



April 25, 2011

Ms. Susan M. Cospers
Technical Director
FASB
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: File Reference Number 2011-175,

Dear Ms. Cospers:

Thank you for the invitation to comment on the IASB's proposed changes to derivative accounting. Hedge Trackers, LLC is a derivative accounting advisory practice and provider of derivative accounting outsourcing service. Since 2000 we have served clients who generally execute plain-vanilla option or forward type contracts to protect their margins from currency, interest rate or commodity price fluctuations. The majority of our clients do not consider currency, interest rate or commodity risk core to their operations, but rather an input whose volatility requires management. Our reactions and responses to the proposed update reflect both our experience as a service provider and our understanding of our clients and their hedging requirements.

We support the objective of the IASB to "represent in the financial statements the effect of an entity's risk management activities that use financial instruments to manage exposures". We feel the proposed standard is re-connecting the economics of hedging with the accounting for hedges. Rather than requiring companies to look at their hedged exposures and the program's effectiveness in a new light to achieve hedge accounting, the IASB is proposing that companies measure and report on the success of their hedge program based on the economic expectations set for those hedges at execution. This re-unites the economics with both the accounting and the disclosures. Current US GAAP has created an accounting hedge relationship that sits apart and outside of the economic relationship that the trades represent. As a result the reporting on hedge ineffectiveness is frequently less valuable than it could be. We work with many companies where hedging is not a core competency and the current accounting framework distances management from an understanding of the accounting for derivatives reported in their financials. When the accounting is operating in a separate control structure than the economic hedge activity there is greater risk that hedge program performance is not understood or appropriately disclosed.

We have responded to selected questions posed by the FASB to highlight our support for guidelines that reconnect the user of the financial statements with the hedge activities of the constituents' traders as follows:

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?*

Under existing ASC815 guidance companies frequently decouple their economic risk management objective from their accounting risk management objective. For example, entities that economically choose to hedge net currency inflows/outflows designate the risk associated with only a portion of inflows (or outflows), entities that wish to hedge fixed rate income designate variable rate expense to facilitate accounting. We believe it would greatly improve hedge programs, as well as the understanding of senior management and users of financial statements, if the accounting guidance and related disclosures reflected the hedge performance against economic objectives rather than against artificial constructs. We foresee little change in the net notional amounts hedged under the proposal and substantial changes in how an entity defines exposures and measures its performance or “hedge effectiveness”. These changes would result in enhanced communication to readers of financial statements. Management that is hedging *net* EUR inflows would not need to pretend they were hedging a small portion of gross revenue, those hedging fixed rate assets would not track and report on the derivative’s performance against variable rate liabilities. The greatest value to financial statement readers is the proposal that hedge performance be measured against economic intent:

Under current USGAAP a company hedging *net EUR inflows* will designate EUR20 of an anticipated EUR100 revenue transaction(s). In the assessment of effectiveness the company always be “perfectly effective” at reporting for accounting purposes, even when the economically actual results were *EURO inflows*--or if they were net outflows. Most interesting is the current common practice of disclosing to shareholders the purpose of hedging as the “accounting purpose” (e.g. hedging a portion of revenue) rather than the “economic purpose” (e.g. hedging anticipated net cash flows). Please see the appendix (Practical Aspects of Measuring Ineffectiveness with a Hypothetical Derivative That Resets) for further information.

We believe that requiring the alignment of a company’s economic strategy with its hedge designation is a positive and necessary transition. Auditors along with management should find application of the proposed standard much more intuitive and transparent. We believe that the notional amounts companies choose to hedge will not change dramatically, but the disclosures and controls surrounding those disclosures will change substantively: both will focus on the effectiveness of the hedge program, rather than success at the hedge accounting game. Our expectation is that internal control standards across the corporations and in their trading organizations have strengthened considerably since the issuance of derivative accounting guidance in 2000 and that SOX controls together with a continued requirement for inception documentation detailing measurement approaches and expected results will continue to be required to establish a hedge relationship thereby providing the necessary controls in hedging environments. You may be interested to learn that current GAAP driven hedge accounting controls are frequently outside of the entities’ trading related control structures due to the divergence between the economic purpose and the accounting purpose.

