Financial Accounting Standards Board

Invitation to Comment, *Selected Issues about Hedge Accounting*
Comment Letter Summary

Background

1. In May 2010, the FASB issued a proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities.* The proposed Update exposed targeted changes to hedge accounting guidance contained in current U.S. GAAP along with proposals on the classification and measurement of financial instruments and impairment accounting. The comment period ended on September 30, 2010. In total, 2,814 comment letters were received.

2. In December 2010, the IASB published the Exposure Draft (ED), *Hedge Accounting*, which proposed changes to hedge accounting guidance substantially different from current U.S. GAAP and IFRS. The comment period ended on March 9, 2011. By the end of the comment period, the IASB received 177 comment letters. In total, 248 responses were received.

3. On February 9, 2011, the FASB issued a Discussion Paper—Invitation to Comment (ITC), *Selected Issues about Hedge Accounting,* to solicit input on the IASB's Exposure Draft, *Hedge Accounting*. The comment period ended on April 25, 2011, and the FASB received 71 comment letters by that date.

4. One purpose of the ITC was to gather feedback from the FASB's stakeholders about whether the changes to current hedge accounting guidance set forth by the IASB's ED represents a better starting point for improving current U.S. GAAP than the changes set forth by the FASB's proposed Update. This comment letter summary provides an overview of the general themes that are prevalent in the ITC comment letters.

5. This document is organized as follows:

(a) Comment Letter Demographics

(b) Main Themes in Comment Letters

(c) Issues in the ITC

(d) Analysis of Comments Received

(e) Miscellaneous Feedback Received

(f) Private Company Feedback Received.

Comment Letter Demographics

6. The following table provides demographic statistics on the comment letters received:

Type of Respondent	Number
Preparer	47
Auditor	7
User	1
Regulator	3
Accountancy Body	3
Standard Setter	3
Other	7
Total	**71**

7. The "other" category consists of several individuals who submitted comment letters, as well as some professional organizations.

8. Only 2 of the 71 letters that the Board received represent the views of private company preparers and auditors. This comment letter summary specifically highlights the views of private company preparers and auditors, as noted in those two letters, in a separate section of this document.

9. The Board received only one letter that represents a user's viewpoint. That letter was from a group of users.

Main Themes in Comment Letters

10. Overall, the comment letters have the following main messages:

    (a) Strong support for global convergence and concern that the FASB and IASB are currently not working together on hedge accounting.

    (b) Support for a more principles-based approach to hedge accounting that would include aligning hedge accounting more closely with risk management strategies.

    (c) Support for the expansion of risks eligible for hedge accounting. Strong support for the need to address macro hedging, which was not addressed in the IASB's ED or the FASB's proposed Update. (The IASB is considering macro hedging separately from its redeliberations of the provisions in its ED.)

    (d) Support for the expansion of items eligible to be designated as hedging instruments.

    (e) Support for the "rebalancing" notion, but many stakeholders believe that it should not be required. Strong support to retain voluntary dedesignation.

    (f) Concern about the IASB's proposed requirements for hedge effectiveness testing and the possibility for divergence in practical interpretation. Many stakeholders note their support for the FASB's original proposal to reduce the effectiveness threshold to *reasonably effective*. (The responses that the IASB received from the United States also request that the term *reasonably effective* should be clarified to make it operational and to avoid divergence.) Very strong support for removal of the "bright line" 80–125 percent test for hedge effectiveness.

    (g) Concern about the increased use of other comprehensive income for fair value hedging that was included in the IASB's ED.

(h) Concerns about the granularity of the disclosures proposed by the IASB's ED, and their emphasis in applying such guidance to derivatives that qualify for hedge accounting rather than derivatives that do not qualify.

Issues in the ITC

11. The ITC included questions on the following topics:

(a) Risk management objectives (Questions 1–4)

(b) Hedging instruments (Question 5)

(c) Hedged items (Questions 6–13)

(d) Hedge effectiveness (Questions 14–15)

(e) Changes to a hedging relationship (Questions 16–17)

(f) Accounting for the time value of options (Question 18)

(g) Hedge accounting presentation and disclosures (Questions 19–22)

(h) Targeted changes to U.S. GAAP versus convergence to the IASB's model (Question 23).

