April 21, 2011

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

Re: File Reference Number 2011-175, Invitation to Comment, *Selected Issues about Hedge Accounting*

Dear Ms. Cosper:

Chatham Financial ("Chatham") is pleased to respond to the Financial Accounting Standards Board's (the "FASB") Invitation to Comment on *Selected Issues about Hedge Accounting* (the "ITC"), which is intended to solicit feedback on the International Accounting Standards Board's ("IASB") proposed changes to International Financial Reporting Standards No. 39, *Financial Instruments: Recognition and Measurement* ("IAS 39") included in its recent Exposure Draft on hedge accounting (the "Exposure Draft").

Chatham serves as a hedging advisor to over 1,000 companies globally in many different industries. More than 400 of our clients apply the hedge accounting provisions of either ASC 815 or IAS 39 and will be impacted by the new hedge accounting provisions. Chatham assists companies with the implementation of ASC 815 and IAS 39 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.

We have carefully considered both the FASB's and the IASB's proposed hedge accounting models. In general, although there are several positive aspects of the IASB's proposed model that we believe would significantly simplify and improve hedge accounting under U.S. GAAP, as discussed below, <u>we believe that the FASB's proposal represents a superior overall starting point</u>. In short, we believe the existing hedge accounting model is fundamentally sound and requires only modest revisions to improve and simplify it. The core principles are well understood by both users and preparers of financial statements, and we are concerned that the IASB's Exposure Draft will introduce unnecessary ambiguity, complexity, and re-interpretation risk (after finally having reached what seems to be a "steady state" and general consensus with respect to the basic understanding and interpretation of the existing model).

However, there are several aspects of the IASB's Exposure Draft that represent significant improvements to the FASB's current and proposed model, which we urge the FASB to strongly consider as it continues its deliberations to improve and simplify the accounting for derivatives and hedging activities. Our principal comments are summarized below. In addition, our responses to the specific questions posed by the FASB in the ITC are included in the Appendix that follows.

Overall Comments

Positive Aspects of IASB's Proposed Hedge Accounting Model

Key aspects of the IASB's proposed hedge accounting model that we believe would significantly simplify and improve U.S. GAAP include:

- Enabling risk components of both financial and nonfinancial items to be designated as hedged items, provided that the risk component is "separately identifiable and reliably measurable"
- Permitting designations of a layer component of the nominal amount of a hedged item (within constraints, as discussed in more detail below)
- Determining the amount of ineffectiveness on cash flow hedges
- Relaxing the homogeneity criterion for closed groups of financial instrument hedged items

Enabling risk components of both financial and nonfinancial items to be hedged

In our view, the single most important and impactful revision that the FASB could make to its guidance would be to adopt the approach proposed by the IASB related to hedging specific risk components of both financial and nonfinancial items.

We strongly agree with the IASB's proposed guidance that would permit an entity to hedge a specific risk component of either a financial or nonfinancial item, provided that the specified risk component is "separately identifiable and reliably measurable." We agree that financial and nonfinancial items should be treated similarly and believe this proposed change will align the accounting treatment for entities hedging components of nonfinancial items with their associated risk management practices. In our view, the existing model that creates distinctions between financial and nonfinancial items is arbitrary, confusing, and unnecessary. Indeed, many companies have exposure to changes in the price of commodities and prudently mitigate these exposures through the use of derivative instruments, similar to the mitigation of interest rate or foreign currency risk in financial items. We further believe that the threshold of requiring that the specified risk component be "separately identifiable and reliably measurable" is appropriate to provide for a robust application of hedge accounting in practice.

In addition, with respect to financial items under current and proposed U.S. GAAP, the ability to hedge specific risk components is too narrowly defined, which has significantly and unnecessarily increased the complexity of applying hedge accounting for many common hedging strategies. Adopting the IASB's approach in this area will (1) result in greater convergence between IFRS and U.S. GAAP, (2) resolve significant practice issues and inconsistencies in the guidance, and (3) significantly simplify the accounting for derivatives and hedging activities.

