EITF ABSTRACTS

Issue No. 96-12

Title: Recognition of Interest Income and Balance Sheet Classification of Structured Notes

Dates Discussed: May 23, 1996; July 18, 1996; September 18-19, 1996; November 14, 1996

References:
- FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases
- FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities
- FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities
- FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities
- FASB Statement No. 155, Accounting for Certain Hybrid Financial Instruments
- APB Opinion No. 20, Accounting Changes
- APB Opinion No. 21, Interest on Receivables and Payables

ISSUE

Structured notes are debt instruments whose cash flows are linked to the movement in one or more indexes, interest rates, foreign exchange rates, commodities prices, prepayment rates, or other market variables. They are issued by U.S. government-sponsored enterprises, multilateral development banks, municipalities, and private corporations. The notes typically contain embedded (but not separable or detachable) forward components or option components such as caps, calls, and floors. Contractual cash flows for principal, interest, or both from structured notes can vary in amount and timing throughout the life of the note based on nontraditional indexes or nontraditional uses of traditional interest rates or indexes.
Statement 115 addresses the accounting for all investments in debt securities, including structured notes that are in the form of debt securities. Under Statement 115, debt securities are classified as held-to-maturity only if the reporting enterprise has the positive intent and ability to hold those securities to maturity; furthermore, Statement 115, as amended by Statement 125, precludes certain instruments from being classified as held-to-maturity. Statement 115 does not prescribe a particular method for recognizing and measuring interest income on a debt security.

This Issue addresses the accounting for certain structured notes that are in the form of debt securities, but it does not address structured notes that have been classified as trading securities under Statement 115, that are otherwise measured at fair value with gains and losses recognized in earnings, or that are multicurrency securities.

The issues are:

1. How an investor in a structured note should estimate the cash flows that will be received
2. How changes in those cash flow estimates should be recognized and measured in interest income.

EITF DISCUSSION

The Task Force reached a consensus that investors should use the retrospective interest method for recognizing income on structured note securities that are classified as available-for-sale or held-to-maturity debt securities under Statement 115 and that meet one or more of the following conditions:

1. Either the contractual principal amount of the note to be paid at maturity or the original investment amount is at risk (for other than failure of the borrower to pay the contractual amounts due). Examples include principal-indexed notes that base principal repayment on movements in the S&P 500 index or notes that base principal repayment on the occurrence of certain events or circumstances.
2. The note's return on investment is subject to variability (other than due to credit rating changes of the borrower) because (a) there is no stated coupon rate or the stated coupon is not fixed or pre-specified, and the variation in the return on investment or coupon rate is not a constant percentage of, or in the same direction as, changes in market-based interest rates or interest rate index, for example, LIBOR or the U.S. Treasury Bill Index, or (b) the variable or fixed coupon rate is below market rates of interest for traditional notes of comparable maturity and a portion of the potential yield (for example, upside potential for principal) is based on the occurrence of future events or circumstances. Examples of instruments that meet this condition include inverse floating-rate notes, dual-index floating notes, and equity-linked bear notes.

3. The contractual maturity of the bond is based on a specific index or on the occurrence of specific events or circumstances outside the control of the parties to the transaction, excluding the passage of time or events that result in normal covenant violations. Examples of instruments that meet this condition include index amortizing notes and notes that base contractual maturity on the price of oil.

[Note: This consensus has been partially nullified by Statement 133. See STATUS section.]

Application of the scope provisions described above to various structured note securities is provided in Exhibit 96-12A.

The consensus in this Issue does not apply to mortgage loans or other similar debt instruments that do not meet the definition of a security under Statement 115, traditional convertible bonds that are convertible into the stock of the issuer, multicurrency debt securities, debt securities classified as trading, nonequity high-risk CMO instruments and mortgage-backed interest-only certificates within the scope of Issues No. 89-4, "Accounting for a Purchased Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate," and No. 93-18, "Recognition of Impairment for an Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate," debt securities
participating directly in the results of an issuer's operations (for example, participating mortgages or similar instruments), or reverse mortgages.

