either party to be relieved of all rights and obligations under the contract and to liquidate its net position without incurring a significant transaction cost.

RESPONSE

Statement 133 indicates in paragraph 57(c)(2) that the term *market mechanism* should be interpreted broadly. That indicates that market mechanisms may have different forms. However, regardless of its form, an established market mechanism as contemplated by paragraph 9(b) must have all four of the primary characteristics described below. In addition, entities should consider the indicators below each of the primary characteristics in determining whether a method of settling a contract qualifies as an established market mechanism under paragraph 9(b). All of the indicators need not be present for an entity to conclude that a market mechanism exists for a particular contract.

1. *It is a means to settle a contract that enables one party to readily liquidate its net position under the contract.* A market mechanism is a means to realize the net gain or loss under a particular contract through a net payment. Net settlement may occur in cash or any other asset. A method of settling a contract that results only in a gross exchange or delivery of an asset for cash (or other payment in kind) does not satisfy the requirement that the mechanism facilitate net settlement as contemplated by paragraph 9(b).

   As discussed in Statement 133 Implementation Issue No. A3, "Impact of Market Liquidity on the Existence of a Market Mechanism," the assessment of whether a market mechanism exists under paragraph 9(b) should be performed on an individual contract basis, not on an aggregate-holdings basis.

   The following are indicators that primary Characteristic 1 is met:

   - Access to potential counterparties is available regardless of the seller's size or market position.
   - Risks assumed by a market maker as a result of acquiring a contract can be transferred by a means other than by repackaging the original contract into a different form.

2. *It results in one party to the contract becoming fully relieved of its rights and obligations under the contract*. A market mechanism enables one party to the contract to surrender all future rights or avoid all future performance obligations under the contract.

   Contracts that do not permit assignment of the contract from the original issuer to another party do not meet the characteristic of net settlement in paragraph 9(b). With respect to contracts that permit assignment, as discussed in Statement 133 Implementation Issue No. A7, "Effect of Contractual Provisions on the Existence of a Market Mechanism That Facilitates Net Settlement," an issuer must assess the substance of an assignment clause to determine whether it precludes the assigning party from being relieved of all rights and obligations under the commitment. If it is reasonably possible or probable that the counterparty will withhold permission to assign the contract, the issuer is prevented from accessing any market mechanism that may exist. As a result, the contract does not meet the characteristic of net settlement in paragraph 9(b). However, for contracts where there is no impediment to assignment (because it is explicitly permitted by the terms of the contract or assignment is allowed with the counterparty's permission and it is remote that the counterparty will withhold permission to assign the contract), an assessment must be made regarding the existence of a market mechanism under paragraph 9(b).

   Statement 133 Implementation Issue No. A15, "Effect of Offsetting Contracts on the Existence of a Market Mechanism That Facilitates Net Settlement," indicates that the ability to enter into an offsetting contract, in and of itself, does not constitute a market mechanism because the rights and obligations from the original contract survive (unless an offsetting contract with the same counterparty relieves the entity of its rights and obligations under the original contract). Generally, the offsetting contract carries a new set of legal rights and obligations, which *offset*, rather than *relieve,* the original contract's set of legal rights and obligations.

   The following are indicators that primary Characteristic 2 is met:

   - There are multiple market participants willing and able to enter into a transaction at market prices to assume the seller's rights and obligations under a contract.
   - There is sufficient liquidity in the market for the contract, as indicated by the transaction volume as well as a relatively narrow observable bid/ask spread.[1]

3. *Liquidation of the net position does not require significant transaction costs*. For the purposes of assessing whether a market mechanism exists under paragraph 9(b), an entity should consider transaction costs to be significant if they are 10 percent or more of the fair value of the contract.

[1] A bid/ask spread is the difference between the highest price a buyer will pay to acquire an instrument and the lowest price at which any investor will sell an instrument.

4. *Liquidation of the net position under the contract occurs without significant negotiation and due diligence and occurs within a time frame that is customary for settlement of the type of contract.* A market mechanism facilitates easy and expedient settlement of the contract. As discussed under primary Characteristic 1, those qualities of a market mechanism do not preclude net settlement in assets other than cash.

   The following are indicators that primary Characteristic 4 is met:

   - Binding prices for the instrument are readily obtainable.
   - Transfers of the instrument involve standardized documentation (rather than contracts with entity-specific modifications) and standardized settlement procedures.
   - Individual contract sales do not require significant negotiation and unique structuring.
   - The closing period is not extensive because of the need to permit legal consultation and document review.

EFFECTIVE DATE AND TRANSITION

The effective date of the implementation guidance in this Issue for each reporting entity is the first day of the first fiscal quarter beginning after April 10, 2002. If an entity had not accounted for a contract as a derivative in its entirety but is required to do so, the entity shall account for the effects of initially complying with the implementation guidance in this Issue prospectively for all existing contracts as of the effective date of this Issue and for all future transactions. In that case, the effects of initially applying this guidance should be reported as a change in accounting principle. If a contract that would not be accounted for as a derivative instrument under this Issue was previously accounted for as a derivative instrument, that accounting treatment shall not be changed. That is, for those contracts, this Issue applies prospectively only to transactions after the effective date.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Definition of a Derivative: Prepaid Interest Rate Swaps
Paragraph references:	6, 9, 13
Date cleared by Board:	July 30, 2003
Date revision posted to website:	February 28, 2007
Affected by:	FASB Statement No. 157, *Fair Value Measurements* Revised September 15, 2006

Note: The guidance in this Issue supersedes the guidance in Statement 133 Implementation Issue No. A9, "Prepaid Interest Rate Swaps."

QUESTION

How does Statement 133 affect the accounting for a prepaid interest rate swap contract?

BACKGROUND

A *prepaid interest rate swap contract*, as that term is used in this Issue, obligates one party to make periodic payments to another party that are based on a variable interest rate applied to an effective notional amount. It is characterized as an at-the-money interest rate swap contract for which the fixed leg has been fully prepaid, with the result that the party that receives the variable-leg-based payments has no obligation whatsoever to make any future payments under the contract. Under that characterization, the fair value of the fixed leg and the fair value of the variable leg are equal and offsetting because the at-the-money interest rate swap contract has an overall fair value of zero.

The following is an example of a prepaid interest rate swap:

Example 1

Entity A pays $1,228,179 to enter into a prepaid interest rate swap contract that requires the counterparty to make quarterly payments based on a $10,000,000 effective notional amount and a variable interest rate equal to 3-month US$ LIBOR. The prepaid interest rate swap contract is characterized as an at-the-money 2-year, interest rate swap with a $10,000,000 notional amount, a fixed interest rate of 6.65 percent, and a variable interest rate of 3-month US$ LIBOR (that is, the same terms as the swap in Example 5 of Statement 133, which has a zero fair value at inception), for which the fixed leg has been fully prepaid. The amount of

> $1,228,179 is the present value of the 8 quarterly fixed payments of $166,250 [$10,000,000 × LIBOR swap rate[1] of 6.65 percent / 4]; the present value[2] is based on the implied spot rate for each of the 8 payment dates under the assumed initial yield curve in that example.
>
> The prepaid interest rate swap contract could also be characterized as a 2-year, structured note ("contract") with a principal amount of $1,228,179 and loan payments based on a formula equal to 8.142 times 3-month US$ LIBOR. (Note that 8.142 = 10,000,000 / 1,228,179.) The terms of the structured note specify no repayment of the principal amount either over the two-year term of the structured note or at the end of its term. The 8.142 leverage factor causes the *effective notional amount* of the structured note also to be $10,000,000, pursuant to footnote * to paragraph 8, as amended by FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities.*

The prepaid interest rate swap contract meets the characteristic of a derivative in paragraph 6(a) of Statement 133 because it has an underlying and an effective notional amount. It also meets the characteristic of a derivative in paragraph 6(c) of Statement 133 because neither party is required to deliver an asset that is associated with the underlying and that has a principal amount, stated amount, face value, number of shares, or other denomination that is equal to the notional amount (refer to paragraph 9(a)). At issue is whether the prepaid interest rate swap contract meets the characteristic of a derivative described in paragraphs 6(b) and 8 related to the initial net investment in a contract.

Paragraph 6 of Statement 133 (as amended by Statement 149) states in part:

> A derivative instrument is a financial instrument or other contract with all three of the following characteristics:…
>
> b. It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.

---

[1]The *LIBOR swap rate* is defined in paragraph 540 of Statement 133 (as amended) as follows:

> The fixed rate on a single-currency, constant-notional interest rate swap that has its floating-rate leg referenced to the London Interbank Offered Rate (LIBOR) with no additional spread over LIBOR on that floating-rate leg. That fixed rate is the derived rate that would result in the swap having a zero fair value at inception because the present value of fixed cash flows, based on that rate, equate to the present value of the floating cash flows.

[2] The examples in this Issue assume both parties to the contract have the same AA credit rating. If the party that is obligated to make the variable payments has a different credit rating (such as BBB), the effect of that different creditworthiness should be reflected in the discount rate used to determine the present value of the amounts payable by that party under the contract.

Paragraph 8 of Statement 133 (as amended by Statement 149), which elaborates on the application of paragraph 6(b), states:

> *Initial net investment.* Many derivative instruments require no initial net investment. Some require an initial net investment as compensation for time value (for example, a premium on an option) or for terms that are more or less favorable than market conditions (for example, a premium on a forward purchase contract with a price less than the current forward price). Others require a mutual exchange of currencies or other assets at inception, in which case the net investment is the difference in the fair values of the assets exchanged. A derivative instrument does not require an initial net investment in the contract that is equal to the notional amount (or the notional amount plus a premium or minus a discount) or that is determined by applying the notional amount to the underlying. If the initial net investment in the contract (after adjustment for the time value of money) is less, by more than a nominal amount, than the initial net investment that would be commensurate with the amount that would be exchanged either to acquire the asset related to the underlying or to incur the obligation related to the underlying, the characteristic in paragraph 6(b) is met. The amount of that asset acquired or liability incurred should be comparable to the effective notional amount of the contract. [Footnote reference omitted.]

RESPONSE

The prepaid interest rate swap contract does not meet the definition of a derivative because it does not satisfy the characteristic of a derivative described in paragraphs 6(b) and 8 related to the initial net investment in the contract. Specifically, the prepaid interest rate swap contract is excluded from the definition of a derivative by the clarifying guidance in paragraph 8, which states that "a derivative instrument does not require an initial net investment in the contract that is equal to the [effective] notional amount…or that is determined by applying the [effective] notional amount to the underlying." The prepaid interest rate swap contract in Example 1 requires an initial net investment that is determined by applying the effective notional amount of $10,000,000 to the underlying (3-month US$ LIBOR) for each of the 8 payment dates specified by the terms of the contract. The initial net investment of $1,228,179 required to enter into the contract is the present value of the 8 quarterly fixed-leg swap payments of $166,250 [$10,000,000 x 6.65 percent / 4]. Because the LIBOR swap rate reflects the applicable portions of the forward three-month US$ LIBOR rate curve for the settlement dates that relate to the specific payments under the swap, the initial net investment is considered to have been "determined by applying the [effective] notional amount to the underlying" and then adjusted for the time value of money.

The last portion of the sentence in paragraph 8 quoted in the previous paragraph also applies the same conclusion to contracts that require larger initial net investments. That is, a contract that requires an initial net investment in the contract that is in excess of the amount determined by applying the effective notional amount to the underlying is also not a derivative in its entirety. Consider the following examples that involve modifications to the assumed facts in Example 1.

> **Example 2**
> Entity B pays $1,782,245 to enter into a prepaid interest rate swap contract that requires the counterparty to make quarterly payments based on a $10,000,000 effective notional amount and a variable interest rate equal to the sum of 3-month US$ LIBOR and 300 basis points. The prepaid interest rate swap contract is characterized as an at-the-money 2-year interest rate swap with a $10,000,000 notional amount, a fixed interest rate of 9.65 percent, and a variable interest rate of 3-month US$ LIBOR plus 300 basis points, for which the fixed leg has been fully prepaid. The amount of $1,782,245 is the present value of the 8 quarterly fixed payments of $241,250 [$10,000,000 × the fixed rate of 9.65 percent / 4]; the present value is based on the implied spot rate for each of the 8 payment dates under the assumed initial yield curve in that example.

Under Example 2, the underlying is 3-month US$ LIBOR (even though the variable rate is 3-month US$ LIBOR plus 300 basis points) and the amount determined by applying the effective notional amount to the underlying (and then adjusted for the time value of money) is $1,228,179, the same as in Example 1. The initial net investment for the prepaid interest rate swap in Example 2 is $1,782,245, an amount that is in excess of $1,228,179—the amount referred to in paragraph 8 as being determined by applying the effective notional amount to the underlying. Consequently, the prepaid interest rate swap in Example 2 is not a derivative in its entirety.

> **Example 3**
> Entity C pays $1,043,490 to enter into a contract that requires the counterparty to make quarterly payments based on a $10,000,000 effective notional amount and a variable interest rate equal to the 3-month US$ LIBOR minus 100 basis points. In the event that 3-month US$ LIBOR is less than 100 basis points, Entity C is obligated to make payments to the counterparty. The prepaid interest rate swap contract is characterized as an at-the-money 2-year, interest rate swap with a $10,000,000 notional amount, a fixed interest rate of 5.65 percent, and a variable interest rate of 3-month US$ LIBOR minus 100 basis points, for which the fixed leg has been fully prepaid. The amount of $1,043,490 is the present value of the 8 quarterly fixed payments of $141,250 [$10,000,000 × the fixed rate of 5.65 percent / 4]; the present value is based on the implied spot rate for each of the 8 payment dates under the assumed initial yield curve in that example.

Under Example 3, the underlying is 3-month US$ LIBOR (even though the variable rate is 3-month US$ LIBOR minus 100 basis points) and the amount determined by applying the effective

notional amount to the underlying (and then adjusted for the time value of money) is $1,228,179, the same as in Example 1. The initial net investment for the contract in Example 3 is $1,043,490, an amount that is *less than* $1,228,179. (The contract is considered not to be fully prepaid because Entity C has not "prepaid" all obligations imposed on it by the contract; Entity C is obligated to make future payments under certain conditions, as noted above.) The difference of $184,689 (about 15 percent[3]) is more than a nominal amount when compared to $1,228,179. Consequently, the contract in Example 3 is a derivative in its entirety.

Because the prepaid interest rate swap contract is not a derivative in its entirety, it should be evaluated to determine whether the contract contains an embedded derivative that, pursuant to paragraph 12, requires separate accounting as a derivative. The prepaid interest rate swap contracts in Examples 1 and 2 are hybrid instruments that are composed of a debt instrument (the host contract) and an embedded derivative based on three-month US$ LIBOR. The embedded derivative contains a provision that could result in the investor (that is, the entity receiving the variable payments) not recovering substantially all of its initial recorded investment in the hybrid instrument under its contractual terms. That is, LIBOR may possibly decrease to such a level that the investor may not recover its initial net investment. Therefore, the embedded interest rate swap is not considered clearly and closely related to the host contract under paragraph 13(a) of Statement 133 with respect to the accounting by both parties to the contract. Paragraph 61(a), which further explains paragraph 13(a), states that if an embedded interest rate derivative contains a provision that permits any possibility whatsoever that the investor's (or creditor's) undiscounted net cash inflows over the life of the instrument would not enable the investor to recover substantially all of its initial recorded investment in the hybrid instrument under its contractual terms, the embedded derivative and the debt host contract are not clearly and closely related. Therefore, unless the contracts described in Examples 1 and 2 are remeasured at fair value with changes in value recorded in earnings as they occur, both prepaid interest rate swap contracts should be bifurcated by both parties to the contract into a debt host contract whose initial carrying amount is equal to the fair value of the prepaid interest rate swap contracts ($1,228,179 and $1,782,245, respectively) and an interest rate swap whose fair value is zero at inception of the hybrid instrument, consistent with the guidance in Statement 133 Implementation Issue No. B20, "Must the Terms of a Separated Non-Option Embedded Derivative Produce a Zero Fair Value at Inception?" The bifurcated interest rate swap contains no financing element that would require special cash flow reporting under paragraph 45A of Statement 133, as amended by Statement 149. The reporting of the cash flows for the related debt host contract would be subject to the provisions of FASB Statement No. 95, *Statement of Cash Flows.*

[3]The amounts in Example 3 are not intended to provide quantitative guidance for distinguishing between being "less, by more than a nominal amount" and being "less by only a nominal amount." The initial net investment for a contract could be less than the amount determined by applying the effective notional amount to the underlying by a percentage lower than 15 percent and still be considered to be "less, by more than a nominal amount" under paragraph 8.

EFFECTIVE DATE AND TRANSITION

The effective date of the implementation guidance in this Issue for each reporting entity is the first day of the first fiscal quarter beginning after August 8, 2003. The implementation guidance in this Issue should be applied prospectively to all contracts entered into on or after the effective date. Early application to all contracts entered into or substantively modified on or after August 1, 2003, is permitted. If an entity had been accounting for a contract entered into prior to the effective date as a derivative in its entirety under Implementation Issue A9 but, under the guidance in this Issue, that contract would not be a derivative in its entirety, the entity should continue accounting for that contract as a derivative in its entirety.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Embedded Derivatives: Separating the Embedded Derivative from the Host Contract
Paragraph references:	12, 60
Date cleared by Board:	June 23, 1999
Date revision posted to website:	March 14, 2006
Affected by:	FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments*

Revised February 16, 2006

QUESTION

An entity (Company A) issues a 5-year "debt" instrument with a principal amount of $1,000,000 indexed to the stock of an unrelated publicly traded entity (Company B). At maturity, the holder of the instrument will receive the principal amount plus any appreciation or minus any depreciation in the fair value of 10,000 shares of Company B, with changes in fair value measured from the issuance date of the debt instrument. No separate interest payments are made. The market price of Company B shares to which the debt instrument is indexed is $100 per share at the issuance date. The instrument is not itself a derivative because it requires an initial net investment equal to the notional amount; however, what is the host contract and what is the embedded derivative composing the hybrid instrument?

RESPONSE

The host contract is a debt instrument because the instrument has a stated maturity and because the holder has none of the rights of a shareholder, such as the ability to vote the shares and receive distributions to shareholders. The embedded derivative is an equity-based derivative that has as its underlying the fair value of the stock of Company B. Paragraph 60 states:

> ...most commonly, a financial instrument host contract will not embody a claim to the residual interest in an entity and, thus, the economic characteristics and risks of the host contract should be considered that of a debt instrument. For example, even though the overall hybrid instrument that provides for repayment of principal may include a return based on the market price…of XYZ Corporation common stock, the host contract does not involve any existing or potential residual interest rights (that is, rights of ownership) and thus would not be an equity instrument. The host contract would instead be considered a debt instrument, and the embedded derivative that incorporates the equity-based return would not be clearly and closely related to the host contract.

Unless the hybrid instrument is remeasured at fair value with changes in value recorded in earnings as they occur, the embedded derivative must be separated from the host contract.

As a result of the host instrument being a debt instrument and the embedded derivative having an equity-based return, the embedded derivative is not clearly and closely related to the host contract and must be separated from the host contract and accounted for as a derivative by both the issuer and the holder of the hybrid instrument. (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 hedging instrument in a Statement 133 hedging relationship.)

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Embedded Derivatives: Leveraged Embedded Terms
Paragraph references:	13(a), 61(a)(1)
Date cleared by Board:	February 17, 1999
Date revision posted to website:	March 14, 2006
Affected by:	FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments*

Revised February 16, 2006

QUESTION

An investor purchases for $10,000,000 a structured note with a face amount of $10,000,000, a coupon of 8.9 percent, and a term of 10 years. The current market rate for 10-year debt is 7 percent given the single-A credit quality of the issuer. The terms of the structured note require that if the interest rate for single-A rated debt has increased to at least 10 percent at the end of 2 years, the coupon on the note is reduced to zero, and the investor must purchase from the issuer for $10,000,000 an additional note with a face amount of $10,000,000, a zero coupon, and a term of 3.5 years. How does the criterion in paragraph 13(a) apply to that structured note? Does the structured note contain an embedded derivative that must be accounted for separately?

RESPONSE

The structured note contains an embedded derivative that must be accounted for separately unless a fair value election is made pursuant to Statement 155. (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 hedging instrument in a Statement 133 hedging relationship.) The requirement that, if interest rates increase and the derivative is triggered, the investor must purchase the second $10,000,000 note for an amount in excess of its fair value (which is about $7,100,000 based on a 10 percent interest rate) generates a result that is economically equivalent to requiring the investor to make a cash payment to the issuer for the amount of the excess. As a result, the cash flows on the original structured note and the excess purchase price on the second note must be considered in concert. The cash inflows ($10,000,000 principal and $1,780,000 interest) that will be received by the investor on the original note must be reduced by the amount ($2,900,000) by which the purchase price of the second note is in excess of its fair value, resulting in a net cash inflow ($8,880,000) that is not substantially all of the investor's initial net investment on the original note.

As described in paragraph 13(a) of Statement 133, an embedded derivative in which the underlying is an interest rate or interest rate index and a host contract that is a debt instrument are considered to be clearly and closely related *unless* the hybrid instrument can contractually be settled in such a way that the investor would not recover substantially all of its initial recorded

investment. Paragraph 61(a)(1) clarifies that this test would be conducted by comparing the investor's undiscounted net cash inflows over the life of the instrument to the initial recorded investment in the hybrid instrument. As demonstrated by the scenario above, if a derivative requires an asset to be purchased for an amount that exceeds its fair value, the amount of the excess — and not the cash flows related to the purchased asset — must be considered when analyzing whether the hybrid instrument can contractually be settled in such a way that the investor would not recover substantially all of its initial recorded investment under paragraph 13(a). Whether that purchased asset is a financial asset or a nonfinancial asset (such as gold) is not relevant to the treatment of the excess purchase price.

It is noted that requiring the investor to make a cash payment to the issuer is also economically equivalent to reducing the principal on the note. The note described in the question above could have been structured to include terms requiring that the principal of the note be substantially reduced and the coupon reduced to zero if the interest rate for single-A rated debt increased to at least 10 percent at the end of 2 years. That alternative structure would clearly have required that the embedded derivative be accounted for separately, because that embedded derivative's existence would have resulted in the possibility that the hybrid instrument could contractually be settled in such a way that the investor would not recover substantially all of its initial recorded investment.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Embedded Derivatives: Investor's Accounting for a Put or Call Option Attached to a Debt Instrument Contemporaneously with or Subsequent to Its Issuance
Paragraph reference:	61(d)
Date cleared by Board:	March 31, 1999
Affected by:	FASB Statement No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*
	Revised September 25, 2000

QUESTION

Should an investor (creditor) account separately for a put or call option that is added to a debt instrument by a third party contemporaneously with or subsequent to the issuance of the debt instrument?

BACKGROUND

Example 1 presents a transaction that involves the addition of a call option contemporaneously with or subsequent to the issuance of debt. Example 2 presents a group of transactions with a similar overall effect.

Example 1

Company X issues 15-year puttable bonds to an Investment Banker for $102. The put option may be exercised at the end of five years. Contemporaneously, the Investment Banker sells the bonds with an attached call option to Investor A for $100. (The call option is a written option from the perspective of Investor A and a purchased option from the perspective of the Investment Banker.) The Investment Banker also sells to Investor B for $3 the call option purchased from Investor A on those bonds. The call option has an exercise date that is the same as the exercise date on the embedded put option. At the end of five years, if interest rates increase, Investor A would presumably put the bonds back to Company X, the issuer. If interest rates decrease, Investor B would presumably call the bonds from Investor A.

Example 2

Company Y issues 15-year puttable bonds to Investor A for $102. The put option may be exercised at the end of five years. Contemporaneously, Company Y purchases a transferable call option on the bonds from Investor A for $2. Company Y immediately sells that call option to Investor B for $3. The call option has an exercise date that is the same as the exercise date of the embedded put option. At the end of five years, if rates increase, Investor A would presumably put the bonds back to Company Y, the issuer. If rates decrease, Investor B would presumably call the bonds from Investor A.

RESPONSE

Yes. A put or call option that is added to a debt instrument by a third party contemporaneously with or subsequent to the issuance of the debt instrument should be separately accounted for as a derivative under Statement 133 by the investor (that is, by the creditor); it must be reported at fair value with changes in value recognized currently in earnings unless designated in a qualifying hedging relationship as a hedging instrument. As a result, in Example 1 above, the call option that is attached by the Investment Banker is a separate derivative from the perspective of Investor A. Similarly, the call option described in Example 2 is a separate freestanding derivative that also must be reported at fair value with changes in value recognized currently in earnings unless designated as a hedging instrument.

An option that is added or attached to an existing debt instrument by another party results in the investor having different counterparties for the option and the debt instrument and, thus, the option should not be considered an *embedded derivative.* The notion of an *embedded derivative* in a hybrid instrument refers to provisions incorporated into a single contract, and not to provisions in separate contracts between different counterparties.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Embedded Derivatives: Foreign Currency Derivatives
Paragraph references:	15, 311
Date cleared by Board:	July 28, 1999
Date latest revision posted to website:	June 16, 2006
Affected by:	FASB Statements No. 149, *Amendment of Statement 133 on Derivative Instruments, and Hedging Activities,* and No. 155, *Accounting for Certain Hybrid Financial Instruments*
	Revised June 16, 2006

QUESTION

Two entities enter into a long-term service contract whereby one entity (A) agrees to provide a service to the other entity (B), at market rates over a three-year period. Entity B forecasts it will pay 1,000 kroner to Entity A at the end of the 3-year period for all services rendered under the contract. Entity A's functional currency is the kroner and Entity B's is the U.S. dollar. In addition to providing the terms under which the service will be provided, the contract includes a foreign currency exchange provision. The provision requires that over the term of the contract, Entity B will pay or receive an amount equal to the fluctuation in the exchange rate of the U.S. dollar and the kroner applied to a notional amount of 100,000 kroner (that is, if the U.S. dollar appreciates versus the kroner, Entity B will pay the appreciation, and if the U.S. dollar depreciates versus the kroner, Entity B will receive the depreciation). The host contract is not a derivative and will not be recorded in the financial statements at market value. For the purpose of applying paragraph 15, is the embedded foreign currency derivative considered to be clearly and closely related to the terms of the service contract?

BACKGROUND

Paragraph 12 of Statement 133 requires that an embedded derivative instrument be separated from the host contract and accounted for as a derivative instrument pursuant to the Statement if certain criteria are met. Paragraph 15, as amended by Statement 149, provides that an embedded foreign currency derivative instrument is not to be separated from the host contract and considered a derivative pursuant to paragraph 12 if the host contract is not a financial instrument and specifies payments denominated in any of the following currencies:

a. The functional currency of any substantial party to that contract
b. The currency in which the price of the related good or service that is acquired or delivered is routinely denominated in international commerce
c. The local currency of any substantial party to the contract
d. The currency used by a substantial party to the contract as if it were the functional currency because the primary economic environment in which the party operates is highly inflationary (as discussed in paragraph 11 of Statement 52).

Paragraph 15 provides the exclusion to paragraph 12 on the basis that if a host contract is not a financial instrument and it is denominated in one of the aforementioned currencies, then the embedded foreign currency derivative is considered to be clearly and closely related to the terms of the service contract.

RESPONSE

No, the foreign currency derivative instrument embedded in the long-term service contract should be separated from the host and considered a derivative instrument under paragraph 12. (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. However, Statement 155 does not apply to hybrid instruments that are not financial instruments, such as contracts that require the delivery of services.)

In paragraph 311, "the Board decided that it was important that the payments be denominated in the functional currency of at least one *substantial* party to the transaction to ensure that the foreign currency is integral to the arrangement and thus considered to be clearly and closely related to the terms of the lease." It follows that the exception provided by paragraph 15 implicitly requires that the other aspects of the embedded foreign currency derivative must be clearly and closely related to the host.

In the example discussed above, because the contract is leveraged by requiring the computation of the payment based on a 100,000 kroner notional amount, the contract is a hybrid instrument that contains an embedded derivative — a foreign currency swap with a notional amount of 99,000 kroner. That embedded derivative is not clearly and closely related to the host contract and under paragraph 12 of Statement 133 must be recorded separately from the 1,000 kroner contract. Either party to the contract can designate the bifurcated foreign currency derivative instrument as a hedging instrument pursuant to Statement 133 if applicable qualifying criteria are met.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Embedded Derivatives: Investor Permitted, but Not Forced, to Settle without Recovering Substantially All of the Initial Net Investment
Paragraph references:	13(a), 61(a)
Date cleared by Board:	July 28, 1999
Date latest revision posted to website:	June 16, 2006
Affected by:	FASB Statements No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*, and No. 155, *Accounting for Certain Hybrid Financial Instruments* Revised June 16, 2006

QUESTION

If the terms of a hybrid instrument permit, but do not require, the investor to settle the hybrid instrument in a manner that causes it not to recover substantially all of its initial recorded investment, does the contract satisfy the condition in paragraph 13(a), thereby causing the embedded derivative to be considered not clearly and closely related to the host contract?

BACKGROUND

Paragraph 13 of Statement 133 states:

> For purposes of applying the provisions of paragraph 12, an embedded derivative instrument in which the underlying is an interest rate or interest rate index that alters net interest payments that otherwise would be paid or received on an interest-bearing host contract is considered to be clearly and closely related to the host contract unless either of the following conditions exist:
>
> a. The hybrid instrument can contractually be settled in such a way that the investor (holder) would not recover *substantially all* of its initial recorded investment.
> b. The embedded derivative meets both of the following conditions:
>
> (1) There is a possible future interest rate scenario (even though it may be remote) under which the embedded derivative would at least double the investor's initial rate of return on the host contract.
>
> (2) For each of the possible interest rate scenarios under which the investor's initial rate of return on the host contract would be doubled (as discussed under paragraph 13(b)(1)), the embedded derivative would at the same time result in a rate of return that is at least twice what otherwise would be the then-current market return (under each of those future interest rate scenarios) for a contract that has the same terms as the host contract and that involves a debtor with a credit quality similar to the issuer's credit quality at inception. [Footnote omitted.]

Even though the above conditions focus on the investor's rate of return and the investor's recovery of its investment, the existence of either of those conditions would result in the embedded derivative instrument being considered not clearly and closely related to the host contract by both parties to the hybrid instrument. (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 hedging instrument in a Statement 133 hedging relationship.)

The following footnote was added at the end of subparagraph (a) by Statement 149: "The condition in paragraph 13(a) does not apply to a situation in which the terms of a hybrid instrument permit, but do not require, the investor to settle the hybrid instrument in a manner that causes it not to recover substantially all of its initial recorded investment, provided that the issuer does not have the contractual right to demand a settlement that causes the investor not to recover substantially all of its initial net investment."

Paragraph 61(a) elaborates on the condition in paragraph 13(a) as follows:

> …the embedded derivative contains a provision that (1) permits any possibility whatsoever that the investor's (or creditor's) undiscounted net cash inflows over the life of the instrument would not recover substantially all of its initial recorded investment in the hybrid instrument under its contractual terms….

RESPONSE

No. The footnote to paragraph 13(a) added by Statement 149 clarifies that the condition in paragraph 13(a) does not apply to a situation in which the terms of a hybrid instrument permit, but do not require, the investor to settle the hybrid instrument in a manner that causes it not to recover substantially all of its initial recorded investment, provided that the issuer does not have the contractual right to demand a settlement that causes the investor not to recover substantially all of its initial recorded investment. Thus, if the investor in a 10-year note has the contingent option at the end of year 2 to put it back to the issuer at its then fair value (based on its original 10-year term), the condition in paragraph 13(a) would not be met even though the note's fair value could have declined so much that, by exercising the option, the investor ends up not recovering substantially all of its initial recorded investment.

The condition in paragraph 13(a) was intended to apply only to those situations in which the investor (creditor) could be forced by the terms of a hybrid instrument to accept settlement at an amount that causes the investor not to recover substantially all of its initial recorded investment. For example, assume the investor purchased from a single-A-rated issuer for $10 million a structured note with a $10 million principal, a 9.5 percent interest coupon, and a term of 10 years

at a time when the current market rate for 10-year single-A-rated debt is 7 percent. Assume further that the terms of the note require that, at the beginning of the third year of its term, the principal on the note is reduced to $7.1 million and the coupon interest rate is reduced to zero for the remaining term to maturity if interest rates for single-A-rated debt have increased to at least 8 percent by that date. That structured note would meet the condition in paragraph 13(a) for *both* the issuer and the investor because the investor could be forced to accept settlement that causes the investor not to recover substantially all of its initial recorded investment. That is, if increases in the interest rate for single-A-rated debt triggers the modification of terms, the investor would receive only $9 million, comprising $1.9 million in interest payments for the first 2 years and $7.1 million in principal repayment, thus not recovering substantially all of its $10 million initial net investment.

This guidance does not address the application of the condition in paragraph 13(b).

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Embedded Derivatives: Allocating the Basis of a Hybrid Instrument to the Host Contract and the Embedded Derivative
Paragraph references:	12–16, 301–303, footnote 13 (to paragraph 49)
Date cleared by Board:	July 28, 1999
Date revision posted to website:	March 14, 2006
Affected by:	FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments*

Revised February 16, 2006

QUESTION

How should the basis of a hybrid instrument be allocated to the host contract and the embedded derivative when separate accounting for the embedded derivative is required by Statement 133? (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 hedging instrument in a Statement 133 hedging relationship.)

BACKGROUND

Three methods have been identified for determining the initial carrying values of the host contract component and the embedded derivative component of a hybrid instrument:

1. Estimating the fair value of each individual component of the hybrid instrument and allocating the basis of the hybrid instrument to the host instrument and the embedded derivative based on the proportion of the fair value of each individual component to the overall fair value of the hybrid (a "relative fair value" method)
2. Recording the embedded derivative at fair value and determining the initial carrying value assigned to the host contract as the difference between the basis of the hybrid instrument and the fair value of the embedded derivative (a "with and without" method based on the fair value of the embedded derivative)
3. Recording the host contract at fair value and determining the carrying value assigned to the embedded derivative as the difference between the basis of the hybrid instrument and the fair value of the host contract (a "with and without" method based on the fair value of the host contract).

Because the "relative fair value" method (#1 above) involves an independent estimation of the fair value of each component, the sum of the fair values of those components may be greater or less than the initial basis of the hybrid instrument, resulting in an initial carrying amount for the embedded derivative that differs from its fair value. Similarly, the "with and without" method based on the fair value of the host contract (#3 above) may result in an initial carrying amount

for the embedded derivative that differs from its fair value. Therefore, both of those methods may result in recognition of an immediate gain or loss upon reporting the embedded derivative at fair value.

RESPONSE

The allocation method that records the embedded derivative at fair value and determines the initial carrying value assigned to the host contract as the difference between the basis of the hybrid instrument and the fair value of the embedded derivative (#2 above) should be used to determine the carrying values of the host contract component and the embedded derivative component of a hybrid instrument when separate accounting for the embedded derivative is required by Statement 133.

Statement 133 requires that an embedded derivative that must be separated from its host contract be measured at fair value. As stated in paragraph 301 of the basis for conclusions, "…the Board believes it should be unusual that an entity would conclude that it cannot reliably separate an embedded derivative from its host contract." Once the carrying value of the host contract is established, it would be accounted for under generally accepted accounting principles applicable to instruments of that type that do not contain embedded derivatives. Upon separation from the host contract, the embedded derivative may be designated as a hedging instrument, if desired, provided it meets the hedge accounting criteria.

If the host contract component of the hybrid instrument is reported at fair value with changes in fair value recognized in earnings or other comprehensive income, then the sum of the fair values of the host contract component and the embedded derivative should not exceed the overall fair value of the hybrid instrument. That is consistent with the requirement of footnote 13 to paragraph 49, which states, in part:

> For a compound derivative that has a foreign currency exchange risk component (such as a foreign currency interest rate swap), an entity is permitted at the date of initial application to separate the compound derivative into two parts: the foreign currency derivative and the remaining derivative. Each of them would thereafter be accounted for at fair value, *with an overall limit that the sum of their fair values could not exceed the fair value of the compound derivative.*

While footnote 13 to paragraph 49 addresses separation of a compound derivative upon initial application of Statement 133, the notion that the sum of the fair values of the components should not exceed the overall fair value of the combined instrument is also applicable to hybrid instruments containing a nonderivative host contract and an embedded derivative. However, in instances where the hybrid instrument is reported at fair value with changes in fair value recognized in earnings, paragraph 12(b) would not be met and therefore separation of the embedded derivative from the host contract would not be permitted.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Embedded Derivatives: Variable Annuity Products and Policyholder Ownership of the Assets
Paragraph references:	12, 200
Date cleared by Board:	June 23, 1999
Affected by:	FASB Statement No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*
	Revised September 25, 2000

QUESTION

If the insurer, rather than the policyholder, actually owns the investments supporting a variable annuity product, does the conclusion that the investment component of a traditional variable annuity contract (described in the second and third bullet points of paragraph 200) does not contain embedded derivatives remain valid?

BACKGROUND

Paragraph 200 of Statement 133, contained in Section 2 of Appendix B, "Examples Illustrating Application of the Clearly-and-Closely-Related Criterion to Derivative Instruments Embedded in Hybrid Instruments," provides examples of variable annuity product structures. The second bullet point of paragraph 200, related to an investment component states, in part:

> The policyholder directs certain premium investments in the investment account that includes equities, bonds, or both, which are held in separate accounts that are distinct from the insurer's general account assets. This component is not considered a derivative because of the unique attributes of traditional variable annuity contracts issued by insurance companies. Furthermore, any embedded derivatives within those investments should not be separated from the host contract by the insurer because the separate account assets are already marked-to-market under Statement 60.

In addition, the third bullet point of paragraph 200 related to an investment account surrender right at market value states:

> Because this right is exercised only at the fund market value (without the insurer's floor guarantee) and relates to a traditional variable annuity contract issued by an insurance company, this right is not within the scope of this Statement.

In concluding that certain traditional variable annuity product structures, as defined in FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, and as contemplated in FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, do not contain embedded derivatives, the second and third bullet points of paragraph 200 do not refer to ownership of the assets specifically resting with either the policyholder or the insurer. While the policyholder is entitled to direct the investment of premiums into various approved funds, the

insurance company actually owns the investments. That is noted by the National Association of Insurance Commissioners' Statement of Statutory Accounting Principles No. 56, *Separate Accounts*, which states that "assets held in separate accounts are owned by the insurer."

A traditional variable annuity product structure, as that term is used in this issue, includes the following attributes:

- The policyholder's payments, after deduction of specified sales and administrative charges, are used to purchase units of a separate investment account (a "separate account").
- The policyholder directs the allocation of the account value among various investment options (typically various mutual funds). The policyholder bears the investment risk (that is, the account value is based entirely on the performance of the directed investments).
- The units may be surrendered for their current value in cash, although there is often a small surrender charge, or the units may be applied to purchase annuity income.
- The insurer guarantees mortality and maximum expense charges, and amounts are deducted periodically from the separate account to cover these charges.
- Deferred annuity contracts typically provide a death benefit during the accumulation period under which the policyholder may receive the greater of the sum of premiums paid or the value of total units to the credit of the account at time of the policyholder's death.

RESPONSE

Yes. The guidance in the second and third bullet points of paragraph 200 that a traditional variable annuity contract contains no embedded derivatives that warrant separate accounting under Statement 133 remains valid even though the insurer, rather than the policyholder, actually owns the assets. The following indicators provide the basis for concluding that a traditional variable annuity contract is not a hybrid instrument to be accounted for under paragraph 12:

- The variable annuity contract is established, approved, and regulated under special rules applicable to variable annuities (such as state insurance laws, securities laws, and tax laws).
- The assets underlying the contract are insulated from the general account liabilities of the insurance company (the policyholder is not subject to insurer default risk to the extent of the assets held in the separate account).
- The policyholder's premium is invested in contract-approved separate accounts at the policyholder's direction.
- The insurer must invest in the assets on which the account values are based.
- The policyholder may redirect its investment among the contract-approved investment options.
- The account values are based entirely on the performance of those directed investments.
- All investment returns are passed through to the policyholder (including dividends, interest, and gains/losses).

- The policyholder may redeem its interests at any time; however, it may be subject to surrender charges.
- The policyholder has voting rights in certain separate account structures.

In addition, although the liability to policyholders is not specifically required to be remeasured at fair value with changes reported in earnings under existing GAAP, current accounting practice for traditional variable annuity contracts is to record a liability equal to the summary total of the market value of the assets held in the separate account for the policyholders.

The guidance in Statement 133 Implementation Issue No. B8, "Embedded Derivatives: Identification of the Host Contract in a Nontraditional Variable Annuity Contract," is based on the above guidance for traditional variable annuity contracts. However, in determining the accounting for other seemingly similar structures, it would be inappropriate to analogize to the above guidance due to the unique attributes of traditional variable annuity contracts and the fact that the above guidance can be viewed as an exception for traditional variable annuity contracts issued by insurance companies.

The minimum death benefit component during the accumulation period is not an embedded derivative that warrants separate accounting under Statement 133, as discussed in paragraph 200.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Embedded Derivatives: Identification of the Host Contract in a Nontraditional Variable Annuity Contract
Paragraph references:	12, 16, 61(e), 200
Date cleared by Board:	July 28, 1999
Affected by:	FASB Statement No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*
	Revised September 25, 2000

QUESTION

How does one determine the host contract in a nontraditional variable annuity contract (a hybrid instrument)?

BACKGROUND

While traditional variable annuity contracts represent the majority of contracts sold today by life insurance and other enterprises, those enterprises have also developed a wide range of variable annuity contracts with nontraditional features. Nontraditional features of traditional variable annuity contracts result in a sharing of investment risk between the issuer and the holder. Nontraditional variable annuity contracts provide for some sort of minimum guarantee of the account value at a specified date. This minimum guarantee may be guaranteed through a minimum accumulation benefit or a guaranteed account value floor. For example, the floor guarantee might be that, at a specified anniversary date, the contract holder will be credited with the greater of (1) the account value, as determined by the separate account assets, or (2) all deposits that are made, plus 3 percent interest compounded annually.

While these nontraditional variable annuity contracts have distinguishing features, they possess a common characteristic: the investment risk associated with the assets backing the contract is shared by the issuer and the policyholder. That is, in contrast to traditional variable annuity contracts, the investment risk is, by virtue of the nontraditional product features, allocated between the two parties and not borne entirely by only one of the parties (the holder in the case of a traditional variable annuity contract).

