November 21, 2005

Ms. Suzanne Q. Bielstein
Director—Major Projects and Technical Activities
Mr. Lawrence W. Smith
Director—Technical Application and Implementation Activities
Financial Accounting Standards Board
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Dear Ms. Bielstein and Mr. Smith:

The American Securitization Forum ("ASF"), the International Swaps and Derivatives Association ("ISDA") and the Securities Industry Association ("SIA") are pleased to offer the following comments in response to the Financial Accounting Standards Board's ("FASB" or "Board") Working Draft (the "Working Draft") of Statement of Financial Accounting Standards No. 15X, *Fair Value Measurements* and the Proposed FASB Staff Position (the "Proposed FSP") No. FAS 133-a, "Accounting for Unrealized Gains (Losses) Relating to Derivative Instruments Measured at Fair Value under Statement 133."

The comments that follow were developed and are being presented jointly by a working group (the "Joint Industry Working Group" or "JIWG") composed of representatives of the respective accounting policy committees of ASF, ISDA and SIA. Collectively, the membership of these committees have substantial professional expertise and practical experience addressing the accounting policy issues and questions raised by this tentative guidance with respect to financial instruments. A description of our organizations is contained in Attachment I.

While this comment letter contains several observations and comments related to the Working Draft and the Proposed FSP, the following is a summary of the key observations and comments that we believe are worth highlighting:

- *Rebuttal of the Transaction Price Presumption:* The Working Draft suggests and the Proposed FSP states that the transaction price presumption cannot be rebutted in the reference market. As written we do not believe this concept is consistent with the FASB's intent and may create unintended consequences. We believe that the transaction price presumption can be rebutted regardless of the market as long as there is persuasive evidence to the contrary.
- *Disclosures of Change in Unrealized Gains and Losses:* The Working Draft requires disclosure of the change in unrealized gains or losses during the period relating to assets and liabilities remeasured at fair value during the period that are still held at the reporting date if the estimates fall within Level 5. We strongly recommend that the FASB remove this disclosure requirement in consideration of the costs and benefits of providing such information.

- *Scope of the Proposed FSP:* The scope of the Proposed FSP and its interaction with the Hybrid Instruments Exposure Draft and Statement 133 is not clearly articulated. We recommend that the Board clarify that the scope of the Proposed FSP should be applied to standalone or bifurcated derivatives only.
- *Disclosures of Unrealized Gains and Losses:* The Proposed FSP requires disclosure of gross unrealized gains and losses at initial recognition of a derivative instrument recognized in income during the current period. We strongly recommend that the FASB not include this disclosure requirement for reasons discussed in more detail in this comment letter.
- *Transition and Interim Period Disclosures:* The transition provisions in the Proposed FSP and the Working Draft (for blocks) require that an entity disclose the effect of the change on income before applying the Proposed FSP in all interim periods for the fiscal year in which the Proposed FSP is adopted. Because this will require significant operational and administrative burdens and because we question the usefulness of the information, we recommend that the transition provisions not be applied to all interim periods within the fiscal year it is adopted.

COMMENTS ON THE FAIR VALUE MEASUREMENTS WORKING DRAFT

The Joint Industry Working Group appreciates that the FASB has made the Working Draft of the Fair Value Measurements Statement available to the public and is supportive of the FASB's objective of developing a framework to clarify the fair value measurement objective and its application. We also appreciate the Board incorporating our comments from previous letters into the Working Draft. We would like to take this opportunity to comment on a few remaining matters in the Working Draft. Although the FASB did not specifically solicit comments, the Joint Industry Working Group believes that certain clarifications would enhance the usefulness of a final Statement and improve its application.

Rebuttal of the Transaction Price Presumption

The Working Draft provides a presumption that the transaction price represents fair value at initial recognition of a transaction and can be rebutted if there is persuasive evidence to the contrary. It states in the Basis for Conclusions, paragraph C48, that:

> "…the transaction price represents the clearing (or equilibrium) price in the reference market for the asset or liability."

This notion that the transaction price represents fair value in the reference market is further elaborated upon in paragraph 3(a) of the Proposed FSP:

> "The transaction price presumption is not rebutted at initial recognition of the derivative instrument if the market in which the transaction occurs is the reference market for the derivative instrument. That would often be the case if the entity is the purchaser of the

derivative instrument (the customer). In that case, the estimate of the fair value of the derivative instrument shall be the price in that market (the transaction price)."

