Testimony of
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Full Text of Testimony

Summary

- The Financial Accounting Standards Board ("FASB" or "Board") is an independent private-sector organization. The FASB's independence is fundamental to achieving our mission—to establish and improve standards of financial accounting and reporting for both public and private enterprises.

- In 1998, in response to requests from many constituents, the Board issued Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities* ("Statement 133").

- 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 generally requires that any changes in the fair value of derivatives (gains or losses) be reported in the enterprise's earnings in the period of the change.

- Statement 133 permits an enterprise, if certain conditions are met, to 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 offsets the earnings effect.

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

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

I am Leslie F. Seidman, a Member of the Financial Accounting Standards Board ("FASB" or "Board"). I am pleased to appear before you today on behalf of the FASB. My testimony includes a brief overview of (1) the FASB, (2) derivatives and hedging activities, (3) the basis for the Board's decision to develop and issue Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities* ("Statement 133"), (4) the process the Board followed in developing Statement 133, (5) some of the key requirements of Statement 133, and (6) how the FASB has responded to requests for additional guidance and other improvements to Statement 133.

The FASB

The FASB is an independent private-sector organization.[1] 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.[2] Those standards are essential to the efficient functioning of the capital markets and the United States ("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.

[1] See Attachment 1 for information about the Financial Accounting Standards Board.
[2] See Attachment 2 for a discussion of the importance of the FASB's independence and neutral accounting standards.

The FASB's independence, the importance of which was recently reaffirmed by the Sarbanes-Oxley Act of 2002 ("Act"),[3] is fundamental to our mission because our work is technical in nature, designed to provide investors and the capital markets with the most accurate possible yardstick to measure and report on the underlying economic transactions of business enterprises. Like investors, Congress and other policy makers need an independent FASB to maintain the integrity of a properly designed yardstick in order to obtain the financial information necessary to appropriately assess and implement the public policies they favor. While bending the yardstick to favor a particular outcome may seem attractive to some in the short run, in the long run an inaccurate yardstick (or a biased accounting standard) is harmful to investors, the capital markets, and the US economy.

The FASB's authority with respect to public enterprises comes from the US Securities and Exchange Commission ("SEC"). The SEC has the statutory authority to establish financial accounting and reporting standards for publicly held enterprises. For 30 years, the SEC has looked to the FASB for leadership in establishing and improving those standards. The SEC recently issued a Policy Statement reaffirming this longstanding relationship.[4]

The Policy Statement, consistent with the language and intent of the Act,[5] also reemphasizes the importance of the FASB's independence described earlier. It states:

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[3] Sarbanes-Oxley Act of 2002, Public Law Number 107-204, Sections 108-109 (July 30, 2002).
[4] Policy Statement: Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter, Exchange Act Release Nos. 33-8221; 34-47743; IC-26028; FR-70 (April 28, 2003).
[5] Sections 108-109; The legislative history of the Sarbanes-Oxley Act of 2002 is clear that the provisions of the Act relating to the FASB were intended to "strengthen the independence of the FASB . . . from . . .

> By virtue of today's Commission determination, the FASB will continue its role as the preeminent accounting standard setter in the private sector. In performing this role, the FASB must use independent judgment in setting standards and should not be constrained in its exploration and discussion of issues. This is necessary to ensure that the standards developed are free from bias and have the maximum credibility in the business and investing communities.[6]

The SEC, together with the private-sector Financial Accounting Foundation,[7] maintains active oversight of the FASB's activities.

The FASB has no power to enforce its standards. Responsibility for ensuring that financial reports comply with accounting standards rests with the officers and directors of the reporting enterprise, with the auditors of the financial statements, and for public enterprises, ultimately with the SEC.

What Are Derivatives and Hedging Activities?

In general, a derivative is a contract between two or more parties that involves little or no up-front exchange of assets. The contract obligates one party to give up cash (or other assets) at some later date and entitles the other party to receive the cash. The amount of cash to be exchanged is often derived from two factors specified in the contract. Those factors are commonly referred to as the "underlying" and the "notional amount."

The underlying is a variable—usually a price index, an interest rate or interest rate index, a foreign exchange rate, or the price of a financial instrument or commodity. The

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companies whose financial statements must conform to FASB's rules." Senate Report 107-205, 107th Congress, 2d Session (July 3, 2002), page 13.

[6] Page 5 of 8.

