



FASB-TECHNICAL DIR. 15010-100 E192DISCLOSURE OF DERIVATIVE INSTRUMENTS AND HEDGING BY DR.JOSEPH S. MARESCA

COMMENTS TO THE: DIRECTOR@FASB.ORG

CONTINUATION IN PART- TO CLARIFY INITIAL COMMENTS ALSO APPENDED

Generally, investors prefer low capitalization ratios as a sign of a normalized or manageable debt. The important point is to analyze the debt increments in terms of risk, rational investment decision-making criteria , major shareholder concurrence and the current and historical verifiability of superior internal accounting controls. Increasing the capitalization can have positive consequences when there is a stability of capital contributions, a superior derivative business strategy, the active involvement of major shareholders and the general confidence of the investor public.

Another important aspect is the mix of debt and equity in the overall investment profile. Too much debt can be more risky when the supporting cash flows are not easily verifiable, risky or non-existent. Too little debt can mean that the management is risk averse.

ORIGINAL COMMENTS ARE LISTED BELOW:

BACKGROUND AND PURPOSE:

THE FASB SEEKS TO CLARIFY THE PURPOSE FOR UTILIZING DERIVATIVES, THE ACCOUNTING UNDER STATEMENT 133 AND THE AFFECT ON FINANCIAL POSITION, RESULTS OF OPERATIONS AND CASH FLOW. IT'S PURPOSE IS TO PROVIDE MORE USEFUL INFORMATION TO READERS OF FINANCIAL STATEMENTS.

ISSUE ANALYSIS:

THE FASB SEEKS TO EXCLUDE PRESCRIPTIVE GUIDANCE. IT APPLIES TO PUBLIC AND PRIVATE ENTITIES. NOTIONAL AMOUNTS, FAIR VALUE, HEDGED ITEMS AND GAINS/LOSSES ARE SET FORTH BY UNDERLYING RISK. CONTINGENCY FEATURES ARE DESCRIBED; SUCH AS, PAYMENT ACCELERATION CLAUSES, THE FAIR VALUE OF DERIVATIVE INSTRUMENTS; FAIR VALUE AS COLLATERAL IN ACCORDANCE WITH CONTINGENCY LIABILITIES. THE NOTIONAL AMOUNTS IN TABLES INCLUDES THE FAIR VALUE OF DERIVATIVE INSTRUMENTS BY PRIMARY UNDERLYING RISK AND THE ACCOUNTING DESIGNATION. ALL GAINS/LOSSES ARE DISCLOSED ON DERIVATIVE INSTRUMENTS IN EXISTENCE DURING THE PERIOD. GAINS AND LOSSES OF HEDGED ITEMS ARE DESCRIBED EXCLUSIVE OF TABLES. HEDGED ITEMS NOT DESIGNATED AND QUALIFIED UNDER STATEMENT 133 WHICH GOVERNS HEDGE RELATIONS ARE TO BE EXCLUDED FROM THE DISCLOSURE TABLES. QUANTITATIVE INFORMATION ABOUT NON-DERIVATIVE INSTRUMENTS USED AS PART OF THE OVERALL RISK MANAGEMENT ISN'T DISCLOSED ON THE TABLES. CONTINGENT LIABILITIES IN DERIVATIVE INSTRUMENTS AND COUNTERPARTY CREDIT RISK IS GIVEN.

Member Comment:

Strategically, the FASB seeks to promote disclosure of derivative instruments by underlying risk i.e. interest rate, credit, foreign exchange stability or overall price. This information provides users of the financial statements with more informed data about the nature of risks and volatility in the different forms. Interest rate risks fluctuate in response to the Federal Reserve control over the money supply and the economic environment of inflation, deflation, a normalized money supply and the cost of money in the USA. Overseas, interest rates are impacted by the governing actions of bourses and the expectations of foreign investors, as well as governmental activities/dispositions.

Credit risks are a function of credit scoring criteria of the major agencies, past collection experience and overall investment portfolio exposure. Foreign exchange risks are a function of currency stability. A stable currency will have a fairly predictable expectation by investors. An unstable currency will be the subject of very risky speculation with gains to the insiders and losses to the investor public . A systemic instability may be due to governmental crises or expropriatory tendencies.

All of these factors come together in arriving at an overall profile which fairly depicts the financial environment of hedging activity, the determination of notional amounts, fair valuation of derivative instruments and the constancy of investor expectations. Contingency features are a factor in derivative instrument payment acceleration clauses. These derivative instrument contingencies also attain for major contingent features and material adverse change clauses in arriving at a net liability position. The "going concern concept" may be enhanced with increased capitalization ratios, obtaining additional

capital contributions, formulation of a derivative business strategy, increasing new capitalization and the involvement of major shareholders in affirming existing commitments or making new ones.

Signs of increased risk include major increases in non-accrued loans, increases in related party transactions, the probability that preferred shareholders will exercise liquidation rights and the existence of major options under Executive Plans. Well-founded assumptions of the “going concern” concept include higher capitalization ratios, stability of capital contributions, a superior derivative business strategy, rational increases in new contributions of capital and the overall contentment of major shareholders and the investor public.

The management of derivative instruments and hedging takes on an important dimension in major Quasi-Reorganizations in bankruptcy. Major reorganizations require the dating of retained earnings for 10 years and additional disclosure and monitoring of plan reorganization requirements. The purpose of a quasi-reorganization is to provide the entity with a rational “second chance”. The management can direct its business activities to a more profitable genre. Financial activities can be shed when there is a strong causative connection to the bankruptcy condition which occasioned the need for a quasi-reorganization.

In this light, a rational management of derivative activities and a more heightened risk averseness is in order. Forward contracts may be made to lock in interest rates on the issuance of debt. Hedging seeks to manage the underlying interest paid on debt through interest rate swaps. The management of fixed and floating rates is another issue in debt portfolio strategy. When deficit retained earnings are too high i.e. > 40% of capital contributions, the entity is critically undercapitalized, there may be a need for a Capital Restoration Plan and no dividends may be paid without prior approval of governmental or quasi-governmental agencies; such as the FDIC. Concurrent with the need for a rational Capital Restoration Plan is the need for a strategic plan to manage and disclose derivatives and their impact on the entity financial position, results of operations and cash flow.

Disclosure is required of the aggregate fair value of assets to be posted as collateral. Timely collateral valuation, volatility of collateral and double counting of collateral are all problematic areas requiring a heightened audit awareness.

The disclosure of the existence of contingent features is encouraged. Circumstances which trigger the contingent features at the end of the period are another important disclosure to the readers of financial statements and the investor public because they document the conditions precedent to rational expectations of the strategic constituencies of an entity.