Footnote 3 of Paragraph 4 of the Proposed FSP further indicates that:

> "If the transaction price presumption is not rebutted at initial recognition of the derivative instrument, the transaction price and the estimate of the fair value of the derivative instrument should be the same. Therefore, there is no unrealized gain (loss)."

These phrases imply that if a derivative transaction occurs in a reference market that the transaction price presumption cannot be rebutted and therefore, there is no day one profit (loss) to be recognized. However, in the inter-dealer securities and derivatives markets, transactions may occur at or nearer to the bid or ask, not necessarily at the mid-market price. While the spread is narrower in the inter-dealer market, the spread has not been eliminated.

We do not believe that the FASB intended to imply that initial unrealized gains and losses do not exist in all reference markets, including a dealer market in securities or derivatives. We believe paragraph 27 of the Working Draft more clearly represents the Board's intent with respect to this issue, which states:

> "If a price in an active market is quoted in terms of bid and asked prices (for example, in an active dealer market where the bid price represents the price the dealer is willing to pay and the asked price represents the price at which the dealer is willing to sell), the estimate of fair value shall represent the price within the bid-asked spread at which marketplace participants would currently transact. For offsetting positions in the same instrument, the same price shall be used to estimate the fair value of both the long and short positions."

In addition, other issues exist if the transaction price presumption cannot be rebutted when the transaction occurs in the reference market. The Proposed FSP indicates in paragraph 5 that:

> "In subsequent periods, changes in the fair value of the derivative instrument shall be recognized in income (or other comprehensive income) in accordance with the provisions of Statement 133. For purposes of recognizing changes in the fair value of the derivative instrument in subsequent periods, the minimum reliability threshold (paragraph 4) does not apply."

The Working Draft states in paragraph 16 that:

> "In periods subsequent to initial recognition in which an asset or liability is remeasured at fair value, the estimate of fair value shall be updated so that it represents the price at which marketplace participants would currently transact."

For transactions in the reference market, we believe that these paragraphs, taken together, could lead to some unintended consequences. For example, consider a derivative asset classified in Level 5 of the fair value hierarchy that is transacted in the reference market at a price of $10. Assume the model value is $12, and thus there exists a day one profit of $2. The day one profit is not recognized (as a deferred credit) because the transaction occurred in the reference market. Therefore, there is a discrepancy between the fair value of $12 and the carrying amount of $10 for the derivative asset. Then, assume at day two the fair value is now $13. The derivative asset could be marked to its fair value of $13 in accordance with how we interpret paragraph 16 of the Working Draft, thus immediately realizing the day one gain of $2 and an additional $1 upon the mark to fair value. We do not believe that this is the intent of the Board.

We recommend that the final FSP allow for the transaction price presumption to be rebutted regardless of the market as long as there is persuasive evidence to the contrary and retain such as a principle without exceptions. In addition, we recommend that the Board delete all references in the Working Draft, including its Basis for Conclusions, and in the Proposed FSP, that indicate the transaction price presumption cannot be rebutted in the reference market. We further recommend that an additional example be added to paragraph 15 of the Working Draft that illustrates another case when the transaction price presumption may be rebutted. We suggest the following example:

> A dealer transacts in the inter-dealer market, which is its reference market, and there is persuasive evidence that a bid-asked spread exists which the dealer may earn, pay away or split in a given transaction.

Disclosures of Change in Unrealized Gains and Losses

Paragraph 36(b) of the Working Draft requires disclosure of:

> "The change in unrealized gains or losses during the period relating to assets and liabilities remeasured at fair value during the period that are still held at the reporting date if the estimates fall within Level 5."