The consensus in this Issue also is not intended to apply to structured note securities that, by their terms, suggest that it is reasonably possible that the investor could lose all or substantially all of its original investment amount (for other than failure of the borrower to pay the contractual amounts due). In such cases, the security should be marked-to-market with all changes in fair value reported in earnings. The consensus in this Issue does not address the issuer's accounting for structured note securities.

Under the retrospective interest method, the income recognized for a reporting period would be measured as the difference between the amortized cost of the security at the end of the period and the amortized cost at the beginning of the period, plus any cash received during the period. The amortized cost would be calculated as the present value of estimated future cash flows using an effective yield, which is the yield that equates all past actual and current estimated future cash flow streams to the initial investment. If the effective yield is negative (that is, the sum of the newly estimated undiscounted cash flows is less than the security's amortized cost), the amortized cost would be calculated using a zero percent effective yield. An example of the application of the retrospective interest method is provided in Exhibit 96-12B.

The Task Force reached a consensus that, for purposes of determining the effective yield at which income will be recognized, all estimates of future cash flows should be based on quoted forward market rates or prices in active markets, when available; otherwise, they should be based on current "spot" rates or prices as of the reporting date.
The Task Force also reached a consensus that, in accordance with the provisions of Statement 115, an enterprise would determine whether an individual structured note security has experienced a decline in value below amortized cost that is other than temporary requiring a write-down of amortized cost, with the amount of the write-down included in earnings. The Task Force noted that, following the recognition of an other-than-temporary impairment, for purposes of determining the revised effective yield at which income will be subsequently recognized, the enterprise should factor collectibility into its determination of estimated future cash flows. Accordingly, immediately following the recognition of an other-than-temporary impairment, it is expected that the enterprise would not assume full repayment of the contractual interest and principal amounts of the note. For example, if the fair value of a structured note security with an original investment amount of $100 moves to $70, prompting the investor to recognize an other-than-temporary impairment of $30, and the investor does not expect to collect more than $80 of principal at maturity, the investor should assume collection of only $80 of principal in its determination of future cash flows. [Note: This consensus has been partially nullified by Statement 133. See STATUS section.]

The Task Force observed that the consensuses described above should be applied to all structured note securities within the scope of this Issue either as a change in accounting principle in accordance with Opinion 20 or prospectively to new securities acquired after November 14, 1996.
STATUS

A related issue was discussed in Issue No. 99-20, “Recognition of Interest Income and Impairment on Purchased Beneficial Interests and Transferor’s Beneficial Interests in Securitized Financial Assets Obtained in a Transfer Accounted for as a Sale.” The scope of that Issue would overlap Issue 96-12 for certain beneficial interests that are considered structured notes, and the Task Force agreed that Issue 99-20 should apply to those beneficial interests.

Statement 133 was issued in June 1998 and has been subsequently amended. The effective date for Statement 133, as amended, is for all fiscal quarters of all fiscal years beginning after June 15, 2000.

Statement 133 partially nullifies the consensus on Issue 2 by requiring that certain "embedded derivatives" be separated from the host contract and accounted for separately as a derivative at fair value. Paragraph 12 requires the embedded derivative to be separated if the following conditions are met:

- A separate instrument with the same terms as the embedded derivative would meet the definition of a derivative instrument in paragraphs 6–11.
- The hybrid instrument (the structured note) is not remeasured at fair value with changes in fair value reported in earnings as they occur.
- 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.

Paragraph 13 provides guidance regarding the clearly-and-closely-related notion; its guidance indicates, in part, that the embedded derivative is not considered clearly and closely related to the host contract if the hybrid instrument can be contractually settled in
such a way that the investor would not recover substantially all of its initial recorded investment.