<u>Specifically, within the cash flow model, we strongly recommend that the FASB expand the definition of interest rate risk to include "separately identifiable and reliably measurable" indices like prime, Fed Funds, and SIFMA</u>. Currently, the cash flow hedge accounting model under U.S. GAAP for hedges of non-benchmark-rate-based assets and liabilities, like prime and Fed Funds, is awkward and unduly complicated. We believe it can be significantly improved in a way that reflects the risk management practices of companies, remains true to the underlying economics, and converges with IFRS. Currently under U.S. GAAP, unnecessary hedge failures occur and hedge ineffectiveness that is *unrelated* to the risk management objectives and underlying economics too frequently results. For example, the accounting for a prime-based swap hedging a pool of prime-based loans should be as straight-forward and intuitive as the accounting for a LIBOR-based swap hedging a pool of LIBOR-based loans. Both strategies are designed only to hedge the risk of variability in an underlying interest rate index, yet one (LIBOR) is allowed to ignore the credit spread on the loans while the other (prime) is forced to consider the credit spread, creating disparate and illogical results in many instances. Similar situations arise with other common indices like Fed Funds and SIFMA. The hedge accounting results and administrative burden for these very similar types of hedging relationships can be vastly different, which is confusing to preparers and users alike. From our perspective, expanding the definition of interest rate risk to include any separately identifiable and reliably measurable interest rate exposure is a simple fix that would be a vast improvement and relieve the frustration of the existing hedging model being so disconnected from the economics.

<u>Similarly, the fair value hedge accounting model could be significantly improved by permitting entities to hedge any separately identifiable and reliably measurable component or portion of a fixed-rate asset or liability, such as the LIBOR component of a fixed-rate debt instrument</u>. With the proposed elimination of the shortcut and "critical terms match" methods under U.S. GAAP, this issue becomes particularly important. Thus, we urge the FASB to adopt the IASB's approach in this area, as it is likely that many more companies will be forced to apply very complex and nuanced ineffectiveness measurements (and potentially effectiveness assessments) under a fair value "long-haul" method, which will significantly increase the cost and complexity of applying hedge accounting for those entities. We believe the IASB's approach represents a reasonable accommodation in this area and will provide much-needed relief. In addition, we believe it would better to align the risk intended to be hedged with the derivatives available for hedging. Very importantly, it will also enable companies to hedge certain common assets or liabilities for which hedge accounting has, in some cases, been nearly impossible to achieve, as discussed further in our response to Question 8 below.

Finally, based on our experience applying IAS 39 with numerous companies, we would note that the IFRS model in this area (that is, the ability to hedge a separately identifiable and reliably measurable portion of a financial instrument's cash flow or fair value) has been robust and non-controversial in practice, still requires hedge ineffectiveness to be measured, and substantially relieves the frustrations caused by the disconnect between the accounting and the economics under the U.S. GAAP model. Accordingly, this would be our single most important recommendation for improving and simplifying the current hedge accounting model under ASC 815.

Permitting designations of a layer component of the nominal amount of a hedged item

Chatham also agrees with the IASB proposal to allow entities to designate a layer component of the nominal amount of an item as the hedged item. We believe this will simplify the hedge accounting model for various risk management strategies and appropriately recognizes the level of uncertainty that may surround the hedged item, for example, due to minor debt extinguishments. However, we do not believe that a blanket prohibition against designating a layer component of a contract that contains a prepayment option if the option's fair value is affected by changes in the hedged risk is the right approach, and we question the theoretical basis for that type of prohibition. Instead, we believe it would be much more consistent and appropriate to require that for such hedging relationships, the hedging instrument and hedged item contain offsetting (mirror-image) prepayment options, such that the prepayment option that is impacted by the hedged risk is included in the hedge effectiveness assessments and measurements.

- As an example, assume that a bank desires to designate a fair value hedge of the LIBOR benchmark interest rate risk of $20 million of a $25 million fixed-rate issuance of brokered CDs. The brokered CD issuance is callable by the bank and generally hedged by a callable/cancelable swap. The values of those prepayment options are directly affected by changes in the designated LIBOR benchmark interest rate. However, due to prepayments related to the death or adjudication of incompetence of the CD holder, often referred to as "death puts" (which are unrelated to changes in the benchmark interest rate), the nominal/principal amount of the hedged item generally changes over its life. It seems reasonable to permit the entity to designate the "bottom" $20 million layer of the $25 million nominal amount of the brokered CD issuance, even though the contract includes a prepayment option (that is, the CDs are callable by the bank as specified in the contract).

From our perspective, as long as (1) the hedging instrument (a cancelable swap in this example) contains a mirror-image prepayment option to the prepayment option included in the hedged item and (2) those fair value changes are included in the assessments and measurements of hedge effectiveness, that type of designation and strategy should be permitted. In those types of hedging strategies, we believe the risk component is separately identifiable and reliably measurable. We strongly encourage the FASB to consider this issue in its ongoing deliberations, as we believe that permitting such strategies *within the proposed guardrails specified above* would not lessen the robustness of the hedge accounting model.

