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2015-220  
Comment Letter No. 9

Ms. Susan M. Cospers  
Technical Director  
Financial Accounting Standards Board  
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**Proposed Accounting Standards Update, *Derivatives and Hedging – Disclosures about Hybrid Financial Instruments with Bifurcated Embedded Derivatives* (File Reference No. 2015-220)**

Dear Ms. Cospers:

We appreciate the opportunity to comment on the proposed Accounting Standards Update (ASU), *Derivatives and Hedging – Disclosures about Hybrid Financial Instruments with Bifurcated Embedded Derivatives* from the Financial Accounting Standards Board (FASB or Board).

We support the FASB's efforts to enhance the transparency and usefulness of information provided to financial statement users. However, as discussed in the Appendix, it is not clear to us to what extent the proposed disclosure would provide decision-useful information. While the proposal would provide more information about an entity's hybrid financial instruments that contain bifurcated derivatives, we question whether it would meet the Board's objective of providing information on the overall economics and cash flows of these instruments. In addition, we believe that some entities may face significant operational challenges in providing the proposed disclosure.

Separately, we believe that the FASB should consider this proposed requirement in the context of the broader disclosure framework it is developing in a separate project. We generally support the development of a framework that the Board would apply consistently when creating new requirements and evaluating existing ones. We also note that the staff of the Securities and Exchange Commission's Division of Corporation Finance is reviewing disclosure requirements in Regulation S-K and Regulation S-X to determine how companies can make them more meaningful to users.

Our Appendix contains responses to the questions raised in the proposal.



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We would be pleased to discuss our comments with the Board or its staff at your convenience.

Very truly yours,

*Ernst & Young LLP*

**Appendix – Responses to questions posed in the proposed ASU, *Derivatives and Hedging – Disclosures about Hybrid Financial Instruments with Bifurcated Embedded Derivatives***

**Question 1:** Will the amendments in this proposed Update result in more transparent, decision useful information about hybrid financial instruments with bifurcated embedded derivatives? If not, please explain why.

It is not clear to us how the proposed disclosure would provide decision-useful information reflecting the overall economics and cash flows of hybrid financial instruments that contain bifurcated derivatives in a manner that would justify the costs of preparing, maintaining and auditing the disclosures. The following paragraphs highlight our key observations.

*Overall economics and future cash flows*

We believe that the proposed disclosure will provide limited information about the overall economics and cash flows of a hybrid financial instrument. For example, if an investor discloses an available-for-sale debt security with a bifurcated redemption feature, we note that it would not be clear from the proposed disclosure (1) which party controls the ability to exercise the feature, (2) what the redemption price is and how it compares to the investor's cost basis, (3) when the feature can be exercised, or (4) whether the price will be paid in cash or shares. While the fair value of the bifurcated derivative generally would reflect these factors, along with others, the proposal would provide minimum visibility on them.

*Level of aggregation*

The proposal would require entities to disclose information about host contracts and their bifurcated derivatives in a single location and would permit aggregation by derivative type. We believe most preparers would aggregate information this way to make the proposed disclosure operable. However, financial statement users would not be able to see the linkage between a host contract and its bifurcated derivative. The proposal implies that providing information that allows users to trace a bifurcated derivative back to its host contract for a single legal contract would be desirable because they would be able to analyze the overall economics and cash flows of the entire hybrid financial instrument. However, this would be difficult because more than one host and derivative could be included in a line item, and the derivative balance could include derivatives that are in asset and liability positions.

Another complication could occur when two embedded derivatives with different risk types are bifurcated from a host instrument. For example, when a conversion option and a redemption option are bifurcated from a debt instrument, Accounting Standards Codification (ASC) 815 requires the derivative to be presented in the balance sheet as one compound derivative. If information is aggregated by derivative type, this compound derivative, and other compound derivatives with multiple risk types, would require separation under the proposal.

### *Current practice*

We generally are not aware of many companies other than certain insurance companies that have a large volume of material bifurcated derivatives. From an issuer's perspective, most entities enter into transactions that are designed to meet their financial needs without requiring derivative accounting. In general, material bifurcated derivatives are more common for entities that are not public business entities.

From the investor perspective, financial institutions tend to hold the largest amount of complex hybrid financial instruments that would commonly require bifurcation. However, we understand that those entities often elect the fair value option for those instruments and, therefore, bifurcation is not required. Depending on their size, nonfinancial institutions may have significant investment portfolios, but their positions tend to consist of debt and equity securities without material derivative features requiring bifurcation.

Transactions that require the bifurcation of a material derivative are often unique to an entity and, therefore, many entities already provide adequate disclosures about these transactions. In these cases, it is common for preparers to disclose the location and amounts reported in the statement of financial performance for host contracts and bifurcated derivatives.

### *Certain contracts in the scope of ASC 944*

While entities within the scope of ASC 944 may have many material bifurcated derivatives, we believe it is unlikely that the proposed disclosure would provide decision-useful information beyond what is already required under US GAAP. For example, certain fixed indexed annuities have embedded derivatives that enhance investment returns to policyholders. Many of these embedded derivatives are required to be bifurcated. In these circumstances, the balances of the host contract (amortized cost) and bifurcated derivative do not represent the contractual amount that will be due to the contract holder. Further, the contract holder may annuitize the contract value at a future date, which would delay the payment of cash over a period that is life-contingent. As a result, we do not believe the proposed disclosure would provide information that would help users understand the overall economics and expected cash flows.

**Question 2:** Should the scope of the amendments in this proposed Update be extended to include nonfinancial hybrid instruments with embedded derivatives that require bifurcation under Topic 815? If yes, please explain why and identify any other instruments that should be included in the proposed amendments.

If the FASB determines that the proposal would achieve its goal of providing decision-useful information that would reflect the overall economics and cash flows of hybrid financial instruments, we see no reason why the same would not be true for nonfinancial hybrid instruments. However, we acknowledge that the proposed disclosure could be confusing in circumstances where a nonfinancial hybrid instrument has a host contract that is not recognized on the balance sheet.

**Question 3:** Are the proposed disclosure requirements operable and auditable? If not, which aspects pose operability or auditability issues and why?

Because the Proposed ASU requires information that is already included in the financial statements, we believe that many entities could provide the disclosure without incurring significant costs. However, we believe that some companies would face operational challenges and have to rely more on manual processes to track linkages. It is our understanding that many entities record host contracts and corresponding bifurcated derivatives under different systems (e.g., a cash system versus a fair value system).

In these cases, the link between the host contract and bifurcated derivative may be lost. We also understand that some systems do not distinguish between financial instruments that are host contracts and those that are not, or which derivatives have been bifurcated or are freestanding. Requiring such distinctions could be costly to preparers, depending on the volume of derivatives. We generally do not expect significant challenges in auditing the proposed disclosures.

**Question 4:** The proposed amendments would apply to all entities. Should the proposed amendments be different for entities that are not public business entities? If so, please describe how and why you think they should be different.

**Question 5:** How much time would be needed to implement the proposed guidance? Should the amount of time needed to implement the proposed amendments by entities that are not public business entities be different from the amount of time needed by public business entities?

We believe that the proposal should apply to all entities. The time an entity would need to implement the proposed guidance would depend on the volume of bifurcated derivatives and whether manual processes would be required for linkage. Because nonpublic business entities tend to have more bifurcated derivatives than public business entities do, and they may need to use manual processes for linkage, we believe the FASB should consider giving more time to nonpublic business entities to implement the proposed guidance.