Paragraphs 12 and 16 of Statement 133 require that, in certain circumstances, an embedded derivative is to be accounted for separately from the host contract as a derivative instrument. An example illustrating the application of paragraph 12 to insurance contracts is provided in paragraph 200 of Statement 133. Paragraph 200, second bullet point entitled "Investment Component," states, in part:

> The policyholder directs certain premium investments in the investment account that includes equities, bonds, or both, which are held in separate accounts that are distinct from the insurer's general account assets. This component is not considered

a derivative because of the unique attributes of traditional variable annuity contracts issued by insurance companies.

RESPONSE

The FASB staff guidance presented in Statement 133 Implementation Issue No. B7, "Variable Annuity Products and Policyholder Ownership of the Assets" indicates that a traditional variable annuity (as described in that Issue) contains no embedded derivatives that warrant separate accounting under Statement 133 even though the insurer, rather than the policyholder, actually owns the assets.

The host contract in a nontraditional variable annuity contract would be considered the traditional variable annuity that, as described in Implementation Issue B7, does not contain an embedded derivative that warrants separate accounting. Nontraditional features (such as a guaranteed investment return through a minimum accumulation benefit or a guaranteed account value floor) would be considered embedded derivatives subject to the requirements of Statement 133. Paragraph 12 of Statement 133, states, in part, that:

> Contracts that do not in their entirety meet the definition of a derivative instrument such as … *insurance policies*… may contain "embedded" derivative instruments—implicit or explicit terms that affect some or all of the cash flows or the value of other exchanges required by the contract in a manner similar to a derivative instrument. The effect of embedding a derivative instrument in another type of contract ("the host contract") is that some or all of the cash flows or other exchanges that otherwise would be required by the host contract, whether unconditional or contingent upon the occurrence of a specified event, will be modified based on one or more underlyings. [Emphasis added; reference omitted.]

The economic characteristics and risks of the investment guarantee and those of the traditional variable annuity contract would typically be considered to be not clearly and closely related.

In determining the accounting for other seemingly similar structures, it would be inappropriate to analogize to the above guidance due to the unique attributes of nontraditional variable annuity contracts and the fact that the above guidance, which is based on Implementation Issue B7, can be viewed as an exception for nontraditional variable annuity contracts issued by insurance companies.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title: Embedded Derivatives: Clearly and Closely Related Criteria for Market Adjusted Value Prepayment Options
Paragraph references: 13, 61(a), 61(d)
Date cleared by Board: December 6, 2000

QUESTION

Are the economic characteristics and risks of the embedded derivative (market adjusted value prepayment option) in a market value annuity contract (MVA or the hybrid instrument) clearly and closely related to the economic characteristics and risks of the host contract?

BACKGROUND

An MVA accounted for as an investment contract under FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, given its lack of significant mortality risk, provides for a return of principal plus a fixed rate of return if held to maturity, or alternatively, a "market adjusted value" if the surrender option is exercised by the contract holder prior to maturity. The market adjusted value is typically based on current interest crediting rates being offered for new MVA purchases. As an example of how the market adjusted value is calculated at any period end, the formula typically takes the contractual guaranteed amount payable at the end of the specified term, including the applicable guaranteed interest, and discounts that future cash flow to its present value using rates currently being offered for new MVA purchases with terms equal to the remaining term to maturity of the existing MVA. As a result, the market value adjustment may be positive or negative, depending upon market interest rates at each period end. In a rising interest rate environment, the market adjustment may be such that less than substantially all principal is recovered upon surrender.

The following is an example of an annuity with a fixed return if held for a specified period or market adjusted value if surrendered early:

- Single premium deposit: $100,000 on 12/31/98
- Maturity date: 12/31/07 (9-year term)
- Guaranteed fixed rate: 7%
- Fixed maturity value: $183,846 ($100,000 @ 7% compounded for 9 years)
- Market value adjustment formula: discount future fixed maturity value to present value at surrender date using currently offered market value annuity rate for the period of time left until maturity.

12/31/99 Valuation Date	5%	9%
(1) Fixed rate account value @7%	$107,000	107,000
(2) Market adjusted value	124,434	92,266
(3) Market value adjustment	$17,434 $	(14,734)

RESPONSE

Yes, the embedded derivative (prepayment option) is clearly and closely related to the host debt contract.

Paragraph 61(d) provides interpretation of the clearly and closely related criteria as it applies to debt with put options, noting that:

> Call options (or put options) that can accelerate the repayment of principal on a debt instrument are considered to be clearly and closely related to a debt instrument that requires principal repayments unless both (1) the debt involves a substantial premium or discount (which is common with zero-coupon bonds) and (2) the put or call option is only contingently exercisable. Thus, if a substantial premium or discount is not involved, embedded calls and puts (including contingent call or put options that are not exercisable unless an event of default occurs) would *not* be separated from the host contract.

The terms of MVAs do not include either feature. There is no substantial premium or discount present in these contracts at inception, and the put option is exercisable at any time by the contract holder (that is, it is not "contingently exercisable").

Since the embedded derivative has an underlying that is an interest rate index and the host contract is a debt instrument, the MVA contract must be analyzed under the criteria in paragraphs 13 and 61(a) as well. Pursuant to the FASB staff guidance presented in Statement 133 Implementation Issue No. B5, "Investor Permitted, but Not Forced, to Settle without Recovering Substantially All of the Initial Net Investment," the condition in paragraph 13(a) was intended to apply only to those situations in which the investor (creditor) could be forced by the terms of a hybrid instrument to accept settlement at an amount that causes the investor not to recover substantially all of its initial recorded investment. That is, because the investor always has the option to hold the MVA contract to maturity and receive the fixed rate and the insurance company cannot force the investor to surrender, the condition in paragraph 13(a) would not be met (that is, the insurance company does not have the contractual right to demand surrender and put the investor in a situation of not recovering substantially all of its initial recorded investment). The condition in paragraph 13(b) also would not be met in a typical MVA contract, since there is no leverage feature that would result in twice the initial and current market rate of return. Because the criteria in paragraphs 13, 61(a), and 61(d) are not met, the prepayment option is considered clearly and closely related to the host debt instrument.

As the above example demonstrates, the prepayment option enables the holder simply to cash out of the instrument at fair value at the surrender date. The prepayment option provides only liquidity to the holder. The holder receives only the market adjusted value, which is equal to the fair value of the investment contract at the surrender date. As such, the prepayment option (the embedded derivative) has a fair value of zero at all times.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Embedded Derivatives: Equity-Indexed Life Insurance Contracts
Paragraph references:	10(c), 12, 200
Date cleared by Board:	July 28, 1999
Date latest revision posted to website:	June 16, 2006
Affected by:	FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments*

Revised June 16, 2006

QUESTION

Is an equity-indexed life insurance contract that combines term life insurance coverage with an investment feature, similar to universal life contracts, outside the scope of Statement 133 because it contains a death benefit provision?

BACKGROUND

Equity-indexed life insurance contracts combine term life insurance coverage with an investment feature, similar to universal life contracts. Death benefit amounts are based upon the amount selected by the policyholder plus the account value. Charges for the cost of insurance and administrative costs are assessed periodically against the account. The policyholder's account value, maintained in the insurance company's general account (not a separate account), is based on the cumulative deposits credited with positive returns based on the S&P 500 index or some other equity index. An essential component of the contract is that the cash surrender value is also linked to the index. Accordingly, the policy's cash surrender value is also linked to an equity index. The death benefit amount may also be dependent upon the cumulative return on the index.

Equity-indexed life insurance contracts are accounted for as universal life (UL) insurance contracts under FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*. For those contracts, the customer's account value (the investment component of a UL contract) is credited with a return indexed to an equity index (for example, the S&P 500) rather than an interest rate established by the insurer, as is done with typical UL contracts.

RESPONSE

No. The existence of the death benefit provision does not exclude the entire equity-indexed life insurance contract from being subject to Statement 133 for either the issuer or the policyholder because the policyholder can obtain an equity-linked return by exercising the surrender option prior to death.

Paragraph 10(c) provides the following guidance:

> …insurance enterprises enter into other types of contracts that may be subject to the provisions of this Statement. In addition, some contracts with insurance or other enterprises *combine derivative instruments*, as defined in this Statement, *with other insurance products* or nonderivative contracts, for example, indexed annuity contracts, variable life insurance contracts.… [Emphasis added.]

Paragraph 12 of Statement 133 states, in part, "Contracts that do not in their entirety meet the definition of a derivative instrument…such as bonds, *insurance policies*, and leases, may contain 'embedded' derivative instruments.…" (Emphasis added.)

The investment component of the equity-indexed life insurance contract would contain an embedded derivative (the equity index-based derivative) that meets all the requirements of paragraph 12 of Statement 133 for separate accounting. (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. However, Statement 155 does not apply to hybrid instruments that are described in paragraph 8 of FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments,* which include insurance contracts as discussed in FASB Statements No. 60, *Accounting and Reporting by Insurance Enterprises,* and No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments,* other than financial guarantees and investment contracts. Hybrid financial instruments that are elected to be accounted for in their entirety at fair value cannot be used as a hedging instrument in a Statement 133 hedging relationship.) The economic characteristics and risks of the embedded derivative are not clearly and closely related to the economic characteristics and risks of the host contract (that is, the host UL contract is a debt instrument and the embedded option is equity-indexed), the hybrid instrument is not remeasured at fair value with changes in fair value reported in earnings as they occur under GAAP, and a separate instrument with the same terms as the embedded derivative instrument would be a derivative instrument pursuant to paragraphs 6–11 of Statement 133.

In contrast, if the contract contained an equity-indexed death benefit component that was over and above the cash surrender value that is payable to the policyholder upon surrender of the policy, that death benefit component would not meet the criterion in paragraph 12(c) for separate accounting—as a separate instrument, that death benefit component would not be a derivative subject to the requirements of Statement 133 due to the paragraph 10(c) exclusion for benefits payable only upon death, as illustrated in paragraph 200. That is, a contract component is not subject to the requirements of Statement 133 if it entitles the holder to be compensated *only* as a result of the death of the insured.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Embedded Derivatives: Volumetric Production Payments
Paragraph references:	6, 9, 10, 12, 16
Date cleared by Board:	May 17, 2000
Date latest revision posted to website:	June 16, 2006
Affected by:	FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments*

Revised June 16, 2006

QUESTION

Do the embedded derivative provisions of Statement 133 apply to volumetric production payments for which the quantity of the commodity that will be delivered is reliably determinable?

BACKGROUND

FASB Statement No. 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies*, addresses the accounting for production payments. The term *production payments* encompasses different types of contracts that warrant different accounting. Statement 19 differentiates between production payments that contractually involve only cash flows, which are accounted for as borrowings (under paragraph 43(b) of that Statement), and those that involve delivery of a commodity (referred to as volumetric production payments), which are accounted for as the transfer of a mineral interest. Paragraph 47(a) of Statement 19 explicitly addresses the latter as follows:

> Some production payments differ from those described in paragraph 43(b) in that the seller's obligation is not expressed in monetary terms but as an obligation to deliver, free and clear of all expenses associated with operation of the property, a specified quantity of oil or gas to the purchaser out of a specified share of future production. Such a transaction is a sale of a mineral interest for which gain shall not be recognized because the seller has a substantial obligation for future performance. The seller shall account for the funds received as unearned revenue to be recognized as the oil or gas is delivered. The purchaser of such a production payment has acquired an interest in a mineral property that shall be recorded at cost and amortized by the unit-of-production method as delivery takes place. The related reserve estimates and production data shall be reported as those of the purchaser of the production payment and not of the seller (paragraphs 50 -56).

Some oil or gas volumetric production payments relate to the production of a single well and involve significant risk with respect to the receipt of the entire quantity specified in the contract. However, in recent years some contracts have essentially eliminated that risk by linking the

deliveries under the volumetric production payments to the production from a group of producing wells or a small volume related to the expected production from a single producing well, thus making the quantity of the commodity that is delivered reliably determinable. Statement 133 specifies criteria in paragraphs 12–15 for determining when an embedded derivative must be separated from a contract and accounted for as a derivative under that Statement.

RESPONSE

Yes. The embedded derivative provisions of Statement 133 do apply to the accounting by all parties for a volumetric production payment for which the quantity of the commodity that will be delivered is reliably determinable. That volumetric production payment is not itself a standalone derivative instrument because, like the contract in Statement 133 Implementation Issue No. A1, "Initial Net Investment," it does not have the characteristic of a derivative discussed in paragraph 6(b) of Statement 133—that is, a smaller or no initial net investment. Although it is not derivative instrument, that volumetric production payment must be analyzed under paragraph 12 of Statement 133. That analysis would typically indicate that such a volumetric production payment effectively is a hybrid instrument composed of a host debt instrument embedded with a commodity forward. The embedded commodity forward meets the criterion in paragraph 12(a) of Statement 133 because commodity prices are not clearly and closely related to interest rates on the debt host contract. The criterion in paragraph 12(b) is met since a volumetric production payment is not remeasured at fair value under otherwise applicable generally accepted accounting principles with changes in fair value reported currently in earnings. Accordingly, if a separate instrument with the same terms as the commodity forward would be a derivative subject to the requirements of Statement 133, the embedded commodity forward would meet the criterion in paragraph 12(c) and must be accounted for separately. (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. However, Statement 155 does not apply to hybrid instruments that are not financial instruments, such as nonfinancial instruments that require volumetric production payments. Hybrid financial instruments that are elected to be accounted for in their entirety at fair value cannot be used as a hedging instrument in a Statement 133 hedging relationship.) However, the embedded commodity forward may nevertheless be eligible to qualify for the normal purchases and normal sales exception in paragraph 10(b) and, if so, would not be subject to the accounting requirements of Statement 133 for the party to whom it is a normal purchase or a normal sale. If it were a normal sale for the oil- or gas-producing company, the entire related volumetric production payment would be accounted for under Statement 19. If the embedded commodity forward does not qualify for the normal purchases and normal sales exception, it may qualify for designation as the hedging instrument in an "all-in-one" hedge, as discussed in Statement 133 Implementation Issue No. G2, "Hedged Transactions That Arise from Gross Settlement of a Derivative ('All-in-One' Hedges)."

If the quantity of the commodity that will be delivered under a volumetric production payment arrangement is not reliably determinable, the embedded commodity forward contracts in such

volumetric production payment arrangements are considered not to contain a notional amount as that term is used in Statement 133. Such a circumstance can occur when the oil or gas volumetric production payments relate to the production of a single well (or relatively unproven properties) and the volume under the contract is relatively large, and thereby involve significant reserve risk with respect to the receipt of the entire quantity specified in the contract. If the embedded commodity forward is not subject to the requirements of Statement 133, the entire related volumetric production payment would be accounted for under Statement 19.

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Title:	Embedded Derivatives: Accounting for Remarketable Put Bonds
Paragraph references:	12, 13, 17, 18, 61(d)
Date cleared by Board:	May 17, 2000
Date revision posted to website:	February 28, 2007
Affected by:	FASB Statement No. 157, *Fair Value Measurements* Revised September 15, 2006

QUESTIONS

In remarketable put bond structures involving three parties—a debtor, an investor (creditor), and an investment bank—what is the required accounting by the debtor and the investor for each of the following features:

- The call option written by the investor and obtained by the investment bank?
- The put option held by the investor?
- The "additional features" that may accompany certain structures?

In addition, if the call option held by the investment bank must be accounted for as a separate, freestanding derivative, how should the carrying value of that call option be determined?

BACKGROUND

In a standard *put bond*, a debtor issues a contract comprising a bond and a written put option. The option allows the investor to put the bond back to the debtor at a specific date in exchange for the bond's par value. In exchange for giving the investor the right to redeem the bond at par before maturity, the debtor pays a lower effective interest rate than would be demanded for a non-puttable bond. In addition, the rate on the bond may reset at the put date (resettable put bonds) and the bond may also involve a call option (callable, resettable put bonds).

A *remarketable put bond* is a puttable bond that generally has the following additional features:

- An investment bank obtains a call option—a right to buy the bond from the investor on the put date for the par amount. (The investment bank usually is either the underwriter of the bond issuance or an affiliate of the underwriter.)
- The bond will automatically be put back to the debtor if the investment bank does not exercise its call option to purchase the bond.
- The strike prices and the exercise dates of the investor's written call option and purchased put option are the same. The exercise dates are prior to the stated maturity of the bond.
- The bond has an interest-rate-reset feature. If the bond is not put, the bond's contractual interest rate for the remaining term to maturity will reset at the put date based on (a) the yield, at the issuance date of the puttable bond, of Treasury bonds of the same remaining

maturity as the bond plus (b) the debtor's credit spread as of the put date. (It is assumed for purposes of this issue that the interest-rate-reset feature does not trigger the condition in paragraph 13(a).)

- The proceeds from issuance exceed the par amount of the bond, net of issuance costs. This premium over par compensates the debtor for the interest-rate-reset feature. The premium generally is less than 10 percent of the par amount.

Economically, one of two scenarios will occur:

- If market interest rates increase, the fair value of the bond (absent the effect of the put option) will decrease. The put option is in the money; therefore, the investors will put the bonds to the debtor.
- If market interest rates decrease, the fair value of the bond (absent the effect of the call option) will increase. The call option is in the money; therefore, the investment bank will call the bonds from investors and resell the repriced bonds in the market at a premium.

RESPONSE

This section separately describes six remarketable put bond structures and three "additional features" that may accompany certain structures and responds to the questions relevant to each.

Structure 1

A debtor issues a resettable, puttable bond to an investment bank. The investment bank sells to an investor that resettable, puttable bond with an attached call option. The attached call option is a written option from the perspective of the investor and a purchased option from the perspective of the investment bank. That is, the investor buys a resettable, puttable bond and simultaneously writes a call option giving the investment bank the right to call the bond and take advantage of the interest-rate-reset feature.

Accounting for the call option obtained by the investment bank: The debtor should not account for the call option purchased by the investment bank from the investor. The debtor is not a party to the call option. The investor's accounting for Structure 1 is addressed in Statement 133 Implementation Issue No. B3, "Investor's Accounting for a Put or Call Option Attached to a Debt Instrument Contemporaneously with or Subsequent to Its Issuance" (refer to Example 1). Implementation Issue B3 requires that an option that is added to a debt instrument by a third party contemporaneously with or subsequent to the issuance of the debt instrument should be separately accounted for as a derivative under Statement 133 by the investor. That is, it must be reported at fair value with changes in value recognized currently in earnings. The investment bank must also account for a freestanding purchased call option.

Determination of the carrying value of the investor's freestanding call option: The carrying value of the investor's attached freestanding written call option to the investment bank

should be its fair value in accordance with paragraph 17 of Statement 133. The remaining proceeds would be allocated to the carrying amount of the puttable bond.

Accounting for the put option held by the investor: Neither the debtor nor the investor is required to account separately for the embedded put option written by the debtor to the investor. Under paragraph 61(d) of Statement 133, the put option is considered clearly and closely related to the economic characteristics of the bond because it simply accelerates the repayment of principal, involves no substantial premium or discount, and is not contingent.

Structure 2

A debtor issues a resettable, puttable bond to an investor. Contemporaneously, the investor writes a freestanding call option that permits the debtor to call the bond on the put date. The debtor immediately sells the purchased call option to an investment bank.

Accounting for the call option obtained by the investment bank: The debtor should not account separately for the call option that is purchased from the investor after it is transferred to the investment bank. The debtor is no longer a party to the call option. The investor's accounting for Structure 2 is addressed in Implementation Issue B3 (refer to Example 2), which indicates that the investor's written call option is a separate freestanding derivative that must be reported at fair value with changes in value recognized currently in earnings. The investment bank must also account for a freestanding purchased call option.

Determination of the carrying value of the investor's freestanding written call option: The carrying value of the investor's freestanding written call option to the investment bank should be its fair value in accordance with paragraph 17 of Statement 133. The remaining proceeds would be allocated to the carrying amount of the puttable bond.

Accounting for the put option held by the investor: Neither the debtor nor the investor is required to account separately for the embedded put option written by the debtor to the investor. Under paragraph 61(d) of Statement 133, the put option is considered clearly and closely related to the economic characteristics of the bond because it simply accelerates the repayment of principal, involves no substantial premium or discount, and is not contingent.

Structure 3

A debtor issues a resettable bond to an investor. The bond is puttable by the investor and callable by the debtor. The terms of the agreement stipulate that if the debtor does not exercise its purchased call option, the investor's purchased put option is automatically exercised. Contemporaneously, the debtor writes a separate, freestanding call option to an investment bank giving the investment bank the right to require the debtor to call the bond from the investor and

deliver the bond to the investment bank. In order to deliver the bond to the investment bank, the debtor must obtain the bond from the investor pursuant to either its purchased call option or its written put option. As a result, the debtor has an obligation to make the investment bank whole if it fails to deliver the bond, and the investment bank has no right to pursue the investor if the investor fails to deliver the bond to the debtor.

Accounting for the call option obtained by the investment bank: The debtor must account separately for the freestanding call option written to the investment bank, and the investment bank must account for a freestanding purchased call option, in accordance with paragraphs 17 and 18 of Statement 133. The investor is not a party to that freestanding written call option and therefore should not account for that option. (In addition to the freestanding call option held by the investment bank, Structure 3 also involves an *embedded* call option written by the investor to the debtor. That embedded call option is not required to be accounted for separately by either the debtor or the investor. Under paragraph 61(d) of Statement 133, that embedded call option is considered clearly and closely related to the economic characteristics of the bond.)

Consistent with the conclusion in Statement 133 Implementation Issue No. K3, "Determination of Whether Combinations of Options with the Same Terms Must Be Viewed as Separate Option Contracts or as a Single Forward Contract," the debtor may not designate its freestanding call option written to the investment bank as a hedge of its embedded call option purchased from the investor. Because the terms of the contractual agreement *require* the debtor to settle its obligation to the investor on the embedded options' exercise date, that "exercise date" is essentially the bond's actual maturity date. Thus, in this structure, there is no embedded option in the bond that would qualify as the hedged item in a fair value hedge in which the hedging instrument is the debtor's freestanding written call option to the investment bank. However, the debtor may designate its freestanding written call option as a hedge of another asset or liability provided that all applicable requirements, including those in paragraph 20(c), are met.

Accounting for the put option held by the investor: Neither the debtor nor the investor is required to account separately for the embedded put option written by the debtor to the investor. Under paragraph 61(d) of Statement 133, the put option is considered clearly and closely related to the economic characteristics of the bond because it simply accelerates the repayment of principal, involves no substantial premium or discount, and is not contingent.

Structure 4 (Trust-Based Format)

A debtor issues resettable, puttable bonds to a trust. The trust issues beneficial interests that mature on the put date. The trust also writes a call option to an investment bank giving the investment bank the right to call the bonds on the put date. If market interest rates fall, the investment bank will call the bonds and the trust will pay the call proceeds (the par amount) to investors to settle the maturing beneficial interests. If market interest rates increase, the trust will

put the bonds back to the debtor and will pay the put proceeds (the par amount) to investors to settle the maturing beneficial interests.

Accounting for the call option obtained by the investment bank: Neither the debtor nor the investor should account for the call option purchased by the investment bank from the trust because neither is a party to that call option. (However, if either the debtor or the investor is required to consolidate the trust, that consolidation will require recognition of the call option written by the trust to the investment bank.) The investment bank must account for a freestanding purchased call option.

Accounting for the put option held by the investor: Neither the debtor nor the investor should account separately for the embedded put option written by the debtor to the trust. From the debtor's perspective, the put option is considered clearly and closely related to the economic characteristics of the bond under paragraph 61(d) of Statement 133 because it simply accelerates the repayment of principal, involves no substantial premium or discount, and is not contingent. The investor is not a party to the embedded put option; rather, the investor simply purchased beneficial interests that mature on the put date.

Structure 5 (Remarketing Format)

A debtor issues to an investor a bond that is both puttable (by the investor) and callable (by the holder of the option). As part of the transaction, the investment bank acquires the exclusive right to purchase the bond from the investor in the future and to remarket the repriced bond. The investment bank's right to purchase the bond from the investor is set forth in the note or the indenture itself and in a separate document (a remarketing agreement) that is not part of the indenture, and is also described in the prospectus supplement. The explicit inclusion in the indenture of the investment bank's right to purchase the bond is designed to obligate initial and future investors to deliver the bond in response to the investment bank's exercise of its right. When the bond is issued, the trustee, in conformity with the transaction documents, must view the investment bank as the only party with a right to call the bond from the investor at the call/put date. Thus, the trustee does not require any involvement by the debtor when enforcing the investment bank's right to purchase the bond from the investor. The debtor's only remaining obligation is to pay interest at the reset rate if the bond remains outstanding.

Accounting for the call option obtained by the investment bank: The debtor should not account separately for the call option held by the investment bank. For accounting purposes, the transaction should be viewed as a purchase of a transferable, freestanding call option by the debtor from the investor and a concurrent transfer by the debtor of that option to the investment bank. Upon that transfer, the debtor is no longer a party to the call option and has surrendered its right to prepay the debt. The investment bank acquired the debtor's right to call the bond and relieved the debtor of the obligation to pay the investor the par amount of the bond upon exercise of the call. The call option is a contract between the investment bank and the investor that permits the investment bank to purchase the bonds from the investor at par. From the investor's perspective, that contract is a freestanding written call

option that must be accounted for in accordance with paragraphs 17 and 18 of Statement 133. That is consistent with the guidance in Statement 133 Implementation Issue No. K2, "Are Transferable Options Freestanding or Embedded?" — an option on a bond incorporated into the terms of the bond at inception that, by the terms of the agreement, is exercisable by a party other than either the debtor or the investor should be considered an attached freestanding derivative instrument. The investment bank must also account for a freestanding purchased call option.

Determination of the carrying value of the investor's freestanding written call option: The carrying value of the investor's freestanding written call option to the investment bank should be its fair value in accordance with paragraph 17 of Statement 133. In the remarketing format, the transfer of the purchased call option is concurrent with the issuance of the bond. The remaining proceeds would be allocated to the carrying amount of the puttable bond. The debtor recognizes no gain or loss upon the transfer of the option to the investment bank.

Accounting for the put option held by the investor: Neither the debtor nor the investor should account separately for the embedded put option written by the debtor to the investor. Under paragraph 61(d) of Statement 133, the put option is considered clearly and closely related to the economic characteristics of the bond because it simply accelerates the repayment of principal, involves no substantial premium or discount, and is not contingent.

Structure 6 (Assignment Format)

A debtor issues to an investor a bond that is both puttable (by the investor) and callable (by the holder of the option). The indenture and the note itself create an assignable right to purchase the bond from the investor and remarket the repriced bond. A legal assignment of that right by the debtor to an investment bank, in exchange for a payment to the debtor, is executed as part of the underwriting process as an amendment to the note. The assignment typically occurs at the time the bond is issued. Upon receipt of the notice of assignment (which typically occurs upon issuance of the bonds), the indenture trustee must view the assignee (that is, the investment bank) as the call holder and does not require any involvement of the debtor when enforcing the assignee's right to call the bond from the investor. The debtor's only remaining obligation is to pay interest at the reset rate.

Accounting for the call option obtained by the investment bank: The debtor is not required to account separately for the call option after its transfer to the investment bank. The debtor purchased a transferable freestanding call option from the investor and transferred that option to the investment bank. Therefore, after the transfer, the debtor is no longer a party to the call option and has surrendered its right to prepay the debt. The investment bank acquired the debtor's right to call the bond and relieved the debtor of the obligation to pay the investor the par amount of the bond upon exercise of the call. Ultimately, the call option is a contract between the investment bank and the investor that permits the investment bank to purchase the bond from the investor at par. From the investor's perspective, that contract

is a freestanding written call option that must be accounted for in accordance with paragraphs 17 and 18 of Statement 133. That is consistent with the guidance in Implementation Issue K2 that an option on a bond incorporated into the terms of the bond at inception that is *explicitly* transferable should be considered an attached, freestanding derivative instrument. The investment bank must also account for a freestanding purchased call option.

Determination of the carrying value of the investor's freestanding written call option: The carrying value of the investor's freestanding written call option to the investment bank should be its fair value in accordance with paragraph 17 of Statement 133 with the remaining proceeds allocated to the carrying amount of the puttable bond. In the assignment format, the transfer of the purchased call option by the debtor to the investment bank may not be concurrent with the issuance of the bond. The debtor recognizes no gain or loss upon the transfer of the call option. In transactions involving a delay between the issuance of the bond and the transfer of the assignable call option to the investment bank, the allocation of the initial proceeds to the carrying value of the option would be equal to the fair value of the option. The remaining proceeds would be allocated to the carrying amount of the puttable bond. During any period of time between the initial issuance of the bond and the transfer of the call option to the investment bank, the call option must be measured at fair value with changes in value recognized in earnings as required by paragraph 18 of Statement 133. As a result of the requirement to measure the call option at fair value during the time period before it is assigned to the investment bank, the debtor would not recognize a gain or loss upon the assignment because the proceeds paid by the investment bank would be the option's current fair value on the date of the assignment, which would be the option's carrying amount at that point in time. Any change in the fair value of the option during the time period before it is assigned to the investment bank would be attributable to the passage of time and changes in market conditions.

Accounting for the put option held by the investor: Neither the debtor nor the investor should account separately for the embedded put option written by the debtor to the investor. Under paragraph 61(d) of Statement 133, the put option is considered clearly and closely related to the economic characteristics of the bond because it simply accelerates the repayment of principal, involves no substantial premium or discount, and is not contingent.

Possible Additional Feature 1 to Structure 5 or 6

A separate agreement may exist that allows the debtor to avoid the remarketing of the bond. That agreement permits the debtor, as of the reset date, to purchase either (a) the repriced bond from

the investment bank at its then fair value or (b) the unexercised call option held by the investment bank at its then fair value, which in turn would permit the debtor to purchase the bond at par from the investor.

Accounting for the additional feature: The additional feature is a separate contract between the debtor and the investment bank. Specifically, it is a freestanding call option purchased by the debtor from the investment bank that permits the debtor to purchase either the repriced bond or the unexercised call option from the investment bank at its then fair value. Paragraphs 17 and 18 of Statement 133 require that all freestanding derivatives be measured at fair value with changes in value recognized in earnings. However, because the exercise price of the debtor's call option is the then fair value of the repriced bonds or the unexercised call option at the date of exercise, the option itself has a zero fair value. As a result, the asset or liability related to the derivative that would be recognized by the debtor as a result of applying the requirements of paragraphs 17 and 18 of Statement 133 has a value of zero.

Possible Additional Feature 2 to Structure 5 or 6

A separate agreement may exist under which the debtor writes an option to the investment bank that permits the investment bank to put its call option to the debtor at fair value if a specified contingency occurs (for example, a failed remarketing). That feature provides loss protection to the investment bank.

Accounting for the additional feature: The additional feature is a separate contract between the debtor and the investment bank. Specifically, it is a freestanding put option written by the debtor to the investment bank. Accordingly, the feature should be accounted for as a freestanding derivative measured at fair value with changes in value recognized in earnings in accordance with the requirements of paragraphs 17 and 18 of Statement 133. However, because the exercise price of the debtor's put option is the then fair value of the unexercised call option at the exercise date, the option itself has a zero fair value. As a result, the asset or liability related to the derivative that would be recognized by the debtor as a result of applying the requirements of paragraphs 17 and 18 of Statement 133 has a value of zero.

Possible Additional Feature 3 to Structure 5 or 6

Some arrangements provide recourse to the investment bank against the debtor for the fair value of the call option if the investor fails to deliver the bonds to the investment bank upon exercise of its call option. That feature provides loss protection to the investment bank.

Accounting for the additional feature: The additional feature is a separate contract between the debtor and the investment bank. Although it is structured as a recourse agreement, the substance of the feature is similar to additional feature 2 in that it is a put option written by the debtor to the investment bank. Accordingly, the feature should be accounted for as a freestanding written put option measured at fair value with changes in value recognized in earnings in accordance with the requirements of paragraphs 17 and 18 of Statement 133.

However, because the exercise price of the debtor's put option is the then fair value of the unexercised call option at the date of exercise, the option itself has a zero fair value. As a result, the asset or liability related to the derivative that would be recognized by the debtor as a result of applying the requirements of paragraphs 17 and 18 of Statement 133 has a value of zero.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Embedded Derivatives: Purchase Contracts with a Selling Price Subject to a Cap and a Floor
Paragraph references:	12, 61(f), 304–311
Date cleared by Board:	May 17, 2000
Date revision posted to website:	May 1, 2003
Affected by:	FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* Revised March 26, 2003

QUESTION

Are the economic characteristics and risks of a floor and cap on the price of an asset embedded in a contract to purchase that asset clearly and closely related to the economic characteristics and risks of the purchase contract? Specifically, are the embedded floor and cap in the illustrative purchase contract below clearly and closely related to the host contract and thus do not warrant separate accounting as derivatives under paragraph 12 of Statement 133?

BACKGROUND

A manufacturer enters into a long-term contract to purchase a specified quantity of certain raw materials from a supplier. Under the contract, the supplier will provide the manufacturer with the materials at the then current list price but within a specified range. For example, the purchase price may not exceed a cap of $120 per ton or fall below a floor of $100 per ton, and the current list price at inception of the contract is $110 per ton. The purchase contract in its entirety does not meet the definition of a derivative due to the absence of a net settlement characteristic (that is, the contract requires delivery of a raw material that is not readily convertible to cash). In addition, the purchase contract is not measured at fair value under other applicable generally accepted accounting principles.

From the manufacturer's perspective, the embedded derivatives contained in the purchase contract are 2 options: a purchased call with a strike price of $120 per ton and a written put with a strike price of $100 per ton. Those options would meet the definition of a derivative under Statement 133 if they were freestanding because they have a notional amount, have an underlying (the price per ton), require a small or no initial net investment, and can be net settled. Those options have the characteristic of net settlement under paragraph 9(a) because they represent an adjustment (that is, either a premium or rebate) of the current list price in an amount equal to the difference between that current list price and the applicable strike amount (of either $120 per ton or $100 per ton). (Paragraph 9(c) does not apply to the options because they have no provision for delivery.) The host contract can be considered a purchase contract that requires delivery of the raw materials at a price equal to the current list price.

RESPONSE

Yes. The economic characteristics and risks of the two options are clearly and closely related to the purchase contract, because the options are indexed to the purchase price of the asset that is the subject of the purchase contract. Although the example purchase contract economically contains embedded derivatives, those derivatives should not be accounted for separately because they are clearly and closely related to the host contract.

In addition, the economic features of the example purchase contract could be viewed as being somewhat similar to that of an interest-bearing debt instrument with a cap and floor on interest rates. Paragraph 61(f) of Statement 133 provides that with respect to debt hosts, interest rate caps and floors are considered to be clearly and closely related unless the conditions in either paragraph 13(a) or paragraph 13(b) are met, in which case the floors or the caps are considered to be not clearly and closely related. However, when deciding whether the economic characteristics and risks of the embedded derivative are clearly and closely related to the host contract for other nonfinancial hybrid contracts, it may not be appropriate to analogize to the guidance in paragraph 61. The guidance in paragraph 61 is not meant to address every possible feature that may be included in a hybrid instrument but, instead, that paragraph covers common features present in financial hybrid contracts.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Embedded Derivatives: Separate Accounting for Multiple Derivative Features Embedded in a Single Hybrid Instrument
Paragraph references:	12, 18, 21(f), 29(g), 181, 182, 361
Date cleared by Board:	May 17, 2000
Date revision posted to website:	March 14, 2006
Affected by:	FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments*

Revised February 16, 2006

QUESTION

Does paragraph 12 permit an entity to account separately for more than one derivative feature embedded in a single hybrid instrument?

BACKGROUND

Paragraph 12 of Statement 133 requires that an embedded derivative instrument be separated from the host contract and accounted for as a derivative instrument pursuant to the Statement if certain criteria are met unless a fair value election is made pursuant to Statement 155. (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 hedging instrument in a Statement 133 hedging relationship.) The embedded derivative provisions of Statement 133 do not provide explicit guidance regarding hybrid instruments that contain more than one embedded derivative feature and how such embedded features should be accounted for. Certain of the example hybrid instruments presented in Section 2 of Appendix B of Statement 133, "Examples Illustrating Application of the Clearly-and-Closely-Related Criterion to Derivative Instruments Embedded in Hybrid Instruments," contain more than one embedded derivative feature (refer to Examples 15 and 16 regarding range floaters and ratchet floaters, respectively), but none of those multiple embedded derivatives require separate accounting.

RESPONSE

No, paragraph 12 does not permit an entity to account separately for more than one derivative feature embedded in a single hybrid instrument. If a hybrid instrument contains more than one embedded derivative feature that would individually warrant separate accounting as a derivative instrument under paragraph 12, those embedded derivative features must be bundled together as a single, compound embedded derivative instrument that would then be bifurcated and accounted for separately from the host contract under Statement 133 unless a fair value election is made pursuant to Statement 155.

- An entity is not permitted to separate a compound embedded derivative instrument into components representing different risks (for example, based on the risks discussed in paragraphs 21(f) and 29(g)) and then account for those components separately.
- If a compound embedded derivative instrument comprises multiple embedded derivative features that all involve the same risk exposure (for example, the risk of changes in market interest rates, the creditworthiness of the obligor, or foreign currency exchange rates), but those embedded derivative features differ from one another by including or excluding optionality or by including a different optionality exposure, an entity is also not permitted to separate that compound embedded derivative instrument into components that would be accounted for separately.

Either all or a proportion of a compound embedded derivative that is accounted for separately may be designated as the hedging instrument; however, an entity is not permitted to designate any of the individual components of a compound embedded derivative as a hedging instrument. Additionally, hybrid financial instruments that are elected to be accounted for in their entirety at fair value pursuant to Statement 155 cannot be used as a hedging instrument in a Statement 133 hedging relationship. Such guidance is consistent with the prohibition against separating a freestanding compound derivative into components representing different risks (refer to paragraph 18). Paragraph 361 of Statement 133 indicates that the rationale for prohibiting the separation of a compound derivative into dissimilar components is due, in part, to fair value measurement complications and the potential weakening of effectiveness tests.

If some of the embedded derivative features in a hybrid instrument are clearly and closely related to the economic characteristics and risks of the host contract, those embedded derivative features should not be included in the compound embedded derivative instrument that is bifurcated from the host contract and separately accounted for.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Embedded Derivatives: Calls and Puts in Debt Instruments
Paragraph references:	12, 13, 61(d)
Date cleared by Board:	May 17, 2000
Date latest revision posted to website:	June 30, 2005
Affected by:	FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*
	Revised June 29, 2005

QUESTION

When should embedded calls and puts that can accelerate the settlement of debt instruments be considered to be not clearly and closely related to the debt host contract and, thus, be accounted for under the provisions of paragraph 61(d) of Statement 133? Specifically, consider the nine illustrative debt instruments in the attachment that contain calls and puts that can accelerate settlement of the debt.

BACKGROUND

Paragraph 61(d) of Statement 133, as amended by Statement 149, states that calls and puts that can accelerate the repayment of principal on a debt instrument are considered to be clearly and closely related to a debt host contract unless both (1) the debt involves a substantial premium or discount and (2) the put or call option is only contingently exercisable, provided the call options (or put options) are also considered to be clearly and closely related to the debt host contract under paragraph 13. The paragraph goes on to state that for contingently exercisable calls and puts to be considered clearly and closely related, they can be indexed only to interest rates or credit risk, not some extraneous event or factor.

RESPONSE

The following four-step decision sequence should be followed in determining whether calls and puts that can accelerate the settlement of debt instruments should be considered to be clearly and closely related to the debt host contract:

Step 1: Is the amount paid upon settlement (also referred to herein as the "payoff") adjusted based on changes in an index (rather than simply being the repayment of principal at par, together with any unpaid accrued interest)? If yes, continue to Step 2. If no, continue to Step 3.

Step 2: Is the payoff indexed to an underlying other than interest rates or credit risk? If yes, then that embedded feature is not clearly and closely related to the debt host contract and further analysis under Steps 3 and 4 is not required. If no, then that embedded feature should be analyzed further under Steps 3 and 4 as well as under the provisions of paragraphs 12, 13, and 61(a).

Step 3: Does the debt involve a substantial premium or discount? If yes, continue to Step 4. If no, in accordance with paragraph 61(d), further analysis of the contract under paragraph 13 is required to determine whether the call or put is clearly and closely related to the debt host contract.

Step 4: Does a contingently exercisable call or put accelerate the repayment of the contractual principal amount? If yes, the call or put is not clearly and closely related to the debt instrument. If not contingently exercisable, in accordance with paragraph 61(d), further analysis of the contract under paragraph 13 is required to determine whether the call or put is clearly and closely related to the debt host contract.

The attachment demonstrates the application of the guidance in this Issue to nine illustrative debt instruments.

EFFECTIVE DATE

The revisions made on April 9, 2002, emphasize that, in determining whether calls and puts that can accelerate the settlement of debt instruments are clearly and closely related to the debt host contract, analysis under paragraph 13 is required. Those changes affected Step 3 and Example 1. The effective date of the April 9, 2002 revisions to the implementation guidance in this Issue for each reporting entity is the first day of its first fiscal quarter beginning after April 10, 2002, the date that the revised Board-cleared guidance was posted to the FASB website. The revisions made on March 26, 2003, and June 29, 2005, do not affect the effective date.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Attachment to Implementation Issue No. B16

Example	Indexed Payoff? (Steps 1 and 2)	Substantial Discount or Premium? (Step 3)	Contingently Exercisable? (Step 4)	Embedded Option Clearly and Closely Related?
1. Debt that is issued at a substantial discount is callable at any time during its 10-year term. If the debt is called, the investor receives the par value of the debt plus any unpaid and accrued interest.	No.	Yes.	No.	The embedded call option is clearly and closely related to the debt host contract because the payoff is not indexed to an underlying other than interest rates or credit risk, and the call option is not contingently exercisable.
2. Debt that is issued at par is callable at any time during its term. If the debt is called, the investor receives the greater of the par value of the debt or the market value of 100,000 shares of XYZ common stock (an unrelated company).	Yes, based on an equity price.	N/A. Analysis not required.	N/A. Analysis not required.	The embedded call option is not clearly and closely related to the debt host contract because the payoff is indexed to an equity price.