Determining the amount of ineffectiveness on cash flow hedges

With respect to determining the amount of ineffectiveness that must be recognized in profit or loss on cash flow hedges, we believe the IASB's current and proposed model (and the FASB's existing model) has a stronger theoretical foundation than the FASB's proposed model. From a conceptual standpoint, we are concerned that in a cash flow hedge, ***nonexistent*** gains and losses (based on a hypothetical derivative that was never executed) that arise solely based on management's expectations of forecasted transactions would be recognized in earnings. Essentially, we share the concern expressed by the Board in Statement 133's Basis for Conclusions relative to recognizing ineffectiveness for "underhedging" in cash flow hedging relationships, that is, that doing so would be inappropriate because "the result would be to defer in OCI a nonexistent gain or loss on the derivative and to recognize in earnings an offsetting nonexistent loss or gain."

We urge the FASB not to create such a fundamental inconsistency in the recognition of hedge ineffectiveness for cash flow hedges between U.S. GAAP and IFRS, which we believe would be unfortunate and a disservice to both users of the financial statements and preparers, especially multi-national companies with reporting requirements under both standards.

Relaxing the homogeneity criterion for closed groups of financial instrument hedged items

Under the existing hedge accounting model under both U.S. GAAP and IFRS, hedging groups of items is particularly challenging, especially for fair value hedging relationships. In fact, we believe that many prudent risk management strategies are precluded because the guidance is overly restrictive. Accordingly, we concur with the IASB's proposed approach in this area to relax the homogeneity criterion, which we believe would reasonably accommodate a greater number of appropriate hedging strategies.

Areas of Concern with the IASB's Proposed Hedge Accounting Model

Our principal areas of concern with the IASB's proposed hedge accounting model that we believe represent substantial shortcomings include:

- Ambiguity/lack of clarity with several of the proposed changes
- Prohibitions against voluntarily discontinuing a hedging relationship
- Changes to the mechanics of fair value hedge accounting
- Prohibitions against written options from qualifying for hedge accounting
- Further divergence from U.S. GAAP

Ambiguity/lack of clarity with several of the proposed changes

One of our principal concerns with the IASB's Exposure Draft relates to the lack of clarity with several of the proposed changes, particularly with respect to the qualifying criteria for hedge accounting, required rebalancing, and accounting for the time value of options.

Specifically, phrases like "other-than-accidental offset" are unclear and confusing, as are the requirements that the hedging relationship "produce an unbiased result and minimize expected hedge ineffectiveness." Without further clarification, we are very concerned that such language could be misinterpreted and taken to extremes in practice by auditors and regulators, which may (1) actually raise the threshold to qualify for hedge accounting beyond what is currently required and (2) significantly increase the cost of hedging. For example, we worry that an auditor or regulator could require an entity to go to great lengths to "minimize" ineffectiveness—to the point that the marginal cost of creating a slightly more effective hedge far exceeds the marginal benefit of further mitigating a particular risk. Unfortunately, the IASB's proposal provides very little clarity or context for phrases such as "other-than-accidental offset" and "unbiased result" and "minimize ineffectiveness," and the resulting ambiguity could create widespread confusion and inconsistent application in practice.

Additional clarity is also needed for entities to effectively apply the IASB's proposed guidance with respect to (1) how risk management and hedge accounting must be linked (risk management is very "macro" or high-level oriented, whereas hedge accounting is very "micro" or transaction-level oriented—and we are very concerned that this will create significant problems in practice, (2) when mandatory rebalancing is required, and (3) how the accounting for the time value of options will be applied in practice (which we believe is much more intuitive under the FASB's model).

Prohibitions against voluntarily discontinuing a hedging relationship

We believe that the proposal to restrict an entity's ability to voluntarily discontinue a hedging relationship is a major step in the wrong direction and will create a host of practice issues and problems. We believe this area is working very well in practice and that a "fix" is completely unnecessary. Accordingly, we are deeply concerned that the proposed guidance in this area will (1) add significant complexity to the hedge accounting model, rather than simplifying it, and (2) restrict a number of appropriate risk management activities.

