



Letter of Comment No: 17  
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Mr. Lawrence W. Smith, Director  
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**Proposed FASB Staff Position FAS 133-a, “Accounting for Unrealized Gains (Losses) Relating to Derivative Instruments Measured at Fair Value under Statement 133”**

Dear Mr. Smith:

We appreciate the opportunity to comment on the proposed FASB Staff Position FAS 133-a, “Accounting for Unrealized Gains (Losses) Relating to Derivative Instruments Measured at Fair Value under Statement 133.” We support the Board’s efforts to provide guidance on fair value measurements for certain derivative instruments, particularly long-dated, over-the-counter instruments in illiquid markets. However, we do not support the issuance of the proposed FSP in its current form.

We believe that certain aspects of the proposed FSP should be reconsidered before the guidance is finalized. Our primary concern relates to the recognition of an unrealized gain or loss as a deferred credit or debit in circumstances in which the transaction price presumption is rebutted (for derivative transactions occurring in a non-reference market) using a fair value estimate derived from Level 5 inputs as described in the proposed fair value hierarchy. The Board’s proposed requirement to recognize a deferred credit or debit appears to be inconsistent with the Board’s conclusions in FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. In addition, it is not appropriate to have different reliability thresholds for initial and subsequent recognition of unrealized gains or losses for those derivative instruments. Prohibiting recognition of an unrealized gain or loss in income initially because fair value estimates are not deemed to be sufficiently reliable (Level 5) is inconsistent with allowing those same estimates to be used to measure subsequent changes in fair value that will be recognized in income.



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Accordingly, we believe that the transaction price presumption should only be rebutted for derivative transactions when two conditions are satisfied—the transaction occurs in a non-reference market and the rebutting fair value estimate is derived from Level 1 – 4 inputs. As such, estimates derived from Level 5 inputs would not rebut the transaction price presumption for derivative transactions entered into in either reference or non-reference markets and, therefore, those transactions would be recorded initially at their transaction price. We further believe that subsequent measurement of those derivative instruments should be subject to the same reliability threshold as applied in initial measurement.

Other aspects of the proposed FSP should also be reconsidered and/or clarified. For example, paragraph 3(a) indicates that the transaction price presumption often will not be rebutted “if the entity is the purchaser of the derivative instrument (the customer).” We believe that it is difficult to make generalizations about relationships between parties to a derivative transaction because the terms “purchaser” and “customer” could take on different meanings in different contexts. Consider, for instance, a “customer” of a bank that writes a call option to the bank. From the bank’s perspective, it is the “purchaser” of the option and the counterparty is the “customer”. How would paragraph 3(a) be interpreted in this situation? Another transaction where application of the guidance may be unclear is an interest rate swap. In this transaction there is no “purchaser” or seller. We believe that the Board could clarify its intent by including simple narrative examples which identify specific counterparties and the most advantageous market in which each party transacts.

Paragraph 3(b) states that the transaction price presumption may be rebutted if the market in which the transaction occurs (for example, a retail market) is not the reference market for the derivative instrument, which would likely be the case if the entity would have otherwise transacted in a more advantageous market (for example, a dealer market). We understand that, in some instances, there may not be a dealer or inter-bank market for certain long-dated derivative instruments. We believe that the proposed FSP should explicitly state that an entity cannot assume the existence of a dealer market for specific instruments unless such a market actually exists.

In a related matter, the Board should consider describing the impact of credit risk considerations on fair value estimates at initial recognition. For example, suppose a derivatives dealer enters into a pay-fixed, receive variable interest rate swap with a B-rated customer. Further suppose that the dealer could enter into an offsetting interest rate swap in the dealer market, which is priced based on a AA credit rating. In this example, we believe that the fair value estimate at initial recognition should be based on the terms that would have been received had the single B-rated customer transacted directly in the dealer market.



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We understand that if a derivative transaction occurs in the reference market, the transaction price presumption is not rebutted at initial recognition or subsequently. However, paragraph 5 could be interpreted to indicate that whether the transaction price presumption was rebutted at initial recognition is not relevant to the recognition of subsequent changes in fair value. The proposed FSP should clarify this matter.

Paragraph 8 is unclear and it seems to imply that if the transaction price presumption is rebutted and the fair value estimate for the hybrid instrument is based on Level 1-4 inputs, then an unrealized gain or loss related to the hybrid instrument would be recognized in earnings. This position appears to be inconsistent with DIG Issue B20 which states that, when separating a nonoption embedded derivative from a hybrid instrument, there should not be a gain or loss recognized on the derivative.

Lastly, the Board should consider the implications of the proposed fair value measurement guidance on the conclusions reached to date in its ongoing revenue recognition project.

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If you have any questions about our comments or wish to discuss any of the matters addressed herein, please contact either Mark Bielstein at (212) 909-5419 or Enrique Tejerina at (212) 909-5530.

Sincerely,

KPMG LLP