

**American Accounting Association's Financial Accounting Standards Committee
Comments to the FASB on Conceptual Standards**

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Preamble

The Financial Accounting Standards Committee of the American Accounting Association (hereafter, the Committee) is charged with responding to requests for input from standard setters on financial reporting issues. At the May 2002 meeting of the Committee and the FASB, members of the FASB staff suggested that a project that reframed current standards as conceptual (principle-based) standards might prove useful to the Board in their future deliberations on this issue. The Committee is pleased to respond to this invitation to comment on conceptual standards. The comments in this letter reflect the views of the individuals on the Committee and not those of the American Accounting Association.

Our response is presented in two sections and two appendices. The first section states the Committee's beliefs about characteristics of conceptual standards. The second section discusses issues the Committee encountered in the process of rewriting two standards as conceptual standards. The two appendices contain illustrations of a conceptual approach for two existing standards. Appendix A delineates a conceptual approach for SFAS No. 87, Employers' Accounting for Pensions, while Appendix B contains a conceptual approach for SFAS No. 133, Accounting for Derivatives and Hedging Activities.

I. Characteristics of Conceptual Standards

1. In a conceptual standard, the economic substance, not the form, of a given transaction/event/item (hereafter, transaction) should guide its financial reporting. The FASB's Conceptual Framework defines the classification and measurement of economic transactions and, accordingly, should serve as the foundation for financial reporting that reflects the economic substance of a transaction.
2. A conceptual standard should include a description of the particular transaction that is the subject of the standard. This description should include the underlying economics of the transaction in order to provide a common, explicit understanding of these economics.¹
3. A conceptual standard should include a general discussion of the mapping between the economics of a transaction and the financial statements, using the Conceptual Framework to guide classification and measurement issues associated with this mapping.
4. A conceptual standard may include implementation guidance, most likely in the form of examples that illustrate application of the standard's general principles to typical transactions covered by the standard. In these implementation examples, it may be necessary to make choices that are based on practicality

¹ Storey and Storey highlight the importance of having "common premises" when developing conceptual statements in their 1998 FASB monograph, "The Framework of Financial Accounting Concepts and Standards." As they state, "If experience is the frame of reference, no one can be sure of the starting point, if one exists at all, because everyone's experience is different." (p. 86)

rather than explicitly on the concepts. We believe this is acceptable, but should be noted as such in the discussion of the example.

5. In a conceptual standard, the Board should be careful when creating “names” for concepts, even if they enhance the readability of the standard. The names may already have connotations for readers that differ from the concept that the Board has in mind. If it is unavoidable to use such names, the Board should articulate their definitions.

6. Conceptual standards should include disclosure requirements related to a description of the economics of the transaction being reported, the assumptions made in the reporting, and any supporting information that will facilitate understanding both the economics and the reporting.

II. Issues Associated with a Conceptual Approach to Standard Setting

The Committee found the task of rewriting SFAS No. 87 and SFAS No. 133 to be both engaging and challenging. In this section, we summarize issues that arose during our process of revising the standards.

Approaches to standards setting can be depicted as a continuum, with purely rules-based standards on one end and purely concepts-based standards on the other. One primary issue the Committee encountered was where on this continuum to place the revised standards. That is, to what extent should conceptual standards represent “ideal” standards that reflect the underlying economics of the transaction in a “pure” fashion? Given the academic orientation of most of the Committee’s members, our natural inclination is to advocate that conceptual standards reflect the economics as purely as possible.

We encountered several issues when taking an economics-based approach for rewriting the two standards. First, we encountered the issue that the reporting for one transaction (e.g., derivatives) depends on the reporting for other transactions (e.g., assets/liabilities). In rewriting SFAS No. 133, problems arose due to the fact that not all of a firm’s economic assets and liabilities are recorded. For example, the expected benefits associated with an anticipated transaction are an “asset” to the firm, but the asset is not recorded. For assets and liabilities that are recorded, not all are recorded at fair value. If all of a firm’s assets and liabilities were recorded at fair values, there would be no need to distinguish between derivatives that were used to hedge versus not used to hedge, between fair value and cash flow hedges, between separate and embedded derivatives, or even between derivatives that are used for hedging and other “instruments” that can act as hedges. One should simply record all derivatives at fair value with changes in fair value recorded in income. Our point here is not (necessarily) an endorsement of fair value accounting, rather, it is simply to point out the issues associated with reflecting “true economics” in rewriting standards as conceptual standards. In our revision of SFAS No. 133 shown in Appendix B, we did not take the “pure economics” approach due to the changes in the accounting for numerous transactions that would be required by such an approach. Thus, it was necessary to include some rules in our revised standard. Our revision of SFAS No. 133 likely represents a standard that is in the middle of the continuum between rules-based and conceptual standards.

A second issue is that many rules in the current standards appear to arise from the practicality of dealing with constituents’ concerns, rather than arising from the underlying economics of the transaction. The transition rules and corridor approach to recognizing unrealized gains and losses in SFAS No. 87 are examples of such rules. The Committee engaged in several lively email exchanges over the extent to which conceptual standards should include such concessions to practicality. That is, to what extent should conceptual standards initially include practical considerations and gradually move to reflect the underlying economics versus imposing an immediate change to an economics-based standard? We don’t have an answer to this question, but raise it as an issue that needs to be considered. The Committee’s

approach to revising SFAS No. 87 shown in Appendix A more closely reflects the immediate transition to economics-based standards, without regards to practical concerns of constituents.

