

VIA ELECTRONIC MAIL (director@fasb.org)

August 23, 2013

Ms. Susan M. Cosper, Technical Director  
Financial Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, CT 06856-5116

**Re: File Reference No. PCC-13-03**

Dear Ms. Cosper:

Chatham Financial (“Chatham”) appreciates the opportunity to provide overall comments and specific responses to the questions for respondents on the Financial Accounting Standards Board’s (“FASB”) Exposure Draft, *Derivatives & Hedging (Topic 815) – Accounting for Certain Receive-Variable, Pay-Fixed Swaps* (the “Exposure Draft”).

Chatham serves as a hedging advisor to over 1,000 companies globally in a wide variety of industries. Several hundred of our clients apply the hedge accounting provisions of Topic 815; some of our clients are private entities that will be directly impacted by the proposed amendments. Chatham assists both private and public companies with the implementation of Topic 815 on a daily basis for thousands of derivative transactions, including providing assistance with hedge designation memos, effectiveness testing, derivative valuations, journal entries, and footnote disclosures for many different types of hedging relationships. Given our role, we believe that we are well-positioned to understand the impact and ramifications of the proposed guidance on a broad spectrum of derivative end users and share the following comments and recommendations from that perspective.

### **Overall Comments**

In general, we believe the proposed standard addresses some of the most common challenges private companies face when applying Topic 815, including the timing and content of the hedge documentation and the complexity of performing derivative valuations. For example, we believe that using “settlement value” for financial reporting provides relief to private companies that don’t have sophisticated valuation models, while still providing sufficient information to investors. We also support giving private companies additional time to finalize hedge documentation.

However, we do question the timing of this project because the Board currently has a comprehensive derivatives and hedging project on its agenda, and one of the primary objectives of both projects is simplification of the hedge accounting model. Given the Board's intention to address derivatives and hedging holistically and the stated purpose of the PCC to "decide whether and when exceptions or modifications to U.S. Generally Accepted Accounting Principles (GAAP) are warranted for private companies," we feel the Board should first address the derivatives and hedging topic broadly for all companies and then determine whether specific modifications are warranted for private companies to meet the needs of users of private company financial statements. In short, the sequence seems out of order to us.

Having said that, assuming the Board continues with this project, our primary additional concern relates to the potential confusion and lack of consistency that will result from adding two new hedge accounting methods to Topic 815, which already has multiple available methodologies (the shortcut method, the critical terms match approach, and several long haul methods, etc.).

In particular, we question the logic of adding the proposed **combined instruments approach**, which we view as being very similar to synthetic instrument accounting and which was disallowed (for a variety of legitimate reasons) when SFAS 133 was issued. We prefer the FASB's current framework for derivatives – that they must be transparently reported on balance sheet at fair value, regardless of the size or capital structure of the entity. The proposed combined instruments approach reverts back to synthetic instrument accounting, which obscures the use of derivatives, results in the combination of assets and liabilities that don't necessarily have any contractual relation to one another, and, under the proposed guidance, relegates potentially significant information to disclosures only. While the combined instruments approach would provide the benefit of simplified accounting, we believe reintroducing synthetic instrument accounting is too risky and is a change that is too fundamentally different from the current framework used by the FASB. Further, private companies would still be required to obtain the settlement value of the interest rate swap for disclosures under this approach. In our view, if an entity can obtain the settlement value of the derivative for disclosure purposes, it should be able to use that value to account for the derivative on the balance sheet at fair value (particularly under the simplified accounting approach, which is straightforward to apply).

On the other hand, we would support the use of the **simplified hedge accounting approach** because it removes some of the cumbersome features of hedge accounting (effectiveness testing, complex valuations) for private companies, but is more consistent with the current hedge accounting framework (given its similarities to the current shortcut method), including the core documentation and on balance sheet recognition requirements. Thus, perhaps a more holistic and internally consistent approach would be to simply add the criteria for this approach to the existing shortcut framework and specify that it applies only to private companies.

