



BDO Seidman, LLP
Accountants and Consultants

233 N. Michigan Ave., Suite 2500
Chicago, Illinois 60601
Telephone: 312-616-4661
Fax: 312-856-9019

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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:

BDO Seidman, LLP is pleased to offer comments on the FASB's December 8, 2006 Exposure Draft (ED), *Disclosures about Derivative Instruments and Hedging Activities— an Amendment of FASB Statement No. 133*. We support the Board's efforts to improve the transparency and understanding of derivative instruments, and have included several comments below which we believe will better achieve this objective. However, recognizing that a uniform approach is not likely to satisfy all constituents, we would reduce the required disclosures for the smallest, private companies and provide a wider array of examples for other companies to meet the needs of more sophisticated financial statement users.

We agree with the value of issuing this pronouncement, as adjusted for our comments, because it would partially improve the disclosure shortcomings the Board acknowledges in its request for comment. However, we also believe the utility of prescribed disclosures for derivative instruments in a hedging relationship under Statement 133 may be reduced as a result of the issuance of Statement 159 since economic hedges using financial instruments carried at fair value would fall outside of the required disclosures in this ED. We recommend the Board revisit disclosure requirements for economic hedges in conjunction with Phase II of the Fair Value Option (FVO). At that time, the Board will have the benefit of hindsight with respect to the effectiveness of the disclosure requirements of Statement 159. In addition, certain nonfinancial assets and liabilities, such as products exchanged in the oil and gas industry, may be incorporated into economic hedges under Phase II of the FVO that were not previously designated in hedging relationships under Statement 133 simply because of the complexity of complying with that standard. Therefore, our recommendation that the Board address disclosure requirements for economic hedges as part of Phase II of the FVO should capture the majority of hedging activity outside the scope of Statement 133, which could become significant.

Finally, we note one of the ED's objectives is to provide information about how derivative instruments affect an entity's financial position, results of operations and cash flows. We are uncertain how the ED would improve a user's understanding of such cash flows.



Paragraph 1 cites qualitative disclosures about counterparty credit risk and contingent features to meet this objective. Such disclosures appear to provide information about *potential* cash flows under possible future scenarios, but do not address *actual* derivative cash flows recorded during the period.

Our responses to issues identified by the Board for comment follow.

Issue 1: The Board concluded that prescriptive guidance about how derivative instruments should be presented and classified in the financial statements should be excluded from the project's scope. Including presentation and classification guidance could potentially delay issuing a standard that would significantly improve the transparency about derivative instruments and hedged items. In addition, various presentation and classification issues related to derivatives and hedged items have an impact on the Board's current project on financial statement presentation and also would need to be addressed in the context of that project. Do you agree with the Board's decision to exclude from the scope of this proposed Statement prescriptive guidance about how derivative instruments should be presented and classified in the financial statements? Why or why not?

We agree for the reasons cited by the Board.

Issue 2: Statement 133 applies to both public and private entities. The requirements in this proposed Statement also would apply to both public and private entities. Do you agree that this proposed Statement should apply to both public and private entities? Why or why not?

While we agree with the general objectives in paragraph 1 of the ED, we believe the application should differ for small, private entities. We note that it is not uncommon for users of a small, private company's financial statements (such as owners, lenders and vendors) to be fully apprised of the entity's simplistic use of derivatives under existing GAAP. For example, a small manufacturing company may be party to a basic interest rate swap with its lender and a hedge on the future price of a commodity used in its production process. Often the lenders require the company to enter into derivatives as a condition of obtaining a loan. We believe the economics of those arrangements are already apparent to the stakeholders that have access to company's financial statements, without the tabular presentation proposed in the ED. Accordingly, we recommend a size-based test for private companies that would retain the broad objectives stated in paragraph 3 of the ED, but would exclude such entities from the prescriptive tabular guidance and allow them sufficient flexibility to tailor the disclosures to their users' needs. This may or may not result in a tabular presentation. We note paragraph 47 of Statement 109 provides at least one precedent in which private companies are allowed to disclose qualitative information in lieu of more detailed numeric disclosures that are required for public companies.



In developing a sized-based test for private companies, we believe the Board should provide a quantitative threshold similar to the scope in Statements 107 and 126, notwithstanding the guidance in paragraph 2(c) of Statement 126. We would further limit this exception to qualifying entities holding no more than a few derivative instruments.