Consistent with our views expressed in our prior comment letters, we support the general concept behind the required disclosures to provide information to users regarding the reliability of the fair value estimates contained in the financial statements. However, we continue to question whether a requirement to disclose the change in unrealized gains or losses provides useful information to users of financial statements, particularly in the context of fair value accounting for derivative and financial instruments. As other disclosures in the Working Draft require disclosure of fair value estimates by hierarchy level and total gains and losses for fair value estimates, it is not clear what incremental beneficial information is obtained through the above mentioned disclosure or how the disclosure furthers the Board's objective. Consider the example of a derivative contract in a net unrealized gain position at the beginning of a period which reports zero change in value in the income statement for the period. This revenue of zero could be composed of a realized gain due to the receipt of contractual cash flows during the period and the related reversal of a portion of the initial unrealized gain. The reversal of the unrealized gain would be reported as an unrealized loss under the disclosure requirements of the Fair Value Measurements Statement and we question how the disclosure of this change in unrealized gain or loss due to the realization of cash improves financial reporting. Note that this disclosure will require significant systems and operational process changes as the change in unrealized gain or loss is not consistent with the manner in which most firms evaluate profitability, which is on a total gain or loss basis. We ask the FASB to consider the costs and benefits associated with providing this information and more clearly articulate the benefits to users of such information.

Further, we do not believe that the disclosure of the change in unrealized gains and losses for Level 5 estimates provides useful information. Consider the disclosure of the unrealized gain (loss) for a financial instrument in Level 5 while portions of the risk of that instrument may be economically hedged by another instrument that falls within a different level of the hierarchy. The offsetting gain or loss on the hedging instrument would be recognized in the income statement, but will not be shown as an offset in this disclosure of unrealized gains (losses). The disclosure of unrealized gains (losses) solely related to Level 5 instruments may fail to illustrate the economics of a transaction, thereby providing users with information that may not accurately convey how the entity manages its risks.

We acknowledge the perception by some that unrealized gains and losses result in a lower quality of earnings than realized gains and losses; however, unrealized gains and losses are an essential component of a fair value measurement model and we believe that the Working Draft contains significant other disclosures that provide information to readers to mitigate such concerns without obfuscation. We recommend the FASB remove the disclosure requirement from paragraph 36(b) of the Working Draft, particularly for derivative instruments.

COMMENTS ON THE PROPOSED FSP FAS 133-A

The Joint Industry Working Group is supportive of the FASB's objective of addressing the accounting for unrealized gains or losses associated with derivative instruments measured at fair value under Statement of Financial Accounting Standards No. 133 ("Statement 133"), *Accounting for Derivative Instruments and Hedging Activities*. This is an important issue and the JIWG appreciates the FASB's effort to make the accounting for unrealized gains (losses) related to derivatives consistent in practice. The Joint Industry Working Group believes the following comments will clarify the application of the Proposed FSP.

Scope of the Proposed FSP

Paragraph 3 of the Proposed FSP requires it be applied to transactions "involving a derivative instrument." In the Exposure Draft, *Accounting for Certain Hybrid Financial Instruments, an amendment to FASB Statements No. 133 and 140*, paragraph 3(c) that amends paragraph 16 of Statement 133 states:

> "Upon identifying a hybrid financial instrument that under paragraph 12 would be required to be separated into a host contract and a derivative instrument, an entity may, at inception, irrevocably elect to remeasure that hybrid financial instrument in its entirety at fair value (with changes in fair value recognized in earnings)."

It is not clear to us how the Proposed FSP would interact with the provisions of the Exposure Draft relating to hybrid instruments that are remeasured in their entirety at fair value with changes in fair value recognized in earnings. We recommend that the Board clarify that the Proposed FSP applies only to standalone or bifurcated derivatives and specifically excludes those embedded derivatives that are clearly and closely related to the economic characteristics and risks of the host contract, as well as those hybrid instruments that are remeasured at fair value in their entirety under otherwise applicable generally accepted accounting principles with changes in fair value reported in earnings as they occur.

Amendment to Statement 133 Implementation Issue B6

We believe that the unintended consequences caused by the inability to rebut the transaction price presumption in one's reference market with persuasive evidence are even more pronounced in the Proposed FSP's amendment to Statement 133 Implementation Issue B6 ("Issue B6"). While we understand and support the Board's intent to achieve recognition consistency for embedded and freestanding derivatives, the amendments as drafted could lead to recognition, not deferral, of day one profit (loss) on Level 5 derivatives embedded in hybrid instruments transacted in one's reference market. Due to the inclusion of the reference market language in the first two paragraphs of the Response in Issue B6, day one profit (loss) on Level 5 derivatives may be either amortized over the life of the hybrid, or recognized in its entirety on the day two remeasurement of the bifurcated derivative's fair value. We enclose an analysis and related bifurcation journal entries illustrating these issues in Attachment II.

