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Letter of Comment No: 35
File Reference: 1100-163
Date Received: 7/9/02

July 9, 2002

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File Reference 1100-163
Proposed Amendment to Statement 133 on Derivative Instruments and Hedging Activities

FASB Staff Guide to Implementation of Statement 140 on Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities - Questions and Answers Related to Derivative Financial Instruments Held or Entered into by a Qualifying Special-Purpose Entity (SPE)

Dear Ms. Bielstein:

Enclosed is our letter of comment on the FASB's Exposure Draft of a Proposed Statement of Financial Accounting Standards, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*, dated May 1, 2002 and the tentative conclusions reached in the Questions and Answers Related to Derivative Financial Instruments Held or Entered into by a Qualifying Special-Purpose Entity that will be included in the FASB staff's Guide to Implementation of Statement 140 on Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.

If you have any questions concerning our comments, please contact John T. Smith at (203) 761-3199.

Yours truly,

**Deloitte
Touche
Tohmatsu**



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Dear Ms. Bielstein:

We are pleased to comment on the FASB's Exposure Draft of a Proposed Statement of Financial Accounting Standards, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* (the "Amendment"), dated May 1, 2002 (the "Exposure Draft" or "ED") and the tentative conclusions reached in the Questions and Answers Related to Derivative Financial Instruments Held or Entered into by a Qualifying Special-Purpose Entity (SPE) that will be included in the FASB staff's Guide to Implementation of Statement 140 on Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (the "Statement 140 Q&As").

We commend the FASB for its efforts to find workable solutions that improve the application of Statement 133 and recognize the complicated and unique aspects of the use of derivatives in business activities. We generally agree with the proposed amendments in the Exposure Draft and support the issuance of the Amendment as a final standard. Our specific comments relating to the Exposure Draft and Statement 140 Q&As for your consideration are summarized in Appendix I and Appendix II, respectively, to this letter.

Although we believe the issuance of the Amendment will improve Statement 133 currently, we believe the FASB should continue to improve the accounting for financial instruments and, in

particular, derivative instruments. We are concerned that as the guidance on derivatives and hedging activities has evolved, it has become voluminous and complex. Following the issuance of the Amendment, the guidance will consist of four Statements of Financial Accounting Standards, over 150 Statement 133 Implementation Issues and several Emerging Issues Task Force Issues. We suggest that the FASB consider devoting resources to consider ways in which the accounting for financial instruments could be changed to provide more intuitive results and to reduce complexity and facilitate the operation of the standard. It may make sense to form a working group to develop alternatives and recommend next steps for a project to potentially result in an approach that will achieve the above mentioned objectives. We would be willing to assist the FASB in these next steps.

If you have any questions regarding our response, please contact John T. Smith at 203-761-3199.

Sincerely,

APPENDIX I
DELOITTE & TOUCHE LLP COMMENTS
FASB EXPOSURE DRAFT, PROPOSED STATEMENT OF FINANCIAL
ACCOUNTING STANDARDS, AN AMENDMENT OF STATEMENT 133 ON
DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

Definition of a Derivative

Paragraph 22(b) of the ED amends paragraph 57(c)(3) to incorporate guidance in Statement 133 Implementation Issue A14, *Derivative Treatment of Stock Purchase Warrants Issued by a Company for Its Own Shares of Stock, Where the Subsequent Sale or Transfer is Restricted*. We are unclear as to why this guidance only applies to stock purchase warrants issued by an entity on its own stock. Limiting this guidance to warrants issued by an entity on its own stock and not addressing situations in which the underlying asset is similarly restricted but not the issuer's own stock will lead to confusion over the concept. The reason why it is not readily obtainable if it is issuer's own stock but it is readily obtainable if it is someone else's stock should be made clear. Consider the following example. A sells a call option to B for 100 shares of XYZ Company's publicly traded common stock. The contract may only be physically settled and, if exercised, B may not sell the XYZ shares for a period of 40 days. The 100 shares may be rapidly absorbed in the market without significantly affecting the price. Would the shares of XYZ Company be considered readily convertible to cash?

Paragraph 22(a) of the ED amends paragraph 57(c)(3) to note that the concept of readily convertible to cash shall be applied to a contract throughout its life, not only at its inception. We believe paragraph 57(c)(2) should be similarly amended to include a statement about the notion of a market mechanism that facilitates net settlement in accordance with Statement 133 Implementation Issue No. A18, *Application of Market Mechanism and Readily Convertible to Cash Subsequent to the Inception or Acquisition of a Contract* (DIG Issue A18). Also, DIG Issue A18 should be attributed to this amendment.