If an entity cannot reliably identify the embedded derivative for separation from the host contract, the entire contract shall be measured at fair value, but it may not be designated as a hedging instrument under Statement 133. However, if the embedded derivative is not required by paragraph 12 or by the transition provisions in paragraph 50, as amended, to be separated from the host contract, the accounting requirement of Issue 96-12 should be followed, if applicable.

Statement 133 provides several examples of securities with various embedded derivatives. Many of the examples in Exhibit 96-12A are included in Statement 133 to demonstrate the application of the “clearly and closely related” provisions. (Refer to Statement 133 Implementation Issue No. D1, “Application of Statement 133 to Beneficial Interests in Securitized Financial Assets.”)

Impairment of the host instrument should continue to be based on the provisions in Statement 115.

Statement 155, which was issued in February 2006, amends Statement 133. Statement 155 provides a fair value measurement election for certain hybrid financial instruments with embedded derivatives that otherwise would require bifurcation. A hybrid financial instrument that is elected to be accounted for in its entirety at fair value cannot be used as a hedging instrument in a Statement 133 hedging relationship.

No further EITF discussion is planned.
Exhibit 96-12A

Application of the Scope Provisions of Issue 96-12
to Various Structured Note Securities

NOTE: Some of the following definitions and examples were provided by Bloomberg.

1. Dual-Index Floater: A bond with a coupon rate that is determined by the spread between two different indices and that usually includes an above-market interest rate in year 1. These bonds may have a "teaser" fixed rate for the first period of the bond's life, after which the interest rate floats according to a predetermined formula.

Example: Bond accrues @ 6% to 7/94; thereafter @ 10-year CMT + 3.1% – 6-month $LIBOR.

   Scope Application: Because the bond's coupon interest rate is based on the spread between two different indices after the first year, the coupon rate will not necessarily move in the general direction of a specific interest rate or index; therefore, this bond is within the scope of Issue 96-12.

2. Inverse Floater: A bond with a coupon rate of interest that varies inversely with changes in specified general interest rate levels or indices (for example, LIBOR).

Example: Coupon = 5.25% to 7/94; thereafter @ 8.75% – 6-month $LIBOR to 1/95. "Stepping" option allows for spread and caps to step semiannually to maturity.

   Scope Application: Because the coupon rate of interest moves opposite the general direction of interest rate levels, this bond is within the scope of Issue 96-12.
3. **Levered Inverse Floater:** A bond with a coupon that varies indirectly with changes in general interest rate levels and that applies a multiplier (greater than 1.00) to the specified index in its calculation of interest.

Example: Bond accrues @ 6% to 6/94; thereafter @ 14.55% – (2.5 × 3-month $LIBOR).

*Scope Application:* Because the coupon rate of interest moves opposite the general direction of interest rate levels, this instrument is within the scope of Issue 96-12.

4. **Delevered Floater:** A bond with a coupon rate of interest that lags overall movements in specified general interest rate levels or indices.

Example: (.5 × 10-year CMT) + 1.25%.

*Scope Application:* This type of bond would not be within the scope of Issue 96-12 because the coupon rate is a constant percentage and varies in the same direction as market-based interest rates.

5. **Range Floater:** A bond in which the investor's coupon is dependent on the number of days that a reference rate stays within a preestablished collar; otherwise, the bond pays either 0% interest or a below-market rate.

Example: Standard range floater—The investor locks into 6% on *every day* that 3-month $LIBOR is between 3% and 4%, with the upper limit stepping annually after 2/95. The bond will accrue at 0% for each day that 3-month $LIBOR is *outside* that range.

Example: Dual-indexed range floater—Bond accrues at [(3-month $LIBOR + 2.07%) × 1.0753] + 2.01% for *every day* that the JPY/USD spot exchange rate is ≥
97.70. The bond will accrue at 2.01% for each day that the JPY/USD spot exchange rate is outside that range.

**Scope Assessment:** Because the bond's coupon rate of interest may not vary in the same direction as a specific market-based interest rate or index (for example, when $LIBOR moves outside the specified range), this instrument would be within the scope of Issue 96-12.

