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August 14, 2008

1590-100

LETTER OF COMMENT NO. 29

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

File Reference No. 1590-100

Dear Mr. Golden:

The Financial Reporting Committee ("FRC") of the Institute of Management Accountants (IMA) appreciates the opportunity to provide its views on the Exposure Draft of Proposed Statement of Financial Accounting Standards, *Accounting for Hedging Activities—an amendment of FASB Statement No. 133* (the "Exposure Draft"). FRC is the financial reporting technical committee of the IMA. The Committee reviews and responds to research studies, statements, pronouncements, pending legislation, proposals and other documents issued by domestic and international agencies and organizations.

FRC agrees with the objectives stated in the Exposure Draft. We encouraged the Board to pursue this project in our comment letter on proposed Statement 133 Implementation Issue E23, *Hedging—General: Issues Involving the Application of the Shortcut Method under Paragraph 68*, because we believed that hedge accounting needed simplification. However, we do not believe the Exposure Draft accomplishes the objectives of simplifying hedge accounting and resolving major practice issues related to the application of hedge accounting, and we question whether it results in an accounting model that is more useful and easier to understand for financial statement users. We do not support issuance of a final standard for the following reasons:

- We are concerned that the Exposure Draft will create more divergence between US GAAP and International Financial Reporting Standards ("IFRS") at a time when the FASB should be working with the IASB to reduce differences.

- With the ever-increasing likelihood that the Securities and Exchange Commission will permit or require US public companies to apply IFRS, we believe it would be a significant burden for companies to change their accounting for hedging activities to comply with a final standard, only to change again when they adopt IFRS. That is particularly the case given the divergence the Board would introduce if it finalizes the guidance in the Exposure Draft.

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- We believe many of the changes proposed in the Exposure Draft will make it more difficult for companies to apply hedge accounting and thus will result in accounting that is not indicative of the economics of how management has elected to hedge a company's exposure to changes in fair value or cash flows.

- The Exposure Draft makes other changes to Statement 133 without explaining the practice issues that necessitated the change or otherwise shedding any light on the Board's reasoning for the change.

We have divided our letter into three sections. The first section focuses on issues related to international convergence because of its significance. In the second section, we offer suggestions on how the Board could simplify hedge accounting. Finally, assuming the Board decides to proceed with issuing guidance, we discuss our concerns with specific provisions in the Exposure Draft in the last section of our letter.

In an appendix to this letter, we expand upon the comments expressed at the beginning of the letter as well as our concerns with specific provisions of the Exposure Draft as summarized in the last section of the letter.

Convergence with International Standards

There are a number of differences between the guidance in FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and IAS 39, *Financial Instruments: Recognition and Measurement.* While the Exposure Draft would eliminate some differences, it would create other differences that we believe will create confusion for investors. For example, both Statement 133 and IAS 39 permit a company to achieve hedge accounting for a specified risk associated with a financial asset or liability. If the Board finalizes the guidance in the Exposure Draft, Statement 133 as amended would preclude most of the circumstances in which companies hedge the benchmark interest rate. The proposed guidance would create the following differences (by way of example—not a complete list):

- IAS 39 permits a company to hedge the change in the fair value or cash flows of a financial asset or a financial liability for changes in the benchmark rate, even when the company enters into the derivative subsequent to the acquisition of the financial asset or issuance of the financial liability. The Exposure Draft would prohibit designating the benchmark rate as the hedged risk for a liability hedge entered into subsequent to issuance and for all hedges of financial assets regardless of when the company enters into the derivative. We note that the IASB has reaffirmed its acceptance of bifurcation by risk hedging in its recently issued IAS 39 amendment, *Eligible Hedged Items*.

- IAS 39 requires a company to discontinue hedge accounting when the company revokes its designation of the derivative as a hedging instrument. The Board, for reasons that are not clear, would preclude companies from revoking their designation of derivatives as a hedging instrument.

- The Exposure Draft would require a company to mark a hedged financial asset or liability to fair value for all risks, even if the company has elected not to hedge those risks. IAS 39 does not. (As discussed in the Appendix, we also believe the resulting accounting will diverge from the underlying economics of the transactions.)

- IAS 39 allows a company to hedge the credit risk associated with a debt security classified as held to maturity. The Exposure Draft proposes to prohibit companies from hedging credit risk.

The examples above are transactions that occur frequently in practice. Because of that, we are concerned that investors will have more difficulty comparing the results of hedging activities of companies following US GAAP to the results of companies following IFRS if the Board issues the guidance in the Exposure Draft as a final standard. We do not believe creating new differences is helpful to companies or investors.

