



May 30, 2001

Mr. Timothy S. Lucas
Chairman
Derivatives Implementation Group
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Dear Tim:

The Committee on Corporate Reporting (CCR) of Financial Executives International is writing to provide its views on Derivatives Implementation Group Issues G20, C14 and C15.

Issue G20, Cash Flow Hedges: Assessing and Measuring the Effectiveness of an Option Used in a Cash Flow Hedge

CCR strongly supports the probabilistic approach proposed by the FASB Staff in measuring the effectiveness of options designated as cash flow hedges. We believe that this model resolves many of the difficulties companies have encountered in applying the FAS 133 in these circumstances. However, many companies also utilize options as fair value hedges and the accounting for those options remains unchanged by the conclusions in Issue G20. We do not understand why this same approach should not apply to options used as fair value hedges. The text of Issue G20 provides no explanation to support the explicit prohibition against doing so.

If the Board is unable to extend the probabilistic approach to options used as fair value hedges, we urge you to consider a limited scope amendment to FAS 133 that would mitigate at least some of the issues that companies encounter in those circumstances. Specifically, CCR would recommend that the Board should amend FAS 133 to allow for amortization of time value on options designated as fair value hedges when a company can demonstrate that it has both the intent and ability to hold the option to maturity. Similar to the accounting for Available For Sale securities under FAS 115, the option would be recorded on the balance sheet at its fair value and the time value would be released to earnings out of Other Comprehensive Income in a systematic pattern. This approach would avoid the significant time value volatility our members have experienced under the current guidance.

Issue C14, Scope Exceptions: Normal Purchases and Normal Sales Exception for Electricity Contracts Subject to Being Booked Out

Issue C15, Scope Exceptions: The Eligibility of Option Contracts on Electricity for the Normal Purchases and Normal Sales Exception

In both of these issues, conflicts arise between the FASB Staff's interpretations of the requirements of FAS 133 and the necessary business practices that result from the fact that: (1) electricity is not storable, and (2) the level of demand for electricity on any given day is inherently uncertain. We believe that it should be clear to all concerned that the business practices followed in the normal course of buying and selling electricity by energy producers and distribution enterprises are a direct result of these realities. It is also unequivocally clear that these practices are in no way speculative in nature.

CCR believes that with respect to option contracts covered by Issue C15, the fact that electricity is not storable causes these contracts to qualify for normal treatment under paragraph 58(b) which states, in part: "Evidence such as past trends, expected future demand, other contracts for delivery of similar items, an entity's and industry's customs for acquiring and storing the related commodities, and an entity's operating locations should help in identifying contracts that qualify as normal purchases and sales."

With respect to book outs, an issue that is broader than just electricity, we encourage the Board to adopt the approach that was recommended by DIG members at their December 2000 meeting, rather than the interpretation proposed by the FASB staff. Under the model proposed by the DIG, contracts would qualify as normal if they met 3 criteria: (1) both parties have credit and performance risk with one another, (2) transfer of title to the commodity passes from one party to another, and (3) gross cash is paid from one party to the other. As currently drafted, Issue C15 will cause substantially all contracts subject to book-out to not qualify as normal and would, in our view, represent an amendment of FAS 138. A conclusion that these are not normal also seems counterintuitive, given the "plain English" meaning of the word, particularly when applied in this context.

The Board's tentative conclusions on both of these issues result in the affected contracts being accounted for as though they are speculative derivative instruments. We fail to see the improvement in financial reporting that will result from marking these "derivatives" to market through earnings. On the other hand, we can see quite clearly the costs of this accounting treatment and the potential for significant confusion that is likely to ensue when these issues become effective. We believe that the merits of the interpretations proposed above speak for themselves and the Board needs to revisit its rationale in light of the broader impact of the counterintuitive accounting that would otherwise result.

It is important to note that C14 and C15 are interrelated and should be resolved in a consistent manner, as proposed above. Favorably resolving the issue with C15, for example, will not solve the broader issues that these unique circumstances create.

We also ask the Board to clarify the meaning of the note at the end of Issue C15, which is included as Attachment A to this letter. It appears to be saying that even though the Board is soliciting comments on this issue, it will not change its mind on the accounting and that constituents should not presume otherwise in the interim. We would hope that the minds of the Board members are still open to other answers and this was simply an honest mistake or a misunderstanding. Clearly, the significance of these issues requires that consideration of other alternatives by the Board not be abandoned prematurely.

The Committee appreciates the opportunity to comment on these issues. We will be pleased to answer any questions you may have regarding the views expressed above.

Sincerely,

A handwritten signature in black ink, appearing to read "Philip D. Ameen". The signature is written in a cursive, flowing style.

Philip D. Ameen
Chair, Committee on Corporate Reporting
Financial Executives International

Attachment A
Staff Note to Issue C15

[Note: The release of the above guidance on the FASB website as a "tentative conclusion" and the associated solicitation of comments in the following italicized notice should not be construed as creating uncertainty about whether option contracts for the purchase or sale of electricity are currently eligible for the normal purchases and normal sales exception in paragraph 10(b). The existing guidance in Implementation Issue C10 (which was cleared by the Board on March 21, 2001 after the Board members had an opportunity to consider the input received at the December 14, 2000 DIG meeting from DIG members and other participants regarding this issue) prohibits option contracts for the purchase or sale of electricity (as well as other option contracts) from being eligible for the normal purchases and normal sales exception.]