6. **Lower-of and Higher-of Floaters:** A bond that pays an interest rate stated as the lower of or higher of two different formulas.

Example: Interest rate floats @ 3-month $LIBOR + .36% to 3/95; thereafter at the lower of (3-month $LIBOR + .36%) or \[19.26% - (2 \times 3\text{-month $LIBOR})\] to 3/27/96. Spread on inverse component steps to 22.26% to maturity.

**Scope Application:** As noted in the example, because the bond may pay a lower coupon rate as 3-month $LIBOR increases (the inverse component), this bond would be within the scope of Issue 96-12.

7. **Ratchet Floater:** A bond that pays a floating rate of interest and has an adjustable cap and/or floor that moves in sync with each new reset rate.

Example: 3-month $LIBOR + 50bp. In addition to having a lifetime cap of 7.25%, the coupon will be collared each period between the previous coupon or the previous coupon + 25bp.

**Scope Application:** Although the bond contains lifetime caps and collars, the coupon interest rate reprices based on a specific market-based interest rate, or is fixed; therefore, this instrument would not be within the scope of Issue 96-12.

8. **Stepped Cap/Floor Floaters:** A bond that pays a floating rate of interest, subject to a scheduled cap and/or floor schedule.
Example: Interest rate floats @ 3-month $LIBOR + 1.1% to 8/96; thereafter @ 3-month $LIBOR + 1.25%. Caps step from 6% to 7.75% – in 25bp increments – quarterly to 8/96; thereafter cap equals 8.25%.

**Scope Application:** Although the bond has a scheduled cap-and-floor schedule, the coupon interest rate reprices based on a specific market-based interest rate or is fixed; therefore, this instrument would not be within the scope of Issue 96-12.

9. **Floating to Floating Notes:** Varying coupon (first-year LIBOR or T-bill based, second-year prime based).

**Scope Application:** Because the coupon interest rate varies based on the direction of specific market-based interest rate indices, these notes would not be within the scope of Issue 96-12.

10. **Floating to Fixed Notes:** Varying coupon (first-year coupon is fixed, second- and third-year coupons are based on LIBOR, T-bills, or prime).

**Scope Application:** Although coupon rates move from fixed to floating, the floating coupon rate is based on, and moves in the same or general direction of, specific market-based interest rate indices. Accordingly, these notes would not be within the scope of Issue 96-12.

11. **Indexed Amortizing Notes:** A bond that repays principal based on a predetermined amortization schedule or target value. This value is linked to movements within a specific mortgage-backed security or index. The maturity of the bond changes as the related index changes. This instrument includes a varying maturity.

Example: "Trigger" structure—Bond retired in whole only if 3-month $LIBOR \( \leq 4.75\% \) on any interest payment date.
**Scope Application:** Because the maturity of the bond is tied to an index, this instrument is within the scope of Issue 96-12.

12. **Equity Indexed Notes:** Bond return of interest and/or principal is tied to a specified equity index (for example, the S&P 500 index). This instrument may contain fixed or varying coupon rate and may place all or a portion of principal at risk.

**Scope Application:** Because the contractual principal amount to be paid at maturity is at risk (for other than failure of the borrower to pay the contractual amounts due) and because the coupon rates may not vary in the general direction of market-based interest rates for traditional bonds, these bonds would be within the scope of Issue 96-12.

13. **Variable Principal Redemption Bond:** A bond whose principal redemption value at maturity is dependent on the change in an underlying index over a predetermined observation period. A typical scenario would be a bond that guarantees a minimum par redemption value of 100%, and the potential for a supplemental principal payment at maturity as compensation for the below-market rate of interest offered with the instrument (providing that the bond satisfies the indexing requirements as outlined in the terms of the offering).