Changes to the mechanics of fair value hedge accounting

The change proposed by the IASB in the mechanics of how fair value hedging relationships will be accounted for and presented in the financial statements represents a substantial increase in complexity, in our view, with little or no apparent benefit over the existing approach. The existing approach in this area is simple to understand and apply and is well understood by both users and preparers of the financial statements. We strongly question the need for fair value hedging relationships to create *separate* line items in the statement of financial position (further cluttering the primary financial statements) or to "gross up" other comprehensive income. We believe this is tantamount to creating meaningless extra steps (e.g., tracking and accounting for gains and losses first through OCI) with the same ultimate impact on profit or loss. We further believe that the transparency of the financial statements will be reduced as OCI becomes increasingly confusing to understand.

Prohibitions against written options from qualifying for hedge accounting

The Exposure Draft prohibits a written option, even if combined with a purchased option at inception, from qualifying for hedge accounting. In our view, such a prohibition is unnecessary and precludes a number of appropriate risk management strategies.

Further divergence from U.S. GAAP

The hedge accounting model being proposed by the IASB creates additional differences with U.S. GAAP in a critically important and complicated area of accounting. We urge both Boards to consider opportunities to significantly (and hopefully completely) converge their hedge accounting models before final guidance is issued.

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Our responses to the specific questions posed by the FASB in the ITC are included in the Appendix below, including several suggested clarifications and recommendations for the FASB to consider for inclusion in the final standard.

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 Board or staff at your convenience. Please do not hesitate to contact me at 484.731.0235 or at cmaxwell@chathamfinancial.com should you have any questions or desire further clarification on any of the topics discussed in this letter.

Sincerely,

/s/ Clark B. Maxwell

Director of Global Accounting Services
Chatham Financial

APPENDIX

Risk Management

Question 1: When an entity uses financial instruments to manage risk exposures in economic hedges but those instruments are not designated in hedging relationships for accounting purposes, do you believe that the proposed guidance would provide useful information about all of the effects of an entity's risk management objectives?

The proposed disclosures within the Exposure Draft may provide some useful information about how companies manage risks, but the disclosure requirements appear to be applicable only to hedging instruments that are designated in qualifying hedging relationships. Given that many entities use hedging instruments as part of economic hedging relationships where hedge accounting is not applied, it would be more beneficial to users of financial statements to provide information about the risk management objectives of such strategies (including the economic impact), the impact of those strategies on the financial statements, and the rationale behind electing to not apply hedge accounting to those relationships.

Question 2: Do you believe that the proposed guidance and illustrative examples included in the IASB's Exposure Draft are sufficient to understand what is meant by risk management, how to apply that notion to determine accounting at a transaction level, and how to determine the appropriate level of documentation required? Why or why not?

No. The IASB's proposed guidance provides little, if any, information as to what is meant by the term "risk management," how to apply that notion in determining the accounting at a transaction level, or how to determine the appropriate level of documentation. Additional clarity, including examples, is needed for entities to apply the proposed guidance. Without further clarity we believe there will be substantial confusion in practice and a lack of consistency in application in this area.

Question 3: Do you foresee an entity changing how it determines, documents, and oversees its risk management objectives as a result of this proposed guidance? If yes, what changes do you foresee? Do you foresee any significant difficulties that an entity would likely encounter in establishing the controls related to complying with the proposed guidance?

Yes. There is a greater emphasis in the IASB's proposed guidance on ensuring that an entity's risk management objectives have been satisfied. This emphasis will likely require active monitoring of whether changes in risk management have occurred and whether those changes either require rebalancing or permit proactive rebalancing. Also, an entity will be required to carefully analyze the sources of ineffectiveness of a hedging relationship at inception, which in some cases may require a more rigorous inception analysis than is currently performed. In addition, the "separately identifiable and reliably measureable" criteria will result in new types of hedging relationships that previously would not have qualified for hedge accounting and will require new analysis, controls, and considerations.

Question 4: Do you foresee any significant auditing issues arising from the proposed articulation of risk management and its link to hedge accounting? For example, is the information required to be disclosed regarding an entity's risk management strategies measurable and objective? Could the inclusion of an entity's risk management objectives create an expectation gap that the auditor is implicitly opining on the adequacy of an entity's risk management objectives?

We believe this will be a difficult and challenging issue for auditors. The required disclosures in the proposed guidance relate only to risk management strategies where hedge accounting is applied. Given that this likely represents only a subset of the risk management strategies of an entity, it seems unreasonable and inappropriate to expect an auditor to render an opinion on the adequacy of an entity's risk management objectives. Furthermore, given that there are no standards for establishing what constitutes an appropriate risk management strategy, it only enhances the difficulties that will be faced by auditors.