***Issue 3:** This proposed Statement would require an entity to provide information on derivative instruments (including, but not limited to, notional amounts and fair value amounts), hedged items, and related gains and losses, by primary underlying risk, accounting designation, and purpose in the tabular form at shown in Appendix A. Do you foresee any significant operational concerns or constraints in compiling the information in the form at required by this proposed Statement? Are there any alternative formats of presentation that would provide the data more concisely?*

We note the final section in paragraph 3(b) indicates individual tables “shall be presented, when applicable, for interest rate risk, credit risk, foreign exchange rate risk, and overall price risk... Individual tables shall also be presented, when applicable for situations in which derivative instruments contain multiple underlying risks” such as interest rate risk and credit risk. It appears this language could result in duplicative disclosures because it would be rare to identify a derivative characterized by only a single risk, for instance interest rate risk without counterparty credit risk. Therefore, some may conclude two tables should be presented that include the same derivative—one based on interest rate risk, a second based on interest rate risk and credit risk.

We also note the first sentence in paragraph 3(b) requires disclosure based on “primary” underlying risk. If use of the word “primary” is designed to preclude duplicative disclosure, we suggest adding language in the final section of paragraph 3(b) clearly stating a derivative instrument should only be presented in a single table.

***Issue 4:** This proposed Statement would require disclosure of (a) the existence and nature of contingent features in derivative instruments (for example, payment acceleration clauses), (b) the aggregate fair value amount of derivative instruments that contain those features, and (c) the aggregate fair value amount of assets that would be required to be posted as collateral or transferred in accordance with the provisions associated with the triggering of the contingent features. Do you foresee any significant operational concerns or constraints in compiling that information for this disclosure?*

Paragraph 3(c) indicates entities that “hold or issue” derivative instruments are subject to the disclosures regarding contingent features. Under that guidance, if the likelihood of the borrower’s default is more than remote, a creditor might be in the position of disclosing the fair value of certain collateral assets that it does not own. For example, if a holder has separated a put option from a debt host contract under Statement 133, it may be required to estimate the fair value of a non-liquid asset owned by the borrower. This raises



operational challenges, potentially including the development of a level 3 fair value estimate under Statement 157 for the pledged asset. This may be complicated in the event of foreclosure because the borrower may be unwilling to provide the information necessary for the creditor to prepare a valuation. Further, the creditor's audit firm would have to test the valuation. These appear to be unintended consequences of the proposed language and we suggest the Board clarify its intent in this regard.

Beyond these operational concerns, we question the usefulness of the disclosure required by item (b) above. We note that contingent features are already considered when determining the fair value of the derivative instruments that are recorded in the financial statements, and as such, disagree that disclosing the fair value of derivative instruments containing contingent features provides any added benefit, as described in paragraph B41. The disclosures contemplated by the Board would effectively create an additional grouping of derivative instruments that share no similarities with respect to risk; their only commonality would be the presence of contingent features. We believe derivatives are more appropriately categorized by primary underlying risk as required in the ED, and that supporting qualitative disclosures would provide sufficient information about the timing, likelihood, and potential cash impact of the contingent features.

If the Board does require disclosure of quantitative information regarding contingent features in derivatives, we believe disclosure of the most probable amount that will be paid when the contingency occurs would provide more useful information.

Issue 5: This proposed Statement would require disclosure of notional amounts in tables that also will include fair values of derivative instruments by primary underlying risk, accounting designation, and purpose. Do you agree that this proposed Statement should require the disclosure of notional amounts? Why or why not?

We disagree with the required disclosure of notional amounts. The Board considered and rejected similar disclosure when Statement 133 was issued, as discussed in paragraph 512 of that pronouncement. We continue to believe that since derivatives are recognized in the statement of financial position at fair value, the incremental benefit of disclosing the "face or contract amount" is negligible. More importantly, the disclosure's usefulness is diminished when the company takes an offsetting position: the absolute value of notional amounts increases, while the net economic impact to the company's entire hedged position is a wash.

If the Board reverses the view previously expressed in the basis for conclusions of Statement 133, we suggest modifying the ED to also require that notional amounts be presented in the appropriate narrative context. For example, in conjunction with numeric data, a company would disclose in its footnotes that "these notional amounts reflect our



strategy to hedge price risk for 50% of our commodity purchases in the next six months.” Such language would ensure that disclosure of notional amounts is meaningful to users.