Example: A supplemental principal payment may be paid to the investor—at maturity— if the final S&P 500 closing value (determined on 3/13/97) is less than the initial value of 642.73 and the 10-year CMT is greater than 2.00% as of 11/26/97. In all cases, the minimum principal redemption will be 100% of par.

**Scope Application:** Because the bond's expected yield is based on upside principal potential, this instrument would be within the scope of Issue 96-12.
14. **Yield Curve Note:** Fixed coupon, principal varies as follows: \[
(5\text{-year swap rate} - 3\text{-month }$LIBOR - 1\%) \times 40 + 100\% \times PAR \text{ (but not less than zero).}
\]

**Scope Application:** Because the contractual principal amount to be paid at maturity is at risk (for other than failure of the borrower to pay the contractual amounts due), this instrument would be within the scope of Issue 96-12.

15. **Crude Oil Knock-in Notes:** 1% coupon, principal guaranteed with upside potential based on the strength of the oil market.

**Scope Application:** Because the bond's expected yield is based on upside principal potential, this instrument would be within the scope of Issue 96-12.

16. **Leveraged Gold Notes:** Coupon is zero, variable principal based on the London Gold Index. These notes are designed to incorporate a collar on gold, whereby the investor buys a call and sells a put, in exchange for the coupon.

**Scope Application:** Because the bond's expected yield is based on upside principal potential, this instrument would be within the scope of Issue 96-12.

17. **Gold-Linked Bull Note:** Fixed 3% coupon, principal is guaranteed with upside potential if the price of gold increases.

**Scope Application:** Because the bond's expected yield is based on upside principal potential, this instrument would be within the scope of Issue 96-12.

18. **Equity-Linked Bear Note:** Fixed 4% coupon, principal is guaranteed with upside potential if the S&P Index falls.

**Scope Application:** Because the bond's expected yield is based on upside principal potential, this instrument would be within the scope of Issue 96-12.

19. **Step-up Bonds:** Bond provides an introductory above-market yield and the bond then steps up to a new coupon that will be below then-current market rates or, alternatively, the bond may be called.
**Scope Application:** Most step-up bonds generally have varying, but stated coupons (for example, some step-up bonds have a first-year coupon rate above market rates, but then provide for increasing stated future-year coupon rates that are below the forward yield curve) and, as such, would not meet condition (b) of the scope of Issue 96-12. Step-up bonds with coupons that reprice based on market interest rates and, therefore, move in the general direction of market interest rates (even though future coupons might be slightly above or below then-current market interest rates) would also not meet scope condition (b). In those situations, step-up bonds should be accounted for in accordance with the guidance in Statement 91.

20. **Multi Step-Ups:** A security that pays investors an introductory above-market yield—reflecting an embedded call option—for a short lockout period, and then is either called or "steps up" to a higher coupon rate (which will be below then-current market rates). These bonds can also take the form of "step-down" or "variable step-up" structures.

Example: 10-year step-up with call option beginning 3/6/97.

**Scope Application:** See Example 19 above.

21. **Credit-Sensitive Bond:** A bond that has a coupon rate of interest that resets based on changes in a company's credit rating.

**Scope Application:** Because the coupon rate on the bond varies based only on changes in the credit quality of the issuer (and adjusts to a rate that adequately compensates the investor for the change in issuer credit quality), this bond is outside the scope of Issue 96-12.

22. **Inflation Bond:** A bond with a contractual principal amount that is indexed to the inflation rate; the coupon rate is typically below that of traditional bonds of similar maturity.

**Scope Application:** Because the coupon rate is below market rates of interest for traditional bonds, and as a portion of the potential yield is based on upside principal, this bond would be within the scope of Issue 96-12.
23. **Disaster Bond:** A bond that pays a coupon above that of traditional bonds; however, a substantial portion or all of the principal amount is subject to loss if a specified disaster occurs.

   **Scope Application:** Because the contractual principal amount of the note is at risk, this bond would be within the scope of Issue 96-12.