A third observation relates to the effect of a conceptual approach on the purpose of standards and the need for multiple standards. Some members of the Committee noted that, in some cases, individual standards would just be straightforward applications of the concepts in the FASB's Conceptual Framework. For example, accounting for pensions may require only a relatively straightforward application of the definition of liabilities and expenses. In effect, one view is that the accounting for pensions already exists in the Conceptual Framework and thus a conceptual standard on pensions would add little. Rather, a conceptual pension standard simply would define pensions in terms of elements of the Conceptual Framework and provide illustrations of applying the framework. On a related point, members of the Committee noted that a move to conceptual standards would allow for some combination of current standards. For example, SFAS No. 87 on pensions and SFAS No. 106 on other post retirement benefits could be combined into a single conceptual standard.

Finally, all of these observations raise the issue of whether the FASB should take a piecemeal or a one-shot, comprehensive approach to rewriting standards as conceptual rather than rules-based. In a piecemeal approach, the FASB would write all new standards as conceptual standards. All past rules would be rewritten one-by-one. Such an approach may be necessary due to practical considerations; however, we raise two issues related to this approach. First, the order in which the recasting of old standards is done is important in order to avoid having to go back and re-recast a standard due to issues that arose in recasting another standard. Second, it may be necessary to undertake a comprehensive re-thinking of the Conceptual Framework before undertaking revision of individual standards. For example, in the extreme, if a conceptual approach is intended to reflect purely the economics of transactions, the idea of what constitutes assets, liabilities, and equity of the firm and the measurement basis for these elements would need to be reconsidered. The Committee realizes that the FASB constantly reconsiders such issues, however, we believe a more comprehensive re-thinking of the Conceptual Framework may be needed prior to undertaking revision of current standards. One approach to accomplishing this goal would be to have a separate project on conceptual standard setting that is distinct from the process of setting current standards.

In closing, the Committee believes consideration of a conceptual approach to standard setting should be given priority. As indicated, the Committee's experience suggests that this process will not be easy and that many issues will need to be resolved, but we believe undertaking such a project will improve standard setting.

Appendix A

A Conceptual Approach for SFAS No. 87, Employers' Accounting for Pensions

Introductory Comments

Three Committee members worked on the revision of SFAS No. 87. The Committee's response contains two separate documents. The first recasts SFAS No. 87 using an economics-based, conceptual approach. The second raises issues related to using the economics-based conceptual approach to revising SFAS No. 87 versus taking a conceptual approach that considers practical concerns of constituents.

An Economic-Based, Conceptual Approach for a Standard on Pensions

Overview and background comments

There are two main economic aspects to the accounting for pensions. The first is to recognize the current period pension expense and the second is to recognize the total unfunded obligation for pension benefits as of the end of the reporting period.

In reformulating SFAS No. 87 from a rules-based to conceptual standard, we focused on capturing economic substance over form and maintaining consistency with the FASB's Conceptual Framework. We believe that the principles underlying SFAS No. 87, as written, generally are consistent with the Conceptual Framework.

However, the detailed rules provided in SFAS No. 87 (e.g., corridor amortization and recognizing a minimum liability amount) are not appropriate to a conceptual standard as outlined in Section I above. Many of these rules appear to be compromises aimed at maintaining certain desired characteristics of the financial statements unrelated to the economic substance of the transactions. The impetus for other detailed rules appears to be the Board's concern over transition accounting at the time of the issuance of the standard. We do not consider transition accounting to be a pertinent concern in a concepts-based standard and so we eliminate the rules related to transition accounting. We expect that any cumulative effect of an accounting change will be reported as such in the year of transition.

We shortened SFAS No. 87 substantially and rewrote it with minimal detailed implementation guidance because we believe that there is a reasonably common and accepted definition of pensions benefits, unlike other transactions such as derivatives. Additionally, the goals of the FASB with respect to pension reporting are quite straightforward and consistent with the Conceptual Framework. We do, however, retain most of the disclosure requirements of SFAS No. 87. We consider these disclosures to be of primary importance to investors in understanding the accounting for pensions. We conclude that a shortened and simplified standard accomplishes the financial reporting goals for pensions.

We believe that under a conceptual approach to standard setting, the standard should encompass all post-employment benefits and not just those related to pensions. We do not perceive an economic or philosophical difference between pension benefits and, for example, health care benefits. However, because of the purpose of this exercise, we felt that the focus should remain on SFAS No. 87 as written, so we did not include other post-employment benefits in the reconstituted standard.

We also note that that certain inconsistencies arise in converting an existing standard such as SFAS No. 87 into a conceptual standard due to the connections among the subject standard and other existing standards. For example, SFAS No. 87 refers to SFAS No. 34 on Capitalization of Interest Costs, among others. We do not address such specific relations, recognizing that if all standards are rewritten as conceptual such inconsistencies should disappear.

We rely on the Conceptual Framework for the definition of both an asset and a liability in determining whether the pension plan assets and the unfunded pension obligation should be carried on the statement of financial position. The change in the net pension asset or liability should be reported in income.

The first section of the existing standard, the Summary, states that SFAS No. 87 retains three fundamental aspects of past pension accounting: delaying recognition of certain events, reporting net cost, and offsetting liabilities and assets. We retain only the third of these reporting approaches. We eliminate the delayed recognition of prior service cost and gains and losses on pension assets - the Committee believes that the underlying economics requires that recognition should be contemporaneous. Secondly, because one of the main objectives of the standard is to report the current period's pension cost, the Committee believes that the compensation (service) component of the cost should be separately reported and not offset against the financial components of the pension cost - therefore we eliminated the reporting of "net cost." We believe that the components of the cost that relate to financing issues—specifically interest expense on the pension liability and gains and losses on the pension asset—should be reported separately from the compensation component. We agree with SFAS No. 87 that offsetting pension assets and liabilities is appropriate - the assets contributed by the employer to the pension plan discharge a portion of the obligation and so we retained the offsetting provision for assets and liabilities.