Hedging Instruments

Question 5: Should cash instruments be eligible to be designated as hedging instruments? Why or why not? If yes, is there sufficient rigor to prevent an entity from circumventing the classification and measurement guidance in other relevant accounting guidance (for example, IFRS 9, *Financial Instruments,* and IAS 21, *The Effects of Changes in Foreign Exchange Rates*)? Are there any operational concerns about designating cash instruments (such as items within a portfolio of receivables) as hedging instruments?

In general, we are supportive of permitting cash instruments that are measured at fair value through profit or loss to be considered eligible hedging instruments, as we believe the operational challenges will be manageable. For entities that use these instruments in practice as part of their risk management activities, we believe it makes sense to permit them to apply hedge accounting when such instruments are being used for risk management purposes. However, we do not believe the practice of designating cash instruments will be widespread, as the full fair value of the cash instrument must be designated as the hedging instrument, and many entities hedge specific risks, which are generally hedged more efficiently with derivatives.

Hedged Items—Overall

Question 6: Do you believe that the proposed guidance is sufficient to understand what constraints apply when determining whether an item in its entirety or a component thereof is eligible to be designated as a hedged item (for example, equity instruments measured at fair value through profit or loss, standalone derivatives, hybrid instruments, and components of instruments measured at fair value through profit or loss that are not permitted to be bifurcated)? If not, what additional guidance should be provided?

Although additional clarity and guidance would be welcome in this area, we believe the proposed guidance is largely sufficient to understand what constraints apply when determining whether an item in its entirety or a component thereof is eligible to be designated as a hedged item. However, we do believe it would be helpful to clarify that homogeneity testing is not needed in order to designate a group of transactions together as a single hedged item.

Hedged Items—Risk Components

Question 7: Do you believe that the proposed criteria are appropriate when designating a component of an item as a hedged item? If not, what criteria do you suggest? Do you believe that the proposed guidance and illustrative examples are sufficient to understand how to determine when the criteria of separately identifiable and reliably measurable have been met? If not, please describe what additional guidance should be provided.

Yes. We believe the proposed criteria are appropriate when designating a component of an item as a hedged item. The guidance provided is also helpful in assisting users to determine when the criteria of separately identifiable and reliably measureable have been met. The examples provided in paragraph B15 are helpful, but additional examples discussing situations related to financial items would be very useful as well.

However, we disagree with the specific preclusion from hedging interest rate risk when the contractual rate of the interest bearing financial asset or liability is below the designated interest rate (e.g. LIBOR). This specific rule contradicts the core principles of the IASB's proposed guidance. We also do not agree with the preclusion from hedging credit risk and would prefer to see a workable solution developed in this area by both the IASB and the FASB.

Question 8: Do you believe that "separately identifiable" should be limited to risk components that are contractually specified? Why or why not?

No. We do not believe that "separately identifiable" should be limited to risk components that are contractually specified. We believe it is reasonable and appropriate to place the burden on companies to successfully demonstrate that a risk component is "separately identifiable and reliably measurable." In our view, this represents a core principle that is simple to understand, and we believe it will be operational in practice.

However, even if the FASB limited the hedging of risk components to those that are contractually specified (but otherwise aligned its guidance to be consistent with the IASB's proposed guidance in this area), we believe such a revision nevertheless would represent a significant step forward and an improvement over existing U.S. GAAP. <u>If the Board were to require that the risk component be contractually specified, however, an explicit exception should be made for identifying the LIBOR component of fixed-rate debt</u>. Swapping fixed-rate debt to floating ("swapping the coupon") is extremely common in practice and, given the proposed elimination of the shortcut method, the hedge accounting model needs to be fair and reasonable in this critical area. In addition, allowing for the identification of the LIBOR component of a fixed-rate debt issuance is consistent with the existing hedge accounting model under IAS 39, which has worked very well for these types of hedging relationships. We note that concept already exists within the cash flow hedging model under ASC 815-20-25-18 (DIG Issue G19) – that is, an entity may hedge "the risk of changes in either…the <u>interest element of the final cash flow</u> if interest is paid only at maturity (emphasis added)…or…the total proceeds attributable to changes in the benchmark interest rate related to the forecasted issuance of fixed rate debt."

We have worked extensively with a wide variety of companies applying "long-haul" fair value hedge accounting to hedges of fixed-rate debt, and the ineffectiveness or "noise" derived from the credit component of the hedged item when interest rate risk is being hedged (since the changes in fair value of the hedged item must be based on the contractual cash flows of the entire hedged item) is confusing to preparers and users alike, feels artificial and contrived in its application, and produces misleading results in the financial statements.