Paragraph 539 of Statement 133 includes a flowchart for determining whether a contract is a freestanding derivative subject to the scope of the Statement. This flowchart should be amended to incorporate the proposed amendments in the ED.

Paragraph 21 of the ED amends paragraph 57(b) by adding the following sentences:

An option-based contract is a derivative if it has an initial net investment equal to the fair value of the option component. A non-option-based contract is a derivative if it requires an initial net investment that is less than 5 percent of the fully prepaid amount (as discussed in paragraph 6(b)).

By indicating that such contracts are derivatives, these sentences make the assumption that the contracts meet the other two characteristics of a derivative specified in paragraphs 6(a) and 6(c). We suggest modifying the sentences to indicate that the

contract meets the initial net investment criterion specified in paragraph 6(b) if the conditions mentioned are met.

Normal Purchases and Normal Sales Exception

Paragraph 23(c) of the ED amends paragraph 58(b) to add the specific criteria established in Statement 133 Implementation Issue C15, *Normal Purchase and Normal Sales Exception for Option-Type Contracts and Forward Contracts in Electricity* (DIG Issue C15), for power purchase or sales agreements to qualify for the normal purchase and normal sales scope exception. One of the criteria listed is that the contract must be a capacity contract, as defined in paragraph 29 of the ED. We suggest that paragraph 10(b)(4), as amended by the ED, be clarified by adding “that is a capacity contract” after the parenthetical phrase. The requirement to meet the definition of a capacity contract is important enough to be included in the body of the Statement as opposed to the appendix containing implementation guidance.

Paragraph 29 of the ED amends paragraph 540 to include a definition of capacity contract. The definition states, in part, “A capacity contract for power has characteristics that include, but are not limited, the following.” This definition is different from the guidance in the Appendix to DIG Issue C15 primarily because it is one-sided. The Appendix to DIG Issue C15 is two-sided in that it contains a table that compares the characteristics of a capacity contract to financial options on electricity in order to assist entities in evaluating whether a contract is a capacity contract. We suggest including this table in the definition so the terms of a contract can be weighed against the characteristics of both types of contracts and a judgment can be made.

Based on our interpretation of paragraph 10(b)(3), as amended, a contract that contains optionality features that permit modification of the quantity of assets to be delivered does not qualify for the normal purchases and normal sales exception, even if the embedded option would not meet the definition of a derivative if it was freestanding. For example, if a contract that is a derivative requires delivery of a minimum quantity of units and the buyer has the option to purchase as many additional units that it requires, the option does not contain a notional amount and, therefore, on a stand-alone basis it would not meet the definition of a derivative. Even though the embedded option does not meet the definition of a derivative, we believe this contract does not qualify for the normal purchases and normal sales exception given the guidance in paragraph 10(b)(3). It is not clear whether this is a new interpretation or was always required by Statement 133 Implementation Issues C10, *Can Option Contracts and Forward Contracts with Optionality Features Qualify for the Normal Purchases and Sales Exception*, and C16, *Applying the Normal Purchases and Normal Sales Exception to Contracts That Combine a Forward Contract and a Purchased Option Contract*. The transition guidance should reflect whether this is a new interpretation or was always required.

The last paragraph in subparagraph (b) of paragraph 7 of the ED states “For contracts that qualify for the normal purchases and normal sales exception under paragraph 10(b)(1), the entity shall document the basis for concluding that it is probable that the contract will

result in physical delivery.” This sentence should also reference subparagraph (3) of paragraph 10(b) (i.e., add “and 10(b)(3)” after “10(b)(1)”).

Other Scope Exceptions

Paragraph 7(a) of the ED amends paragraph 10(a) to add guidance for contracts for the purchase and sale of when-, as-, or if-issued or to-be-announced securities. The guidance is somewhat confusing. The second sentence of paragraph 10(a), as amended, states “...a contract for an existing security does not qualify for the regular-way security trades exception if it requires or permits net settlement (as discussed in paragraphs 9(a) and 57(c)(1)), or if a market mechanism to facilitate net settlement of that contract (as discussed in paragraphs 9(b) and 57(c)(2)) exists.” The third sentence then refers to paragraph 59(a) for guidance on contracts to purchase or sell when-, as-, or if-issued or to-be-announced securities, which, in many cases, meet the net settlement criteria in paragraphs 9(a) and/or 9(b). Paragraph 59(a), as amended, indicates that such contracts qualify for the regular-way security trades scope exception if certain criteria are met. The ED would be more accurate if the phrase “*except for* contracts for the purchase and sale of when-, as-, or if-issued or to-be-announced securities that meet the criteria in paragraph 59(a)” was added to the end of the second sentence of paragraph 10(a), as amended, and the third sentence of paragraph 10(a), as amended, was deleted.

