Investors Technical Advisory Committee
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LETTER OF COMMENT NO. 3

Via Email

July 25, 2008

Mr. Robert H. Herz
Chairman
Financial Accounting Standards Board
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Re: Proposed Amendment to FASB Statement No. 133 - Accounting for Hedging Activities

Dear Chairman Herz,

As you are aware, the ITAC strongly supports the FASB's objective to improve the quality, transparency, comparability and relevance of financial reporting and to reduce its complexity.[1] We are writing to provide views to both the FASB and the IASB on the issue of fair value measurement of financial instruments, and specifically to indicate ITAC's general support of the current proposal to amend Statement No. 133, the Accounting for Hedging Activities.

We believe that all financial assets and liabilities should be reported at fair value (please see our comment letter re: Fair Value Measurement for Financial Instruments, dated May 23, 2008). Measuring all financial instruments at fair value in the balance sheet with changes reported in the income statement accompanied by sufficient disclosure in the footnotes, would increase the transparency of financial reporting, and have the major benefit of eliminating the need for special hedge accounting. Such an improvement would enhance investors' understanding of a company's operations and of its returns and risks. At the same time, these changes would reduce the complexity of financial reporting, and improve the relevance of financial reports, if applied on a consistent basis to all financial assets and liabilities.

[1] This letter represents the views of the ITAC and does not necessarily represent the views of its individual members, the organizations in which they are employed, or the views of the Financial Accounting Standards Board ("FASB" or "Board") or its staff. For more information about the ITAC, including a list of the current members and the organizations in which they are employed, see http://www.fasb.org/investors_technical_advisory_committee.

While the simplest and most transparent accounting would be to have all financial instruments reported at fair value, we support the general thrust of FASB's progressive proposal to revise Statement No. 133. The proposal represents movement towards achieving the objective of financial reporting stated herein. Importantly, the proposal is also consistent with the direction of IFRS as suggested in the Discussion Paper entitled 'Reducing Complexity in Reporting Financial Instruments.'[2] ITAC intends to provide more specific comments on that Discussion Paper in a separate letter to the FASB and IASB.

We believe the proposed Statement would improve the usefulness of financial statements by requiring measurement of all changes in fair value of both the hedging instruments and hedged items. Moreover, the reporting of hedged financial assets and liabilities at fair value, accompanied by sufficient disclosures, would provide more insight into the alternative approaches companies take in risk management, and would provide investors with a sense of context in judging the company's hedging strategy. A degree of subjectivity is involved in the assessment of the need for hedging and whether the hedging undertaken by companies serves a business purpose or is motivated by financial speculation. The proposed Statement, combined with more useful disclosures, would allow for a more careful review by investors of a company's hedging strategy.

However, we have some additional recommendations that we believe would further improve the clarity of reporting for derivatives while also simplifying the preparation of the reports for preparers. Our recommendations will be provided both in our commentary on specific issues, as requested in the Exposure Draft.

Hedged Risk - Issue 1

We agree that eliminating "the ability of an entity to designate individual risks as the hedged risk in a fair value or cash flow hedge" (with two exceptions) would more comprehensively reflect risk exposures while, at the same time, eliminate the arbitrary and error-prone bifurcation of risk effects associated with hedged assets and liabilities.

As has often been observed, no perfect hedges exist, and, therefore, hedging transactions entered into in order to achieve legitimate risk management or other risk distribution reshaping objectives (e.g., transactions that would increase a company's risk exposures that are explicitly admitted for hedge accounting treatment under Statement No. 133) must necessarily subject the company to other than the target risk(s). Thus, investors and other users are better served by having relevant information on a company's complete risk exposure profile, consistent with full fair value reporting for financial instruments.

In this regard, one of the provisions in the original Statement No. 133 that impaired its usefulness to investors was the provision that required only the revaluation of that portion of a particular risk hedged in a position. For example, if a company chose to hedge only

[2] IASB Discussion Paper, Reducing Complexity in Reporting Financial Instruments (issued March 19, 2008) and FASB Invitation to Comment, Reducing Complexity in Reporting Financial Instruments (issued March 28, 2008), which includes a copy of the IASB Discussion Paper.

40% of the price risk in a particular commodity inventory, then only 40% of the hedged item would be marked to market for the hedged risk, leaving the remaining 60% at the original historical cost. This provision was a compromise engineered to reduce the volatility in earnings that might occur as a result of marking the unhedged portion to fair value. That is, an accommodation was made to those who, at that time, were concerned about the possible adverse effects of fully reflecting the effects of a company's full risk profile in the primary financial statements.