Attachment to Implementation Issue No. B16

Example	Indexed Payoff? (Steps 1 and 2)	Substantial Discount or Premium? (Step 3)	Contingently Exercisable? (Step 4)	Embedded Option Clearly and Closely Related?
3. Debt that is issued at par is puttable if the S&P 500 increases by at least 20 percent. If the debt is put, the investor receives the par amount of the debt adjusted for the percentage increase in the S&P 500.	Yes, based on an equity index (S&P 500).	N/A. Analysis not required.	N/A. Analysis not required.	The embedded put option is not clearly and closely related to the debt host contract because the payoff is indexed to an equity price.
4. Debt that is issued at a substantial discount is puttable at par if LIBOR either increases or decreases by 150 basis points.	No.	Yes.	Yes, contingent on a movement of LIBOR of at least 150 basis points.	The put option is not clearly and closely related to the debt host contract because the debt was issued at a substantial discount and the put option is contingently exercisable.

Attachment to Implementation Issue No. B16

Example	Indexed Payoff? (Steps 1 and 2)	Substantial Discount or Premium? (Step 3)	Contingently Exercisable? (Step 4)	Embedded Option Clearly and Closely Related?
5. Debt that is issued at a substantial discount is puttable at par in the event of a change in control.	No.	Yes.	Yes, contingent on a change in control.	The put option is not clearly and closely related to the debt host contract because the debt was issued at a substantial discount and the put option is contingently exercisable.
6. Zero coupon debt is issued at a substantial discount and is callable in the event of a change in control. If the debt is called, the issuer pays the accreted value (calculated per amortization table based on the effective interest rate method).	No.	Yes.	Yes, contingent on a change in control, but since the debt is callable at accreted value, the call option does not accelerate the repayment of principal.	The call option is clearly and closely related to the debt host contract. Although the debt was issued at a substantial discount and the call option is contingently exercisable, the call option does not accelerate the repayment of principal because the debt is callable at the accreted value.

Attachment to Implementation Issue No. B16

Example	Indexed Payoff? (Steps 1 and 2)	Substantial Discount or Premium? (Step 3)	Contingently Exercisable? (Step 4)	Embedded Option Clearly and Closely Related?
7. Debt that is issued at par is puttable at par in the event that the issuer has an initial public offering.	No.	No	N/A. Analysis not required.	Further analysis under paragraph 13 is required.
8. Debt that is issued at par is puttable if the price of the common stock of Company XYZ (a company unrelated to the issuer or investor) changes by 20 percent. If the debt is put, the investor will be repaid based on the value of Company XYZ's common stock.	Yes, based on an equity price (price of Company XYZ's common stock).	N/A. Analysis not required.	N/A. Analysis not required.	The embedded put option is not clearly and closely related to the debt host contract because the payoff is indexed to an equity price.

Attachment to Implementation Issue No. B16

Example	Indexed Payoff? (Steps 1 and 2)	Substantial Discount or Premium? (Step 3)	Contingently Exercisable? (Step 4)	Embedded Option Clearly and Closely Related?
9. Debt is issued at a slight discount and is puttable if interest rates move 200 basis points. If the debt is put, the investor will be repaid based on the S&P 500.	Yes, based on an equity index (S&P 500).	N/A. Analysis not required.	N/A. Analysis not required.	The embedded put option is not clearly and closely related to the debt host contract because the payoff is based on an equity index.

Title:	Embedded Derivatives: Term-Extending Options in Contracts Other Than Debt Hosts
Paragraph references:	12, 61(g)
Date cleared by Board:	June 28, 2000
Date latest revision posted to website:	June 16, 2006
Affected by:	FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments*

Revised June 16, 2006

QUESTION

Should the guidance in paragraph 61(g) of Statement 133 relating to term-extending options in debt host contracts be applied by analogy to non-debt host contracts that have term extension features? Paragraph 61(g) requires a term-extending option to be considered not clearly and closely related to the debt host contract (as discussed in paragraph 12(a)) if, among other conditions, the interest rate on the debt host is not reset concurrently with the extension to the then current market rate of interest.

RESPONSE

No. Paragraph 61(g) is not meant to provide guidance for determining whether term-extending options in non-debt host contracts are clearly and closely related to the host contract, as discussed in paragraph 12(a). Paragraph 61(g) specifically addresses term-extending options in debt hosts, which would typically involve postponement of the repayment of principal. Paragraph 61(g) was designed to prevent circumvention of the guidance in paragraph 61(a), which indicates that an embedded derivative may not be considered clearly and closely related to a debt host if the investor may potentially not recover substantially all of its initial recorded investment. The postponement of repayment of principal does not cause the failure to recover substantially all of its initial recorded investment, though it can significantly reduce the fair value of the recovery of that investment.

A term-extending option in a non-debt host contract can have a significantly different effect than a term-extending option in a debt host contract. Non-debt contracts (as well as debt contracts) that contain embedded term-extension features should be evaluated under paragraph 12 of Statement 133 to determine whether the term-extension feature is a derivative that must be accounted for separately. (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. However, Statement 155 does not apply to hybrid instruments that are not financial instruments. Hybrid financial instruments that are elected to be accounted for in their entirety at fair value cannot be used as a hedging instrument in a Statement 133 hedging relationship.) Paragraph 12 provides that if a host contract contains implicit or explicit terms that affect some or all of the cash flows or the value of other exchanges required by the contract in a manner similar to a

derivative instrument, the embedded instrument shall be separately accounted for as a derivative if all of the following conditions are met:

a. The economic characteristics and risks of the embedded derivative instrument are not clearly and closely related to the economic characteristics and risks of the host contract.
b. The contract ("the hybrid instrument") that embodies both the embedded derivative instrument and the host contract is not remeasured at fair value under otherwise applicable generally accepted accounting principles with changes in fair value reported in earnings as they occur.
c. A separate instrument with the same terms as the embedded derivative instrument would, pursuant to paragraphs 6–11, be a derivative instrument subject to the requirements of this Statement. (The initial net investment for the hybrid instrument shall not be considered to be the initial net investment for the embedded derivative.)

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Embedded Derivatives: Applicability of Paragraph 12 to Contracts That Meet the Exception in Paragraph 10(b)
Paragraph references:	10(b), 58(b), 12, 197
Date cleared by Board:	June 28, 2000
Date revision posted to website:	May 1, 2003
Affected by:	FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* Revised March 26, 2003

QUESTION

If a contract, in its entirety, meets the definition of a derivative as set forth in paragraphs 6–9 of Statement 133 but qualifies for a scope exception under paragraph 10(b), must that contract also be assessed under paragraph 12 to determine whether it is a hybrid instrument that contains an embedded derivative that must be accounted for separately?

BACKGROUND

Paragraph 10 of Statement 133 indicates that derivative instruments that meet the criteria in paragraph 10(b) for the normal purchases and normal sales exception are not subject to the requirements of that Statement.

Paragraph 12 of Statement 133 states:

> Contracts that do not in their entirety meet the definition of a derivative instrument (refer to paragraphs 6–9), such as bonds, insurance policies, and leases, may contain "embedded" derivative instruments—implicit or explicit terms that affect some or all of the cash flows or the value of other exchanges required by the contract in a manner similar to a derivative instrument….An embedded derivative instrument shall be separated from the host contract and accounted for as a derivative instrument pursuant to this Statement if and only if all of the following criteria are met:
>
> a. The economic characteristics and risks of the embedded derivative instrument are not clearly and closely related to the economic characteristics and risks of the host contract….
> b. The contract ("the hybrid instrument") that embodies both the embedded derivative instrument and the host contract is not remeasured at fair value under otherwise applicable generally accepted accounting principles with changes in fair value reported in earnings as they occur.
> c. A separate instrument with the same terms as the embedded derivative instrument would, pursuant to paragraphs 6–11, be a derivative instrument subject to the requirements of this Statement….

In June 2000, the FASB issued FASB Statement No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*, an amendment of Statement 133. Statement 138 revised Example 31 in paragraph 197 of Statement 133 to indicate that a compound derivative (in the example, representing a foreign currency derivative and a forward commodity contract) cannot be separated into its components and accounted for separately under Statement 133. Paragraph 10(b) (as amended by Statement 138 and Statement 149) states that "contracts that have a price based on an underlying that is not clearly and closely related to the asset being sold or purchased (such as a price in a contract for the sale of a grain commodity based in part on changes in the S&P index) or that are denominated in a foreign currency that meets none of the criteria in paragraphs 15(a)–15(d) shall not be considered normal purchases and normal sales." Thus, the example contract in paragraph 197 must be accounted for as a derivative.

RESPONSE

No. A contract that meets the definition of a derivative in its entirety but qualifies for a scope exception under paragraph 10(b) of Statement 133 should not also be assessed under paragraph 12. Paragraph 12 applies only to contracts that do not meet the definition of a derivative in their entirety. That conclusion is not changed by the fact that a contract that meets the definition of a derivative in its entirety is not subject to the requirements of Statement 133 pursuant to a scope exception provided by paragraph 10(b).

Statement 133 does not intend for a contract to both meet the definition of a derivative in its entirety and be considered a hybrid instrument that contains an embedded derivative that requires separate accounting. Paragraph 12 explicitly states, "Contracts that do *not in their entirety* meet the definition of a derivative instrument (refer to paragraphs 6–9), such as bonds, insurance policies, and leases, may contain 'embedded' derivative instruments…" (emphasis added).

The exception outlined in paragraph 10(b) is written narrowly to permit only a subset of contracts with certain specific characteristics to qualify. If a contract has characteristics that extend beyond those described in paragraphs 10(b) and 58(b), the application of the scope exception is not permitted and the contract, in its entirety, must be accounted for as a derivative. As noted above, contracts that have a price based on an underlying that is not clearly and closely related to the asset being sold or purchased (such as a price in a contract for the sale of a grain commodity based in part on changes in the S&P index) or that are denominated in a foreign currency that does not meet the criteria in paragraphs 15(a)–15(d) shall not be considered normal purchases and normal sales. An entity is prohibited from separating a compound derivative into a portion that qualifies for the scope exception under paragraph 10(b) and a portion that must be accounted for as a derivative under Statement 133. Example 31 in paragraph 197 of Statement 133 (as amended by Statement 138) provides explicit guidance that prohibits such bifurcation.

If a contract meets the criteria to qualify for that scope exception, that contract is not subject to the accounting requirements of Statement 133 for derivatives but, rather, shall be accounted for based on generally accepted accounting principles applicable to instruments of that type.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title: Embedded Derivatives: Identifying the Characteristics of a Debt Host Contract
Paragraph references: 12, 60
Date cleared by Board: June 28, 2000

QUESTION

How does an entity identify the characteristics of a debt host contract? Is the debt host contract for a hybrid bond embedded with a derivative required to be a fixed-rate, floating-rate, or zero-coupon bond? For example, for a bond indexed to the Standard and Poor's Composite Index of 500 Stocks (S&P 500) with coupons based on the S&P 500 yield, it isn't clear whether the host, plain-vanilla debt contract is a fixed-rate, floating-rate, or zero-coupon instrument.

BACKGROUND

Paragraph 12 of Statement 133 requires that an embedded derivative instrument be separated from the host contract and accounted for as a derivative instrument pursuant to the Statement if certain criteria are met. Paragraph 60 of Statement 133 provides guidance for determining whether the host contract is a debt or equity instrument. However, the embedded derivative provisions of Statement 133 do not provide explicit guidance regarding whether a debt host contract is required to be a fixed-rate, floating-rate, or zero-coupon bond.

RESPONSE

The characteristics of a debt host contract generally should be based on the stated or implied substantive terms of the hybrid instrument. Those terms may include a fixed-rate, floating-rate, zero-coupon, discount or premium, or some combination thereof.

In the absence of stated or implied terms, an entity may make its own determination of whether to account for the debt host as a fixed-rate, floating-rate, or zero-coupon bond. That determination requires the application of judgment, which is appropriate because the circumstances surrounding each hybrid instrument containing an embedded derivative may be different. That is, in the absence of stated or implied terms, it is appropriate to consider the features of the hybrid instrument, the issuer, and the market in which the instrument is issued, as well as other factors, in order to determine the characteristics of the debt host contract.

However, an entity may not express the characteristics of the debt host contract in a manner that would result in identifying an embedded derivative that is not already clearly present in a hybrid instrument. For example, it would be inappropriate to identify a floating-rate host contract and an interest rate swap component that has a comparable floating-rate leg in an embedded compound derivative, in lieu of identifying a fixed-rate host contract. Similarly, it would be inappropriate to identify a fixed-rate host contract and a fixed-to-floating interest rate swap

component in an embedded compound derivative in lieu of identifying a floating-rate host contract.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Embedded Derivatives: Must the Terms of a Separated Non-Option Embedded Derivative Produce a Zero Fair Value at Inception?
Paragraph reference:	12
Date cleared by Board:	June 28, 2000
Date revision posted to website:	March 14, 2006
Affected by:	FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments*

Revised February 16, 2006

QUESTION

In separating a non-option embedded derivative from the host contract under paragraph 12, must the terms of that non-option embedded derivative be determined so as to result in the derivative having a fair value of zero (that is, be "at-the-market") at the inception of the hybrid instrument? This question assumes that the non-option embedded derivative is a plain-vanilla forward contract with symmetrical risk exposure and that the hybrid instrument was newly entered into by the parties to the contract. Specifically, should the separation of the illustrative hybrid instruments below (that is, the structured notes) into embedded derivatives and host debt instruments (1) be the same for all five terms described for the structured note (because they are merely different descriptions of the same ultimate cash flows) or (b) be different (either mandatorily or permissively) in order to reflect the terms of the structured note?

BACKGROUND

Paragraph 12 of Statement 133 requires that an embedded derivative instrument be separated from the host contract and accounted for as a derivative instrument pursuant to the Statement if certain criteria are met. (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 hedging instrument in a Statement 133 hedging relationship.) The embedded derivative provisions of Statement 133 do not provide explicit guidance regarding whether an embedded derivative must be assumed to have a fair value of zero at the inception of the hybrid instrument. For purposes of this Issue, assume that the hybrid instrument is not a derivative in its entirety.

Example Hybrid Instruments — Embedded Forward Contracts

Company A plans to advance Company X $900 for 1 year at a 6 percent interest rate and concurrently enter into an equity-based derivative in which it will receive any increase or pay any decrease in the current market price ($200) of XYZ Corporation's common stock. Those two transactions (that is, the loan and the derivative) can be bundled in a structured note that

could have almost an infinite variety of terms. The following presents 5 possible contractual terms for the structured note that would be purchased by Company A for $900:

1. Note 1: Company A is entitled to receive at the end of 1 year $954 plus any excess (or minus any shortfall) of the current per share market price of XYZ Corporation's common stock over (or under) $200.
2. Note 2: Company A is entitled to receive at the end of 1 year $955 plus any excess (or minus any shortfall) of the current per share market price of XYZ Corporation's common stock over (or under) $201.
3. Note 3: Company A is entitled to receive at the end of 1 year $755 plus any excess (or minus any shortfall) of the current per share market price of XYZ Corporation's common stock over (or under) $1.
4. Note 4: Company A is entitled to receive at the end of 1 year $1,054 plus any excess (or minus any shortfall) of the current per share market price of XYZ Corporation's common stock over (or under) $300.
5. Note 5: Company A is entitled to receive at the end of 1 year $1,060 plus any excess (or minus any shortfall) of the current per share market price of XYZ Corporation's common stock over (or under) $306.

All of the above five terms of a structured note will provide the same cash flows, given a specified market price of XYZ Corporation's common stock. If the market price of XYZ Corporation's common stock at the end of 1 year is still $200, Company A will receive $954 under all 5 note terms. If the market price of XYZ Corporation's common stock at the end of 1 year increases to $306, Company A will receive $1,060 under all 5 note terms.

For simplicity in constructing this example, it is assumed that an equity-based cash-settled forward contract with a strike price equal to the stock's current market price has a zero fair value. In many circumstances, a zero-value forward contract can have a strike price greater or less than the stock's current market price.

RESPONSE

Yes. In separating a non-option embedded derivative from the host contract under paragraph 12, the terms of that non-option embedded derivative should be determined in a manner that results in its fair value generally being equal to zero at the inception of the hybrid instrument. Since a loan and a derivative can be bundled in a structured note that could have almost an infinite variety of stated terms, it is inappropriate to necessarily attribute significance to every one of the note's stated terms in determining the terms of the non-option embedded derivative. If a non-option embedded derivative has stated terms that are off-market at inception, that amount should be quantified and allocated to the host contract since it effectively represents a borrowing. (This Issue does not address the bifurcation of the embedded derivative by a holder who has acquired the hybrid instrument from a third party *subsequent* to the inception of that hybrid instrument.)

The non-option embedded derivative should contain a notional amount and an underlying consistent with the terms of the hybrid instrument. Artificial terms should not be created to introduce leverage, asymmetry, or some other risk exposure not already present in the hybrid instrument. Generally, the appropriate terms for the non-option embedded derivative will be readily apparent. Often, simply adjusting the referenced forward price (pursuant to documented legal terms) to be at-the-market for the purpose of separately accounting for the embedded derivative will result in that non-option embedded derivative having a fair value of zero at inception of the hybrid instrument.

The differences in the terms for the above five notes are totally arbitrary because those differences have no impact on the ultimate cash flows under the structured note; thus, those differences are nonsubstantive and should have no influence on how the terms of an embedded derivative are identified. Therefore, the separation of the hybrid instrument into an embedded derivative and a host debt instrument should be the same for all five terms described above for the structured note (because they are merely different descriptions of the same ultimate cash flows). That bifurcation would generally result in the structured note being accounted for as a debt host contract with an initial carrying amount of $900 and a fixed annual rate of interest of 6 percent and an embedded forward contract with a $200 forward price, which results in an initial fair value of zero. Instead, if the five notes were bifurcated based on all their contractual terms, such bifurcation would be the equivalent of simply marking an arbitrary portion of a debt instrument to market based on nonsubstantive arbitrary differences in those contractual terms—an inappropriate outcome.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Embedded Derivatives: When Embedded Foreign Currency Derivatives Warrant Separate Accounting
Paragraph reference:	15
Date cleared by Board:	June 28, 2000
Date revision posted to website:	May 1, 2003
Affected by:	FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* Revised March 26, 2003

QUESTIONS

1. How does the bifurcation exception for foreign currency derivatives in paragraph 15(a) of Statement 133 apply when the contract's payments are denominated in a currency that is not the functional currency of any substantial party to the contract but is used pursuant to paragraph 11 of FASB Statement No. 52, *Foreign Currency Translation,* as if it were the functional currency to remeasure the financial statements of a substantial party to the contract due to that party's primary economic environment being highly inflationary? What is the impact on the application of paragraph 15(a) if the economy of that primary economic environment later ceases to be highly inflationary? (Refer to Examples 1 and 1A below.)
2. Is a guarantor a substantial party to the contract under paragraph 15(a)? (Refer to Example 2 below.)
3. How should the phrase *routinely denominated in international commerce* in paragraph 15(b) be applied? Should the application of that phrase be based on how similar transactions for a certain product or service in international commerce are routinely structured around the world or just within the local area of one of the substantial parties to the contract? How does that phrase apply to Example 3, in which the lease payments for private lease transactions for real or personal property are denominated in U.S. dollars even though the substantial parties to the lease do not have the U.S. dollar as their functional currencies?

BACKGROUND

Paragraph 15 of Statement 133, as amended by Statement 149, states:

> An embedded foreign currency derivative instrument shall *not* be separated from the host contract and considered a derivative instrument under paragraph 12 if the host contract is not a financial instrument and it requires payment(s) denominated in (a) the functional currency of any substantial party to that contract, (b) the currency in which the price of the related good or service that is acquired or delivered is routinely

> denominated in international commerce (for example, the U.S. dollar for crude oil transactions),* (c) the local currency of any substantial party to the contract, or (d) the currency used by a substantial party to the contract as if it were the functional currency because the primary economic environment in which the party operates is highly inflationary (as discussed in paragraph 11 of Statement 52). The evaluation of whether a contract qualifies for the exception in this paragraph should be performed only at inception of the contract. Unsettled foreign currency transactions, including financial instruments, that are monetary items and have their principal payments, interest payments, or both denominated in a foreign currency are subject to the requirement in Statement 52 to recognize any foreign currency transaction gain or loss in earnings and shall not be considered to contain embedded foreign currency derivative instruments under this Statement. The same proscription applies to available-for-sale or trading securities that have cash flows denominated in a foreign currency.
>
> * If similar transactions for a certain product or service are routinely denominated in international commerce in various different currencies, the transaction does not qualify for the exception.

Statement 52 defines *functional currency* as the currency of the primary economic environment in which the entity operates; normally, that is the currency of the environment in which an entity primarily generates and expends cash. Paragraph 11 of Statement 52 requires the financial statements of foreign entities in highly inflationary economies to be remeasured *as if* the functional currency were the reporting currency. For example, if a U.S. parent company (for which the U.S. dollar is both the functional currency and the reporting currency) had concluded that the Venezuelan bolivar was the functional currency of its Venezuelan subsidiary but the Venezuelan economy was considered highly inflationary under the criteria in paragraph 11, the subsidiary's financial statements would be remeasured as though the U.S. dollar were its functional currency.

The following examples are relevant to the questions posed:

Example 1: The payments are denominated in a currency that, while not the functional currency, is used as if it were the functional currency due to a highly inflationary economy

A U.S. parent company for which the U.S. dollar is both the functional currency and the reporting currency has a Venezuelan subsidiary. The subsidiary's sales, expenses, and financing are primarily denominated in the Mexican peso, and therefore the subsidiary considers the peso to be its functional currency as required by Statement 52. However, assume that the economy in Mexico is highly inflationary, and therefore Statement 52 requires that the parent company's reporting currency (that is, the U.S. dollar) be used as if it were the subsidiary's functional currency. The subsidiary enters into a lease with a Canadian company for property in Venezuela that requires the subsidiary to make lease payments in U.S. dollars. Further, assume that the Canadian company's functional currency is the Canadian dollar. The Venezuelan subsidiary's local currency is the bolivar.

Example 1A: The economy of the primary economic environment ceases to be highly inflationary after the inception of the contract

Assume the same facts as discussed in Example 1 except that during the term of the property lease, the Mexican economy ceases to be highly inflationary. Therefore, the Venezuelan subsidiary's financial statements cease to be remeasured as if the U.S. dollar were the functional currency and, instead, those financial statements are remeasured using the subsidiary's functional currency, the Mexican peso.

Example 2: A guarantor as a substantial party to the contract

A U.S. parent company for which the U.S. dollar is the functional currency has a French subsidiary with a Euro functional currency. The subsidiary enters into a lease with a Canadian company for which the Canadian dollar is the functional currency that requires lease payments denominated in U.S. dollars. The parent company guarantees the lease.

Example 3: Understanding the application of the phrase *routinely denominated in international commerce*

A real estate lease negotiated privately between companies involved in international commerce in certain South American economies would routinely require U.S. dollar payments. Real estate leases negotiated privately between companies involved in international commerce in European economies would routinely not require U.S. dollar payments. The lessee is a Canadian company that uses the Canadian dollar as its functional currency. The lessor is a Venezuelan company whose functional currency is the Mexican peso. The lease payments are denominated in U.S. dollars.

RESPONSE

Question 1

Paragraph 15 of Statement 133, as amended by Statement 149, states that an embedded foreign currency derivative instrument should not be separated from the host contract and considered a derivative instrument under paragraph 12 if the host contract is not a financial instrument and it requires payment(s) denominated in one of the following currencies:

1. The functional currency of any substantial party to that contract
2. The currency in which the price of the related good or service that is acquired or delivered is routinely denominated in international commerce (for example, the U.S. dollar for crude oil transactions)
3. The local currency of any substantial party to the contract
4. The currency used by a substantial party to the contract as if it were the functional currency because the primary economic environment in which the party operates is highly inflationary (as discussed in paragraph 11 of Statement 52).

If a contract's payments are denominated in one of those currencies, then that foreign currency is integral to the arrangement and thus considered to be clearly and closely related to the terms of the contract. The evaluation of whether a contract qualifies for the exception in paragraph 15 is performed only at inception of the contract.

The exception in paragraph 15 applies to the contract in Example 1 because the subsidiary uses the U.S. dollar as if it were the functional currency. The conclusion is not affected by the fact that the U.S. dollar is not the currency of the primary economic environment in which either the Venezuelan subsidiary or the Canadian lessor operates (that is, the U.S. dollar is not the functional currency of either party to the lease). The forward contract to deliver U.S. dollars embedded in the lease contract should not be bifurcated from the lease host. The exception in paragraph 15 would apply to the lease contract in Example 1 if the payments under that contract were denominated in any of the following four currencies: (1) the U.S. dollar, (2) the Mexican peso, (3) the Venezuelan bolivar, or (4) the Canadian dollar. The exception applies to both of the substantial parties to the contract, the lessor and the lessee.

In Example 1A, when the lease was entered into, the subsidiary used the U.S. dollar as if it were the functional currency; therefore, the foreign currency embedded derivative would have qualified for the exception in paragraph 15 for both the lessor and the lessee. The fact that the subsidiary subsequently ceased using the U.S. dollar as if it were the functional currency and, instead, now uses the peso (which was outside the control of management of the entity because it is contingent upon a change in the Mexican economy) does not affect the application of the exception because the subsidiary qualified for the exception at the inception of the contract. However, if the subsidiary would enter into an extension of the lease or a new lease that required payments in the U.S. dollar, the exception would not apply because at the time the new or extended lease was entered into, the subsidiary no longer used the U.S. dollar as if it were the functional currency.

Question 2

No, the exception in paragraph 15(a) does not apply to the contract in Example 2. The substantial parties to a lease contract are the lessor and the lessee; a third-party guarantor is not a substantial party to a two-party lease, even when it is a related party (such as a parent company). Thus, the functional currency of a guarantor is not relevant to the application of paragraph 15(a).

Question 3

The application of the phrase *routinely denominated in international commerce* in paragraph 15(b) should be based on how similar transactions for a certain product or service are routinely structured around the world, not just in one local area. Therefore, if similar transactions for a certain product or service are routinely denominated in international commerce in various different currencies, the exception in paragraph 15(b) does not apply to any of those similar transactions (as noted in the footnote to paragraph 15). The evaluation of whether a contract qualifies for the exception in paragraph 15(b) is performed only at inception of the contract.

In Example 3, because real estate leases around the world are not routinely denominated in U.S. dollars, the leasing transaction would not qualify for the exception in paragraph 15(b).

At its June 28, 2000 meeting, the Board reached the above answers.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Embedded Derivatives: Whether the Terms of a Separated Option-Based Embedded Derivative Must Produce a Zero Fair Value (Other Than Time Value)
Paragraph reference:	12
Date cleared by Board:	December 6, 2000

QUESTION

In separating an option-based embedded derivative from the host contract under paragraph 12, must the terms of that option-based embedded derivative be determined so as to result in the derivative being "at-the-money" (that is, the strike price equals the price of the asset associated with the underlying, in which case the intrinsic value is zero) and, therefore, a fair value equal to the time value component?

BACKGROUND

Paragraph 12 of Statement 133 requires that an embedded derivative instrument be separated from the host contract and accounted for as a derivative instrument pursuant to the Statement if certain criteria are met. The embedded derivative provisions of Statement 133 do not provide explicit guidance regarding whether an embedded derivative must be assumed to have a fair value of zero (that is, be at-the-money). The conclusion in Statement 133 Implementation Issue No. B20, "Must the Terms of a Separated Non-Option Embedded Derivative Produce a Zero Fair Value at Inception?" indicates that in separating a non-option embedded derivative from the host contract under paragraph 12, the terms of that non-option embedded derivative should be determined in a manner that results in a fair value generally equal to zero at the inception of the hybrid instrument. For purposes of this Issue, assume that the hybrid instrument is not a derivative in its entirety.

RESPONSE

No, the terms of the option-based embedded derivative should not be adjusted to result in the derivative being at-the-money at the inception of the hybrid. In separating an option-based embedded derivative from the host contract under paragraph 12, the strike price of the embedded derivative should be based on the stated terms documented in the hybrid contract. As a result, the option-based embedded derivative at inception may have a strike price that does not equal the market price of the asset associated with the underlying.

There are substantive, fundamental differences between forward-based and option-based contracts. Adjusting the strike price of an option-based embedded derivative fundamentally alters the economics of the hybrid instrument, whereas adjusting the strike price of a forward-based embedded derivative does not necessarily fundamentally alter the economics of the hybrid instrument, as discussed in Implementation Issue B20. For example, if an option-based derivative is in-the-money, that intrinsic value amount does not represent a lending activity since

the option may never be exercised (that is, it may expire out-of-the-money due to a change in the underlying) and, therefore, a cash flow may not occur by the end of the term. Conversely, the contractual terms of a forward contract are such that a cash flow will occur at maturity. Thus, if the terms of a forward contract result in a fair value other than zero, that amount effectively represents a borrowing (pursuant to the guidance in Implementation Issue B20). The foregoing fundamental distinctions warrant different guidance on accounting for option-based and non-option-based embedded derivatives.

The guidance in this Issue addresses the bifurcation of the option-based embedded derivative by a holder who has acquired the hybrid instrument from a third party either at inception or subsequent to inception of that hybrid instrument. The guidance also addresses the bifurcation of the option-based embedded derivative by the issuer when separate accounting for that embedded derivative is required.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Embedded Derivatives: Terms of a Separated Non-Option Embedded Derivative When the Holder Has Acquired the Hybrid Instrument Subsequent to Its Inception
Paragraph reference:	12
Date cleared by Board:	December 6, 2000
Date revision posted to website:	March 14, 2006
Affected by:	FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments*

Revised February 16, 2006

QUESTION

If the holder has acquired the hybrid instrument that includes a non-option embedded derivative *subsequent* to the inception of that hybrid instrument, must the terms of that non-option embedded derivative that is separated from the host contract under paragraph 12 be determined by the holder so as to result in the derivative having a fair value of zero (that is, be "at-the-market") at the date the holder enters into (that is, acquires) the hybrid instrument or at the earlier inception of the hybrid instrument when an unrelated third party enters into it?

BACKGROUND

Paragraph 12 of Statement 133 requires that an embedded derivative instrument be separated from the host contract and accounted for as a derivative instrument pursuant to the Statement if certain criteria are met. (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 hedging instrument in a Statement 133 hedging relationship.) The embedded derivative provisions of Statement 133 do not provide explicit guidance regarding whether an embedded derivative must be assumed to have a fair value of zero (that is, be at-the-market). The conclusion in Statement 133 Implementation Issue No. B20, "Must the Terms of a Separated Non-Option Embedded Derivative Produce a Zero Fair Value at Inception?" indicates that in separating a non-option embedded derivative from the host contract under paragraph 12, the terms of that non-option embedded derivative should be determined in a manner that results in a fair value generally equal to zero at the date the holder enters into the hybrid instrument (which is assumed to be the inception of the hybrid instrument). That Issue does not address the bifurcation of the embedded derivative by a holder who has acquired a pre-existing hybrid instrument from a third party *subsequent* to the inception of that hybrid instrument.

RESPONSE

In separating a non-option embedded derivative from the host contract under paragraph 12 when the holder has acquired the hybrid instrument in a secondary market *subsequent* to the inception of the hybrid instrument, the terms of the embedded derivative should be determined by the holder so as to result in the derivative having a fair value generally equal to zero at the date the holder enters into (that is, acquires) the hybrid instrument. The initial accounting by the holder of the hybrid instrument should not be impacted by whether it purchased the hybrid instrument at inception or subsequent to inception in a secondary market.

The above guidance should also be applied at the date an entity adopts Statement 133 (if the entity has not elected the grandfathering provisions in paragraph 50) such that the terms of the non-option embedded derivative should be determined by the entity so as to result in the derivative having a fair value generally equal to zero at the date that entity enters into the hybrid instrument regardless of whether that date is the inception of the hybrid instrument or a later point in time.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Embedded Derivatives: Interaction of the Requirements of EITF Issue No. 86-28 and Statement 133 Related to Structured Notes Containing Embedded Derivatives
Paragraph reference:	12(b)
Date cleared by Board:	December 6, 2000
Date revision posted to website:	March 14, 2006
Affected by:	FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments*

Revised February 16, 2006

QUESTION

An entity that issued a structured note that is not eligible to be grandfathered under paragraph 50 of Statement 133 (as amended by FASB Statement No. 137, *Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133*) determined that the structured note does not meet the definition of a derivative in its entirety but contains an embedded feature that is not clearly and closely related to the host contract and meets the definition of a derivative pursuant to paragraph 6 of Statement 133. Prior to its adoption of Statement 133, the entity applied the consensus in EITF Issue No. 86-28, "Accounting Implications of Indexed Debt Instruments," to the structured note. The entity did not allocate proceeds to the contingent payment feature, and any change in the liability resulting from a change in the relevant index value is recorded as an adjustment of the carrying amount of the debt obligation that is recognized in earnings currently. May the entity consider the criterion in paragraph 12(b) of Statement 133 as *not* met because the structured note's contingent payment feature is measured based on an index value with changes in that value reported in earnings as they occur and, therefore, avoid accounting for the embedded feature separately?

BACKGROUND

Issue 86-28 addresses a situation in which an entity issues a debt instrument with both a guaranteed and contingent payment. The contingent payment may be linked to the price of a specific commodity (for example, oil) or a specific index (for example, the S&P 500). In some instances, the investor's right to receive the contingent payment is separable from the debt instrument. The issue addresses (1) whether the proceeds should be allocated between the debt liability and the investor's right to receive a contingent payment and (2) the issuer's subsequent accounting for recognition of increases in the underlying commodity or index values.

On item (1) above, the Task Force reached a consensus that, if the investor's right to receive contingent payments is separable, the issuer should allocate the proceeds between the debt instrument and the investor's stated right to receive the contingent payments. On item (2) above, the Task Force reached a consensus that, irrespective of whether any portion of the proceeds is allocated to the contingent payment, as the applicable index value increases such to

that the issuer would be required to pay the investor a contingent payment at maturity, the issuer should recognize a liability for the amount that the contingent payment exceeds the amount, if any, originally attributed to the contingent payment feature. The liability for the contingent payment feature should be based on the applicable index value at the balance sheet date and should not anticipate any future changes in the index value. When no proceeds are originally allocated the contingent payment, the additional liability resulting from the fluctuating index value should be accounted for as an adjustment of the carrying amount of the debt obligation. If the index increases and the issuer would be required to establish an additional liability, a majority of the Task Force favored recognizing the increase in the contingent payment as a current expense, but a consensus was not reached. The issue summary indicates that, if the index increases to a level that would require liability accrual, the staff believes the issuer should recognize the contingent payment as additional expense.

Paragraph 12 of Statement 133 states, in part:

> Contracts that do not in their entirety meet the definition of a derivative instrument…may contain "embedded" derivative instruments—implicit or explicit terms that affect some or all of the cash flows or the value of other exchanges required by the contract in a manner similar to a derivative instrument….An embedded derivative instrument shall be separated from the host contract and accounted for as a derivative instrument pursuant to this Statement if and only if all of the following criteria are met:
>
> a. The economic characteristics and risks of the embedded derivative instrument are not clearly and closely related to the economic characteristics and risks of the host contract….
> b. The contract ("the hybrid instrument") that embodies both the embedded instrument and the host contract is not remeasured at fair value under otherwise applicable generally accepted accounting principles with changes in fair value reported in earnings as they occur.
> c. A separate instrument with the same terms as the embedded derivative instrument would, pursuant to paragraphs 6–11, be a derivative instrument subject to the requirements of this Statement….

RESPONSE

No. The requirement in the Issue 86-28 consensus to recognize a liability for the amount that the contingent payment exceeds the amount, if any, originally attributed to the contingent payment feature satisfies the criterion of paragraph 12(b) that the structured note is *not* measured at fair value, with changes in value reported in current earnings, and thus does not enable an entity to avoid separating an embedded derivative from a host contract unless a fair value election had been made upon the adoption of Statement 155. (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 hedging instrument in a Statement 133 hedging relationship.) Measurement of a structured note's contingent payment feature based on an "index" value is generally not equal to measurement of the overall hybrid instrument based on fair value because the overall hybrid instrument's fair value encompasses components of value that are not captured by measuring only the note's contingent payment feature based on an index value. For example, the hybrid instrument's fair value would reflect adjustments attributable to interest rate risk (if the structured note bears a fixed rate of interest), credit risk, and liquidity risk. Therefore, structured notes that are not in their entirety measured based on fair value and that contain embedded derivative features must be evaluated under the provisions of paragraphs 12(a) and 12(c) of Statement 133 to determine whether they contain embedded derivatives that must be accounted for separately.

However, the consensus in Issue 86-28 would continue to be applicable to structured notes with contingent payments linked to the price of a specific commodity or index that are grandfathered by paragraph 50 of Statement 133 (as amended by Statement 137), which permits entities not to account separately for embedded derivatives in hybrid instruments issued before January 1, 1998 or January 1, 1999, as elected by the reporting entity.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Embedded Derivatives: Deferred Variable Annuity Contracts with Payment Alternatives at the End of the Accumulation Period
Paragraph references:	6(c), 9, 10(c), 12, 57(c), 200
Date cleared by Board:	March 14, 2001
Date posted to website:	April 10, 2001
Date revision posted to website:	January 9, 2002 Revised December 19, 2001

QUESTIONS

There are various types of annuity payment options offered by insurance enterprises to policyholders. This Issue addresses four common payment alternatives. The first three questions address the accounting for payment alternatives offered during the accumulation phase of the contract, while the fourth question addresses the accounting for guaranteed minimum periodic annuity payments in the contract's payout phase.

1. During the accumulation phase of a deferred variable annuity contract, would the guarantee of a minimum interest rate to be used in computing periodic annuity payments if and when a policyholder elects to annuitize require separate accounting as an embedded derivative under paragraph 12 of Statement 133?
2. During the accumulation phase of a deferred variable annuity contract, would a provision that guarantees a minimum account value that is available to annuitize if and when a policyholder elects to annuitize require separate accounting as an embedded derivative under paragraph 12 of Statement 133?
3. During the accumulation phase of a deferred variable annuity contract, would a provision that guarantees a minimum level of periodic annuity payments during the payout phase if and when a policyholder elects to annuitize into a variable-payout annuity require separate accounting as an embedded derivative under paragraph 12 of Statement 133? This question assumes that the contract is annuitized at its contract value without any floor account value guarantee specified in Question 2.
4. During the payout phase of a variable-payout annuity, would a provision that guarantees a minimum level of periodic payments require separate accounting as an embedded derivative under paragraph 12 of Statement 133? (This type of provision may be found in contracts referred to as standalone immediate-payout annuities or in the payout phase of an existing annuity.)

BACKGROUND

Paragraph 12 of Statement 133 states, in part:

> An embedded derivative instrument shall be separated from the host contract and accounted for as a derivative instrument pursuant to this Statement if and only if all of the following criteria are met:
>
> a. The economic characteristics and risks of the embedded derivative instrument are not clearly and closely related to the economic characteristics and risks of the host contract. Additional guidance on applying this criterion to various contracts containing embedded derivative instruments is included in Appendix A of this Statement.
> b. The contract ("the hybrid instrument") that embodies both the embedded derivative instrument and the host contract is not remeasured at fair value under otherwise applicable generally accepted accounting principles with changes in fair value reported in earnings as they occur.
> c. A separate instrument with the same terms as the embedded derivative instrument would, pursuant to paragraphs 6–11, be a derivative instrument subject to the requirements of this Statement. (The initial net investment for the hybrid instrument shall not be considered to be the initial net investment for the embedded derivative.)

An annuity contract, as defined in FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, is a contract that provides fixed or variable periodic payments made from a stated or contingent date and continuing for a specified period, such as for a number of years or for life. A variable annuity contract is defined in Statement 60 as follows:

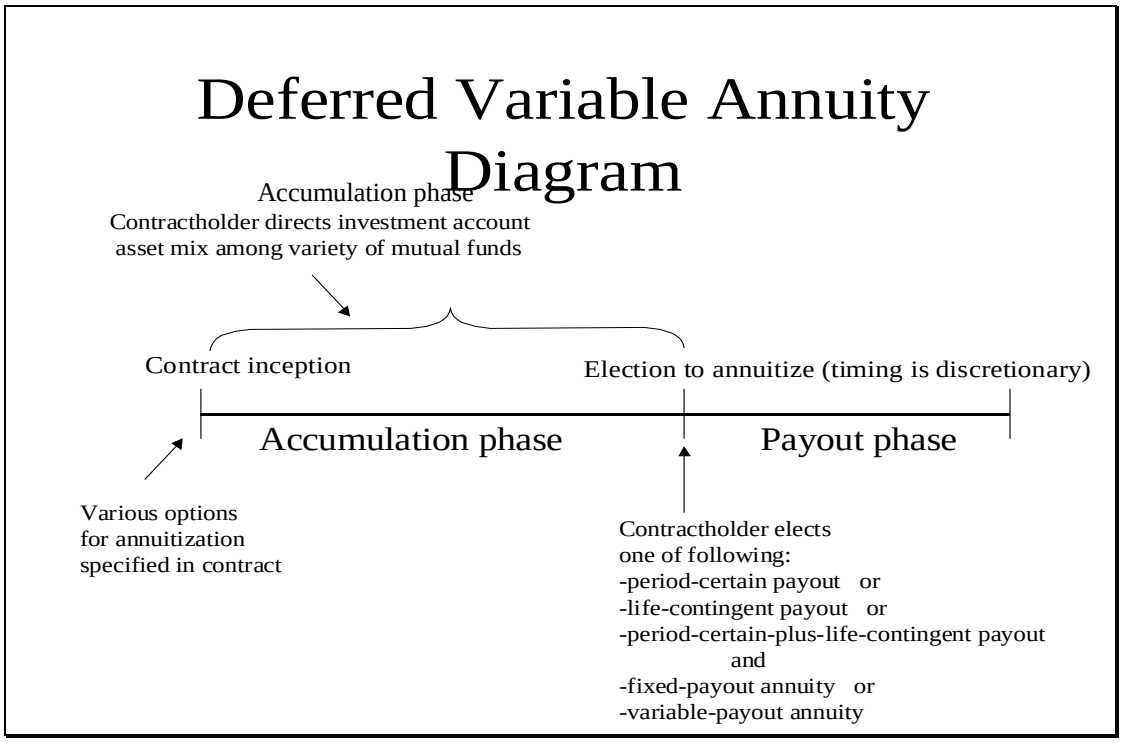
> An annuity in which the amount of payments to be made are specified in units, rather than in dollars. When payment is due, the amount is determined based on the value of the investments in the annuity fund.

