April 17, 2006

Ms. Suzanne Q. Bielstein  
Technical Director  
Financial Accounting Standards Board  
401 Merritt 7  
PO Box 5116  
Norwalk, CT 06856-5116


Dear Ms. Bielstein:

We appreciate the opportunity to comment on the FASB’s Proposed Statement of Financial Accounting Standards: The Fair Value Option for Financial Assets and Financial Liabilities (the ED). We believe the ED, if adopted in its current form, would both positively and negatively impact the quality of financial information creditors use in their decision making.

Moody's supports the ED's stated objectives: mitigation of earnings volatility caused by hedge accounting and continued international convergence. We believe that including reliable fair value information in the financial statements, in certain situations, can assist financial statement users in analyzing and understanding an entity's economic position when provided in conjunction with historical cost data and other disclosures.

However, we believe there are features of the ED that could negatively impact the comparability, reliability and relevance of financial statements, possibly to the point of compelling users to unwind some of the proposed accounting through analytic adjustments. Our concerns are the following:

- **Optional application and broad scope of the proposed standard could undermine comparability** – In general, we do not favor treatment alternatives in accounting standards due to their negative impact on comparability. The use of fair value accounting under the proposed standard will be completely optional for most financial assets and financial liabilities, possibly decreasing comparability between entities when different measurement methodologies are applied to similar financial assets and liabilities. Additionally, the fair value election can be made on a contract-by-contract basis, which could create comparability issues within an entity as it would be permitted to have identical financial assets or financial liabilities accounted for under different methodologies.

However, the proposed standard’s impact on comparability could be mitigated if, in practice, management were to narrowly elect the option. We believe management could be motivated to limit its fair value option to hedging relationships with asymmetrical accounting (i.e. – one side of the hedge is accounted for at historical cost and the other side at fair value) while hesitate in applying it to financial assets and liabilities that are not in hedging relationships due to earnings volatility concerns. Unfortunately, it does not appear from the ED that the FASB has explored the extent companies will use the fair value option.

Although volatility inherit in fair value accounting could lead to a narrow application of the proposed standard on an ongoing basis, permitting optional treatment for existing financial assets and financial liabilities at initial adoption of the standard will likely lead to widespread “cherry-picking.” Such cherry picking will afford the most favorable accounting result and thereby undermine comparability.
• Considering a company’s own creditworthiness in measuring the value of its debt reduces financial statement relevance — We acknowledge there are situations in which measuring debt at fair value can be useful. One example is a company utilizing debt as part of a “matched book” asset and liability management strategy. Another is when debt has a high likelihood of early redemption. However, in many cases, electing to measure a company’s own debt at fair value results in irrelevant or potentially misleading reporting. For example:

➤ *Fair value measurement can contemplate changes to the debt contract.* For example, assume that a company owes $1 million the day following the balance sheet date and that the fair value of that debt is $250,000. In that case, the fair value measurement contemplates that the company will not honor its contract and that the contract will be modified. In general, we believe that accounting for debt should reflect existing contracts and record the effects of changes in contracts in the periods in which they occur. In this example, the argument that $250,000 is relevant because the debt could be settled at this amount is specious because the company cannot afford to settle the debt (which is why its fair value is so far below the contractual obligation). By measuring the debt at $250,000, the user of financial statements could incorrectly conclude that an insolvent company is solvent and fail to see that the company is about to default on its debt, which in turn could trigger imminent bankruptcy, liquidation, or sale of the company.

➤ *Fair value measurement of debt sometimes signals false positive results.* A reduction of debt resulting from deteriorating credit risk both reduces debt and increases income, and affects many of the components that make up metrics that have historically proven to be relevant to assessing credit risk. These include the amount of debt, interest or income. Ironically, fair valuing a company’s own debt improves credit metrics at the very time that credit risk is increasing. Measurement of a class of debt at fair value can also give misleading signals about the amount of a creditors claim in the event of the company’s bankruptcy, a critical factor in assigning credit ratings to various classes of debt instruments.

We have considered two arguments in favor of fair valuation of a company’s own debt, and rejected both.

The first is that gains from re-measurement of debt in times of deteriorating credit will be more than offset from declines in the company’s assets, thereby avoiding false positive results. We believe that asset re-measurement is unlikely to occur in a pattern that avoids sending false positive signals. Many of the assets that are eroding during declines in business are not recognized in the financial statements, so there is nothing to re-measure. Further, re-measurement of many assets is infrequent and lumpy (e.g. impairment) unlike re-measurement of debt at fair value.

The second argument for fair value is that it best represents the amount at which a company could settle its debt. However, in times of deteriorating credit, many companies cannot afford to settle their debt, and so measuring it at settlement amount is less relevant to decision making, and sometimes presents a misleading picture of credit risk.