## **Answers to Specific Questions to Respondents**

**Question 1:** *Please describe the entity or individual responding to this proposed Update. For example:*

- a. Please indicate whether you primarily are a preparer, user, public accountant, or other (if other, please specify).*
- b. If you are a preparer of financial statements, please indicate whether your entity is privately held or publicly held and describe your primary business and its size (in terms of annual revenue, the number of employees, or other relevant metric).*
- c. If you are a public accountant, please describe the size of your firm (in terms of number of partners or other relevant metric) and indicate whether your practice focuses primarily on public entities, private entities, or both.*
- d. If you are a user of financial statements, please indicate in what capacity (for example, lender, investor, analyst, or rating agency) and whether you primarily use financial statements of private entities or those of both private entities and public entities.*

Chatham serves as a hedging advisor to over 1,000 companies globally in a wide variety of industries. Chatham assists both private and public companies with the implementation of Topic 815 on a daily basis for thousands of derivative transactions, including providing assistance with hedge designation memos, effectiveness testing, derivative valuations, journal entries, and footnote disclosures for many different types of hedging relationships.

**Question 2:** *Do you agree that the scopes of both the combined instruments approach and the simplified hedge accounting approach should exclude financial institutions described in paragraph 942-320-50-1, such as banks, savings and loan associations, savings banks, credit unions, finance companies, and insurance entities? If not, please explain why. Are there any other entities that should be excluded? (See also Question 3 below.)*

We agree that the scope of both the combined instruments approach and the simplified hedge accounting approach should exclude financial institutions.

Generally speaking, we believe financial institutions have distinct differences from other private companies, such that an exception to the normal accounting outlined in Topic 815 would not be warranted. Unlike other private companies that may have a limited number of funding sources, most financial institutions have a wide variety of funding sources accessible to them, so they generally can obtain fixed- or floating-rate debt more easily. As regulated entities, financial institutions are more accustomed to implementing complex accounting and regulatory requirements due to the nature of their businesses. Additionally, from a modeling perspective, many financial institutions are required to measure interest rate risk using an ALM or EVE model, and most trade bonds or otherwise manage investment portfolios, which enhances their expertise in fixed income valuation. Thus, in short, the business models, balance sheet make-

up, and level of sophistication of most financial institutions differentiate them from other private companies.

**Question 3:** *Should the Board consider expanding the scope of either the combined instruments approach or the simplified hedge accounting approach (or both) to other entities, such as publicly traded companies or not-for-profit entities? If the scope is expanded to other entities, what changes, if any, should the Board consider for these approaches? Please explain why.*

If the Board decides to expand the scope of this project to other types of entities, we believe the only appropriate way to do so would be as part of a comprehensive reconsideration of derivatives and hedging, which is currently on the Board's agenda. This will allow the Board to address operational concerns based on a principles-based framework rather than issuing what might become rule-riddled and patchwork guidance based on exclusions and exemptions.

As noted in our overall comments, we do have significant reservations about the combined instruments approach, which we would not recommend for any type of entity (public or private). **Finally, any change to the guidance should carefully consider and take into account convergence efforts with IFRS.**

**Question 4:** *Do you agree with the required criteria for applying the combined instruments approach and the simplified hedge accounting approach, respectively? If not, please explain why.*

In general, we agree with the requirements, but our preference is that the Board combine the criteria for the two approaches into one and allow only the simplified hedge accounting approach, which would still accomplish the Board's and PCC's objective of simplification.

That said, we believe that the criteria will create some audit risk because many of the terms meant to provide flexibility will be subject to interpretation. For example, the swap's inception fair value must be at or near zero, the term of the swap must approximate the term of the borrowing, and the swap must be effective at the same time or within a few days of the effective date of the borrowing, etc. In short, the language is quite vague (perhaps intentionally) and therefore will be subject to varying interpretations and subjectivity.

**Question 5:** *Do you agree with the differences in criteria for applying the combined instruments approach versus the simplified hedge accounting approach? If not, please explain why.*

Because we prefer the simplified hedge accounting approach and would disallow the combined instruments approach, we feel the differences between the two approaches are not necessary and would default to the criteria stipulated under the simplified hedge accounting approach.

**Question 6:** *For applying the combined instruments approach, should additional criteria about management's intent to hold the swap to maturity (unless the borrowing is prepaid) be included? Please explain why.*

While we strongly prefer that the Board only allow the simplified hedge accounting approach, we believe that if the combined instruments approach is allowed, there should be a requirement that the swap and the debt be terminated/prepaid concurrently to be consistent with the overarching objective of synthetically creating fixed-rate debt.

