

Director of Major Projects and Technical Activities File Reference No. 1100-163 Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116 Letter of Comment No: 4/1
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We are pleased to comment on the Financial Accounting Standards Board's (FASB's) Proposed Statement of Financial Accounting Standards, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* (No. 1100-163; May 1, 2002).

FASB Should Explain Why Guidance Applies Differently to Qualifying and Nonqualifying SPEs

The proposals do not adequately explain why some of the FASB's proposed guidance applies differently to qualifying and nonqualifying special-purpose entities (SPEs). Implementation Issues B12, "Beneficial Interests Issued by Qualifying Special-Purpose Entities," and B36, "Bifurcation of Embedded Credit Derivatives," are suggested to apply to OSPEs but not to other SPEs but it isn't clear why.

Example 3 in Implementation Issue B12 involves an interest in a QSPE that purchases equity securities with proceeds from issuing beneficial interests that pass through all distributions and dividends from the shares but do not pass through any voting rights. The FASB has concluded that interest should be accounted for as a debt host with an embedded equity derivative that must be bifurcated by the beneficial interest holder. Isn't the same true for an interest issued by an SPE? The basis for conclusions should explain why the Board concluded the host instrument is not an equity instrument.

Further, the Board should address the implications its conclusions about Example 3 in Implementation Issue B12 have for accounting by an investor in an equity mutual fund. Presumably, the Board is saying the investor has a debt security embedded with an equity derivative? What about an investment in a debt fund? These matters need to be explained so preparers and auditors can ground themselves in the conceptual model governing the Board's conclusion.

FASB Should Clarify Initial Net Investment Issues - Paragraph 6(b)

The Board should consider replacing the words "initial investment equal to the time value" in paragraph 6(b) with the words "initial investment equal to or less than the time value." Otherwise, the definition will, for certain contracts that do not seem problematic, result in unwieldy accounting while not resulting in better reporting. To illustrate, consider the pay-fixed-rate, receive-capped-floating-rate interest-rate swap in Example 3 of Proposed Implementation Issue A20. The FASB has concluded that because the premium for the cap is paid through off-market terms, the swap – for accounting purposes – is not in its entirety a derivative instrument but a debt host (with a value equal to the option premium) and a

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compound derivative comprising an at-the-money swap component and a written cap component. With the suggested wording change, the swap in its entirety would be treated as a derivative instrument. If the cap were in the money when written, there would be a debt host.

The most basic of interest-rate swaps have financing elements of a sort. Consider a receive-fixed, pay-floating interest-rate swap that at inception has an at-market fixed rate and, other than the bid/ask spread,* a fair value of zero. The first net settlement under the swap is known with certainty at the swap's inception. Considering a scenario in which the yield curve at inception is upward-sloping and interest rates do not change over the term of the swap – the fixed-rate receiver will be a net debtor in the early periods of the swap, repaying its "debt" in the later periods of the swap. We believe it is not necessary to apply any special "financing" accounting to this element of a basic swap.

*The bid/ask spread at inception of a swap gives the swap a fair value other than zero with an immediate gain to the swap dealer and immediate loss to the buyer/hedger. We understand that practice does not involve recognition of an immediate loss by a buyer/hedger for the bid/ask spread but a notation entry for the swap at a fair value of zero. We understand practice for swap dealers is to recognize the bid/ask spread at inception.

However, it is possible to have a swap with, other than the bid/ask spread, a fair value of zero at inception, but that involves a financing that builds over time due to *off-market* terms favorable to the debtor in early periods and that is repaid under off-market terms that are unfavorable to the debtor in later periods. How would the Proposed Statement address those circumstances?

The FASB should explicitly address how a preparer should apply the revised paragraph 6(b) to a deep-in-the-money option. Is a deep-in-the-money option an option-based contract that should be accounted for as a derivative in its entirety? Or is it so close to being a forward contract that it is essentially prepaid in part? We believe the latter would be the answer under the FASB's proposal, but we're not sure whether that is the Board's intent. We have asked the FASB to address this matter in the past. The Proposed Statement does not suggest the FASB has considered this fundamental issue. The basis for conclusions should explain the governing principles the Board is establishing so constituents will reach the Board's intended conclusions when analyzing particular circumstances.

