

August 18, 2008

Technical Director-File Reference No. 1590-100  
 Financial Accounting Standards Board  
 401 Merritt 7 P.O. Box 5116  
 Norwalk, CT 06856-5116



LETTER OF COMMENT NO. 111

The Accounting Standards Executive Committee (AcSEC) of the American Institute of Certified Public Accountants (AICPA) has reviewed the Proposed Statement of Financial Accounting Standards, *Accounting for Hedging Activities, an amendment of FASB Statement No. 133*, and is pleased to provide our comments. AcSEC supports the overall objectives of the Exposure Draft to:

- a. Simplify accounting for hedging activities;
- b. Improve the financial reporting of hedging activities to make the accounting model and associated disclosures more useful and easier to understand for users of financial statements;
- c. Resolve major practice issues related to hedge accounting that have arisen under FASB Statement No.133; and,
- d. Address differences resulting from recognition and measurement anomalies between the accounting for derivative instruments and the accounting for hedged items or transactions.

AcSEC believes that the current proposal does not meet those objectives, results in significant implementation issues, and therefore, as discussed more fully in our response to Issue #11 in the Appendix to this letter, recommends that the Board withdraw the project from its agenda.

AcSEC recognizes that the Board is moving towards a “principles based” set of accounting standards, and recommends that to be effective those principles need to be clearly articulated and that new terminology needs to be clearly defined. Without clear definitions, there will be inconsistent application of the principles resulting in financial statements that are not comparable.

### **International Financial Reporting Standards (IFRS) Convergence**

AcSEC observes that the current FASB Statement No.133 hedge accounting model has many similarities with International Accounting Standard No. 39. AcSEC agrees with the position of the two dissenting Board members as stated in the Basis for Conclusions. These Board members observe that since this project was added to the Board’s agenda, the sense of urgency about convergence of accounting standards has heightened. These Board members believe it is now likely that U.S. public companies will adopt IFRS in the foreseeable future. Looking at derivatives and hedge accounting in isolation, they believe it is unreasonable to ask

participants in the U.S. markets to understand, implement and interpret this proposed Statement, which is different from current U.S. GAAP, then change to IASB No. 39 in a few years, and then possibly change again in a few years depending on the outcome of the IASB’s discussion document on the accounting for all financial instruments at fair value.

### **Elimination of Bifurcation by Risk**

AcSEC believes that it would be a more efficient use of resources to work with the IASB to develop consistent Standards, rather than issuing this proposal that diverges from current IFRS. AcSEC does not believe that the Board should move forward with a project that may conflict with IFRS at this time.

AcSEC is opposed to the elimination of bifurcation by risk because it is inconsistent with current asset-liability risk management programs used by most companies and will create inconsistencies in accounting for similar hedges. In practice, companies' risk management strategies are designed to hedge individual risk components, and the accounting should reflect those strategies. Recording the fair value changes for the entire financial instrument would result in the recognition in earnings of the changes in fair value attributable to risk components not being hedged. For the interest rate risk component, a well-established derivatives market already exists that can provide effective hedges. However, other risk components, such as credit and basis risk, often cannot be effectively hedged because no derivative exists to effectively hedge those components.

Furthermore, companies hedge their own issued debt not only on the date of issuance but also at future dates (late hedges) as a part of ongoing asset-liability risk management. Companies hedging their own debt on the day of issuance would account differently for that transaction than for a transaction hedging the same or similar debt within a short period after issuance. This treatment creates significant inconsistencies in accounting both within a single company and among companies. This treatment is also inconsistent with the objective of addressing differences resulting from recognition and measurement anomalies between the accounting for derivative instruments and accounting for hedged items or transactions and creates significant inconsistencies for the user in evaluating and comparing financial statements.

The elimination of bifurcation by risk will lead companies hedging their own debt to hedge both interest rate risk and the debtor's credit risk. AcSEC believes that hedging the debtor's credit risk will have a negative impact on financial reporting for the following reasons:

- There continue to be significant difficulties and diversity in practice in measuring a company's own credit risk in accordance with the provisions of SFAS No. 157, *Fair Value Measurements*.
- It will be difficult to demonstrate what is "reasonably effective" in the current volatile credit spread environment.
- There are possible legal concerns about hedging a company's own credit risk, including self dealing and enforceability in bankruptcy.