[7] See Attachment 1 for information about the Financial Accounting Foundation.

notional amount is an amount of currency or a physical quantity (for example, a number of bushels or pounds). The product of the two (the underlying times the notional amount) determines the amount of cash to be exchanged. Some common examples of derivatives are options, swaps, forward contracts, and futures contracts.

Enterprises may use derivatives to hedge against or offset adverse changes in price or changes in cash flows. Derivatives also are used to seek extra returns, which is a form of speculation. Of course, a derivative usually is a two-edged sword. Many derivatives offer as much potential for loss as for gain.

What Was the Basis for the Board's Decision to Develop and Issue Statement 133?

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,[8] the American Institute of Certified Public Accountants,[9] 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.

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[8] United States General Accounting Office, Report to Congressional Requesters, *Financial Derivatives: Actions Needed to Protect the Financial System* (May 1994).
[9] AICPA Special Committee on Financial Reporting, *Improving Business Reporting—A Customer Focus* (December 1994).

At the time, the existing standards applicable to the accounting and reporting 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.

Many enterprises reported only the current cash payments or receipts on their derivatives. For example, enterprises that were users of interest rate swaps usually reported only the amount of the next payment or receipt on the contract. Reporting only the next payment or receipt did not accurately represent the financial position of the users of the swap. If interest rates changed significantly following the initiation of the swap, one party could be expected to make relatively large future payments and the other could be expected to receive those payments. One party had an unrecorded asset and the other had an unrecorded liability.

Some of the other results of the incomplete and inconsistent accounting for derivatives were:

- Different enterprises reported very similar derivative activities differently, and even an individual enterprise could report similar activities differently.

- Gains and losses on derivatives used to hedge risks often were reported as liabilities and assets, rather than as income or expenses in the enterprise's income statement. Reporting an actual loss as an asset or a gain as a liability was misleading to the users of the financial statements.

What Process Did the FASB Follow in Developing Statement 133?

Because the actions of the FASB affect so many organizations, its decision-making process must be fair. The FASB carefully considers the views of all interested parties—users, issuers, and auditors of financial information. Our Rules of Procedure require an extensive due process. It involves public meetings, public hearings or roundtables, and exposure of our proposed standards to external scrutiny and public comment. The Board makes final decisions after carefully considering and analyzing the input of all parties. While this process is similar to the Administrative Procedure Act process used for federal agency rulemaking, it provides far greater opportunities for interaction with the Board by interested parties. It is also focused on making technical, rather than political or legal judgments.

Some of the highlights of the FASB's due process in developing Statement 133 are as follows:

- The Board began deliberating issues related to derivatives and hedging activities at public meetings in January 1992.

- The Board appointed outside experts who represented various points of views on the issues to a Financial Instruments Task Force ("FITF"). The FITF provided expertise, a diversity of viewpoints, and a mechanism for communicating with those who would be affected by any change to the accounting for derivatives and hedging.

- Between January 1992 and June 1996, the Board discussed issues related to the accounting for derivatives and hedging at 100 public meetings.
- In June 1996, the Board issued an Exposure Draft of a proposed standard.[10]
- Approximately 300 organizations and individuals responded to the Exposure Draft, some with multiple letters.
- The Board held four days of public hearings in November 1996. Thirty-six individuals and organizations testified. In addition, six enterprises participated in limited field tests of the provisions of the Exposure Draft.
- In December 1996, the Board met with the FITF to discuss the issues raised during the comment letter process and during the public hearings and field tests.
- The Board considered the comments and field test results during its redeliberations of the issues addressed by the Exposure Draft in 21 public meetings in the first 7 months of 1997.
- The FITF met again with the Board in April 1997 and discussed, among other things, proposed changes to the Exposure Draft reflected in a draft of the final Statement.

[10] FASB Exposure Draft, *Accounting for Derivative and Similar Financial Instruments and for Hedging Activities* (June 1996).

- In August 1997, a revised draft of the standards section of the final Statement and related examples was made available to the FITF and other interested parties for comment on the draft's clarity and operationality.

- The Board received approximately 150 comment letters on the revised draft and discussed those comments in 10 public meetings. Those comments led to additional changes to the requirements, intended to make the Statement clearer and more operational.

- The Board issued Statement 133 in June 1998.[11] As issued, Statement 133 was effective for all fiscal quarters of all fiscal years beginning after June 15, 1999, with earlier application encouraged.