We note that there are many techniques used by actuaries to determine the total amount of the employer's pension obligation. We do not believe that it is appropriate for a conceptual standard to specify the form of the computation or the techniques and assumptions to be applied. The standard requires disclosure of the techniques and assumptions used by the actuary to determine the gross pension obligation and the components of periodic pension expense (income).

Consistent with Section I of this document, the revised statement for SFAS No. 87 consists of the following six sections:

- A. Objective of Statement
- B. Scope and Definitions
- C. Disclosure Requirements
- D. Glossary of Terms
- E. Appendix (optional)

The outline of the reconstituted standard is provided below in tabular format with the conceptual standard's antecedent from the original SFAS No. 87 pronouncement shown in the first column.

Because the revised standard is quite short, the entire standard is presented below in standard typeface (with the exception of the glossary terms). Editorial comments by the Committee are shown in *italics*.

Statement 87 (paragraph #'s)	Suggested Text / Comments
<p>Summary</p> <p>(6)</p> <p>(35)</p> <p>(10-14, 39)</p>	<p>A. <u>Objective of Statement</u></p> <p>The objective of this statement is to provide standards for the recognition and disclosure of the employer’s compensation cost for pension benefits for the reporting period and of the employer’s related liability for employees’ pension benefits as of the end of the reporting period.</p> <p>Pension benefits constitute one element of employee compensation and, as with other forms of compensation, the cost of that compensation is to be accrued and recognized as an expense in the period incurred.</p> <p>For pension costs that have been accrued but not funded, a corresponding liability for the unfunded obligation is to be recognized on the balance sheet. An employer with an overfunded pension obligation has an asset for the amount overfunded.</p> <p>Absent convincing evidence to the contrary, the terms of the plan that define the benefits an employee will receive (the plan’s benefit formula) provide the most relevant and reliable indication of how pension costs and obligations are incurred.</p> <p>The Board recognizes that computation of the current period’s pension expense and of the end of period pension obligation requires the use of estimates as well as the prediction of events over which the employer has little or no control. Actuarial assumptions include discount rates and probability of payment. The necessity of making and incorporating such estimates and predictions does not diminish the importance of recognizing the cost and obligation in order to reflect on the financial statements of the firm, the economic implications and consequences for the employer of providing pension benefits for employees.</p>
<p>Introduction (1-5)</p>	<p><i>History of pension accounting – not appropriate for inclusion in body of standard – perhaps relegate to an appendix – or eliminate.</i></p>
<p>Scope (7, 8, 9)</p>	<p>B. <u>Scope and Definitions</u></p> <p>Pension plans in the U.S. are governed by many laws and regulations. Generally these require that pension plans be funded by the employer and that the assets funding the pensions be transferred to the pension trustee. Pension plans take many forms. Frequently, pension benefits provide for periodic payment to retired employees or to their survivors, but they may also include lump sum payments or other types of benefits. All such plans are included within the scope of this standard. Statutory funding requirements should have no effect on the recognition of the cost and liability associated with pensions.</p>

<p>(12)</p> <p>(16, 21, 24)</p> <p>(22)</p> <p>(36)</p>	<p>Likewise, an employer’s obligation to provide pension benefits may take a variety of forms and may be financed in different ways. This Statement applies to any arrangement that is similar in economic substance to a pension plan regardless of the particular terms of the plan or the form of financing. This Statement applies to a written plan as well as to a plan whose existence may be implied from a well-established but perhaps unwritten practice of paying postretirement benefits</p> <p>Pension benefits. Pension benefits are part of the compensation paid to an employee for services. Generally, but not always, the amount of benefit to be paid depends on a number of future events (including, for example, the employee’s years of service, the employee’s compensation, how long the employee and any survivor lives) that are incorporated into the computation of the benefit. The total amount of the promised benefit can only be estimated.</p> <p>Pension (service) cost. This is the current period cost of the employer of providing pension benefits to employees for the services rendered during the period. The actuarial present value of these benefits is generally determined by the terms of the plan. This cost may include several additional components, including but not limited to: the impact of plan amendments, including retroactive enhancements; and changes in actuarial assumptions related to employees (e.g., age at retirement, years of retirement).</p> <p>Pension (financing) cost. The current period financing cost of the pension plans includes the interest cost on the gross liability net of the change in the fair market value of the plan assets, adjusted for contributions and disbursements.</p> <p>Net Pension obligation (asset): The accumulated liability of the employer for the employees’ pension benefits less the fair value of plan assets.</p>
<p>(15-53)</p>	<p><i>These paragraphs provide both detailed definitions of terms, including components of periodic net pension cost and measures of the accumulated pension obligation, and detailed rules as to the accounting for the cost and the liability. Some of these terms are not consistent with the Conceptual Framework. In addition, the Committee finds that several of the terms together with the required accounting treatment are inconsistent with the underlying economics of providing pension benefits for employees. The Committee points specifically, as examples of uneconomic treatment, to the provisions in (25) for amortization of the cost of retroactive benefits, to (29) on nonrecognition of gain or loss, to (32) for required amortization of an unrecognized gain or loss when that gain or loss exceeds a 10% threshold, to (36) for the minimum liability computation, and to (37) for the recognition of an intangible asset to offset the minimum liability in (36).</i></p> <p><i>We eliminate both the detailed terminology and the detailed reporting rules.</i></p>

(54)

C. Disclosure Requirements

This standard requires the employer to provide disclosures necessary for understanding the source and amounts of the reported pension cost and pension obligation. The underlying assumptions used in the computations are integral to such an understanding. These disclosures must include but are not limited to:

- a. A description of the plan including employee groups covered, type of benefit formula, funding policy, and the nature and effect of significant matters affecting comparability of information for all periods presented
- b. Actuarial present value of benefits attributed by the plan's benefit formula to services rendered by employees during the reporting period including the key assumptions behind the computation (the service cost component).
- c. Assumptions and computations supporting the financing cost component of pension cost.
- d. Actuarial present value of all benefits attributed by the plan's benefit formula to employee service rendered prior to the current reporting period.
- e. Actuarial present value of all vested pension benefits as of the reporting date.
- f. Description of the plan assets as of the reporting date including the types of assets held and their fair market value.
- g. Schedule reconciling the change in the fair market value of plan assets from the previous reporting date, including, but not limited to the following:
 - i) actual return on plan assets
 - ii) employer's contribution during the period
 - iii) benefits paid to employees during the period
 - iv) realized gains and losses on plan assets during the period
 - v) unrealized gains and losses on plan assets during the period
- h. Amount of pension cost deductible for federal income tax purposes
- i. Key actuarial assumptions
- j. Effect of changes in actuarial assumptions on the current period pension cost and the end of the period pension liability
- k. Expected impact of statutory funding requirements on liquidity and financial position.

(55-75)	<i>We exclude these paragraphs because they provide detailed rules for employers with two or more plans, for annuity contracts and other life insurance company contracts, for defined contribution plans, for multiple employer plans, etc., all of which we believe are covered conceptually in the above paragraphs.</i>
(76-77)	Transition Rules <i>As indicated, we exclude transition rules. The cumulative effect of the accounting change would be shown as such in the income statement of the year of change.</i>
Appendix B	<i>Contains detailed implementation guidance using examples. Eliminate.</i>
Appendix D	<p>D. Glossary <i>(Eliminate most terms. Retain the following. The actual definitions are provided on the following pages. Some of the definitions are taken directly from SFAS No. 87 and some are modifications.)</i></p> <ul style="list-style-type: none"> Actual return on plan assets Actuarial funding method Actuarial present value Assumptions Benefits Interest cost Pension benefit formula Plan assets Service Service cost Vested benefit obligation Vested benefits
Appendix C	E. Appendix <i>History of U.S. pension accounting. Not part of a conceptual standard. Retain or eliminate.</i>

Appendix D

Glossary

This appendix contains definitions of certain terms used in accounting for pensions.

Actual return on plan assets. The difference between the fair value of plan assets at the end of the period and the fair value at the beginning of the period, adjusted for contributions and payments of benefits during the period.

Actuarial funding method. Any of several techniques that actuaries use in determining the amounts and incidence of employer contributions to provide for pension benefits.

Actuarial present value. The value, as of a specified date, of an amount or series of amounts payable or receivable thereafter, with each amount adjusted to reflect (a) the time value of money (through discounts for interest) and (b) the probability of payment (by means of decrements for events such as death, disability, withdrawal, or retirement) between the specified date and the expected date of payment.

Actuarial assumptions. Estimates of the occurrence of future events affecting pension costs, such as mortality, withdrawal, disablement and retirement, changes in compensation and national pension benefits, and discount rates to reflect the time value of money.

Benefits. Payments to which participants may be entitled under a pension plan, including pension benefits, death benefits, and benefits due on termination of employment.

Interest cost. The accrual of interest on the total pension liability over the reporting period.

Pension benefit formula. The basis for determining payments to which participants may be entitled under a pension plan. Pension benefit formulas usually refer to the employee's service or compensation or both.

Plan assets. Assets—usually stocks, bonds, and other investments—that have been segregated and restricted (usually in a trust) to provide benefits. Plan assets include amounts contributed by the employer (and by employees for a contributory plan) and amounts earned from investing the contributions, less benefits paid.

Service. Employment taken into consideration under a pension plan. Years of employment before the inception of a plan constitute an employee's past service; years thereafter are classified in relation to the particular actuarial valuation being made or discussed. Years of employment (including past service) prior to the date of a particular valuation constitute prior service; years of employment following the date of the valuation constitute future service; a year of employment adjacent to the date of valuation, or in which such date falls, constitutes current service.

Service cost. The actuarial present value of benefits attributed by the pension benefit formula to services rendered by employees during that period.

Vested benefit obligation. The actuarial present value of vested benefits.

Vested benefits. Benefits for which the employee's right to receive a present or future pension benefit is no longer contingent on remaining in the service of the employer. (Other conditions, such as inadequacy of the pension fund, may prevent the employee from receiving the vested benefit.)

Issues Related to an Economic-Based Conceptual Approach to Revision of SFAS No. 87

This commentary raises issues related to two different approaches for drafting a conceptual standard for SFAS No. 87. These two approaches would result in very different documents. The point of this commentary is not to advocate one approach or the other, but rather to highlight issues related to the two approaches that need to be considered in choosing an approach to conceptual standard setting.

Approach 1: Draft a conceptual standard that considers the environment and institutional constraints faced by the FASB in 1985. This approach highlights the important roles that practicality and the need for a gradual change play in the FASB's decision making.

In the case of SFAS No. 87 this approach likely would result in a document that is very similar to SFAS No. 87 as currently written. Appendix A of the statement, which summarizes the Board's considerations in reaching the conclusions in the statement, indicates that the Board considered a standard that in spirit is very similar to an economics-based, conceptual standard and rejected this approach. The belief was that such an approach would represent too great of a change from past practice and thus was inconsistent with SFAC No. 5, paragraph 2, which indicates that the standard-setting approach taken by the Board is gradual and evolutionary.