Paragraph 7(d) of the ED amends paragraph 10 to include guidance on the accounting for loan commitments based on whether the commitment relates to mortgage loans originated or acquired for investment purposes or mortgage loans originated or acquired that will be held for sale, as discussed in FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*, as amended (Statement 65). The new guidance states that the scope exception for loan commitments that relate to loans originated or acquired for investment purposes applies not only to mortgage loans, but to other types of loans as well. Loan commitments that relate to mortgage loans originated or acquired that will be held for sale are required to be accounted for as derivatives. Many entities analogize to Statement 65 for loans other than mortgage loans and account for such loans as held for sale. The ED is not clear as to whether loan commitments for such loans should also be accounted for as derivatives. We suggest that paragraph 7(d) of the ED be clarified to include all loan commitments related to loans that are held for sale.

Calls and Puts in Debt Instruments

We are confused about the interaction between paragraphs 13, 61(d) and Statement 133 Implementation Issue B16, *Calls and Puts in Debt Instruments* (DIG Issue B16). Paragraph 13 provides guidance for determining whether embedded interest rate derivatives are clearly and closely related to their host contracts and, if amended, will state:

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 [footnote omitted] 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 a 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 (that may be currently remote) under which the embedded derivative would at least double the investor's initial rate of return on the host contract
 - (2) For any 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)(i)) 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 future interest rate scenario) 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) provides implementation guidance on applying paragraph 13 to calls and puts on debt instruments and states, in part:

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. [Emphasis added]

DIG Issue B16 was issued to clarify paragraph 61(d) and created a four-step decision sequence to assist in evaluating calls and puts on debt instruments. Prior to its revision on April 9, 2002, and consistent with paragraph 61(d), DIG Issue B16 indicated that if the amount paid upon settlement of a call or put option on a debt instrument was not indexed to an underlying other than interest rates or credit risk and the debt was not issued at a substantial premium or discount, the call or put option was considered clearly and closely related to the host contract (i.e., the entity does not have to apply Step 4 in DIG Issue B16 and no further analysis is needed). On April 9, 2002, Step 3 and example one in the appendix to DIG Issue B16 were revised to require evaluation under paragraph 13 even if the debt instrument did not involve a substantial premium or discount. This appears to conflict with the guidance in paragraph 61(d), which does not indicate that additional analysis under paragraph 13 is necessary. Consider the following example. Company ABC issues 10-year fixed rate debt with a face amount of \$100 million. ABC pays a

semi-annual coupon of 2.5 %. The debt is callable at par by ABC at any time after 6 months (no contingency). ABC's initial spread to LIBOR is 0.5%. ABC receives proceeds of \$97 million at issuance. Because this instrument does not involve a substantial discount, paragraph 61(d) indicates that ABC would not have to bifurcate an embedded interest rate derivative. However, this instrument appears to include an embedded derivative that must be bifurcated under paragraph 13 based on the following analysis.

Par amount of debt instrument	\$100 million
Issue price	\$97 million
Term of debt instrument	10 years
Coupon (semi-annual payments)	5.0% (annual rate)
Yield to maturity [A]	5.39%
Date initially callable	6 months from issue date
Yield if called at earliest date	11.4%
Double initial rate - [A] * 2	10.8%
Double then-current market rate*	1.0%
Fail paragraph 13a	NO
Fail paragraph 13b	YES

* Calculated assuming worst-case scenario that LIBOR falls to zero; issuer's spread is .5% at inception.

This example illustrates the conflicts between paragraph 13, 61(d) and DIG Issue B16. We are unclear about which situations require the application of paragraph 13 and which do not. If analysis under paragraph 13 is always required for embedded calls and puts in debt instruments that are only indexed to interest rates, then we believe paragraphs 61(d) and DIG Issue B16 are unnecessary. However, the application of paragraph 13 to all callable or puttable instruments (including those that do not involve a substantial premium or discount) will create an operational burden on both issuers and investors in such debt instruments since they will now be required to perform a quantitative analysis. Interestingly, the following is an excerpt from a summary of an Emerging Issues Task Force (EITF) Issue, *The Effect of Dual-Indexation Both to a Company's Own Stock and to Interest Rates and the Company's Credit Risk in Evaluating the Exception under paragraph 11(a) of FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities*, that was included in the EITF Agenda Committee Report, dated March 5, 2002:

View B supporters believe that, based on the guidance in FAS 133 Implementation Issue No. B16, "Embedded Derivatives: Calls and Puts in Debt Instruments," bifurcation is not required. The amount paid pursuant to the put is not adjusted or indexed to something other than interest rates or credit risk, and the debt does not have a significant premium or discount (the notes are expected to be recorded at par).