- Following the issuance of Statement 133, some enterprises and auditors expressed concern about certain challenges they faced in applying Statement 133. Those challenges included organization-wide educational efforts and information system modifications that were made more difficult by the modifications and testing of systems to ensure their proper operation in the year 2000.

- On May 20, 1999, the Board issued an Exposure Draft that proposed deferring the effective date of Statement 133 for one year.[12] The Board received 77 letters of comment from respondents.

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[11] See Attachment 3 for News Release, "FASB Derivatives Statement Now Available" (June 16, 1998).
[12] FASB Exposure Draft, *Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133* (May 20, 1999).

- In June 1999, the Board issued Statement of Financial Accounting Standards No. 137, *Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133* ("Statement 137").[13] Statement 137 deferred the effective date of Statement 133 to all fiscal quarters of all fiscal years beginning after June 15, 2000.

What Are Some of the Key Requirements of Statement 133?[14]

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 (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 transactions. 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

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[13] See Attachment 3 for News Release, "FASB Delays Implementation Date for Derivatives and Hedging Standard" (July 7, 1999).
[14] See Attachment 4 for a summary of the requirements of Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities* (June 1998).

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 a recognized asset or liability or an unrecognized firm commitment or (2) as a hedge of the exposure to variable cash flows of a forecasted transaction. The accounting for changes in the fair value (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 a recognized asset or liability or a firm commitment (referred to as a fair value hedge), 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 (referred to as a cash flow hedge), the gain or loss on the derivative is initially deferred in other comprehensive income (which is 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. Several other disclosures are required to help investors understand how and when the deferred amount will be reclassified into earnings.

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 approach to managing risk.

How Has the FASB Responded to Requests for Additional Guidance and Improvements to Statement 133?

Implementation Guidance

At the time Statement 133 was issued in June 1998, the Board was aware of the complexities associated with transactions involving derivatives and their prevalent use as hedging instruments. Because of that, even before Statement 133 was issued, the Board established a Derivatives Implementation Group ("DIG") of outside experts to assist the FASB in answering questions that companies might face as they began implementing the Statement.[15]

The responsibilities of the DIG were to identify practice issues that arose from applying the requirements of Statement 133 and to advise the FASB on how to resolve those issues. Public meetings of the DIG were held bimonthly during 1998, 1999, and 2000. The DIG identified and assisted the FASB in resolving more than 150 discrete issues relating to the implementation of Statement 133.

In 2001, as the number of new implementation questions diminished, the responsibility for addressing Statement 133 implementation issues was transferred from the DIG to the FASB's Emerging Issues Task Force.[16]

Amendments

[15] See Attachment 3 for News Release, "FASB Appoints Task Force to Aid with Implementation Issues on Derivatives" (February 5, 1998) and Attachment 5 for a description of the Derivatives Implementation Group and a list of its members.
[16] See Attachment 1 for a description of the Emerging Issues Task Force.

Prior to Statement 133 becoming effective in July 2000, the FASB received numerous requests from enterprises and auditors to amend that Statement. The requests focused mainly on guidance related to specific issues that, if amended, would ease implementation difficulties. In analyzing those requests, the Board did not discover any new significant information suggesting that the framework of Statement 133 was inappropriate or that major changes should be made.

In June 2000, in response to the requests, the FASB issued Statement of Financial Accounting Standards No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities* ("Statement 138"), amending certain provisions of Statement 133.[17] In general, Statement 138 (1) expands the scope of certain transactions that are excluded from the requirements of Statement 133, (2) broadens the criteria that permit enterprises to qualify for special hedge accounting, and (3) clarifies certain provisions based on the recommendations of the DIG.

More recently, in April 2003, the Board issued Statement of Financial Accounting Standards No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* ("Statement 149").[18] Statement 149 amends Statement 133 largely to revise and further clarify the scope of Statement 133 and codify several issues that were identified and resolved as part of the DIG process.

[17] See Attachment 3 for News Release, "FASB Issues Amendment to Derivatives Standard" (June 15, 2000).
[18] See Attachment 3 for News Release, "FASB Issues Standard That Amends and Clarifies Accounting Guidance on Derivatives" (April 30, 2003).

Consistent with the FASB’s mission and Rules of Procedure, the FASB stands ready to consider any additional implementation issues or proposed improvements to the accounting for derivatives and hedging activities.

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