An annuity contract for which payments have not yet commenced is referred to as a deferred annuity. Deferred annuities may be considered in two separate phases. The first phase is the deferred or accumulation phase, during which payments received by the insurance enterprise are accumulated and earn either a fixed or variable return. Much like a savings account, the cash surrender value may be withdrawn. The second phase is the payout phase, during which annuity income payments are made to the annuitant. For the payout phase of an annuity, annuity income payments are made to the annuitant under one of various options chosen by the policyholder upon annuitization, including the following:

- Life-contingent payments (payable for life of the annuitant)
- Payments for a period certain (for example, a 10-year period-certain annuity would be paid for 10 years to the annuitant or the annuitant's beneficiary or estate)
- Period-certain-plus-life-contingent payments (for example, a life-and-10-year-certain annuity pays the annuity benefit for the greater of the annuitant's life or 10 years).

Historically, contracts have typically been structured such that once the payout phase has begun, there is no longer a cash surrender value. However, more recently, some insurance companies have begun offering contracts with withdrawal features that allow withdrawals of all or a portion of the present value of a policyholder's future contractual annuity payments within a specified period during the payout phase. Upon surrender, additional withdrawal charges to cover investment costs may or may not be imposed.

The following diagram illustrates an overview of a deferred variable annuity contract:



Paragraph 7 of FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, provides that the accumulation phase and the payout phase of a deferred annuity contract are typically treated as if they were two separate contracts. That is, Statement 97 notes the following:

> A contract provision that allows the holder of a long-duration contract to purchase an annuity at a guaranteed price on settlement of the contract does not entail a mortality risk until the right to purchase is executed. If purchased, the annuity is a new contract to be evaluated on its own terms.

Fixed or variable annuity contracts in the accumulation phase and period-certain annuities in the payout phase are typically considered investment contracts under Statement 97 given that they typically lack significant mortality risk. Fixed or variable annuities in the payout phase that

provide for life-contingent payments are typically accounted for as insurance contracts given that they contain significant mortality risk. Payout phase period-certain-plus-life-contingent annuities are accounted for as insurance contracts under Statement 97 unless (a) the probability that life-contingent payments will be made is remote or (b) the present value of the expected life-contingent payments relative to the present value of all expected payments under the contract is insignificant.

Paragraph 10(c) notes that, generally, contracts of the type that are within the scope of Statement 60, Statement 97, and FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, are not subject to the requirements of Statement 133. Paragraph 7 of Statement 97 indicates that mortality risk is present if, under the terms of an annuity contract, the enterprise is required to make payments contingent upon the continued survival of a specific individual or group of individuals.

Paragraph 200 discusses the application of Statement 133 to "traditional" variable annuity product structures, as contemplated in Statement 60 and Statement 97, and states that they are generally not subject to the scope of this Statement, except for payment options at the end of the accumulation period. According to paragraph 200, payment alternatives are options subject to the requirements of this Statement if interest rates or other underlying variables affect the value.

A policyholder can also elect an immediate payment of the account value during or at the end of the accumulation period. Any sort of minimum guarantee offered in conjunction with a variable annuity that is provided *prior to* annuitization would be covered by Statement 133 Implementation Issue No. B8, "Identification of the Host Contract in a Nontraditional Variable Annuity Contract," rather than by this Issue.

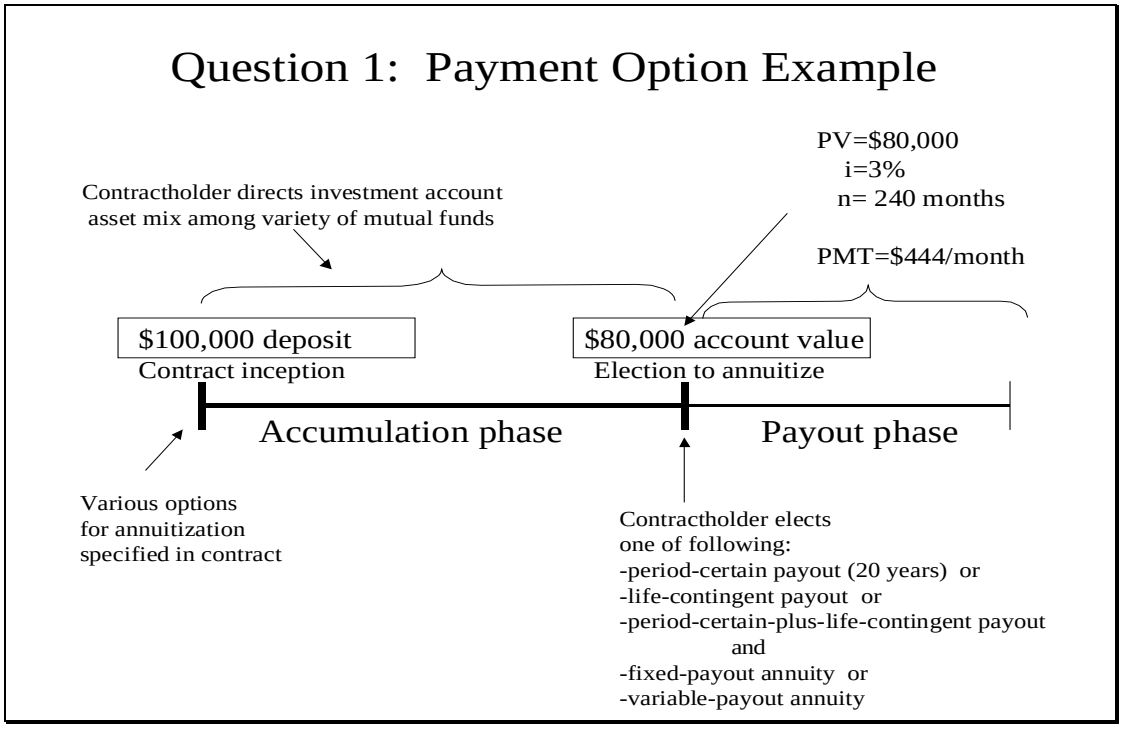
Background Information Applicable to Question 1

A common feature in most, if not all, deferred variable annuities is the option to annuitize at a guaranteed minimum annuity interest rate. That is, at the date of annuitization, the fixed periodic annuity payments would be determined using whatever current accumulated account value existed at the date of annuitization and the higher of the minimum guaranteed interest rate and currently offered annuity interest rates. For life contingent annuities, a mortality table would also be specified. The following narrative provides an example of this rate guarantee.

Question 1 Example: The policyholder deposits $100,000 in a deferred variable annuity that provides for a guaranteed minimum interest rate of 3 percent in computing future periodic annuity payments if the policyholder chooses to annuitize at a future date. The policyholder directs his deposit to equity-based mutual funds within the separate account. At the date that the policyholder chooses to annuitize, his account value has declined to $80,000 due to stock market declines. He elects a 20-year period-certain fixed-payout annuity, payable monthly in arrears. Using the $80,000 account value at the date of annuitization and the 3 percent interest rate (which is above the currently offered annuity interest rate), the insurance company calculates his

monthly periodic annuity payments to be $444. Because a fixed-payout annuity is elected, the $444 monthly annuity payment would be fixed throughout the entire payout period.

The following diagram illustrates the payment option discussed in Question 1:



Question 1 (Repeated from Above)

During the accumulation phase of a deferred variable annuity contract, would the guarantee of a minimum interest rate to be used in computing periodic annuity payments if and when a policyholder elects to annuitize require separate accounting as an embedded derivative under paragraph 12 of Statement 133?

RESPONSE TO QUESTION 1

No, during the accumulation phase of a deferred annuity contract, the guarantee of a minimum interest rate to be used in computing periodic annuity payments if and when a policyholder elects to annuitize does not require separate accounting under paragraph 12, because the criterion in paragraph 12(c) is not met. The embedded option does not meet the definition of a derivative instrument because it does not meet the net settlement criteria in paragraph 6(c) and paragraph 9. Settlement of the option can be achieved only by an investment of the account balance in a payout annuity contract in lieu of electing an immediate payment of the account value. (Refer to Statement 133 Implementation Issue No. A13, "Whether Settlement Provisions That Require a Structured Payout Constitute Net Settlement under Paragraph 9(a).")

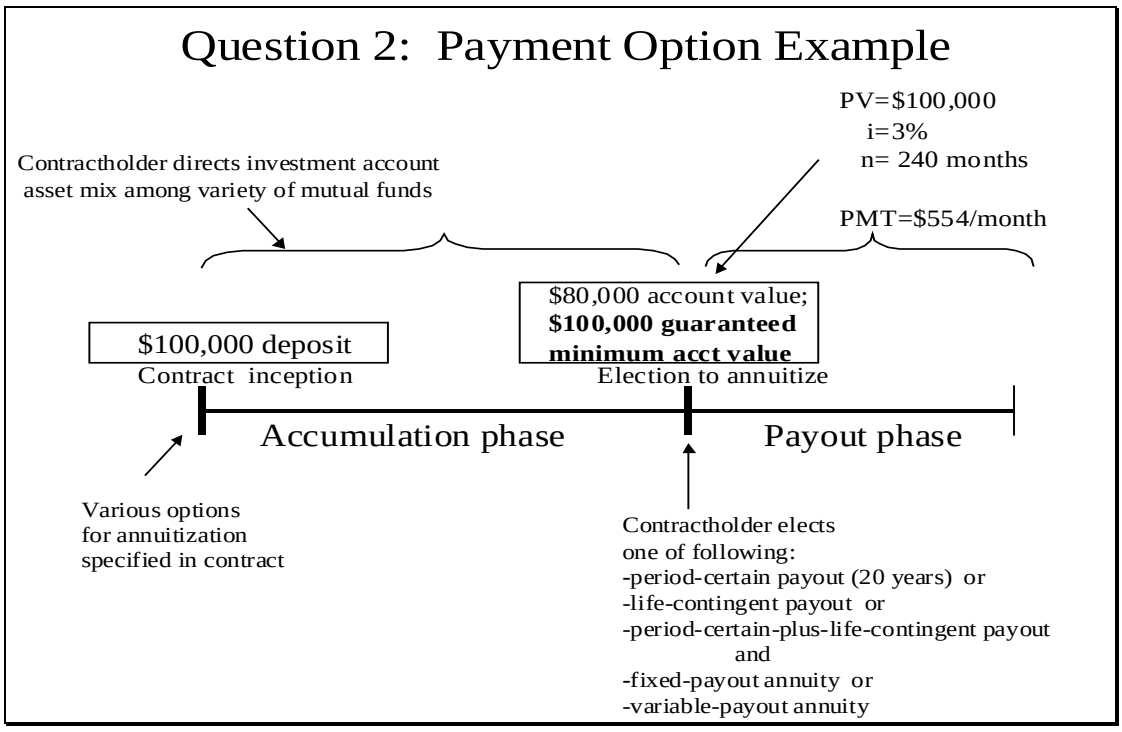
If an additional provision existed whereby the policyholder could withdraw all or a portion of its account balance during the payout phase, an embedded derivative would still not exist because the economic benefit of the guaranteed minimum interest rate would be obtainable only if an entity were to maintain the annuity contract through its specified maturity date.

Background Information Applicable to Question 2

Some deferred variable annuities, in exchange for the issuer's right to charge a fee, may provide a guaranteed minimum amount available to annuitize after a specified period in addition to a guaranteed minimum annuity interest rate (as discussed in Question 1). These benefits are often referred to as guaranteed minimum income benefits, or "GMIBs." These payment alternatives have the effect of modifying the account value at the end of the accumulation period. The following narrative provides an example of this guarantee.

Question 2 Example: The policyholder deposits $100,000 in a deferred variable annuity that provides for a guaranteed minimum interest rate of 3 percent in computing future periodic annuity payments if the policyholder chooses to annuitize at a future date. The policy also specifies that if the policyholder elects to annuitize, the amount available to annuitize will be the higher of the then account value or the sum of deposits made into the deferred annuity. The policyholder directs the $100,000 deposit to equity-based mutual funds within the separate account. At the date that the policyholder chooses to annuitize, the account value has declined to $80,000 due to stock market declines. The policyholder elects a 20-year period-certain fixed payout annuity, payable monthly in arrears. Using the $100,000 guaranteed minimum account value at the date of annuitization and the contractual 3 percent interest rate, the insurance company calculates the policyholder's monthly periodic annuity payments to be $554. Because a fixed-payout annuity is elected, the $554 monthly annuity payment would be fixed throughout the entire payout period.

The following diagram illustrates the payment option discussed in Question 2:



Question 2 (Repeated from Above)

During the accumulation phase of a deferred variable annuity contract, would a provision that guarantees a minimum account value that is available to annuitize if and when a policyholder elects to annuitize require separate accounting as an embedded derivative under paragraph 12 of Statement 133?

RESPONSE TO QUESTION 2

No. The provision that guarantees a minimum account value that is available to annuitize if and when a policyholder elects to annuitize fails to meet the definition of a derivative during the accumulation phase because it cannot be net settled. The benefit of the minimum account value is realized by the policyholder by annuitizing and receiving the economic benefit over the payout term, similar to the above response to Question 1. However, if the policyholder is able to withdraw all or a portion of the guaranteed account balance during the payout (annuitization) period, or the payout (annuitization) period is set to an unrealistically short period such as one year, this is equivalent to net settlement, and the guarantee (or the portion of the guarantee that is withdrawable, if applicable) is an embedded derivative only during the accumulation period.

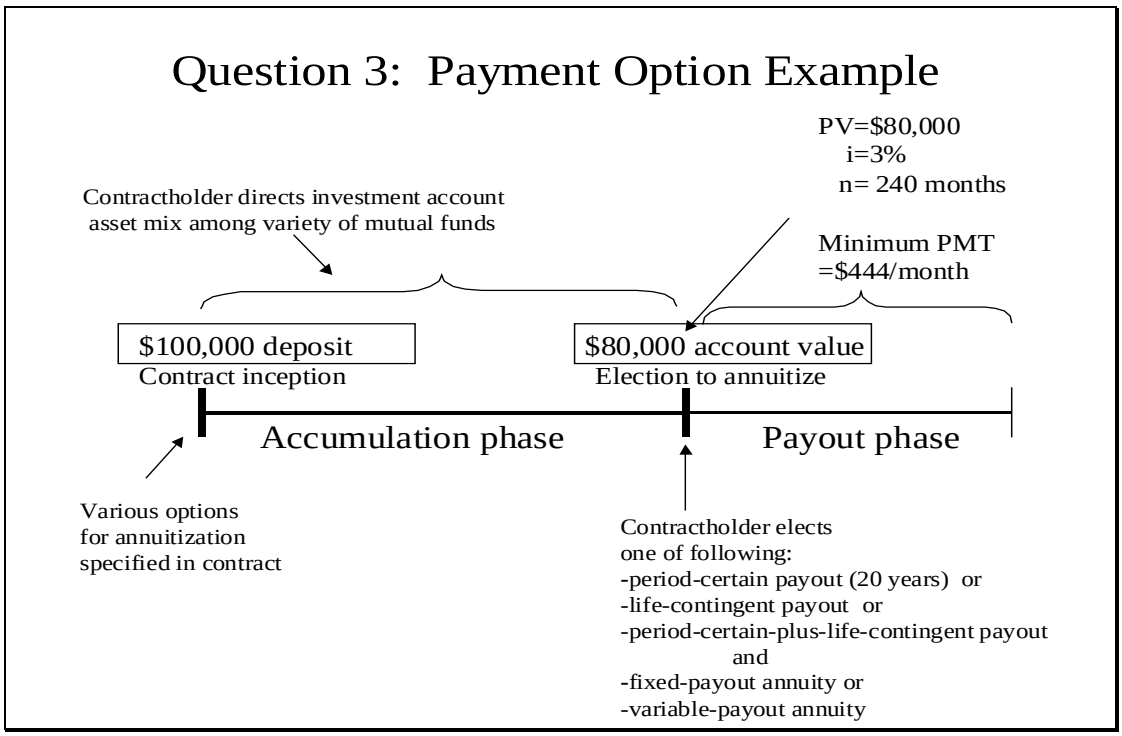
Background Information Applicable to Question 3

Other deferred annuities, instead of providing a guaranteed minimum account value upon annuitization, may instead provide for a variable-payout annuity option with a minimum guarantee on the periodic annuity payments made during the payout phase. That is, once the

payout phase has begun, the periodic annuity payments may be variable (that is, benefits will vary with investment performance of underlying funds, a formula, or an index such as the S&P 500), but with a provision that each periodic payment will be at least equal to a specified minimum amount. The following narrative provides an example of this rate guarantee.

Question 3 Example: The policyholder deposits $100,000 in a deferred variable annuity that provides for a guaranteed minimum interest rate of 3 percent in computing future periodic annuity payments if the policyholder chooses to annuitize at a future date. The policy also specifies that if the policyholder elects a variable-payout annuity option, the insurance company will guarantee a minimum monthly periodic payment during the payout phase that will be calculated using the account value at the annuitization date. The policyholder directs the $100,000 deposit to equity-based mutual funds within the separate account. At the date that the policyholder chooses to annuitize, the account value has declined to $80,000 due to stock market declines. The policyholder elects a 20-year period-certain variable-payout annuity, payable monthly in arrears. The policyholder directs his $80,000 to equity-based mutual funds within the separate account. Using the $80,000 account value at the date of annuitization and the contractual 3 percent interest rate, the insurance company calculates the policyholder's guaranteed minimum monthly periodic annuity payments to be $444. If the mutual funds appreciate such that the variable monthly payment at some future point is recalculated at $500, the policyholder will receive the $500 monthly payment; if the mutual funds decline in value such that the variable monthly payment at some future date before application of the floor guarantee would be $400, the policyholder will receive the agreed-upon floor guarantee amount of a $444 monthly payment.

The following diagram illustrates the payment option discussed in Question 3:



Question 3 (Repeated from Above)

During the accumulation phase of a deferred variable annuity contract, would a provision that guarantees a minimum level of periodic annuity payments during the payout phase if and when a policyholder elects to annuitize into a variable-payout annuity require separate accounting as an embedded derivative under paragraph 12 of Statement 133? This question assumes that the contract is annuitized at its contract value without any floor account value guarantee specified in Question 2.

RESPONSE TO QUESTION 3

No. An embedded derivative does not exist during the accumulation phase of a deferred variable annuity contract because the policyholder cannot net settle the contract. Similar to the Question 1 response, the only way the policyholder can obtain the benefit of the floor payment guarantee is over the life of the variable-payout annuity.

Background Information Applicable to Question 4

Question 3 discussed the accounting *during the accumulation phase* for a *deferred* annuity contract in which the policyholder could choose to annuitize under a variable-payout annuity option and receive a minimum guarantee on the periodic annuity payments to be made during the payout phase. Question 4 addresses the accounting for a variable-payout annuity with a floor payment guarantee *during the payout phase* of the contract. A variable annuity with a minimum guarantee on the periodic annuity payments can also be offered as part of a standalone

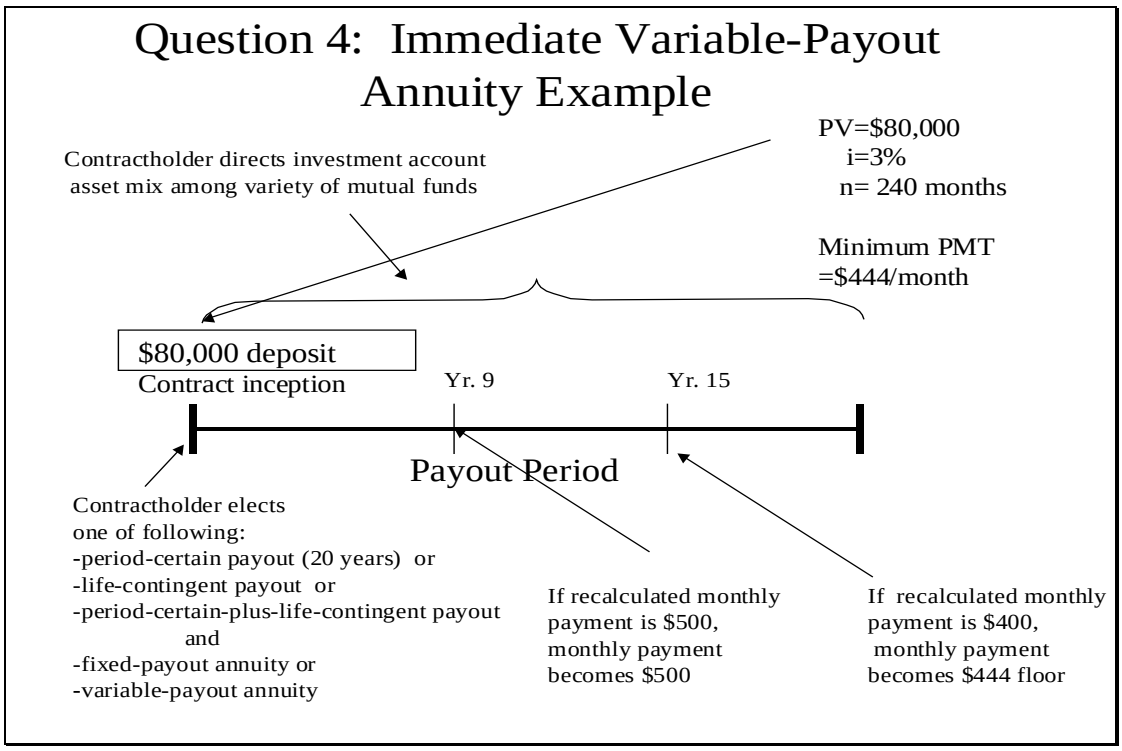
immediate-payout annuity. Like the deferred annuities, the term of the annuity payments may be period-certain, solely life-contingent, or life-contingent-plus-period-certain, and some companies have begun offering annuities with partial withdrawal features during the payout phase. The following narrative provides an example of those payout floor guarantees.

Payout Annuity Example: An existing policyholder with a deferred annuity with an account value of $80,000 elects to annuitize into a variable-payout annuity that provides a minimum guarantee on the periodic annuity payments. Alternatively, a new policyholder with $80,000 to invest may purchase an immediate variable-payout annuity that provides the same minimum guarantee. Both policyholders may elect to incorporate any of the following three payout options in the variable-payout annuity purchased:

- A 20-year period-certain variable-payout annuity, payable monthly in arrears
- A life-contingent variable-payout annuity, payable monthly in arrears
- A 20-year period-certain-plus-life-contingent variable-payout annuity, payable monthly in arrears.

The remaining facts and discussion apply equally to both situations, as they are deemed to be analogous. The policyholder directs the $80,000 to equity-based mutual funds within the separate account. Using the $80,000 deposit at the date of annuitization and the contractual 3 percent interest rate, the insurance company calculates the guaranteed minimum monthly periodic annuity payments to be $444. If the mutual funds appreciate such that the variable monthly payment at some future point is recalculated at $500, the policyholder will receive the $500 monthly payment; if the mutual funds decline in value such that the variable monthly payment at some future date before application of the floor guarantee would be less than $444 (such as $400), the policyholder will receive the agreed-upon floor guarantee amount of a $444 monthly payment.

The following diagram illustrates the payment option discussed in Question 4:



Question 4 (Repeated from Above)

During the payout phase of a variable-payout annuity, would a provision that guarantees a minimum level of periodic payments require separate accounting as an embedded derivative under paragraph 12 of Statement 133? (This type of provision may be found in an immediate-payout annuity contract or in the payout phase of a deferred annuity contract.)

RESPONSE TO QUESTION 4

The accounting treatment for the contractual provision for guaranteed minimum periodic payments is dependent upon the payout option in the variable-payout annuity contract. For the period-certain variable-payout annuity, the guaranteed minimum periodic payments are, during the payout phase, an embedded derivative that is required to be separated under paragraph 12 of Statement 133. This conclusion is based on the assessment that the guaranteed payment floor is not clearly and closely related to the host contract—a traditional variable-payout annuity contract. This is consistent with Statement 133 Implementation Issue No. B8, "Identification of the Host Contract in a Nontraditional Variable Annuity Contract." However, a solely life-contingent variable-payout annuity contract with features described above that meets the definition of an insurance contract under paragraph 8 of Statement 97 would not be subject to the requirements of Statement 133 provided there are no withdrawal features.

For a period-certain-plus-life-contingent variable-payout annuity contract, the embedded derivative related only to the period-certain guaranteed minimum periodic payments would be required to be separated under paragraph 12, whereas the embedded derivative related to the life-contingent guaranteed minimum periodic payments would not be separated under paragraph 12. Separate accounting for the embedded derivative related only to the period-certain guaranteed minimum periodic payments would be required even if the period-certain-plus-life-contingent annuity, in its entirety, meets the definition of an insurance contract under paragraph 8 of Statement 97 and has no withdrawal features.

EFFECTIVE DATE

Implementation guidance on this Issue was originally posted to the website on April 10, 2001. The effective date of the December 19, 2001 revisions to the implementation guidance in this Issue for each reporting entity is the first day of its first fiscal quarter beginning after January 9, 2002, the date that the revised Board-cleared guidance was posted on the FASB website. Those revisions related to a period-certain-plus-life-contingent variable-payout annuity contract.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Embedded Derivatives: Dual-Trigger Property and Casualty Insurance Contracts
Paragraph references:	10(c), 10(e)(2), 12
Date cleared by Board:	March 14, 2001
Date posted to website:	April 10, 2001

QUESTION

From both the insurer's and policyholder's standpoint, does a property and casualty insurance contract for which payment of a benefit/claim is triggered by the occurrence of both an insurable event and changes in a separate pre-identified variable contain an embedded derivative instrument that is required to be separately accounted for as a derivative instrument under Statement 133?

BACKGROUND

Paragraph 10(c)(2) of Statement 133 states:

> *Traditional property and casualty contracts*. The payment of benefits is the result of an identifiable insurable event (for example, theft or fire) instead of changes in a variable.

Paragraph 10(c) states:

> *Certain insurance contracts*. Generally, contracts of the type that are within the scope of FASB Statements No. 60, *Accounting and Reporting by Insurance Enterprises*, No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, and No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, are not subject to the requirements of this Statement whether or not they are written by insurance enterprises. That is, a contract is not subject to the requirements of this Statement if it entitles the holder to be compensated only if, as a result of an identifiable insurable event (other than a change in price), the holder incurs a liability or there is an adverse change in the value of a specific asset or liability for which the holder is at risk.

Paragraph 281 states:

> Insurance contracts often have some of the same characteristics as derivative instruments that are within the scope of this Statement. Often, however, they lack one or more of those characteristics. As a result, most traditional insurance contracts will not be derivative instruments as defined in this Statement. They will be excluded from

> that definition because they entitle the holder to compensation only if, as a result of an identifiable insurable event (other than a change in price), the holder incurs a liability or there is an adverse change in the value of a specific asset or liability for which the holder is at risk.

Based on this guidance, it is unclear how to account for insurance contracts with terms that require that the insured incur an actual loss other than a change in price *and* that a specified change in a variable occur (or be referenced) in order for a benefit/claim to be paid. This has become an issue as insurance products evolve to provide tailored commercial risk coverage at lower premiums. A common characteristic of dual-trigger policies is that the payment of a claim is triggered by the occurrence of two events (that is, the occurrence of both an insurable event and changes in a *separate* pre-identified variable). Since the likelihood of both events occurring is less than the likelihood of only one of the events occurring, the dual-trigger policy premiums are lower than traditional policies that insure only one of the risks. The policyholder is often purchasing the policy to provide for coverage against a catastrophe since if both events occur, the combined impact may be disastrous to its business. The following examples illustrate the characteristics of dual-trigger policies offered to different types of policyholders that have different risk management needs.

Electric Utility Company
A dual-trigger policy pays for a level of actual losses caused by the following two events occurring simultaneously:

1. A power outage resulting from equipment failure or storm-related damage causes more than 500 megawatts (MW) of lost power.
2. The spot market price for power exceeds $65 per MW hour during the storm or equipment-failure period.

The contract pays the difference between the strike price and the actual market price for the lost power (that is, the cost of replacement power).

Trucking Delivery Company
A dual-trigger policy pays extra expenses associated with rerouting trucks over a certain time period if snowfall exceeds a specified level during that time period. The snowfall causes delays and creates the need to reroute trucks to meet delivery demands.

Hospital
A dual-trigger policy pays actual medical malpractice claims above a specified level only if the value of the hospital's equity portfolio falls below a specified level during the same period.

Iron Ore Mining Company
A dual-trigger policy pays a specified level of workers' compensation claims (not to exceed actual claims) if the claims exceed a specified level at the same time iron ore prices decrease below a specified level.

Golf Resort in Florida
A dual-trigger policy pays property damage from hurricanes incurred by a specific golf resort in Florida; however, the losses are covered only if other golf courses in the region incur hurricane-related losses and the claims cannot exceed the average property damages incurred by the other golf resorts in the county.

Cherry Orchard in Michigan
A dual-trigger policy pays crop losses incurred due to bad weather during growing season, and the claims are at risk of being reduced based on changes in the inflation rate in Brazil. The cherry producer has no operations in Brazil or any transactions in Brazilian currency. However, a Brazilian cherry producer exports cherries to the United States and is a competitor of the Michigan cherry producer.

Property-Casualty Reinsurance Contract
Reinsurance contracts, which indemnify the holder of the contract (the reinsured) against loss or liability relating to insurance risk, are accounted for under the provisions of FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*. Reinsurance contract provisions often adjust the amount at risk or the price of the amount at risk for a number of events or circumstances, such as loss experience or premium volume, while continuing to provide indemnification related to insurance risk. One type of reinsurance contract, an "excess contract," provides the reinsured with indemnification against a finite amount of insured losses in excess of a defined level of insured losses retained by the reinsured.

The following is an example of a reinsurance contract with a provision that adjusts the retention amount downward based on the performance of a specified equity index:

Reinsurer enters into a reinsurance contract with Reinsured to indemnify Reinsured for certain insured losses in excess of a defined retention. The intent of the coverage is to protect Reinsured from significant or catastrophic property-casualty losses. The coverage would include a retention amount that would be adjusted downward according to a scale tied to the Dow Jones Industrial Average (DJIA). If a catastrophic loss occurs, Reinsured would likely have to liquidate some of its investment holdings (bonds or equities) to pay its losses, which exposes Reinsured to significant investment risk in a down market. The adjustment feature provides protection against investment risk by allowing Reinsured to recover more losses in a declining investment market. Reinsured has no ability to receive appreciation in the DJIA.

Parties:	Reinsurer and Reinsured
Coverage:	Property Losses
Period:	1/1/X1 through 12/31/X1
Retention:	$20 million per occurrence, adjusted downward in the same percentage as period-to-date (from 1/1/X1 to measurement date) decreases in the DJIA, not to exceed 50%

Limit: $15 million per occurrence, $15 million per annum
Premium: $1.4 million per annum

Both of the following scenarios assume that the DJIA on 1/1/X1 was 10,000.

	Scenario 1		**Scenario 2**	
	7/1/X1	**9/1/X1**	**7/1/X1**	**9/1/X1**
Property-casualty losses	$25,000,000	$25,000,000	$15,000,000	$15,000,000
DJIA	10,000	8,000	10,000	7,000
Retention	20,000,000	16,000,000	20,000,000	14,000,000
Recovery under contract	5,000,000	9,000,000	0	1,000,000

RESPONSE

Only those contracts for which payment of a claim is triggered only by a bona fide insurable exposure (that is, contracts comprising either solely insurance or both an insurance component and a derivative instrument) may qualify for the exception under paragraph 10(c). In order to qualify, the contract must provide for a legitimate transfer of risk, not simply constitute a deposit or form of self-insurance. A property and casualty contract that provides for the payment of benefits/claims as a result of both an identifiable insurable event *and* changes in a variable would in its entirety qualify for the insurance exclusion in paragraph 10(c)(2) of Statement 133 (and thus not contain an embedded derivative instrument that is required to be separately accounted for as a derivative instrument) provided all of the following conditions are met:

1. Benefits/claims are paid only if an identifiable insurable event occurs (for example, theft or fire) pursuant to the requirements of paragraph 10(c)(2) of Statement 133.
2. The amount of the payment is limited to the amount of the policyholder's incurred insured loss.
3. The contract does not involve essentially assured amounts of cash flows (regardless of the timing of those cash flows) based on insurable events highly probable of occurrence because the insured would nearly always receive the benefits (or suffer the detriment) of changes in the variable. If there is an actuarially determined minimum amount of expected claim payments (and those cash flows are indexed to or altered by changes in a variable) that are the result of insurable events that are highly probable of occurring under the contract and those minimum payment amounts are expected to be paid each policy year (or on another predictable basis), that "portion" of the contract does not qualify for the insurance exception. (For example, if an insured has received at least $2 million in claim payments from its insurance company [or at least $2 million in claim payments were made by the insurance company on the insured's behalf] for each of the previous 5 years related to specific types of insured events that occur each year, that minimum level of coverage would not qualify for the insurance exclusion.) If an insurance contract has an actuarially determined minimum amount of expected claim payments that are highly probable of occurring, then effectively the amount of those claims is the contract's minimum notional amount (analogous to the

guidance in Statement 133 Implementation Issue No. A6, "Notional Amounts of Commodity Contracts") in determining the embedded derivative.

Based on this framework, all the contracts discussed in the background section qualify for either the paragraph 10(c)(2) exception for traditional property and casualty contracts or the paragraph 10(e)(2) exception for non-exchange-traded contracts involving non-financial assets. Therefore, the dual-trigger variable in those contracts is not separated and accounted for separately as a derivative. In contrast, if a contract issued by an insurance company involves essentially assured amounts of cash flows based on insurable events that are highly probable of occurrence (as discussed in Condition 3 above), an embedded derivative instrument related to changes in the separate pre-identified variable for that portion of the contract would be required to be separately accounted for as a derivative instrument.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Embedded Derivatives: Dual-Trigger Financial Guarantee Contracts
Paragraph references:	10(d), 12, 16, 17, 18
Date cleared by Board:	March 14, 2001
Date posted to website:	April 10, 2001
Date revision posted to website:	May 1, 2003
Affected by:	FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*

Revised March 26, 2003

QUESTION

If the payment of a claim under a financial guarantee insurance contract is triggered only by the occurrence of both the insured's credit losses exceeding a specified level and the credit losses in a customized pool of loans by third parties exceeding a specified level, does that financial guarantee insurance contract contain an embedded derivative that requires separate accounting under Statement 133?

BACKGROUND

ABC Company (ABC) extends credit to consumers through credit cards and personal loans of various sorts. The company is exposed to credit losses from its managed asset portfolio, including owned and securitized receivables. ABC would like to purchase an insurance policy to protect itself against high levels of consumer default.

The proposed insurance policy will entitle ABC to collect claims to the extent that its credit losses exceed a specified minimum level but limited to the amount by which the credit losses on a customized pool or index of consumer loans exceed that same specified minimum level. Thus, ABC will collect claims based on the lesser of either (1) its actual credit losses or (2) the credit losses on a customized pool or index of consumer loans. Although the insurer's payment to ABC may be affected by credit losses on a customized pool, the payment nevertheless represents compensation for actual credit losses ABC incurred. ABC purchases this insurance to obtain a lower premium because claims are limited by external charge-off rates and the insurer is not exposed to ABC's underwriting performance. This type of control may also exist in property and casualty reinsurance policies. For example, an insurance company may purchase reinsurance that covers actual hurricane losses in excess of a specified level in their block of business, but the coverage does not apply to losses in excess of a geographically diversified index of hurricane losses.

Paragraph 10(d) of Statement 133, as amended by Statement 149, indicates that financial guarantee contracts are not subject to the Statement only if all of the following conditions are met:

1. They provide for payments to be made solely to reimburse the guaranteed party for failure of the debtor to satisfy its required payment obligations under a nonderivative contract, either at pre-specified payment dates or accelerated payment dates as a result of the incurrence of an event of default (as defined in the financial obligation covered by the guarantee contract) or notice of acceleration being made to the debtor by the creditor.
2. Payment under the financial guarantee contract is made only if the debtor's obligation to make payments as a result of conditions as described in (1) above is past due.
3. The guaranteed party is, as a precondition in the contract (or in the back-to-back arrangement, if applicable) for receiving payment of any claim under the guarantee, exposed to the risk of nonpayment both at inception of the financial guarantee contract and throughout its term either through direct legal ownership of the guaranteed obligation or through a back-to-back arrangement with another party that is required by the back-to-back arrangement to maintain direct ownership of the guaranteed obligation.

Thus, financial guarantee contracts are subject to Statement 133 if they do not meet all of the above three criteria, for example, if they provide for payments to be made in response to changes in another underlying such as a decrease in a specified debtor's creditworthiness.

RESPONSE

Financial guarantee insurance contracts are not subject to Statement 133 only if all of the conditions in paragraph 10(d) of Statement 133, as amended by Statement 149, are met. The description of the financial guarantee insurance contract in this Issue is insufficient for determining whether those conditions are met. The provisions of that contract that (a) limit any claims to the extent that ABC's actual credit losses exceed a specified minimum level and (b) limit any payments for those claims to the amount by which the credit losses on a customized pool or index of consumer loans exceed that same specified minimum level represent a type of deductible and do not affect the application of the conditions in paragraph 10(d).

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Embedded Derivatives: Foreign Currency Elements of Insurance Contracts
Paragraph references:	10(c), 12, 15, 311
Date cleared by Board:	March 14, 2001
Date posted to website:	April 10, 2001
Date revision posted to website:	May 1, 2003
Affected by:	FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*
	Revised March 26, 2003

QUESTION

May the scope exception in paragraph 15 be applied during the period between the inception of the contract and the loss occurrence date by analogy to an insurance contract in which losses are denominated in either (a) the functional currency of one of the parties to that contract or (b) the local currency of the country in which the loss is incurred?

BACKGROUND

Insurance contracts that provide coverage for various types of property and casualty exposure are commonly executed between U.S.-based insurance companies and multinational corporations that have operations in foreign countries. The contracts may be structured to provide for payment of claims in the functional currency of the insurer or in the functional currency of the entity experiencing the loss and will typically specify the exchange rate to be utilized in calculating loss payments.

Example

A contract provides for the payment of losses in U.S. dollars (that is, the functional currency of the insurer). Losses are reported to the insurance company in the functional currency of the entity experiencing the loss, but losses are paid by the insurer in U.S. dollars. From the perspective of the insurer, the contract terms may provide that the rate of exchange to be used to convert the losses from the functional currency of the foreign entity to the U.S. dollar for purposes of claim payments be one of the following:

a. The rate of exchange as of the settlement date (payment date) of the claim
b. The rate of exchange as of the loss occurrence date
c. The rate of exchange at inception of the contract.

Paragraph 10(c)(2) of Statement 133 indicates that *traditional* property and casualty insurance contracts are not subject to the requirements of the Statement because the payment of benefits is the result of an identifiable insurable event (for example, theft or fire) instead of changes in a

variable. Paragraph 10(c) also states, "…some contracts with insurance or other enterprises combine derivative instruments ... with other insurance or nonderivative contracts, for example…property and casualty contracts that combine traditional coverages with foreign currency options. Contracts that consist of both derivative portions and nonderivative portions are addressed in paragraph 12." The contract described in this issue does not qualify as traditional insurance under paragraph 10(c)(2) because it contains a foreign currency element.

Paragraph 15 of Statement 133 states:

> An embedded foreign currency derivative instrument shall *not* be separated from the host contract and considered a derivative instrument under paragraph 12 if the host contract *is not a financial instrument* and it requires payment(s) denominated in (a) the functional currency of any substantial party to the contract….Unsettled foreign currency transactions, including financial instruments, that are monetary items and have their principal payments, interest payments, or both denominated in a foreign currency are subject to the requirement in Statement 52 to recognize any foreign currency transaction gain or loss in *earnings and shall not be considered to contain embedded foreign currency derivative instruments under this Statement*. [Emphasis added.]

Because the insurance company does not record a claim liability until losses are incurred in accordance with FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, no foreign-currency-denominated liability exists (that would otherwise be subject to FASB Statement No. 52, *Foreign Currency Translation*, as contemplated by paragraph 15) during the period between the inception of the insurance contract and the loss occurrence date. Also, insurance contracts are financial instruments that are not covered by the scope exception in the first part of paragraph 15 that applies to non-financial contracts. Therefore, the insurance contract must be assessed to determine whether it contains an embedded foreign currency derivative under paragraph 12 of Statement 133.

This issue addresses whether insurance contracts in which losses are denominated in either (a) the functional currency of one of the parties to that contract or (b) the local currency of the country in which the loss is incurred during the period between the inception of the contract and the loss occurrence date, that would otherwise be deemed to contain embedded foreign currency derivatives, may be excluded from the scope of Statement 133 by analogy to paragraph 15.

RESPONSE

Yes. Although the exception in the first part of paragraph 15 of Statement 133 does not apply to financial instruments, paragraph 15 applies to this situation in which a normal insurance contract involves payment in the functional currency of either of the two parties to the contract. Paragraph 311 in the basis for conclusions states, "The Board decided that it was important that the payments be denominated in the functional currency of at least one *substantial* party to the

transaction to ensure that the foreign currency is integral to the arrangement and thus considered to be clearly and closely related to the terms of the lease." The insurance contracts described in this Issue are similar to operating leases, which are covered by the exception in paragraph 15, because neither contract gives rise to a recognized asset or liability that would be measured under Statement 52 until an amount becomes receivable or payable under the contract. Therefore, the exception in paragraph 15 also applies to insurance contracts that involve payment of losses in the functional currency of either of the two parties to the contract. In addition, the paragraph 15 exception would also apply to those contracts if it involves payment in the local currency of the country in which the loss is incurred, irrespective of the functional currencies of the parties to the transaction.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Embedded Derivatives: Equity-Indexed Annuity Contracts with Embedded Derivatives
Paragraph references:	10, 12, 16, 17, 18, 200
Date cleared by Board:	March 14, 2001
Date latest revision posted to website:	June 16, 2006
Affected by:	FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments*

Revised June 16, 2006

QUESTIONS

The following questions address certain Statement 133 accounting implications related to the issuer and the holder of equity-indexed annuity (EIA) products.

1. From the holder's perspective, what is the accounting for an EIA product?
2. What is the accounting for the option components of an EIA product that specifies:
   a. A point-to-point design? Does the equity-indexed return feature that specifies a point-to-point design meet the definition of a derivative and require separate accounting under paragraph 12 of Statement 133?
   b. A periodic ratchet design?