Analysis of Comments Received

Risk Management (Questions 1–4)

The IASB's proposed guidance would rely substantially on an entity's risk management objectives as a basis for hedge accounting. The IASB's ED 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" (p. 1). As noted in a later section on hedge effectiveness, compliance with an internally defined risk management strategy is a main criterion for qualifying for hedge accounting.

12. Respondents to the ITC, especially preparers and auditors, note that risk management is broader than hedging activities alone. Preparers comment that risk

management activities occur on multiple levels, such as the entity level, business unit level, portfolio level, and transaction level. Hedging strategies usually apply only to transaction level or portfolio level risk management strategies. In addition, not all hedging strategies are designated as accounting hedges (that is, they are simply economic hedges). Preparers and auditors express concern about the potential lack of granularity in linking risk management strategies to hedge accounting and the potential for diversity in practice. It is noted that merely having a risk management strategy in place is not sufficient to qualify for hedge accounting under the IASB's ED.

13. Despite the concerns set out above about the application of a "risk management objective," preparers and auditors strongly support a principles-based approach to hedge accounting. Preparers and auditors comment that the current rules-based guidance is extremely cumbersome to comply with and understand. Preparers and auditors are hopeful that the Boards can jointly develop an approach to hedge accounting that will result in less volatility in the income statement as a result of some hedging activities falling out of compliance with hedge accounting criteria.

14. If the Boards were to link hedge accounting to "risk management objectives," many auditors and preparers do not foresee changes in how an entity determines or oversees its risk management objectives as a result of the proposed guidance. Many preparers and auditors anticipate that more transactions will qualify for hedge accounting if the IASB's risk management objective notion is further developed.

15. Some preparers acknowledge that while qualifying for hedge accounting may become simpler, auditor and regulator pressure on documentation of risk management objectives may increase dramatically. Therefore, those preparers believe that changes in documentation practices will be driven by audit pressures. Some preparers specifically note that the level at which an entity needs to document its risk management objectives is unclear. As mentioned in paragraph 12, because risk management is performed at different levels within the reporting entity, requiring the direct linkage of risk management documentation with that for

hedge accounting strategies would be overly burdensome and potentially lead to the documentation of objectives for hedge accounting purposes alone.

16. Most auditors and preparers believe that relying on risk management strategies and objectives as a criterion for qualifying for hedge accounting does not create the impression of an implicit opinion on the adequacy of an entity's risk management strategy. Auditors suggest that the Board consult with audit standard-setting bodies for consideration of whether auditing standards need to be amended to be consistent with those proposed changes to hedge accounting guidance. Those auditors believe that collaboration between the Board and auditing standard setters would ensure that an auditor's responsibility for hedge accounting qualification and effectiveness assessment is clearly defined.

17. Some preparers express concern that under the IASB's proposed guidance, risk management objectives would be subject to the auditor's opinion. Essentially, those preparers argue that under a dedesignation scenario, the auditor may need to express an opinion about whether the risk management strategy of the entity has changed sufficiently for dedesignation to be appropriate.

18. Many auditors and preparers note that macro hedging is a critical component of many entities' risk management strategies, yet it is not included in either current or proposed hedge accounting guidance in U.S. GAAP or IFRS. Auditors and preparers cite this point as an argument about why the current objective of aligning hedge accounting with risk management strategies is not fully comprehensive. Respondents recognize that integrating macro hedging into current models is complex; however, they encourage the Boards to undertake this effort.

19. Users also express concern that preparers and auditors may reach different conclusions on whether an economic hedge qualifies for hedge accounting because there is much room for interpretation in determining compliance with a broadly defined risk management strategy. Given the economic risk inherent in derivatives and the misapplication of hedge accounting standards by preparers in the past, users strongly oppose guidance that they consider to be subjective because it places too much reliance on management's intent.

Hedging Instruments (Question 5)

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.

20. Most auditors, preparers, and accountancy bodies support the expansion of eligible hedging instruments to include cash instruments that are measured at fair value through profit or loss (FV-NI). Those stakeholders believe that the nature of the instrument should not preclude it from being used to achieve hedge accounting treatment if it is legitimately part of the entity's risk management practices. Other auditors and preparers conceptually agree with the proposed guidance, but cite practical limitations to using cash instruments as hedging instruments. Those latter stakeholders believe that derivative instruments can hedge some risks more efficiently than cash instruments.