Approach 2: Draft a document under the assumption there are no constraints and the goal therefore is to produce an "ideal" conceptual pension standard, i.e., a standard that produces numbers that best reflect the economic reality underlying firms' pensions.

It is questionable that a conceptual pension standard is needed under this approach. It seems that financial reporting for pensions follows in a rather straightforward fashion from accrual accounting and the Conceptual Framework that defines assets, liabilities, revenue, expenses, gains and losses, (SFAC No. 6), discusses recognition and measurement issues (SFAC Nos. 5 and 7), discusses the objective of financial reporting (SFAC No. 1), and outlines desirable characteristics of accounting information (SFAC No. 2). In other words, it seems that with respect to pension accounting there is no unique principle that justifies a specific standard. The only unique feature of pension accounting is the high uncertainty surrounding the value of the pension obligation. However, a principle-based standard should leave to experts the decision how to best estimate this liability.

Additionally, if the FASB were to switch to "ideal" conceptual standards, the Conceptual Framework likely would need adjustment. For example, paragraph 2 of statement of concepts No. 5 related to the "gradual change" nature of standard setting must be eliminated.

Appendix B

A Conceptual Approach for SFAS No. 133, Accounting for Derivatives and Hedging Activities.

Introductory Comments

Two Committee members worked on the revision of SFAS No. 133. As indicated in the comments in Section II of this letter, these members encountered difficulty converting SFAS No. 133 to an economics-based standard. Thus, the revised standard reflects many of the current rules of SFAS No.133, but indicates where the Committee believes these rules deviate from an economics-based approach.

A Conceptual Approach for a Standard for Derivatives and Hedging Activities

Overview and background comments

We believe it is particularly important that a concepts-based standard for SFAS No. 133 describe the nature of the transaction and explain how the transaction is used in practice. This is because the fundamental idea of the standard is to account for hedging and non-hedging activities differently, yet SFAS No. 133 does not define hedging directly. It defines a derivative instrument as a “hedge” if it meets certain criteria. However, the criteria simultaneously try to distinguish between fair value and cash flow hedges and deal with SFAS No. 52 issues. The end result is that the Board’s conceptual notion of what a hedge represents is not clear.

In fact, the Board acknowledges that “...there is little agreement about just what the ‘economics’ of hedging and risk management activities are.” (Paragraph 352) The purpose of paragraph 352 is to explain that parties will disagree about whether the standard will result in financial statements that accurately reflect the economics of these transactions because they don’t even agree on the economics. We agree that this issue is a fundamental problem. We believe that one way to mitigate the problem is to explicitly describe the economics.

We believe that a conceptual standard for derivatives and hedging activities will include implementation guidance and examples that take the place of specific rules. For example, the implementation guidance for SFAS No. 133 would include a section that establishes the minimal acceptable documentation to designate that a derivative instrument is intended as a hedge.

We also believe the Board should be careful when creating “names” for concepts related to derivatives and hedging activities, even if they enhance the readability of the standard. For example, we suggest not having names such as a “fair value hedge” or a “cash flow hedge.” However, for concepts that already have names but that are not well defined, the Board should articulate its definition. In SFAS No.133, the Board should define “hedge”, “risk management”, “speculation” and “position taking.” These terms are used in practice, but there is no convention.

Finally, many of the changes we suggest simply relocate conceptual statements that are currently included in the “Background information and basis for conclusions” to the standard and make the rules, in the form of examples, implementation guidance. One might question whether these changes in geography constitute an improvement. We believe that the benefit of the reorganization is that the standard is more generalizable, and will allow implementation groups to interpret these concepts and apply them to new situations. By contrast, new situations may not fit into the boxes that exist in a rule-based standard.

In the following paragraphs, the Committee’s revision of SFAS No. 133 is presented in standard typeface. Editorial comments by the Committee are shown in *italics*.

A Conceptual Standard for SFAS No. 133

Part I: Background information - economic uses of derivative instruments

We expect that a conceptual standard would contain a description of the economic uses of derivative instruments. The example shown below contains the types of information we would consider appropriate. Note that some of the language is taken directly from the existing standard or the “Background information and basis for conclusions.

A derivative instrument is defined as ... (Paragraphs 6-9 define derivative instruments and we agree with the conceptual level of the definition.)

Derivative instruments can be embedded in other financial instruments. The effect of embedding a derivative instrument in another type of contract (“the host contract”) is that some or all of the cash flows or other exchanges that otherwise would be required by the contract, whether unconditional or contingent upon the occurrence of a specified event, will be modified based on one or more underlyings.

Derivative instruments are used for two major purposes – risk management and profitable trading. Some aspects of risk management are hard to distinguish from speculation or position taking. Our view is that risk management is ... while speculation is ... and position taking is ... Hedging is ... (Given the diversity in definitions for these terms, we did not provide specific definitions. A conceptual standard would need to include definitions.) Strategies may involve reducing total risk (upside and downside risk) or only the risk of price movement in one direction.

The largest dollar volume of derivative instruments are indexed to prices over which managers generally have no control such as interest rates, commodity prices, and foreign exchange rates. However, over-the-counter products can be designed to relate to the changes in the price of almost anything.

Firms can manage risks associated with operating, investing, or financing activities. Firms state that they use derivatives to manage the values associated with assets and liabilities and to manage the risk associated with cash flows or earnings. In one survey, 50% of firms ranked managing cash flow volatility as the most important objective for using derivatives, and 42% ranked managing earnings volatility as the most important objective. The remainder indicated that the most important objective was to manage firm values or balance sheet accounts. The Board does not intend to recognize the difference between hedges of cash flows and hedges of earnings.