We therefore reiterate our recommendation that the rebuttal of the transaction price presumption by persuasive evidence be consistent in both non-reference and reference markets. In Attachment II, we also recommend specific drafting changes to the Issue B6 amendment in order to ensure that, applied in practice, embedded derivative recognition will be similar to that of freestanding derivatives.

Further, we believe that paragraph 18 of the Proposed FSP clearly articulates the Board's principles regarding the application of Issue B6 and recommend that the discussion be included in the actual amendment to Issue B6 as it clearly states the principle of the amendment. We recommend that paragraph 19 of the Proposed FSP be reconciled with paragraph 18 or be deleted in its entirety, as recognition of a gain or loss on the host contract is inconsistent with the paragraph 18 principle of similar recognition for components of a hybrid instrument whether transacted on a freestanding or combined basis.

Disclosures of Unrealized Gains and Losses

Paragraph 6(a) of the proposed FSP requires that an entity disclose:

> "Gross unrealized gains and losses at initial recognition of a derivative instrument recognized in income during the current period."

Since the FASB has concluded that the gross unrealized gain (loss) recognized during the period for transactions in Levels 1 through 4 have met the minimum reliability threshold, we fail to understand the significance of this disclosure and question its usefulness to users of financial statements. We continue to believe the most meaningful information to disclose is the deferred unrealized gains (losses) and those gains (losses) that were not initially recognized in the income statement because they did not meet the minimum reliability threshold, but have subsequently been recognized in the income statement. That information is required to be disclosed under paragraph 6(b) of the Proposed FSP.

We emphasize that the disclosure required by paragraph 6(a) will require significant systems and operational process changes, and therefore significant costs, as the gross unrealized gain or loss apart from portfolio market movement gains or losses are not currently recorded at initial recognition in the systems that firms use for their derivatives, especially for those that are priced using observable market inputs where any day one profit (loss) is not deferred under current accounting requirements. In addition, for dealers in derivatives there may be considerable intraday trade activity for which this information is not currently tracked. Segregating profit (loss) at the moment of a trade as opposed to profit (loss) generated by intraday market movements on the volume of more liquid trades is much more subjective than objective and we fail to see the benefit of providing such information. We question whether this disclosure requirement meets a significant need of users of financial information and question whether or not the costs it imposes are justified in relation to the overall benefits.

We urge the FASB to refrain from imposing derivative disclosure requirements on a piecemeal basis, but develop a more comprehensive disclosure framework for derivative instruments in the Derivatives Disclosure project where issues surrounding the disaggregation of changes in the fair value of derivatives can be more fully vetted. Therefore, we strongly recommend that the FASB not include the disclosure requirement in paragraph 6(a) as part of the requirements of the Proposed FSP.

Transition and Interim Period Disclosures

Paragraph 10 of the Proposed FSP contains the following transition provisions:

> "This FSP shall be applied retrospectively as of the beginning of the fiscal year in which this FSP is initially applied. An offsetting adjustment, if any, shall be made to the opening balance of retained earnings for that fiscal year. In the fiscal year in which this FSP is initially applied, *and in all interim periods within that fiscal year*, an entity shall disclose the effect of the change in accounting principle on income before extraordinary

> items and any affected per-share amounts, if applicable (FASB Statement No. 154, Accounting Changes and Error Corrections, paragraphs 17(b)(2) and 18)." [Emphasis added]

The transition provisions in the Proposed FSP, the Working Draft (for blocks) and Statement 154 require that an entity disclose the effect of the change on income before applying the Proposed FSP in all interim periods for the fiscal year in which the Proposed FSP is adopted. While we understand that this requirement originates from Statement 154, we struggle to understand its importance for the Proposed FSP.

Requiring disclosure of the effect of the change in accounting principle on income for all interim periods in the fiscal year when the Proposed FSP has been adopted will require significant operational and administrative burdens. To apply the Proposed FSP companies would have to (1) maintain their previous accounting systems in place in addition to their new systems for the entire year in which a company adopts the Proposed FSP, (2) make decisions related to recognition/deferral of day one profit (loss) based on both superseded accounting guidance and new accounting guidance and (3) obtain the historical information needed to show the impact of applying the Proposed FSP to previous interim periods if not adopted at the beginning of the fiscal year.

