April 23, 2006

Mr. Lawrence Smith  
Director of Technical Application and Implementation Activities  
Financial Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, CT 06856-5116


Dear Mr. Smith:

The Financial Reporting Committee of the Institute of Management Accountants appreciates the opportunity to provide its views on the Exposure Draft, The Fair Value Option for Financial Assets and Liabilities. The FRC supports the ED as we believe that the elective accounting provided would be beneficial to certain financial institutions in addressing the anomalous results associated with the mixed attribute model and obviating hedge accounting for those entities in a number of common scenarios. However, we also observe that there are a great many issues that continue to exist with accounting for derivatives and hedging activities that are not addressed by this ED and will not be solved in phase 2 of the project. We therefore request that the Board make additions to its limited scope project to address certain issues that exist with FAS 133. Our detailed comments on each of these matters are provided below.

The Fair Value Option ED

We believe that the proposed accounting will be very helpful to financial institutions that fair value many of their assets (e.g., investment securities classified as trading, derivative portfolios, etc.) through earnings but are unable to obtain similar accounting for the liabilities that finance those assets. We also believe that the option will be helpful in replacing fair value hedge accounting in certain areas.

We applaud the Board’s efforts to craft guidance that is relatively simple and straightforward and express our hope that it will remain so even after redeliberations are complete. While we have questions about matters such as determining the appropriate unit of account for measurement, we believe that preparers should be permitted to exercise appropriate professional judgment provided that they apply their conclusions consistently in all similar situations.
While we are troubled by the notion of recognizing gains and losses in earnings attributable to changes in a reporting entity's own credit rating, we choose not to object to the principle in a standard that permits that accounting as an option. To the extent that a number of financial institutions choose to do so, it would be interesting and helpful to learn how users of their financial statements react to that information. As the ED has been heralded as the solution to the complexities associated with hedge accounting, we wish to observe that companies will find the fair value option an unattractive alternative to fair value hedging, because recognition of changes in their own credit spread will create earnings volatility. Under FAS 133, entities can hedge the financial risk related to the benchmark interest rate; the effects of changes in their own credit spread on the fair values of their liabilities is not measured or recorded in earnings.

We would support expanding the scope of phase 1 of this project to include finance/capital leases and written loan commitments. We believe such leases are not sufficiently different from loans and other non-traded financial instruments that would justify prohibiting them from receiving this accounting. At a minimum, we believe the fair value option should be extended to full payout leases in which there is no unguaranteed residual interest. Contrary to the conclusion in paragraph A6.c., which suggests that sales-type and direct financing leases are not purely financial assets, the asset recognized in a full payout lease is purely a financial asset. We also do not understand why loan commitments that are not within the scope of FAS 133 would be excluded from the scope of this standard while at the same time a forward to acquire such assets would be. Assuming that the Board agrees that the fair value option should be extended to loan commitments, we believe it should provide guidance on the unit of account. For example, should a company value each commitment separately, or would it be appropriate to value pools of commitments sharing similar characteristics, such as loan term and interest rate?

We agree with the Board's decision to not prescribe specific disclosures for each enterprise. It would be enormously difficult to prescribe specific disclosures that would meet the objectives set forth in the ED. However, it was not clear how the disclosures required by paragraph 12b differ from those required by paragraph 12c and suggest that the Board either clarify paragraph 12b or provide some examples of disclosures that might assist companies in being responsive to the intended objective.

**Hedge Accounting Simplification**

As we noted previously, the fair value option does not address many of the issues that exist today with cash flow hedging and hedging of non-financial assets and liabilities. In addition, out of concern over earnings volatility related to credit spreads, some entities have already decided against using the fair value option as an alternative to fair value hedge accounting. It would therefore be truly unfortunate if the Board's interest in and enthusiasm for the fair value option causes it to overlook or assign a low priority to addressing the very real issues that continue unabated with the Board's standard on hedge accounting.

There have been numerous FAS 133-related restatements. Most commonly, the restatements result from the judgment that the short-cut method has been inappropriately used and, as a result, a company did not perform the mechanical measurement of hedge ineffectiveness on a quarterly basis. As a result, the company must restate all periods to remove the effect of hedge accounting. In the cases we are aware of, the hedges were highly effective from an economic standpoint. While restatement might be justified if it provided users of financial statements with better financial information, we do not believe such restatements provide information that is
decision useful. The financial statement effect in the restatement(s) bears no relationship to what the actual accounting result would have been had the company performed the quarterly assessment. It would make far more sense in such situations to retrospectively assess whether the hedges were effective and recognize the cumulative ineffectiveness in earnings.

We believe that issues associated with application of the short-cut method are symptomatic of more fundamental problems with the standard. Not only is FAS 133 one of the most complex standards the Board has ever issued, it also is one of the most technically demanding — meaning that there are dire consequences for even the smallest errors in application. Beyond application of the short-cut method, we have significant concerns that there are issues looming with documentation matters, grouping of hedged items, and identification of forecasted transactions. Neither the actions that the Board has taken thus far with respect to the fair value option nor the proposed future actions in phase 2 will help in any of these areas.

We also believe the Board should revisit its recent agenda decision concerning the issue of bifurcation/componentizing risks in hedges of non-financial assets and liabilities. We understand that at least for some Board members, the rationale for not adding the project was that the issue would be addressed by the fair value option. We wish to make clear that even phase 2 of the project will not help with this issue, because the fair value option will require companies to record fair value volatility in the entire non-financial asset. What companies desire to achieve through the hedge is to protect against the price risk from a specific embedded commodity component. The fair value option will not achieve that objective. Further, many of the arrangements where this issue arises are cash flow hedges of anticipated transactions. Therefore, it is difficult to see how the fair value option will provide significant relief.

We therefore urge the Board to be proactive on these hedge accounting issues by including them in the scope of the current projects on FAS 133 implementation issues, enabling the Board to study these and other application issues. The FRC would be pleased to work with members of the Board and staff to identify specific issues and to recommend potential solutions. You may contact me at 513-983-3874.

Sincerely,

Teri L. List
Chair, Financial Reporting Committee