21. While the majority of the above respondents support the inclusion of cash instruments reported at FV-NI as hedging instruments, another preparer asserts that eligible instruments should be expanded even further. That stakeholder suggests that amortized cost instruments also should be eligible hedging instruments on the basis that loans can be part of an entity's risk management in the same way as cash instruments that are reported at FV-NI. That stakeholder argues that if risk management is a central underpinning of eligibility for hedge accounting, then all financial instruments that are utilized for achieving risk management objectives should be eligible for hedge accounting.

22. Of the respondents who support the inclusion of cash instruments as hedging instruments, there is mixed feedback about whether the proposed guidance provides sufficient rigor to adequately prevent circumvention of classification and measurement guidance.

    (a) Most auditor and preparer respondents believe that limiting eligible cash instruments to those that are measured at fair value through profit or loss prevents entities from shifting the measurement of an item simply by designating it as a hedging instrument.

(b) A preparer states that additional guidance may be needed to clearly define when cash instruments could be designated as hedging instruments. That preparer is concerned about potential abuses arising from circumventing the classification and measurement model.

(c) Another preparer notes that it will be easier to assess the effect of hedge accounting on other relevant guidance once the Boards have reached final conclusions on classification and measurement.

23. Although the majority of respondents agree with the eligibility of cash instruments as hedging instruments, letters that present the views of some users and regulators express disagreement with the proposed guidance. Those respondents believe that expanding the ability to apply hedge accounting will provide management with additional flexibility to apply whatever measurement is most favorable at inception of the hedging relationship and to freely modify the hedging instrument's classification and measurement for the life of the hedging relationship. Accordingly, those respondents believe the proposed guidance does not contain sufficient rigor to prevent misapplication of classification and measurement guidance in IFRS 9, *Financial Instruments*.

Hedged Items (Questions 6–13)

Under the IASB's proposed guidance, a hedged item can be a recognized asset or liability, an unrecognized firm commitment, a highly probably forecast transaction, or a net investment in a foreign operation. The IASB's proposed guidance specifies 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 ED illustrate that a hedged item could be a component that is not contractually specified or a component that is inferred.

24. Generally, there is widespread support among most auditors, preparers, regulators, and accountancy bodies to broaden the range of hedged items to include risk components. Most comment letters received from those stakeholders express the need for additional guidance about what constraints apply when determining whether an item in its entirety or a component thereof is eligible to be designated as

a hedged item. (In contrast, several preparers and an auditor state that the proposed guidance is sufficiently clear about which constraints apply.) For example, some stakeholders suggest that the guidance should explicitly state that instruments carried at FV-NI are not eligible as a hedged item. Those respondents assert that allowing those instruments to be designated as a hedged item would allow gains or losses that should flow to earnings to be inappropriately diverted to other comprehensive income.

25. Auditors and preparers responded favorably to the proposed criteria of risk components being separately identifiable and reliably measurable in order to qualify as a hedged item. While they believe those criteria are appropriate, they note that additional guidance is needed for effective implementation. Those stakeholders are especially concerned about cases in which the hedged risk components are not contractually specified. Although there is general consensus surrounding the appropriateness of the criteria, an auditor specifies that the *separately identifiable* and *reliably measurable* criteria themselves must be further clarified.

26. Users disagree with the *separately identifiable* and *reliably measurable* criteria. Users believe that those criteria are ill-defined and will lead to diversity in practice. Additionally, users and regulators are concerned that those loosely defined criteria will provide too much flexibility in identifying customized hedging instruments for certain risk components, opening the door for potential "cherry picking" of effective components only. Therefore, entities would be able to avoid any ineffective portions related to those hedged risk components flowing to net income.

27. The IASB's ED implies that credit risk and inflation cannot be separately identified and, therefore, cannot be treated as hedged items under the proposed guidance. Auditors, preparers, and regulators express concern about this implication because they argue that this notion runs counter to practice and conflicts with the stated objective of hedge accounting to more accurately reflect an entity's risk management strategies. Those stakeholders strongly believe that hedge accounting should be permitted for hedging of credit risk with credit derivatives.

