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Financial Services



On-Call Accounting Alert

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FASB Posts Proposed Guidance on Embedded Credit Derivatives to its Website for Public Comment

As previously discussed in our December 16, 2008 On-Call Accounting Alert, the FASB added a short-term project to its agenda during its December 15, 2008 Board meeting to expeditiously address certain matters regarding the accounting for financial instruments that require immediate attention, most of which emanated from the series of roundtable discussions sponsored by the U.S. Securities and Exchange Commission on fair value accounting, as well as the three joint IASB and FASB roundtables on prominent issues arising from the recent dislocation in the global financial markets. One of the matters the FASB agreed to address as part of this short-term project on financial instruments is application of FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140* ("SFAS 155"), and the diversity the FASB staff believes exists in how practitioners interpret the embedded credit derivative scope exception in paragraph 14B of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* ("SFAS 133").

On January 14, 2009 the FASB posted to its website its proposed amendments to SFAS 133 in the form of SFAS 133 Implementation Issue No. C22, *Scope Exceptions: Exception Related to Embedded Credit Derivatives*, which are intended to clarify when embedded credit derivatives, including those in collateralized debt obligations (CDOs) and synthetic CDOs, are not considered embedded derivatives that must be separately accounted for at fair value with changes reported in earnings. The stated objective of the SFAS 133 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 of SFAS 133. The Implementation Issue added two additional examples illustrating application of SFAS 155: (i) a partially funded synthetic CDO and (ii) to a fully funded synthetic CDO. These examples are intended to clarify that a holder of a contract must bifurcate embedded credit derivatives that could require a holder to make potential payments back to the issuer, and not merely suffer reduced cash inflows on its investment. Based on the implementation guidance, it appears that the prior accounting conclusions under SFAS 155 for a large number of structured credit products will not be impacted.

The effective date of the implementation guidance in this Implementation Issue for each reporting entity is the first day of its first fiscal quarter beginning after December 15, 2008. The proposed clarifications will provide that, upon adoption of the guidance in the Implementation Issue, an entity shall assess only those preexisting contracts that were acquired or issued on or after the date of each reporting entity's adoption of SFAS 155, determining whether any of those contracts contains one or more embedded credit derivatives (assuming the entire contract is not a freestanding derivative instrument) 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 for the implementation guidance to determine whether the embedded credit derivative is required to be separated from the host contract and accounted for separately. However, if a hybrid financial instrument would be required to be separated into a host contract and a derivative 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 concurrent documentation.

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.

The public comment period for this proposed guidance ends on February 13, 2009. Please find a link to the proposed amendment on the FASB's website immediately below.

http://www.fasb.org/derivatives/01-14-09_C22.pdf

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