We also noted similar transition provisions are required for blocks in the Working Draft. We believe the administrative costs to disclose the current accounting for interim periods before and after adoption of the Proposed FSP and the block requirements of the Working Draft are significant in comparison to the benefit provided to users. We question the usefulness of providing the interim information based on previous accounting principles given the FASB's conclusion that the Proposed FSP and the Working Draft will improve financial reporting.

Therefore, we recommend that the FASB not require disclosure of the effects of the Proposed FSP as well as the effect of paragraph 28 of the Working Draft relating to blocks be applied for all interim periods within the fiscal year it is adopted.

ADDITIONAL COMMENTS ON THE FAIR VALUE MEASUREMENTS WORKING DRAFT

Levels 3 and 4 of the Fair Value Hierarchy

Paragraph 32 of the Working Draft states:

> "Level 3 inputs are market inputs other than quoted prices that are directly observable for the asset or liability. If the asset or liability is a financial instrument, a Level 3 input must be observable over the full term of the instrument. Examples include interest rates, yield curves, volatilities, and default rates."

While it is helpful that the FASB provided examples of what are considered observable inputs for financial instruments classified within Level 3, which includes interest rates and particularly yield curves, we continue to believe the language in the Working Draft could be read to imply that normal interpolation between observable market input points that are directly related to the asset or liability would not be included in Level 3. This is particularly true given the language for Level 4 estimates in paragraph 33 of the Working Draft which states:

> "Level 4 inputs are market inputs that are not directly observable for the asset or liability but that are corroborated by other market data through correlation or by other means, thereby incorporating market data that are observable (market-corroborated inputs). If the asset or liability is a financial instrument, a Level 4 input must be corroborated by other market data over the full term of the instrument. Examples include inputs that are derived through extrapolation or *interpolation*." [Emphasis added]

Given that for Level 3 financial instruments the FASB states that an example of market inputs that are observable includes yield curves, it implicitly supports the notion that Level 3 estimates include anything that is interpolated using observable market data. However, without explicitly including interpolation in Level 3, we believe there will be diversity in practice in interpreting and applying Levels 3 and 4 of the fair value hierarchy based on discussions amongst representatives of the Joint Industry Working Group.

For example, market participants consider the entire USD Libor swap curve to be observable as any desired point on the curve can be interpolated using commonly accepted calculations; however, direct market inputs would be available only for certain points along the curve (for example, four-year, five-year, etc.). In applying the current definition of Level 3, we believe that a 5-year plain vanilla USD interest rate swap would be grouped in Level 3 on day one because there are direct market inputs for the swap, and then in the next quarter when it becomes a 4 year 9 month swap, it could be grouped in Level 4 because the data must be interpolated. We believe that the FASB's intent with respect to interpolation in Levels 3 and 4 was to differentiate interpolation of inputs between similar assets or similar liabilities as opposed to interpolation within inputs directly related to the asset or liability being priced.

Therefore, to encourage consistent application we recommend that the FASB explicitly define Level 3 inputs to include interpolated market inputs and suggest the following wording:

> "Level 3 inputs are market inputs other than quoted prices that are directly observable for the asset or liability. If the asset or liability is a financial instrument, a Level 3 input must be observable <u>at the commonly quoted intervals</u> over the full term of the instrument. Examples include interest rates, yield curves, volatilities, and default rates."

We appreciate the FASB incorporating some of the concepts we have suggested in previous comment letters regarding Level 4 estimates into the Basis for Conclusions of the Working Draft. However, because of the significance of those concepts, we recommend the FASB incorporate them into the definition of Level 4 and the main body of the final Fair Value Measurements Statement, and suggest the following wording for Level 4 estimates:

> "Level 4 inputs are market inputs that are not directly observable for the asset or liability but that are derived principally from or corroborated by other market data through correlation or by other means, thereby incorporating market data that are observable (market-corroborated inputs). If the asset or liability is a financial instrument, a Level 4 input must be corroborated by other market data over the full term of the instrument. Examples include inputs that are derived through extrapolation or interpolation."