28. In addition to their position with respect to credit risk, most auditors, preparers, and regulators argue that the separately identifiable criterion should not limit hedged items to risk components that are contractually specified. Many respondents note that entities hedge risk components whether they are contractually specified or not. Another preparer notes inflation as a primary example of a risk that is hedged in practice for which there may not be a contractual specification. Additionally, that preparer notes that prohibitive language in the proposed guidance undermines the general principles-based direction of the proposed guidance and would lead to rules-based application. Moving past the proposed contractually specified limitation, several auditors call for additional guidance on the implementation of risk components that are not contractually specified.

The IASB's ED 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.

29. Generally, auditors and preparers support the proposal to allow a layer component of the nominal amount to be designated as a hedged item. Most respondents from these groups believe that a defined, but open, population should be eligible for designation as a hedged layer component only if the designation contains sufficient specificity such that transactions can be identified as hedged transactions when they occur. If the layer can only be identified retrospectively at the end of the specified period, then auditors and preparers believe this layer component should not be eligible. Several auditor and preparer respondents directly comment on the example in Question 10 of the ITC, which asks whether the last 10,000 widgets sold during a specified period could be designated a layer component in a cash flow hedge. Most auditors and preparers state that they believe the example could not be a hedged layer because those transactions are not specifically identifiable as hedged transactions at the time they occur.

30. An auditor contends that the FASB misconstrues the IASB's ED to suggest that the population in the given scenario would be eligible for designation. The auditor

argues that the FASB's 10,000 widgets example is inconsistent with the IASB's principle of a defined, but open, population and, therefore, is properly excluded from the examples offered in paragraph B21 of the IASB's ED. In order to avoid confusion, that auditor believes that the proposed guidance should make it explicit that a layer component requiring a look-back period for identification is ineligible for designation as a hedged item.

31. Yet another auditor commenting on the 10,000 widgets example calls for clarity in determining treatment of an open population. While that stakeholder acknowledges that the proposed guidance is clear relative to a closed population, he believes that the guidance is vague for open positions and may result in two divergent interpretations. The first interpretation follows existing IAS 39 implementation guidance in which an example with the same fact pattern is not permitted as a hedged item because it is unclear at the time of the transaction whether it is or is not a hedged transaction. The second interpretation is that open populations are allowed because the guidance does not specifically preclude it. Those differing interpretations highlight the need for additional guidance in this area.

In the IASB's ED, 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.

32. Most auditors and preparers do not agree with the proposed guidance to prohibit the aforementioned prepayment option from designation as a hedged item. Several preparers note that this exclusion is reminiscent of rules-based guidance and is inconsistent with the principles-based approach of the IASB's ED. Several preparers suggest that a layer component of a contract that includes a prepayment option should be eligible for hedge accounting only when a hedging instrument with a prepayment option that mirrors that of the hedged item is used. An auditor notes that compensation mechanisms, such as a "make-whole provision," may

mitigate interest rate risk to an acceptable level such that designation of a layer component with a prepayment option as a hedged item may still be appropriate.

33. While auditors and preparers welcome the proposal to expand the range of eligible hedged items to include a component layer of the nominal amount and question the ineligibility of a layer component of a contract containing a prepayment option, users take the opposite position on both issues. Users are concerned that providing additional options for hedged item designation will increase structuring opportunities through which entities would eliminate the recognition of ineffectiveness in net income. In regard to prepayment options, users agree with the IASB's proposal to prohibit those components from designation as a hedged item.

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

34. Generally, auditors and preparers support the application of hedge accounting to aggregated exposures as this practice more closely reflects an entity's risk management strategy. Most auditors and preparers express strong support for the need to address macro hedging. Some respondents note that it is difficult to identify specific operational concerns in that piece of the proposed guidance without understanding what, if any, macro hedging guidance the IASB will propose at a later date. Another respondent asks for clarification of qualifying criteria for aggregating a group of items.