Hedging does not imply 100% risk reduction. The costs of derivative instruments and their benefits in terms of volatility reduction depend on the characteristics of the instrument and the risk being hedged. A firm’s derivative instrument choices may reflect a cost/benefit trade-off. A consequence of the cost/benefit trade-off is that many risk management strategies are not, and are not intended to be, perfect. For convenience, or because of illiquidity in certain markets, firms may cross-hedge. For example, a firm may hedge the risk associated with 10,216 bushels of soft wheat grown in Michigan and harvested in mid-August with contracts on 10,000 bushels of hard wheat that is stored in a warehouse in Kansas City and the contracts expire in early August. While the differences in basis create a risk for the firm, designing the perfect contract may be prohibitively expensive. As another example, a firm may hedge only the risk of extreme pricing outcomes for the underlying in the tails of the distribution because realizations in the extreme ranges are costly, but realizations within the interquartile range (for example) are acceptable. The cost of hedging the mid-range volatility is greater than the benefit.

There is some basis risk in almost all hedging relationships such that the anticipated change in value of the hedging instrument will differ from the change in value of the hedged item. The expected level of the

difference can be measured at inception of the hedge. Even when the expected difference is small, the realized difference may be large.

Commonly used methods for measuring performance of hedging strategies are... *(The standard would include a description of these methods.)*

The pricing of derivative instruments is complex. For exchange-traded derivative instruments, reliable market prices generally exist. However, the liquidity in derivative instrument markets differs. Market prices in low-liquidity markets may not be the most reliable measure of value. For derivative instruments that are not exchange-traded or for which the market is illiquid, pricing models exist. The Board recognizes that valuations from these models are less reliable than market prices. In many cases, however, the models produce sufficiently reliable valuations.

Firms can use derivative instruments for pure profit motives, without intending to offset existing risks. This type of derivatives-related activity, however, is likely to affect the risk of the firm. Firms that use derivatives for profit motives generally trade in instruments that are indexed to a price related to its core business. Knowledge of prices allows the firm to make profits on average. For example, banks may trade interest rate derivatives for profit because they have superior knowledge of future interest rate changes relative to the market, and thus using derivative instruments for profit is a positive net present value activity. Since banks' core operations are exposed to interest rate risk, it is highly likely that the changes in value in its derivatives portfolio will be associated with the changes in value of its portfolio of non-derivative assets and liabilities and the association may be negative in some periods. However, such offsetting does not imply that the derivative instruments were intended for risk reduction. The concept of "risk" implies that something might occur in the *future*, so the intention of the firm at the time a contract is entered is important for distinguishing its purpose.

One characteristic of derivative instruments that distinguishes them from many other financial instruments is that they can be assets at one point in time and liabilities at another. Also, the changes in value of derivative instruments can occur very quickly, unlike the changes in the value for other types of assets. *(Examples/figures could be provided here.)*

Part II: The Standard

Paragraphs are lettered to distinguish them from the numbered paragraphs in SFAS No. 133. Also, some paragraphs are taken verbatim from the original standard; others are paraphrasing. Commentary is in italics. We did not incorporate the accounting for FX hedges since we believe the primary point should be clear from the fair value and cash flow hedges. The wording is meant to be an example of the level of detail that would be appropriate in a conceptual standard; it is not meant to illustrate the exact wording.

A. This Statement addresses the accounting for derivative instruments.

Prior to this statement, derivatives used in hedging activities related to changes in foreign exchange rates were addressed in SFAS No. 52. SFAS No. 80 addressed the use of futures contracts. Those Statements addressed only certain derivative instruments and differed in the criteria required for hedge accounting. In addition, the EITF addressed the accounting for derivative instruments used in various hedging activities in a number of issues.

This statement applies to all entities. *(Insert not-for-profit exclusion).*

B. The primary goal of the standard is to insure that items that meet the definitions of assets and liabilities in SFAC No. 2 are properly recognized on the balance sheet.

Derivative instruments represent rights or obligations that meet the definitions of assets or liabilities and all derivative instruments should be reported in the financial statements. The purpose for which derivatives are used does not affect whether they are assets or liabilities.

Some embedded derivatives are not considered derivative instruments for the purposes of the standard while others are. This decision is a practical accommodation. Embedded derivatives that are excluded are those that are ... They are excluded because ... *(The standard would need to describe the excluded items and the basis for their exclusion.)*

The clearly and closely related language appears to have been a way for the Board to justify what was a practical rather than conceptual decision. The FASB was concerned that in practice firms would create instruments with embedded derivatives to avoid the accounting prescribed by SFAS No. 133. (See paragraph 305.) Rather than having an artificial name and concept, we believe it is acceptable to admit in a conceptual standard that certain “concepts” are practical accommodations. In this case, the practical accommodation is related to the fact that the scope of SFAS No. 133 is limited to derivative instruments and that other financial instruments are covered by other standards. Such admissions will give implementation groups appropriate flexibility when/if the need for the practical accommodations changes.

C. Fair value is the most relevant measure for financial instruments and the only relevant measure for derivative instruments. Derivative instruments should be recorded on the balance sheet at fair value.

Note that the wording above is from SFAS No.133, but we disagree with the statement. Fair value is a reasonable measure for purposes of representing derivative instruments in the balance sheet. However, fair value does not adequately capture the “risk” associated with these instruments unless other characteristics of the derivative instruments are known. Either here, or later in the section on disclosure, the goal for disclosures, which in this case is to highlight potential losses that are not obvious from fair values alone, should be made clear.