This question comprises a series of related questions dealing with the accounting for options embedded in EIA products whose terms specify a periodic ratchet design (discussed in the background section below as an option to lock in the yearly investment results or a floor return). In most product designs, the notional amount, participation rate, cap rate, and strike price of the forward-starting options are not known until the subsequent policy anniversary dates are reached. Therefore, do those forward-starting options meet the definition of a derivative instrument in Statement 133? If the forward-starting options are derivatives and require valuation at the policy inception and throughout the life of the contract, what amounts should be used for the unknown factors impacting the options' fair values? If the forward-starting options are not subject to Statement 133, should only the first individual, currently operable option be valued?

BACKGROUND

An EIA is a deferred fixed annuity contract with a guaranteed minimum interest rate plus a contingent return based on some internal or external equity index, such as the S&P 500. The guaranteed contract value is generally designed to meet certain regulatory requirements such that the contract holder receives no less than 90 percent of the initial deposit, compounded annually at 3 percent, which establishes a floor value for the contract.

EIAs typically have minimal mortality risk and are therefore classified as investment contracts under FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*. EIAs often do not have specified maturity dates; therefore, the contracts remain in the deferral (accumulation) phase until the customer either surrenders the contract or elects annuitization.[1]

Customers typically can surrender the contract at any point in time, at which time they receive their account value, as specified in the contract, less any applicable surrender charges. The account value is defined in the policy as generally the greater of the policyholder's initial investment plus the equity-indexed return or a guaranteed floor amount (calculated as the policyholder's initial investment plus a specified annual percentage return).

There are two basic designs for EIA products:

- The periodic ratchet design, where in the annual version, the customer receives the greater of the appreciation in the equity index during a series of one-year periods (ending on each policy anniversary date) or the guaranteed minimum fixed rate of return over that period
- The point-to-point design, where the customer receives the greater of the appreciation in the equity index during a specified period (for example, five or seven years, starting on the policy issue date) or the guaranteed minimum fixed rate of return over that period.

For many products of either design, the contract holder receives only a portion of the appreciation in the S&P 500 (or other index, as applicable) during the specified period (a "participation rate") and/or has an upper limit on the amount of appreciation that will be credited during any period (a "cap rate"). For the annual ratchet design, the prospective participation and cap rates for each one-year period are often at the discretion of the issuer, and may be reset on future policy anniversary dates, subject to contractual guarantees. Flexibility on the part of the issuer to establish new cap and participation rates, coupled with uncertainty around the customer's account value (which establishes the notional amount of the option) and strike price (which is determined by the level of the index on subsequent anniversary dates) make several of the terms of the forward-starting options unknown at the annuity contract's inception. However, those flexible terms can be viewed as a bundle of options.

Paragraph 185 of Statement 133 discusses generic equity-indexed notes, and paragraph 200, as amended, discusses equity-indexed annuities, noting that "…if the product were an equity-index-based interest annuity (rather than a traditional variable annuity), the investment component would contain an embedded derivative (the equity-index-based derivative) that meets all the requirements of paragraph 12 of this Statement for separate accounting…."

[1]This refers to the policyholder receiving periodic payments under various payment options, including their remaining life or for a term-certain period.

RESPONSE

Question 1

Industry practice has evolved to require that the holder record its investment based upon EITF Issue No. 96-12, "Recognition of Interest Income and Balance Sheet Classification of Structured Notes." This guidance does not result in a fair value presentation of the asset. As a result, the scope exception in Statement 133 for contracts carried at fair value with changes in value recorded in earnings does not apply. Therefore, holders of equity-indexed annuities that are preparing financial statements must separate the equity-indexed return portion of the contract, apply Statement 133, and follow the guidance in Question 2.

Question 2(a)

From an insurer's perspective, the option component of an EIA product that specifies a point-to-point design meets the definition of a derivative and requires separate accounting under paragraph 12 of Statement 133 unless a fair value election is made pursuant to Statement 155. (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. However, Statement 155 does not apply to hybrid financial instruments that are described in paragraph 8 of FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, which include insurance contracts as discussed in FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, and Statement 97, other than financial guarantees and investment contracts. Hybrid financial instruments that are elected to be accounted for in their entirety at fair value cannot be used as a hedging instrument in a Statement 133 hedging relationship.) This guidance also applies to the policyholder because it does not qualify for a scope exclusion as stated above.

Question 2(b)

For the periodic ratchet design product, the insurer has committed to issue a series of options on the index over the duration of the contract. *All* of those forward-starting options meet the Statement 133 definition of a derivative and require separate accounting under paragraph 12 of Statement 133 from the perspective of the insurer unless a fair value election is made pursuant to Statement 155. (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. However, Statement 155 does not apply to hybrid financial instruments that are described in paragraph 8 of FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, which include insurance contracts as discussed in Statements 60 and 97, other than financial guarantees and investment contracts. Hybrid financial instruments that are elected to be accounted for in their entirety at fair value cannot be used as a hedging instrument in a Statement 133 hedging relationship.) Statement 133 Implementation Issue No. B15, "Separate Accounting for Multiple Derivative Features Embedded in a Single Hybrid Instrument," requires that the embedded feature with multiple components must be separately accounted for as one compound embedded derivative. In valuing those options, there are three main components to be considered:

1. Future S&P 500 index values will need to be estimated to determine both the future notional amounts at each ratchet date and the future strike prices of the future forward starting options.
2. Future annual cap and participation rates, which are often at the discretion of the contract issuer, subject to contractually specified minimums and maximums, will need to be estimated.
3. Non-economic factors related to policyholder-driven developments such as policy surrenders or mortality.

Given the three components, the forward starting options should be valued using the expected future terms (that is, index values and cap and participation rates), but in no event should the value be less than the minimum amounts contractually agreed upon in the contract. Expected terms represent management's estimates of cap and participation rates, rather than contractually guaranteed amounts. This guidance is supported by an analogy to the general guidance in Statement 133 Implementation Issue No. A6, "Notional Amounts of Commodity Contracts." The estimated value reflects the notion that the contract provides for a level of equity-indexed return that can be estimated even when considering the issuer's options to adjust the policyholder's participation and cap rates. In subsequent periods when the terms of the forward-starting options become known, the actual terms should be substituted for the expected terms for purposes of valuation.

This guidance also applies to the policyholder (provided it prepares GAAP-based financial statements) since the contracts do not qualify for a scope exception.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Embedded Derivatives: Application of Statement 97 and Statement 133 to Equity-Indexed Annuity Contracts
Paragraph references:	10, 12, 16, 17, 18, 200
Date cleared by Board:	March 14, 2001
Date latest revision posted to website:	June 16, 2006
Affected by:	FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments*

Revised June 16, 2006

QUESTIONS

From the insurer's perspective, how does FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, affect Statement 133 requirements when an embedded derivative in an equity-indexed annuity (EIA) contract is required to be separated and accounted for as a derivative?

With respect to EIA contracts that have embedded derivatives, how should an issuer apply the guidance in paragraph 16 of Statement 133 that requires that the host contract be accounted for based on generally accepted accounting principles (GAAP) applicable to instruments of that type? Is the host contract a debt instrument that is subject to financial instrument accounting, and, if so, at what rate and to what maturity date would the debt host be accreted?

BACKGROUND

An EIA contract is a deferred fixed annuity contract with a guaranteed minimum interest rate plus a contingent return based on some internal or external index, such as the S&P 500. The guaranteed contract value is generally designed to meet certain regulatory requirements such that the contract holder receives no less than 90 percent of the initial deposit, compounded annually at 3 percent, which establishes a floor value for the contract.

EIA contracts typically have minimal mortality risk and are therefore classified as investment contracts under Statement 97. Paragraph 15 of Statement 97 states that "amounts received as payments for such contracts shall not be reported as revenues. Payments received by the insurance enterprise shall be reported as liabilities and accounted for in a manner consistent with the accounting for interest-bearing or other financial instruments."[1]

[1] Practice has developed referring to the insurance company's accounting for its investment contract liabilities as being "Statement 97 accounting," including references to the "Statement 97 account value" and the retrospective deposit method. Those practice-developed references are used in this Issue for convenience.

EIA contracts often do not have specified maturity dates; therefore, the contracts remain in the deferral (accumulation) phase until the customer either surrenders the contract or elects annuitization.[2] Customers typically can surrender the contract at any point in time, at which time they receive their account value, as specified in the contract, less any applicable surrender charges. The account value is defined in the policy as generally the greater of the policyholder's initial investment plus the equity-indexed return or a guaranteed floor amount (calculated as the policyholder's initial investment plus a specified annual percentage return).

There are two basic designs for EIA products:

- The periodic ratchet design, where in the annual version, the customer receives the greater of the appreciation in the equity index during a series of one-year periods (ending on each policy anniversary date) or the guaranteed minimum fixed rate of return over that period
- The point-to-point design, where the customer receives the greater of the appreciation in the equity index during a specified period (for example, five or seven years, starting on the policy issue date) or the guaranteed minimum fixed rate of return over that period.

For many products of either design, the contract holder receives only a portion of the appreciation in the S&P 500 during the specified period (a "participation rate") and/or has an upper limit on the amount of appreciation that they will be credited during any period (a "cap rate"). For the annual ratchet design, the participation and cap rates for each one-year period are often at the discretion of the issuer, and may be reset on future policy anniversary dates, subject to contractual guarantees. Flexibility on the part of the issuer to establish new cap and participation rates, coupled with uncertainty around the customer's account value (which establishes the notional amount of the option) and implied option-strike price (which is determined by the level of the index on subsequent anniversary dates) would require the issuer to make several assumptions in valuing the forward-starting options at the annuity contract's inception and throughout the term of the contract.

Paragraph 185 of Statement 133 discusses generic equity-indexed notes, and paragraph 200, as amended, discusses equity-indexed annuities, noting that "…if the product were an equity-index-based interest annuity (rather than a traditional variable annuity), the investment component would contain an embedded derivative (the equity-index-based derivative) that meets all the requirements of paragraph 12 of this Statement for separate accounting." (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. However, Statement 155 does not apply to hybrid financial instruments that are described in paragraph 8 of FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, which include insurance contracts as

[2] This refers to the policyholder receiving periodic payments under various payment options, including their remaining life or for a term-certain period.

discussed in FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, and Statement 97, other than financial guarantees and investment contracts. Hybrid financial instruments that are elected to be accounted for in their entirety at fair value cannot be used as a hedging instrument in a Statement 133 hedging relationship.)

To illustrate the host contract and embedded derivative valuation issues, consider the following EIA point-to-point design example, which includes a minimum account value stated as a return on the principal amount of the annuity:

Initial premium	$100,000
Participation rate	100% participation in the equity returns, credited at the end of the contract term
Contract term	3 years
Minimum account value at the end of the contract term	$103,030 ($100,000 compounded annually at the minimum accumulation rate of 1% per year))
Implied option strike price	Current S&P 500 × 1.0303
Embedded option valuation	Monte-Carlo-Option model calculated value at $20,000 at inception

At inception, the insurer has received $100,000, recorded as follows:

Cash	100,000	
Embedded derivative		20,000
Host zero-coupon debt obligation		80,000

In the above journal entry, Statement 133 Implementation Issue No. B6, "Allocating the Basis of a Hybrid Instrument to the Host Contract and the Embedded Derivative," is followed: the embedded derivative is recorded at fair value, and the carrying value assigned to the host contract is the difference between the proceeds received from the issuance of the hybrid instrument and the fair value of the embedded derivative. Paragraph 16 states that "if an embedded derivative instrument is separated from its host contract, the host contract shall be accounted for based on GAAP applicable to instruments of that type that do not contain embedded derivative instruments." Accordingly, in this example, the host contract would be accreted annually to the minimum account value at the end of the contract ($103,030) using an effective yield method (in this example, the implicit interest rate underlying the host is 8.8 percent).

Consider the following scenarios at the end of year 1.

Scenario 1 — S&P index increases 15%. The components are valued as follows:

Embedded derivative	$28,968	(Assumed)
Accreted value of host contract	87,032	($80,000 × 1.088)
Value of hybrid instrument	$116,000	

Statement 97 value (in absence of Statement 133): $115,000 ($100,000 at 15% return)

Note that because of the market's implicit valuation of future volatility in the S&P index, as reflected in the fair value of the embedded derivative, the combined value of the embedded derivative and the host contract is greater than that which would be calculated for the contract as a whole under Statement 97. The proper accounting in Scenario 1 is to record a total liability of $116,000, the Statement 133 hybrid contract value.

Scenario 2 — S&P Index has declined. The components are valued as follows:

Embedded derivative	$ 7,968
Accreted value of host contract	87,032
Value of hybrid instrument	$95,000

Statement 97 value (in absence of Statement 133): $101,000 ($100,000 at 1% return)

In Scenario 2, how should the insurer interpret the requirements of Statement 97 and Statement 133? The above components already reflect the application of paragraph 12 (the derivative is measured at fair value) and paragraph 16 (the host contract is accreted like a debt instrument). However, prior to adoption of Statement 133, the accreted minimum liability to be reported under Statement 97 would have been $101,000. Should a loss of $6,000 be recorded to bring the total liability balance up to the $101,000 Statement 97 value?

RESPONSE

From the issuer's (insurer's) perspective, an EIA liability comprises a fixed annuity host and an embedded written equity option. The embedded equity option should be accounted for under the provisions of Statement 133. The fixed annuity component should be accounted for under the provisions of Statement 97 that require debt instrument accounting. In this example, the host contract is a discounted debt instrument that should be accreted using the effective yield method to its minimum account value at the projected maturity or termination date.

Upon receipt of consideration for an EIA contract, the issuing company should allocate a portion of the consideration to the embedded written option, as described in Implementation Issue B6, using the "with and without" method (that is, the fair value of the option is assigned to the embedded derivative). The remainder of the consideration should be assigned to a fixed annuity host contract. Both credited interest and changes in the fair value of the embedded equity option would be recognized in earnings. Accordingly, in this example, the host contract would be accreted annually to the minimum account value at the end of the contract ($103,030) using an effective yield method (in this example, the implicit interest rate underlying the host is 8.8 percent).

As a result, in Scenario 2 above, the EIA liability would be recorded at $95,000 at the end of year 1. A separate calculation of a Statement 97 account value is no longer required because the derivative is carried at fair value in accordance with Statement 133 and the host contract is recorded following the GAAP accounting guidance for a Statement 97 investment contract. Therefore, the insurer should ignore any minimum liability that exceeds the sum of the embedded derivative separately accounted for and the host debt instrument that is accounted for applying the debt model.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Embedded Derivatives: Accounting for Purchases of Life Insurance
Paragraph references:	10(c), 12
Date cleared by Board:	July 11, 2001
Date posted to website:	July 12, 2001
Date latest revision posted to website:	June 16, 2006
Affected by:	FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities,* and FASB Staff Position FTB 85-4-1, "Accounting for Life Settlement Contracts by Third-Party Investors"

Revised March 27, 2006

QUESTIONS

1. From the policyholder's perspective, do life insurance contracts that are within the scope of FASB Technical Bulletin No. 85-4, *Accounting for Purchases of Life Insurance*, qualify for the embedded derivative scope exception in paragraph 12(b) of Statement 133 for contracts that are carried at fair value?

2. If life insurance contracts that are within the scope of Technical Bulletin 85-4 do not qualify for the embedded derivative scope exception in paragraph 12(b) of Statement 133, how should Statement 133 be applied by the policyholder to those life insurance contracts that contain embedded derivatives that would warrant separate accounting?

BACKGROUND

The accounting for purchases of life insurance contracts commonly referred to as COLI (corporate-owned life insurance), BOLI (business-owned life insurance), or key-man insurance is addressed by Technical Bulletin 85-4. That Technical Bulletin requires that "the amount that could be realized under the insurance contract as of the date of the statement of financial position should be reported as an asset. The change in cash surrender or contract value during the period is an adjustment of premiums paid in determining the expense or income to be recognized under the contract for the period" (refer to paragraph 2). Although the asset is not specifically remeasured at fair value with changes reported in earnings, the amount recorded may at times be close to fair value.

Paragraph 12 of Statement 133 provides criteria for determining when the derivative-like provisions of a nonderivative contract should be separated from the host contract and accounted for as a derivative. Some constituents have questioned whether a life insurance policy that provides for a cash surrender value that is periodically adjusted to reflect the return on a portfolio of equity securities should be accounted for as containing an embedded derivative that warrants separate accounting under paragraph 12.

RESPONSE

Question 1

A policyholder's investment in a life insurance contract that is subject to Technical Bulletin 85-4 is reported at net realizable value (cash surrender value), which does not equal fair value (even though the amount may at times be close to fair value). Therefore, the investment in a life insurance contract does not qualify for the embedded derivative scope exception in paragraph 12(b) of Statement 133 applicable to contracts that are carried at fair value with changes in value recorded in earnings.

Question 2

From the policyholder's perspective, the application of Technical Bulletin 85-4 to the host contract (the life insurance contract absent the embedded derivative that is accounted for separately) cannot be accomplished because the hypothetical host contract has no stated cash surrender value. The policyholder should account for its investment in a life insurance contract in its entirety pursuant to the provisions of Technical Bulletin 85-4, even if the insurance contract includes derivative-like provisions that would otherwise require separate accounting as a derivative under paragraph 12 of Statement 133. The policyholder should not apply the embedded derivative provisions of Statement 133 to a life insurance contract that is subject to Technical Bulletin 85-4.

This guidance applies only to the accounting by the policyholder and does not affect the accounting by the insurer.

At its July 11, 2001 meeting, the Board reached the above answer. Statement 149 amended Statement 133 to add a new scope exception in paragraph 10(g), which states:

> g. *Investments in life insurance.* A policyholder's investment in a life insurance contract that is accounted for under FASB Technical Bulletin No. 85-4, *Accounting for Purchases of Life Insurance,* or FASB Staff Position FTB 85-4-1, "Accounting for Life Settlement Contracts by Third-Party Investors," is not subject to this Statement. This [exception] does not affect the accounting by the issuer of the life insurance contract.

The guidance in this Issue should not be applied by analogy to contracts that are not life insurance contracts subject to the provisions of Technical Bulletin 85-4.

EFFECTIVE DATE AND TRANSITION

The effective date of implementation guidance in this Issue for each reporting entity is the first day of its first fiscal quarter beginning after July 12, 2001, the date that the Board-cleared guidance was posted on the FASB website. Earlier application as of the first day of an earlier fiscal quarter for which financial statements have not been issued is permitted provided that the

entity had not designated the embedded derivative (in the life insurance contract) that had been accounted for separately as the hedging instrument in a cash flow hedge for any part of that earlier fiscal quarter. The revisions made on March 26, 2003, do not affect the effective date.

At the date of initial adoption of the guidance (the first day of a fiscal quarter), the host contract and the related embedded derivative should be combined and accounted for as a single investment in life insurance; the adjustment (if any) of the combined carrying amounts to the cash surrender value of that investment in life insurance should be reported as a cumulative-effect-type adjustment of net income (even if the derivative had been accounted for under Statement 133 as the hedging instrument in a cash flow hedge in a previous period).

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Embedded Derivatives: Application of Paragraph 15(a) regarding Substantial Party to a Contract
Paragraph references:	15(a), 311, Implementation Issue B21
Date cleared by Board:	March 21, 2001
Date posted to website:	April 10, 2001
Date revision posted to website:	May 1, 2003
Affected by:	FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* Revised March 26, 2003

QUESTION

How should an entity determine what constitutes a "substantial party" to an international construction contract in the context of paragraphs 15(a) and 311? Specifically, how does one evaluate the role of a parent company that may not be a legal party to the contract but who provides the majority of resources required under the contract on behalf of the subsidiary who is the legal party to the contract?

BACKGROUND

Paragraph 15(a), as amended, states that an embedded foreign currency derivative instrument shall not be separated from the host contract and considered a derivative instrument under paragraph 12 if the host contract is not a financial instrument and it requires payment(s) denominated in the functional currency of any substantial party to that contract.

Paragraph 311 states, in part, that "the Board decided that it was important that the payments be denominated in the functional currency of at least one *substantial* party to the transaction to ensure that the foreign currency is integral to the arrangement."

It is a common practice in the international construction industry to enter into contracts in foreign countries via local subsidiaries to meet the local tax and political requirements. In fact, this is sometimes a requirement to the contractor, especially when the contract is entered into with a foreign government as a customer. However, the customer will typically "look through" the contracting subsidiary to its parent company to provide the experience, management, knowledge, financial resources, infrastructure, and other services under the construction contract and bear the responsibility for the contract management and execution. This responsibility may or may not be evidenced legally through a financial guarantee or other credit comfort provided by the parent company to the customer.

The following fact pattern further illustrates this Issue.

A U.S.-based construction company (the Parent) pursues business in a foreign country on a major construction contract. The Parent has an operating subsidiary (the Subsidiary) in that foreign country. The Subsidiary's functional currency is determined to be the local currency (because of business activities unrelated to the construction contract), which is also the functional currency of the customer under the contract. The Parent's functional currency is the U.S. dollar.

Primarily for tax and political reasons, the Parent causes its Subsidiary to enter into a contract with the customer (that is, the contract is legally between the Subsidiary and the customer). The contract requires payments by the customer in U.S. dollars. The payments are in U.S. dollars to facilitate the compensation of the Parent for its significant involvement in and management of the contract entered into by the Subsidiary.

The Subsidiary, by itself, does not possess the requisite financial, human, and other resources, technology, and knowledge to execute the construction contract on its own. The Parent provides the majority of the resources required under the contract, including direct involvement in negotiating the terms of the contract, managing and executing the contract throughout its duration, and maintaining all contract supporting functions, such as legal, tax, insurance, and risk management. Because it is controlled by the Parent, the Subsidiary does not have a choice of subcontractor for these resources and services and will always integrate the Parent into all phases of the contract. Without the Parent, the Subsidiary and the customer would probably never have entered into the construction contract because the Subsidiary could not perform under this contract without the help of the Parent.

RESPONSE

The Parent should be considered a substantial party to the contract. When determining who is a substantial party to the contract for purposes of applying paragraph 15(a), the entity needs to consider all facts and circumstances pertaining to that contract (including whether the contracting party possesses the requisite knowledge, resources, and technology to fulfill the contract without relying on related parties), and look through the legal form to evaluate the substance of the underlying relationships. In the illustration above, the Parent is a substantial party to the construction contract entered into by the Subsidiary for the purposes of applying paragraph 15(a) of Statement 133 because the Parent will be providing the majority of resources required under the contract on behalf of the Subsidiary, who is the legal party to the contract.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Embedded Derivatives: Applicability of Paragraph 15 to Embedded Foreign Currency Options
Paragraph references:	15, 195, 311
Date cleared by Board:	March 21, 2001
Date posted to website:	April 10, 2001
Date revision posted to website:	May 1, 2003
Affected by:	FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*

Revised March 26, 2003

QUESTION

Is an embedded foreign currency option that merely introduces a cap or floor on the functional currency equivalent price under a purchase contract eligible for the exclusion in paragraph 15 that requires, in certain circumstances, that an embedded foreign currency derivative instrument not be separated from a host nonfinancial instrument contract (and considered a derivative instrument) under paragraph 12?

BACKGROUND

Paragraph 15 of Statement 133, as amended by Statement 149, states:

> An embedded foreign currency derivative instrument shall *not* be separated from the host contract and considered a derivative instrument under paragraph 12 if the host contract is not a financial instrument and it requires payment(s) denominated in (a) the functional currency of any substantial party to that contract, (b) the currency in which the price of the related good or service that is acquired or delivered is routinely denominated in international commerce (for example, the U.S. dollar for crude oil transactions),* (c) the local currency of any substantial party to the contract, or (d) the currency used by a substantial party to the contract as if it were the functional currency because the primary economic environment in which the party operates is highly inflationary (as discussed in paragraph 11 of Statement 52). The evaluation of whether a contract qualifies for the exception in this paragraph should be performed only at inception of the contract. Unsettled foreign currency transactions, including financial instruments, that are monetary items and have their principal payments, interest payments, or both denominated in a foreign currency are subject to the requirement in Statement 52 to recognize any foreign currency transaction gain or loss in earnings and shall not be considered to contain embedded foreign currency derivative instruments

under this Statement. The same proscription applies to available-for-sale or trading securities that have cash flows denominated in a foreign currency.

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[*] If similar transactions for a certain product or service are routinely denominated in international commerce in various different currencies, the transaction does not qualify for the exception.

Paragraph 311 of the basis for conclusions indicates that "the Board decided that it was important that the payments be denominated in the functional currency of at least one *substantial* party to the transaction to ensure that the foreign currency is integral to the arrangement and thus considered to be clearly and closely related to the terms of the lease." Statement 133 Implementation Issue No. B4, "Foreign Currency Derivatives," further clarifies "it follows that the exception provided by paragraph 15 implicitly requires that the other aspects of the embedded foreign currency derivative must be clearly and closely related to the host."

Paragraph 195 of Appendix B describes an example of the scope application of Statement 133 for a short-term loan with a foreign currency option. Paragraph 195 states:

> A U.S. lender issues a loan at an above-market interest rate. The loan is made in U.S. dollars, the borrower's functional currency, and the borrower has the option to repay the loan in U.S. dollars or in a fixed amount of a specified foreign currency.
>
> *Scope Application:* This instrument can be viewed as combining a loan at prevailing market interest rates and a foreign currency option. The lender has written a foreign currency option exposing it to changes in foreign currency exchange rates during the outstanding period of the loan. The premium for the option has been paid as part of the interest rate. Because the borrower has the option to repay the loan in U.S. dollars or in a fixed amount of a specified foreign currency, the provisions of paragraph 15 are not relevant to this example. Paragraph 15 addresses foreign-currency-denominated interest or principal payments but does not apply to foreign currency options. Because a foreign currency option is not clearly and closely related to issuing a loan, the embedded option should be separated from the host contract and accounted for by both parties pursuant to the provisions of this Statement. In contrast, if both the principal payment and the interest payments on the loan had been payable only in a fixed amount of a specified foreign currency, there would be no embedded foreign currency derivative pursuant to this Statement.

Example

On March 1, 20X0, Company A enters into a Japanese yen-denominated forward purchase agreement to purchase a specified quantity of widgets in six months from Company B. Company A's functional currency is US$ and Company B's functional currency is JPY. The spot JPY/US$ foreign exchange rate at the inception of the agreement is US$1.00 equals JPY110. Company A wishes to collar its foreign exchange rate risk by ensuring that it will never pay more than the

JPY equivalent to US$11.00 per widget in return for committing to Company B that it will never pay less than the JPY equivalent to US$8.80 per widget. The agreement defines the price according to the following schedule:

When US$1.00 equals…	**The JPY price per widget is…**
More than JPY125	The JPY equivalent to US$11.00
Between JPY100 and JPY125	JPY1,100
Less than JPY100	The JPY equivalent to US$8.80

Company A is exposed to foreign exchange risk in the range between JPY100 and JPY125, whereas Company B is exposed outside that range. The following are various scenarios:

	Scenario 1	Scenario 2	Scenario 3	Scenario 4	Scenario 5
FX rate (JPY/US$)	110/1	125/1	100/1	80/1	135/1
Purchase price (JPY)	1,100	1,100	1,100	880	1,188
US$-equivalent purchase price	10.00	8.80	11.00	11.00	8.80

In essence, Company A has not locked in a US$ price or a JPY price for the purchased widgets. Instead, as desired, Company A has locked in a price range in its functional currency (US$) between $8.80 and $11.00 for the purchased widgets. The final price to be paid within this range will be determined based upon the JPY/US$ foreign exchange rate. Based on the terms, the contract contains an embedded cap and floor (options). For purposes of this example, assume that the combination of options represents a net purchased option for Company A.

RESPONSE

Yes. The discussion in paragraph 15 relating to embedded foreign currency derivative instruments within nonfinancial contracts was intended to relate to all embedded foreign currency caps or floors within such contracts.

The embedded foreign currency cap or floor (or combination thereof) within a nonfinancial contract would be considered clearly and closely related to the host nonfinancial contract, and thus not be accounted for separately as a derivative, only if (1) the nonfinancial contract requires payment(s) denominated in any of the currencies permitted by paragraphs 15(a)~~)~~–15(d), (2) the embedded cap or floor (or combination thereof) does not contain leverage features, and (3) the embedded cap or floor (or combination thereof) does not represent a written or net written option.

In the example provided in the background section, since (1) the options are denominated in JPY/US$ (the functional currencies of both parties to the contract), (2) there is no leverage feature within the option contracts, and (3) the combination of foreign currency options represents a net purchased option, the embedded foreign currency options within Company A's purchase contract would qualify for the exclusion for purposes of Company A's accounting.

However, when an embedded cap or floor (or combination thereof) represents a purchased or net purchased option to one party to the contract, it would represent a written or net written option to the counterparty to that contract. In that case, that counterparty could not qualify for the paragraph 15 exclusion because criterion 3 above would not be met (due to the embedded foreign currency cap or floor (or combination thereof) representing a written or net written option). However, if the embedded derivative represented a zero-cost collar (as described in Statement 133 Implementation Issue No. E2, "Combinations of Options," or No. E5, "Complex Combinations of Options," as appropriate), both parties to the contract would meet criterion 3 above and be eligible to qualify for the exclusion.

The example provided in paragraph 195 illustrates a financial instrument that contains an embedded foreign currency option contract that permits repayment of the loan in a fixed amount of a specified currency that is not the functional currency of either party to the contract. In contrast, the options in the example for this Issue are embedded within a nonfinancial instrument and are denominated in JPY/US$ (the functional currencies of both parties to the contract). Consequently, the example in paragraph 195 is not relevant to this Issue.

In addition, if a financial or nonfinancial contract contained an option that allowed the payer to remit funds in an equivalent amount of a currency other than the functional currency of a substantial party to the contract at the payment date, that option would not need to be separated from the host contract because the option merely allows the payer to make an equivalent payment in a choice of currencies (based on current spot prices).

The discussion in paragraph 15 relating to embedded foreign currency derivative instruments within nonfinancial contracts was not intended to relate to all embedded foreign currency options within such contracts. The guidance in this Issue is not meant to address every possible type of foreign currency option that may be embedded in a nonfinancial contract, and an analogy to the response included in this Issue may not be appropriate for such foreign currency options.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Embedded Derivatives: Application of Statement 133 to a Not-for-Profit Organization's Obligation Arising from an Irrevocable Split-Interest Agreement
Paragraph references:	5, 10(c), 12
Date cleared by Board:	April 9, 2002
Date latest revision posted to website:	February 28, 2007
Affected by:	FASB Statements No. 155, *Accounting for Certain Hybrid Financial Instruments*, and No. 157, *Fair Value Measurements*

Revised September 15, 2006

QUESTION

When does a not-for-profit (NFP) organization's obligation arising from an irrevocable split-interest agreement contain an embedded derivative instrument that should be bifurcated and accounted for as a derivative instrument pursuant to the requirements of paragraph 12 in Statement 133?

BACKGROUND

General

Split-interest agreements are agreements in which donors enter into trusts or other arrangements under which NFP organizations receive benefits that are shared with other beneficiaries. A typical split-interest agreement has two components—a lead interest and a remainder interest. The lead interest is the right to the benefits (cash flows or use) of the transferred assets during the term of the agreement, which generally starts upon the signing of the agreement and terminates either (1) after a specified number of years (*period-certain*) or (2) upon the occurrence of a certain event, commonly either the death of the donor or the death of the lead interest beneficiary (*life-contingent*). The remainder interest is the right to receive all or a portion of the assets remaining at the end of the agreement's term.

Chapter 6 of the AICPA Audit and Accounting Guide, *Not-for-Profit Organizations* (NFP Guide), addresses the accounting for irrevocable split-interest agreements by NFP organizations. In an irrevocable split-interest agreement, the donor may give the NFP organization the right to control the contributed assets by either (1) naming them trustee of the trust holding the assets or (2) granting them the right to hold the assets as general assets of their organization. In either case, the assets are recorded on the NFP organization's statement of financial position at their fair value when received. The NFP organization's obligation to make specified cash payments to a designated beneficiary or to convey the remaining assets to the donor or the donor's

beneficiary is recognized as a liability[1] and measured based on the present value of the future expected payments to the beneficiary. Although the NFP organization's liability may coincidentally be equal to fair value, that liability is not measured at fair value under generally accepted accounting principles (GAAP) because the NFP Guide requires that the discount rate used in estimating the present value of future expected payments to the beneficiary be determined at the time the contribution is initially recognized and is not revised subsequently.

Perceived Conflict with Statement 133

Paragraph 5 of Statement 133 indicates that its scope includes NFP organizations, but the Statement does not specifically address the application of its provisions to the accounting for NFP organizations' obligations arising from split-interest agreements. Nevertheless, Statement 133 could apply to certain liabilities of NFP organizations arising from split-interest agreements.

Paragraph 6 of Statement 133 specifies the characteristics that a contract must have to be considered a derivative instrument in its entirety under that Statement. Paragraph 12 addresses contracts that do not in their entirety meet the definition of a derivative instrument in paragraph 6 but may contain provisions that constitute an embedded derivative instrument that could warrant separate accounting. (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. However, Statement 155 does not apply to hybrid financial instruments that are described in paragraph 8 of FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments,* which include insurance contracts as discussed in FASB Statements No. 60, *Accounting and Reporting by Insurance Enterprises,* and No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments,* other than financial guarantees and investment contracts. Hybrid financial instruments that are elected to be accounted for in their entirety at fair value cannot be used as a hedging instrument in a Statement 133 hedging relationship.) Paragraph 12 states, in part, that an embedded derivative instrument shall be separated from the host contract and accounted for as a derivative instrument if and only if all of the following criteria are met:

a. The economic characteristics and risks of the embedded derivative instrument are not clearly and closely related to the economic characteristics and risks of the host contract.
b. The contract ("the hybrid instrument") that embodies both the embedded derivative instrument and the host contract is not remeasured at fair value under otherwise applicable generally accepted accounting principles with changes in fair value reported in earnings as they occur.

[1] The use of the term *liability* in this Issue is consistent with the use of that term in the NFP Guide. This Issue does not address whether or not the obligation is a liability or a form of minority interest.

c. A separate instrument with the same terms as the embedded derivative instrument would, pursuant to paragraphs 6–11, be a derivative instrument subject to the requirements of this Statement. (The initial net investment for the hybrid instrument shall not be considered to be the initial net investment for the embedded derivative.)

The accounting for the liability in an irrevocable split-interest agreement under the NFP Guide could be in conflict with the accounting under Statement 133 as amended if that liability contains an embedded derivative that meets the criteria in paragraph 12 of Statement 133 requiring separate accounting for that derivative or if the fair value election is made pursuant to Statement 155.

Two General Types of Structures

General Structure of a Lead Trust for an NFP Organization: Assets such as cash or shares of stock are contributed by the donor to the control of the NFP organization (either through the NFP organization's role as trustee of a trust holding the assets, or directly by the NFP organization holding the assets as general assets of their organization). The NFP organization receives periodic cash payments (the lead interest) that are either a fixed dollar amount or a specified percentage of the fair value of the assets as of the beginning of each period. (Note: Some of the assets may need to be liquidated in order to make the required payments.) At the termination of the agreement, the remaining assets revert to the donor or the donor's beneficiary (the remainder interest). During the term of the agreement, the NFP organization has a liability for the remainder interest. The NFP organization's liability for its obligation to the donor or the donor's beneficiary is based in part on the fair value of the assets.

General Structure of a Remainder Trust for an NFP Organization: Assets such as cash or shares of stock are contributed by the donor to the control of the NFP organization (either through the NFP organization's role as trustee of a trust holding the assets, or directly by the NFP organization holding the assets as general assets of their organization). The NFP organization (or the trust) makes periodic payments to the donor or the donor's beneficiary that are either a fixed dollar amount or a specified percentage of the fair value of the assets during the term of the agreement. (Some of the assets may need to be liquidated to make the payments.) At the termination of the agreement, the remaining assets revert to the NFP organization. During the term of the agreement, the NFP organization has a liability for the lead interest. If the lead interest payments to the donor or the donor's beneficiary are based on a specified percentage of the fair value of the assets, the NFP organization's liability for its obligation to the donor or the donor's beneficiary is based on the fair value of the contributed assets.

Two aspects of the split-interest agreement's payment terms for the lead interest—whether the payments are a fixed or variable cash amount and whether the agreement is period-certain or life-contingent—affect the accounting treatment for the NFP organization's liability for the payment or payments to the donor or the donor's beneficiary. Paragraph 10(c) of Statement 133 notes

that, generally, contracts of the type that are within the scope of FASB Statements No. 60, *Accounting and Reporting by Insurance Enterprises*, No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, and No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, are not subject to the requirements of Statement 133, because payment of benefits is a result of an identified insurable event, such as the death of an identified individual (mortality risk). Paragraph 7 of Statement 97 indicates that mortality risk is present if, under the terms of an annuity contract, the enterprise is required to make payments contingent upon the continued survival of a specific individual or group of individuals.

RESPONSE

The NFP organization's liability for its obligation to the donor or the donor's beneficiary under an irrevocable split-interest agreement should be analyzed to determine whether it qualifies for the exception in paragraph 10(c), in which case that liability would not be subject to the requirements of Statement 133. For example, if the obligation is solely life-contingent (that is, contingent upon the survival of an identified individual, in which case the payments are made only if the individual is alive when the payments are due), that obligation would qualify for the exception in paragraph 10(c). That conclusion is consistent with the guidance to Question 4 in Statement 133 Implementation Issue No. B25, "Deferred Variable Annuity Contracts with Payment Alternatives at the End of the Accumulation Period." If the NFP organization's liability for its obligation under the split-interest agreement does not qualify for the exception in paragraph 10(c) because the agreement is not solely life-contingent, the NFP organization must determine whether that liability meets the definition of a derivative in its entirety under paragraph 6 or whether it contains an embedded derivative instrument that could warrant separate accounting under paragraph 12 unless a fair value election is made pursuant to Statement 155.

The NFP organization's liability for its obligation under a split-interest agreement would typically not meet the definition of a derivative instrument in its entirety because it would not meet the criterion in paragraph 6(b). That criterion requires the contract to have no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors. In contrast, the initial net investment for the liability recognized for typical split-interest agreements is its fair value (generally measured at the present value of the estimated future payments). If the NFP organization's liability for its obligation under the split-interest agreement does not in its entirety meet the definition of a derivative instrument in paragraph 6, that liability must be analyzed to determine whether it contains provisions that constitute an embedded derivative instrument that warrants separate accounting under paragraph 12. Generally, the liability representing an obligation under a split-interest agreement contains an embedded derivative that warrants separate accounting if the payments are variable and the agreement is period-certain (rather than life-contingent) unless a fair value election is made pursuant to Statement 155. The following examples, although not all-inclusive, provide an understanding of the applicability of paragraph 12 to various split-interest agreements.

Example 1: Remainder Trust (period-certain, fixed payments) [also known as a Charitable Remainder Annuity Trust]

Shares of common stock are contributed to the control of the NFP organization, who is required to pay the donor or the donor's beneficiary an annual fixed cash payment for 20 years, after which time the remaining shares revert to the NFP organization. During the term of the agreement (20 years), the NFP organization has a liability that does not require bifurcation of an embedded derivative. Since the periodic cash payment is a fixed dollar amount, the liability has no underlying and, thus, does not meet the criterion in paragraph 6(a) of the definition of a derivative instrument. Because there is no underlying, there is also no embedded derivative that warrants separate accounting under paragraph 12.

Example 2: Remainder Trust (period-certain, variable payments) [also known as a Charitable Remainder Unitrust]

Shares of common stock are contributed to the control of the NFP organization, who is required to make 20 annual cash payments to the donor or the donor's beneficiary that are equal to a specified percentage of the fair value of the assets as of the beginning of each annual period. After the 20 payments have been made, the remaining shares will revert to the NFP organization. During the term of the agreement (20 years), the NFP organization has a liability that must be bifurcated because it contains an embedded derivative instrument that warrants separate accounting unless a fair value election is made pursuant to Statement 155. Under paragraph 12, the liability represents a hybrid instrument that is composed of a debt host contract and an embedded equity-based derivative that is not clearly and closely related to the debt host and that would meet the definition of a derivative if it were freestanding. That is, it has an underlying (price of shares) and a notional amount (number of shares in the trust at the beginning of each annual period), it satisfies the no-or-smaller initial net investment characteristic in paragraph 6(b), and it would meet the net settlement characteristic in paragraph 6(c) (because each annual payment is adjusted for the effect of the equity-based derivative). That analysis is consistent with the analysis under paragraph 185 of Statement 133 for equity-indexed debt. (The debt host represents the liability for the series of 20 annual payments that would be required based on the assumption that the fair value of the common stock does not change over the 20-year period. The embedded equity-based derivative relates to the increase or decrease in each of the 20 annual payments due to changes in the fair value of the common stock.)

Example 3: Remainder Trust (life-contingent, variable or fixed payments)

Shares of common stock are contributed to the control of the NFP organization, who is required to make annual cash payments to the donor or the donor's beneficiary that are either a fixed dollar amount or a specified percentage of the fair value of the assets at the beginning of each annual period until the death of the donor or the donor's beneficiary, upon which time the remaining shares will revert to the NFP organization. During the term of the agreement, the NFP organization has a liability that is not bifurcated because it is solely life-contingent and thus qualifies for the exception in paragraph 10(c).

Example 4: Remainder Trust (period-certain-plus-life-contingent, fixed payments)
Shares of common stock are contributed to the control of the NFP organization, who is required to pay the donor or the donor's beneficiary an annual fixed cash payment for the longer of the beneficiary's remaining life or a specified period. The remaining shares then revert to the NFP organization. During the term of the agreement, the NFP organization has a liability that, for purposes of applying Statement 133, must be analyzed as consisting of two separate liabilities: one liability relating to the period-certain cash payments and a second liability relating to the possible additional cash payments that are contingent upon the beneficiary living beyond the end of the period-certain payments. The NFP organization's liability does not require the bifurcation of any embedded derivative because the portion of the liability related to the fixed period-certain payments has no underlying, and the portion of the liability related to the possible life-contingent payments qualifies for the exception in paragraph 10(c).