In fact, however, investors may well be more concerned about the effects on the company's operations of the unhedged risk exposure than they would the hedged 40%. Hence, we believe financial reporting would be substantially improved if the Board were to take this opportunity of updating and revising Statement No. 133 to eliminate this reporting loophole and require that the full amount of a hedged position be fair valued, thus making clear the effects on a company's operations of the decision to hedge as well as the decision to not hedge and bear a portion of the risk.

We agree with the provision in paragraphs 17 and 18 that the designation of a hedge of interest rate risk in issuance of own debt should be designated at inception. However, the expression "within a reasonably short period" seems to us to be unnecessarily ambiguous and vague and is likely to provide ample opportunity for gaming. We recommend clarifying what is meant by "within a reasonably short period."

We note that the accounting and financial reporting for cash flow hedges remains exceedingly complex and convoluted. Indeed, a significant portion of the Exposure Draft is devoted to the various provisions necessary to achieve the desired accounting effect. The underlying problem that these elaborate provisions are addressing is the desire to defer gains and losses on the hedging instrument in accumulated other comprehensive income in order to be able to match them with the effects of the forecasted hedged item at some indeterminate future time, a period which could stretch for decades into the future.[3]

As a matter of policy, we do not believe that the deferral of gains and losses can be justified for any reason and that such provisions both impair transparency and the usefulness of financial reporting for investors. We would encourage the Board to reconsider these provisions with a view to eliminating the deferral provisions of cash flow hedges. Such a change would not affect in any way a company's ability to continue to hedge such risk exposures. However, it would greatly improve the integrity of financial reporting. Any concerns managers have regarding users' understanding of the nature of the transactions could be fully dealt with in disclosures in the footnotes to the statements.

Hedged Risk -Issue 2

While we have some sympathy with the Board's decisions, explained in paragraphs A18-20, to both (1) encourage company managers to seek the lowest possible borrowing costs

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[3] For example, see Bloomberg article by Jonathan Weil dated December 5, 2007.
http://www.bloomberg.com/apps/news?pid=20601039&refer=columnist_weil&sid=ahoxGPj68WN0

available to it by entering into synthetic transactions that have the effect of achieving this objective, and (2) to actively manage foreign currency risk exposures, a major consideration in markets at present, we would note that this accommodation comes at the cost of underreporting other risk exposures, e.g., counterparty risk, that would otherwise be reported under the proposed amended Statement No. 133. That is, counterparty risk would be recognized in all transactions except those covered by the two exceptions. Given that the effectiveness test for the two exceptions would include only the risk managed, and not other risks, we are concerned that, the financial statements would not reflect information about the risks that an entity chooses not to manage as part of a particular hedging relationship. If companies synthetically convert issued debt to reflect the net terms that they desired when they issued the debt with related hedges, investors should have sufficient information disclosed to understand the effects on the financial statements of these synthetic transactions.

Hedge Effectiveness - Issue 3

We understand that confusion, abuse and restatements have resulted from implementing the shortcut method. We agree with the provisions in the Exposure Draft that "would eliminate the shortcut method and critical terms matching." These changes would remove the ability for managers to "assume a hedging relationship is highly effective and recognize no ineffectiveness in earnings during the term of the hedge". Financial reporting should not be based on such entity specific or manager assumptions; rather, financial reporting should be based on objective evidence about effectiveness, which should be updated at each reporting period. Indeed, the elimination of the shortcut method would be entirely consistent with what we understand to be the spirit of these proposals, to more fully reflect company exposures and risk profiles.

The fact that this proposal would also enhance consistency and comparability in reporting for hedging transactions, both within companies across time and across different companies, while it also reduces complexity in financial reporting, are added attractions.

We do not see any "significant operational concerns or constraints in calculating ineffectiveness for fair value hedging relationships and cash flow hedging relationships." Indeed, if managers seek to manage risk exposures by entering into hedging transactions, it is a fundamental presumption that they must be able to measure the fair value of the positions being managed.

We agree with the provision in paragraph 11 that managers electing hedge accounting under Statement No. 133 be required to consider counterparty risk in their evaluation of effectiveness. Indeed, we believe that all risks that could affect the fair value of a hedging instrument or any other financial instrument, including liquidity risk (e.g., the inability to exit an OTC instrument) should be taken into account.

Hedge Effectiveness - Issue 4

We do not believe the Board has adequately articulated the basis for loosening the assessment requirement, from "highly effective" to "reasonably effective." Moreover, it is unclear to us how "reasonably effective" would be defined. We assume that this amendment was proposed to accommodate the reporting of fair value changes in all risks rather than just a single designated risk. However, our main concern is that the lower standard would permit greater deferral of derivative gains and losses from earnings under the guise of cash flow hedging, a concern we discussed above under Issue 1.