The FASB should explicitly address how paragraph 9(a) of Statement 133 (as amended) would be applied to penny warrants to purchase stock of a nonpublic company (that is, a warrant whose exercise price is one cent). There is essentially no economic difference between gross and net settlement of a penny warrant – the number and value of shares received under a net share settlement is virtually identical to that under a gross settlement. Given the goal of the Proposed Statement, ("the changes required by this proposed Statement would improve financial reporting by requiring that contracts with comparable characteristics be accounted for similarly"), we fail to understand the very different accounting that will be applied to contracts that economically are identical – contracts that permit only gross settlement to acquire nonpublic company stock would not be considered derivative instruments while those that permit net share settlement would. One approach would be to say in the final Statement that penny warrants are deemed to involve gross physical settlement. The Board needs to explain what governing principle constituents should follow in analyzing particular circumstances.

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FASB Should Distill Guidance Into a Single Document

The Proposed Statement and its nexus with a variety of other materials issued by the FASB are difficult to grasp. Specifically, the FASB has issued:

- Examples to illustrate the application of the proposed amended wording of paragraphs 13 and 30(d) of Statement 133
- FASB Staff Statement 133 Implementation Issues
 - A20, "Application of Paragraph 6(b) regarding Initial Net Investment"
 - B12, "Beneficial Interests Issued by Qualifying Special-Purpose Entities"
 - B36, "Bifurcation of Embedded Credit Derivatives"
 - C17, "Application of the Exception in Paragraph 14 to Beneficial Interests That Arise in a Securitization"
 - D2, "Applying Statement 133 to Beneficial Interests in Securitized Financial Assets"
 - E21, "Continuing the Shortcut Method after a Purchase Business Combination"
- A document, "Questions and Answers Related to Derivative Instruments Held or Entered into by a
 Qualifying Special-Purpose Entity (SPE)"
- EITF Issue No. 02-12, "Permitted Activities of a Qualifying Special-Purpose Entity in Issuing Beneficial Interests under [FASB Statement 140]"

The FASB should reconcile the details and distill its final guidance into a single document with a robust basis for conclusions. That guidance should also be reconciled with the following guidance the Board has proposed:

- A Proposed Interpretation, Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others
- A Proposed Statement, Consolidation of Certain Special-Purpose Entities

The Proposed Statement does not contain the same level of guidance or examples as the guidance it is intended to incorporate. As we expressed in our prior comments to the staff, that is very troubling. Shouldn't the supporting discussion and examples be incorporated in the final Statement as amendments, addenda to the "illustrations and examples" appendix of Statement 133, or in the basis for conclusions? We strongly oppose the idea of the guidance (for example, in Questions B12 and B36) existing apart from Statement 133 as FASB staff question-and-answers independent of the amendments. We fear failure to include the guidance in the Proposed Statement suggests the Board lacks confidence in its conclusions. Further, if the full tenor of the guidance isn't carried forward into the final Statement, we fear constituents will be lost trying to fit the pieces of the puzzle together.

Further, the FASB should analyze the intersection between the proposal and existing and active EITF matters. That analysis is critical to understanding whether the Proposed Statement is workable. We ask that the Board formally amend its protocol to require that such an analysis be included in every FASB exposure draft and final statement and, most important, be a *prerequisite* to Board consideration of a draft for exposure.

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In analyzing interaction with EITF issues, the Board should consider whether EITF 96-11, "Accounting for Forward Contracts and Purchased Options to Acquire Securities Covered by FASB Statement No. 115," applies to contracts exempted from the requirements of Statement 133 through the proposed amendments. It should also consider the interaction with pending EITF matter involving "Application of Issue No. 99-20 When a Special-Purpose Entity Holds Equity Securities and Whether an Investment That Is Redeemable at the Option of the Investor Should Be Considered an Equity Security or Debt Security" and Issue No. 02-D, "The Effect of Dual-Indexation Both to a Company's Own Stock and to Interest Rates and the Company's Credit Risk in Evaluating the Exception under Paragraph 11(a)(1)."

