



ILLINOIS CPA SOCIETY.



August 15, 2008

Technical Director
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
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LETTER OF COMMENT NO. 65

File Reference No. 1590-100

The Accounting Principles Committee of the Illinois CPA Society (Committee) appreciates the opportunity to provide its perspective on the Exposure Draft of the Proposed Statement of Financial Accounting Standards, *Accounting for Hedging Activities, an amendment of FASB Statement No. 133*. The organization and operating procedures of the Committee are reflected in the attached Appendix A to this letter. These recommendations and comments represent the position of the Illinois CPA Society rather than any members of the Committee or of the organizations with which such members are associated.

Although, the Committee appreciates the Board's desire to simplify the accounting for hedging activities and to resolve major practice issues relating to the application of Statement 133, we do not support issuance of the proposal in its current form at this time. For the reasons expressed by two Board members, we agree with the alternative views that the proposal does not significantly simplify the accounting for derivatives and produces results that are inconsistent with risk management. Further, in these times of international convergence, we believe it inappropriate for the Board to make changes to the accounting for hedging activities when such changes might be reversed upon adoption of IFRS or further convergence in a few years.

Our comments in response to the questions raised in the document are as follows:

Hedged Risk

Issue 1: *For the reasons stated in paragraph A16 of this proposed Statement, the Board decided to eliminate (with two exceptions) the ability of an entity to designate individual risks as the hedged risk in a fair value or cash flow hedge. As a result of that change, the financial statements would reflect information about the risks in the hedged item or transaction that an entity both chooses to manage and not to manage as part of a particular hedging relationship.*

Do you believe that the proposed Statement would improve or impair the usefulness of financial statements by eliminating the ability of an entity to designate individual risks and requiring the reporting of the risks inherent in the hedged item or transaction?

We do not believe the proposal would improve financial reporting. In our opinion, accounting should be consistent with the business model. Many entities currently hedge only interest rate



ILLINOIS CPA SOCIETY

risk. Eliminating the bifurcation-by-risk model could disqualify some of the simplest hedging strategies often used in current practice. Further, it seems that adjusting the hedged items for all inherent risks is tantamount to recording the items at fair value. Until the Board completes its deliberations on fair value accounting, we believe entities should be permitted to hedge individual risks.

Issue 2: *For the reasons stated in paragraphs A18–A20, the Board decided to continue to permit an entity the ability to designate the following individual risks as the hedged risk in a fair value or cash flow hedge: (a) interest rate risk related to its own issued debt (that is, its liability for funds borrowed), if hedged at inception, and (b) foreign currency exchange risk. For those two exceptions, the financial statements would not reflect information about the risks that an entity chooses not to manage as part of a particular hedging relationship.*

Do you believe the Board should continue to permit an entity to designate those individual risks as a hedged risk?

As discussed above, we do not agree with the elimination of the bifurcation-by risk model. If the Board goes forward with the proposal, we support these exceptions. However, we believe the Board should expand the exceptions to permit an entity to hedge interest rate risk related to its own debt before and after issuance. For various reasons, including negative connotations, few entities hedge their own credit risk.

In addition, we believe entities should be given the ability to bifurcate and hedge any individual risk associated with a forecasted transaction or balance sheet exposure. Current rules as well as the proposed new rules would only permit entities to bifurcate foreign currency or interest rate risk. We believe entities should also be able to bifurcate other risks, including commodity and inflation risks.

Hedge Effectiveness

Issue 3: *This proposed Statement would eliminate the shortcut method and critical terms matching. Therefore, an entity would no longer have the ability upon compliance with strict criteria to assume a hedging relationship is highly effective and recognize no ineffectiveness in earnings during the term of the hedge. As a result, when accounting for the hedging relationship, an entity would be required, in all cases, to independently determine the changes in fair value of the hedged item for fair value hedges and the present value of the cumulative change in expected future cash flows on the hedged transaction.*

Do you foresee any significant operational concerns or constraints in calculating ineffectiveness for fair value hedging relationships and cash flow hedging relationships?

We do not foresee significant operational concerns in calculating ineffectiveness for fair value hedges of financial assets and liabilities. The calculation of ineffectiveness seems more



ILLINOIS CPA SOCIETY

troublesome for cash flow hedges since it might be difficult to obtain fair values for a derivative that exactly offsets the forecasted cash flows. For example, the incorporation of credit risk into a hypothetical derivative might require the use of complex models.

Do you believe that the proposed Statement would improve or impair the usefulness of financial statements by eliminating the shortcut method and critical terms matching, which would eliminate the ability of an entity to assume a hedging relationship is highly effective and to recognize no ineffectiveness in earnings?

