April 20, 2011

director@fash.org

Financial Accounting Standards Board

File Reference No. 2011-175

Re: Selected Issues about Hedge Accounting

To The Technical Director:

The Accounting Principles and Auditing Standards Committee (the AP&AS “Committee”) of the California Society of Certified Public Accountants (CalCPA) is pleased to provide our comments to the Financial Accounting Standards Board (“FASB”) on the proposed accounting standard update.

The AP&AS Committee is the senior technical committee of the CalCPA. CalCPA has approximately 35,000 members. The Committee is comprised of 50 members, of whom 67 percent are from local or regional firms, 23 percent are sole practitioners in public practice, 5 percent are in industry and 5 percent are in academia.

Below are our comments.

Risk Management

The IASB’s proposed guidance would rely substantially on an entity’s risk management objectives as a basis for hedge accounting. Paragraph 1 of the IASB’s Exposure Draft states that “The objective of hedge accounting is to represent in the financial statements the effect of an entity’s risk management activities that use financial instruments to manage exposures arising from particular risks that could affect profit or loss.”

**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?

*Yes. The IASB ED requires disclosure of an entity’s risk management strategy and how it is applied to manage risk.*

**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?

*Yes, they are sufficient. They do not answer all the questions, but provide a conceptual base for resolving issues.*
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?

We do not see much change in how an entity determines, documents, and oversees its risk management objectives as a result of this proposed guidance. However, since the accounting is more closely aligned with the entity’s risk management objectives, it is likely that compliance with the ED will be easier than complying with the current IASB and FASB standards. More entities may adopt hedging strategies once the accounting is simplified, and they may encounter initial difficulties in defining objectives and establishing the controls related to complying with the proposed guidance, but no more so than would occur with any new and potentially complex transaction.

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?

The AP&AS Committee believes the principal challenge for auditors will be to achieve a sufficient understanding of financial markets and financial instruments to understand an entity’s risk management objectives and strategies. The risk management objective is inherently subjective, and is a management decision. The strategies are also subjective and based on a management decision, but the auditor should be able to determine that the strategies chosen are consistent with the objectives, and the required (para. 44) explanation of the strategy is based on reasonably objective information that can be verified through management’s documentation and actual behavior.

As to whether inclusion of an entity’s risk management objectives can create an expectation gap that the auditor is implicitly opining on the adequacy of the objectives, we do not see this as an issue since this is only one of many business objectives already reported on in financial statements. Of more concern is whether the auditor might be implicitly opining on the adequacy of management’s risk management strategies, particularly if hindsight shows the strategies failed. Since the proposed disclosures are not very different than those already required under U.S. GAAP, this concern may not be that important.

Hedging Instruments

The IASB’s proposed guidance would permit an entity to designate as hedging instruments nonderivative financial assets (for example, cash instruments such as debt securities) and nonderivative financial liabilities measured in their entirety at fair value through profit or loss.

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?

Yes, cash instruments should be eligible to be designated as hedging instruments. They can be used to hedge risks, and therefore should be eligible. The disclosure of management's objectives and strategies should overcome any concern about circumventing other classification and measurement guidance. The fact of the matter is that hedging gives a different accounting result than not hedging because it is a business strategy that needs to be evaluated as to its effectiveness in the financial statements. There may be some cash instruments that will be difficult to designate as hedging instruments for operational reasons, but handling that should be left to each entity; some may be able to do it and others unable.

Hedged Items—Overall

Under the IASB’s proposed guidance, a hedged item can be a recognized asset or liability, an unrecognized firm commitment, a highly probable forecast transaction, or a net investment in a foreign operation.

**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?

*We believe the constraints on what can be hedged is a major failing of current U.S. GAAP. The constraints in the proposed guidance are relatively limited, but seem very clear. The AP&AS Committee does not see a need for additional guidance.*

Hedged Items—Risk Components

The IASB’s proposed guidance would specify that a portion (referred to as a “component”) of an item can be designated as a hedged risk if it is separately identifiable and reliably measurable. Examples in the IASB’s Exposure Draft illustrate that a hedged item could be a component that is not contractually specified or a component that is inferred.

**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, the proposed criteria are appropriate when designating a component of an item as a hedged item.*

**Question 8:** Do you believe that “separately identifiable” should be limited to risk components that are contractually specified? Why or why not?
No. If it can be objectively identified, that is sufficient.

[Question 9: Missing?]

Hedged Items—Layer Component

The Exposure Draft would permit a layer component of the nominal amount of an item to be eligible for designation as a hedged item. A layer component may be specified from a defined, but open, population or from a defined nominal amount. However, a layer component of a contract that includes a prepayment option would not be eligible as a hedged item in a fair value hedge if the option’s fair value is affected by changes in the hedged risk.

**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?

Yes, the proposed guidance is sufficient to understand what constraints apply to determining a layer component from a defined, but open, population.

Please note that the AP&AS Committee does not agree that a layer component of a contract that includes a prepayment option should not be eligible as a hedged item in a fair value hedge if the option’s fair value is affected by changes in the hedged risk. The AP&AS Committee believes that circumstances may exist where the layer component of the nominal amount that includes a prepayment option may be subject to a hedging strategy for which effectiveness could be measured.

Hedged Items—Aggregated Exposures and Groups of Items

The IASB’s proposed guidance would permit an entity to apply hedge accounting to aggregated exposures and groups of items, including net positions.

**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?

The operational concerns in applying other guidance in IFRS should be no different for aggregated positions being hedged than they are for individual items being hedged. For example, if an item being hedged suffers impairment, whether it is an individual item or part of an aggregation, the amount of the hedge may change in both instances.