The FASB also proposes to eliminate the shortcut method and "matched-terms" method from Statement 133 (as supplemented by SEC staff comments from the March 2007 meeting of the FASB Emerging Issues Task Force (EITF)). Although IAS 39 states that it does not permit the shortcut method, it provides guidance that facilitates and simplifies the application of hedge accounting in paragraphs 81 and 90 of IAS 39 and contains similarities to the matched-terms method in paragraph AG108. Accordingly, we believe eliminating that method would lead to further differences with IFRS and therefore is not a change that we believe will be helpful to investors. Further, even though the shortcut method is not literally consistent with IFRS, FRC believes the Board should preserve that approach. Hedge accounting is complex when not using the shortcut method and requires a significant investment of time and money to get it right. Smaller companies in particular do not have unlimited resources and therefore struggle to comply with the requirements of the standard when applying the "long-haul" method as currently interpreted. If companies are not able to apply the shortcut method for simple transactions involving an interest rate swap and an interest-bearing asset or liability, the financial statements will reflect volatility that does not economically exist. We do not believe that result would be meaningful to investors.

Simplifying Hedge Accounting

If the Board wants to make changes to Statement 133 in advance of US companies converting to IFRS in the interests of simplifying hedge accounting, we believe the Board could achieve that objective by doing the following:

- Retain the Exposure Draft's proposal to modify the effectiveness threshold to "reasonably effective" and eliminate the requirement to assess effectiveness every reporting period.

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- Simplify the "long-haul" method for interest rate hedges (particularly fair value hedges) by incorporating the guidance in paragraphs 81 and 90 of IAS 39.

- Expand "bifurcation-by-risk" hedging to encompass commodities where the hedged risk is an identifiable, separately measurable component by eliminating the requirement in paragraphs 21(e) and 29(g) that a company consider the location of the hedged item. We agree with the October 27, 2005 letter to the FASB from a number of organizations, including the Chicago Board of Trade. Companies have had difficulty in qualifying to apply hedge accounting to commitments and anticipated purchases of commodities, even when the price of the commodity is indexed to a market rate (for example, the price of gas at the Henry Hub), because of need to consider the costs to deliver the commodity. The Board's concerns described in paragraph 417 of Statement 133 are not applicable to such transactions because the hedged risk is identifiable and separately measurable. Therefore, the change is conceptually supportable. Hedging the variability in the price of a commodity while not hedging the variability in the delivery costs does not seem conceptually different than hedging the change in the benchmark rate while not hedging the credit risk component of a financial asset or liability.

- Finalize the proposed FASB Derivatives Implementation Group (DIG) issue on hedging commercial paper (DIG 13-11/12). The guidance in the proposal is still relevant and helpful in practice for a complex issue.

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Concerns with Exposure Draft

Assuming the Board decides to proceed with issuing the guidance in the Exposure Draft, FRC has concerns with the following proposed changes:

- Requiring companies to mark the hedged item to fair value for all risks, even though a company has elected to only hedge specific risks, unless the company meets newly-created exceptions.

- Prohibiting hedge accounting for companies that hedge the foreign currency exposure in a forecasted intercompany transaction.

- Eliminating the guidance in Statement 133 Implementation Issue G20 on accounting for the time value of purchased options.

- Changing how companies measure ineffectiveness on cash flow hedges.

- Prohibiting companies from dedesignating a derivative used in a hedge relationship and from ever designating a derivative that a company effectively terminated by entering into an offsetting derivative in a hedge relationship.

In addition, we are concerned about the extensive disclosure requirements included in the Exposure Draft, as well as the timing of when companies would be required to comply with a final standard.

We recommend that the Board drop this project and work with the IASB on the hedging aspects of the Discussion Paper, *Reducing Complexity in Reporting Financial Instruments*, to avoid two possible changes in accounting for US companies—one resulting from this Exposure Draft and another from convergence with IFRS. We discuss these matters, as well as further comments on the concerns expressed at the outset of this letter, in the attached appendix.

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We would be pleased to discuss our comments further with the Board or the FASB staff. You may contact me at (513) 983-6666.

Sincerely,

Mick Homan
Chair, Financial Reporting Committee

Attachment

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Appendix

IMA FRC Response to FASB Exposure Draft to Amend Statement 133

Overall Comments and Interest Rate Hedging

We strongly agree with the views expressed in the Alternative Views. We confirm the correctness of those views with respect to economics, operationality issues, and consequences.

While we agree with the proposed relaxation of the rigor of the effectiveness testing process, the Exposure Draft does not come close to meeting its stated objectives.

- We question the usefulness of the information provided. We do not understand how marking the unhedged risk to fair value is helpful to users of financial statements. That decision may have the counterintuitive consequence of making a company that hedges a part of its exposure look "riskier" than a company that has the same risk profile, but does not hedge. We do not think that answer will make sense to investors. We are concerned the Board is using the Exposure Draft to require the expanded use of fair value accounting through earnings without going through the appropriate due process.

- The Exposure Draft does not address several common practice issues. We have made several suggestions that would simplify hedge accounting in our cover letter.