The Committee has no comment on whether the elimination of the shortcut would impair or improve the usefulness of financial statements. However, the Committee notes that in many instances where the shortcut or critical terms match approach could be applied under current practice, there will be no ineffectiveness under the proposal. The assumption of no ineffectiveness is a practical approach to evaluating hedging relationships that are designed to be perfectly or “almost” perfectly effective. We recommend, that if these approaches are retained, the Board make the shortcut and critical terms match less onerous to achieve.

Issue 4: *This proposed Statement would modify the effectiveness threshold necessary for applying hedge accounting from highly effective to reasonably effective at offsetting changes in fair value or variability in cash flows.*

Do you believe that modifying the effectiveness threshold from highly effective to reasonably effective is appropriate? Why or why not?

Yes. As mentioned above we believe accounting should be consistent with the business model. Notwithstanding our concerns about eliminating the bifurcation-by-risk model, we believe this lower threshold would qualify more derivatives for hedge accounting. We recommend, however, that the Board consider providing some additional guidance or examples to illustrate when an economic relationship exists and when a derivative would be reasonably effective.

For situations in which interest rate risk is currently designated as the hedged risk for financial instruments but would no longer be permitted under this proposed Statement (except for an entity’s own issued debt at inception), do you believe you would continue to qualify for hedge accounting utilizing your current hedging strategy? If not, would you (a) modify your hedging strategy to incorporate other derivative instruments, (b) stop applying hedge accounting, (c) elect the fair value option for those financial instruments, or (d) adopt some other strategy for managing risk?

The Committee has no comment.

Issue 5: *This proposed Statement always would require an effectiveness evaluation at inception of the hedging relationship. After inception of the hedging relationship, an*



ILLINOIS CPA SOCIETY.

effectiveness evaluation would be required if circumstances suggest that the hedging relationship may no longer be reasonably effective.

Do you foresee any significant operational concerns in 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?

The Committee recommends that the Board provide examples of situations that would require reassessment and clarify if such situations should be documented in an entity's initial documentation of hedge accounting.

Do you believe that requiring an effectiveness evaluation after inception only if circumstances suggest that the hedging relationship may no longer be reasonably effective would result in a reduction in the number of times hedging relationships would be discontinued? If so, why?

No comment.

Issue 6: *The Board considered but decided against eliminating any assessment of effectiveness after the inception of the hedging relationship. The Board believes that eliminating such an assessment of effectiveness could result in the continuation of hedge accounting even when situations suggest that the hedge relationship may no longer be reasonably effective. Some observe that an implication of the decision to not eliminate any assessment after the inception of the hedging relationship could be that hedge accounting results would be reflected in some reporting periods and not in other reporting periods throughout the life of the relationship. Also, in a hedge accounting model that generally does not permit hedging of individual risks, changes in the relationship between the individual risks being managed and those not being managed could increase the likelihood that the hedging relationship would no longer be reasonably effective. That would result in hedge accounting no longer being permitted for a portion of an expected hedge term. That "in and out" of hedge accounting would make it more difficult for users to interpret financial statements.*

Do you agree with the Board's decision to continue to require that hedge accounting be discontinued if a hedge becomes ineffective? Alternatively, should an effectiveness evaluation not be required under any circumstances after inception of a hedging relationship if it was determined at inception that the hedging relationship was expected to be reasonably effective over the expected hedge term?

We agree. An entity should discontinue hedge accounting if a hedge is no longer reasonably effective.



ILLINOIS CPA SOCIETY.

Presentation of Hedging Gains and Losses

Issue 7: *In the statement of operations, Statement 133 does not prescribe the presentation of gains and losses associated with hedging instruments, including the effective portion, the ineffective portion, and any amounts excluded from the evaluation of effectiveness, such as forward points. Some have suggested that such a prescription would improve financial reporting by creating consistency in the presentation of these amounts across all entities. Others observe that FASB Statement No. 161, Disclosures about Derivative Instruments and Hedging Activities, requires disclosure about that information, and they question whether a prescriptive approach is appropriate given the diverse hedge accounting strategies employed by entities.*

Do you believe that Statement 133 should be amended to prescribe the presentation of these amounts? For example, the Statement could require that the effective portion of derivatives hedging the interest rate risk in issued debt be classified within interest expense and that the ineffective portion and any amounts excluded from the evaluation of effectiveness be presented within other income or loss.

We do not believe the Statement should be prescriptive.

Effective Date and Transition

Issue 8: *The Board's goal is to issue a final Statement by December 31, 2008. The proposed Statement would require application of the amended hedging requirements for financial statements issued for fiscal years beginning after June 15, 2009, and interim periods within those fiscal years.*

Do you believe that the proposed effective date would provide enough time for entities to adopt the proposed Statement? Why or why not?

The Committee believes entities would have sufficient time to adopt the proposed Statement.

Issue 9: *The Board did not prescribe any specific transition disclosures upon adoption of this Statement.*

Do you believe that there are specific disclosures that should be required during transition? If so, what? Please be specific as to how any suggested disclosures would be used.

