1997

Comment letter on Accounting for derivative and similar financial instruments and for hedging activities

American Institute of Certified Public Accountants. Accounting Standards Executive Committee

October 10, 1997

To the Present and Past Members of the Accounting
Standards Executive Committee:

WHAT: FINAL COMMENT LETTER
WHY: FOR YOUR INFORMATION

Reference (No. 176-A; August 29, 1997)

Please find attached AcSEC's final comment letter on the FASB's proposed Statement of Financial Accounting Standards, *Accounting for Derivative and Similar Financial Instruments and for Hedging Activities*.

Sincerely,

Liz Fender

Elizabeth A. Fender, CPA
Director
Accounting Standards

EAF:sm
Attch:

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AICPA

October 10, 1997

Mr. Timothy S. Lucas
Director of Research and Technical Activities
File Reference No. 176-A
Financial Accounting Standards Board
P.O. Box 5116
Norwalk, CT 06856-5116

Dear Mr. Lucas:

The Accounting Standards Executive Committee (AcSEC) of the American Institute of Certified Public Accountants (AICPA) appreciates the opportunity to offer comments on the Financial Accounting Standards Board's (the Board's) proposed Statement of Financial Accounting Standards (the Statement), *Accounting for Derivative and Similar Financial Instruments and for Hedging Activities* (No. 176-A; August 29, 1997). AcSEC supports the Board's efforts to address this difficult area of accounting, supports the process followed by the Board in arriving at its conclusions, and supports the issuance of this Statement. AcSEC believes the final Statement should be issued quickly—the sooner the final requirements are issued, the sooner implementation can begin.

We observe that the Board did not make all of the changes recommended by AcSEC in our October 10, 1996 comment letter on the Exposure Draft. However, on balance, AcSEC supports the issuance of the Statement because it:

- Requires that entities measure all derivatives at fair value in balance sheets. AcSEC concurs with the Board that fair value is the most relevant measure for these instruments. By requiring that all derivatives be shown at fair value on the balance sheet, their visibility will increase and the relevance and usefulness of financial statements will be enhanced.

- Provides a consistent framework for accounting for derivative financial instruments by eliminating many of the inconsistencies that exist in current guidance.

- Addresses hedging activities more pragmatically than in the Exposure Draft, resulting in a model that better reflects the economic results entities seek. The Board has achieved this result in several instances, some of which are:

  — Permitting derivatives to hedge the fair value changes and cash flow changes of specific risk components of hedged assets, liabilities, firm commitments, and forecasted transactions
  — Allowing the income statement effect of cash flow hedges to match the earnings effect of hedged forecasted transactions
  — Further accommodating interest rate swaps whose critical terms match those of the underlying, one of the most common derivatives and hedging instruments

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As the Board finalizes the Statement, AcSEC believes that the Board should consider the following changes to enhance the Statement's clarity and operationality:

- Discounts and Premiums on Interest-Bearing Instruments—Requiring that an entity begin to amortize discounts and premiums on hedged instruments starting no later than when a hedge is closed rather than immediately based on a recalculated effective yield (that is, the methodology used in Statement No. 80 and the question-and-answer document on Statement No. 115), may enhance the Statement's operationality.

- Forecasted Transactions—Permitting basis adjustments for the accumulated gain or loss on the hedging instrument upon the acquisition of a forecasted purchase would simplify record keeping and reduce the information systems modifications necessary to implement the final Statement.

- Fair Value Hedge Accounting for Foreign Currency Assets and Liabilities (Other than Available-for-Sale Debt Securities)—Qualifying these items for a fair-value-hedge relationship seems consistent with other fair value hedges. For example, in a currency swap hedging fixed-rate, foreign-currency-denominated debt (that is, no fixed-to-variable interest-rate conversion), changes in relative interest rates between the two countries can introduce significant volatility. This volatility occurs even if the critical terms of the derivative match precisely those of the underlying.

- Physically Settled Contracts—Underlying is Convertible to Cash—The Statement includes contracts that AcSEC believed were inappropriately omitted from the Exposure Draft. However, the revised definition now includes non-financial assets and non-financial liabilities and an additional requirement to evaluate normal purchases and sales of non-financial assets and non-financial liabilities (for example, commodities). We believe our earlier recommendation to expand the definition of a derivative to incrementally include only gross-settled contracts on foreign currency and marketable securities to be a more operational solution.

AcSEC observes that the proposed standard is necessarily complex. AcSEC acknowledges that this complexity results from the complicated nature of the derivative instruments being accounted for and how they are used. Preparers and auditors will need to evaluate the pervasive effects of the Statement's requirements on accounting for common embedded-derivative instruments like convertible debt, operating leases with inflation clauses and inflation-indexed bonds. Other implementation issues may surface. In particular, the proposed Statement's illustrations for measuring the effectiveness of an interest-rate swap show the complex questions involved and difficult measurements required. Sufficient time will be needed to analyze the final Statement, identify its implications, modify accounting routines and information systems to appropriately apply its provisions.

Given the tasks required of preparers, AcSEC recommends that the Statement be effective for fiscal years beginning after December 15, 1999, with earlier application encouraged. This recommendation should in no way be construed as altering AcSEC's support for the Statement, rather it is AcSEC's belief that the additional time allowed will help ensure a smooth transition to the new standard. AcSEC also expects that some of the implementation questions that may arise will be widely applicable and may warrant authoritative answers. AcSEC believes that preparers, users and auditors would benefit from an expedited interpretation process during the transition period.

Representatives of AcSEC will be pleased to discuss these comments with the Board or its representatives.

Sincerely,

G. Michael Crooch/eaf

G. Michael Crooch, Chair
Accounting Standards Executive Committee

James A. Johnson/eaf

James A. Johnson, Chair
Financial Instruments Task Force