AcSEC observes that for these reasons the proposed Statement does not improve financial reporting and specifically does not achieve the benefits described in paragraph A44 in the Basis for Conclusions.

### **Elimination of the "Shortcut Method"**

AcSEC recommends that the Board retain the shortcut and critical terms matching methods. While larger public companies may have moved away from the use of the shortcut and matched terms methods due to their perceived negative consequences, the shortcut method is still being used extensively by medium and small firms as well as by private companies. Both lenders and borrowers have modified lending agreements and derivative contracts in order to qualify for use of the shortcut method. The recent clarifications in DIG Issue E23 provide useful guidance in ensuring the requirements for use of the shortcut method are being met. Elimination of the shortcut method would create an operational burden for these companies and they would

need to implement systems, procedures, and policies to address the potential immaterial ineffectiveness on an ongoing basis.

AcSEC recommends that the Board withdraw the proposed Statement from its agenda. However, it recognizes that the Board may decide to proceed with the project and therefore has included several suggestions for revision. These recommendations are addressed in the Appendix to this letter and respond to the major Issues for which the Board is seeking input.

Representatives of AcSEC would be pleased to meet with the Board and/or its staff at their convenience.

Sincerely yours,

Benjamin Neuhausen, Chairman  
Accounting Standards Executive Committee

Richard Juntilla, Chairman  
SFAS No. 133 Hedge Accounting Task Force

**APPENDIX**

**ISSUE #1 – For the reasons stated in paragraph A16 of this proposed Statement, the Board decided to eliminate (with two exceptions) the ability of an entity to designate individual risks as the hedged risk in a fair value or cash flow hedge. As a result of that change, the financial statements would reflect information about the risks in the hedged item or transaction that an entity both chooses to manage and not to manage as part of a particular hedging strategy.**

**Do you believe that the proposed Statement would improve or impair the usefulness of financial statements by eliminating the ability of an entity to designate individual risks and requiring the reporting of the risks inherent in the hedged item or transaction?**

- As discussed in the cover letter, we believe that the proposed Statement would impair the usefulness of financial statements by eliminating the ability of an entity to designate individual risks and requiring the reporting of fair value changes in unhedged risks inherent in the hedged item or transaction. This change would have a significant impact on how entities currently manage assets and liabilities. The change creates inconsistencies in the accounting for hedging of one's own debt if the hedge relationship is entered into on day 1 versus day 2.
- Additionally, we believe the prohibition on hedging interest rate risk after issuance creates significant issues with accounting for changes in fair value of one's own credit, a view that is acknowledged as a significant concern by the Board itself in the Exposure Draft.
- AcSEC does not believe that the Board's proposed approach of recording fair value changes related to the risks not being hedged is the best way of informing users about these risks. Instead, AcSEC believes that expanded disclosures would be a more beneficial approach. In FASB Statement No. 161, the Board considered, but decided against, requiring information about how all risks are managed (whether through derivatives or other financial instruments). The Board decided instead to address risk management in an overall disclosure standard project. It would be prudent for the Board to continue to address this concept in a separate overall financial instrument disclosure standard in coordination with the IASB, rather than making changes to the accounting that will change the way entities manage risks.

**ISSUE #2: For the reasons stated in paragraphs A18-A20, the Board decided to continue to permit an entity the ability to designate the following individual risks as the hedged risk in a fair value or cash flow hedge: (a) interest rate risk related to its own issued debt (that is, its liability for funds borrowed), if hedged at inception, and (b) foreign currency exchange risk. For those two exceptions, the financial statements would not reflect information about the risks that an entity chooses not to manage as part of a particular hedging relationship.**

**Do you believe the Board should continue to permit an entity to designate those individual risks as a hedged risk? (Also see responses to Issue #1 above)**

- We believe the Board should continue to permit an entity to designate those individual risks as the hedged risk. In addition, we recommend that an entity should be permitted to designate the interest rate risk on its own debt as the hedged risk at any time, not just at issuance. Under the Board's proposal, entities hedging their own debt after issuance often will be compelled to hedge their own credit risk to achieve an effective hedge for accounting purposes. As noted in the cover letter, we believe hedging an entity's own credit risk creates significant reputational and legal concerns in

addition to the practical difficulties of measuring own credit risk for many entities.

- As discussed in the cover letter, we believe that it is prudent to permit bifurcation by risk in all situations, but at a minimum we recommend that the Board permit bifurcation by risk for an entity's own debt after issuance.