The Committee agrees with the Board's decision.

Issue 10: *The Board decided to permit an entity a one-time fair value option election under FASB Statements 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*



ILLINOIS CPA SOCIETY

application and (b) eligible financial instruments designated as a hedged item on the date immediately preceding initial application of this proposed Statement.

Do you agree with the Board's decision to allow a one-time fair value option at the initial adoption of this proposed Statement?

The Committee agrees with the Board's decision.

Do you agree with the Board's decision to limit the option to assets and liabilities that are currently designated as hedged items under Statement 133?

The Committee agrees with the Board's decision.

Benefit-Cost Considerations

Issue 11: *The objective of financial reporting is to provide information that is useful to present and potential investors, creditors, donors, and other capital market participants in making rational investment, credit, and similar resource allocation decisions. However, the benefits of providing information for that purpose should justify the related costs. The benefit-cost considerations considered by the Board are provided in paragraphs A43--A50 in Appendix B of this proposed Statement.*

Do you believe the Board identified the appropriate benefits and costs related to this proposed Statement? If not, what additional benefits or costs should the Board consider?

The Committee believes that entities will incur additional costs as we converge further with international accounting standards. As mentioned above, we believe this proposal should not be issued as a final standard until IASB finishes its deliberations on hedge accounting.

Additional Comments

In the Exposure Draft, the de-designation of a hedging relationship is not permitted unless the derivative is no longer effective, expired, sold, terminated or exercised. The Committee believes that de-designation of a hedging relationship should be allowed because an entity's risk management strategy will evolve over time. The Committee believes the current proposal may increase transaction costs for companies if they have to enter into offsetting derivatives to effectively de-designate. In addition, the notion of voluntary de-designations had not previously been highlighted as a complex element of the Statement.

In a proposed technical correction, the Exposure Draft clarifies that hedges of the foreign currency risk associated with intercompany royalty cash flows are only permitted to the extent that the forecasted royalties affect earnings for the entity being reported on. We believe the



ILLINOIS CPA SOCIETY

FASB should clarify the proposed guidance such that intercompany hedging would be permitted for forecasted transactions that will affect consolidated earnings in future periods as well as earnings in the current period.

We appreciate the opportunity to offer our comments.

Sincerely,

John A. Hepp, CPA
Chair, Accounting Principles Committee



ILLINOIS CPA SOCIETY

APPENDIX A
ILLINOIS CPA SOCIETY
ACCOUNTING PRINCIPLES COMMITTEE
ORGANIZATION AND OPERATING PROCEDURES
2008-2009

The Accounting Principles Committee of the Illinois CPA Society (Committee) is composed of the following technically qualified, experienced members appointed from industry, education and public accounting. These members have Committee service ranging from newly appointed to more than 20 years. The Committee is an appointed senior technical committee of the Society and has been delegated the authority to issue written positions representing the Society on matters regarding the setting of accounting standards. The Committee's comments reflect solely the views of the Committee, and do not purport to represent the views of their business affiliations.

The Committee usually operates by assigning Subcommittees of its members to study and discuss fully exposure documents proposing additions to or revisions of accounting standards. The Subcommittee ordinarily develops a proposed response that is considered, discussed and voted on by the full Committee. Support by the full Committee then results in the issuance of a formal response, which at times, includes a minority viewpoint.

Current members of the Committee and their business affiliations are as follows:

Public Accounting Firms:

Large: (national & regional)

John A. Hepp, CPA	Grant Thornton LLP
Alvin W. Herbert, Jr., CPA	Retired/Clifton Gunderson LLP
Michael J. Maffei, CPA	BDO Seidman LLP
Matthew G. Mitzen, CPA	Virchow Krause & Company, LLP
Reva B. Steinberg, CPA	BDO Seidman LLP
Jeffery P. Watson, CPA	Blackman Kallick LLP

Medium: (more than 40 employees)

Barbara Dennison, CPA	Selden Fox, Ltd.
Marvin A. Gordon, CPA	Frost, Ruttenberg & Rothblatt, P.C.
Ronald R. Knakmuhs, CPA	Miller, Cooper & Co. Ltd.

Small: (less than 40 employees)

Walter J. Jagiello, CPA	Walter J. Jagiello, CPA
Kathleen A. Musial, CPA	BIK & Company LLP

Industry:

John M. Becerril, CPA	Cabot Microelectronics
Gloria M. Evans-Melton, CPA	National Council of State Boards of Nursing
Melinda S. Henbest, CPA	The Boeing Co.
James B. Lindsey, CPA	TTX Company
Laura T. Naddy, CPA	Gaming Capital Group
Anthony Peters, CPA	McDonald's Corporation

Educators:

James L. Fuehrmeyer, Jr. CPA	University of Notre Dame
David L. Senteney, CPA	Ohio University
Leonard C. Soffer, CPA	University of Chicago

Staff Representatives:

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