Example 5: Remainder Trust (period-certain-plus-life-contingent, variable payments)
Shares of common stock are contributed to the control of the NFP organization, who is required to pay the donor or the donor's beneficiary an annual cash payment equal to a specified percentage of the fair value of the assets at the beginning of each annual period for the greater of the beneficiary's remaining life or a specified period. The remaining assets revert to the NFP organization. During the term of the agreement, the NFP organization has a liability that, for purposes of applying Statement 133, must be analyzed as consisting of two separate liabilities: one liability relating to the period-certain cash payments and a second liability relating to the possible additional cash payments that are contingent upon the beneficiary living beyond the end of the period-certain payments. Statement 133 requires that the equity-based derivative embedded in the portion of the liability related to the period-certain variable cash payments be bifurcated from a debt host contract (consistent with the analysis in Example 2). The equity-based derivative embedded in the portion of the liability related to the possible life-contingent cash payments that can occur after the end of the specified period is not subject to Statement 133 because it qualifies for the exception in paragraph 10(c).

Example 6: Lead Trust (period-certain, fixed or variable payments)
An NFP organization receives cash from a donor, which is invested by the NFP organization in common equity securities. The donor designates the organization as lead beneficiary. The NFP organization receives an annual cash payment of either a fixed amount or a specified percentage of the fair value of the investment amount at the beginning of each annual period for a specified period of time. After that time, the remaining assets revert to the donor or the donor's beneficiary. During the term of the agreement, the NFP organization has a liability that must be bifurcated. Under paragraph 12, the liability represents a hybrid instrument that is composed of a debt host contract and an embedded equity-based derivative that is not clearly and closely related to the debt host and that would meet the definition of a derivative if it were freestanding. That is, it has an underlying (price of shares) and a notional amount (number of shares at the beginning of each annual period), it satisfies the no-or-smaller initial net investment characteristic in paragraph 6(b), and it would meet the net settlement characteristic in paragraph 6(c). Regardless of whether the lead interest payments are fixed or variable, the value of the liability

representing the remainder interest—the assets remaining at the end of the agreement that will be paid to the donor or the donor's beneficiary—is affected by changes in the equity value, thus requiring the equity-based derivative to be bifurcated unless a fair value election is made pursuant to Statement 155. That analysis is consistent with the analysis under paragraph 185 of Statement 133 for equity-indexed debt.

Example 7: Lead Trust (life-contingent, fixed or variable payments)
An NFP organization receives cash from a donor, which is invested by the NFP organization in common equity securities. The donor designates the organization as lead beneficiary. The NFP organization receives an annual cash payment of either a fixed dollar amount or a specified percentage of the fair value of the investment amount at the beginning of each annual period until the death of the donor or the donor's beneficiary, at which time the remaining assets revert to the donor or the donor's beneficiary. During the term of the agreement, the NFP organization has a liability that is not subject to Statement 133 because the remainder interest liability relates to a single payment whose amount and timing is life-contingent and thus qualifies for the exception in paragraph 10(c).

Example 8: Lead Trust (period-certain-plus-life-contingent, variable or fixed payments)
An NFP organization receives cash from a donor, which is invested by the NFP organization in common equity securities. The donor designates the organization as lead beneficiary. The NFP organization receives an annual cash payment for either a specified percentage of the fair value of the assets at the beginning of each annual period or a fixed dollar amount. That cash payment is made for the greater of the beneficiary's (or the donor's) remaining life or a specified period. After that time, the remaining assets revert to the donor or the donor's beneficiary. During the term of the agreement, the NFP organization has a liability that is not subject to Statement 133 because, unlike the liability in Example 5, the period-certain aspect of the liability cannot be separated from the life-contingent aspect of the liability (because there is only one payment whose timing and value are affected by mortality risk). Thus, the remainder interest liability relates to a single payment whose amount and timing is life-contingent and thus qualifies for the exception in paragraph 10(c). (If payment occurs only when the beneficiary (or donor) is alive, such as in an agreement where the period is for the *lesser of* the beneficiary's (donor's) remaining life or a specified period, then every payment is life-contingent and qualifies for the exception in paragraph 10(c).) It should be noted that if during the terms of a *greater-of*-period-certain-or-life-contingent agreement, the beneficiary dies prior to the end of the period-certain terms in the agreement, that change in circumstance eliminates the life-contingent aspect of the contract. Thus, the agreement is now only a period-certain agreement and mirrors the agreement outlined in Example 6, requiring bifurcation of the embedded derivative.

Other Split-Interest Agreements When the Contributed Assets Are Other Than Equity Securities

Some split-interest agreements may involve the gift of corporate or U.S. government debt securities, or other securities that are not equity. In determining whether or not those split-interest agreements contain an embedded derivative, the same analysis should be applied as that given in the above examples and as outlined in paragraph 12 of Statement 133. The notion of clearly and closely related, as defined in paragraph 12(a), shall involve an assessment of the economic characteristics and risks associated with the non-equity securities in relation to the economic characteristics and risks of the NFP organization's debt host contract. Generally, because of the differences in credit risk, the change in the fair value of corporate bonds (based on that corporation's credit and interest rate risk) will not be clearly and closely related to the change in the economic characteristics and risks of the NFP organization's debt host contract. Thus, an embedded derivative requiring bifurcation and separate accounting for the embedded derivative would exist unless a fair value election is made pursuant to Statement 155.

Other Split-Interest Agreements When the NFP Organization Does Not Have Control of the Contributed Assets

Some NFP organizations are parties to split-interest agreements that are similar to those outlined above but involve a third party who maintains control of the donor's contributed assets. The NFP organization does not have an obligation to pay either the remainder or lead interest to the designated beneficiary, as that responsibility remains with the third party who maintains control of the assets (thus, the NFP organization does not recognize a liability). However, the NFP organization does have an asset and contribution revenue representing their entitlement to the lead interest payments or the remainder interest, as stipulated in the agreement. In accordance with the NFP Guide, the NFP organization should recognize its beneficial interest in those assets by debiting Beneficial Interest in Split-Interest Agreement and crediting Temporarily Restricted Contribution Revenue, at fair value. Subsequent changes in the fair value of the beneficial interest are recognized in the statement of activities. Thus, under paragraph 12 of Statement 133, the embedded derivative in the above contract would not be bifurcated, as the criterion under subparagraph 12(b) is not met.

EFFECTIVE DATE

The effective date of the implementation guidance in this Issue for each reporting entity is the first day of its first fiscal year beginning after June 15, 2002. Restatement of previously issued financial statements is not required.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Embedded Derivatives: 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
Paragraph references:	12, 14, 61(c)
Date cleared by Board:	April 2, 2003
Date latest revision posted to website:	June 16, 2006
Affected by:	FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments*, and FASB Statement No. 156, *Accounting for Servicing of Financial Assets*

Revised June 16, 2006

QUESTIONS

Are the embedded features of a debt instrument that incorporates credit risk exposures that are unrelated or only partially related to the creditworthiness of the obligor under that instrument clearly and closely related to the debt host contract? Does a modified coinsurance arrangement, in which funds are withheld by the ceding insurer and a return on those withheld funds is paid based on the ceding company's return on certain of its investments, contain an embedded derivative feature that is not clearly and closely related to the host contract?

BACKGROUND

Questions have been raised regarding the following examples that illustrate instruments that incorporate credit risk exposures that are unrelated or only partially related to the creditworthiness of the obligor under that instrument.

Example 1—Credit-Linked Note Issued by a Corporation

Company A issues a fixed-rate, 10-year, $10 million credit-linked note to an investor that provides for periodic interest payments and the repayment of principal at maturity. However, upon default of a specified reference security (a Company X subordinated debt obligation)[1] the redemption value of the note may be zero or there may be some claim to the recovery value of the reference security (depending on the terms of the specific arrangement). In an event of default of the specified reference security, there is no recourse to the general credit of the obligor

[1] Generally, the term *reference security* refers to the security whose credit rating or default determines the cash flows under a credit derivative. Usually, the terms of credit-linked notes explicitly reference CUSIP numbers of securities in the marketplace.

(Company A). In exchange for accepting the default risk of the reference security, the note entitles the investor to an enhanced yield. The transaction results in the investor "selling credit protection" and Company A "buying credit protection."

Example 2—Reinsurer's Receivable Arising from a Modified Coinsurance Arrangement
Reinsurance Company B enters into a modified coinsurance arrangement (also referred to as a modco arrangement), which is a reinsurance arrangement in which funds are withheld by the ceding insurer, thereby creating an obligation for the ceding company to pay the reinsurer at a later date. Concurrently, the reinsurer (Company B) recognizes a funds-withheld receivable from the ceding insurer as well as a liability representing reserves for the insurance coverage assumed under the modco arrangement. (The amount of Company B's receivable is the ceding company's statutory reserve, whereas the amount of Company B's liability is the reserve under generally accepted accounting principles.) The terms of the ceding company's payable (and Company B's funds-withheld receivable) provide for the future payment of a "principal" amount plus a return (that may be negative) that is based on a specified proportion of the ceding company's return on either its general account assets or a specified block of those assets (such as a specific portfolio of its investment securities). That portfolio is typically composed primarily of fixed-rate debt securities.

Paragraph 61(c) of Statement 133 discusses whether certain embedded credit-sensitive features are clearly and closely related to the host contract. It states:

> *Credit-sensitive payments*. The creditworthiness of the debtor and the interest rate on a debt instrument are considered to be clearly and closely related. Thus, for debt instruments that have the interest rate reset in the event of (1) default (such as violation of a credit-risk-related covenant), (2) a change in the debtor's published credit rating, or (3) a change in the debtor's creditworthiness indicated by a change in its spread over Treasury bonds, the related embedded derivative would *not* be separated from the host contract.

RESPONSE

No. Paragraph 61(c) of Statement 133 indicates that the creditworthiness of an obligor (debtor) of a debt instrument and the interest rate on that instrument are clearly and closely related. Paragraph 190 illustrates a credit-sensitive bond in which the interest rate resets based on changes in the obligor's credit rating. The analysis of that example indicates that the economic characteristics and risks of the embedded credit derivative are clearly and closely related to the economic characteristics and risks of the debt host contract. Conversely, if an instrument incorporates a credit risk exposure that is different from the risk exposure arising from the creditworthiness of the obligor under that instrument, such that the value of the instrument is affected by an event of default or a change in creditworthiness of a third party (that is, an entity that is not the obligor), then the economic characteristics and risks of the embedded credit

derivative are not clearly and closely related to the economic characteristics and risks of the host contract, even though the obligor may own securities issued by that third party.

The credit-linked note described in Example 1 includes an embedded credit derivative feature. In that example, the credit risk exposure of the reference security (Company X) and the risk exposure arising from the creditworthiness of the obligor (Company A) are not clearly and closely related. Thus, the economic characteristics and risks of the embedded derivative feature are not clearly and closely related to the economic characteristics and risks of the debt host contract and, accordingly, the criterion in paragraph 12(a) is met. (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. However, Statement 155 does not apply to hybrid financial instruments that are described in paragraph 8 of FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments,* which include insurance contracts as discussed in FASB Statements No. 60, *Accounting and Reporting by Insurance Enterprises,* and No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments,* other than financial guarantees and investment contracts. Hybrid financial instruments that are elected to be accounted for in their entirety at fair value cannot be used as a hedging instrument in a Statement 133 hedging relationship.)

With respect to the **modco arrangement** in Example 2, the ceding company's funds-withheld payable and Company B's funds-withheld receivable includes an embedded derivative feature that is not clearly and closely related to the host contract. The yield on the payable and receivable in the host contract in this example is based on a specified proportion of the ceding company's return on either its general account assets or a specified block of those assets (such as a specific portfolio of the ceding company's investment securities). The risk exposure of the ceding company's return on its general account assets or its securities portfolio is not clearly and closely related to the risk exposure arising from the overall creditworthiness of the ceding company, which is also affected by other factors. Consequently, the economic characteristics and risks of the embedded derivative feature are not clearly and closely related to the economic characteristics and risks of the host contract and, accordingly, the criterion in paragraph 12(a) is met. This analysis applies whether the host contract is determined to be a debt host or an insurance contract. For example, if the host contract is determined to be the modco arrangement (including the funds-withheld receivable-payable but excluding the embedded derivative), the economic characteristics and risks of the embedded derivative feature are not clearly and closely related to the economic characteristics and risks of the host contract and, accordingly, the criterion in paragraph 12(a) is met.

In both of these examples, the embedded derivative feature generally will require bifurcation. However, the criteria in paragraphs 12(b) and 12(c) of Statement 133 must be considered prior to concluding that the embedded derivative feature should be bifurcated and accounted for separately. In Example 1, consideration should be given to whether the embedded derivative feature could possibly not be subject to Statement 133 as a financial guarantee under paragraph 10(d) and, in that case, the embedded derivative feature would not warrant bifurcation. In

Example 2, the other criteria in paragraph 12 generally would be met, thereby requiring that the embedded derivative feature be bifurcated and accounted for separately. The nature of the embedded derivative feature and the host contract in both examples should be determined based on the facts and circumstances of the individual contract.

Statement 133 Implementation Issue No. D1, "Application of Statement 133 to Beneficial Interests in Securitized Financial Assets," addresses implementation issues related to the scope exception in paragraph 14 of Statement 133 for interest-only strips and principal-only strips but only for instruments recognized prior to the effective date of Statement 155. Implementation Issue D1 indicates that certain assets or liabilities that are beneficial interests or interests that continue to be held by a transferor in *securitized* financial assets are not subject to Statement 133. Implementation Issue D1 does not apply to interests in *nonsecuritized* financial assets. Accordingly, the implementation guidance in Implementation Issue B36 does not apply to hybrid instruments that are beneficial interests or interests that continue to be held by a transferor in *securitized* financial assets if they are not subject to Statement 133 pursuant to Implementation Issue D1.

This Implementation Issue should be applied to all other arrangements that incorporate credit risk exposures that are unrelated or only partially related to the creditworthiness of the issuer of that instrument. The guidance in this Implementation Issue does not affect the accounting for a nonrecourse debt arrangement (that is, a debt arrangement in which, in the event that the debtor does not make the payments due under the loan, the creditor has recourse solely to the specified property pledged as collateral).

At any time during the fiscal quarter that the guidance in this Implementation Issue is initially applied, companies that have ceded insurance under existing modco arrangements may reclassify securities from the held-to-maturity and available-for-sale categories into the trading category without calling into question the intent of those companies to hold other debt securities to maturity in the future; however, those "taint-free" reclassifications are limited to the amount and type of securities related to the embedded derivatives that are being newly accounted for as derivatives in conjunction with the initial application of that guidance to modco arrangements. The ceding companies should account for those reclassifications as a transfer between categories of investments under paragraph 15 of FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities.*

EFFECTIVE DATE AND TRANSITION

The effective date of the implementation guidance in this Issue is the first day of the first fiscal quarter beginning after September 15, 2003. Earlier application as of the beginning of a fiscal quarter is permitted. If an entity had not bifurcated an embedded derivative but is required to do so under the revised guidance, the entity should account for the effects of initially complying with the revised implementation guidance prospectively for all existing financial instruments,

except for the existing contracts that qualify for the grandfathering provisions of paragraph 50, which exempts certain hybrid instruments from the embedded derivative provisions of Statement 133 on an all-or-none basis. The effects of initially complying with the revised implementation guidance as of the effective date should be reported as a cumulative-effect-type adjustment of net income.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Embedded Derivatives: Mandatorily Redeemable Preferred Stock Denominated in either a Precious Metal or a Foreign Currency
Paragraph references:	11(a), 12, 15, 188, 195, 285, 286
Date cleared by Board:	June 28, 2000
Date latest revision posted to website:	June 16, 2006
Affected by:	FASB Statements No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, and No. 155, *Accounting for Certain Hybrid Financial Instruments*

Revised June 16, 2006

QUESTION

Does mandatorily redeemable preferred stock issued by the reporting entity with payments that are denominated in either a precious metal or a foreign currency contain an embedded derivative under paragraphs 12, 15, 188, and 195 of Statement 133 that is required to be identified and separately accounted for as a derivative by the issuer?

BACKGROUND

A reporting entity issues $100,000 of mandatorily redeemable preferred stock whose preferred dividends are payable in cash but that requires redemption at the end of 1 year for a payment of 312 ounces of gold. Alternatively, the reporting entity issues $100,000 of mandatorily redeemable preferred stock whose redemption at the end of 1 year is payable only in a fixed amount of a specified foreign currency.

Paragraph 11(a) of Statement 133 provides that a reporting entity should not consider a contract to be a derivative instrument for purposes of Statement 133 if the contract is both (1) indexed to the reporting entity's own stock and (2) classified in stockholders' equity in the reporting entity's statement of financial position. FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, was issued in May 2003. Statement 150 requires that mandatorily redeemable financial instruments in the form of shares, as defined in that Statement, be classified as liabilities, and not as temporary equity (which had been done previously). Consequently, this Issue does not address the application of paragraph 11(a).

Paragraph 15 of Statement 133 states, "Unsettled foreign currency transactions, including financial instruments, that are monetary items and have their principal payments, interest payments, or both denominated in a foreign currency are subject to the requirement in [FASB Statement No. 52, *Foreign Currency Translation*] to recognize any foreign currency transaction gain or loss in earnings and shall not be considered to contain embedded foreign currency derivative instruments under this Statement."

Paragraph 188 of Statement 133 provides an example of a note contract with an embedded derivative linked to the price of gold. The gold-linked bull note, which is issued at par, has a fixed below-market 3 percent coupon interest rate and guarantees repayment of principal at maturity with upside potential if the price of gold increases. The gold-linked bull note can be viewed as combining an interest-bearing instrument with a call option contract. By purchasing the note at par rather than at the discount typically associated with the note's below-market interest rate, the investor is effectively purchasing the call option that provides the investor with potential gains resulting from increases in gold prices. (That is, the difference between the typical discount and par is the premium paid for the call option.) Paragraph 188 states that because the option contract is indexed to the price of gold, it is not clearly and closely related to an investment in an interest-bearing note. Therefore, the embedded call option contract should be separated from the host contract and accounted for by both parties pursuant to the provisions of Statement 133. (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. However, Statement 155 does not apply to hybrid instruments that are not financial instruments, such as nonfinancial instruments that require payments in a commodity, for example, gold. Hybrid financial instruments that are elected to be accounted for in their entirety at fair value cannot be used as a hedging instrument in a Statement 133 hedging relationship.)

Paragraph 195 of Statement 133 provides an example of debt with an embedded foreign currency option. A U.S. lender makes a loan in U.S. dollars, the borrower's functional currency, and receives a note payable that bears an above-market interest rate and gives the borrower the option to repay the loan's principal in U.S. dollars or in a fixed amount of a specified foreign currency. The note payable can be viewed as combining a loan at prevailing market interest rates and a foreign currency option. In purchasing the borrower's note at par rather than at the premium typically associated with the note's above-market interest rate, the lender is being compensated for writing a foreign currency option exposing it to changes in foreign currency exchange rates during the outstanding period of the loan. Because the borrower has the option to repay the loan either in U.S. dollars or in a fixed amount of a specified foreign currency, the provisions of paragraph 15 are not relevant to this example. Paragraph 15 addresses foreign-currency-denominated interest or principal payments but does not apply to foreign currency options. Because a foreign currency option is not clearly and closely related to issuing a loan, the embedded option should be separated from the host contract and accounted for by both parties pursuant to the provisions of Statement 133 unless a fair value election is made pursuant to Statement 155. In contrast, if both the principal payment and the interest payments on the loan had been payable only in a fixed amount of a specified foreign currency, there would be no embedded foreign currency derivative pursuant to Statement 133.

RESPONSE

Mandatorily Redeemable Preferred Stock Payable in Gold

The mandatorily redeemable preferred stock payable in gold contains an embedded derivative whose underlying is the price of gold. That embedded derivative should be separated from the host contract and accounted for as a derivative because the embedded derivative is not clearly and closely related to the host contract.

Foreign-Currency-Denominated Mandatorily Redeemable Preferred Stock

Mandatorily redeemable preferred stock whose periodic preferred "dividend" payments, redemption payment, or both are payable only in a stipulated amount of a specified foreign currency contain no embedded foreign currency derivative that warrants separate accounting under Statement 133. Instead, the reporting entity must apply the provisions of Statement 52 to the foreign-currency-denominated mandatorily redeemable preferred stock.

In contrast, if the holder of the mandatorily redeemable preferred stock had the choice of receiving, or the issuer had the choice of making, the redemption payment, the "dividend" payments, or both in either a stipulated amount of U.S. dollars or a stipulated amount of a specified currency, then that instrument contains an embedded foreign currency option that is subject to Statement 133. Because the reporting entity has the option to make payments in U.S. dollars or in a specified foreign currency, the provisions of paragraph 15 of Statement 133 are not relevant to that instrument. That embedded foreign currency option should be separated from the host contract and accounted for as a derivative because the embedded foreign currency option is not clearly and closely related to issuing preferred stock unless a fair value election is made pursuant to Statement 155.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Statement 133 Implementation Issue **No. B38**

Title:	Embedded Derivatives: Evaluation of Net Settlement with Respect to the Settlement of a Debt Instrument through Exercise of an Embedded Put Option or Call Option
Paragraph references:	9, 12, 13
Date cleared by Board:	June 29, 2005
Date posted to website:	June 30, 2005

QUESTION

In applying paragraph 12(c) to a put option or call option (including a prepayment option) embedded in a debt instrument, does the potential settlement of the debtor's obligation to the creditor that would occur upon exercise of the put option or call option meet the net settlement criterion in paragraph 9(a)? The application of paragraph 12(c) is relevant when an embedded put option or call option is not considered to be clearly and closely related to the debt host under paragraph 12(a) and related paragraph 13 or 61(d). Statement 133 Implementation Issue No. B39, "Application of Paragraph 13(b) to Call Options That Are Exercisable Only by the Debtor," cleared by the Board concurrent with this Implementation Issue, describes the circumstances in which an embedded call option (including a prepayment option) that can accelerate the settlement of a hybrid instrument containing a debt host contract would not be subject to the conditions in paragraph 13(b).

BACKGROUND

Paragraph 9(a) of Statement 133 states, in part:

> Neither party is required to deliver an asset that is associated with the underlying and that has a principal amount, stated amount, face value, number of shares, or other denomination that is equal to the notional amount (or the notional amount plus a premium or minus a discount).

RESPONSE

Yes. The potential settlement of the debtor's obligation to the creditor that would occur upon exercise of the put option or call option meets the net settlement criterion in paragraph 9(a). The debtor's settlement of its liability by settling the debt should be considered as not involving the delivery of an asset, notwithstanding whether the creditor concurrently returns to the debtor the evidence of the debtor's indebtedness (such as a note payable marked "paid" by the creditor). The cash paid to the creditor in settling the debtor's obligation is not associated with the underlying because cash (paid currently and denominated in the entity's functional currency), by its very nature, is not related to any underlying for the embedded put option or call option (for example, market interest rates). Therefore, because (1) the debtor does not receive an asset when

it settles the debt obligation in conjunction with exercise of the put option or call option and (2) the creditor does not receive an asset associated with the underlying, "neither party is required to deliver an asset that is associated with the underlying…." Thus, the criterion in paragraph 9(a) is met.

The guidance in this Implementation Issue also would be applicable when analyzing the net settlement criterion under paragraph 9(a) for a freestanding call option held by the debtor on its own debt instrument and for a freestanding put option issued by the debtor on its own debt instrument. The guidance in this Implementation Issue does not apply to put or call options that are added to a debt instrument by a third party contemporaneously with or subsequent to the issuance of a debt instrument, guidance for which is provided in Statement 133 Implementation Issue No. B3, "Investor's Acccounting for a Put or Call Option Attached to a Debt Instrument Contemporaneously with or Subsequent to Its Issuance." The guidance in this issue may not be applied by analogy to an embedded put or call option in a hybrid instrument that does not contain a debt host contract.

If all the criteria in paragraph 12 are met, the embedded put or call option should be bifurcated from the debt host contract and accounted for separately under the provisions of Statement 133.

EFFECTIVE DATE AND TRANSITION

The effective date of the implementation guidance in this Issue is the first day of the first fiscal quarter beginning after December 15, 2005. Earlier application as of the beginning of a fiscal quarter is permitted provided that early application as of the same date is elected for Statement 133 Implementation Issue No. B39, "Application of Paragraph 13(b) to Call Options That Are Exercisable Only by the Debtor." If an entity had not bifurcated an embedded derivative but is required to do so under the guidance in this Issue (after also having taken into consideration the guidance in Implementation Issue B39), the entity should account for the effects of initially complying with the implementation guidance prospectively for all existing financial instruments, except for the existing contracts that qualify for the grandfathering provisions of paragraph 50, which exempts certain hybrid instruments from the embedded derivative provisions of Statement 133 on an all-or-none basis. The effects of initially complying with the implementation guidance in this Issue as of the effective date should be reported as a cumulative-effect-type adjustment directly to retained earnings in accordance with FASB Statement No. 154, *Accounting Changes and Error Corrections*. The cumulative effect adjustment should be calculated in accordance with the transition provisions as described in paragraph 51 of Statement 133.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Embedded Derivatives: Application of Paragraph 13(b) to Call Options That Are Exercisable Only by the Debtor
Paragraph references:	13, 61(a), 61(d)
Date cleared by Board:	June 29, 2005
Date latest revision posted to website:	January 17, 2007
Affected by:	FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments* Statement 133 Implementation Issue No. B40, "Application of Paragraph 13(b) to Securitized Interests in Prepayable Financial Assets" Revised December 20, 2006

QUESTION

Are there circumstances in which an embedded call option (including a prepayment option) that can accelerate the settlement of a hybrid instrument containing a debt host contract would not be subject to the conditions in paragraph 13(b) of Statement 133?

BACKGROUND

Paragraph 13 of Statement 133 states:

> For purposes of applying the provisions of paragraph 12, an embedded derivative instrument in which the underlying is an interest rate or interest rate index that alters net interest payments that otherwise would be paid or received on an interest-bearing host contract is considered to be clearly and closely related to the host contract unless either of the following conditions exist:
>
> a. The hybrid instrument can contractually be settled in such a way that the investor (holder) would not recover *substantially all* of its initial recorded investment.*
>
> b. The embedded derivative meets both of the following conditions:
>
> (1) There is a possible future interest rate scenario (even though it may be remote) under which the embedded derivative would at least double the investor's initial rate of return on the host contract.

(2) For each of the possible interest rate scenarios under which the investor's initial rate of return on the host contract would be doubled (as discussed under paragraph 13(b)(1)), the embedded derivative would at the same time result in a rate of return that is at least twice what otherwise would be the then-current market return (under each of those future interest rate scenarios) for a contract that has the same terms as the host contract and that involves a debtor with a credit quality similar to the issuer's credit quality at inception.

Even though the above conditions focus on the investor's rate of return and the investor's recovery of its investment, the existence of either of those conditions would result in the embedded derivative instrument not being considered clearly and closely related to the host contract by both parties to the hybrid instrument. (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 hedging instrument in a Statement 133 hedging relationship.) Because the existence of those conditions is assessed at the date that the hybrid instrument is acquired (or incurred) by the reporting entity, the acquirer of a hybrid instrument in the secondary market could potentially reach a different conclusion than could the issuer of the hybrid instrument due to applying the conditions in this paragraph at different points in time. [Footnote 6 omitted.]

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* The condition in paragraph 13(a) does not apply to a situation in which the terms of a hybrid instrument permit, but do not require, the investor to settle the hybrid instrument in a manner that causes it not to recover substantially all of its initial recorded investment, provided that the issuer does not have the contractual right to demand a settlement that causes the investor not to recover substantially all of its initial net investment.

Paragraph 61(a) elaborates on the condition in paragraph 13(b) as follows:

An embedded derivative in which the underlying is an interest rate or interest rate index and a host contract that is considered a debt instrument are considered to be clearly and closely related unless, as discussed in paragraph 13, the embedded derivative contains a provision that…could under any possibility whatsoever at least double the investor's initial rate of return on the host contract and at the same time result in a rate of return that is at least twice what otherwise would be the then-current market return for a contract that has the same terms as the host contract and that involves a debtor with a similar credit quality.

Paragraph 61(d) of Statement 133 elaborates on the applicability of paragraph 13 to embedded calls and puts in debt instruments as follows:

> Call options (or put options) that can accelerate the repayment of principal on a debt instrument are considered to be clearly and closely related to a debt instrument that requires principal repayments unless both (1) the debt involves a substantial premium or discount (which is common with zero-coupon bonds) and (2) the put or call option is only contingently exercisable, provided the call options (or put options) are also considered to be clearly and closely related to the debt host contract under paragraph 13.

RESPONSE

The conditions in paragraph 13(b) do not apply to an embedded call option in a hybrid instrument containing a debt host contract if the right to accelerate the settlement of the debt can be exercised only by the debtor (issuer/borrower). This guidance does not affect the application of the condition in paragraph 13(a) or the application of the provisions of paragraph 61(d) as interpreted by Statement 133 Implementation Issue No. B16, "Calls and Puts in Debt Instruments." In addition, this guidance does not apply to other embedded derivative features that may be present in the same hybrid instrument.

The conditions in paragraph 13(b) were intended to apply only to situations that meet the two conditions specified in paragraphs 13(b)(1) and 13(b)(2) and for which the investor has the unilateral ability to obtain the right to receive the high rate of return specified in those paragraphs. When the embedded derivative is an option rather than a forward contract, it is important to analyze whether the investor is the holder of that option. For an embedded call option, the issuer or borrower (and not the investor) is the holder, and thus only the issuer (borrower) can exercise the option. Consequently, the investor does not have the unilateral ability to obtain the right to receive the high rate of return, which is contingent upon the issuer's exercise of the embedded call option.

Application of this guidance to specific debt instruments is provided below.

Example	Paragraph 13(b) Applicable to the Embedded Call Option?	Comments
1. An unsecured commercial loan that includes a prepayment option that permits the loan to be prepaid by the borrower at a fixed amount at any time at a specified premium over the initial principal amount of the loan.	No.	The commercial loan is prepayable only at the option of the borrower.

Example	Paragraph 13(b) Applicable to the Embedded Call Option?	Comments
2. A fixed-rate debt instrument issued at a discount that is callable at par value at any time during its 10-year term.	No.	The fixed-rate debt instrument is callable at par value only by the issuer.
3. A fixed-rate 10-year bond that contains a call option that permits the issuer to prepay the bond at any time after issuance by paying the investor an amount equal to all the future contractual cash flows discounted at the then-current Treasury rate plus 45 basis points. The spread over the Treasury rate for the borrower at the issuance of the bond was 300 basis points.	No.	The fixed-rate 10-year bond is callable only at the option of the issuer.
4. A 5-year debt instrument issued at par that has a quarterly coupon equal to 15 percent minus 3 times 3-month LIBOR and that includes a call provision that allows the issuer to call the debt at any time at a specified premium over par.	No.	The instrument is callable only by the issuer, so the embedded call option feature will not be subject to the conditions in paragraph 13(b). However, the conditions in paragraph 13(b) are still applicable to the levered index feature of the debt.
5. A fixed-rate debt instrument is issued at par and is callable at any time during its 10-year term. If the debt is called, the investor receives the greater of the par value of the debt or the market value of 100,000 shares of XYZ common stock (an unrelated company).	No.	The instrument is callable only by the issuer, so the embedded call option feature will not be subject to the conditions in paragraph 13(b). However, the embedded call option is not considered clearly and closely related to the debt host contract because the payoff is based on an equity price.

Example	Paragraph 13(b) Applicable to the Embedded Call Option?	Comments
6. A mortgage-backed security (MBS) is issued, whereby cash flows associated with principal payments (including full or partial prepayments and related penalties) received on the related mortgage loans are passed through to the MBS investors.	Not applicable (see comments).	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. While the MBS investor is subject to prepayment risk, the MBS issuer has the obligation (not the option) to pass through cash flows from the related mortgage loans to the MBS investors. Therefore, MBS are not within the scope of this Issue. Issue B40 addresses the application of paragraph 13(b) to securitized interests in prepayable financial assets.

EFFECTIVE DATE AND TRANSITION

The effective date of the implementation guidance in this Issue is the first day of the first fiscal quarter beginning after December 15, 2005. Earlier application as of the beginning of a fiscal quarter is permitted provided that early application as of the same date is elected for Statement 133 Implementation Issue No. B38, "Evaluation of Net Settlement with Respect to the Settlement of a Debt Instrument through Exercise of an Embedded Put Option or Call Option." If an entity had bifurcated an embedded derivative but is no longer required to do so under the guidance in this Issue, the entity should account for the effects of initially complying with the implementation guidance prospectively for all existing financial instruments. The carrying amount of the related hybrid instrument at the guidance's effective date should be the sum of the carrying amount of the host contract and the fair value of the previously bifurcated embedded derivative.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Embedded Derivatives: Application of Paragraph 13(b) to Securitized Interests in Prepayable Financial Assets
Paragraph references:	13(b), 14A, 61(a), 61(d)
Date cleared by Board:	December 20, 2006
Date posted to website	January 17, 2007

QUESTION

Are there circumstances in which a securitized interest in prepayable financial assets would not be subject to the conditions in paragraph 13(b) of Statement 133?

BACKGROUND

FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments*, amended Statement 133 to, among other things, establish 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. As a result, upon the adoption of Statement 155, some securitized financial assets are required to be analyzed in accordance with Statement 133 for the first time. (Previously, holders of beneficial interests in securitized financial assets were not subject to Statement 133 if they elected to apply the guidance in Statement 133 Implementation Issue No. D1, "Application of Statement 133 to Beneficial Interests in Securitized Financial Assets.")

Paragraph 14A of Statement 133 (as amended by Statement 155) states:

> 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.

Paragraph 13 of Statement 133 states:

> For purposes of applying the provisions of paragraph 12, an embedded derivative instrument in which the underlying is an interest rate or interest rate index that alters net interest payments that otherwise would be paid or received on an interest-bearing host contract is considered to be clearly and closely related to the host contract unless either of the following conditions exist:

a. The hybrid instrument can contractually be settled in such a way that the investor (holder) would not recover substantially all of its initial recorded investment.[6a]

b. The embedded derivative meets both of the following conditions:

(1) There is a possible future interest rate scenario (even though it may be remote) under which the embedded derivative would at least double the investor's initial rate of return on the host contract.

(2) For each of the possible interest rate scenarios under which the investor's initial rate of return on the host contract would be doubled (as discussed under paragraph 13(b)(1)), the embedded derivative would at the same time result in a rate of return that is at least twice what otherwise would be the then-current market return (under each of those future interest rate scenarios) for a contract that has the same terms as the host contract and that involves a debtor with a credit quality similar to the issuer's credit quality at inception.

Even though the above conditions focus on the investor's rate of return and the investor's recovery of its investment, the existence of either of those conditions would result in the embedded derivative instrument not being considered clearly and closely related to the host contract by both parties to the hybrid instrument. Because the existence of those conditions is assessed at the date that the hybrid instrument is acquired (or incurred) by the reporting entity, the acquirer of a hybrid instrument in the secondary market could potentially reach a different conclusion than could the issuer of the hybrid instrument due to applying the conditions in this paragraph at different points in time. [Footnote 6 omitted.]

[6a] The condition in paragraph 13(a) does not apply to a situation in which the terms of a hybrid instrument permit, but do not require, the investor to settle the hybrid instrument in a manner that causes it not to recover substantially all of its initial recorded investment, provided that the issuer does not have the contractual right to demand a settlement that causes the investor not to recover substantially all of its initial net investment.

Paragraph 61(a) elaborates on the condition in paragraph 13(b) as follows:

An embedded derivative in which the underlying is an interest rate or interest rate index and a host contract that is considered a debt instrument are considered to be clearly and closely related unless, as discussed in paragraph 13, the embedded derivative contains a provision that . . . could under any possibility whatsoever at

> least double the investor's initial rate of return on the host contract and at the same time result in a rate of return that is at least twice what otherwise would be the then-current market return for a contract that has the same terms as the host contract and that involves a debtor with a similar credit quality.

Paragraph 61(d) of Statement 133 elaborates on the applicability of paragraph 13 to embedded calls and puts in debt instruments as follows:

> Call options (or put options) that can accelerate the repayment of principal on a debt instrument are considered to be clearly and closely related to a debt instrument that requires principal repayments unless both (1) the debt involves a substantial premium or discount (which is common with zero-coupon bonds) and (2) the put or call option is only contingently exercisable, provided the call options (or put options) are also considered to be clearly and closely related to the debt host contract under paragraph 13.

RESPONSE

Yes. A securitized interest in prepayable financial assets would not be subject to the conditions in paragraph 13(b) of Statement 133 if it meets both of the following criteria:

a. The right to accelerate the settlement of the securitized interest cannot be controlled by the investor.
b. The securitized interest itself does not contain an embedded derivative (including an interest-rate-related derivative) for which bifurcation would be required other than an embedded derivative that results solely from the embedded call options in the underlying financial assets.[1]

The objective of this guidance is to provide a narrow scope exception from paragraph 13(b) of Statement 133 for securitized interests that contain **only** an embedded derivative that is tied to the prepayment risk of the underlying prepayable financial assets and that meet the criteria above. If a securitized interest contains any other terms that affect some or all of the cash flows or the value of other exchanges required by the contract in a manner similar to a derivative instrument and those terms create an embedded derivative that requires bifurcation (ignoring the effects of the embedded call options in the underlying financial assets), that securitized interest would be subject to the requirements of paragraph 13(b) of Statement 133 (for example, an inverse floater).

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[1] See Effective Date and Transition for the delayed effective date for this criterion.

As discussed in Statement 133 Implementation Issue No. B39, "Application of Paragraph 13(b) to Call Options That Are Exercisable Only by the Debtor," the conditions in paragraph 13(b) were intended to apply only to situations that meet the two conditions specified in paragraphs 13(b)(1) and 13(b)(2) and for which the investor has the unilateral ability to obtain the right to receive the high rate of return specified in those paragraphs. Questions later arose about whether that guidance was intended to apply to securitized interests when the underlying assets are prepayable. Because the securitization process allows for the reallocation of risk, the Board decided that the investor's ability to obtain the right to receive the high rate of return specified in those paragraphs should not be the only condition considered when applying paragraph 13(b) to securitized interests. The Board decided to add another criterion to ensure that securitized interests are evaluated for embedded derivatives that are not related to the embedded call options in the underlying assets.

Whether the securitized interest itself contains an embedded derivative (including an interest-rate-related derivative) for which bifurcation would be required, other than an embedded derivative that results solely from the embedded call options in the underlying financial assets, should be determined in accordance with paragraph 14A of Statement 133. This assessment is expected to be simple for basic securitized interests but could be more difficult for complex securitized interests (for example, in securitizations involving the resecuritization of tranches from previous transactions, the analysis might require an understanding of each securitization making up the resecuritization transaction).

A securitized interest in prepayable financial assets that does not meet both of the above criteria is subject to the conditions in paragraph 13(b) of Statement 133. When assessing the conditions in paragraph 13(b) for those instruments, an entity must consider the effect of prepayment risk.

The table below illustrates the application of this guidance to specific securitized interests in prepayable financial assets. The analysis of the examples considers only paragraph 13(b) of Statement 133, which is the subject of this Issue. The examples provide no discussion of the requirements of paragraphs 12 and 13(a) of Statement 133; however, an analysis of those paragraphs would be required to determine whether the instruments meet criterion (b) of this Issue.

Example	Application of This Guidance
1. Guaranteed Single-Class Mortgage Pass-Through Security A fixed-rate guaranteed single-class mortgage pass-through security is issued, whereby the net cash flows received on the underlying fixed-rate, prepayable, single-family mortgage loans are proportionately passed through to the investors. Both the interest and principal payments are guaranteed by a third party for a fixed market-based guarantee fee, and a servicer receives a market-based servicing fee that is expected to be more than adequate compensation. Both the guarantee fee and the servicing fee have priority over the payments to the investors. Additionally, the investor does not have the right to accelerate the settlement of the securitized interest.	While the priority of the payments to the guarantor and servicer reallocates the cash flows, the example security meets the two criteria. **Conclusion:** Paragraph 13(b) is not applicable to the guaranteed single-class mortgage pass-through security.
2. Securitization Trust Includes a Freestanding Derivative Assume the same facts as presented in Example 1, except that the underlying prepayable single-family mortgage loans have a floating interest rate. The securitization trust also holds an interest rate swap that is designed to perfectly swap the floating interest rate assets to a fixed interest rate to match the payments on the fixed-rate guaranteed single-class mortgage pass-through security.	Because the addition of the freestanding derivative (the interest rate swap) does not create an embedded derivative that requires bifurcation in the guaranteed single-class mortgage pass-through security itself, the example security meets the two criteria. However, if the notional amounts of the securitized loans and the interest rate swap do not match, the fixed-rate securitized interest would have to be evaluated for an embedded derivative because the financial instruments held by the entity might not provide the necessary cash flows. **Conclusion:** Paragraph 13(b) is not applicable to the guaranteed single-class mortgage pass-through security.

Example	Application of This Guidance
3. Sequential-Pay Collateralized Mortgage Obligation (CMO) An entity securitizes a pool of guaranteed single-class mortgage pass-through securities (identical to those described in Example 1). The principal payments received, including prepayments of principal, on the underlying collateral are not allocated proportionately to all investors (bond holders). Three classes of securities are issued, Class A, Class B, and Class C, which mature sequentially. All three classes participate in interest payments from the underlying collateral, but, initially, only Class A receives principal payments. Class A receives all principal payments, including prepayments of principal, until it is retired. Next, all principal payments are paid to Class B until it is retired, and so on. Additionally, the investor does not have the right to accelerate the settlement of the securitized interest.	The analysis of the bonds requires the holder to assess the securitized interest in accordance with criterion (b) of this Issue. To determine whether the individual bond classes contain an embedded derivative that requires bifurcation, the investor would have to understand the nature and amount of assets, liabilities, and other financial instruments that compose the entire securitization transaction. The holder should obtain sufficient information about the payoff structure and the payment priority of the interest to determine whether an embedded derivative that requires bifurcation exists. Because the securitized interests (assumed to be identical to those described in Example 1) included in the resecuritization do not contain any embedded derivatives and there have been no other changes in the cash flows that create other embedded derivatives that require bifurcation, criterion (b) of this Issue is met. While the prepayment risk in the underlying financial assets is reallocated through the securitization process, concentrating prepayment risk in certain bond classes, all three classes in the example meet the two criteria. **Conclusion:** Paragraph 13(b) is not applicable to any of the bond classes in the sequential-pay CMO.

