



September 24, 2007

Mr. Russell G. Golden
Director of Technical Application and Implementation Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

### File Reference: Proposed Issue E23

Dear Mr. Golden:

The Financial Reporting Committee of the Institute of Management Accountants appreciates the opportunity to provide its views on proposed Statement 133 Implementation Issue E23, "Hedging – General: Issues Involving the Application of the Shortcut Method under Paragraph 68" ("DIG Issue E23"). The FRC believes the shortcut method should be preserved. Hedge accounting is complex when not using the shortcut method and requires a significant investment of time and money to get it right. Companies do not have unlimited resources and therefore struggle to comply with the requirements of the standard when applying the "long-haul" method. If companies are not able to apply the shortcut method for simple transactions involving an interest rate swap and an interest-bearing asset or liability, the financial statements will reflect volatility that does not economically exist. We do not believe that result would be meaningful to investors. The FRC views the proposed FSP as a step in the wrong direction as it even further restricts the ability of companies to apply the shortcut method to standard arrangements and will create even more demand for additional interpretations and clarifications, adding complexity to an already complex area. Accordingly, we do not support the issuance of a final FSP for the following reasons:

• The prohibition on "late hedges" qualifying for the shortcut method.





- Concerns that the proposed modifications to paragraph 68(e) are not operational and will create more confusion in practice.
- Questions over whether the guidance is internally consistent.

Our detailed comments on each of these matters are provided below.

# Prohibition on "Late Hedges"

We strongly object to the Board's decision to prohibit hedges entered into subsequent to the date that the hedged item was originated ("late hedges") from qualifying for the application of the shortcut method. To our knowledge, there has not been significant diversity in practice as to companies' application of the shortcut method in these circumstances. Accordingly, we do not understand why, almost seven years after the effective date of Statement 133, the Board has decided to prohibit the application of the shortcut method to those hedging relationships. Regardless of its reasons for addressing this issue now, we believe the Board has reached the wrong conclusion.

We understand the change in the fair value of an interest rate swap that has a zero fair value at inception will differ from the change in the fair value of an interest-bearing asset or liability that has a fair value on the date the hedging relationship is designated. However, we do not believe that ineffectiveness results from the terms of the interest rate swap or the interest-bearing asset or liability. Therefore, we do not agree that paragraph 68(e) provides a basis to preclude the use of the shortcut method for late hedges. The terms of both instruments could be "typical" and thus not invalidate the assumption of no ineffectiveness, but a company still would not be allowed to apply the shortcut method as a result of the Board's decision. Further, we believe the amount of ineffectiveness in that hedging relationship may well be less than the ineffectiveness the Board originally agreed to accept when it decided that credit spreads were not relevant in determining whether the shortcut method was appropriate.





As noted in the General Comments to Statement 133 Implementation Issue E4,

Statement 133 acknowledges in paragraph 70 that a hedging relationship that meets all of the applicable conditions in paragraph 68 may nevertheless involve some ineffectiveness .... Yet Statement 133 permits application of the shortcut method, which does not recognize such ineffectiveness currently in earnings. For example, the change in the fair value of an interest rate swap may not offset the change in the fair value of a fixed-rate receivable attributable to the hedged risk (resulting in hedge ineffectiveness) due to a change in the creditworthiness of the counterparty on the swap. Although an expectation of such ineffectiveness potentially could either (a) preclude fair value hedge accounting at inception or (b) trigger current recognition in earnings under regular fair value hedge accounting, the shortcut method masks that ineffectiveness and does not require its current recognition in earnings. In fact, the shortcut method does not even require that the change in the fair value of the hedged fixed-rate receivable attributable to the hedged risk be calculated.

We believe the commentary to Statement 133 Implementation Issue E4 supports our view that changes in the fair value of the hedged item that are not offset by changes in the fair value of the interest rate swap are not meaningful in determining whether the shortcut method applies, as long as all of the conditions in paragraph 68 are met. As noted in the preceding paragraph, we do not agree that paragraph 68(e), either as it currently exists or as the Board proposes to modify it, supports a conclusion that a late hedge does not qualify for the shortcut method as long as the terms of the interest rate swap and the hedged item are "typical."

Finally, we disagree with the Board's assertion that its decision to preclude the application of the shortcut method to late hedges is consistent with the guidance in Statement 133 Implementation Issue E15. Statement 133 Implementation Issue E15 concluded it was unlikely that the shortcut method could be applied in the fact pattern described because the swap's fair value would rarely be zero at the date of the business combination.