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?*

Companies currently are required to detail their risk management policy and objective. Current articulation is generally inadequate as noted by the FASB and now IASB continuing quests to require more information through additional disclosures. Constituents fail to adequately communicate what is happening in their hedge programs. Current guidance requires detailing an accounting objective formulated by accountants to meet accounting objectives. It is not designed to educate users of the financial statements about the success of the hedge efforts. The IASB proposal requires detailing of the economic objective. Auditor responsibility would not fall to opining on the adequacy of the risk management objective, but opining on the alignment between the actions of the traders, the measurement of the program's success against stated objectives and the quality of the disclosure in summarizing the facts. Clarity of purpose is what we believe is proposed and what we would support.

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?*

We agree that non-derivative financial assets and a non-derivative financial liabilities measured at fair value through profit or loss should be eligible hedge instruments. Special hedge accounting is the conduit for aligning the timing in the financial statements of exposures with hedges. When a company has "natural hedges" as a result of offsetting exposures, the ability to designate an exposure currently recognized on the balance sheet, as a hedge of a second that may still be anticipated reduces the need to execute derivatives. Companies that expect cash inflows in a foreign currency would be able to align the borrowing costs with the anticipated revenues expected to repay those borrowings. Current accounting would require the entity to buy forward (using a financial contract) an amount equal to the foreign borrowing (if held in a parent or other functional currency entity) to protect earnings from volatility associated with monthly remeasurement. The entity would then sell forward (a second financial contract) an amount equal to the anticipated revenue related cash flows that will be used to repay the borrowings. The current rules require two derivatives where economically none is needed. Under proposed guidance there would not be a requirement in the above example to enlist a third party (with attendant counterparty or liquidity risks) to receive hedge accounting treatment to align in cash and in the financial statements the rate of the borrowings with those of the cash inflows used for repayment.

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.

We strongly support the ability to designate “a component of an item” as a hedged item, and believe that the proposed guidance and illustrative examples are sufficient to understand how to determine when the criteria of separately identifiable and reliably measurable may be applied.

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

We do not believe that “separately identifiable” should be limited to risk components that are contractually specified. This would unnecessarily restrict hedged items. A purchaser of coffee may choose to hedge grade X coffee prices from changes in Arabica coffee (futures standard) in six months. Grade X is quoted in the market as a spread over Arabica. Under the proposal the company would not be required to execute a long term contract to protect themselves against Arabica changes, and would therefore only remain exposed to changes in the *spread over Arabica*: a risk that is not hedge-able in the market and a risk they are comfortable not hedging. Limiting hedge accounting to “contractually specified” risk components would be interpreted to disallow hedge accounting treatment unless the company had already contractually committed to volumes from a specified vendor. Cash flow hedging would then need to meet firm commitment hedging criteria.

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?*

We welcome the ability to define layers in fair value hedges as the hedged item. Under current guidance fair value hedges lose hedge accounting when a portion of the hedged item (contract) is cancelled or settled, even when that cancellation is a percent that was anticipated at inception and the hedge notional was executed at the lower notional in anticipation of notional reduction exposure. We recommend current USGAAP layering instructions for cash flow hedges to the IASB to address layering concerns.

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?*

We believe the ability to hedge offsetting net positions would provide more transparent and consistent information about an entities use of derivatives as the hedge effectiveness would be measured in terms of the company’s economic objective. Hedge accounting for cash or non-cash instruments should track the individual elements that make up the exposure: When hedging a net of revenues and expenses, the exposure would be the grossed up revenues **and** expenses. If the expenses occurred but revenue fell short of covering expenses, ineffectiveness in the revenue leg of the transaction would be recognized in earnings and detailed in tabular disclosures. Under current US GAAP the hedged item would have been defined as a small revenue amount and zero ineffectiveness would likely be reported to shareholders as long as that small amount of revenue

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was recognized, even though there was zero net income (recall the economic objective of the hedge was to protect *net* income).

We strongly support the replacing current “like item testing” with a requirement that individual elements within a pool would need to qualify for hedge accounting. At present company’s are precluded by national audit firm interpretation from hedging unleaded gasoline purchases around the country because they find it cost prohibitive to prove that across the nation each individual gas stations’ unleaded gasoline price changes in a highly correlated way to the average of all gas stations providing fuel to the company. Under the new guidelines ineffectiveness associated with any individual gas station’s failure to follow the pricing movement of another by would be captured and disclosed as ineffectiveness but would not preclude hedge accounting.