It appears that the FASB staff did not believe it was necessary to evaluate the put under paragraph 13 once it was determined that the instrument did not involve a substantial premium or discount. As discussed above, we are confused by the amendment to DIG Issue B16.

Embedded Interest Rate Derivatives

Statement 133 Implementation Issue B5, *Investor Permitted, but Not Forced, to Settle without Recovering Substantially All of the Initial Net Investment* (DIG Issue B5), only interprets paragraph 13(a) with respect to an investor's purchased option (e.g., a put option) and states, in part:

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, assuming 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.

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

It is unclear why this issue does not apply by analogy to the guidance in 13(b) with respect to an issuer's embedded purchased call option in a debt instrument. Consider the example described above in the "calls and puts in debt instruments" section. The issuer has the right, but not the obligation, to settle the instrument such that the investor will double its initial yield and the then-current market rate. We believe the logic in DIG Issue B5, which focuses on the option but not the requirement to settle at an unfavorable amount, should apply by analogy such that the embedded derivative would not be required to be bifurcated (that is, if analysis under paragraph 13 is necessary – see comments above).

Paragraphs 9 and 25(a) of the ED cite Statement 133 Implementation Issue B9, *Clearly and Closely Related Criteria for Market Adjusted Value Prepayment Options* (DIG Issue B9), as the reference for the amendments to paragraphs 13(b) and 61(a)(2). We are unsure how DIG Issue B9 relates to the amendments to paragraph 13(b) and 61(a)(2). We recommend that this reference be deleted or the basis for conclusions be expanded to include the reasoning for the reference to DIG Issue B9. This is particularly important because the transition guidance would be different depending on whether or not the amendment relates to an Implementation Issue that has previously been cleared by the FASB Board (the "Board"). Paragraph 39 of the ED indicates that paragraphs 9 and

25(a) relate to guidance in a previously cleared Implementation Issue (i.e., DIG Issue B9) and has been effective in accordance with its respective effective date. If an entity applied paragraphs 13(b) and/or 61(a)(2) incorrectly, based on the amended paragraphs, the entity would have to restate its financial statements in order to comply with the transition provisions of the ED. If paragraphs 9 and 25(a) were excluded from paragraph 39, the entity would treat the change in accounting prospectively.

Statement 133 Implementation Issue B14, *Purchase Contracts with a Selling Price Subject to a Cap and a Floor* (DIG Issue B14), analogizes to paragraph 61(f) as the basis for its conclusion that at- or out-of-the-money price caps and floors embedded in purchase contracts are clearly and closely related to the purchase contract. The response in DIG Issue B14 should be revised to reflect the amendment to paragraph 61(f).

The last sentence of paragraph 12(a) of Statement 133 states that additional guidance on applying the concept of clearly and closely related criterion is included in Appendix A. We believe this sentence should be amended to include paragraphs 13 and 15.

Examples Illustrating the Application of the Proposed Amendment of Paragraph 13 of Statement 133

The examples provided to illustrate the application of paragraph 13 of Statement 133 are extremely helpful. However, we disagree with the conclusion in Example 3 with respect to the application of paragraph 13(b). The example provided is as follows:

An investor holds a bond with a coupon rate of interest that varies based on LIBOR; however, if LIBOR is at or above 10 percent at any reset date, the investor receives 12 percent. A variable-rate bond could have been issued at par by the entity without a cap at LIBOR minus 2 percent. At the date of issuance LIBOR is 8 percent. The bonds are issued at par and the investor paid par.

The conclusion to the application of paragraph 13(b), states, in part:

When LIBOR is at or above 10 percent, the embedded cap provides the holder with a return of 12 percent, and since 12 percent is double the investor's initial rate of return on the host contract, which was 6 percent, the provisions of the first part of paragraph 13(b) are met.