It is also not clear to us what qualitative or quantitative differences in practice would occur as a result of a reduction of the effectiveness requirement. Although a rule of thumb approach to the assessment of "highly effective" of 80%-120% offset has frequently been applied under Statement No. 133, this practice was a carry-forward from earlier standard setting and not an explicit provision of Statement No. 133 itself. Hence, we have no way of assessing what practices have been actually applied on average.

However, if managers decide to enter hedging transactions as a way of managing one or more risk exposures and also qualify for hedge accounting, we believe that such a financial-reporting decision should be allowed, subject to the documentation requirements of the revised Statement No. 133 and the "managed risk exposure" documentation requirements of the SEC.

Yet again, we must observe that if all financial assets and liabilities were required to be measured and reported at fair value, such a concern would not arise in the first place. Managers would enter transactions in financial instruments, including hedges, that they deem appropriate and the fair value measurement would report the effects of the transactions each period.

In this regard, to the extent that the reduction in the effectiveness threshold may be fueled by concern about the "in-and-out" problem of hedge accounting as a result of changes in hedge effectiveness over time, we believe that this concern is misplaced. The "in-and-out" problem is merely an artifact of the rather arbitrary provisions of hedge accounting that full fair value measurement would eliminate.

We are not opposed to the proposed accounting changes for hedge effectiveness as long as they are accompanied with sufficient disclosure requirements. For instance, to assist users in assessing risk management strategies, companies should be required to present, in tabular form where possible, the following information, by financial-statement-line item: the fair value of hedging instruments linked with the fair value amount of their hedged items; the corresponding changes in the hedges and hedged items during the period; the amount of hedges that 'moved out' of hedge accounting during the period due to ineffectiveness; the total amount and changes during the period of hedges not under hedge accounting; and useful descriptions of the hedge transactions.

We appreciate that Statement No. 161 should facilitate the ability for users to assess the effective vs. ineffective portions of fair value hedges by contract, and of cash flow hedges (assuming this distinction is made clear by disclosures of the changes in the fair value of hedges in the income statement vs. those in Accumulated Other Comprehensive Income). However, for these disclosures to be useful, we recommend the required presentation of the effective vs. the ineffective portions by line items in the financial statements. Furthermore, we recommend that the disclosure requirements required under Statement No. 161 be expanded or clarified to also require disclosures of the entity's accounting policies and attributes (qualitative and quantitative). These should include how the company assesses hedge effectiveness, both at and after inception, as well as the "circumstances that may suggest that a particular hedging relationship may no longer be sufficiently effective." Moreover, the Board should also emphasize disclosures of the company's risk exposures and the strategies it employs to manage such risks using derivative and other asset-liability management practices. This is particularly relevant since hedged risk under the proposed Statement must be the risk of all changes in fair value of the hedged item or all changes in the hedged cash flows (with two exceptions).

Hedge Effectiveness – Issues 5 and 6

We have some concerns about the provision to "require an effectiveness evaluation at inception of the hedging relationship," but to suspend such requirements following inception, relying instead on managers' "creating processes that will determine when circumstances suggest that a hedging relationship may no longer be reasonably effective without requiring reassessment of the hedge effectiveness each reporting period."

Hedge accounting is both voluntary and selective in nature, a departure from the usual and normal accounting for items. Therefore, we believe that it would be reasonable to require a continuing periodic assessment of the effectiveness of the hedging arrangement if the election were to be continued.

However, our primary reservation about this provision stems from our belief that if managers properly measure and report the values of hedges and hedged items each reporting period, given that the shortcut method and related assumptions about effectiveness would no longer be permitted, managers would necessarily have to generate the information they would need to make the assessment, and thus, the evaluation would require little if any additional effort. Consequently, the underlying motivation for this provision is not clear to us.

To the extent that this provision may be driven by concerns about "in-and-out" accounting or other such operational matters, we believe for the reasons we provided in the previous section that the concerns are, again, misplaced.

Finally, if the Board is indeed concerned about "in-and-out" effects, the ultimate solution is not to eliminate requirements for monitoring of hedges—a provision of dubious financial reporting merit—but to require that hedges once so designated for hedge accounting purposes not be permitted to be "de-designated" until either the hedging

derivative is sold or otherwise terminated, or the hedged position is similarly sold or terminated. That is, the election would be permanent and irrevocable.