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?*

Companies using derivatives to hedge expect other-than-accidental offset, else they would not be considered hedges. That said, companies are not universally prudent in their selections of hedge instruments and strategies. Guidance might specify that when the underlyings are clearly related (a perfect match not necessary) **and** when simple instruments/strategies are employed other than accidental offset may be assumed. Ongoing lack of offset would require analysis to support future or continued use of similar hedge relationships.

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?*

We support both the FASB and the IASB’s changing their emphasis **from assessing** hedge effectiveness **to measuring** changes in value of the derivative and hedged item and reporting ineffectiveness in income. We concur with the IASB focus on determining “the value of the hedged item on a present value basis” and offering the hypothetical as a method for measuring effectiveness. Their discussion recognizes the need to measure changes in underlyings other than interest rates hedged with swaps. We think the method to capture the change in measurement of the underlying should be clearly defined at hedge inception and that neither the FASB nor IASB have sufficiently understood the ramifications in terms of cost/benefit of **re-**setting the inception derivative to zero at each measurement point. We recommend an option to establish the hypothetical derivative value at inception/designation of the hedge relationship. At each measurement date the hypothetical future cash flows would be restructured to follow then current expectations, but the fixed rate would not be re-determined. For example, at designation a company expects to sell a widget in foreign currency in 6 months and executes a six month sale of FC and simultaneously designates a 6 month forward hypothetical derivative. At the time of the trade the company does not have access to a download of the complete forward point curve. At the end of month two the company determines that the sale is now anticipated in 5 months (rather than the 4 originally expected). Where does the company find the 7 month forward points for the hypothetical derivative that must be structured back at hedge execution? Using end of day rates? End of day rates do not represent the market rates associated with the point in

time the 6 month rate was determined. Should we interpolate the 7 month rate from the 6 month rate? That defies the purpose of adjusting the hypothetical inception value. We recommend that the hypothetical's 6 month forward rate would be the point from which changes in the hypothetical were determined. This would result in comparing the derivative's 6M forward contractual rate to the month end 4M forward rate to capture the change in the derivative; and comparing the hypothetical's 6M forward contractual rate to the month end 5M forward rate to capture the change in the hypothetical. This contrasts with the current reading of the hypothetical method where we are comparing the derivative's 6M forward contractual rate to the month end 4M forward rate to capture the change in the derivative; and comparing the hypothetical's *newly minted 7M* forward contractual rate to the month end 5M forward rate to capture the change in the hypothetical.

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?*

The restriction on creating a biased result is an elegant solution to the risk of companies designating large underlyings to ensure that the change in the derivative would always be smaller than the change in hedged item, thereby eliminating reported ineffectiveness. This approach allows the IFRS to continue to follow the existing rule set limiting P&L impacts in cash flow hedges to overperformance of the derivative. This is a much more palatable solution than the FASB's proposal to record overperformance of anticipated transactions in earnings. Underhedging (the result of the underlying outperforming the hedge) does not create risk for a company; rather it does not mitigate all of a business risk. Overhedging on the other hand creates a new risk for the company that is not related to its core business and thus should be recognized in the P&L and disclosed. We believe that accumulating changes in hedged future transactions in OCI further degrades the meaning and value of OCI.

We have had experiences when hedging "overall changes" where a hedged commodity was one component of the cost and that costs increased substantially becoming a larger proportion of the total cost. In cases where a commodity input may not qualify for "component hedging" this rebalancing concept would be a welcome replacement of the current result: loss of hedge accounting. We did not find specific guidance but expect the starting point for collecting cumulative changes in the hedged item would necessarily change at each rebalancing date. This additional detail would be useful.

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?*

We find capitalizing of option premiums is generally consistent with 815-30-35-33 as currently applied, the difference being whether amounts accumulated in OCI may adjust non-financial items or be held to be reclassified to income. Practically speaking it is much easier to reclassify values to income at the appropriate time by adjusting the basis than by making schedules that are expected to reflect the reclassification to income.