**Question 7:** *Under the combined instruments approach, should there be a requirement that there have been no adverse developments regarding the risk of counterparty default such that the swap is not expected to be effective in economically converting variable-rate borrowing to fixed-rate borrowing? Please explain why or why not.*

The issue framed in this question is one of the reasons we do not support the combined instruments approach. The private company is dependent on the performance of a third-party to actually achieve fixed-rate debt service. If the Board were to allow the combined instruments approach, we do believe that there should be a requirement that there have been no adverse developments regarding the risk of counterparty default such that the swap is not expected to be effective in achieving the economic objectives.

**Question 8:** *Do you agree that the primary difference between settlement value (that is, the amount to be paid to or received from the swap counterparty to terminate the swap) and fair value is that generally the nonperformance risk of the swap counterparties is not considered in the settlement value? If not, please explain why.*

Yes, we believe the primary difference between the fair value and the settlement value of the derivative relates to the nonperformance risk of the swap counterparties.

**Question 9:** *Would disclosure of the swap's settlement value (instead of its fair value) adequately provide users of financial statements with an indication of potential future cash flows if the swap were to be terminated at the reporting date? If not, please explain why.*

Yes, we believe that disclosure of the settlement value of the derivatives provides the best estimate of cash flows that would be paid or received if the derivative were terminated at the reporting date.

**Question 10:** *Are the costs of obtaining and auditing settlement value significantly less than fair value? Please explain why.*

Yes, we believe the costs of obtaining and auditing settlement value are significantly less than fair value.

**Question 11:** *Do you agree that the following should be disclosed if the combined instruments approach is applied and that no additional disclosures should be required? If not, please explain why.*

- a. The settlement value of the swap (along with the valuation method and assumptions)*
- b. The principal amount of the borrowing for which the forecasted interest payments have been swapped to a fixed rate and the remaining principal amount of the borrowing that has not been swapped to a fixed rate*
- c. The location and amount of the gains and losses reported in the statement of financial performance arising from early termination, if any, of the swap*
- d. The nature and existence of credit-risk-related contingent features and the circumstances in which the features could be triggered in a swap that is in a loss position at the end of the reporting period.*

We believe the disclosures noted in the question are all relevant disclosures if the combined instruments approach is permitted. However, as noted in our general comments, we believe that the combined instruments approach should be disallowed as it obscures the use of derivatives and relegates potentially significant economic information to footnote disclosure only.

**Question 12:** *Do you agree that the current U.S. GAAP disclosures, including those under Topics 815 and 820 should apply for a swap accounted for under the simplified hedge accounting approach and that the settlement value may be substituted for fair value, wherever applicable? If not, please explain why.*

Yes, we believe that the current disclosure requirements, including those under Topics 815 and 820, should be used for the simplified hedge accounting approach because the entity is applying the core provisions of those standards. For entities that qualify for the simplified hedge accounting approach, we further support the use of settlement value in place of fair value.

**Question 13:** *Do you agree with providing an entity-wide accounting policy election for applying the combined instruments approach? If that policy election is availed, should this approach be applicable for all qualifying swaps, whether entered into on or after the date of adoption or existing at that date? If not, please explain why.*

We believe that providing an entity-wide policy election would be appropriate if the combined instruments approach is permitted. We further believe that if that policy election is availed, that the approach should be applicable on a prospective basis only, that is, for all qualifying swaps entered into on or after the date of adoption, given the challenges and questions that will otherwise occur upon transition in moving from an “on-balance sheet” to “off-balance sheet” approach (reversal of asset/liability/AOCI balances, etc.).

**Question 14:** *Do you agree that the entity-wide accounting policy election to apply the combined instruments approach must be made upon adoption of the amendments in this proposed Update or, for entities that do not have existing eligible swaps, within a few weeks after the entity enters into its first transaction that is eligible for the accounting policy election? If not, please explain why.*

Should the combined instruments approach be permitted, we believe a private entity should have to establish its entity-wide accounting policy election within a few weeks of transacting eligible swaps after the proposed Update is effective. We prefer to make the timing of all hedge documentation (simplified hedge accounting approach) or policy elections consistent.