Managers now have available the provisions of Statement No. 159 which, for hedged financial assets and liabilities, could achieve the same fair value financial reporting effect as Statement No. 133, but in a simpler and more straightforward fashion. Thus, if managers choose to elect hedge accounting under Statement No. 133, a somewhat more cumbersome alternative, a requirement that it be a permanent election would remove some of the operational problems and potential gaming that might otherwise occur, while at the same time simplifying reporting.

Presentation of Hedging Gains and Losses - Issue 7

It should not be necessary to amend Statement No. 133 to prescribe the presentation of gains and losses associated with hedging instruments if the disclosures in Statement No. 161 are sufficiently robust. While we believe it is essential to have it made clear on the face of the financial statements the line items where fair value gross gains and gross losses are included, and their amounts, we believe that the usefulness and transparency of the information produced under Statement No. 133 should improve considerably due to the disclosure requirements of Statement No. 161. We are hopeful that the Joint Financial Statement Presentation Project will go a step further and make the gross gains and losses even more transparent on the face of the financial statements. However, if it is not contemplated that Statement No. 161 will achieve these objectives, then, by default, the disclosures must be required in Statement No. 133.

Investors must be able to ascertain where the gains and losses are classified in the financial statements and need retrospective disclosure if managers are free to change the classification and presentation from period to period. Without such presentation and disclosure, comparability across companies is impaired.

Effective Date and Transition – Issue 8

We believe that the effective date provides sufficient time not only for managers to adopt the provisions but to adjust either their hedging programs or financial reporting standards, e.g., by electing to report such arrangements under Statement No. 159 if they choose.

Given that the proposals in these revisions would eliminate much of the complexity and simplify the financial reporting, we do not believe that they would prove problematic for preparers.

Effective Date and Transition – Issue 9

We believe that it would enhance transparency if managers were to provide sufficient qualitative and quantitative disclosure to enable investors and other users to understand what managers' intentions are regarding their election of the either the proposed Statement No. 133, or alternatively, Statement No. 159 if they choose to elect the Fair

Value Option for their hedging transactions going forward. Specifically, the transition disclosures should provide information on transfers between the held-to-maturity and the available-for-sale or trading categories; re-designation of hedged items to fair value accounting under Statements No. 156 and 159; and the amount of adjustments made to the carrying values of assets or liabilities.

Due to the de-designation and re-designation requirements of the proposed Statement, there potentially may be meaningful changes in positions or elections to qualify for hedge accounting. We believe that the Board should require disclosure of changes to hedge relationships or elections to apply hedge accounting as a result of the application of the proposed Statement and a discussion of effects on comparability of reported results across periods.

Effective Date and Transition – Issue 10

We agree with the Board's decision "to permit an entity a one-time fair value option election under FASB Statement No. 156, Accounting for Servicing of Financial Assets, and No. 159, The Fair Value Option for Financial Assets and Financial Liabilities, for (a) servicing assets and servicing liabilities designated as a hedged item on the date immediately preceding initial application and (b) eligible financial instruments designated as a hedged item on the date immediately preceding initial application of this proposed Statement."

However, we do not agree with the proposal in paragraph 38 to permit "the net effect of the adjustment [to be] recorded directly to retained earnings." As a matter of policy, gains and losses on assets and liabilities, regardless of their source, i.e., whether from fair value or other operational changes or from changes in accounting principles, voluntary or mandatory, should not be permitted to escape immediate and full recognition in net income. Allowing any such recognition loopholes reduces the integrity of financial reporting for all users of financial statements, including investors, and should not be allowed.

Consequently, we would encourage the Board to reconsider these provisions and to require that any adjustments be required to be recognized in income with appropriate disclosure in the footnotes.

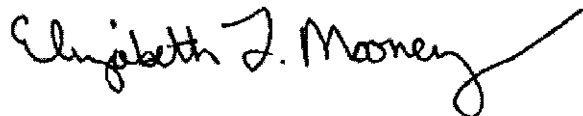
Benefit-Cost Considerations – Issue 11

In assessing the benefit-cost considerations, we strongly encourage the Boards to consider the costs to users of not having the transparency or the improved financial reporting that would result from the changes in the proposed Statement accompanied by our recommended disclosures.

Thank you for your consideration of our views on accounting for hedging activities and fair value reporting for financial instruments, which we view as critical in strengthening investor confidence in financial reporting. If you need further clarification or require

additional information, please feel free to contact the undersigned or any other member of ITAC's Hedging Subgroup. We would be pleased to discuss our recommendations with members of the Boards or their staff.

Sincerely,



Elizabeth F. Mooney
Member

cc: Russell Golden, Technical Director, FASB
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