FASB Should Clarify Prepayable Swap Issues (Paragraph 68(b))

The words "is equal to the time value" in paragraph 68(b) should be replaced with the words "is equal to or less than the time value." That will ensure that a zero-fair-value swap having a prepayment option financed through off-market terms continues to qualify for the short-cut method. Without this change, the Proposed Statement would reverse the guidance the FASB staff has previously given constituents. Specifically, a zero-fair-value swap having a prepayment option financed through off-market terms would no longer meet the paragraph 68(b) criterion but an at-market swap with a fair value other than zero through a premium paid in cash up front would — an answer completely opposite from how the FASB staff has been advising constituents.

Before the proposed amendment, paragraph 68(d) explicitly says the shortcut method can be applied to a prepayable interest-rate swap but paragraph 68(b) requires the fair value of the swap at inception of the hedging relationship be zero. We understood from discussion with the FASB staff that to satisfy this criterion, a company must enter into off-market terms to finance the premium for the option feature in the swap. Because such a swap would be designed to have zero fair value at inception of the hedging relationship, the shortcut criteria under paragraphs 68(b) and 68(d) of Statement 133 would be met. We also understood that the financing of the option premium is a typical term of such a swap, and, so, does not itself violate qualification criterion in paragraph 68(e) of Statement 133. In contrast, a prepayable swap with at-market terms and an up-front payment for the option would have a fair value other than zero but according to the FASB staff's previous guidance cannot qualify for the shortcut method.

If the FASB does not change the wording as we have suggested, then the Board's amendments to paragraph 68(b) should only be required to be applied prospectively.

Paragraph 68 precludes the shortcut method if a swap designated as a hedging instrument is prepayable and the hedged asset or liability is not. The final statement should explain that a swap should not be considered prepayable when one party has the right to terminate the swap at its then-current fair value (as defined by paragraph 540 of Statement 133) but should specify that the definition of fair value requires consideration of the specific credit risk of the counterparty. We understand that some agreements allude to fair value, but do not consider the credit risk of the counterparty, rather they consider a hypothetical fair value for an otherwise identical swap with, say, a AA-rated counterparty. If the amount at which a swap would be terminated does not consider the specific credit risk of the counterparty, then the termination value is not fair value as defined in Statement 133 and the swap should be considered prepayable.

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FASB Should Address Restrictions on Sales of Asset Under Physically Settled Contracts

The FASB should address the application of paragraph 9(c) of Statement 133 to circumstances that are not addressed currently through the guidance originated in Implementation Issue A14, "Derivative Treatment of Stock Purchase Warrants Issued by a Company for Its Own Shares of Stock Where the Subsequent Sale or Transfer Is Restricted." Specifically, if a contract requires delivery of an asset associated with the underlying but prohibits the party taking delivery of the asset from selling the asset or creates a period during which such sale is prohibited, how do those restrictions affect a conclusion about whether the asset is readily convertible to cash? We understand the FASB is not addressing that issue through Implementation Issue A14, but the question exists and needs to be answered.

FASB Should Address Subsequent Recognition and Measurement of Loan Commitments

The FASB should address the following matters with respect to the accounting for loan commitments that are derivatives?

- How should the loan commitment's fair value be determined? As we have commented previously, given the Board's conclusion in Statement 140 regarding the recognition of servicing assets, some have questioned whether the inherent fair value of the potential servicing asset should be included in the reported value of the loan commitment. The Board has, to date, chosen not to address this issue and, by that, left practice open to inconsistencies.
- If the writer of a loan commitment has an asset the moment the commitment is signed, is the offsetting entry revenue (an unusual answer for a written option)? What about the subsequent mark-to-fair-value accounting on the loan commitment are those adjustments to revenue? As amended, Statement 133's model suggests a "yes" answer to both questions. Is that what the Board intends?
- What is the accounting for loan origination costs when a loan commitment qualifies as a derivative?

FASB Should Address Credit Features Associated With Settlement Of Derivatives

Credit features associated with settlement of certain derivative instruments could dramatically affect valuation and hedge effectiveness. We believe the FASB should address this matter explicitly in the final Statement. See the attached Andersen Hot Topic, "Derivatives and Hedging - Credit Features Must Be Considered," for further explanation.

FASB Should Consider Basis for "Rare" Reclassification of Investment Securities

FASB Statement of Financial Accounting Standards No. 115, Accounting for Certain Investments in Debt and Equity Securities, explains that a transfer of securities between available-for-sale and trading categories should be rare. Paragraph 55 of Statement 133 provided explicit justification for a reporting entity to make such a reclassification (effectively acknowledging implementation of Statement 133 created circumstances that were rare enough to justify such reclassifications). The FASB should explicitly address whether the final Statement's effect on accounting for hybrid instruments constitutes a circumstance rare enough to justify a reclassification concurrent with implementation of the final Statement.