**ISSUE #3 – This proposed Statement would eliminate the shortcut method and critical terms matching. Therefore, an entity would no longer have the ability upon compliance with strict criteria to assume a hedging relationship is highly effective and recognize no ineffectiveness in earnings during the term of the hedge. As a result, when accounting for the hedging relationship, an entity would be required, in all cases, to independently determine the changes in fair value of the hedged item for fair value hedges and the present value of the cumulative change in expected future cash flows on the hedged transaction.**

**Do you foresee any significant operational concerns or constraints in calculating ineffectiveness for fair value hedging relationships and cash flow hedging relationships?**

**Do you believe that the proposed Statement would improve or impair the usefulness of financial statements by eliminating the shortcut method and critical terms matching, which would eliminate the ability of an entity to assume a hedging relationship is highly effective and to recognize no ineffectiveness in earnings?**

- While larger public companies, including larger financial institutions, may have moved away from the use of the shortcut and matched terms methods due to their perceived misapplication, the shortcut method is still being used extensively by medium and small firms as well as by private entities. Both lenders and borrowers have modified lending agreements and derivative contracts in order to qualify for use of the shortcut method. The recent clarifications in DIG Issue E23 provide useful guidance for these entities in ensuring the requirements for use of the shortcut method are being met. Elimination of the shortcut method would create an operational burden for these entities and they would need to implement systems, procedures, and policies to address the potential immaterial ineffectiveness on an ongoing basis.
- Many larger financial institutions have moved away from application of the shortcut and matched terms methods, not because of concerns about effects on their financial statements, but because of the perceived negative reputation that has developed in recent years caused by numerous restatements and SEC staff comments. We believe for many medium to small institutions this elimination will have a significant impact on the entity's decision to continue to apply hedge accounting. These entities do not have the internal systems or models to appropriately measure ineffectiveness and will incur significant costs to develop such systems. Whether the elimination of these methods improves or impairs usefulness will not matter, because it is likely to eliminate the use of hedge accounting for many of these entities. [redundant]

**ISSUE #4 – This proposed Statement would modify the effectiveness threshold necessary for applying hedge accounting from *highly effective* to *reasonably effective* at offsetting changes in fair value or variability in cash flows.**

**Do you believe that modifying the effectiveness threshold from highly effective to reasonably effective is appropriate? Why or why not?**

**For situations in which interest rate risk is currently designated as the hedged risk for financial instruments but would no longer be permitted under this proposed Statement (except for an entity's**

own issued debt at inception), do you believe you would continue to qualify for hedge accounting utilizing your current hedging strategy? If not, would you (a) modify your hedging strategy to incorporate other derivative instruments, (b) stop applying hedge accounting, (c) elect the fair value option for those financial instruments, or (d) adopt some other strategy for managing risk?

- AcSEC supports the decision to modify the effectiveness threshold for applying hedge accounting from “highly effective” to “reasonably effective.” This decision is consistent with the Board’s decision to move towards principles-based accounting.
- We are concerned, however, that the modification of the effectiveness threshold from highly effective to reasonably effective may create diversity in practice without some guidelines and examples on how to make that determination. Without some guidelines of what would qualitatively or quantitatively constitute a reasonably effective hedge, we cannot indicate whether a plain fixed to floating hedging relationship or other “plain vanilla” interest rate hedging strategy will continue to qualify as hedges going forward. The application of reasonably effective is more difficult because of the elimination of bifurcation by risk, because an entity will need to evaluate whether a hedging instrument is reasonably effective in offsetting the entire change in fair value of hedged debt, including credit risk and basis differences. AcSEC recommends that the Board give examples of what is and what is not reasonably effective in order to narrow the range of choices and provide consistency in application.
- We suggest that the Board consider providing additional examples on the application of the criteria of the establishment of an economic relationship and the fact that hedging the predominant risk can result in a determination that the hedging relationship is reasonably effective.
- If the Board decides to retain bifurcation by risk as recommended by AcSEC, the requirement for hedge effectiveness should be maintained as highly effective so as to prevent abuses SFAS No. 133 sought to eliminate.

**ISSUE #5** – This proposed Statement always would require an effectiveness evaluation at inception of the hedging relationship. After inception of the hedging relationship, an effectiveness evaluation would be required if circumstances suggest that the hedging relationship may no longer be reasonably effective.