➤ *Companies under financial stress are likely to consider the option upon transition to the new standard.* Distressed companies may be motivated to measure their debt at fair value at transition so as to appear more solvent and less leveraged, and to avoid triggering debt covenants. In these circumstances, measurement of a company’s debt at fair value can be misleading for the reasons outlined above.

• Valuing financial assets and financial liabilities without readily determinable fair values may undermine the reliability of reported amounts - The proposed standard would include a fair value option for financial assets and liabilities that may not have a readily determinable fair value such as equity method investments. Although the permitted methodologies for calculating fair value is outside the scope of this standard, the wide disparity in the methods and assumptions used to value certain financial assets and liabilities could introduce unreliable measurements into the financial statements and make assessment of the reliability of those measurements difficult. This also would likely create comparability issues between entities. This concern is evidenced by the FASB’s recent efforts to bring additional consistency and comparability to fair value measurements and disclosures through its Proposed Statement of Financial Accounting Standards: Fair Value Measurements.
Our Suggestions

To address the risk that the fair value option undermines comparability, we suggest the Board determine preparers’ likely scope of applying the fair value option. If preparers’ will apply the option narrowly (i.e. primarily applied to asymmetrical hedging relationships), the impact on comparability of financial statements could be limited and more than offset by benefits related to hedge accounting and international convergence.

Ways to determine the likely scope of application is to conduct a survey or field test. Further, perhaps the Board could learn from the experience of companies applying the fair value option in IAS 39 - Financial Instruments: Recognition and Measurement. Although the fair value option in the ED is not identical to the option in IAS 39, perhaps there are enough similarities for the IAS experience to be instructive.

To assist financial statement users in understanding management’s utilization of the fair value option, we believe companies should disclose why the fair value option was exercised for each contract or class of contracts. Additionally, if the fair value election is not chosen for all contracts in one class, disclosure explaining the reasons for the partial election should be made. This disclosure will provide insight into management’s motivation for using the fair value option. For example, this disclosure would highlight which contracts are being used for asset and liability management purposes.

To avoid companies cherry picking the most advantageous accounting upon transition to the new statement, we suggest the Board consider allowing prospective application only. We understand this would eliminate the benefit of reducing volatility in existing long-term hedging relationships with asymmetrical accounting, but believe this is a less onerous impact compared to the significant financial statement manipulation that could occur under the ED.

Regarding our concerns about the usefulness of fair valuing a company’s own debt, the Board should consider limiting the fair value option for a company’s own debt to cases in which the company manages its debt as part of a "matched book" or it is likely the company will settle its debt in the near-term.

Moody’s will likely adjust the financial statements of companies electing to measure their debt at fair value to restate the debt to amortized cost, in many cases. We will do this to reverse the misleading impact on our key credit metrics we perceive will occur by measuring debt at fair value. Except for the limited circumstances mentioned above, we believe amortized cost is often the more relevant measure as it better represents the likely cash flows that will need to be made to service the debt. Therefore, we request that the Board require companies to disclose information that will help us adjust the financial statements to amortized cost and to understand the contractual cash flows required under debt agreements:

- The proposed standard requires the disclosure of "the difference between the carrying amount of any financial liabilities reported at fair value...and the aggregate principal amount...[due] at maturity." This will not provide a financial statement user with sufficient understanding of the timing of future cash outflows related to debt servicing. We believe the proposed standard should require the disclosure of an annual debt maturity schedule at contractual value with a reconciliation in aggregate to amortized cost.

- The proposed standard requires the disclosure of "information sufficient to allow users of financial statements to understand the effect on earnings...of changes in...fair values" and "quantitative information by line item indicating where in the income statement gains and losses are reported that arise from changes in...fair value." Instead, we suggest the proposed standard require the specific quantification and disclosure of gains or losses arising from changes in the fair value of debt, and in which specific line item this gain or loss has been recorded. If the gains or losses from changes in the fair value of debt are recorded in multiple income statement line items, companies should disclose and quantify the impact on each line item.

Although we are troubled with the prospect of companies measuring their debt at fair value, we do not support the idea of excluding the effects of a company’s own credit risk from fair value measurement (partial fair value). We find partial fair value measurement to be confusing and unhelpful.
Regarding our concerns about the reliability of fair value measurements in certain cases, we recommend that the Board:

- Not finalize the fair value option proposal until after it has issued its statement on fair value measurement. We suspect that the guidance in the measurement standard will be helpful in measuring assets and liabilities whose measurements are inherently uncertain. Further, the fair value disclosures required by that statement will help users understand the inherent uncertainty in fair value measurement and the elements of fair value change included in the reported income or loss.

- Consider precluding the fair value option for assets and liabilities falling into the lower categories of reliability, with the exception of financial assets and financial liabilities without an appropriate alternative to fair value measurement, such as derivatives.

Thank you for considering our comments and we would be pleased answer any questions you may have at your convenience.

Sincerely,

Gregory Jonas
Managing Director

Craig Emrick
VP – Senior Accounting Analyst