Example	Application of This Guidance
4. Planned Amortization Class (PAC) and Companion CMO An entity securitizes a pool of guaranteed single-class mortgage pass-through securities (identical to those described in Example 1). The principal payments received, including prepayments of principal, on the underlying collateral are not allocated proportionately to all investors (bond holders). Two classes of securities are issued, a PAC bond and a companion bond. The PAC bond is designed to reduce the prepayment risk to investors by transferring prepayment risk to the companion bond. The PAC bond offers a fixed principal repayment schedule that will be met if prepayment on the underlying collateral is within a specified range. Additionally, the investor does not have the right to accelerate the settlement of the securitized interest.	The analysis of the bonds requires the holder to assess the securitized interest in accordance with criterion (b) of this Issue. To determine whether the individual bond classes contain an embedded derivative that requires bifurcation, the investor would have to understand the nature and amount of assets, liabilities, and other financial instruments that compose the entire securitization transaction. The holder should obtain sufficient information about the payoff structure and the payment priority of the interest to determine whether an embedded derivative that requires bifurcation exists. Because the securitized interests (assumed to be identical to those described in Example 1) included in the resecuritization do not contain any embedded derivatives and there have been no other changes in the cash flows that create other embedded derivatives that require bifurcation, criterion (b) of this Issue is met. While the prepayment risk in the underlying prepayable financial assets is reallocated through the securitization process, concentrating prepayment risk in the companion bond, the example securities meet the two criteria. **Conclusion:** Paragraph 13(b) is not applicable to either the PAC or the companion CMO.

Example	Application of This Guidance
5. Inverse Floater CMO A CMO is issued with a coupon that fluctuates inversely with a referenced rate. The underlying securitized financial assets are fixed-rate, prepayable, single-family mortgage loans. Two classes of securitized interests are issued, one with a coupon based on a referenced rate (for example, LIBOR) and the second with a coupon that fluctuates inversely with that same referenced rate (the inverse floater CMO). Cash flows received on the underlying collateral are first used to pay a servicer a market-based servicing fee that is expected to be more than adequate compensation. Additionally, the investor does not have the right to accelerate the settlement of the securitized interest.	While the inverse floater CMO meets criterion (a) of this Issue, the fact that the coupon rate fluctuates inversely with the referenced rate results in the instrument failing criterion (b) of this Issue. The inverse floater contains an embedded interest rate derivative that requires bifurcation, and that embedded interest rate derivative does not result solely from the embedded call options in the underlying financial assets. Said another way, the inverse floater meets the conditions of paragraph 13(b) without consideration of the prepayment risk in the underlying mortgage loans. **Conclusion:** Paragraph 13(b) would be applicable to the inverse floater. When assessing the conditions in paragraph 13(b), the holder must consider the effect of prepayment risk. Therefore, the holder may identify both an embedded derivative related to the prepayment risk and an embedded derivative related to the inverse interest rate risk, which would be combined and recorded as one instrument.

Example	Application of This Guidance
6. Interest-Only Strip and Principal-Only Strip An interest-only strip and principal-only strip are created by separating the net interest cash flows from the principal cash flows received on a pool of guaranteed single-class mortgage pass-through securities (identical to those described in Example 1). The interest cash flows form one bond, which is the interest-only strip. The principal cash flows form the second bond, which is the principal-only strip. Additionally, the investor does not have the right to accelerate the settlement of the securitized interest.	As a result of the guarantee fee and the servicing fee in excess of adequate compensation in the underlying guaranteed single-class mortgage pass-through securities, neither the interest-only strip nor the principal-only strip qualifies for the scope exception in paragraph 14 of Statement 133. The analysis of the interest-only and principal-only strip requires the holder to assess the securitized interest in accordance with criterion (b) of this Issue. To determine whether the individual bond classes contain an embedded derivative that requires bifurcation, the investor would have to understand the nature and amount of assets, liabilities, and other financial instruments that compose the entire securitization transaction. The holder should obtain sufficient information about the payoff structure and the payment priority of the interest to determine whether an embedded derivative that requires bifurcation exists. Because the securitized interests (assumed to be identical to those described in Example 1) included in the resecuritization do not contain any embedded derivatives and there have been no other changes in the cash flows that create other embedded derivatives that require bifurcation, criterion (b) of this Issue is met. While the prepayment risk in the underlying prepayable financial assets is reallocated through the securitization process, concentrating prepayment risk in certain bond classes, both the interest-only strip and principal-only strip in the example meet the two criteria.

Example	Application of This Guidance
6. Interest-Only Strip and Principal-Only Strip (Continued)	**Conclusion:** Paragraph 13(b) is not applicable to either the interest-only strip or the principal-only strip.

EFFECTIVE DATE AND TRANSITION

The guidance in this Issue shall be applied upon adoption of Statement 155 (except, in certain circumstances, for criterion (b)). Criterion (b) of this Issue is not applicable to securitized interests (a) that were issued before June 30, 2007, and (b) that only include embedded derivatives, other than an embedded derivative that results solely from the embedded call options in the underlying financial assets, that have an extremely remote possibility of having greater than a trivial fair value at any time during the instrument's life (for example, an embedded derivative that only has value when an interest rate index reaches an extremely remote level) as determined on the adoption of Statement 155 or the purchase of the instrument, whichever occurs later. An entity that adopted Statement 155 prior to December 31, 2006, shall apply the guidance in this Issue in the first reporting period beginning before December 31, 2006, for which financial statements have not yet been issued.

If an entity had previously adopted Statement 155 and, in doing so, had treated derivatives embedded in a securitized interest in prepayable financial assets in a manner consistent with the guidance in this Issue, then that entity would not be required to retrospectively apply the guidance in this Issue to prior periods. An entity is not permitted to change the FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities,* classification of the instrument on the application of this guidance. However, if that entity had not treated derivatives embedded in a securitized interest in prepayable financial assets in a manner consistent with the guidance in this Issue, then that entity shall apply the guidance in this Issue retrospectively to the date of adoption of Statement 155. If in applying this guidance retrospectively the entity must recombine a host instrument with a previously bifurcated embedded derivative, that entity shall reverse any changes in the fair value of the embedded derivative that were previously recognized in income. Additionally, entities required to retrospectively apply the guidance in this Issue shall classify the instrument as follows:

a. Entities that upon applying Statement 155 (1) previously identified embedded derivatives that no longer require bifurcation in accordance with the guidance in this Issue and (2) elected to measure the entire hybrid financial instrument at fair value under that Statement, may elect any appropriate classification in accordance with Statement 115 for the financial instrument.

b. In all other circumstances, the resulting financial instrument (which may no longer be a hybrid financial instrument or may be a host instrument that is different from the prior host) shall be classified in the Statement 115 category previously elected for the prior host instrument.

DISSENT

One Board member, Mr. Trott, dissents from the issuance of this Implementation Issue. That Board member does not agree with providing a "prepayment" exception for deciding when an embedded derivative is considered to be not clearly and closely related to the host instrument. That Board member believes that the guidance in paragraph 13 should be applied to determine whether an embedded derivative is to be bifurcated and either accounted for separately under Statement 133 or accounted for under the option provided by Statement 155 of carrying the combined host and embedded derivative at fair value with changes reported in net income. One of the objectives of Statement 155 was to eliminate the scope exception in Statement 133 Implementation Issue No. D1, "Recognition and Measurement of Derivatives: Application of Statement 133 to Beneficial Interests in Securitized Financial Assets," for evaluating securitized beneficial interests for embedded derivatives. This Statement 133 Implementation Issue effectively reinstates this exception for a large number of securitized interests. The shifting of prepayment risk is one of the most common features of securitization of prepayable financial assets and this shifting of prepayment risk creates a significant embedded derivative that otherwise could meet the criteria for bifurcation. The tests in paragraph 13 were established in Statement 133 to provide a mechanical test for making an otherwise difficult judgment concerning whether the embedded derivative is to be accounted for as a derivative. This type of test was requested by many auditors and preparers. The reaction to applying the test some eight years after it was established based on the unpopularity of having to apply the test and the potential result of its application is not appropriate.

The above response has been approved by the Board by written ballot.

Appendix

IMPACT ON STATEMENT 133 IMPLEMENTATION ISSUES

This appendix addresses the impact of the provisions of this Statement 133 Implementation Issue on the responses to other Statement 133 Implementation Issues through December 31, 2006.

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 [added text is underlined and deleted text is ~~struck out~~]:

a. The "Paragraph 13(b) Applicable to the Embedded Call Option" section of Example 6 in the chart illustrating the guidance to specific debt instruments:

   ~~No, unless the impacts of the embedded call feature are disproportionately allocated to interest holders~~ Not Applicable (see comments).

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

   ~~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.~~ 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. While the MBS investor is subject to prepayment risk, the MBS issuer has the obligation (not the option) to pass through cash flows from the related mortgage loans to the MBS investors. Therefore, MBS are not within the scope of this Issue. Issue B40 addresses the application of paragraph 13(b) to securitized interests in prepayable financial assets.

Title: Scope Exceptions: Exception Related to Physical Variables
Paragraph references: 10(c), 10(e)(1), 252, 254
Date cleared by Board: February 17, 1999

QUESTION

If a contract's payment provision specifies that the issuer will pay to the holder $10,000,000 if aggregate property damage from all hurricanes in the state of Florida exceeds $50,000,000 during the year 2001, is the contract included in the scope of Statement 133? Alternatively, if the contract specifies that the issuer pays the holder $10,000,000 in the event that a hurricane occurs in Florida in 2001, is the contract included in the scope of Statement 133?

RESPONSE

If the contract contains a payment provision that requires the issuer to pay to the holder a specified dollar amount based on a financial variable, the contract is subject to the requirements of Statement 133. In the first example above, the payment under the contract occurs if aggregate property damage from all hurricanes in the state of Florida exceeds $50,000,000 during the year 2001. The contract in that example contains 2 underlyings – a physical variable (that is, the occurrence of at least 1 hurricane) and a financial variable (that is, aggregate property damage exceeding a specified or determinable dollar limit of $50,000,000). Because of the presence of the financial variable as an underlying, the derivative contract does not qualify for the scope exclusion in paragraph 10(e)(1) of Statement 133.

In contrast, if the contract contains a payment provision that requires the issuer to pay to the holder a specified dollar amount that is linked *solely* to a climatic or other physical variable (for example, wind velocity or flood-water level), the contract is not subject to the requirements of Statement 133. In the second example above, the payment provision is triggered if a hurricane occurs in Florida in 2001. The underlying in that example is a physical variable (that is, occurrence of a hurricane). Therefore, the contract qualifies for the scope exclusion in paragraph 10(e)(1) of Statement 133.

However, if the contract requires a payment only when the holder incurs a decline in revenue or an increase in expense as a result of an event (for example, a hurricane) *and* the amount of the payoff is solely compensation for the amount of the holder's loss, the contract would be a traditional insurance contract that is excluded from the scope of Statement 133 under paragraph 10(c).

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Scope Exceptions: Application of the Exception to Contracts Classified in Temporary Equity
Paragraph reference:	11(a)
Date cleared by Board:	February 17, 1999
Date revision posted to website:	June 10, 2003
Affected by:	FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity* Revised May 27, 2003

QUESTION

An entity that issues shares of its common stock with an embedded written put option requiring physical settlement is required by analogy to the SEC's Accounting Series Release No. 268, *Presentation in Financial Statements of "Redeemable Preferred Stock,"* to reclassify an amount into temporary equity equal to the amount related to the number of the shares subject to the put option. For purposes of applying paragraph 11(a) of Statement 133, should items classified in temporary equity be considered classified in stockholders' equity even though temporary equity is displayed outside of stockholders' equity in the statement of financial position? In this example, is the embedded put option required to be separated from the host contract by the entity issuing the shares?

RESPONSE

FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, was issued in May 2003. The Statement requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances). However, for purposes of analyzing the application of paragraph 11(a) of Statement 133 to an embedded derivative financial instrument as though it were a separate instrument, paragraphs 9–12 of Statement 150 should be disregarded. Those embedded features are analyzed by applying other applicable guidance.

EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock," as partially nullified by Statement 150, requires that an *embedded* derivative financial instrument indexed to a company's own stock to be settled in shares be reported in permanent equity and an amount equal to the cash redemption amount under the physical settlement be transferred to temporary equity. Paragraph 11(a) of Statement 133 requires that the reporting entity shall consider contracts indexed to its own stock and classified in stockholders' equity in its statement of financial position not to be derivative instruments for purposes of Statement 133. Although ASR 268 requires reclassification of an amount from permanent equity into temporary equity equal to the amount related to the number of shares subject to the put option, temporary equity is considered stockholders' equity even though it is required by the SEC to be displayed outside of the permanent equity section.

From the investor's perspective, the purchase of common stock with an embedded purchased put option that requires physical settlement is a hybrid instrument that must be evaluated to determine whether it has an embedded derivative that must be accounted for separately. The embedded purchased put option must be separated from the equity host because the common stock and the embedded put option are not clearly and closely related (refer to paragraph 61(e) of Statement 133).

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Scope Exceptions: Exception Related to Share-Based Payment Arrangements
Paragraph references:	11(a), 11(b)
Date cleared by Board:	February 17, 1999
Date latest revision posted to website:	June 16, 2006
Affected by:	FASB Statement No. 123 (revised 2004), *Share-Based Payment*, and FASB Staff Position FAS 123(R)-1, "Classification and Measurement of Freestanding Financial Instruments Originally Issued in Exchange for Employee Services under FASB Statement No. 123(R),"

Revised June 16, 2006

QUESTION

Are equity instruments (including stock options) that are granted to nonemployees as compensation for goods and services in share-based payment transactions subject to Statement 133?

RESPONSE

Issuer's Accounting

Yes, for the issuer, once performance has occurred (as discussed in EITF Issue No. 96-18, "Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services") and provided that the scope exception in paragraph 11(a) of Statement 133 does not apply. From the perspective of the issuer, equity instruments (including stock options) granted to a nonemployee for goods and services in share-based payment transactions are not included in the scope of Statement 133 if performance has not yet occurred. Paragraph 11(b) of Statement 133 (as amended) states that, "contracts issued by the entity that are subject to FASB Statement No. 123 (revised 2004), *Share-Based Payment*," are not considered to be derivative instruments for purposes of Statement 133. Any equity instrument granted in a share-based payment transaction subject to Statement 123(R) and its interpretive guidance for the reporting entity is not considered to be a derivative instrument subject to Statement 133 by that entity during the period that the equity instrument is subject to Statement 123(R) and its interpretive guidance.

Statement 123(R) contains the concept that equity instruments that are granted in share-based payment transactions may initially be subject to that Statement, but after certain events or circumstances, those equity instruments may cease being subject to that Statement. For example,

paragraph A231 of Statement 123(R)[1] states, "A freestanding financial instrument ceases to be subject to this Statement and becomes subject to the recognition and measurement requirements of Statement 150 or other applicable GAAP when the rights conveyed by the instrument to the holder are no longer dependent on the holder being an employee of the entity (that is, no longer dependent on providing service)." Issue 96-18 provides guidance for accounting by the issuer for certain share-based compensation arrangements granted to nonemployees for goods and services, as noted in Statement 123(R), including guidance regarding counterparty performance commitments and conditions in share-based payment transactions. EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock," states the following:

> This Issue also does not address the accounting for contracts that are issued (a) to compensate employees or (b) to acquire goods or services from nonemployees when performance has not yet occurred. However, this Issue applies to contracts issued to acquire goods or services from nonemployees when performance has occurred. [paragraph 3]

Thus, an equity instrument (including a stock option) granted to a nonemployee for goods and services in a share-based payment transaction would typically cease being subject to Statement 123(R) and its interpretive guidance after performance has occurred. At that point, the scope exception in paragraph 11(b) would no longer apply. The issuer would then need to determine whether that equity instrument meets the definition of a derivative and is within the scope of Statement 133 by analyzing the terms of the instrument. The scope exception in paragraph 11(a) may apply. That paragraph states that "Contracts issued or held by [the] reporting entity that are both (1) indexed to its own stock and (2) classified in stockholders' equity in its statement of financial position" are not considered to be derivative instruments for purposes of Statement 133. EITF Issue No. 01-6, "The Meaning of 'Indexed to a Company's Own Stock,'" provides guidance about the application of paragraph 11(a).

Holder's Accounting

Yes, for the holder. The exception in paragraph 11(b) of Statement 133 does not apply to the holder of those derivatives. Thus, equity instruments (including stock options) received by nonemployees as compensation for goods and services are included in the scope of Statement 133.

[1]FASB Staff Position FAS 123(R)-1, "Classification and Measurement of Freestanding Financial Instruments Originally Issued in Exchange for Employee Services under FASB Statement No. 123(R)," defers the guidance in paragraph A231 of Statement 123(R) for employee awards under certain circumstances and provides additional guidance about when those awards cease to be subject to Statement 123(R). The terms of an award that ceases to be subject to Statement 123(R) in accordance with that FSP should be analyzed to determine whether the award is subject to Statement 133.

EFFECTIVE DATE

The revisions made on December 15, 2004, reflect the issuance of Statement 123(R). The effective date of the December 15, 2004, revisions to the implementation guidance in this Issue for each reporting entity is the first day of the fiscal quarter in which that entity initially adopts Statement 123(R).

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Scope Exceptions: Interest-Only and Principal-Only Strips
Date cleared by Board:	February 17, 1999
Superseded by:	FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments*

Statement 133 Implementation Issue **No. C5**
[Previously No. A4]

Title: Scope Exceptions: Exception Related to a Nonfinancial Asset of One of the Parties
Paragraph references: 10(e)(2)
Date cleared by Board: February 17, 1999

QUESTION

Paragraph 10(e)(2) of Statement 133 explains that contracts that are not traded on an exchange are not subject to the requirements of Statement 133 if the underlying on which settlement is based is the price or value of a nonfinancial asset of one of the parties to the contract provided that the nonfinancial asset is not readily convertible to cash. Does it matter which party has the asset? For example, Company A enters into a non-exchange-traded forward contract to buy from Company B 100 interchangeable (fungible) units of a nonfinancial asset that are not readily convertible to cash. The contract permits net settlement through its default provisions. Company A already owns more than 100 units of that nonfinancial asset, but Company B does not own any units of that nonfinancial asset. Does the contract meet the scope exception in paragraph 10(e)(2) of Statement 133?

RESPONSE

The scope exception in paragraph 10(e)(2) does depend on which party has the nonfinancial asset, as discussed in #2 below. That scope exception does not apply to the accounting for the above contract for two reasons:

1. Paragraph 10(e)(2) applies only to nonfinancial assets that are unique. The contract's settlement is based on an underlying associated with a nonfinancial asset that is not unique (because it is based on the price or value of an interchangeable, nonfinancial unit).
2. The exception in paragraph 10(e)(2) applies only if the nonfinancial asset related to the underlying is owned by the party who would *not* benefit *under the contract* from an increase in the price or value of the nonfinancial asset. If the contract is an option contract, the exception in paragraph 10(e)(2) applies only if that nonfinancial asset is owned by the party who would not benefit under the contract from an increase in the price or value of the nonfinancial asset above the option's strike price. In the above example, the entity that owns the nonfinancial asset related to the underlying (that is, Company A) is the buyer of the units and thus would benefit from the forward contract if the price or value increases. Consequently, neither Company A nor Company B qualifies for the exception in paragraph 10(e)(2).

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Scope Exceptions: Derivative Instruments Related to Assets Transferred in Financing Transactions
Paragraph references:	10(f), 12, 13, 284
Date cleared by Board:	March 31, 1999
Date revision posted to website:	March 8, 2004 Revised March 26, 2003

QUESTION

In a transfer of financial assets accounted for as a financing under FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, is a derivative instrument that arises because of the transfer subject to the scope of Statement 133 if it does not itself serve as an impediment to achieving sale accounting but sale accounting could not be achieved due to an impediment that is unrelated to the derivative?

BACKGROUND

Paragraph 10(f) of Statement 133 provides a scope exception for a derivative instrument that serves as an impediment to sale accounting under Statement 140. For example, if an entity transfers financial assets that are not readily obtainable by a transferee and holds a call option on those transferred assets, the call option would not be subject to Statement 133 because the call option served as an impediment to sale accounting. Paragraph 284 in the basis for conclusions of Statement 133 further explains the need for that scope exception. It states:

> The existence of certain derivatives affects the accounting for the transfer of an asset or a pool of assets. For example, a call option that enables a transferor to repurchase transferred financial assets that are not readily available would prevent accounting for that transfer as a sale. The consequence is that to recognize the call option would be to count the same thing twice. The holder of the option already recognizes in its financial statements the assets that it has the option to purchase. Thus those types of derivatives are excluded from the scope of this Statement.

Examples of derivatives that may arise in transfers of financial assets accounted for as financings under Statement 140 are call options retained by the transferor on securities transferred and interest-rate swaps that convert the fixed-rate nature of financial assets transferred to variable-rate assets.

RESPONSE

A derivative held by a transferor that relates to assets transferred in a transaction accounted for as a financing under Statement 140, but which does not itself serve as an impediment to sale accounting, is not subject to Statement 133 if recognizing both the derivative and either the

transferred asset or the liability arising from the transfer would result in counting the same thing twice in the transferor's balance sheet. However, if recognizing both the derivative and either the transferred asset or the liability arising from the transfer would not result in counting the same thing twice in the transferor's balance sheet, the derivative should be accounted for in accordance with Statement 133.

Examples applying that approach in situations in which the transferor accounts for the transfer as a financing are presented below.

- If a transferor transfers financial assets but retains a call option on those assets, the condition in paragraph 9(c) of Statement 140 may be satisfied because the assets transferred are readily obtainable; however, the transfer may fail the isolation condition in paragraph 9(a) because of significant continued involvement by the transferor. In that example, because the transferor is required to continue to recognize the assets transferred, recognition of the call option on those assets would effectively result in recording the assets twice. Therefore, the derivative is not subject to the scope of Statement 133.
- In the situation described above, the transferor may have sold to the transferee a put option. Exercise of the put option by the transferee would result in the transferor repurchasing certain assets that it has transferred, but which it still records as assets in its balance sheet. Because the transferor is required to recognize the borrowing, recognition of the put option would result in recording the liability twice. Therefore, the derivative is not subject to the scope of Statement 133.
- A transferor may transfer fixed-rate financial assets to a transferee and guarantee a floating-rate return. If the transfer is accounted for as a sale and an interest-rate swap is entered into as part of the contractual provisions of the transfer, the transferor records the interest-rate swap as one of the financial components. In that case, the interest-rate swap should be accounted for separately in accordance with Statement 133. However, if the transfer is accounted for as a financing, the transferor records on its balance sheet the issuance of floating-rate debt and continues to report the fixed-rate financial assets; no derivative is recognized under Statement 133.
- In a securitization transaction, a transferor transfers $100 of fixed-rate financial assets and the contractual terms of the beneficial interests incorporate an interest-rate swap with a notional principal of $1 million. If the transfer is accounted for as a sale and the interest rate swap is entered into as part of the contractual provisions of the transfer, the transferor identifies and records the interest-rate swap as one of the financial components. In that case, the interest-rate swap would be accounted for separately in accordance with Statement 133. However, if the transfer is accounted for as a financing, the transferor records in its balance sheet a $100 floating-rate borrowing and continues to report the $100 of fixed-rate financial assets. In this example, because the liability is leveraged, requiring computation of interest flows based on a $1 million notional amount, the liability (which does not meet the definition of a derivative in its entirety) is a hybrid instrument that contains an embedded derivative—such as an

interest rate swap with a notional amount of $999,900. That embedded derivative is not clearly and closely related to the host contract under paragraphs 12 and 13(b) of Statement 133 because it could result in a rate of return on the counterparty's asset that is at least double the initial rate and that is at least twice what otherwise would be the then-current market return for a contract that has the same terms as the host contract and that involves a debtor with credit quality similar to the issuer's credit quality at inception. Therefore, the derivative must be recorded separately under paragraph 12 of Statement 133.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Scope Exceptions: Certain Financial Guarantee Contracts
Paragraph references:	10(d), 59(b), 281
Date cleared by Board:	July 28, 1999
Superseded by:	FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*

Title: Scope Exceptions: Derivatives That Are Indexed to both an Entity's Own Stock and Currency Exchange Rates
Paragraph references: 11, 12, 18, 286
Date cleared by Board: May 17, 2000

QUESTION

Does a forward contract that is indexed to both an entity's own stock and currency exchange rates qualify for the exception in paragraph 11(a) of Statement 133, under which the forward contract would not be considered a derivative instrument by that entity?

BACKGROUND

For example, assume that Company A, whose functional currency is the U.S. dollar (US$), and the Counterparty enter into a one-year forward contract that is indexed to Company A's common share price translated into euros (EUR) at spot rates and that will be settled in net shares of Company A. If the value of Company A's common stock in EUR appreciates, then Company A will receive from the Counterparty a number of shares of Company A stock equal to the appreciation. If the value of Company A's stock in EUR depreciates, then Company A will pay Counterparty a number of shares of Company A stock equal to the depreciation. Thus, the forward contract is indexed both to Company A's common stock and the US$/EUR currency exchange rates.

Assume further that Company A's common stock price at inception is 100 US$ per share, and the forward exchange rate of US$ to EUR is 1:1.2. The strike price of the forward contract is then set at 120 EUR. One year later, the share price of Company A rises to 150 US$, and the spot exchange rate of US$ to EUR is 1:1. Then, the share price of Company A translated is 150 EUR. At settlement, Company A will receive from the Counterparty 20 shares of its own common stock according to the following calculation:

(150 EUR – 120 EUR) × 100 shares = 3,000 EUR

3,000 EUR / 150 EUR per share = 20 shares

Paragraph 11(a) of Statement 133 states that "contracts issued or held by that reporting entity that are both (1) indexed to its own stock and (2) classified in stockholders' equity in its statement of financial position" shall not be considered derivative instruments under Statement 133. However, paragraph 11 also states the following:

> …a contract that an entity either can or must settle by issuing its own equity instruments but that is indexed in part or in full to something other than its own stock can be a derivative instrument for the issuer under paragraphs 6–10, in which case it

would be accounted for as a liability or an asset in accordance with the requirements of this Statement.

RESPONSE

No. A forward contract that is indexed to both an entity's own stock and currency exchange rates does not qualify for the exception in paragraph 11(a) of Statement 133 with respect to that entity's accounting because the forward contract is indexed in part to something other than that entity's own stock (namely, currency exchange rates). That forward contract should be accounted for as a derivative instrument in its entirety by both parties to the contract if the contract in its entirety meets the definition of a derivative in paragraphs 6–9. Paragraph 286 of Statement 133 provides the rationale for why contracts that provide for settlement in shares of an entity's stock but that are indexed in part or in full to something other than the entity's stock are to be accounted for as derivative instruments if the contracts satisfy the criteria in paragraphs 6–9 of Statement 133. Paragraph 286 makes it clear that paragraph 11(a)(1) should be understood as being applicable to contracts that are indexed *only* to the issuer's own stock.

Paragraph 18 of Statement 133 prohibits separating a derivative into components based on different risks. Consequently, it would be inappropriate to bifurcate the forward contract described in the above example according to its differing exposures to changes in Company A's stock price and changes in the US$/EUR exchange rate and then attempt to apply paragraph 11(a) only to the exposure to changes in Company A's stock price. Paragraph 11(a) must be applied to an entire contract.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Scope Exceptions: Can Option Contracts and Forward Contracts with Optionality Features Qualify for the Normal Purchases and Normal Sales Exception?
Paragraph references:	10(b), 58(b)
Date cleared by Board:	March 21, 2001
Date posted to website:	April 10, 2001
Date latest revision posted to website:	May 1, 2003
Affected by:	FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* Revised March 26, 2003

QUESTIONS

In what instances can the normal purchases and normal sales exception in paragraph 10(b) (as amended) be applied to (1) purchased option contracts (including net purchased options) and written option contracts (including net written options) that would require delivery of the related asset at an established price under the contract only if exercised, and (2) forward contracts with optionality features?

BACKGROUND

Paragraph 10(b) of Statement 133 (as amended by Statement 149) states, in part:

> Normal purchases and normal sales are contracts that provide for the purchase or sale of something other than a financial instrument or derivative instrument that will be delivered in quantities expected to be used or sold by the reporting entity over a reasonable period in the normal course of business. The following guidance should be considered in determining whether a specific type of contract qualifies for the normal purchases and normal sales exception:
>
> (1) *Forward contracts (non-option-based contracts).* Forward contracts are eligible to qualify for the normal purchases and normal sales exception. However, forward contracts that contain net settlement provisions as described in either paragraph 9(a) or paragraph 9(b) are not eligible for the normal purchases and normal sales exception unless it is probable at inception and throughout the term of the individual contract that the contract will not settle net and will result in physical delivery.* Net settlement (as described in paragraphs 9(a) and 9(b)) of contracts in a group of contracts similarly designated as normal purchases and normal sales would call into question the classification of all such contracts as normal purchases or normal sales. Contracts that require cash settlements of gains or losses or are otherwise settled net on a periodic basis, including individual contracts that are part of a series of sequential contracts intended to accomplish ultimate acquisition or sale of a commodity, do not qualify for this exception.

(2) *Freestanding option contracts*. Option contracts that would require delivery of the related asset at an established price under the contract only if exercised are not eligible to qualify for the normal purchases and normal sales exception, except as indicated in paragraph 10(b)(4) below.
(3) *Forward contracts that contain optionality features.* Forward contracts that contain optionality features that do not modify the quantity of the asset to be delivered under the contract are eligible to qualify for the normal purchases and normal sales exception. Except for power purchase or sales agreements addressed in paragraph 10(b)(4), if an option component permits modification of the quantity of the assets to be delivered, the contract is not eligible for the normal purchases and normal sales exception, unless the option component permits the holder only to purchase or sell additional quantities at the market price at the date of delivery. In order for forward contracts that contain optionality features to qualify for the normal purchases and normal sales exception, the criteria discussed in paragraph 10(b)(1) must be met.
(4) *Power purchase or sales agreements.* Notwithstanding the criteria in paragraph 10(b)(1) and 10(b)(3), a power purchase or sales agreement (whether a forward contract, option contract, or a combination of both) that is a **capacity contract** also qualifies for the normal purchases and normal sales exception if it meets the criteria in paragraph 58(b).

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[*]Contracts that are subject to unplanned netting (referred to as a "book out" in the electricity utility industry) do not qualify for this exception except as specified in paragraph 58(b).

The contracts addressed in this Issue do not have a price based on an underlying that is not clearly and closely related to the asset being purchased, nor do they require cash settlement of gains or losses as stipulated in paragraph 10(b).

In some circumstances, an option contract may be combined with a forward contract. In some cases, the optionality feature in the forward contract can modify the quantity of the asset to be delivered under the contract. In other cases, the optionality feature in the forward contract can modify only the price to be paid or the timing of the delivery.

RESPONSE

Paragraph 10(b) of Statement 133, as amended by Statement 149, indicates that purchased option contracts (including net purchased options) and written option contracts (including net written options) that would require delivery of the related asset at an established price under the contract only if exercised are generally not eligible to qualify for the normal purchases and normal sales exception, except as indicated in paragraph 10(b)(4) and the related guidance in paragraph 58(b), as amended, and Statement 133 Implementation Issue No. C15, "Normal Purchases and Normal Sales Exception for Option-Type Contracts and Forward Contracts in Electricity." The normal

purchases and normal sales exception applies only to contracts that provide for the purchase or sale of something other than a financial instrument or derivative instrument that will be delivered in quantities expected to be used or sold by the reporting entity over a reasonable period in the normal course of business. Option contracts only contingently provide for such purchase or sale since exercise of an option contract is not assured. Thus, in accordance with paragraph 10(b)(2) of Statement 133, as amended, freestanding option contracts (including in-the-money option contracts) are not eligible to qualify for the normal purchases and normal sales exception. Furthermore, because of the contingent nature of an option contract (whose potential exercise is typically dependent upon future changes in the underlying), an entity cannot determine at the inception of the option contract that it will be probable throughout the term of the contract that physical delivery will result. Thus, option contracts cannot meet the requirement in paragraph 10(b) that it be "probable at inception and throughout the term of the individual contract that the contract … will result in physical delivery." The normal purchases and normal sales exception applies only to forward contracts. However, as indicated in paragraph 10(b)(3), forward contracts that contain optionality features would be eligible to qualify for the normal purchases and normal sales exception only if the optionality feature could not modify the quantity of the asset to be delivered under the contract. (Refer to the following discussion.)

The following are examples of forward contracts with optionality features:

1. Company A enters into a forward contract to purchase on a specified date a specified quantity of a raw material that is readily convertible to cash. The purchase price is the current market price on the date of purchase, not to exceed a specified maximum price (a cap) nor to be less than a specified minimum price (a floor).
2. Company B enters into a forward contract to purchase on a specified date a specified quantity of a raw material that is readily convertible to cash. The contract's purchase price is a fixed amount per unit that is below the current forward price; however, if the market price on the date of purchase has fallen below a specified level, Company B's purchase price would be adjusted to a higher fixed amount significantly in excess of the current forward price at the inception of the contract. (The contract entered into by Company B is a compound derivative consisting of a forward contract to purchase raw material at the original fixed price and a written option that obligates Company B to purchase the raw material for the higher adjusted price if the market price of the raw material falls below the specified level. In exchange for the written option, Company B received a premium representing the difference between the purchase price in the contract and the forward market price of the raw material at the inception of the contract.)
3. Company C enters into a forward contract to purchase on a specified date a specified quantity of a raw material that is readily convertible to cash. The contract's purchase price is a fixed amount per unit that is below the current forward price. However, if the market price on the date of purchase has fallen below a specified level that is below the contract's fixed purchase price, Company C would be required to purchase a specified additional quantity of the raw material at the contract's fixed purchase price (which is above the current market price on the date of purchase). (The contract entered into by Company C is a compound derivative

consisting of a forward contract to purchase raw material at the original fixed price and a written option that obligates Company C to purchase additional quantities of the raw material at an above-market price if the market price of the raw material falls below the specified level.)

In the above cases, the optionality feature must be analyzed to determine whether it could modify the quantity of the asset to be delivered under the contract. In doing so, the conclusion as to whether the contract is eligible for the normal purchases and normal sales exception applies in the same way to both counterparties—the purchaser and the writer of the option (within the forward contract).

In cases in which the optionality feature in the forward contract can modify the quantity of the asset to be delivered under the contract, if that option feature has expired or has been completely exercised (even if delivery has not yet occurred), there is no longer any uncertainty as to the quantity to be delivered under the forward contract. Accordingly, following such expiration or exercise, the forward contract would be eligible for designation as a normal purchase or normal sale, provided that the other conditions in paragraph 10(b) are met.

In Example 1, the optionality feature cannot modify the quantity to be delivered; thus, the contract is eligible to qualify for the normal purchases and normal sales exception.

Similarly, the contract in Example 2 is also eligible to qualify for the normal purchases and normal sales exception because the optionality feature in the contract cannot modify the quantity to be delivered.

The contract in Example 3 is not eligible to qualify for the normal purchases and normal sales exception since the optionality feature in the contract can modify the quantity of the asset to be delivered under the contract.

EFFECTIVE DATE

The effective date of the revised implementation guidance in this Issue for each reporting entity is the first day of its first fiscal quarter beginning after June 29, 2001, the date that the Board-cleared revised guidance was posted on the FASB website. The revisions made on March 26, 2003, do not affect the effective date.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Scope Exceptions: Interpretation of *Clearly and Closely Related* in Contracts That Qualify for the Normal Purchases and Normal Sales Exception
Paragraph reference:	10(b)
Date cleared by Board:	March 21, 2001
Date posted to website:	April 10, 2001
Superseded by:	Issuance of Issue C20

Title:	Scope Exceptions: Interpreting the Normal Purchases and Normal Sales Exception as an Election
Paragraph reference:	10(b)
Date cleared by Board:	March 21, 2001
Date posted to website:	April 10, 2001
Date revision posted to website:	May 1, 2003
Affected by:	FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* Revised March 26, 2003

QUESTION

Can the application of the normal purchases and normal sales exception to a contract that meets both the definition of a derivative and the criteria in paragraph 10(b) effectively be interpreted as an election based on whether or not the entity chooses to document the basis for concluding that it is probable that the contract will result in physical delivery?

BACKGROUND

Paragraph 10(b) of Statement 133, as amended by Statement 149, states, in part:

> For contracts that qualify for the normal purchases and normal sales exception, the entity shall document the designation of the contract as a normal purchase or normal sale. For contracts that qualify for the normal purchases and normal sales exception under paragraphs 10(b)(1) and 10(b)(3), the entity shall document the basis for concluding that it is probable that the contract will not settle net and will result in physical delivery. For contracts that qualify for the normal purchases and normal sales exception under paragraph 10(b)(4), the entity shall document the basis for concluding that the agreement meets the criteria in paragraph 58(b). The documentation requirements can be applied either to groups of similarly designated contracts or to each individual contract. Failure to comply with the documentation requirements precludes application of the normal purchases and normal sales exception to contracts that would otherwise qualify for that exception.

Without the required documentation completed, derivative contracts that would otherwise qualify for the scope exception in paragraph 10(b) would be subject to the requirements of Statement 133. Some have suggested that an entity's ability to choose whether or not to deliberately fail to comply with that documentation requirement effectively constitutes an election.

RESPONSE

Yes. The normal purchases and normal sales exception in paragraph 10(b) could effectively be interpreted as an election in all cases. However, once an entity documents compliance with the requirements of paragraph 10(b), which could be done at the inception of the contract or at a later date, the entity is not permitted at a later date to change its election and treat the contract as a derivative.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Statement 133 Implementation Issue **No. C13**
[Previously No. E13]

Title:	Scope Exceptions: When a Loan Commitment Is Included in the Scope of Statement 133
Paragraph references:	9, 57(c)(2), 291
Date cleared by Board:	March 13, 2002
Date posted to website:	April 10, 2002
Date revision posted to website:	May 1, 2003
Affected by:	FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* Revised March 26, 2003

QUESTION

In what circumstances must a loan commitment be included in the scope of Statement 133 and accounted for as a derivative instrument?

BACKGROUND

Loan commitments[1] are legally binding commitments to extend credit to a counterparty under certain pre-specified terms and conditions. They have fixed expiration dates and may either be fixed-rate or variable-rate. Loan commitments can either be revolving (in which the amount of the overall line of credit is re-established upon repayment of previously drawn amounts) or non-revolving (in which the amount of the overall line of credit is not re-established upon repayment of previously drawn amounts). Loan commitments can be distributed through syndication arrangements, in which one entity acts as a lead and an agent on behalf of other entities that will each extend credit to a single borrower.

Loan commitments generally permit the lender to terminate the arrangement under the terms of covenants negotiated under the agreement. As discussed in EITF Issue No. 87-30, "Sale of a Short-Term Loan Made under a Long-Term Credit Commitment," two types of financial-related covenants are (1) covenants that permit the lender to determine the borrower's compliance subjectively ("subjective covenants"); that is, they contain provisions that can be evaluated differently by the parties to the agreement, such as a provision referring to a material adverse change and (2) covenants that require the financial institution to determine the borrower's compliance objectively ("objective covenants"); that is, they typically refer to financial ratios and other data.

[1] The description of loan commitments in this section is not an authoritative or all-encompassing definition. Primary information sources include the instructions for bank Call Reports (FFIEC 031, Consolidated Reports of Condition and Income for a Bank with Domestic and Foreign Offices), June 2001, and The Encyclopedia of Banking and Finance.

Types of loan commitments include (but are not limited to) the following:

- One- to four-family residential mortgage loan commitments
- Loan commitments for multifamily properties, commercial real estate, construction, and land development
- Commercial loan commitments (that is, commitments to extend credit to commercial or industrial entities)
- Credit card lines (that is, commitments to extend credit to individuals or commercial or industrial entities through credit cards)
- Home equity lines (that is, commitments to extend credit under revolving, open-end lines of credit secured by one- to four-family residential property)
- Manufactured housing
- Automobile financing
- Sub-prime lending.

Statement 133 References

Loan commitments are discussed in paragraphs 291 and 292 of the basis for conclusions of Statement 133. Those paragraphs state:

> This Statement's definition of derivative contracts excludes certain contracts that were included in the scope of Statement 119. *For example, a loan commitment would be excluded if it (a) requires the holder to deliver a promissory note that would not be readily convertible to cash and (b) cannot readily be settled net.* Other conditional and executory contracts that were included in the scope of Statement 119 may not qualify as derivative instruments under the definition in this Statement. The Board decided that some change in scope from Statement 119 is an appropriate consequence of defining derivative instruments based on their primary characteristics. [Emphasis added.]
>
> This Statement supersedes Statement 119. Therefore, one result of excluding instruments that were included in the scope of Statement 119 from the scope of this Statement is that some disclosures previously required for those excluded contracts will no longer be required. The Board considers that result to be acceptable. Moreover, Statement 107 continues to require disclosure of the fair value of all financial instruments by the entities to which it applies.

Based on discussions during the deliberations leading to Statement 133, some believed that loan commitments were not covered by the scope of Statement 133. However, prior to the amendment by Statement 149, paragraph 10 of Statement 133 did not provide an explicit scope exception for loan commitments. Assuming the other characteristics of the definition of a derivative are met, paragraph 291 indicates that if a loan commitment meets one of the criteria for net settlement from the perspective of either the lender or borrower, either because it can readily be settled net by a means outside the contract as discussed in paragraph 9(b) or because

the underlying loan is readily convertible to cash as discussed in paragraph 9(c), both parties must consider that loan commitment to meet the definition of a derivative in Statement 133.

Perceived Conflict with Existing GAAP Prior to Amendments by Statement 149

While in some circumstances loan commitments can meet the definition of a derivative instrument in Statement 133, an overlap exists between a requirement to account for loan commitments as derivatives and the existing accounting guidance for loan commitment fees and costs in paragraphs 8–10 of FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases,* and paragraphs 21–27 of FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities* (as amended). The accounting requirements of Statement 91 and Statement 65 (as amended) for loan and commitment fees are as follows:

- Paragraphs 8–10 of Statement 91 address the accounting for loan commitment fees and costs. Paragraph 8 generally requires that fees received for a commitment to originate or purchase loan(s) be deferred and recognized over the life of the loan as an adjustment of the yield if the commitment is exercised. Paragraph 10 states that available lines of credit under credit card and similar charge card arrangements are loan commitments, and requires that fees that are periodically charged to cardholders be deferred and recognized on a straight-line basis over the period the fee entitles the cardholder to use the card.