35. While some auditors and preparers cannot sufficiently identify any operational concerns applying other guidance in IFRS, others see operational concerns with respect to the impairment guidance. Specifically, those auditors and preparers call for additional guidance on the rebalancing requirements following impairment of

an individual item within an aggregated exposure. When an impairment occurs and rebalancing the hedge ratio is necessary to maintain an unbiased result, it is unclear whether the required rebalancing would result in continuation of the existing hedge relationship or create a dedesignation/new designation situation. Some auditors note potential difficulty in allocating a carrying value adjustment to an individual instrument that has suffered an impairment when that instrument is part of an aggregated exposure. Those respondents assert that the adjustment must be properly allocated so that the instrument's carrying value and subsequent gain or loss upon the instrument's sale or extinguishment is accurately reflected in the financial statements.

36. Auditors and preparers seek additional clarity around hedging relationships related to "synthetic instruments." When an entity hedges a synthetic instrument and subsequently terminates that hedging relationship, some respondents are unsure about the accounting for the synthetic instrument. Those auditors and preparers are uncertain about whether the synthetic instrument should be bifurcated with each component accounted for separately or remain in a designated hedging relationship with each other. The bifurcation of a synthetic instrument may raise classification and measurement issues as well as uncertainty around basis adjustments related to the hedged item in the hedging relationship. It is noted that the proposed accounting for aggregated exposures in the IASB's ED is different from synthetic instrument accounting.

37. Most auditors and preparers believe that the proposed guidance on aggregated exposures will provide more transparent and consistent information about an entity's use of derivatives. Because many entities enter into hedging relationships on net positions to reduce the cost of hedging, the ability to account for those aggregated exposures provides more transparent information about how an entity uses derivatives to manage risk. Some auditors and preparers believe that sufficient disclosure regarding those aggregate exposures should be included as well to provide users with further transparent and consistent information.

38. One auditor disagrees with presenting the results of hedging a net position as a separate line item on the income statement. This auditor contends that the results should be allocated to the relevant line items as this provides more transparent information to users and is consistent with the objective of the proposed guidance to align accounting with risk management strategy.

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

39. Most auditors and preparers support the proposed guidance to permit the application of hedge accounting to a group of cash instruments that offset and qualify as a group. Those respondents support this guidance because it is in line with entities' actual risk management strategies. Several auditors and preparers do not agree that a group of items should be limited to only those that have offsetting cash flows affecting profit or loss in the same period in the case of a cash flow hedging relationship. Those respondents note that this limitation introduces an artificial cut-off and strays from how entities economically manage their risk, making it inconsistent with the IASB's ED's principle to more accurately reflect an entity's risk management practices. As with the discussion on other aggregated exposures, two auditors note the need for additional guidance about qualifying criteria for items that may be included in a group.

40. Most regulators and users disagree with the IASB's proposed guidance related to aggregated exposures and groups of items. Users are concerned about increased complexity related to understandability and comparability of financial statements through the increased opportunities to qualify for hedge accounting. Generally, regulators are against allowing hedge accounting for any groups of items because of the complications they foresee in allocating offset to individual components that may behave differently than changes in the hedged risk.

Hedge Effectiveness (Questions 14 and 15)

To qualify for hedge accounting, the IASB's proposed guidance would require that the hedging relationship both:

(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.

The IASB decided that the objective of the hedge effectiveness assessment should not be based on particular level of hedge effectiveness (similar to the 80–125 percent range required in IAS 39). Rather, the IASB believes that the objective of the hedge effectiveness assessment should reflect that hedge accounting is based on the notion of offset. Under the IASB's proposed guidance, the qualifying criteria for hedge accounting would focus on the hedge ratio and require that there should be no expectation that changes in the value of the hedging instrument will systematically either exceed or be less than the change in value of the hedged item. As a result, hedging relationships should not be established (for accounting purposes) in such a way that they include a deliberate mismatch in the weightings of the hedged item and of the hedging instrument (BC82).

The IASB's ED proposed that hedge effectiveness is assessed at inception of the hedging relationship and on an ongoing basis (at a minimum at each reporting date or upon a significant change in the circumstances affecting the hedge effectiveness requirements, whichever comes first).

41. Most auditors and preparers express the need for additional guidance on what is meant by the terminology introduced in the IASB's ED, particularly *unbiased result* and *other-than-accidental offset.* While those respondents welcome the move away from the arbitrary 80–125 percent bright line toward a more qualitative analysis, they believe that the proposed terminology is vague and foresee operational challenges in determining whether a hedging relationship meets the effectiveness threshold under the proposed guidance. Those respondents request additional illustrative examples to demonstrate how an entity should apply the hedge effectiveness assessment.