- As discussed in the Alternative Views section of the Exposure Draft, the proposed amendment would create and introduce new complexities.

- The conclusions simply are not consistent with the economics and business purpose of hedging, irrespective of the multiple assertions to the contrary in the Exposure Draft.

In reaching its conclusions in the Exposure Draft, the Board has chosen to ignore history. Statement 133 as originally issued did not provide for hedging the benchmark interest rate. Constituents told the FASB at that time that not permitting that type of hedge ignored "real world" risk management and that companies in many cases could not effectively hedge all risks, including the credit risk component. The FASB ultimately agreed and issued Statement 138 (see in particular paragraphs 14-21 of Statement 138). Nothing has changed in this regard since the time the Board decided to amend Statement 133 to permit hedging the benchmark rate. Therefore, it appears as if the Board's real goal is to eliminate hedge accounting in its entirety. Given the fact nothing has changed with respect to the inherent difficulties in a company's ability to hedge its own credit risk, either companies will discontinue applying hedge accounting or discontinue hedging. In either event, the Board will not realize its goal of companies reporting information about the risks they have not hedged.

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The FASB is eliminating some rules it made up earlier (for example, the shortcut method), but is making up new, but different, rules that lack concept. For example, the Exposure Draft allows hedges of the benchmark interest rate, but only if a company enters into the hedge at inception and only for liabilities.

We understand some Board members are troubled about the conceptual underpinnings and understandability of the carrying amount of a hedged item in a fair value hedge under current GAAP. The carrying amount of the hedged item may not be cost or fair value, but some confusing combination. Assuming this is a problematic aspect of current accounting, the Exposure Draft would do quite little to address the issue. Only when an item is hedged from its inception and hedged for full changes in fair value (not the permitted benchmark in the Exposure Draft) would the carrying amount not be the combination.

Hedging Foreign Currency Exposure in Forecasted Intercompany Transactions

We strongly disagree with the proposed change to hedging the foreign currency exposure in a forecasted intercompany transaction. The change is inconsistent with the economics and ignores the original clear intent of the FASB. It is not a "difference between the intent of the guidance ... and how practice developed" as stated in paragraph A38 of the Exposure Draft. Paragraph 40 of Statement 133 specifically mentions hedging an intercompany royalty. Our view is supported by the discussion in paragraphs 469-471 and 481-487 of the Basis for Conclusions of Statement 133, the Status Update to EITF Issue 91-1, and Statement 133 Implementation Issue H13. Further, we think the context is clear—consolidated financial statement, not separate company reporting.

We note that the Board provides no background discussion of the change, no discussion in the Basis for Conclusions to support its assertion that the FASB never intended for a company to be able to achieve hedge accounting in consolidation for the foreign currency risk in a forecasted intercompany transaction, and no question for respondents. In addition, we can find no record that the matter, which goes beyond a mere administrative or clarification issue, was discussed and voted on at a public meeting, which is inconsistent with the Board's normal procedures.

Statement 133 Implementation Issue G20

We do not agree with the proposed change to Statement 133 Implementation Issue G20 as explained in paragraph A33 of the Exposure Draft and believe it diverges from the stated purpose of the project to simplify hedge accounting. The concept behind this issue was the expected cash flows concept in FASB Concepts Statement No. 7 and hedging expected cash flows above/below specified levels. Nothing has changed in this regard. By eliminating the guidance in Statement 133 Implementation Issue G20, the Board will complicate hedge accounting using purchased options.

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Appendix

Measuring Ineffectiveness

We do not agree with the change in measuring ineffectiveness for cash flow hedging when a company has under-hedged. What has changed from the Board's original concerns (discussed in paragraphs 379 and 380 of the Basis for Conclusions of Statement 133) to lead the current Board to conclude that those concerns no longer exist or are not relevant? We believe they still exist and are relevant. We also disagree with the assertion in paragraph A30 of the Exposure Draft that there is no conceptual basis for cash flow hedge accounting.

Dedesignation

We strongly disagree with the change prohibiting companies from dedesignating hedges and do not understand the FASB's stated rationale for that prohibition. Further, we believe prohibiting a company from ever redesignating as a hedge a derivative that a company effectively terminated by entering into an offsetting position is without concept. Companies' risk management strategies change over time. They are not static, and only a view that they are static could explain the reasons for prohibiting either dedesignation or redesignation of a "terminated" derivative. The Board should explain what it means when it refers to "managing the classification of certain items reported in earnings" (paragraph A11 of the Exposure Draft). If the Board believes companies are managing their operating results by dedesignating derivatives, we would be very interested in knowing how the Board feels they do that. Normally a company doesn't know what the derivative value will be in the future, so it would be difficult to use a derivative to manage earnings.