**Do you foresee any significant operational concerns in creating processes that will determine when circumstances suggest that a hedging relationship may no longer be reasonably effective without requiring reassessment of the hedge effectiveness each reporting period?**

**Do you believe that requiring an effectiveness evaluation after inception only if circumstances suggest that the hedging relationship may no longer be reasonably effective would result in a reduction in the number of times hedging relationships would be discontinued? If so, why?**

- We believe that the Board should consider including examples of circumstances that would suggest that a hedging relationship may no longer be reasonably effective. With added examples, we believe that an entity should be able to operationalize controls to determine on an ongoing basis whether any circumstances have arisen to suggest that a hedging relationship is no longer reasonably effective. AcSEC believes that the newly created principle of reasonably effective is not clearly understood, so it is difficult to decide what hedging relationships will meet this test. As stated above, AcSEC believes that it is possible to clearly explain the principles (without giving bright lines) if the Board provides examples that compare and contrast and that will help narrow potential diversity in practice.
- AcSEC reiterates its position that the Board should continue to permit bifurcation by risk to reduce

the amount of ineffectiveness. (See Issue 4 for comment about hedge effectiveness).

**ISSUE #6 – The Board considered but decided against eliminating any assessment of effectiveness after the inception of the hedging relationship. The Board believes that eliminating such as assessment of effectiveness could result in the continuation of hedge accounting even when situations suggest that the hedge relationship may no longer be reasonably effective. Some observe that an implication of the decision to not eliminate any assessment after the inception of the hedging relationship could be that hedge accounting results would be reflected in some reporting periods and not in other reporting periods throughout the life of the relationship. Also, in a hedge accounting model that generally does not permit hedging of individual risks, changes in the relationship between the individual risks being managed and those not being managed could increase the likelihood that the hedging relationship would no longer be reasonably effective. That would result in hedge accounting no longer being permitted for a portion of an expected hedge term. That “in and out” of hedge accounting would make it more difficult for users to interpret financial statements.**

**Do you agree with the Board’s decision to continue to require that hedge accounting be discontinued if a hedge becomes ineffective? Alternatively, should an effectiveness evaluation not be required under any circumstances after inception of a hedging relationship if it was determined at inception that the hedging relationship was expected to be reasonably effective over the expected hedge term?**

- We agree with the Board’s decision. We believe that entities should not be allowed to continue applying hedge accounting if the amount of ineffectiveness becomes significant.

**ISSUE #7 – In the statement of operations, Statement 133 does not prescribe the presentation of gains and losses associated with hedging instruments, including the effective portion, the ineffective portion, and any amounts excluded from the evaluation of effectiveness, such as forward points. Some have suggested that such a prescription would improve financial reporting by creating consistency in the presentation of these amounts across all entities. Others observe that FASB Statement No. 161, *Disclosures about Derivative Instruments and Hedging Activities*, requires disclosure about that information, and they question whether a prescriptive approach is appropriate given the diverse hedge accounting strategies employed by entities.**

**Do you believe that Statement 133 should be amended to prescribe the presentation of these amounts? For example, the Statement could require that the effective portion of derivatives hedging the interest rate risk in issued debt be classified within interest expense and that the ineffective portion and any amounts excluded from the evaluation of effectiveness be presented within other income or loss.**

- We agree with Board’s decision not to prescribe the presentation of gains and losses associated with hedging instruments. We believe that FASB Statement No. 161 appropriately addresses the disclosure of where these amounts are included in the financial statements. We also believe that because of the diversity in hedge accounting applied by different entities, FASB Statement No. 161’s enhanced disclosure requirements appropriately addresses any concerns about where gains and losses are displayed.

**ISSUE #8 – The Board’s goal is to issue a final Statement by December 31, 2008. The proposed Statement would require application of the amended hedging requirements for financial statements**

issued for fiscal years beginning after June 15, 2009, and interim periods within those fiscal years.