We welcome either the FASB's or the IASB's proposals on amortization of premium. There is some question as to reasonable methods of amortizing premiums, especially for *multiple period* instruments such as caps and floors. Examples would be useful.

We are increasingly concerned about derivative structures presented to companies that provide more downside than upside when consolidated with the hedged item. The appropriateness of instruments or constructs as "hedges" should be more directly addressed by the FASB and IASB. A clearer discussion of when a written option test is or is not required would be useful.

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?*

We believe it is imperative that the FASB and IASB converge on hedge accounting. We support the concept of economic risk management driving hedge accounting as opposed to the current environment where companies first determine their economic exposure and then search for a "qualifying" accounting exposure.

Conclusion:

We appreciate the opportunity to share our thoughts on the IASB's proposed update. We would welcome the opportunity to provide practical examples and case studies from corporate portfolios to improve the quality of examples in the guidance, specifically around capturing and measuring ineffectiveness. We have attached an appendix to further address the practical issues associated with hypothetical derivatives. We look forward to additional clarity and remain optimistic that the final standard will indeed simplify hedge accounting and provide additional clarity to users of financial statements.

Sincerely,



Helen M. Kane
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Appendix:**Practical Aspects of Measuring Ineffectiveness with a Hypothetical Derivative That Resets**

Hedge Trackers, LLC would like to take this opportunity while the FASB and IASB are considering convergence to raise questions on the hypothetical derivative construct. Under current guidance ineffectiveness is calculated based on a comparison of the change in the tested component of a derivative and the change in the perfectly effective hypothetical derivative (hypo). The hypo is defined by FASB as a modeled swap (derivative) having terms that identically match the critical terms of the floating-rate asset or liability and a zero fair value at the inception of the hedging relationship. The change in the fair value of the hypo can thus “be regarded as a proxy for the present value of the cumulative change in expected future cash flows on the hedged transaction”. The IASB recognizes that a hypo is “a derivative that would have terms that match the critical terms of the hedged item and would be at the money at the time of designation of the hedging relationship... is one possible way of calculating the change in the value of the hedged item.”

The difficulty with the hypo as currently understood is that the inception rate (forward currency rate, fixed rate on an interest rate swap, commodity swap rate), the rate that returns a “zero fair value at the inception of the hedging relationship” or is “at the money at the time of designation of the hedging relationship” would change over time as the hedged item changes. For example, consider an entity that hedged revolver debt with the ability to elect LIBOR rates and executed a receive-1M LIBOR pay-fixed for 2 years and had effectiveness tested appropriate LIBOR elections. Nine months into the hedge relationship the client decides to elect 3M LIBOR on their revolver and their documentation indicates that future expected resets will be based on current period elections. The hypo’s fixed rate must be re-determined at month nine to reflect the fixed rate at inception (9 months ago) that determines the zero fair value of a swap that has 1M resets for 9 months and 3 month resets for the subsequent 15 months. Most swap modeling software does not contemplate differing tenors in an underlying as most swaps do not have varying tenors. Underlyings are generally much more flexible, especially variable rate underlyings common in corporate revolvers and term borrowings. So the swap must be modeled as a 9 month swap with 1M resets and a forward starting swap with 3M resets that begin in 9 months and continue for 15 months. The combination of two swaps with the same fixed rate must equal zero at inception (9 months ago), a fixed rate slightly but clearly different from the fixed rate used for capturing ineffectiveness for the first 9 months of the relationship. A fixed rate distinct from the rate at which realized effective gains and losses were reported in income over the first 9 months, possibly spanning 4 reporting quarters. Now consider a more sophisticated example where the hedged underlying is made up of more than one tranche of variable rate debt. Some of the layers reprice monthly, some reprice every 3 months and there are reset dates on different layers covered by the hedge relationship. Every period the hypothetical derivative is re-cast by modeling dozens of swaps reflecting the layers to measure the amount of ineffectiveness. Although time consuming, the swap models can be managed to capture the values necessary for accounting. However it is difficult to historically model the layers as they have moved from 1M to 3M to 1M to 3M over the life of the swap. As mentioned earlier, standard swap models do not contemplate changing tenors. Finding the zero fair value for the hypothetical derivative in this

case would require tens or potentially hundreds of hypothetical swaps that would need to be set to zero as a group at the inception date.

