

COMMITTEE ON PRIVATE COMPANY STANDARDS

September 30, 2010

Technical Director Financial Accounting Standards Board 401 Merritt 7 P. O. Box 5116 Norwalk, CT 06856-5116

Sent by email to director@fasb.org

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Dear Technical Director:

The Committee on Private Company Standards (CPC-S) of Financial Executives International (FEI) wishes to express its views on the Financial Accounting Standards Board's (FASB's) Exposure Draft of a Proposed Accounting Standards Update, Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities—Financial Instruments (Topic 825) and Derivatives and Hedging (Topic 815).

FEI is the leading advocate for the views of corporate financial management in the United States. It is a professional association of more than 15,000 CFOs, treasurers, controllers and other senior financial managers. CPC-S is a technical committee of FEI which formulates private company positions for FEI in line with the views of the membership. This letter represents the views of CPC-S and not necessarily the views of FEI.

Our responses are limited to financial instruments that are more general in nature and specifically exclude some assets or liabilities of financial institutions. We believe accounting for financial institutions is a specialized and regulated area that should be left to regulators. If general-purpose financial statements do not provide information relevant to regulators, they have the ability to require additional information without affecting the general accounting principles used by unregulated entities. Attempting to incorporate specialized rules into a standard intended to cover all companies can lead to unintended consequences in its implementation or interpretation by unregulated entities.

Scope

Question 1: Do you agree with the scope of financial instruments included in this proposed Update? If not, which other financial instruments do you believe should be excluded or which financial instruments should be included that are proposed to be excluded? Why?

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In general, users of private company financial statements are different than users of public company financial statements. The investment objective, the ability to change or monetize the investment, and the vested interest in the long-term effects of decisions are all differences between public company investors and private company investors. Private companies also relate to other non-equity users differently in their ability to provide additional information if asked. This selective disclosure is not possible with other users of public company financial statements.

Because of these differences, the immediate exit value of an asset as it contributes to the fair value of the entity is less relevant to a private company user than it is to a public company user.

We also believe that related party assets and liabilities should be excluded from the scope of the standard. Related party financing and cross ownership is common in private companies that may not be in the same consolidated group. Related party transactions already have significant disclosures about their terms and will be more difficult to value with certainty. We believe that remeasuring the value of related party amounts will not improve the financial statements and may lead to unintended consequences for users.

We do not agree with the scope as it relates to financial assets or liabilities held to maturity. We believe that while some current financial assets are technically marketable, the most relevant metric is the expected cash flow from the current asset. The practice and intent of the entity is relevant, and a possible outcome that is remote is not the most relevant measure. If the intended disposition of the asset is for it to be held to maturity, it should be carried at its historical cost and appropriate allowances for discounts taken or bad debts recorded. Measurement at an amount that is remote instead of an amount that is most probable does not provide relevant, decision-useful information.

Issued debt is another instance where we believe the scope should be limited. If the intent is to hold the debt to maturity, the most relevant financial metric is the expected future cash flows measured by historical cost. It is inconceivable that marking issued debt to a currently tradable value is more relevant if it is neither the intent nor the expected outcome. We believe changing the value of a liability to an amount that will not be settled distorts the financial condition of the company, whether the change is included in net income or other comprehensive income. It doesn't matter where the change is recorded, the change is inappropriate and provides misleading information to the private company financial statement user whose investment horizon is longer than a single reporting period and does not routinely use a reported period's statements for immediate exit value determinations.

The scope should exclude assets or liabilities that are expected to be held to maturities unless those assets or liabilities are quoted on an exchange such as publicly traded stocks, bonds or derivatives.

Question 4: The proposed guidance would require an entity to not only determine if they have significant influence over the investee as described currently in Topic 323 on accounting for equity method investments and joint ventures but also to determine if the operations of the investee are related to the entity's consolidated business to qualify for the equity method of accounting. Do you agree with this proposed change to the criteria for equity method of accounting? If not, why?

No, we do not agree that the equity method should be limited to investees whose businesses are related to the entity's consolidated operations. We believe the equity method concept, while not perfect, does fairly reflect the economic interest held by the investor and is an appropriate measurement of operational performance of the investee, consistent with the primary focus of private company financial statement users. We do not believe a more subjective measure of value would be more relevant, only more subjective. We do not agree that Level 3 valuations improve the usefulness of financial statements and substantial investments that would otherwise qualify for equity method treatment would likely be classified as Level 3 investments. Users of private company financial statements find objective measures, even of investees whose activities are unrelated to the nature of the parents operations, more relevant than fluctuating estimates of fair value. Even in cases where a Level 1 valuation of an investee is available, the operating performance of an investee is a more relevant indicator of performance to both the parent and the users of the parent's consolidated statements, than a subjective valuation of enterprise value. Unlike public company investors, the users of the parent company consolidated statements have the ability to compel an independent business appraisal of a controlled investee if desired. Anecdotal evidence indicates that demands for valuations of investees occur substantially less frequently than, and are unrelated to, the publication of periodic private company financial statements. While mandating via GAAP that such valuations be incorporated into financial statements may satisfy public company investors, such information hinders private company users in how they use financial statements for decision-making purposes.