**Do you believe that the proposed effective date would provide enough time for entities to adopt the proposed Statement? Why or why not?**

- If the Board issues a final Statement by December 31, 2008, we believe that an appropriate effective date would be for financial statements issued for fiscal years beginning after November 15, 2009, and interim periods within those fiscal years. If the Statement is not issued until the first or second quarter of 2009, we recommend that the effective date be for financial statements issued for fiscal years beginning after June 15, 2010, and interim periods within those fiscal years. The changes that this potential standard will cause to an entity's risk management strategies, financial reporting, and controls and operations will be significant, and we believe that a six-month time period for application is not enough time to address all of the changes. However, AcSEC believes that the timetable can be altered depending on whether the Board decides to retain bifurcation by risk and allow entities to continue to apply the shortcut method. One possible transition approach could delay implementation of any changes to the shortcut method by 24-48 months to allow entities to phase out existing hedges.
- Although the Board may perceive that the proposed Standard will ease burdens and require only minor operational changes, AcSEC disagrees as discussed throughout this comment letter.

**ISSUE #9 –The Board did not prescribe any specific transition disclosures upon the adoption of this Statement.**

**Do you believe that there are specific disclosures that should be required during transition? If so, what? Please be specific as to how any suggested disclosures would be used.**

- Due to the de-designation and re-designation requirements of the Proposed Statement, there may be meaningful changes in positions or elections to qualify for hedge accounting. We believe that the Board should require disclosure, articulated in a principles-based fashion, of (a) material changes to hedge relationships or elections to apply hedge accounting as a result of the application of the Proposed Statement and (b) material ensuing effects on comparability of reported results among periods.
- In addition, the transition disclosures should provide information on transfers from the held-to-maturity to the available-for-sale or trading categories, designation of financial assets and liabilities to fair value accounting under FASB Statements No. 156 and 159, as well as the amount of adjustments made to the carrying values of assets or liabilities, the effect of which is recorded directly in retained earnings.
- Additionally, we recommend that FASB Statement No. 161's disclosure requirements be expanded or clarified to require disclosures of an entity's accounting policies and attributes (qualitative and quantitative) governing its assessment of its hedges' reasonable effectiveness both at and after inception as well as the "circumstances that may suggest that a particular hedging relationship may no longer be reasonably effective."

**ISSUE #10 – The Board decided to permit an entity a one-time fair value option election under FAS Statement No. 156, *Accounting for Servicing of Financial Assets*, and No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, for (a) servicing assets and servicing liabilities designated as a hedged item on the date immediately preceding initial application and (b) eligible financial instruments designated as a hedged item on the date immediately preceding initial application of this**

proposed Statement.

**Do you agree with the Board's decision to allow a one-time fair value option at the initial adoption of this proposed Statement? Do you agree with the Board's decision to limit the option to assets and liabilities that are currently designated as hedged items under Statement 133?**

- Because of the significant effects this statement will have on future risk management strategies for all of an entity's financial assets and liabilities, we believe that a one-time fair value option for all financial assets and liabilities would be more appropriate. Changes brought upon by this Statement will have significant effects on financial assets and liabilities not currently designated as hedged items because of the changes in strategies employed for all financial instruments.

**ISSUE #11 – The objective of financial reporting is to provide information that is useful to present and potential investors, creditors, donors, and other capital market participants in making rational investment, credit, and similar resource allocation decisions. However, the benefits of providing information for that purpose should justify the related costs. The benefit-cost considerations considered by the Board are provided in paragraphs A43-A50 in Appendix B of this proposed Statement.**

**Do you believe the Board identified the appropriate benefits and costs related to this proposed Statement? If not, what additional benefits or costs should the Board consider?**

- As discussed in the cover letter and in the Appendix, AcSEC believes the most prudent course of action is to drop the project.
- AcSEC believes that the Board should permit entities to continue to bifurcate risk because that approach provides users with the most representationally faithful financial statements.
- We believe that elimination of the shortcut and critical terms match methods will have a significant effect on costs for medium and smaller entities and may likely eliminate the viability of hedge accounting for these entities.
- We believe that the current hedge accounting model has been through rigorous interpretation and application and is currently “working” in practice. Introduction of a new hedge accounting model that is not convergent with IFRS will create significant ongoing costs and inconsistencies in practice that will be borne by preparers both at inception of the new model and on an ongoing basis.
- With respect to other additional benefits or costs, we believe the following should be considered:
  - Costs and the ability of including and measuring credit risk – particularly an entity's own credit risk.
  - Costs of adopting multiple new standards at the same time, including consideration of implementation of the expected new FAS 140 and FIN 46R standards.
- The Board should consider the costs and benefits of requiring additional disclosures related to hedging application to allow users a better understanding of financial statements, versus the costs and benefits of introducing dramatic changes to the hedge accounting model.