One possible extension of paragraph C is to prioritize the “best” measures of fair value. Paragraph 17 does this, in part, by explaining that the weight given to evidence shall be commensurate with its verifiability. Additional guidance on how to weigh various alternatives would also improve the generalizability of the standard. For example, should preparers place a premium on the ability to describe the measurement process?

D. Given that the fair values of derivative instruments are to be recorded on the balance sheet, and given clean-surplus accounting, the changes in fair value of derivative instruments must be recognized in net income or other comprehensive income. In this Statement, the change in the fair value of an entire financial asset or liability for a period refers to the difference between its fair value at the beginning of the period (or acquisition date) and the end of the period adjusted to exclude (a) changes in fair value due to the passage of time and (b) changes in fair value related to any payments received or made, such as in partially recovering the asset or partially settling the liability.

E. Another goal of the standard is to produce an income statement that provides information that is useful for predicting the amount, timing, and uncertainty of future cash flows. The income statement should represent volatility that is real, but it should not create volatility where none exists. The appropriate representation of volatility is an important consideration in the accounting for derivative instrument gains and losses given that the objective of some, but not all, derivative instrument transactions is to reduce volatility.

The accounting for changes in the fair value (that is, gains or losses) of derivative instruments depends on whether it is part of a hedging relationship and, if so, the nature of that hedging relationship. It is possible

for only part of a derivative instrument to be considered a hedging instrument. The distinct parts of derivative instruments, distinguished by their intended purpose, should be accounted for separately.

A hedging relationship is one in which the firm intends that the derivative instrument will reduce the volatility in a hedged item. A hedged item can be an asset, liability, firm commitment, cash flow, forecasted transaction, etc. A hedged item can be only part of one of these items, such as the interest rate risk of a debt instrument. A hedged item can be a portfolio of items; like items can be grouped together for purposes of evaluating risk management. While almost anything can be a hedged, we exclude the following from the list of hedged items for accounting purposes for practical reasons. *(The exclusions are in paragraph 21. The standard should explain the conceptual basis for each exclusion. We did not understand the conceptual basis for some of the exclusions, so this section is not written in detail. For some exclusions, (such as those related to cross-hedging), the explanations currently provided in the standard can be simplified and the exclusions will be easier to justify on conceptual grounds given that the standard includes the description of the economics of derivatives use. Some of the details in paragraph 21 should be included as implementation guidance.)*

- i) When a firm's primary objective for using derivative instruments is a profit motive, defined as speculation above, the changes in the derivative instrument's value meet the definitions of revenues and expenses if derivatives use is a central activity of the firm, and meet the definitions of gains and losses if derivatives use is an incidental activity of the firm. Thus, the change in value for a period should be recognized in that period in operating earnings. Recording the gains and losses in net income immediately will create volatility that appropriately represents the realizations related to additional risks assumed by the firm.
- ii) When a firm's primary objective is to reduce volatility, defined as hedging or risk management above, and the firm's strategy is effective at reducing volatility, the changes in value of the derivative instruments should be reported in net income in the period in which the offsetting changes in value of the hedged item are recognized in net income. Matching the timing of the recognition of the gains and losses of the hedging instrument with those of the hedged item will provide a net income number that appropriately represents the volatility reduction achieved by the hedging relationship.
- iii) Even if a firm's primary objective is to reduce volatility, the changes in value of the derivative instruments should be reported in net income immediately without any consideration for matching if the intended hedge was not effective. For a hedge that was significantly but not perfectly effective, the ineffective portion of the hedge should be recorded in net income; only the effective portion should be matched.

Paragraph E(iii) illustrates that the concept of effectiveness is important for two reasons. First, for accounting purposes, a hedging relationship exists only if the gains and losses on the derivative instrument significantly offset the realized gains and losses on the hedged item. This assertion reflects the Board's focus on realization rather than expectation. Thus, even if a firm intended for a hedging relationship to exist when the derivative instrument was acquired, which assumes that the firm anticipated that the gains and losses on the derivative instrument would significantly offset those on the hedged item, it may not be considered a hedging relationship for accounting purposes if ex post the gains and losses do not offset each other. That is, effectiveness determines whether the derivative instrument is part of a hedging relationship. Second, effectiveness determines how gains and losses on derivative instruments in hedging relationships are recorded. Even in cases of a successful hedging relationship where significant offset occurs, the likelihood of exact offset is effectively zero because of differences in basis. The gains and losses related to the "ineffective" portion of the hedge, however small, represent the realization of a risk associated with using derivative instruments. Reporting these gains and losses in net income appropriately reflects the outcome of a risk that the firm has taken.

Matching the timing of recognition of gains and losses on hedging instruments to hedged items should continue as long as the hedging relationship, that is effective, is in effect. Events that may cause the need to terminate hedge accounting would include ... *(from paragraphs 25, 26, 32, 33). The guidance in these paragraphs should be simplified by moving some of it to the implementation guidance.*

F. The matching of the gains and losses from the effective portion of a hedging instrument with those from a hedged item should occur regardless of the source of volatility that is being managed (i.e., cash flow volatility or asset/liability value volatility). However, the means of achieving this matching will differ because the current accounting models for the hedged items differ.