Questions for All Respondents

Question 8: Do you agree with the initial measurement principles for financial instruments? If not, why?

We believe all items should initially be measured at their amortized cost. All fair value remeasurements should be recorded in other comprehensive income.

Question 9: For financial instruments for which qualifying changes in fair value are recognized in other comprehensive income, do you agree that a significant difference between the transaction price and the fair value on the transaction date should be recognized in net income if the significant difference relates to something other than fees or costs or because the market in which the transaction occurs is different from the market in which the reporting entity would transact? If not, why?

We believe that any and all fair value remeasurements should be recorded as other comprehensive income.

Question 10: Do you believe that there should be a single initial measurement principle regardless of whether changes in fair value of a financial instrument are recognized in net income or other comprehensive income? If yes, should that principle require initial measurement at the transaction price or fair value? Why?

Other comprehensive income is an enigma. It is not well defined and the development of accounting standards is substantially inconsistent with its definition in the FASB Concepts Statements. While we think we can understand why some items are recorded as other comprehensive income, we cannot come up with a consistent theory that allows us to determine when an item should be categorized as net income versus other comprehensive income. Because of this, we do not see any reason why the classification difference between other comprehensive income or net income should matter for any decision of initial measurement.

We believe that the lack of clearly defined and consistently applied concept of separating items to be included in net income and other comprehensive income impairs the credibility of the income statement and designation of net income. The partial evolution of a theory that puts some economic events into comprehensive income, and some not, hinders the usefulness of financial statements to private company decision-makers.

Question 11: Do you agree that transaction fees and costs should be (1) expensed immediately for financial instruments measured at fair value with all changes in fair value recognized in net income and (2) deferred and amortized as an adjustment of the yield for financial instruments measured at fair value with qualifying changes in fair value recognized in other comprehensive income? If not, why?

We believe that immediately expensing transaction costs more clearly reflects the immediate cash flow of the enterprise; however, the concept of accrual basis accounting and the matching principle in particular may make deferral more appropriate to the user. Immediate cash flow impacts can be seen on the statement of cash flows and may not be necessary on the income statements. Accounting concepts generally allow for deferring cash expenses today that will benefit future periods. The concept of inventory and fixed assets are examples of deferring expenses that benefit future periods. Financial assets may still benefit future periods. While these financial assets may not have a readily determinable fair value, they are expenditures in the past which will benefit a period in the future and therefore should be deferred assets. Capitalizing the costs of putting one type of asset into place (e.g. property, plant and equipment), and not capitalizing similar costs for another type of asset is confusing to the user who is trying to comprehend what operating income represents.

The systematic elimination of matching revenues and expenses is a troubling trend. The fair value of an asset is not the only relevant measure and measuring all assets at fair value ignores the impact on the income statement. The income statement is a very relevant statement to many users and is more relevant to private company users as the ultimate

scorecard of their past decisions. Understanding the matching of the consumption of resources in a company's operations to the resources obtained in return from that consumption (i.e., expenses versus revenues) remains the primary use of private company financial statements.

Subsequent Measurement

Questions for All Respondents

Question 13: The Board believes that both fair value information and amortized cost information should be provided for financial instruments an entity intends to hold for collection or payment(s) of contractual cash flows. Most Board members believe that this information should be provided in the totals on the face of the financial statements with changes in fair value recognized in reported stockholders' equity as a net increase (decrease) in net assets. Some Board members believe fair value should be presented parenthetically in the statement of financial position. The basis for conclusions and the alternative views describe the reasons for those views. Do you believe the default measurement attribute for financial instruments should be fair value? If not, why? Do you believe that certain financial instruments should be measured using a different measurement attribute? If so, why?

Increasing the complexity of the balance sheet is not a good answer. The most relevant value should be presented on the balance sheet, the changes in the income statement or in other comprehensive income. Additional explanations belong in the notes to the financial statements. Financial statements are already becoming too complex and complicated for the average user to understand and digest. Adding additional requirements for the face of the balance sheet will only exacerbate the complexity problem.

Also, we agree that an entity should be permitted to measure its short-term receivables and payables at their amortized cost. However, we do not agree with the proposal to exclude credit card receivables from this exception. For entities operating in the retail trade, for example, credit card receivables are generally collected in less than one week (often, in no more than two days). Therefore, measuring such receivables at fair value would be wasted effort, as the difference between such value and amortized cost would be insignificant and meaningless.

Hedge Accounting

Questions for All Respondents

Question 56: Do you believe that modifying the effectiveness threshold from *highly effective* to *reasonably effective* is appropriate? Why or why not?