What practice problems has the FASB seen in this area, and why did the Exposure Draft not describe those problems? We believe the conclusion in the Exposure Draft promotes form over substance because a company could terminate a derivative and later enter into a new transaction that accomplishes the same risk management objective that the company would have accomplished had it been able to redesignate the derivative. Why not just require disclosure when a derivative is dedesignated and when it is redesignated?

Disclosures

The proposed disclosures in paragraph 28 of the Exposure Draft seem onerous and will require systems changes to enable companies to track the required information. We believe the proposed disclosures will not provide a significant benefit to users beyond the disclosures that were required in Statement 161.

Further, we do not understand the benefit of providing users with information as to what the weighted average interest rate on debt would have been if the company hadn't hedged (paragraph 29). The company did hedge, so why is a hypothetical interest rate informative? The disclosure of what the rate would have been if the company hadn't hedged, in addition to being hypothetical, also is out of context. The company may have entered into the hedge to mitigate repricing differences between its assets and liabilities. Only giving one side of the equation ignores what happened on the other side and could give the impression that management took on greater risks than if it had not hedged, even though it used the derivative to mitigate repricing risk. Further, the impact of the derivative on the hedged item is likely offset by the change in expected future cash flows of an asset that is not marked to fair value.

Other Comments

We have the following additional comments:

- We do not understand the proposed changes to paragraph 13 of Statement 133. There is no background discussion to help constituents understand the practice issues or the Board's concerns.

- Paragraph 17 of the Exposure Draft indicates that a company may designate foreign exchange risk if it designates interest payments as the hedged transaction. Does that mean a company with debt denominated in a foreign currency can't hedge the principal repayment?

- The proposed guidance may not reduce the number of quantitative assessments of effectiveness because of how the Board has decided to define the hedged item. Except in limited circumstances, the Exposure Draft obligates a company to assess effectiveness by comparing the change in the fair value of a derivative indexed to the benchmark rate to changes in the fair value of an asset or liability for interest rate and credit risk. A qualitative assessment may be difficult in this situation.

- As pointed out in the Alternative Views in paragraph A56, the Board's majority view may be summarized as follows: "... there is no reason to expect that changes in the value of an interest rate swap would provide a reasonable degree of offset to the change in fair value of the loan—the swap provides no protection against changes in the credit risk of the loan, which are clearly part of its fair value." No one is arguing that changes in credit risk aren't part of an asset's fair value, but that isn't what is being hedged. We find that view to be illogical.

- The guidance in Statement 133 Implementation Issue E7 should be retained—the Exposure Draft does not eliminate prospective effectiveness assessments.

- The guidance in Statement 133 Implementation Issue F11 should be retained—it addresses a strategy for assessing whether a hedge will be effective.

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- The guidance in Statement 133 Implementation Issue G10 should be retained—it addresses default risk on the derivative, which still seems relevant under the Exposure Draft.

- Assuming the FASB proceeds with the Exposure Draft, the Board should retain the guidance in Statement 133 Implementation Issue G25 and instead supersede the guidance in Statement 133 Implementation Issue G13. G25 is more broadly focused while G13 is limited to hedging the benchmark, which is precluded by the Exposure Draft for hedges of assets.

- We do not understand the proposed change to Statement 133 Implementation Issue H8. Please explain. Are cross currency interest rate swaps no longer permissible as effective hedging instruments?

Transition

Assuming the Board proceeds, we have the following comments regarding the proposed transition:

- We agree with the last sentence of paragraph 32.

- Redesignation will result in there being a "financing" element to be present, which will lead to significant ineffectiveness and potentially disqualification. We suggest that a final statement provide guidance that preparers should ignore the financing element (unless there was a financing element when they originally entered into the derivative) in doing their qualitative and quantitative assessments in the future.

- With respect to the catch-up adjustment to other comprehensive income in paragraph 34 of the Exposure Draft, companies would be required to expend significant effort to invent the hypothetically perfect derivatives for the past. Is it really worth the effort?

- What is the transition for the changes to paragraph 30 of the Exposure Draft?

- Assuming the FASB issues the guidance as a final statement, we believe it should delay the effective date at least until years beginning after December 15, 2009. We believe prohibiting the use of the shortcut and matched-terms methods, in addition to eliminating, in many cases, the ability of companies to designate the benchmark rate as the hedged risk, will increase the number of hedge effectiveness assessments a company will be required to make. Even if the final standard permits a qualitative assessment of effectiveness, we believe many companies will have difficulty concluding that a hedge is expected to be effective based solely on the qualitative assessment, particularly when they are required to consider changes in credit risk as part of the hedged item. Further, we believe determining the adjustment of other

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comprehensive income required for the change in how a company should measure the ineffectiveness of a cash flow hedge will require a significant amount of time to accomplish (e.g., at transition). Finally, companies will be required to adjust systems and controls to address the changes and will need time to implement those necessary changes.

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