## Clarification of Paragraph 68(e)

We do not believe the guidance in paragraph 68(e) is operational. We are concerned that what is "typical" will depend on the perspective of a particular person, creating the potential for others to second-guess the conclusions reached by preparers. If the Board decides to proceed with the proposed amendments to paragraph 68(e), we believe it should clarify:

- How to determine whether the terms of an interest rate swap and an interest-bearing asset or liability are "typical."
- How changes in the terms demanded by participants in the debt or swap markets affects the determination of what terms are "typical."
- Whether changes in the terms demanded by market participants affects the accounting for existing hedging relationships.
- On what terms preparers and their auditors should focus.

Because transactions in the swap market are individually negotiated, it may be difficult for a company with limited hedging activities to determine whether the terms of the interest rate swap it entered into are "typical." Are assurances provided by the counterparty sufficient for a company to conclude that the terms are typical?

We assume that changes in the terms demanded by market participants would not affect the accounting for existing hedging relationships, but it is not clear whether the conditions in paragraph 68(e) are only required to be applied at inception.

Finally, we believe the Board should provide guidance about which terms preparers and auditors should consider. We presume the focus should be on the significant terms that could give rise to ineffectiveness, but we are not sure based on two recent restatements that were triggered because the notification period in the interest rate swap and the hedged item did not match exactly. Given the perception that the application of the shortcut method carries with it an increased risk of restatement, we believe explicit





guidance on what terms are important is necessary to align the regulator's view of what terms should be considered with a registrant's view.

## Interaction Between Paragraph 68(b) and Paragraph 68(e)

In its proposed amendment to paragraph 68(a), the Board notes that an interest rate swap that is designed to match the estimated rate of unscheduled prepayments, but does not exactly match the outstanding principal balance, on a debt security would not qualify for application of the shortcut method. The Board then notes, in the Basis for Conclusions, that

... a swap with a notional amount that changes at each settlement to match the principal of the interest-bearing asset or liability on which the calculation of interest is based complies with paragraph 68(a).

In order to meet the criterion of paragraph 68(a) when the hedged item is subject to unscheduled principal reductions, the interest rate swap would need to include call and put options so that the notional amount could be adjusted to match the outstanding balance (either because prepayments were slower or faster than expected). Because the counterparty would charge an option premium for such a structured swap, in order to meet the criterion in paragraph 68(b), the pay-leg of the swap would need to be adjusted to pay the premium over the life of the interest rate swap. Would financing the option premium through the adjustment of the pay-leg of the interest rate swap lead to a conclusion under paragraph 68(e)(2) that the terms of the interest rate swap would invalidate the assumption of no ineffectiveness? We believe the guidance in proposed DIG Issue E23 should be clarified to address that question.

### **Concluding Comments**

For the reasons specified above, we would recommend to the Board that the proposed guidance in DIG Issue E23 be modified to make clear that the use of the shortcut method would be permitted for late hedges. In addition, we believe the Board should include a statement in the final guidance that differences in terms not explicitly described in paragraph 68 would only preclude the use of the shortcut method if they do not meet the criteria in paragraph 68(e), and should also clarify how it intends the phrase "do not





invalidate the expectation of no ineffectiveness" to be applied. As noted earlier, the Board acknowledged in Statement 133 that a hedging relationship that meets all of the conditions to apply the shortcut method may involve some ineffectiveness, particularly relating to credit spreads. However, we believe the manner in which regulators are interpreting the guidance ignores the fact that a shortcut relationship is not perfectly effective. Accordingly, we would ask that the Board clarify that an "expectation of no ineffectiveness" would not be met if the differences in terms would be expected to result in ineffectiveness that is more than de minimis. Hopefully by clarifying the intended application of the guidance we can avoid any more restatements for differences in terms that would not be expected to result in more than de minimis ineffectiveness.

Whether or not the Board issues proposed DIG Issue E23, the FRC encourages you to accelerate your efforts on the project added to your agenda in May 2007 as the problems with accounting for hedging activities go well beyond the application of the shortcut method. We note that one of the objectives of that project is to simplify the accounting for hedging activities. We hope that means something other than eliminating all hedge accounting, which would be simple but would introduce volatility into the income statement that does not exist.

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We would be pleased to discuss our comments further with the Board or the FASB staff. You may contact me at (212) 484-6680.

Sincerely.

Pascal Desroches

Chair, Financial Reporting Committee

