

Morgan Stanley

Letter of Comment No: 7
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November 21, 2005

Suzanne Q. Bielstein
Director—Major Projects and Technical Activities
Mr. Lawrence W. Smith
Director—Technical Application and Implementation Activities – FSP
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: Proposed FASB Staff Position No. FAS 133-a, Accounting for Unrealized Gains (Losses) Relating to Derivative Instruments Measured at Fair Value under Statement 133 (the “Proposed FSP”)

Dear Ms. Bielstein and Mr. Smith:

Morgan Stanley appreciates the opportunity to provide comments in response to the Proposed FSP. We agree with the Board that practice is diverse with regard to both the method and timing of recognition of unrealized gains (losses). The Proposed FSP, if issued in its current form, would result in an improvement in financial reporting in that it provides guidance for subsequent (day two) recognition of unrealized gains (losses), thus leading to consistency in accounting, and provides a clearer framework for when transparency is achieved in terms of initial (day one) recognition of unrealized gains (losses). However, we have specific concerns with the transition provisions in the Proposed FSP. More broadly speaking, though, we also see conceptual inconsistencies with a minimum reliability threshold in the context of a fair value measurement model.

Morgan Stanley actively contributed to the development of comments in the letter responding to the Proposed FSP presented jointly by the American Securitization Forum (ASF), the International Swaps and Derivatives Association (ISDA), and Securities Industry Association (SIA), dated November 21, 2005. We endorse the tenets in that letter.

Our comments are further elaborated upon below.

Fair Value Measurement Model

We have been longstanding advocates for the importance and usefulness of fair value accounting. We believe that the refined definition of fair value, the enhanced guidance on “how to” apply fair value and certain of the new disclosure requirements contained in the forthcoming FASB statement on *Fair Value Measurements* (the “Fair Value Measurements statement”) should mitigate the Board’s and users’ concerns about the reliability of fair value estimates and possible measurement error.

Therefore, we question why the FSP creates a distinction for recognizing the fair value of certain assets or liabilities in earnings. We concur with the three Board members who commented at the July 7, 2005 Board meeting that the deferral of day one unrealized gains (losses) is inappropriate. Statement of Financial Accounting Standards No. 133 (“Statement 133”), *Accounting for Derivative Instruments and Hedging Activities*, does not impose a minimum reliability threshold; and as noted in paragraph 229 of Statement 133, the deferred debit or credit that results from deferring unrealized gains (losses) associated with Level V estimates of assets and liabilities does not meet the definition of an asset or a liability as defined in paragraph 35 of Statement of Financial Concepts No. 6, *Elements of Financial Statements*. Finally, we note that the Board appropriately will not require a minimum reliability threshold for the recognition of day two unrealized gains (losses). We advocate the same approach be applied to day one unrealized gains (losses) because that will result in the most consistent, clear and intuitive financial reporting.

In addition, paragraph 3 of the Proposed FSP states that “the transaction price...is presumed to represent the fair value of the asset or liability...absent persuasive evidence to the contrary. For a transaction involving a derivative instrument: [t]he transaction price presumption is not rebutted at initial recognition of the derivative instrument if the market in which the transaction occurs is the reference market.” In the Basis for Conclusions of the Fair Value Measurements statement, paragraph C48 then states that “the transaction price represents the clearing (or equilibrium) price in the reference market for the asset or liability.” The concept that the transaction price can be rebutted when persuasive evidence exists and the presumption that the transaction price can not be rebutted when transacted in the reference market seem contradictory. Even within reference markets, markets are not perfectly efficient and different prices can exist. In applying the fair value hierarchy and the guidance contained within the Fair Value Measurements statement, fair value estimates will be based on the best available evidence. As such, we believe that the standard for determination of a fair value estimate should be the concept of persuasive evidence having been deemed to rebut the transaction price. Thus, we recommend that paragraph 3.a of the Proposed FSP be deleted. Further, paragraph C48 of the Fair Value Measurements statement should be modified.

Transition

In transitioning to the Proposed FSP, there are potentially two separate accounting changes:

- 1) a change in an entity's judgments for when initial unrealized gains (losses) on standalone derivatives can be recognized in income attributed to the clarifying guidance contained in the Fair Value Measurements statement with respect to the fair value hierarchy; and
- 2) for some entities, a change in the method of accounting in subsequent periods for initial unrealized gains (losses) that have been deferred under existing literature from a method whereby these amounts were amortized into income over the life of the derivative to a method whereby such amounts are required to be deferred until the minimum reliability threshold has been met under the Proposed FSP.¹

With regard to the application of the fair value hierarchy levels in determining when unrealized gains (losses) have met the minimum reliability threshold in connection with applying the Proposed FSP, we respectfully disagree with the Board's decision that the Proposed FSP be adopted via limited retrospective application. Transition is a significant issue for those entities who, under EITF Issue No. 02-3 ("EITF 02-3"), "Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities," currently defer, in full, day one unrealized gains (losses) until certain observability criteria are met. For these entities, limited retrospective application will result in a decline in future revenue (and earnings) as it relates to fair value estimates that are not currently judged to meet an entity's observability standards under EITF 02-3 but, upon adoption of the Proposed FSP, will meet the entity's revised judgments about whether the minimum reliability threshold for recognition has been met (based on the clarifying guidance contained in the Fair Value Measurements statement surrounding the fair value hierarchy). This loss of future revenue arises because certain deferred unrealized gains at transition will be reclassified into beginning retained earnings, never to be recognized in the statement of income, even though such deferred gains will actually be realized by the entity. In addition, we believe that limited retrospective application will lead to financial reporting results that distort the usefulness of the financial statements for users:

- Deferred gains (losses) under EITF 02-3 represent true economic profits of an entity. Analyst reports have highlighted that these amounts represent real and material profits of securities firms and efforts have been made by these analysts to estimate the impact on firms' revenues. We fail to see how reporting revenue deemed to be earned (as a result of meeting the revised minimum reliability threshold under the Fair Value Measurements statement) as an adjustment to retained earnings provides financial statement users with desired information regarding revenues from derivative transactions in a functional manner.

¹ Note that under current guidance Morgan Stanley does not amortize initial unrealized gains (losses) on derivatives but rather defers such unrealized gains (losses) until its standards for observability have been met.

- Limited retrospective application leads to anomalous reporting results in that Level IV and higher fair value estimates of existing derivatives that thus do meet the minimum reliability threshold upon transition to the Proposed FSP are never eligible for earnings recognition; however, Level V fair value estimates of existing derivatives will eventually qualify for earnings recognition. We fail to see why such a distinction should exist.

While we agree that a change in practice from amortizing initial unrealized gains (losses) to deferring initial unrealized gains (losses) under the Proposed FSP until the minimum reliability threshold for recognition is met is a change in accounting principle, limited retrospective application appears to provide an unintended and unequal consequence in this regard. At transition, entities that discontinue amortization will have comparatively less deferred unrealized gains (losses) on their balance sheet as it relates to fair value estimates that meet the minimum reliability threshold. Thus, such reporting entities will (i) have received the benefit of partial revenue recognition in the past, which will be adjusted through beginning retained earnings and not as a reversal of revenue in the income statement and (ii) be allowed to recognize the balance of their derivative trades as revenue prospectively (except for the same population discussed above with regards to Level IV and higher estimates). From an income statement perspective, it appears that these entities would effectively be able to recognize the same revenue twice.

We believe the Board should mandate prospective application in the final FSP. With respect to estimates of fair value, under EITF 02-3, the transaction price rather than a model value was deemed to be the fair value in the absence of observable market data. The model value was not considered fair value under generally accepted accounting principles. Under the Proposed FSP, the model value is now deemed fair value if the transaction price has been rebutted with persuasive evidence. For fair value estimates of derivatives that were based on the transaction price under EITF 02-3 that are now estimated under the fair value hierarchy, the change in the determination of fair value is a change in estimate, not a change in an accounting method. As the Proposed FSP is rightfully linked to the Fair Value Measurements statement, estimates of derivative fair values require judgments regarding the observability of inputs and classification of estimates within the fair value hierarchy. Further, the inputs in most fair value estimates require qualitative assessments. Therefore, the effect of a change in the method used to estimate fair value likely will not be separable from the change in the estimate. The process of revising fair value estimates of derivatives in connection with adopting the FSP and the Fair Value Measurements statement appears consistent with the guidance contained in paragraph 20 of Statement of Financial Accounting Standards No. 154 (“SFAS 154”), *Accounting Changes and Error Corrections*, which discusses the “continuing process of obtaining additional information and revising estimates” and adopting methods that involve the “recognition of a change in the estimated future benefits inherent in the asset...or the information available to the entity about those benefits.” As such, we believe the impact of adopting the proposed FSP related to derivatives previously recognized under the transaction price approach of EITF 02-3 should be recognized prospectively in accordance with SFAS 154 as a change in estimate.

Prospective application is warranted for numerous reasons beyond the technical analysis of SFAS 154 presented above. First, as outlined above, prospective application would prove the most relevant transition approach to users of our financial statements. Second, the Board concluded that the forthcoming statement regarding *Fair Value Measurements*, which interacts with and will have the same effective date as this Proposed FSP, should be applied prospectively (except for block discounts). Since many reporting entities will apply that statement in conjunction with this Proposed FSP, we believe that prospective application for both would represent the most operational, consistent, relevant and simplified path to follow. Third, a change to prospective application in the final FSP would be consistent and in alignment with the prospective application provisions originally required when EITF 02-3 became effective. Finally, considering that transition is an inherently arbitrary topic, prospective application is the most simple and straightforward approach. As noted earlier, retrospective application will have a different effect on reporting entities depending on whether they previously deferred or amortized day one unrealized gains (losses).

Again, we thank the Board for addressing many issues related to initial and subsequent unrealized gain (loss) recognition of derivatives measured at fair value as we have in the past encouraged the Board to take up this matter. We would be pleased to discuss our comments with the Board or Staff. Please contact Karen Dealey at (212) 276-2452, David Shelton at (212) 276-2423 or myself at (212) 276-2620 with any questions or comments.

Sincerely,

/s/ David S. Moser
Managing Director
Principal Accounting Officer