Not to belabor the point, but the situation is even worse and more pronounced for hedges of callable debt, further underscoring the importance of permitting the LIBOR component of fixed-rate debt to be identified as the risk component being hedged. As noted in our comment letter to the FASB dated September 30, 2010:

> The concern is perhaps best illustrated by considering a plain-vanilla hedge of fixed-rate callable debt. The basis for conclusions in Statement 133 mentions that the Board agreed during its deliberations that hedge accounting should be available for hedges of callable debt, even though the hedging derivative includes an embedded written option (paragraph 397). <u>Even though the Board clearly intended to permit hedges of callable debt, in practice, it is nearly impossible to qualify, since very few hedging relationships pass the strict "written option" test</u>. This is due to the fact that changes in the value of the call option in the debt are impacted not only by changes in interest rates (and associated volatility), but also <u>credit</u> (even holding the inception credit spread

constant), whereas changes in the value of the written option in the swap are based solely on changes in interest rates (and associated volatility) – so the call options are almost never perfectly aligned and the written option test, strictly applied, almost always results in failure. Today, in practice, to pass the written option test, the option in the swap must be significantly devalued, distorting the economics of the hedge and creating additional ineffectiveness—assuming the test can be passed without simultaneously causing the overall hedging relationship to fail the "highly effective" criterion. In fact, some companies have been compelled to use a non-callable swap to hedge callable debt and simply hope that the call option will remain largely out-of-the-money based on the absolute level of interest rates. Hedging callable debt is a very common hedging strategy and companies will be extremely limited in their ability to hedge such a basic instrument, particularly once shortcut is eliminated.

In contrast, allowing entities to hedge identifiable and measurable portions of the fair value of an instrument (for example, the LIBOR component of a fixed-rate debt instrument) "aligns" the economics of the swap and debt, since changes in the option values of both instruments then could be based on the identifiable hedged risk (generally changes in LIBOR) and offsetting changes could be demonstrated for all possible changes in the underlying. We believe this is an incredibly important issue—and perhaps one not well understood by many companies at this point. Along those lines, we would welcome the opportunity to discuss these issues in more detail with the Board and staff and would be happy to illustrate the issues highlighted above.

Hedged Items—Layer Component

Question 10: Do you believe that the proposed guidance is sufficient to understand what constraints apply to determining a layer component from a defined, but open, population? (For example, do you believe that the sale of the last 10,000 widgets sold during a specified period could be designated a layer component in a cash flow hedge?) If not, what additional guidance should be provided?

Although additional clarification may be helpful in this area, in general, we believe that the proposed guidance is sufficient to understand what constraints apply to determining a layer component from a defined, but open, population. We believe that under the proposed guidance, similar to the guidance in IAS 39, it is not possible to designate a layer consisting of the sale of the last 10,000 widgets sold during a specified period, as such a designation does not provide sufficient specificity to identify a transaction as the hedged transaction when it occurs—it is only possible to identify such a transaction after all transactions for a period have occurred.

Hedged Items—Aggregated Exposures and Groups of Items

Question 11: Do you foresee any operational concerns applying other guidance in IFRS (for example, guidance on impairment, income recognition, or derecognition) to those aggregated positions being hedged? For example, do you foresee any operational concerns arising when an impairment of individual items within a group being hedged occurs? If yes, what concerns do you foresee and how would you alleviate them?

We have no comments on this question.

Question 12: Do you believe that the proposed guidance on aggregated exposures will provide more transparent and consistent information about an entity's use of derivatives? Why or why not?

Although we do not believe it will be widespread in practice, we are supportive of permitting an aggregated exposure that is a combination of another exposure and a derivative to be designated as a hedged item. We believe it would be useful in certain situations, such as those described in paragraphs B9(a) and (b) of the IASB's proposed guidance, as it provides entities with more flexibility in applying hedge accounting to actual risks that are reflected in their financial statements. Coupled with sufficient disclosure about how an entity hedges such an exposure, we believe that the proposed guidance will provide more transparent and consistent information.

Question 13: Do you believe that an entity should be permitted to apply hedge accounting to a group of cash instruments or portions thereof that offset and qualify as a group under the proposed guidance and satisfy the proposed hedge effectiveness criteria? Why or why not?

We support the proposed criteria for the eligibility of groups of items as hedged items presented in paragraphs 34(a) and (b), but envision issues in practice with the requirements imposed by paragraph 34(c) that any offsetting cash flows in a cash flow hedging relationship must affect profit or loss in the same reporting period.