We believe the initial rate of return on the host contract (6 percent in this case) should be compared to the overall yield on the instrument assuming the worst-case scenario, **not** the coupon reset rate (that is, 12 percent). In this example, since LIBOR is 8 percent at issuance, the embedded cap is out-of-the-money and the bond pays 8 percent at inception. Therefore, the yield to maturity is slightly less than 12 percent assuming the first coupon is set at 8% and the worst-case scenario for the remaining coupons (i.e., the cap is in-the-money). We believe the provisions of the first part of paragraph 13(b) would not be met since the yield on the instrument does not double the initial rate of return on the host contract.

The conclusion further states, in part:

... when LIBOR is at or above 10.00 percent, the embedded derivative does not provide a return that is at least twice the then-current return for the host. (For example, when LIBOR is at 10.00 percent, the return on the hybrid instrument is 12 percent, and the return on the host contract would have been 8.00 percent. Since the hybrid provides a return of 12 percent when LIBOR is 10.00 percent and the host contract would have provided a return of 8.00 percent, the embedded derivative does not provide a return that is at least twice the then-current market return for the host.) As a result, the provisions of paragraph 13(b) are not met.

Consistent with our comment above, we believe that the yield to maturity and not the coupon reset rate should be compared to the then-current market rate on the host contract. Our conclusion on the second part of paragraph 13(b) would have been the same in this case. Our conclusions were consistent with the FASB's conclusions for Examples 1 and 2, even though our analysis would reflect the yield to maturity approach versus the coupon reset rate method. This is because in Examples 1 and 2 the embedded derivatives were in-the-money at inception and result in a yield that is equal to the coupon reset rate. However, if the FASB agrees with our analysis, the other two examples should be revised to reflect the yield to maturity approach.

Beneficial Interests in Securitized Financial Assets

Paragraph 14 of Statement 133 provides an exception to certain beneficial interests that arise in a securitization. We recommend including the definition of securitization from FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (Statement 140), to the glossary of Statement 133 (paragraph 540) and adding a footnote indicating that the definition is from Statement 140.

Implementation Issue C17, *Application of the Exception in Paragraph 14 to Beneficial Interests That Arise in a Securitization* (DIG Issue C17), provides implementation guidance for applying paragraph 14. DIG Issue C17 specifies that paragraph 14(b) is satisfied if the beneficial interests in the securitized assets receive cash flows that arise solely from the *particular* assets that were securitized. Further, DIG Issue C17 states that beneficial interests qualify for the exception *even if* the prepayment and/or credit risks are not proportionally allocated among tranches. The latter concept is important and should be included in Statement 133 as opposed to an Implementation Issue.

Cash Flow Hedges

Paragraph 19 of the ED amends paragraph 30(d). Statement 133 Implementation Issue G20, *Assessing and Measuring the Effectiveness of a Purchased Option Used in a Cash Flow Hedge* (DIG Issue G20), is cited as the basis for the amendment. However, a portion of the amendment appears to be from Implementation Issue H15, *Using a*

Forward Contract to Hedge a Forecasted Foreign Currency Transaction That Becomes Recognized (DIG Issue H15). A reference to DIG Issue H15 should be added. Also, it is unclear why the ED only includes the guidance in DIG Issue G20 with respect to foreign currency hedges. We believe Statement 133 should be amended to incorporate the guidance in DIG Issue G20 for all types of cash flow hedges.

The Shortcut Method

Paragraph 26(b) of the ED amends paragraph 68(b) of Statement 133 to include the requirement that at the inception of the hedging relationship the fair value of a swap containing an embedded mirror-image call or put option, which hedges a prepayable interest-bearing asset or liability (as discussed in paragraph 68(d)), must be equal to the time value of the embedded call or put option in order to qualify for the shortcut method. The amendment appears to require an up-front cash payment equal to the time value of the put or call option. There are situations in which an up-front cash payment is not required on the swap. As a result, many swaps on callable and puttable debt will not qualify for the shortcut method. We suggest replacing “is equal to the time value” with “is less than or equal to the time value.”

Effective Date and Transition of Proposed Statement

Paragraph 41 of the ED states “if a contract that would not be accounted for as a derivative instrument under this Statement was previously accounted for as a derivative instrument, that accounting treatment shall not be changed. That is, for those contracts, this Statement applies prospectively only to transactions after the effective date.” This treatment is not consistent with Statement 133 Implementation Issue K5, *Transition Provisions for Applying the Guidance in Statement 133 Implementation Issues* (DIG Issue K5), or with the spirit of the transition provisions in Statement 133. DIG Issue K5 states, in part:

An entity...should account for the effects of initially complying with that implementation guidance *prospectively* for all existing contracts [emphasis added] and future transactions, as of the effective date for that guidance.