24. **Specific Equity-Linked Bond:** A bond that pays a coupon slightly below that of traditional bonds of similar maturity; however, the principal amount is linked to the stock market performance of an equity investee of the issuer. The issuer may settle the obligation by delivering the underlying shares of the equity investee or may deliver the equivalent fair value in cash.

   **Scope Application:** Because the contractual principal amount of the bond is at risk, this bond would be within the scope of Issue 96-12.
Exhibit 96-12B

Application of the Retrospective Interest Method

Retrospective Interest Method Concept and Procedures

Under the retrospective interest approach, income for the current period is measured as the difference between the amortized cost at the end of the period and the amortized cost at the beginning of the period, plus any cash received during the period. The amortized cost amount is calculated as the present value of estimated future cash flows using an effective yield, which is the yield that equates all past actual and current estimates of future cash flow streams to the initial investment. If the effective yield is negative, the amortized cost amount should be calculated using a zero percent effective yield. Thus, the following procedures would be required for each reporting period:

1. Calculate the effective yield that equates all past actual cash flows and current estimates of future cash flows to the initial investment amount.
2. Using the rate calculated in (1) above, or zero percent if negative, calculate the present value of the estimated future cash flows. That amount represents the amortized cost at the end of the period.
3. Adjust the amortized cost balance\(^1\) to the amount calculated in (2) above with the offsetting amount recognized as income for the period.

Assumptions and Calculation of Income Recognized under the Retrospective Interest Method

- Assume the investor purchases a 3-year, $100 par value structured note at par.
- Assume the principal to be repaid at maturity is based on the performance of the S&P 500 Index, which, based on current S&P Futures indices, is expected to provide the investor with principal of $106 at the end of year 3, and the coupon interest on the note is fixed at 6% per year.
- On the acquisition date of the note, assume the investor expects the following cash flows and income to be recognized over the life of the note:

\(^1\)The pre-adjusted amortized cost balance should represent the amortized cost balance at the beginning of the period less any cash received on the investment during the period.
Period | Cash Flows | Income Recognized | Noncash Income | Ending Amortized Cost  
--- | --- | --- | --- | ---  
Acquisition | $(100) | | |  
Year 1 | 6 | $7.85 | $1.85 | $101.85  
Year 2 | 6 | 8.00 | 2.00 | 103.85  
Year 3 | 112 | 8.15 | 2.15 |  

These cash flows produce an effective yield of 7.85%.

- At the end of year 1, assume the investor expects to receive only $80 in principal at the end of year 3, which results in a negative effective yield of 0.71% over the life of the note (assume that the investor concludes that an other-than-temporary impairment has not occurred). Accordingly, the amortized cost amount must be reduced to the present value of the estimated future cash flows using a 0% effective yield, or $92, at the end of year 1. The income recognized in year 1 is negative $2 (the amortized cost amount at the end of year 1 in the table below of $92 less the amortized cost amount at the beginning of the year of $100 plus cash received during the year of $6). The cash flow and income recognition table as of the end of year 1 is as follows:

| Period | Cash Flows | Income Recognized | Noncash Income | Negative Yield Adjustment Recognized | Ending Amortized Cost  
--- | --- | --- | --- | --- | ---  
Acquisition | $(100) | | | |  
Year 1 | 6 | $7.85 | $1.85 | $(9.85) | $92  
Year 2 | 6 | 0 | (6) | 0 | 86  
Year 3 | 86 | 0 | (6) | 0 | 0  

These cash flows produce an effective yield of negative 0.71%.

- At the end of year 2, assume the S&P 500 Index market reverses and the investor now expects to receive the same cash flows that it expected upon acquisition of the note. Using the first table above, the investor would increase the amortized cost amount of the note to $103.85 at the end of year 2, which would result in recognizing income of $17.85 in year 2 (amortized cost from the first table at the end of year 2 of $103.85 less the amortized cost from the second table at the end of year 1 of $92 plus cash received in year 2 of $6).
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