42. Some auditors and preparers note that the *reasonably effective* terminology in the FASB's proposed Update is preferred for the effectiveness threshold. Those respondents prefer the *reasonably effective* threshold over the IASB's proposed

guidance because *reasonably effective* is more in line with the objective of risk management, is broad enough to accommodate most hedging strategies, and assures a higher level of effectiveness based on the presumption that a reasonably effective offset would inherently encompass one that is other-than-accidental.

43. Some preparers express concern about the *unbiased result* threshold because it seems more stringent than the reasonably effective criterion put forth in the FASB's proposed Update. Some entities may seek a hedging relationship that is less than perfectly effective based on their expectations of changes in certain risk components, and requiring the higher level of an *unbiased result* may not align with the entity's risk management strategy. Additionally, maintaining a high standard of an unbiased result may require rebalancing every period, which would cause entities to incur significant transaction costs.

44. Some auditors and preparers presume that the elimination of retrospective effectiveness analysis was intended to reduce the administrative burden of quantitative effectiveness testing. While some preparers welcome this change, others are not convinced that it will have the intended effect. Because of their assumption of the high threshold established by the *unbiased result* criterion, several preparers foresee the need to conduct burdensome quantitative analysis to ensure the hedge relationship produces an unbiased result, thus undermining the IASB's objective to simplify hedge accounting and to reduce quantitative assessments.

45. Some auditors comment that the proposed guidance is devoid of a discussion of the ineffectiveness measurement for cash flow hedge accounting. Current U.S. GAAP provides three methods for measuring the ineffective portion of cash flow hedges, one of which is the hypothetical derivative method. The FASB's proposed Update would require entities to use the hypothetical derivative method in measuring the effectiveness of a cash flow hedging relationship. Respondents support the FASB's proposal because the hypothetical derivative method is the method most widely used in practice. Furthermore, the elimination of other methodologies in

measuring ineffectiveness in cash flow hedging would serve to reduce complexity and diversity in practice.

46. Regulators share some of the opinions of auditor and preparer respondents. Regulators support the FASB's *proposed reasonably* effective criterion over the IASB's proposed criterion. Those respondents note that the *reasonably effective* threshold would be better understood by users and preparers, while establishing a higher hurdle than other-than-accidental. In the regulators' view, the other-than-accidental threshold could lead to weakly correlated relationships qualifying for hedge accounting. Additionally, regulators are concerned that the proposed effectiveness criteria could lead to most hedging relationships qualifying for hedge accounting, thereby effectively establishing an unrestricted hedge accounting option. Regulators did not comment on the removal of the retrospective effectiveness testing, but did express support for maintaining prospective testing. While regulators did not specify how frequently they believe prospective effectiveness testing should occur, they did make reference to the "change in circumstances" basis put forth in the FASB's proposed Update as a potential starting point.

47. Users note general concern about the proposed hedge effectiveness criteria. Similar to auditors and preparers, users believe the terms *unbiased result* and *other-than-accidental* offset are not clearly defined. Users are concerned about the lack of comparability and decision usefulness they foresee in the proposed criteria, rather than about the challenges in applying the proposed guidance operationally. Similar to regulators, users emphasize that hedge accounting is intended to be an exception to the classification and measurement guidance. Users perceive the effectiveness threshold as significantly lower in the proposed guidance than in current U.S. GAAP, thereby enabling entities to invoke the hedge accounting measurement exception far more frequently.

Changes to a Hedging Relationship (Questions 16 and 17)

> *The IASB's ED 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 ED would require the entity to discontinue hedge accounting. 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 prospectively to continue to qualify for hedge accounting.*

48. Most auditors and preparers agree with voluntary, proactive rebalancing but disagree with required rebalancing and the prohibition of voluntary discontinuation. Generally, those respondents support the inclusion of a rebalancing notion as this reflects what an entity commonly does as part of its risk management activities. Voluntary rebalancing would allow hedge accounting to continue in accordance with dynamic risk management, which enables hedge accounting to be more closely aligned with risk management. However, some are concerned that required rebalancing might result in an operationally burdensome accounting exercise rather than reflecting risk management objectives.