We believe the changes made to the effectiveness testing are an improvement when compared to the testing in the existing standard. However, not all private companies

calculated effectiveness under the existing standard and the proposed standard would impose additional compliance costs on those entities.

We also believe that the term reasonably effective would be more effective if it were better defined. Not establishing or defining reasonably effective will not limit the abuse and manipulation. Reasonably effective should be defined more explicitly.

Question 57: Should no effectiveness evaluation be required under any circumstances after inception of a hedging relationship if it was determined at inception that the hedging relationship was expected to be reasonably effective over the expected hedge term? Why or why not?

If circumstances change substantially, such as paying off floating rate debt that had an effective interest rate swap to fixed, the accounting for the derivative should change.

Question 58: Do you believe that requiring an effectiveness evaluation after inception only if circumstances suggest that the hedging relationship may no longer be reasonably effective would result in a reduction in the number of times hedging relationships would be discontinued? Why or why not?

We believe the changes made to the effectiveness testing are an improvement when compared to the testing in the existing standard. However, not all private companies calculated effectiveness under the existing standard and the proposed standard would impose additional compliance costs on those entities.

Questions for Preparers and Auditors

Question 61: Do you foresee any significant operational concerns or constraints in calculating ineffectiveness for cash flow hedging relationships? If yes, what constraints do you foresee and how would you alleviate them?

Yes, we do see significant operational concerns in calculating the ineffectiveness of cash flow hedges. Specifically, the elimination of the safe harbor treatment of treating all hedges as ineffective will increase audit and compliance costs.

In the past, many private companies chose to comply with the documentation requirements to have derivatives qualify as hedges. However, many private companies also choose not to designate any of these derivatives as hedges, in order to avoid the additional audit costs that would be incurred to check the documentation. The documentation was kept to satisfy tax hedge accounting treatment, but not used for financial accounting treatment.

By removing this shortcut and allowing a simplified ineffectiveness test, the audit costs will increase when compared to no audit costs at all. All of the effectiveness testing will have to be done initially and will be reviewed. The review will increase audit fees that otherwise would not have been incurred. Easier testing is still testing. The shortcut allowed before

required no testing, only the verification of ending values which is also required in the proposed standard.

What we find most unfortunate is that the information is irrelevant. By using the shortcut of the past, all changes in fair value were recorded in net income. Other comprehensive income treatment did not matter since the fair value change was being ignored. Ignoring the change in net income was as easy as ignoring other comprehensive income. Under the proposed standard, the result will still be ignored. It may be partially ignored in net income and ignored in other comprehensive income, but the end result will be the same and it will be totally ignored.

The adjustment of a hedge to fair value may be important to a residual equity investor of a public company. The change in fair value does not have the same significance to a private company equity owner. A private company equity owner does not have the ability to immediately monetize the value of the investment and therefore fair market value measures have less relevance to them as a group.

Question 62: Do you foresee any significant operational concerns or constraints in creating processes that will determine when changes in circumstances suggest that a hedging relationship may no longer be reasonably effective without requiring reassessment of the hedge effectiveness at each reporting period? If yes, what constraints do you foresee and how would you alleviate them?

This is another example of where additional audit fees will be incurred as a result of the elimination of the shortcut method of not designating any derivatives as hedges.

Question 63: Do you foresee any significant operational concerns or constraints arising from the inability to discontinue fair value hedge accounting or cash flow hedge accounting by simply dedesignating the hedging relationship? If yes, what constraints do you foresee and how would you alleviate them?

See response to Q 61 and Q 62. Audit fees will increase but the total financial results will not change. We do not see any value in forcing additional costs on companies only to require them to record some portion of a change in fair value as other comprehensive income.

Question 64: Do you foresee any significant operational concerns or constraints arising from the required concurrent documentation of the effective termination of a hedging derivative attributable to the entity's entering into an offsetting derivative instrument? If yes, what constraints do you foresee and how would you alleviate them?

See response to questions 61, 62 and 63.

Effective Date and Transition

Questions for All Respondents

Question 69: Do you agree with the proposed delayed effective date for certain aspects of the proposed guidance for nonpublic entities with less than \$1 billion in total consolidated assets? If not, why?

While we agree that a delay in the effective date for some entities is appropriate, we do not agree that size is the appropriate test. We believe a delay should be based on relevance to the user and the appropriate division is publicly traded entities vs. private enterprises.

Questions for Preparers and Auditors

Question 70: How much time do you believe is needed to implement the proposed guidance?

We believe that all private entities should be allowed the deferral period proposed for entities of \$1 Billion or less.

Thank you for considering our comments. If you have any questions or wish to discuss this letter, please feel free to contact me at (918) 456-1472 or by email at dbuck@reasors.com, or Ronald Wei at FEI (973) 765-1025 or by email at rwei@financialexecutives.org.

Sincerely,

Daryl E. Buck, Chair

Committee on Private Company Standards

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Financial Executives International