We do not agree with the prohibition against hedging a layer component of an eligible group of items that contain prepayment options. As noted in our introductory comments above, we do not understand the rationale for the IASB's decision on this matter and recommend that it be removed from the final standard.

Hedge Effectiveness

Question 14: Do you foresee any significant operational concerns, including auditing issues, in determining how to assess whether a hedge achieves other-than-accidental offset? If yes, what concerns do you foresee and how would you alleviate them?

Yes. We foresee situations in which there may be operational concerns and/or auditing issues associated with evaluating whether a hedge has achieved other-than-accidental offset. The IASB's proposed guidance on what constitutes other-than-accidental offset is much too vague and ambiguous. In addition, evaluating whether other-than-accidental offset has been achieved will be a matter of professional judgment, which likely will differ across entities and audit firms. As a result, it is likely that similar situations will be evaluated differently, resulting in a lack of comparability in practice.

Question 15: Do you believe that the proposed guidance and illustrative examples are sufficient to understand how to analyze hedge effectiveness (for example, how to measure the change in the value of the hedged item attributable to the related hedged risk for nonfinancial items)? If not, what additional guidance is needed?

Certain aspects of how to analyze hedge effectiveness are relatively clear in the proposed guidance. For example, we believe the proposed guidance is clear that:

- Sources of ineffectiveness must be analyzed;
- A hedging relationship does not have to be perfectly effective to qualify for hedge accounting;
- The economic relationship between the hedged item and the hedging instrument should be evaluated to determine if other-than-accidental offset has occurred;
- Effectiveness testing must be performed prospectively only and should be performed at a minimum on each reporting date;
- A single method of assessing effectiveness is not required; and
- If the critical terms of the hedging relationship match or are closely aligned, a qualitative approach could be utilized (paragraph B34).

However, other aspects of analyzing hedge effectiveness are less clear and will likely result in confusion and inconsistency in practice. Examples include:

- The proposed guidance does not provide adequate information on what constitutes an "unbiased result" or what is intended by "minimize ineffectiveness" or what "other-than-accidental offset" means; and

- Paragraph B38 indicates that an entity's risk management is the main source of information to perform the assessment and that management information used for decision-making purposes can be used as a basis to assess whether a hedging relationship meets the hedge effectiveness requirements; however, the proposed guidance is unclear as to what type of information is permissible in making the assessment.

We believe that providing additional guidance in the following areas would be beneficial:

- Guidelines and examples of the sources of ineffectiveness that should be analyzed as part of designating a hedging relationship (paragraph B28);
- Further clarity on what constitutes other-than-accidental offset, unbiased result, and minimizing ineffectiveness (these terms, as presented, are ambiguous and will likely result in substantial confusion and inconsistency in application);
- Clarification or examples illustrating the point at which a qualitative approach is no longer acceptable in determining whether a hedging instrument has satisfied the objective of the hedge effectiveness assessment;
- Guidelines, examples, and further clarity on what types of management analysis can be utilized for assessing effectiveness; and
- Whether discounted or undiscounted cash flow information is required or permitted to be used in performing the assessment of hedge effectiveness.

Changes to a Hedging Relationship

Question 16: Do you foresee any significant operational concerns or constraints in determining whether (a) a change to a hedging relationship represents a rebalancing versus a discontinuation of the hedging relationship or (b) an entity's risk management objective has changed? If yes, what concerns or constraints do you foresee and how would you alleviate them?

Yes. We believe there will be significant operational difficulties in this area for many companies due to the lack of clarity provided by the IASB around key concepts, including the qualifying criteria for hedge accounting (particularly with respect to the ambiguous terms described in Question 15 above) and assessing whether the risk management objective has changed.

Although paragraph B46 provides a flowchart that illustrates how to evaluate when a hedging relationship is rebalanced, the key decision points in the flowchart include the concepts listed above, which are not clearly articulated in the IASB's proposed guidance. As a result, we believe that determining whether a change to a hedging relationship represents a rebalancing versus a discontinuation of the hedging relationship, or whether an entity's risk management objective has changed, will be very challenging in practice.

Question 17: Do you foresee any significant operational concerns or constraints relating to the potential need to rebalance the hedging relationship to continue to qualify for hedge accounting? If yes, what concerns or constraints do you foresee and how would you alleviate them?

Yes. For companies with a significant number of hedges, monitoring the individual hedging relationships to ensure they each continue to satisfy objectives of the hedge effectiveness test as well as the risk management objective may pose operational challenges.