***Issue 6:** This proposed Statement would require disclosure of gains and losses on all derivative instruments that existed during the reporting period regardless of whether those derivatives exist at the end of the reporting period. This proposed Statement would not require disclosure of the aggregate notional amounts related to those derivatives that existed during the reporting period but no longer exist at the end of the reporting period. Do you agree that this proposed Statement should not require the disclosure of the aggregate notional amounts related to derivatives that no longer exist at the end of the reporting period? Why or why not?*

As discussed in our response to Issue 6, we believe there should be no requirement to disclose notional amounts. However, if required, we believe it should be accompanied by a plain-English narrative to provide context for the reader.

***Issue 7:** This proposed Statement would require disclosure of the gains and losses on hedged items that are in a designated and qualifying hedging relationship under Statement 133. The Board decided that an entity would not be permitted to include information in the tables on “hedged items” that are not in designated and qualifying Statement 133 hedging relationships because “economic hedging” means different things to different people. Do you agree that information about “hedged items” that are not in designated and qualifying Statement 133 hedging relationships should be excluded from the disclosure tables? Alternatively, should the tables include gains and losses on “hedged items” that are recorded at fair value and are used in hedging relationships not designated and qualifying under Statement 133? Why or why not? Would your answer be affected by the forthcoming FASB Statement on the fair value option for financial assets and financial liabilities, which will provide the option to report certain financial assets and liabilities at fair value?*

We agree qualifying hedges under Statement 133 should not be presented in the same table as hedging relationships that do not qualify (i.e., “economic hedges”). However, we believe the Board should encourage, but not require, tabular disclosures of economic hedges with supporting narrative based on the three objectives in paragraph 1 of the ED. Recognizing this creates the need to define “accounting hedges” as contrasted with “economic hedges,” we believe this could be accomplished by distinguishing between hedges that meet the requirements of Statement 133 versus those that do not. In that respect, we note paragraph B35 encourages certain disclosures regarding hedges not designated as accounting hedges under Statement 133, but paragraph B34 indicates that tabular disclosure of such information is not permitted. We agree that information disclosed should clearly distinguish hedges designated and qualified in a Statement 133 hedging relationship from hedges that are not designated under Statement 133. However, a separate table disclosing information about an entity’s risk management activities that do



not involve accounting hedges would provide useful information that an entity should be permitted to disclose at its discretion.

We recommend the Board clarify these presentation requirements in the body of the standard by explaining in the proposed paragraph 44C of Statement 133 which items are precluded from inclusion in the tabular presentation required by that paragraph, without eliminating the option to present information about economic hedges in a similar, but separate table.

We believe this approach will also encourage disclosure of economic hedges developed under Statement 159 and Phase II of the FVO, which as discussed in the introduction to this letter, may become more prevalent than accounting hedges under Statement 133 in the future.

***Issue 8:** Under this proposed Statement, quantitative information about nonderivative instruments used as part of an entity's overall risk management strategy would not be included in the disclosure tables. However, paragraphs 44 and 45 of Statement 133 would permit an entity to provide qualitative and quantitative information about the derivatives included in the disclosure tables as those derivatives (a) relate to the overall context of its risk management activities and (b) are related by activity to other financial instruments. Do you agree that information that could be provided in the qualitative and quantitative disclosures encouraged by paragraphs 44 and 45 of Statement 133 would be sufficient to appropriately inform users of financial statements about the risk management strategies of an entity? If not, should additional information about an entity's overall risk management strategies be provided as part of the tabular disclosure required by this proposed Statement?*

We agree with the Board's proposal to encourage, but not require, disclosures about an entity's overall risk management strategy and believe the sufficiency of such disclosures will vary among user groups. We believe this guidance should be facilitated by the optional use of tabular presentations of economic hedges as discussed in our response to Issue 7.

***Issue 9:** This proposed Statement includes examples of qualitative disclosures about objectives and strategies for using derivative instruments, contingent features in derivative instruments, and counterparty credit risk. Those examples are intended to illustrate one potential way of communicating information about how and why an entity uses derivatives and the overall effect of derivatives on an entity's financial position, results of operations, and cash flows. The examples are not intended to be construed as the only way to comply with the disclosure requirements. Are those examples helpful in communicating the objectives of providing information on how and why an entity uses derivatives and on the overall effect of derivatives on an entity's financial position, results of operations, and*



cash flows? Or, do you believe those examples would be viewed as a prescribed method to comply with the requirements of this proposed Statement?

