**Testimony of**
**Leslie F. Seidman**
**Financial Accounting Standards Board**
**Before the**
**Subcommittee on Commerce, Trade and Consumer Protection of the**
**Committee on Energy and Commerce**
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**Prepared Remarks**

Chairman Stearns, Ranking Member Schakowsky, and Members of the Subcommittee:

I am Leslie F. Seidman, a Member of the Financial Accounting Standards Board. I am pleased to appear before you today on behalf of the FASB. I have brief prepared remarks, and I would respectfully request that the full text of my testimony and all supporting materials be entered into the public record.

The FASB is an independent private-sector organization subject to oversight by the United States Securities and Exchange Commission. Our independence from enterprises, auditors, and other constituents is fundamental to achieving our mission—to establish and improve standards of financial accounting and reporting for both public and private enterprises. Those standards are essential to the efficient functioning of the capital markets and the US economy because investors and other users of financial reports rely heavily on credible, transparent, comparable, and unbiased financial information to make rational resource allocation decisions.

Beginning in the 1980s and continuing in the 1990s, as the use and the complexity of derivatives and hedging activities grew rapidly, many investors, creditors, and other users of financial statements were surprised and concerned by large unexpected losses on derivatives that were reported by several enterprises that had previously provided little if any information about those contracts in their financial reports.

Members of Congress, the SEC, the General Accounting Office, the American Institute of Certified Public Accountants, and many investors, creditors, and other users of financial reports urged the FASB to develop and issue a standard that would provide comprehensive accounting requirements for derivatives and related hedging activities.

At the time, the existing standards applicable to the accounting for derivatives and hedging activities were incomplete. There were no specific standards for many types of derivatives and hedging activities. Where standards did exist, they were inconsistent. Where they did not exist, the practices that had developed varied widely. As a result, the financial statements of enterprises that used derivatives did not report their derivative and hedging activities in a way that users of those financial statements could compare or understand.

Following an extensive and open due process, described more fully in the full text of my testimony, in 1998, the FASB issued Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities.*

Statement 133 requires that an enterprise report all of its derivatives as either assets or liabilities on the face of its financial statements and measure those instruments at their fair value.

Statement 133 also generally requires that any changes in the fair value of derivatives, or derivative gains or losses, be reported in the enterprise's earnings in the period of the change.

If, however, certain conditions are met, an enterprise may specifically designate a derivative as a hedge of a related item and receive special accounting for the combination of the derivative and the related item in a manner that matches or offsets the earnings effect.

Hedge accounting is a special accounting practice that reflects an entity's intended strategy between two separate items. Rather than applying the applicable standards to each component of the strategy, hedge accounting allows the entity to recognize the gains or losses on the derivative in the same period as the income statement effect of the hedged item. Entities engaged in risk management activities desire hedge accounting so that the income statement reflects the effect of their hedging strategies in the same period as the item being hedged. Because hedge accounting defers recognition of gains and losses on derivatives, numerous conditions must be met at the outset of the transaction and over the life of the transaction; these are called hedge criteria. The criteria differ, depending on the nature of the risk being hedged.

In general, a derivative may be specifically designated (1) as a hedge of the exposure to changes in the fair value of an asset or liability—a fair value hedge—or (2) as a hedge of the exposure to variable cash flows of a forecasted transaction—a cash flow hedge. The accounting for changes in the fair value, or the gains or losses, of the derivative differs depending on that designation.

For a derivative designated as hedging the exposure to changes in the fair value of an asset or liability, the gain or loss on the derivative is recognized in earnings in the period of change together with the offsetting loss or gain on the hedged item attributable to the risk being hedged. An example of a fair value hedge is the use of an interest rate swap to change the interest rate risk on a fixed-rate bond from fixed to floating. In a perfect hedge, hedge accounting will show net interest expense at the new floating rate. However, if the hedge is not perfect, the differences are required to be reported in earnings and, thus, are transparent to investors.

For a derivative designated as hedging the exposure to variable cash flows of a forecasted transaction, the gain or loss on the derivative is initially deferred in a balance sheet account to the extent that the hedge is effective; the gain or loss is subsequently reclassified into earnings in the period that the related forecasted transaction affects earnings. An example of a cash flow hedge is the use of an interest rate swap to change the risk profile on a floating-rate loan—the swap serves to lock in the cash flows associated with the transaction. In a perfect hedge, hedge accounting will show net interest income at the new fixed rate. To the extent that the swap is not effective in offsetting the cash flows on the loan, any ineffectiveness is reported in earnings immediately and separately disclosed.

An enterprise that elects to apply special hedge accounting is required to identify and document at the inception of the hedge (1) the specific item(s) that are being hedged and the entity's risk management strategy, (2) the method it will use for assessing the effectiveness of the hedging derivative, and (3) the measurement approach for determining the ineffective aspect of the hedge. Those methods must be consistent with the entity's overall approach to managing risk.

At the time Statement 133 was issued, the Board established a Derivatives Implementation Group of outside experts to assist the FASB in answering questions that companies might face as they began implementing the Statement. More than 150 constituent questions have been answered through that effort.

In April 2003, the FASB issued an amendment to Statement 133 to clarify the scope of the Statement and codify several issues that had been identified and resolved as part of the DIG process.

Consistent with its mission and Rules of Procedure, the FASB stands ready to consider any additional guidance or potential improvements to the accounting for derivatives and hedging activities.

Thank you, Mr. Chairman. I would be happy to respond to any questions.