The unfortunate reality is that very large institutions are not required to manage their hypothetical derivatives to this extent because of “materiality”. The unfortunate smaller, less sophisticated companies that are required by loan covenants to execute one or more swaps, are required to prove that the impact of the shift is immaterial through actual measurement. This task is manageable when attributed to future cash flows, but untenable when applied to historical cash flows. So those entities with the sophistication to develop appropriate modeling software to historically recalibrate their hedge relationships are rarely required to do so, while less sophisticated users end up modeling and remodeling inception fixed rates that immaterially impact their financial statements.

The FASB’s discussion of hypothetical derivatives is limited to swaps, but the concept is broadly applied and in the proposed guidance is expected to be applied to all other risk classes. The difficulty of resetting the hypothetical at inception to zero for other risk categories at each measurement date is equally problematic. Although not familiar with financial institution practices we are unaware of any corporate derivative programs that capture the forward curve at the moment of hedge execution. Without the forward curve the recreation of the hypo is imprecise. Assume anticipated foreign currency revenue 9-12 months in the future (September – December). The company executes a 12 month forward contract to the expected cash flow date in December. The defined hypothetical derivative (including time value) however reflects the expected transaction (revenue) date in 9 months. Two months into the designation the company receives a notice indicating the underlying revenue will record in November. To recreate the hypo at the end of month two the company must determine where the forward points were at hedge inception for an 11 month forward contract. At the time of execution the company made note of the 9 month forward points for measuring ineffectiveness, however they did not capture the entire currency curve at the point of trading. There are very few (and those are very expensive) providers of historical forward point curves. The more unusual the currency pair (and therefore the most likely to have bumpy curves) the more difficult the data is to secure. Even when historical daily information is available, the end of day rates may have little to do with where rates were when the company traded. Additionally it is rare for companies to know the spread (for credit and profit) that was used at the time of the transaction. The company could interpolate using the 9 and 11 month data points, but interpolating defeats the purpose of the hypo to identify nuances in the curve associated with the time period.

We find the concept of this perfectly effective hypothetical derivative intellectually compelling, but practically untenable. We are concerned about the audit implications of ASC guidance indicating that the term match is used “to mean be exactly the same or correspond exactly” and a hypothetical derivative definition specified as “having terms that identically match the critical terms of the floating-rate asset or liability”. The hypothetical derivative concept is not new, however, it is only the FASB’s recent signals to the audit world through proposed changes in hedge accounting that the focus has started to shift away from effectiveness testing and rigorous reviews of regression statistics of historical relationships towards effectiveness measures and the nuances of a changing inception value in the hypothetical derivative.

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All of our experience to date has indicated that the shifting of the inception value of the hypo has had an immaterial impact on the financial results and a serious impact on the costs of maintaining a hedge accounting program. Freezing the inception value of the hypothetical derivative actually drives an increase in ineffectiveness as the ineffectiveness then includes the forecast timing error. There is less ineffectiveness in comparing a derivative's forward point change from 12 months at inception to 10 months at measurement and the hypo's changing from 11 months to 9 months than there would be if the hypo's inception value with 9 month forward points were compared with the current expectation of 9 months forward points. Although the spot portion of the relationship would offset the forward point values would create ineffectiveness, and more ineffectiveness when the inception hypothetical rate is frozen. Although generally not a fan of introducing more ineffectiveness into a relationship, the cost of constantly modifying the hypo substantially outweighs the benefits of marginally improved effectiveness. You will probably note that if the impact is immaterial, it should not raise a concern. However, our experience is that smaller companies with fewer resources are subject to intensive rigor with respect to the practical aspects of derivative accounting. The current reality is that very large corporations continue to assert critical terms match, while smaller companies spend precious time and resources convincing auditors that 6-month present valued spot to spot changes in a currency are highly correlated to 3-month spot to spot changes in the same currency with R-squares, beta slopes, t-tests, p-values and most recently y-intercept analysis.

We would welcome the opportunity to provide detail examples of the efforts required to support the hypothetical derivative as currently contemplated. We also challenge any assumption that the change in the hypothetical derivative is commonly measured this way in practice because of the modeling difficulties. Measurement has taken a back seat to statistical analysis. Now that measurement will move to the fore, a practical measurement approach is imperative.