The proposed guidance would define an aggregated exposure as a combination of another exposure and a derivative. The proposed guidance would permit an entity to recognize changes in the fair values of derivatives that are part of the aggregated exposure to be reflected in other comprehensive income rather than through profit or loss.
**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?

The AP&AS Committee believes transparent and consistent information about an entity’s use of derivatives can be provided regardless of whether changes in the fair values of derivatives that are part of the aggregated exposure are reflected in other comprehensive income or through profit or loss.

The proposed guidance would permit net offsetting positions involving only cash instruments to be accounted for as a hedge if certain requirements are met.

**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?

Yes. If management’s strategy is to hedge a group defined in this manner and they can satisfy the proposed hedge effectiveness criteria, then hedge accounting should be permitted. This is consistent with the overall objective of the IASB’s proposal on hedge accounting.

**Hedge Effectiveness**

To qualify for hedge accounting, the IASB’s proposed guidance would require that the hedging relationship (a) meets the objective of the hedge effectiveness assessment (that is, to ensure that the hedging relationship will produce an unbiased result and minimize expected hedge ineffectiveness) and (b) is expected to achieve other-than-accidental offset.

**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?

Choice of a hedge instrument is often complex and can be difficult, regardless of the accounting rules. The guidance in the proposed IFRS is sufficiently robust to screen out accidental offsets.

The IASB’s proposed guidance would require an entity to assess hedge effectiveness on a prospective basis in an ongoing manner.

**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?

Yes, the AP&AS Committee believes the proposed guidance and illustrative examples are sufficient to understand how to analyze hedge effectiveness.
Changes to a Hedging Relationship

The IASB’s Exposure Draft would permit and sometimes require an entity to “rebalance” an existing hedging relationship and continue to account for the revised hedging relationship as an accounting hedge. However, when there is a change in the entity’s risk management objective for a hedging relationship or a hedge ceases to meet the qualifying criteria, the IASB’s Exposure Draft would require the entity to discontinue hedge accounting.

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?

The AP&AS Committee believes that management has discretion, under the IASB proposal, to change its objectives and strategies as it deems appropriate, and the accounting should follow management’s decision.

The IASB’s proposed guidance would require an entity to assess hedge effectiveness at every reporting date (at a minimum). Depending on that assessment, an entity may be required to rebalance its hedging relationship to continue to qualify for hedge accounting.

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?

No. The AP&AS Committee agrees with the approach the IASB proposes, and the AP&AS Committee does not foresee any unusual operational concerns.

Accounting for the Time Value of Options

For transaction-related hedged items, the IASB’s Exposure Draft would require an entity to capitalize the time value of an option as a basis adjustment of the hedged item if the hedged item subsequently results in the recognition of a nonfinancial asset or liability.

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?

The AP&AS Committee agrees with capitalizing the time value of an option as a basis adjustment of nonfinancial items. It sees little point in accounting for the time value separately since it is part of the total cost of the asset or liability.

Hedge Accounting and Presentation

For fair value hedges, the IASB’s Exposure Draft would change the recognition of gain or loss on the hedging instrument and hedged item (for changes in the hedged risk). Those gains or losses would be recognized in other comprehensive income rather than through profit or loss. An
entity would be required to measure ineffectiveness and transfer any ineffective portion of the gain or loss from other comprehensive income to profit or loss.

**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?

*The AP&AS Committee agrees with the proposed presentation of the gains and losses in other comprehensive income. The usefulness of the information is more likely a function of the clarity of other disclosures, rather than where the gains and losses are recorded.*

The IASB’s Exposure Draft would change the presentation of fair value hedges in the statement of financial position. The hedged items would no longer be adjusted for changes in fair value attributable to the hedged risk. Rather, those changes would be reflected as a separate line item in the statement of financial position, presented next to the line item that includes the hedged asset or liability.

**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?

*The AP&AS Committee does not agree that changes in the value of hedged items must be reflected as a separate line item in the statement of financial position. We believe that the presentation can be made in the notes to the financial statements and still adequately communicate the impact of hedging activities.*

**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?

*Yes. The AP&AS Committee 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.*

Disclosures

The Exposure Draft would require disclosures about the risks that an entity decides to hedge and for which hedge accounting is applied.

**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?

*See response to Question No. 4. The AP&AS Committee does not oppose inclusion of risk management disclosures in the notes to the financial statements, but if significant substantive concerns are raised by others over auditing issues arising from the inclusion of risk management*
disclosures in the notes to the financial statements, we would not oppose including them in other information in documents containing financial statements.

Other

The Exposure Draft proposes changes to certain aspects of accounting for derivatives and hedging activities beyond just those linked to financial instruments. There are many other aspects that differ between U.S. GAAP and IFRS relating to the accounting for derivatives and hedging activities.

**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?

*The current standards of both the IASB and the FASB for derivatives and hedging activities have significant shortcomings. The IASB has taken the initiative in proposing changes to improve accounting for derivatives and hedging activities, and the AP&AS Committee believes that it provides the best starting point for changes to U.S. GAAP. The AP&AS Committee opposes the FASB be making targeted changes to U.S. GAAP, as that will not serve the ultimate objective of convergence. Therefore, the FASB should move toward converging its overall standards on derivatives and hedging activities with the IASB’s standards, while at the same time seeking to have the IASB amend its proposals to facilitate convergence.*

We thank you for the opportunity to comment on this matter. We would be glad to discuss our opinions with you further should you have any questions or require additional information.

Sincerely,

\[
\text{JoAnn Guattery, Chair} \\
\text{Accounting Principles and Auditing Standards Committee} \\
\text{California Society of Public Accountants}
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