This guidance encompasses situations in which...an entity accounted for a contract as a derivative instrument under Statement 133 but will not account for that contract as a derivative instrument under the newly issued implementation guidance.

If an entity had been accounting for a contract as a derivative under Statement 133 but will not do so under the newly issued implementation guidance, the contract’s fair value at the effective date shall become its net carrying amount at that date. The entity should apply other generally accepted accounting principles that are applicable to that contract prospectively... (Prospective application only to future transactions would not be appropriate.)

DIG Issue K5 establishes similar guidance for contracts that contain embedded derivatives which were accounted for separately but may not be accounted for separately under newly issued implementation guidance and, again, acknowledges that prospective treatment only to hybrid contracts entered into after the effective date of the guidance would not be appropriate. We believe the transition guidance in the ED should be consistent with DIG Issue K5.

Paragraph 42 of the ED states that certain paragraphs of the ED do not apply to either the transferor or the *beneficial interest (BI) holders* in a formerly qualifying SPE that meets certain requirements. Why should BI holders be exempt from applying Statement 133 just because they purchased their investment from a formerly qualifying SPE? From a practical perspective, it will be difficult for a third-party BI holder to determine whether it purchased its investment from a qualifying SPE and whether the SPE meets the requirements to continue to be qualifying. We suggest that this exception only apply to the transferor.

Paragraph 39 of the ED includes paragraph 26 in its entirety as an amendment to Statement 133 that relates to guidance in Implementation Issues that have been previously cleared by the Board and have been effective in accordance with their respective effective dates. However, only paragraph 26(a) has a reference to a specific Statement 133 Implementation Issue (DIG Issue E10). If the Board intended include paragraph 26 in its entirety in the scope of paragraph 39, then a reference to an Implementation Issue should be added to paragraph 26(b). If the Board only intended to include paragraph 26(a) in the scope of paragraph 39, then paragraph 39 should be changed to only note paragraph 26(a).

Disclosures

Paragraph 44 of the ED requires a transferor to a formerly qualifying SPE that meets the grandfathering requirements of paragraph 42 to disclose in its financial statements the aggregate amount of assets and liabilities in existing structures that are currently off-balance sheet. Paragraph 25 of Statement 140 includes similar grandfathering provisions as paragraph 42 of the ED with respect to formerly qualifying SPEs. However, Statement 140 does not require similar disclosures, which is inconsistent. We recommend the disclosure requirement be removed, as the information is not useful.

Appendix A: Background Information, Basis for Conclusions, and Alternative View

The second sentence in paragraph A31 of Appendix A, *Background Information, Basis for Conclusions, and Alternative View*, of the ED states “The amended language in paragraph 7(f) of this Statement...” Subparagraph (f) does not exist under paragraph 7. We believe it should be subparagraph (c).

APPENDIX II
DELOITTE & TOUCHE LLP COMMENTS
FASB STAFF GUIDE TO IMPLEMENTATION OF STATEMENT 140 ON
ACCOUNTING FOR TRANSFERS AND SERVICING OF FINANCIAL ASSETS
AND EXTINGUISHMENTS OF LIABILITIES - QUESTIONS AND ANSWERS
RELATED TO DERIVATIVE FINANCIAL INSTRUMENTS HELD OR
ENTERED INTO BY A QUALIFYING SPECIAL-PURPOSE ENTITY (SPE)

Question 1

Question 1 concludes that “the derivative financial instrument component of a hybrid instrument retained in a securitization is not a retained interest as defined in Statement 140, so the disclosures that pertain to retained interests [required by paragraphs 17(f)(3) and 17(g)], although permitted, are not required for that portion of a bifurcated hybrid instrument; however, the disclosures required by Statement 133 (paragraphs 44 and 45) do apply to the derivative financial instrument”. We agree that the required disclosures for such embedded derivatives should be made in accordance with Statement 133 and the disclosures required by paragraphs 17(f)(3) and 17(g) do not apply. However, we believe the mechanics for allocating the carrying amount of the assets sold and retained based on their relative fair values has not changed. That is, if an asset retained contains an embedded derivative that must be bifurcated, the relative fair value used in allocating the carrying amount would be the fair value of the hybrid instrument. The embedded derivative would then be bifurcated at fair value. If the FASB staff agrees with us, the conclusion to Question 1 should be clarified.