CONCLUSION

The Joint Working Group appreciates the opportunity to provide the foregoing comments. Should you have any questions or desire any clarification concerning the matters addressed in this letter please do not hesitate to contact any of the undersigned at the telephone numbers provided, or Robert Pickel, Director and CEO of ISDA at 212.901.6020, George Miller, Executive Director of the ASF at 646.637.9216 or Jerry Quinn, Vice President and Associate General Counsel of SIA at 212.618.0507.

Sincerely,

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Attachment I

The American Securitization Forum is a broadly-based professional forum of participants in the U.S. securitization market. Among other roles, the ASF members act as issuers, underwriters, dealers, investors, servicers and professional advisors working on securitization transactions. More information about the ASF and their respective members and activities may be found at the ASF's internet website, located at www.americansecuritization.com.

ISDA is the global trade association representing leading participants in the privately negotiated derivatives industry. ISDA was chartered in 1985, and today has more than 600 member institutions from 46 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

The Securities Industry Association, established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Banker's Association, brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs 790,600 individuals. Industry personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2003, the industry generated $213 billion in domestic revenue and an estimated $283 billion in global revenues. (More information about SIA is available on its home page: www.sia.com.)

Attachment II

Amendment to Statement 133 Implementation Issue B6

Paragraph 8 of the Proposed FSP amends Statement 133 Implementation Issue B6 ("Issue B6") and states:

> "If the reference market in which the transaction occurs is the reference market for the hybrid instrument and the embedded derivative, 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 (that is, the transaction price) 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.
>
> "If the reference market in which the transaction occurs is not the reference market for the hybrid instrument or the embedded derivative, an unrealized gain (loss) component related to the hybrid instrument should be separately recognized as a deferred credit (debit) or in income for the period in accordance with the provisions of FASB Staff Position FAS 133-a, 'Accounting for Unrealized Gains (Losses) Relating to Derivative Instruments Measured at Fair Value under Statement 133.' The initial carrying value assigned to the host contract shall be determined as the difference between the basis of the hybrid instrument (that is, the transaction price) and the fair value of the embedded derivative less the unrealized gain (loss) component." [Footnote omitted]

Based on our understanding of the paragraphs above, we believe the journal entries below are those that would be required upon application of the Proposed FSP. We use the example below to demonstrate the inconsistency that still remains between the accounting for the day one profit (loss) for an embedded derivative and a standalone derivative, particularly with respect to the proposed concepts surrounding transactions occurring in the reference market.

Consider a hybrid instrument classified within Level 5 of the hierarchy issued with a transaction price of $100, a fair value of $98 and a day one profit of $2 attributable to the embedded derivative. Assume that the Level 5 embedded derivative, which for purposes of the example is required to be separated from the host contract, has a fair value of $8. The following journal entries represent the current accounting requirements under Issue B6 for this example:

<u>Current Accounting under Issue B6</u>

Cash	$100	
Debt		$92
Embedded Derivative		$8

To record the issuance of the debt and separation of the derivative from the host contract

If the derivative's day one profit of $2 were to be recognized upfront, the debt would have had a carrying value of $90, resulting in a $10 discount amortized into interest expense over the life of the hybrid instrument. The current interpretation of Issue B6 requires that the profit of $2 must be embedded in the host contract, which changes the initial carrying value from $90 to $92, and results in decreased interest expense and subsequent amortization of the day one profit of $2 over the life of the hybrid instrument.

Consider the following journal entries for the same scenario above, but assume the transaction does *not* take place in the reference market for either the hybrid instrument or the embedded derivative and is subject to the accounting requirements of the Proposed FSP:

<u>Example 1 – Hybrid Instrument or Embedded Derivative *Not Transacted* in the Reference Market</u>

Cash	$100	
Debt		$90
Embedded Derivative		$8
Deferred Gain		$2

To record the issuance of the debt, separation of the derivative from the host contract and the deferred gain

We believe that the result in Example 1 is as the Board intended. Profit is deferred, and not implicitly amortized over the life of the hybrid instrument.

Consider the following journal entries for the same scenario above, but assume the transaction occurs *in the reference market* for both the hybrid instrument and the embedded derivative and is subject to the accounting requirements of the Proposed FSP. This example also assumes that it is the Board's intent that the "fair value" of the bifurcated derivative be presumed to equal the transaction price of the bifurcated derivative, if so day one profit (loss) on the Level 5 derivative may be recognized on day two. In this example, the transaction price (composed of the derivative model value of $8 plus the gain on the derivative of $2) is presumed to be the fair value of the embedded derivative, and is therefore the basis for the "with and without" calculation outlined in the first paragraph of the amended Response.