**Question 15:** *Do you agree that the simplified hedge accounting approach could be elected for any qualifying swaps, whether existing at the date of adoption or entered into on or after the adoption date? If not, please explain why.*

Although we don’t have a strong opinion on this issue, we believe the application of the provisions of the Exposure Draft should be prospective (that is, apply only to swaps entered into on or after the adoption date), which will simplify the challenges and questions that will otherwise occur upon transition.

**Question 16:** *Do you agree that the election to apply the simplified hedge accounting approach to an existing qualifying swap must be made upon adoption of the amendments in this proposed Update? If not, please explain why.*

See our response to Question 15 regarding prospective application. However, if the Board decides to permit the election for existing swaps, we believe that entities should be allowed to make the election to apply the simplified hedge accounting approach to an existing swap "within a few weeks" of the adoption of the proposed Update. Allowing for a few weeks would

be consistent with the time provided to complete the hedge documentation when an entity first enters into a transaction that is eligible for this approach.

**Question 17:** *Do you agree that the formal documentation required by paragraph 815-20-25-3 to qualify for hedge accounting must be completed within a few weeks of hedge designation under the simplified hedge accounting approach? If not, please explain why.*

We believe that hedge documentation under the simplified hedge accounting approach should be completed within a few weeks after hedge execution, but no later than the end of the reporting period. We also recommend that the Board consider some allowance for private entities that have their documentation in place on time, but may not have included every required component. For example, perhaps the Board would consider requiring private companies to create their internal hedge documentation within a few weeks of the trade, but allow through the end of one audit or review period to enhance that documentation with the auditor's input without consequence.

We believe that this approach will allow an entity to perform the necessary accounting research, contact auditors with questions, and put together complete hedge documentation within a reasonable time period after hedge execution and without imposing harsh penalties for minor documentation errors (as has sometimes occurred in practice).

**Question 18:** *Do you agree that entities within the scope of this proposed Update should be provided with an option to apply the amendments in this proposed Update using either (a) a modified retrospective approach in which the opening balances of the current period presented would be adjusted to reflect application of the proposed amendments or (b) a full retrospective approach in which financial statements for each individual prior period presented and the opening balances of the earliest period presented would be adjusted to reflect the period-specific effects of applying the proposed amendments? If not, please explain why.*

Although we would recommend prospective application only, if the Board decides to permit retrospective application, we would prefer a full retrospective approach.

**Question 19:** *Do you agree that an entity within the scope of this proposed Update should be permitted to early adopt the proposed amendments? If not, please explain why.*

We believe that entities should be able to early adopt the proposed Update.



**Question 20:** *How much time is needed to implement the proposed amendments? Please explain.*

We believe the amount of time needed to implement the proposed amendments should be relatively short, given the overall simplification of the hedge accounting requirements permitted by the standard.

**Question 21:** *The scope of this proposed Update uses the term publicly traded company from an existing definition in the Master Glossary. In a separate project about the definition of a nonpublic entity, the Board is deliberating which types of business entities would be considered public and would not be included within the scope of the Private Company Decision-Making Framework. The Board and PCC expect that the final definition of a public business entity resulting from that project would be added to the Master Glossary and would amend the scope of this proposed Update. The Board has tentatively decided that a public business entity would be defined as a business entity meeting any one of the following criteria:*

- a. It is required to file or furnish financial statements with the SEC.*
  - b. It is required to file or furnish financial statements with a regulatory agency in preparation for the sale of securities or for purposes of issuing securities.*
  - c. It has issued (or is a conduit bond obligor) for unrestricted securities that can be traded on an exchange or an over-the-counter market.*
  - d. Its securities are unrestricted, and it is required to provide U.S. GAAP financial statements to be made publicly available on a periodic basis pursuant to a legal or regulatory requirement.*
- Do you agree with the Board's tentative decisions reached about the definition of a public business entity? If not, please explain why.*

We agree with the Board's tentative decisions on this question.

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We thank the Board for its consideration of our comments and recommendations and would be pleased to discuss these issues in more detail with the PCC, Board, or staff at your convenience. Please do not hesitate to contact me at (484) 731-0233 or at scastleton@chathamfinancial.com should you have any questions or desire further clarification on the topics discussed in this letter.

Sincerely,

/s/ Steven P. Castleton

Steven P. Castleton  
Managing Director, Accounting Services  
Chatham Financial