- Paragraphs 21–27 of Statement 65 (as amended by Statement 91) address the accounting for loan and commitment fees related to mortgage loans that will either be held for resale or held for investment. As indicated in paragraph 21 of Statement 65 (as amended) there is a distinction between the accounting models for fees related to the origination of mortgage loans for resale and the origination of mortgage loans for investment. Statement 65 (as amended) requires that (1) if a mortgage loan is held for resale, loan origination fees and direct loan origination costs shall be deferred until the related loan is sold; (2) fees received for guaranteeing the funding of mortgage loans to borrowers, builders, or developers must be accounted for in accordance with paragraph 8 of Statement 91; and (3) if the commitment fee relates to a mortgage loan that will be held for investment, the fees and costs associated with originating or acquiring or committing to originate or acquire loans for investment be accounted for as prescribed in Statement 91.

Accordingly, Statement 91 and Statement 65 require different income recognition patterns than would be required if a loan commitment was accounted for as a derivative and measured at fair value with changes in fair value recognized currently in earnings under Statement 133. Those paragraphs in Statement 91 and Statement 65 cited above were not amended by Statement 133. Further, paragraph 10 of Statement 133 (as originally issued) did not include an explicit scope exception for loan commitments.

RESPONSE

Loan commitments that relate to the origination of mortgage loans that will be held for resale, as discussed in paragraphs 21 and 23 of Statement 65 (as amended), must be accounted for as derivative instruments in accordance with Statement 133. Those loan commitments are subject to Statement 133 if they are legally binding contracts, regardless of the existence of a material adverse change clause that may be invoked by a lender to terminate the arrangement based either on a subjective evaluation that a material adverse change has occurred or on criteria that are objectively determinable. However, the holder of the commitment (that is, the potential borrower under the arrangement) is not required to account for its contract as a derivative. That exception is limited to loan commitments that relate to the origination of mortgage loans that will be held for resale and no analogy is permitted for other types of contracts.

The accounting for loan commitments discussed in the above paragraph as derivatives by the lender recognizes that a distinct accounting model exists in Statement 65 for mortgage loans originated to be held for resale. In addition, the ability to convert the underlying loan to cash is inherent in the business activity of entering into loan commitments to originate mortgage loans to be held for resale.

However, loan commitments that relate to the origination of mortgage loans that will be held for investment, as discussed in paragraph 25 of Statement 65 (as amended), must continue to be accounted for in accordance with the requirements of that paragraph. That is, paragraph 25 of Statement 65 (as amended) requires that fees and costs associated with originating or committing to originate loans for investment shall be accounted for as prescribed in Statement 91. Further, commitments that relate to the origination of other types of loans (that is, other than mortgage loans) that are not covered by the scope of Statement 65 must also continue to be accounted for in accordance with the guidance in Statement 91. For example, commitments to extend credit to commercial or industrial entities that will not give rise to mortgage loans must be accounted for in accordance with the guidance in Statement 91. In those cases, Statement 133 does not override the existing accounting requirements of Statement 91.

The conclusions herein result in a scope exception to Statement 133 for loan commitments that would otherwise be subject to the scope of that Statement but that relate to the origination of mortgage loans that will be held for investment purposes and all loan commitments that relate to the origination of other types of loans. In addition, the guidance in this Issue results in a scope exception to Statement 133 for the holder of a loan commitment that relates to the origination of mortgage loans that will be held for resale (that is, the potential borrower under such an arrangement).

At the March 13, 2002 meeting, the Board reached the conclusions outlined in this Response section. The guidance in this Issue should not be applied by analogy to other types of contracts.

Statement 149 amended Statement 133 to incorporate those conclusions. Specifically, the following paragraph is added after paragraph 6(c) of Statement 133:

> Notwithstanding the above characteristics, loan commitments that relate to the origination of mortgage loans that will be held for sale, as discussed in paragraph 21 of FASB Statement No. 65, *Accounting for Mortgage Banking Activities* (as amended), shall be accounted for as derivative instruments by the issuer of the loan commitment (that is, the potential lender). Paragraph 10(i) provides a scope exception for the accounting of loan commitments by issuers of certain commitments to originate loans and all holders of commitments to originate loans (that is, the potential borrowers).

In addition, Statement 149 added a new scope exception in paragraph 10(i), as follows:

> *Loan commitments.* The holder of any commitment to originate a loan (that is, the potential borrower) is not subject to the requirements of this Statement. Issuers of commitments to originate mortgage loans that will be held for investment purposes, as discussed in paragraphs 21 and 25 of Statement 65, are not subject to this Statement. In addition, issuers of loan commitments to originate other types of loans (that is, other than mortgage loans) are not subject to the requirements of this Statement.

The amendments of Statement 133 related to loan commitments and the conclusions outlined in this Issue do not affect the accounting for commitments to purchase or sell mortgage loans or other types of loans at a future date. Those types of loan commitments must be evaluated under the definition of a derivative to determine whether Statement 133 is applicable.

EFFECTIVE DATE AND TRANSITION

The effective date of the implementation guidance in this Issue for each reporting entity is the first day of the first fiscal quarter beginning after April 10, 2002. If an entity had not accounted for a contract as a derivative in its entirety but is required to do so, the entity shall account for the effects of initially complying with the implementation guidance in this Issue prospectively for all existing contracts as of the effective date of this Issue and for all future transactions. In that case, the effects of initially applying this guidance should be reported as a change in accounting principle. If a contract that would not be accounted for as a derivative instrument under this Issue was previously accounted for as a derivative instrument, that accounting treatment shall not be changed. That is, for those contracts, this Issue applies prospectively only to transactions after the effective date. The revisions made on March 26, 2003, relate to the amendments made by Statement 149 and clarification that the scope exception for loan commitments does not apply to contracts for the acquisition of pre-existing loans. Those revisions are effective for contracts entered into or modified after June 30, 2003.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Scope Exceptions: Normal Purchases and Normal Sales Exception for Certain Option-Type Contracts and Forward Contracts in Electricity
Paragraph references:	10(b), 58(b)
Date cleared by Board:	June 27, 2001
Date posted to website:	June 29, 2001
Date latest revision posted to website:	November 10, 2003
Affected by:	FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* Revised November 5, 2003

QUESTION

Can the normal purchases and normal sales exception be extended to power purchase or sale agreements (whether forward contracts, option contracts, or combinations of both), including capacity contracts, for the purchase or sale of electricity?

BACKGROUND

In many situations, companies in the electric industry enter into contracts that permit one party to purchase electricity (also referred to as "power") from another. Such contracts can vary substantially in terms, with some requiring delivery of a specific quantity of power and others providing optionality regarding the quantity to be delivered.

The types of contracts typically used to buy and sell power are driven by the characteristics of the electric power industry. A unique characteristic of the industry is that electricity cannot be readily stored in significant quantities. As a result, some of the contracts to buy and sell electricity permit the buyer some flexibility in determining when to take electricity and in what quantity in order to match power to fluctuating demand.

Another characteristic of the industry is that fixed costs are a very high percentage of the total cost of producing power. In order to provide for recovery of such fixed costs, power contracts that are option contracts typically include a specified charge (sometimes referred to as the capacity or demand charge) to provide for recovery of the cost of the plant (or, in some cases, recovery of the market-based value of the plant) and related financing. An option contract will also include a variable charge to recover, among other things, the variable cost of producing power (the energy charge). Option contracts that contain a specified capacity charge that is based on recovering the cost of the plant and a variable energy charge are often referred to as capacity contracts, although that term is also used for certain forward contracts.

In a regulated electric industry, regulators set rates in order to recover plant fixed costs and variable costs plus a reasonable return. Tariffs are established that generally separate the capacity charge and the energy charge, among other charges. With the introduction of independent power plants, some contracts to buy and sell power also include capacity charges and energy charges, which in the past were generally established by regulators. The intent to physically deliver power at rates that will recover the cost of plant and energy while giving the purchaser the ability to have some control over when and in what quantity power is delivered is a consistent characteristic of those contracts.

With the deregulation of the electric utility industry, the above industry characteristics continue to drive how contracts to buy and sell power are structured. The buyer of power needs some flexibility in when to take power and in what quantity, and the seller needs to price such arrangements in order to cover the high fixed costs of producing electricity. In some cases, the purchase price of the electricity is entirely fixed, as in a forward contract or in an option contract that involves an initial premium payment for the time value of the option. More commonly for option contracts, the purchase price of the electricity is composed of an initial specified element and a variable element that is payable only if the option is exercised and electricity is delivered.

RESPONSE

Paragraph 10(b)(4), as amended by Statement 149, permits power purchase or sales agreements (whether forward contracts, option contracts, or combinations of both) for the purchase or sale of electricity to qualify for the normal purchases and normal sales exception (in paragraph 10(b)(4)) provided that all of the applicable criteria in paragraph 58(b), as amended, are met. Those criteria are presented below, with supplemental comments for criterion 2.

Criteria applicable to both parties to the contract:

1. The terms of the contract require physical delivery of electricity. That is, the contract does not permit net settlement, as described in paragraphs 9(a) and 57(c)(1). For an option contract, physical delivery is required if the option contract is exercised.
2. The power purchase or sales agreement (whether a forward contract, an option contract, or a combination of both) is a capacity contract, as defined in Statement 133 (as amended). Differentiating between an option contract that is a capacity contract and a traditional option contract (that is, a financial option on electricity) is a matter of judgment that depends on the facts and circumstances. For power purchase or sale agreements that contain option features, the characteristics of an option contract that is a capacity contract and a traditional option contract, which are set forth in the appendix to this Issue, should be considered in that evaluation; however, other characteristics not listed in the appendix may also be relevant to that evaluation.

Criterion applicable only to the seller of electricity:

3. The electricity that would be deliverable under the contract involves quantities that are expected to be sold by the reporting entity in the normal course of business.

Criteria applicable only to the buyer of electricity:

4. The electricity that would be deliverable under the contract involves quantities that are expected to be used or sold by the reporting entity in the normal course of business.
5. The buyer of the electricity under the power purchase or sales agreement is an entity that is engaged in selling electricity to retail or wholesale customers and is statutorily or otherwise contractually obligated to maintain sufficient capacity to meet electricity needs of its customer base.
6. The contracts are entered into to meet the buyer's obligation to maintain a sufficient capacity, including a reasonable reserve margin established by or based upon a regulatory commission, local standards, regional reliability councils, or regional transmission organizations.

Because electricity cannot be readily stored in significant quantities and the entity engaged in selling electricity is obligated to maintain sufficient capacity to meet the electricity needs of its customer base, an option contract for the purchase of electricity that meets the above criteria qualifies for the normal purchases and normal sales exception in paragraph 10(b)(4). In contrast, Statement 133 Implementation Issue No. C10, "Can Option Contracts and Forward Contracts with Optionality Features Qualify for the Normal Purchases and Normal Sales Exception?" prohibits that exception from being applied to a contract for the purchase of an asset other than electricity if the contract contains an optionality feature that can modify the quantity of the asset to be delivered under the contract.

Power purchase or sales agreements that meet only the above applicable criteria qualify for the normal purchases and normal sales exception even if they are subject to being booked out or are scheduled to be booked out. Forward contracts for the purchase or sale of electricity that do not meet the criteria in this Issue as well as other forward contracts are nevertheless *eligible* to qualify for the normal purchases and normal sales exception in paragraph 10(b)(1) by meeting all the criteria in that paragraph, unless those contracts are subject to unplanned netting (that is, subject to possibly being booked out).

The above guidance does not affect the accounting for requirements contracts that would not be required to be accounted for under the guidance in Statement 133 pursuant to Statement 133 Implementation Issue No. A6, "Notional Amounts of Commodity Contracts." Contracts that qualify for the normal purchases and normal sales exception based on the guidance in this Issue do not require compliance with any additional guidance in paragraph 10(b). However, contracts that have a price based on an underlying that is not clearly and closely related to the electricity being sold or purchased or that are denominated in a foreign currency that meets none of the criteria in paragraphs 15(a)–15(d) shall not be considered normal purchases and normal sales.

For contracts that qualify for the normal purchases and normal sales exception provided by this Issue, the entity shall document the basis for concluding that the agreement is a capacity contract.

The guidance in this Issue should not be applied by analogy to the accounting for other types of contracts not meeting the criteria in the above paragraphs.

EFFECTIVE DATE

The effective date of the implementation guidance in this Issue for each reporting entity is the first day of its first fiscal quarter beginning after June 29, 2001, the date that the Board-cleared guidance was first posted on the FASB website. Revisions were subsequently made on October 10 and December 19, 2001. The effective date of those revisions to the implementation guidance in this Issue for each reporting entity is the first day of its second fiscal quarter beginning after December 28, 2001, the date that the revised cleared guidance was posted on the FASB website. Revisions were also made on November 5, 2003. The effective date of those revisions to the implementation guidance in this Issue for each reporting entity is the first day of its first fiscal quarter beginning after November 10, 2003, the date that the most recently revised cleared guidance was posted on the FASB website. The revised implementation guidance applies to all power purchase or sales agreements existing on or after that effective date. Early application is permitted. The revisions made on March 26, 2003, do not affect the effective date.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Appendix to Implementation Issue No. C15

Characteristics of both Option Contracts That Are Capacity Contracts and Financial Options on Electricity

	Option Contract That Is a Capacity Contract	Financial Option Contract on Electricity
1	The contract usually specifies the power plant or group of power plants providing the electricity.	No reference is made to the generation origination of the electricity.
2	The strike price (paid upon exercise) includes pricing terms to compensate the plant operator for variable operations and maintenance costs expected during the specified production periods.	The strike price is structured based on the expected forward prices of power.
3	The specified quantity is based on individual needs of parties to the agreement.	The specified quantity reflects standard amounts of electric energy, which facilitate market liquidity (for example, exercise in increments of 10,000 KwH).
4	The title transfer point is usually at one or a group of specified physical delivery point(s), as opposed to a major market hub.	The specified index transfer point is a major market hub (liquid trading hub), not seller- or buyer-site specific.
5	The contract usually specifies certain operational performance by the facility (for example, the achievement of a certain heat rate).	No operational performance is specified (not plant specific).
6	The contract sometimes incorporates requirements for interconnection facilities, physical transmission facilities, or reservations for transmission services.	None specified.
7	The contract may specify jointly agreed-to plant outages (for example, for maintenance) and provide for penalties in the event of unexpected outages.	Penalties for outages are not specified (not plant specific).
8	Damage provisions upon default are usually based on a reduction of the capacity payment (which is not market based). If default provisions specify market liquidating damages, they usually contain some form of floor, ceiling, or both. The characteristics of the default provision are usually tied to the expected generation facility.	Damage provisions upon default are based on market liquidating damages.
9	The contract's term is usually long (one year or more).	The contract's term is not longer than 18 to 24 months because financial options on electricity are currently illiquid beyond that period.

Title:	Scope Exceptions: Applying the Normal Purchases and Normal Sales Exception to Contracts That Combine a Forward Contract and a Purchased Option Contract
Paragraph reference:	10(b)
Date cleared by Board:	September 19, 2001
Date posted to website:	October 10, 2001
Date latest revision posted to website:	May 1, 2003
Affected by:	FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* Revised March 26, 2003

QUESTION

If a purchased option that would, if exercised, require delivery of the related asset at an established price under the contract is combined with a forward contract in a single supply contract and that single supply contract meets the definition of a derivative, is that single supply contract eligible to qualify for the normal purchases and normal sales exception in paragraph 10(b)?

BACKGROUND

Some utilities and independent power producers (also called IPPs) have fuel supply contracts that require delivery of a contractual minimum quantity of fuel at a fixed price and have an option that permits the holder to take specified additional amounts of fuel at the same fixed price at various times. Essentially, that option to take more fuel is a purchased option that is combined with the forward contract in a single supply contract. Typically, the option to take additional fuel is built into the contract to ensure that the buyer has a supply of fuel in order to produce the electricity during peak demands; however, the buyer may have the ability to sell to third parties the additional fuel purchased through exercise of the purchased option. Due to the difficulty in estimating peak electricity load and thus the amount of fuel needed to generate the required electricity, those fuel supply contracts are common in the electric utility industry (though similar supply contracts may exist in other industries). Those fuel supply contracts are not requirements contracts that are addressed in Statement 133 Implementation Issue No. A6, "Notional Amounts of Commodity Contracts."

Many of those contracts meet the definition of a derivative because they have a notional amount and an underlying, require no or a smaller initial net investment, and provide for net settlement (for example, through their default provisions or by requiring delivery of an asset that is readily convertible to cash). For purposes of applying Statement 133 to contracts that meet the definition of a derivative, it is necessary to determine whether the fuel supply contract qualifies

for the normal purchases and normal sales exception, whether bifurcation of the option is permitted if it does not qualify for the normal purchases and normal sales exception, or whether the entire contract is accounted for as a derivative.

Statement 133 Implementation Issue No. C15, "Normal Purchases and Normal Sales Exception for Certain Option-Type Contracts and Forward Contracts in Electricity," indicates that power purchase or sales agreements (including combinations of a forward contract and an option contract) that meet the criteria in that Implementation Issue qualify for the normal purchases and normal sales exception in paragraph 10(b).

Although the above background information discusses utilities and independent power producers, this Implementation Issue applies to all entities that enter into contracts that combine a forward contract and a purchased option contract, not just to utilities and independent power producers.

RESPONSE

The inclusion of a purchased option that would, if exercised, require delivery of the related asset at an established price under the contract within the single supply contract that meets the definition of a derivative disqualifies the entire derivative fuel supply contract from being eligible to qualify for the normal purchases and normal sales exception in paragraph 10(b) except as provided in paragraph 10(b)(4) of Statement 133, as amended, and Implementation Issue C15 with respect to certain power purchase or sales agreements. Statement 133 Implementation Issue No. C10, "Can Option Contracts and Forward Contracts with Optionality Features Qualify for the Normal Purchases and Normal Sales Exception?" states, "Option contracts only contingently provide for such purchase or sale since exercise of the option contract is not assured. Thus, in accordance with paragraph 10(b)(2) of Statement 133, as amended, freestanding option contracts (including in-the-money options contracts) are not eligible to qualify for the normal purchases and normal sales exception." Paragraph 10(b)(3) of Statement 133, as amended, and Implementation Issue C10 further indicate that forward contracts with embedded optionality can qualify for the normal purchases and normal sales exception only if the embedded optionality (such as price caps) does not affect the quantity to be delivered. The fuel supply contract cannot qualify for the normal purchases and normal sales exception because of the optionality regarding the quantity of fuel to be delivered under the contract.

An entity is not permitted to bifurcate the forward contract component and the option contract component of a fuel supply contract that in its entirety meets the definition of a derivative and then assert that the forward contract component is eligible to qualify for the normal purchases and normal sales exception. Paragraph 18 indicates that an entity is prohibited from separating a compound derivative into components representing different risks. (The provisions of paragraph 12 require that certain derivatives that are embedded in non-derivative hybrid instruments must be split out from the host contract and accounted for separately as a derivative; however, paragraph 12 does not apply to a contract that meets the definition of a derivative in its entirety.)

An entity may wish to enter into two separate contracts—a forward contract and an option contract—that economically achieve the same results as the single derivative contract described in the background section and determine whether the exception in paragraph 10(b) applies to the separate forward contract.

Similar to the option contracts discussed in Implementation Issue C10, this Issue addresses option components that would require delivery of the related asset at an established price under the contract. If the option component does not provide any benefit to the holder beyond the assurance of a guaranteed supply of the underlying commodity for use in the normal course of business and that option component only permits the holder to purchase additional quantities at the market price at the date of delivery (that is, that option component will always have a fair value of zero), that option component would not require delivery of the related asset at an established price under the contract.

If an entity's single supply contract included at its inception both a forward contract and an option contract and, in subsequent renegotiations, that contract is negated and replaced by two separate contracts (a forward contract for a specific quantity that will be purchased and an option contract for additional quantities whose purchase is conditional upon exercise of the option), the new forward contract would be eligible to qualify for the normal purchases and normal sales exception under paragraph 10(b), whereas the new option contract would not be eligible for that exception. From the inception of that new separate option contract, it would be accounted for under Statement 133. However, the guidance in this Implementation Issue would not retroactively affect the accounting for the combination derivative contract that was negated prior to the effective date of this Implementation Issue.

If on the effective date of this Implementation Issue, an entity was party to a combination derivative contract that included both a forward contract and an option contract but the entity had not been accounting for that derivative contract under Statement 133 because it had documented an asserted compliance with paragraph 10(b), that combination derivative contract would be reported at its fair value on the effective date of this Implementation Issue, with the offsetting entry recorded in current period earnings. The combination derivative contract cannot be bifurcated into a forward contract that would have been eligible to qualify for the normal purchases and normal sales exception and an option contract.

EFFECTIVE DATE

The effective date of the implementation guidance in this Issue for each reporting entity is the first day of its second fiscal quarter beginning after October 10, 2001, the date that the Board-cleared guidance was posted on the FASB website. The revisions made on March 26, 2003, do not affect the effective date.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Scope Exceptions: Shortest Period Criterion for Applying the Regular-Way Security Trades Exception to When-Issued Securities or Other Securities That Do Not Yet Exist
Paragraph references:	10(a), 58(a), 59(a), 276
Date cleared by Board:	March 26, 2003
Date posted to website:	May 1, 2003
Affected by:	FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*

QUESTION

Assume a variety of forward contracts exists for a when-issued security, such as a to-be-announced (TBA) security, that provides a choice of settlement dates for each of the next three months (such as November, December, or January). An entity enters into a forward to purchase the TBA security, which will otherwise meet the qualifications of paragraphs 10(a), 58(a), and 59(a), that requires delivery in the second-nearest month (such as December), not the nearest month (such as November). May that entity apply the regular-way security trade exception to the December settlement TBA forward contract?

BACKGROUND

Paragraph 10(a) of Statement 133 provides an exception to forward contracts that require the delivery of a security within the time frame generally established by regulations or conventions in the marketplace in which the transaction is executed. Paragraph 59(a), as amended by Statement 149, addresses the application of the regular-way security trades exception to a contract for the purchase or sale of when-issued securities or other securities that do not yet exist, as follows:

> Contracts for the purchase or sale of when-issued securities or other securities that do not yet exist are excluded from the requirements of this Statement as a regular-way security trade only if (1) there is no other way to purchase or sell that security, (2) delivery of that security and settlement will occur within the shortest period possible for that type of security, and (3) it is probable at inception and throughout the term of the individual contract that the contract will not settle net and will result in physical delivery of a security when it is issued. A contract for the purchase or sale of when-issued securities or other securities that do not yet exist is eligible to qualify for the regular-way security trades exception even though that contract permits net settlement (as discussed in paragraphs 9(a) and 57(c)(1)) or a market mechanism to facilitate net settlement of that contract (as discussed in paragraph 9(b) and 57(c)(2)) exists.…

RESPONSE

No. The entity may not apply the regular-way security trade exception to the TBA forward contract that requires delivery in the second-nearest month (such as December). The regular-way security trade exception may be applied to forward contracts for TBA or when-issued securities provided that delivery of the security is within the shortest period permitted for that type of security. In the example above, the TBA security (identified by issuer, contractual maturity of the underlying loans, and the net coupon, such as 30-year GNMA 7s) is available under multiple settlement periods (that is, the standardized settlement date in November, December, or January). The regular-way security trade exception may be applied only to forward contracts for that TBA security that require delivery in November, the shortest period permitted for that type of TBA security. The December and January settlement TBA forward contracts in this example must be accounted for as derivatives under Statement 133. If they meet the hedge accounting criteria, they may be designated as cash flow hedges of the anticipated purchase of the securities, as discussed in Statement 133 Implementation Issue No. G2, "Hedged Transactions That Arise from Gross Settlement of a Derivative ('All-in-One' Hedges)."

EFFECTIVE DATE

The effective date of the implementation guidance in this Issue for each reporting entity is the first day of its second fiscal quarter beginning after May 1, 2003, the date that the Board-cleared guidance was posted on the FASB website.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Scope Exceptions: Interpretation of the Meaning of *Not Clearly and Closely Related* in Paragraph 10(b) regarding Contracts with a Price Adjustment Feature
Paragraph reference:	10(b)
Date cleared by Board	June 25, 2003
Date posted to website:	June 27, 2003

QUESTION

For purposes of determining the applicability of the normal purchases and normal sales scope exception, how should *not clearly and closely related to the asset being sold or purchased* (as used in paragraph 10(b) of Statement 133) be applied to price adjustments in purchase or sales contracts?

BACKGROUND

In many cases, certain contracts that meet the definition of a derivative in their entirety and may otherwise qualify for the normal purchases and normal sales scope exception have a price adjustment feature the underlying of which is based on the fair value of an asset that is different from the asset to be delivered under the contract. In other cases, the underlying of the price adjustment feature is based on an index or other variable that is not related to the asset to be delivered under the contract.

The normal purchases and normal sales scope exception provided in paragraph 10(b) (as amended) states that "…contracts that have a price based on an underlying that is not clearly and closely related to the asset being sold or purchased (such as a price in a contract for the sale of a grain commodity based in part on changes in the S&P index)…shall not be considered normal purchases and normal sales."

The phrase *not clearly and closely related* is also used in paragraphs 12(a) and 60 of Statement 133 with respect to the relationship between an embedded derivative and the host contract in which it is embedded. In that context, the phrase focuses on the "economic characteristics and risks" of the embedded derivative and the host contract.

RESPONSE

The phrase *not clearly and closely related* in paragraph 10(b) with respect to the normal purchases and normal sales scope exception is used to convey a different meaning than in paragraphs 12(a) and 60 of Statement 133 with respect to the relationship between an embedded derivative and the host contract in which it is embedded. The guidance in this Issue does not affect the use of the phrase *not clearly and closely related* in paragraphs other than paragraph 10(b) as amended.

For purposes of determining whether a contract qualifies for the normal purchases and normal sales scope exception, the application of the phrase *not clearly and closely related to the asset being sold or purchased* should involve an analysis of both qualitative and quantitative considerations. The analysis is specific to the contract being considered for the normal purchases and normal sales scope exception and may include identification of the components of the asset being sold or purchased.

The underlying in a price adjustment incorporated into a contract that otherwise satisfies the requirements for the normal purchases and normal sales exception would be considered to be *not clearly and closely related to the asset being sold or purchased* in any of the following three circumstances:

1. The underlying is extraneous (that is, irrelevant and not pertinent) to both the changes in the cost and the changes in the fair value of the asset being sold or purchased, including being extraneous to an ingredient or direct factor in the customary or specific production of that asset.
2. If the underlying is not extraneous as discussed in (1) above, the magnitude and direction of the impact of the price adjustment is not consistent with the relevancy of the underlying. That is, the magnitude of the price adjustment based on the underlying is significantly disproportionate to the impact of the underlying on the fair value or cost of the asset being purchased or sold (or of an ingredient or direct factor, as appropriate).
3. The underlying is a currency exchange rate involving a foreign currency that meets none of the criteria in paragraphs 15(a)–15(d) of Statement 133 (as amended) for that reporting entity. (The inclusion of this circumstance is consistent with the portion of paragraph 10(b) that states, "contracts that…are denominated in a foreign currency that meets none of the criteria in paragraphs 15(a)–15(d) shall not be considered normal purchases and normal sales.")

For example, in the case in which the price adjustment focuses on the changes in the fair value of the asset being purchased or sold, if the terms of the price adjustment are expected, at the inception of the contract, to impact the purchase or sales price in a manner comparable to the outcome that would be obtained if, at each delivery date, the parties were to reprice the contract amount under the then-existing conditions for the asset being delivered on that date, the price adjustment's underlying is considered to be clearly and closely related to the asset being sold or purchased and the price adjustment would not be an impediment to the contract qualifying for the normal purchases and normal sales scope exception.

The assessment of whether a contract qualifies for the normal purchases and normal sales scope exception (including whether the underlying of a price adjustment within the contract is not clearly and closely related to the asset being sold or purchased) must be performed only at the inception of the contract.

If the underlying in a price adjustment incorporated into a purchase or sales contract is not an impediment to qualifying for the normal purchases and normal sales scope exception because it is considered to be *clearly and closely related to the asset being sold or purchased*, the contract must meet the other requirements in paragraph 10(b) to qualify for that scope exception.

Statement 133 Implementation Issue No. C11, "Interpretation of *Clearly and Closely Related* in Contracts That Qualify for the Normal Purchases and Normal Sales Exception," provided guidance regarding when a price adjustment feature in a contract would not be an impediment to the contract qualifying for the normal purchases and normal sales scope exception. Under Implementation Issue C11, a price adjustment feature based on an ingredient or direct factor in the production of the item being purchased or sold under the contract would be considered to be *clearly and closely related to the asset being sold or purchased* and thus the price adjustment feature would not be an impediment, that is, would not preclude election of the normal purchases and normal sales scope exception. That Issue did not permit the use of a broad market index to serve as a surrogate or proxy for an ingredient or direct factor. Thus, a price adjustment feature based on a broad market index that was not a direct factor or ingredient would be an impediment to the contract qualifying for the normal purchases or normal sales scope exception under Implementation Issue C11. (The guidance in Implementation Issue C11 is superseded by the guidance in Implementation Issue C20.)

EFFECTIVE DATE AND TRANSITION

The effective date of the implementation guidance in this Issue for each reporting entity is the first day of the first fiscal quarter beginning after July 10, 2003. Early application to any fiscal quarter beginning after clearance of this Issue is permitted. The implementation guidance in this Issue should be applied prospectively for all existing contracts as of the effective date of this Issue and for all future transactions. In conjunction with initially applying the implementation guidance in this Issue, a special transition adjustment shall be recognized by an entity that had been applying the normal purchases and normal sales scope exception to a derivative contract that under Implementation Issue C11 (as discussed in the preceding paragraph) was not eligible for the application of that scope exception because the contract contains a price adjustment feature that was based on neither the fair value of the item being purchased or sold under the contract nor an ingredient or direct factor in its production. That entity should recognize the derivative contract (to which that scope exception had been applied) at fair value as of the date of the initial application of this Issue, with a corresponding adjustment of net income as the effect of a change in accounting principle and presented in a manner similar to the cumulative effect of a change in accounting principle as described in paragraph 20 of APB Opinion No. 20, *Accounting Changes*. However, in order to be consistent with the transition provisions of Statement 133 and because no retroactive designation of hedging relationships and no retroactive application of the implementation guidance are permitted, no pro forma disclosures of the effects of retroactive application are required or permitted. Similarly, to be consistent with the transition provisions of Statement 133, the cumulative-effect-type adjustment related to initially applying that

implementation guidance at the beginning of a fiscal quarter that is not the first fiscal quarter of the entity's fiscal year should not be reported pursuant to FASB Statement No. 3, *Reporting Accounting Changes in Interim Financial Statements.*

The implementation guidance in this Issue does not impose any prohibitions against accounting for any contract as a derivative because application of the normal purchases and normal sales scope exception is never mandated. Statement 133 Implementation Issue No. C12, "Interpreting the Normal Purchases and Normal Sales Exception as an Election," indicates that the application of the normal purchases and normal sales scope exception effectively is elective. A party to a contract with a price adjustment feature that was an impediment to the contract qualifying for the normal purchase or normal sale scope exception under Implementation Issue C11 but is not an impediment under this Implementation Issue may, if the contract meets the other requirements in paragraph 10(b), elect to apply prospectively that scope exception on the day of the initial application of this Implementation Issue or on a later date (regardless of whether that entity had to recognize the special transition adjustment described in the preceding paragraph).

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Notice for Recipients
of This Proposed Statement 133 Implementation Issue

This proposed Implementation Issue would amend the accounting and reporting requirements of paragraph 14B of Statement 133 to provide clarifying language to Statement 133 regarding when embedded credit derivative features, including those in collateralized debt obligations (CDOs) and synthetic CDOs, are not considered embedded derivatives subject to potential bifurcation and separate accounting. The objective of this proposed Implementation Issue is to improve financial reporting by resolving some potential ambiguity about the breadth of the embedded credit derivative scope exception in paragraph 14B.

The Board invites individuals and organizations to send written comments on all matters in this proposed Implementation Issue. Comments are requested from those who agree with the provisions of this proposed Implementation Issue as well as from those who do not. Comments are most helpful if they identify the issues to which they relate and clearly explain the issue or question. Those who disagree with the provisions are asked to describe their suggested alternatives, supported by specific reasoning.

Responses from interested parties wishing to comment must be received in writing by Friday, February 13, 2009. Interested parties should submit their comments by email to "director@fasb.org, File Reference: Proposed Issue C22." Those without email may send their comments to "Russell G. Golden, Technical Director, FASB, 401 Merritt 7, PO Box 5116, Norwalk, CT 06856-5116, File Reference: Proposed Issue C22." Responses should **not** be sent by fax.

All comments received by the FASB are considered public information. Those comments will be posted to the FASB's website and will be included as part of the public record with other project materials.

Title:	Scope Exceptions: Exception Related to Embedded Credit Derivatives
Paragraph references:	12, 14B
Date released:	January 14, 2009
Comment deadline:	February 13, 2009

INTRODUCTION

This proposed Implementation Issue addresses the scope exception for embedded credit derivative features related to the concentration of credit risk in the form of subordination of one financial instrument to another. The question being addressed is how to determine, under paragraph 14B of Statement 133, which embedded credit derivative features, including those in collateralized debt obligations (CDOs) and synthetic CDOs, are considered not to be embedded derivatives that must be analyzed under paragraphs 12 and 13 for potential bifurcation and separate accounting. This proposed Implementation Issue would amend the accounting and reporting standards of paragraph 14B of Statement 133, as indicated below.

STATEMENT 133 IMPLEMENTATION ISSUE GUIDANCE

Paragraph 14B

1. The embedded credit derivative feature related only to the concentration of credit risk in the form of subordination of one financial instrument to another shall not be considered an embedded derivative that is subject to the application of paragraphs 12, 13, and 14A. Thus, those embedded credit derivative features do not need to be analyzed under those paragraphs for potential bifurcation from the host contract and separate accounting as a derivative.

2. Other embedded credit derivative features, including those in some CDOs and synthetic CDOs, are considered embedded derivatives subject to the application of paragraphs 12, 13, and 14A (including analysis of whether the economic characteristics and risks of the embedded credit derivative features are clearly and closely related to the economic characteristics and risks of the host contract), provided that the overall contract is not a derivative in its entirety under paragraph 6.

AMENDMENTS TO STATEMENT 133

FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, is amended as follows: [Added text is <u>underlined</u> and deleted text is ~~struck out~~.]

Paragraph 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 only of subordination of one financial instrument to another shall not be considered an embedded derivative subject to the application of paragraphs 12, 13, and 14A of ~~under~~ this Statement.

Paragraph 200A:

Example 35: A Dollar-Denominated Floating-Rate Interest Issued by an SPE That Holds Yen-Denominated Floating-Rate Bonds and a Matching 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~~ the bifurcation of an embedded derivative would not be required under paragraphs 12, 13, and 14A because the economic characteristics and risks of any perceived embedded derivative feature would be clearly and closely related to the economic characteristics and risks of the host contract ~~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~~.

Paragraph 200B:

Example 36: A Variable-Rate Interest Issued by an SPE That Holds Fixed-Rate Bonds and a Matching Pay-Fixed, Receive-Variable Interest Rate Swap. The variable-rate interest would *not* have an embedded derivative requiring bifurcation under paragraphs 12, 13, and 14A because the economic characteristics and risks of any perceived embedded derivative feature would be clearly and closely related to the economic characteristics and risks of the host contract ~~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 (thereby creating the possibility that the financial instruments held by the SPE might not provide the necessary cash flows to the swap counterparty), the variable-rate interest provisions would have to be evaluated for an embedded derivative under paragraph 13 because the underlying is an interest rate or interest rate index ~~financial instruments held by the entity might not provide the necessary cash flows~~.

Paragraph 200D:

Example 38: A Securitization That Introduces New Credit Risk. An SPE ~~entity~~ holds a credit derivative referenced to Company A and high-quality bonds, but issues beneficial

interests explicitly referenced to Company B (thus, the cash flows relating to changes in the credit risk of Company B are not present in the financial instruments held by the SPE). The beneficial interests would be a hybrid financial instrument with an embedded derivative subject to the application of paragraphs 12, 13, and 14A because the embedded credit derivative feature referenced to Company B is not based only on the concentration of credit risk in the form of subordination of one financial instrument to another and because the financial instruments held by the SPE might not provide the necessary cash flows related to the embedded credit derivative feature referenced to Company B ~~the cash flows relating to changes in the credit risk of Company B are not present in the financial instruments held by the entity~~.

Paragraph 200E is added as follows:

Example 39: Partially Funded Synthetic CDO. An SPE that holds GICs and that wrote a credit default swap on a referenced credit to a third party, with a significantly larger notional amount than the GICs, issues various tranches of credit-linked beneficial interests to investors that differ in terms of priority and in their potential obligation to fund any losses on the credit default swap. That is, if credit losses greater than the value of the GICs are incurred under the credit default swap, the investors in one or more tranches may be required to provide additional funds to the special purpose entity, which would then be passed on as payments to the holder of the credit default swap. Under paragraph 14B (as revised), the investor's embedded credit derivative feature that relates only to the concentration of credit risk in the form of subordination of one tranche to another is not an embedded derivative subject to the application of paragraphs 12, 13, and 14A of Statement 133. However, the tranches that expose the investor to making potential payments related to defaults on the written credit default swap would contain an embedded derivative subject to the application of paragraphs 12, 13, and 14A (provided that the investor's overall contract is not a derivative in its entirety under paragraph 6 of Statement 133). While the risk in those tranches is credit-related, the investor can lose more than its original investment. Therefore, the credit risk is not related only to subordination and must be evaluated under paragraphs 12, 13, and 14A. Because the credit default swap relates to a referenced credit and could expose the investor to potential payments (not merely reduced cash inflows), the swap's credit risk is not related to the risk of simply failing to receive cash inflows from the referenced credit; thus, the economic characteristics and risks of the credit default swap would not be clearly and closely related to the economic characteristics and risks of the host contract.

Paragraph 200F is added as follows:

Example 40: Fully Funded Synthetic CDO. An SPE that holds U.S. Treasury securities and that wrote a credit default swap on a referenced credit to a third party, with a smaller notional amount than the U.S. Treasury securities, issues various tranches of credit-linked

beneficial interests to investors that differ in terms of priority for the distribution of cash flows from the SPE. The assets in the SPE are sufficient to fund any losses on the credit default swap. Thus, none of the tranches expose the investor to potential future payments related to defaults on the written credit default swap; the investor cannot lose more than its original investment. Rather, the investor is exposed to a potential reduction in its future cash inflows, which is the effect of the credit-related risk. That reduction in future cash flows is allocated among the tranches by the subordination of one tranche to another. Under paragraph 14B (as revised), the investor's embedded credit derivative feature is not an embedded derivative subject to the application of paragraphs 12, 13, and 14A of Statement 133 because it relates only to the concentration of credit risk in the form of subordination of one tranche to another.

EFFECTIVE DATE AND TRANSITION

The effective date of the implementation guidance in this Issue for each reporting entity is the first day of its first fiscal quarter beginning after December 15, 2008.

At the date of adoption for the implementation guidance in this Issue, an entity shall assess each preexisting contract that was acquired or issued on or after the date of the reporting entity's adoption of FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments,* to determine whether any contract contains one or more embedded credit derivatives that, under the revised paragraph 14B, would no longer qualify for the scope exception in that paragraph. The provisions of paragraphs 12, 13, and 14A shall be applied to such contracts at the date of adoption of this Issue to determine whether the embedded credit derivative is required to be separated from the host contract and accounted for separately. However, if a contract (that is, hybrid instrument) would be required to be separated into a host contract and a derivative instrument and if the contract is a hybrid financial instrument, the entity may irrevocably elect to initially and subsequently measure that contract in its entirety at fair value (with changes in fair value recognized in earnings). The fair value election shall be determined on an instrument-by-instrument basis and supported by documentation completed by the end of the fiscal quarter of initial adoption. If the fair value election is not elected for a hybrid contract that is required to be separated into a host contract and a derivative instrument under the revised paragraph 14B, the carrying amount of the host contract at adoption of this Issue would be based upon a pro forma bifurcation as of the inception of the hybrid contract and the host contract's subsequent accounting to the date of adoption.

At adoption, any difference between the total carrying amount of the individual components of the existing bifurcated hybrid instrument and the carrying amount of the combined hybrid instrument prior to bifurcation should be recognized as a cumulative-effect adjustment to beginning retained earnings for the period of adoption. 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.

BASIS FOR CONCLUSIONS

Following a December 11, 2008 administrative meeting, the Board Chairman decided to add a project to the FASB's technical agenda that would provide clarifying language to Statement 133 regarding when embedded credit derivative features, including those in CDOs and synthetic CDOs, are not considered embedded derivatives subject to potential bifurcation and separate accounting. The objective of this Implementation Issue is to improve financial reporting by resolving some potential ambiguity about the breadth of the embedded credit derivative scope exception in paragraph 14B.

Need for Guidance

Questions have arisen in practice about the intended breadth of the embedded credit derivative scope exception in paragraph 14B. It is clear that the concentration of credit risk in the form only of subordination of one financial instrument to another shall not be considered an embedded derivative under Statement 133 and, thus, not be subject to potential bifurcation and separate accounting under paragraphs 12, 13, and 14A. There is some ambiguity in practice about what is meant by the first sentence in paragraph 14B and whether other embedded credit derivative features, including those in some CDOs and synthetic CDOs, are considered not to be embedded derivatives subject to the application of paragraphs 12, 13, and 14A of Statement 133.

In particular, Board members were concerned about the application of the scope exception in paragraph 14B to all embedded credit derivatives, even to embedded credit derivative features (such as a credit default swap on unrelated public company debt) that are not clearly and closely related to the host contract. That broad application of the scope exception for embedded credit derivatives exceeds what was intended by Board members and is not supported in Statement 155's basis for conclusions, paragraphs A21–A24. Consequently, the Board decided to amend paragraph 14B and to provide the guidance in this Implementation Issue. The Board emphasized that credit risk that is not related only to the subordination of one financial instrument to another must be evaluated under paragraphs 12, 13, and 14A.

The Board also realizes that the application of the scope exception in paragraph 14B is not a relevant issue for some synthetic CDOs (such as certain interests in an unfunded synthetic CDO) because the contract may meet the definition of derivative in its entirety. The embedded derivative provisions of paragraphs 12, 13, and 14A do not apply to a contract that meets the definition of a derivative in its entirety.

[Refer to separate document (allissuesp2.pdf) for Implementation Issues in Sections D through K.]