- i) For derivative instruments that the firm intends to hedge cash flow volatility associated with existing assets or liabilities or forecasted transactions, and which effectively do so, the changes in value of the hedged item will be recognized in income under existing GAAP. The effective portion of the changes in value of the derivative instrument will be recorded in net income to match the timing of the recognition those cash flows. Fair value changes on the derivative instrument that occur in an accounting period prior to the recognition of the hedged cash flows will be recorded in other comprehensive income in the period incurred, and reclassified to net income in the period that the offsetting changes in value of the hedged item are recognized. The ineffective portion of the change in value of the derivative instrument is recognized immediately. The balance of the accumulated other comprehensive account should contain only those gains and losses that are related to ongoing hedging relationships that are still effective. To the extent the account contains gains or losses related to terminated hedging relationships, either voluntarily or because they have been deemed ineffective, or the hedged item is impaired, the balance should be adjusted to reflect the changing circumstances. *(This is meant to capture paragraph 35, for example.)*
- ii) For derivative instruments that the firm intends to hedge the volatility in fair values of assets or liabilities, including those that are not recognized under GAAP such as a firm commitment, the change in the value of the hedged item will be recorded in net income in the period incurred. Because the goal is to show appropriate volatility in the income statement and to match gains and losses on derivative instruments with those they were intended to hedge, the change in fair value of the hedged item is only the change related to the risk being hedged, which may represent only a portion of the change in value of the asset or liability or firm commitment to which it relates. The change in value of the derivative instrument will also be recorded in the period incurred. To the extent the hedge is effective, this approach will achieve matching of gains and losses, but net income will retain volatility that is appropriate because of unhedged risks or ineffective hedging.

The adjustment of the carrying amount of a hedged asset or liability shall be accounted for in the same manner as other components of the carrying amount of that asset or liability. The recognition of the adjustment in this fashion, rather than as a separate account, represents the Board's fundamental conclusion that *(We believe that a conceptual explanation should be provided; however, we could not find such an explanation in either the Background Information or Basis for Conclusions of SFAS No. 133.)* The Board recognizes that this approach is a complicated mixed attribute model in which the accounting for some assets and liabilities is a function of whether they are being hedged and the accounting for some parts of the asset or liability may even be different.

G. Intent is important and must be documented at inception of the hedge. As noted in describing the economics of derivatives use, "risk" is a concept about the future; risk management implies that there is intent to change what might happen in the future. Intent includes an understanding of the risk management objectives and how the instruments used are able to meet those objectives.

Disclosures

H. While fair value is a relevant measure of derivative instruments to include in the balance sheet, this summary measure clearly does not indicate the risks associated with the instruments. The goal of additional disclosures about the instruments is to accurately portray the risks of loss associated with the instruments. Firm characteristics may affect the most effective way to portray these risks. Within a firm, the most effective way may differ across derivatives.

In determining the useful disclosures about its derivatives activities, firms should consider the following:

- 1) Derivatives are used for different purposes and these differences are important for assessing the risk of the derivative instruments.
- 2) The purpose of hedging is to reduce volatility of cash flows, earnings, or values. Volatility is a time-series concept. Financial statement users will not be able to discern the effect of derivatives use on volatility from a limited time-series of observations of fair value changes. To overcome this deficiency of the financial statements, firms should provide information about its strategies and objectives, the specific instruments used to achieve these objectives, and the historical results of the activities, that is useful for assessing how the changes in value of derivatives have or will offset fair value changes of existing assets or liabilities or cash flows.
- 3) Given that the values of derivative instruments can change frequently, and can change sign, it is important to disclose qualitative and quantitative characteristics of the instruments that are useful for understanding potential losses.

Comments on particular paragraphs:

In this section, the Committee has provided a mapping between paragraphs of SFAS No. 133 and the Committee's concepts-based approach shown above.

Para-graph	Comment
1	Incorporated into A
2	Incorporated into A
3	Incorporated into B, C, and E
4	Summary – unnecessary
5	Incorporated into A
6-9	Incorporated into the “ <i>Economic uses of derivative instruments</i> ”
10-11	Given that the standard defines a derivative instrument, and given that it includes all derivatives within its scope, the paragraphs that explain that certain instruments are included (or excluded) because they meet (or do not meet) the criteria to be defined as a derivative instrument are irrelevant (Paragraphs 10a, 10b and 10d). Paragraphs 10c, 10e, 10f, and 11a-c are necessary because they exclude from the scope transactions that would be included based on the definition of a derivative. A concepts-based standard should provide an explanation for why these instruments are excluded. This explanation will facilitate the process of excluding (or not) new instruments as they are introduced. Note that paragraphs 11b and c, which exclude contracts issued in association with stock-based compensation arrangements or business combinations, explain (implicitly) that these instruments are excluded because they are addressed in other standards. The explanations for excluding other instruments are provided, in part, in the “Basis for Conclusions.”

12	Incorporated into the “ <i>Economic uses of derivative instruments</i> ” and B
13-15	These paragraphs and the Appendix on “clearly and closely related” embedded derivatives should be implementation guidance.
16	Incorporated into B
17	Incorporated into B and C
18	Incorporated into E and F
19	Incorporated into D
20	Incorporated into E and G, but with less detail. The exact requirements for documenting intent, which includes an assessment of the derivative instrument’s potential effectiveness, should be included in the implementation guidance. The concepts-based standard should simply stress that intent is a necessary condition to establish that a hedging relationship exists.
21	Incorporated into E; the details should be implementation guidance.
22	Incorporated into E
23	This paragraph is redundant. The concepts apply to all hedged items, including AFS securities. This paragraph should be implementation guidance.
24	The first sentence is incorporated into E. The “example” in the paragraph should be included in implementation guidance.
25	Incorporated into E
26	Incorporated into E
27	Implementation guidance.
28	The definition of a cash flow hedge (but without naming it) is included in E. The exact requirements for documenting intent, which includes an assessment of potential effectiveness, should be included in implementation guidance. See paragraph 20.
29	Incorporated into E. Much of this paragraph should be implementation guidance.
30	The general concept is incorporated into E. Much of this paragraph should be implementation guidance.
31	Incorporated into E
32-33	See paragraphs 25 and 26.
34-35	These paragraphs should be implementation guidance.