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Other Comments

Following are our other comments:

- Illustrative examples would be very helpful in clarifying the amended guidance. Consider giving
 examples for all transition provisions and to illustrate the points raised in paragraphs A53 and A59.
 (We note that the FASB is sending conflicting signals in paragraphs 40, 42, and A59 and the FASB's
 July 26, 2002. Technical Plan.)
- The Board should reconcile and explain the differences in its transition conclusion discussed in paragraph A49 and its conclusions in ratifying Implementation Issue K5, "Transition Provisions for Applying the Guidance in Statement 133 Implementation Issues." We are not sure why an entity would continue to mark to fair value an item that ceases to be a derivative.
- The final Statement should explicitly address whether the alternative of bifurcating a small initial net investment (a) can be elected transaction by transaction or (b) involves adopting, disclosing, and consistently applying a single accounting policy to all transactions.
- The FASB needs to reconcile the definition of "capacity contract" in the proposed amendments to paragraph 540 with the definition of "capacity contract" in EITF 98-10, "Accounting for Contracts Involved in Energy Trading and Risk Management Activities."
- Example 8 beginning in paragraph 154 of Statement 133, the guidance in Implementation Issue G13, "Hedging the Variable Interest Payments on a Group of Floating-Rate Interest-Bearing Loans," and the guidance in Implementation Issue G16, "Designating the Hedged Forecasted Transaction When Its Timing Involves Some Uncertainty within a Range," send conflicting signals about whether derivative gains and losses should continue to be deferred in other comprehensive income upon a change in terms of a cash flow hedging relationship. On one hand, the Implementation Issues suggest in certain circumstances the letter of the designation governs the accounting. On the other hand, the change in the way in which a transaction was "initially expected to be accomplished" and the guidance in footnote 25 to Statement 133 suggest a higher hurdle. We think this area needs a clearer model to ensure greater consistency in application of GAAP.
- We don't understand the assertion in paragraph A3 of the Proposed Statement that "accounting for interests held by the transferor as derivatives under Statement 133 conflicts with the requirement of Statement 140 to initially measure those interests by allocating the previous carrying amount between assets sold and retained interests based on their relative fair values at the date of transfer." Further, how does this reconcile with paragraph 60(f)'s statement that "the initial net investment in a beneficial interest held by a transferor (for example, a retained interest) is the fair value at the date of transfer of the interest retained."
- The FASB should address the following question: Can an assertion about the probability of forecasted interest cash flows on floating-rate debt be based solely on the existence of a debt agreement or is the hurdle higher? For example, say a reporting entity enters into a 10-year receive-floating, pay-fixed swap and wishes to designate a cash flow hedging relationship with floating interest payments. Is it enough that the reporting entity has 10-year floating rate debt outstanding or does the reporting entity have to expect interest payments to be probable even if that debt is refunded at some point during the 10-year term to maturity? We believe the latter answer is correct (for example, in evaluating probability, the reporting entity would have to consider the possibility that it might prepay the 10-year debt or refund it with equity or fixed rate debt), but understand practice may vary.

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- The FASB should address whether the contract in the second sentence of footnote 8 is a derivative subject to the requirements of Statement 133.
- In paragraph 57(b), the phrase "is a derivative" should be changed to "has the characteristic discussed in paragraph 6(b) of Statement 133." That is, a contract is not a derivative unless it has all the characteristics in paragraph 6 of Statement 133. The fact that it has a smaller net investment is only one consideration.
- Paragraph 57(c) refers to a call option but does not address applicability to a put option. Also, the
 phrase "issued by an entity only for its own stock" should be "issued by an entity whose own stock is
 the underlying." Otherwise, the phrase could be mistakenly read to apply only to circumstances in
 which the issuer receives its own stock as consideration for its issuance of the warrant.
- Paragraph 59(a) addresses the effects of net settlement under paragraphs 9(a) and 9(b) of Statement 133, but doesn't address paragraph 9(c). The phrase "the security that will be delivered is readily convertible to cash and" should be inserted after the words "even though" in the penultimate sentence.
- Given the FASB's clarification, paragraph 61(f) of Statement 133 should be deleted in its entirety. It adds nothing. It merely tells readers to "go see paragraph 13." We would be interested in the FASB's view of whether an embedded floor that is in-the-money at its inception could ever fail the criteria in paragraph 13 and be required to be bifurcated. If the FASB cannot demonstrate how bifurcation would ever be required, why not simply say so?
- Shouldn't the reference to paragraph 61(a) made in proposed paragraph 63(m) be a reference to paragraph 13?
- The basis for conclusions should explain why paragraph 19 is being deleted. What message should constituents take away? Is paragraph 19 incorrect? How should the term "change in fair value" be interpreted?
- The FASB should correct the typographical error made originally in paragraph 13(a) and has been carried forward into the Proposed Statement. Specifically, "in a such a way" should be "in such a way."