<u>Example 2a – Hybrid Instrument and Embedded Derivative Both *Transacted* in the Reference Market</u>

Cash	$100	
Debt		$90
Embedded Derivative		$10

To record the issuance of the debt and separation of the derivative from the host contract

The Level 5 embedded derivative would be subsequently remeasured according to how we interpret paragraph 16 of the Working Draft. The remeasurement to the new estimate of fair value used by market participants in possession of persuasive evidence would release the gain on the derivative on the subsequent remeasurement, even though the instrument is classified within Level 5.

If however it is the Board's intent that the fair value of the bifurcated derivative equal the model value of the bifurcated derivative then day one profit (loss) on the Level 5 derivative may be amortized.

Example 2b – Hybrid Instrument and Embedded Derivative Both *Transacted* in the Reference Market

Cash	$100	
Debt		$92
Embedded Derivative		$8

To record the issuance of the debt and separation of the derivative from the host contract

Assuming in this example that the derivative "fair value" basis for the "with and without" method is the modeled value of $8, this bifurcation would result in a higher allocation to the debt ($92 vs. $90) resulting in a lower originally issued discount amount and a lower interest expense recognized over the life. The difference of $2, which represents the day one profit, is implicitly recognized in the income statement over the life of the debt.

We reiterate our recommendation that the reference market paragraphs be removed from the Proposed FSP and incorporated with our suggested amendments in the Fair Value Measurements Statement.

We recommend that the Proposed FSP amend the Issue B6 Background item number 2 as follows:

> 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 and the unrealized gain or loss component related to the embedded derivative (a "with and without" method based on the fair value of the embedded derivative).

We recommend that the Proposed FSP amend the Issue B6 Response as follows[1]:

> **RESPONSE**
> ~~If the reference market[1] in which the transaction occurs is the reference market for the hybrid instrument and the embedded derivative, t~~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, ~~(that is, the transaction price) and~~ the fair value of the embedded derivative, and the unrealized gain (loss) component related to the embedded derivative (#2 above) should be used to determine the carrying values of the host contract component and the embedded

[1] Note that the changes made to Issue B6 assume the FASB's proposed changes in the Proposed FSP were implemented, and therefore it shows how we would amend Issue B6 as it appears in the Proposed FSP and not in Statement 133.

derivative component of a hybrid instrument when separate accounting for the embedded derivative is required by Statement 133. <u>The unrealized gain (loss) component related to the embedded derivative should be recognized in accordance with paragraph 4 of FSP FAS 133-a.</u>

~~If the reference market in which the transaction occurs is not the reference market for the hybrid instrument or the embedded derivative, an unrealized gain (loss) component related to the hybrid instrument should be separately recognized as a deferred credit (debit) or in income for the period in accordance with the provisions of FASB Staff Position FAS 133-a, "Accounting for Unrealized Gains (Losses) Relating to Derivative Instruments Measured at Fair Value under Statement 133." The initial carrying value assigned to the host contract shall be determined as the difference between the basis of the hybrid instrument (that is, the transaction price) and the fair value of the embedded derivative less the unrealized gain (loss) component.~~

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 reference market in which the transaction occurs is the reference market for the hybrid instrument and the embedded derivative and~~ 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[2], 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*. [Emphasis added.]

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[1] The term *reference market* is used consistent with its use in FASB Statement No. 15X, *Fair Value Measurements*.

<u>[2] We do not believe that the reference market amendment to the discussion of the combined versus separated fair values of the hybrid instrument components is required based on the Board's view that the deferred credit does not comprise part of the fair value of an instrument. In our example, the fair value of the hybrid is $98, and the combined carrying value of the host and the bifurcated derivative should not exceed that amount, regardless of the market in which the hybrid instrument is traded.</u>

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.

EFFECTIVE DATE

The revisions made on [XXX] reflect the issuance of FSP FAS 133-a. The effective date of the [XXX] revisions to the implementation guidance in this Issue for each reporting entity is the first day of the fiscal quarter in which the entity initially applies FSP FAS 133-a.