An additional area of operational complexity will arise from splitting the original hedging relationship into a rebalanced hedging relationship that represents less than the entire originally designated amount and a residual amount that is not designated and for which mark to market accounting is applied. For larger portfolios, this could significantly increase effort required to apply hedge accounting.

Accounting for the Time Value of Options

Question 18: Do you believe that capitalizing the time value of an option as a basis adjustment of nonfinancial items (in other words, marking the asset or liability away from market) will improve the information that is provided in an entity's statement of financial position? Why or why not?

In general, we prefer the approach under existing U.S. GAAP with respect to the accounting for the time value of options. However, the IASB's proposed guidance in this area represents a substantial improvement over IAS 39, for which changes in time value must be recognized immediately in profit or loss.

With respect to the question of capitalization versus deferral in OCI of the time value component of an option, we have a slight preference for deferral in OCI (rather than adjusting the basis of nonfinancial items), but believe either approach is reasonable, operational, and will provide adequate information to users of financial statements.

Anecdotally, based on our experience with hundreds of companies applying U.S. GAAP for these types of hedging relationships, we believe that following the guidance in ASC 815-30-35-36 (DIG Issue G20), in which allocated fair value amounts are reclassified from other comprehensive income to earnings when the associated hedged forecasted transactions affect earnings, has worked very well in practice.

Hedge Accounting and Presentation

Question 19: Do you believe that the proposed presentation of the gains and losses in other comprehensive income will provide users of financial statements with more useful information? Why or why not?

No. We strongly disagree with the IASB's proposal to record in other comprehensive income the gains and losses from the hedging instrument and hedged item in fair value hedging relationships. As noted in our introductory comments above, we believe the current presentation approach for fair value hedging relationships is well understood, and we are concerned that the IASB's proposed approach simply adds unnecessary clutter and complexity and does not provide more useful information to users of financial statements.

Question 20: Do you believe that the proposed presentation of a separate line item in the statement of financial position would increase the transparency and the usefulness of the information about an entity's hedging activities? Why or why not?

No. We believe the IASB's proposed presentation of separate line items will make the statement of financial position more cluttered, less transparent, and more challenging for users to understand.

Question 21: Do you believe that there is sufficient guidance to specifically link the hedging adjustments to the hedged assets and liabilities that compose a hedged net position with respect to presenting a separate line item in the statement of financial position?

No. In our view, the IASB's proposed guidance is overly ambiguous in this area, and we believe additional clarifying guidance is needed to specifically link the hedging adjustments to the hedged assets and liabilities that compose a hedged net position.

Disclosures

Question 22: Do you foresee any significant auditing issues arising from the inclusion of risk management disclosures in the notes to the financial statements? If yes, what issues do you foresee and how would you alleviate them? Do you believe that it is appropriate to include risk management disclosures in the notes to the financial statements rather than in other information in documents containing financial statements? Why or why not?

Since there is little, if any, guidance on what constitutes acceptable disclosure around risk management, we anticipate that this will create challenges for auditors that are attempting to opine on the appropriateness of an entity's risk management activities. We would therefore recommend that the FASB and IASB *encourage* rather than *require* such disclosures in the notes to the financial statements.

Other

Question 23: Do you believe that the changes proposed by the IASB provide a superior starting point for any changes to U.S. GAAP as it relates to derivatives and hedging activities? Why or why not? Should the FASB be making targeted changes to U.S. GAAP or moving toward converging its overall standards on derivatives and hedging activities with the IASB's standards?

As noted in our introductory comments, <u>we believe that the FASB's proposed model (rather than the IASB's proposed model) represents a superior starting point for changes as it relates to derivatives and hedging activities</u>. Based on our experience, we believe that targeted changes to the core hedge accounting model are sufficient to simplify and improve it, and we are very concerned that the extent of changes being proposed by the IASB will lead to unnecessary ambiguity and undue complexity in practice.

However, we are strong proponents of convergence and hope the Boards will work closely together to produce a high quality hedge accounting standard that is fundamentally consistent in the U.S. and internationally. Creating further divergence on a topic as critical as hedge accounting would be very unfortunate for both users and preparers of financial statements. Accordingly, our strong recommendation would be to begin with the FASB's proposed model as the starting point and then incorporate positive aspects of the IASB's proposal, most significantly those provisions relating to the hedging of risk components in both financial and nonfinancial items, provided that the risk components are "separately identifiable and reliably measurable." In our view, this would (1) represent a significant improvement over current practice, (2) simplify and converge the hedge accounting models, and (3) appropriately align the hedge accounting guidance with the risk management practices for the widest array of companies.

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