The examples appear to reflect a simple scenario, which may not be helpful to banks and other financial institutions that will be the most directly impacted constituents of this pronouncement. The disclosures may also have the effect of encouraging cursory disclosures that do not fairly represent the complexity of the underlying economics for companies with a large volume of derivatives. As a result, we recommend providing additional examples, including tables, that reflect these situations. Not only would these examples assist a larger group of preparers, the inclusion of examples that reflect basic, medium, and high levels of derivative activity will mitigate the effect of a single example being perceived as prescriptive guidance.

Additionally, we believe it would be helpful if the example language in Section 2 was consistent with the table that follows Section 3. Paragraph A11 indicates such language would precede the table in paragraph A15 and describes a situation where “the Company has entered into interest rate swaps to change the characteristics of interest rate payments from fixed-rate payments to short-term LIBOR-based variable rate payments,” which implies this interest rate risk management arrangement is a fair value hedge. However, the table in Section 3 does not include line items for fair value hedges relating to fixed rate debt instruments. Using different fact patterns to demonstrate the qualitative and quantitative disclosures impairs the understandability of the standard. We suggest the examples in Section 2 and Section 3 be modified to apply a consistent fact pattern to all the disclosure requirements of the ED.

***Issue 10:** The Board considered but decided against requiring additional disclosures as described in paragraphs B55–B63. Those disclosures focused on providing information on an entity’s overall risk management profile, methods for assessing hedge effectiveness, and situations in which an entity could have elected the normal purchases and sales exception. Do you agree with the Board’s decisions not to require disclosures in those areas? Why or why not?*

We agree for the reasons cited by the Board.

***Issue 11:** The Board’s goal is to issue a final Statement by June 30, 2007. The proposed effective date would be for fiscal years and interim periods ending after December 15, 2007. At initial adoption, comparative disclosures for earlier periods presented would be encouraged, but not required. Beginning in the year after initial adoption, comparative disclosures for earlier periods presented would be required. Does the effective date provide sufficient time for implementation?*

We suggest an effective date for periods ending after December 15, 2008. Based on



informal discussions with banks and other financial institutions, we understand some entities will expend significant resources calibrating information systems to filter derivative instruments by underlying risk, accounting designation and purpose, as well as to identify derivatives with contingent features and leverage factors. We understand such systems were primarily designed to capture the *amounts* of derivative transactions that are recorded in the financial statements; additional refinement will be required to separate contracts with *terms* that will require disclosure from those that do not. Lastly, some of the fair value disclosures associated with certain contingent features could be problematic (as discussed previously), especially in the year of adoption. As a result, we recommend an additional year to facilitate implementation efforts.

We also recommend reducing the required disclosures for interim periods. We believe annual disclosures, supplemented with disclosure of material changes during interim periods, would be sufficient for most users when compared to the preparers' cost of providing such information more frequently.

Additional Comments:

Scope: The scope of the ED should be clarified by elevating the guidance in paragraph B5 to paragraph 2. In addition, we would expect a similar exception for host instruments carried at fair value as a result of electing the provisions of Statement 159.

Embedded derivatives that have been separated from the host contract: The ED focuses on derivatives in hedging relationships. For embedded derivatives that have been separated from a host contract, such as a conversion option in a convertible debt instrument, a large portion of the disclosures are based on risk-management concepts and will not be directly applicable, as the Board contemplates in the last sentence of paragraph B 16. We suggest adding additional guidance for these instruments, particularly how they should be portrayed in the tabular example in paragraph A15.

Leverage factors, default provisions, and contingent features : We suggest providing formal definitions for these terms in the final pronouncement to minimize potential differences of interpretation.

Editorial clarification: As proposed, entities will be required to disclose information about master netting arrangements under paragraph 44E(c), as well as paragraph 1 5A(d) of Statement 107. We were not able to discern a meaningful difference between “information about the arrangements for which the entity is a party” and “a brief description of the terms of those arrangements...” We suggest clarifying any distinction or removing the phrase, “information about the arrangements for which the entity is a party.”



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We would be pleased to discuss our comments with the Board or the FASB staff. Please direct questions to Ben Neuhausen at 312-616-4661.

Very truly yours,

s/ BDO Seidman, LLP