If there is anything in our comment letter that requires clarification, please call us. We welcome the opportunity to explain our comments more fully if they are not clear or to elaborate on our concerns about the Proposed Statement and proposed solutions.

Very truly yours,

arthur anderson LLP

ATTACHMENT

Derivatives and Hedging - Credit Features Must Be Considered

March 19, 2002

Summary: Credit features associated with settlement of certain derivative instruments could dramatically affect valuation and effectiveness.

Background: The terms of derivative contracts generally are outlined in two legal documents: (a) the specific transaction contract or confirmation, and (b) the International Swap Dealers Association, Inc. (ISDA) Master Agreement and any addenda or schedules to that agreement. The ISDA Master Agreement generally is executed with each derivative counterparty to apply to all derivative transactions with that single counterparty.

We have learned recently of a provision negotiated in the schedule to ISDA Master Agreements by certain parties providing that, if one party is in default (as defined) under the ISDA Master Agreement, the nondefaulting party may settle its net amount owed to the defaulting party by tendering "obligations of the defaulting party." Apparently, the right to deliver "obligations of the defaulting party" has been interpreted to include debt of the defaulting party having a par value equal to the net amount owed. That feature could dramatically affect valuation of derivatives transactions between counterparties, should be recognized at its fair value, and its existence and nature should be disclosed. The feature also affects whether a derivative instrument can be highly effective as a hedging instrument.

To illustrate, assume that Company and Investment Bank enter into an ISDA Master Agreement and specific transaction contracts involving (a) an interest-rate swap and (b) a currency swap. Assume that, at a date when the interest-rate swap feature economically is an asset of 160 to Company and the currency swap feature economically is a liability of 60 to Company, Company is in default under the ISDA Master Agreement by failing to make an interest payment on its debt. The schedule to the ISDA Master Agreement provides effectively that Investment Bank may settle its net liability of 100 to Company by tendering Company debt with a par value of 100. Investment Bank may have (a) acquired Company's debt at the date the debt was issued, (b) purchased Company's debt at a discount before the default, or (c) purchased Company's debt after the default but before the settlement date.

This feature has important implications for Company's liquidity because what otherwise would appear to be a net receivable from the Investment Bank (on the basis of changes in interest and currency exchange rates since inception of the agreement) is contingent on Company's own credit risk. In the illustrative example, if Company's debt is trading at 80 cents on the dollar and Company defaults under the ISDA Master Agreement, Investment Bank can purchase debt with a par value of 100 for a payment of 80, then tender that debt to Company in settlement of Investment Bank's net liability of 100. That is, what would otherwise appear to be a net receivable of 100 from Investment Bank in reality has a fair value of only 80.

In effect, a company that has agreed to such a provision has written an option on the decline in its own creditworthiness (or simply the difference between the par and fair value of its obligations) contingent on an event of default. If a decline in the company's creditworthiness is accompanied by an event of default (as defined), amounts that otherwise might be received due to market price changes under specific transaction contracts subject to the ISDA Master Agreement can evaporate and will not be available to other creditors or the company's shareholders.

Companies should inspect their ISDA Master Agreements, any schedule or addendum thereto, and specific transaction contracts to identify such provisions. Such a feature should be given recognition at its fair value and its nature and existence should be disclosed. Such features in derivative contracts raise questions about whether the derivative can be expected to be effective as a hedging instrument due to the uncertainty about changes in creditworthiness during the term to maturity of the derivative.

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