49. Another concern auditors and preparers raise is the threshold for required rebalancing. The proposed guidance states that rebalancing would be required when the hedging relationship ceases to meet the objective of the hedge effectiveness assessment but the risk management objective for that designated relationship remains the same. Because of the lack of clarity perceived by those respondents around the criteria related to hedge effectiveness (as noted in paragraphs 41–47), those respondents indicate that the same ambiguity carries over to determining when an entity is required to rebalance. Those respondents believe that additional guidance should more specifically address when hedge effectiveness is maintained versus when an entity must rebalance a relationship. Furthermore, those respondents are concerned by the requirement to rebalance, as opposed to voluntary rebalancing. If the threshold for rebalancing is such that frequent

rebalancing is necessary to maintain hedge effectiveness, then required rebalancing will result in increased transaction costs and operational burdens.

50. Auditors and preparers also foresee some operational challenges in determining when a change to a hedging relationship is one that requires rebalancing versus a new risk management strategy requiring discontinuation. Those respondents request additional guidance and illustrative examples on this delineation. As noted in paragraphs 12–19 of this comment letter summary, many stakeholders request clarification on the level of granularity to which risk management strategy applies. Because a change in the entity's risk management strategy and objective warrants discontinuation, guidance must contain sufficient rigor to avoid diversity in practice. Several auditors also raise questions related to the accounting ramifications for an entity failing to rebalance a hedging relationship.

51. Most auditors and preparers believe that voluntary discontinuation should remain in hedge accounting guidance. The primary argument for this position is that hedge accounting is inherently a voluntary election and, therefore, discontinuing hedge accounting should be voluntary as well. Additionally, voluntary dedesignation is allowed under current U.S. GAAP and IFRS, and numerous auditors and preparers state that they are not aware of abuses related to voluntary dedesignation.

52. Auditors and preparers note that while voluntary discontinuation is explicitly removed from the IASB's proposed guidance, it remains possible to achieve. If an entity were to assert that its risk management objective has changed subsequent to the proper designation and documentation of a hedging relationship, then the entity could essentially discontinue the designated relationship at will. Another auditor notes that the lack of clarity in the rebalancing versus discontinuation issue, discussed in paragraph 49 above, could also provide management with discretion in voluntarily discontinuing a hedging relationship.

53. Users are concerned about the notion of rebalancing because they believe it will allow management to mask hedge ineffectiveness and avoid its recognition in profit and loss. Users argue that entities will be able to remain in hedge accounting indefinitely by asserting that the risk management objective has not changed. At

that point, managers will be able to rebalance ineffective relationships without having to disclose that such actions have been taken. Users are concerned that this practice will give a false sense to financial statement users that hedging relationships are effectively offsetting identified risks. (It is noted that the IASB's ED allows hedge accounting to continue only when the hedging relationship continues to meet all hedge qualifying criteria.)

Accounting for the Time Value of Options (Question 18)

The IASB's ED would allow an entity to separate the intrinsic value and time value of an option contract and to designate as the hedging instrument only the change in intrinsic value of the option. When an entity makes this election, the treatment of the change in the fair value of the time value of an option would differ depending on whether the option hedges a time-period-related hedged item or a transaction-related hedged item.

- *For time-period-related hedged items, the change in fair value of an option would be recognized in other comprehensive income. The original time value paid to the option writer or seller is amortized on a rational basis over the term of the hedging relationship.*
- *For transaction-related hedged items, the change in fair value of an option would be recognized in other comprehensive income like time-period-related hedged items; however, the amount accumulated in other comprehensive income is reclassified to profit or loss in the same period or periods during which the hedged expected future cash flows affect earnings.*
- *For transaction-related hedged items in which the hedged item subsequently results in the recognition of a nonfinancial asset or nonfinancial liability, changes in the fair value of an option would initially be recognized in other comprehensive income and then capitalized as a basis adjustment of the hedged item upon recognition of the nonfinancial asset or liability.*

54. Most auditors and preparers support the IASB's proposed guidance to capitalize the time value of an option as a basis adjustment of nonfinancial items. They agree that the initial time value of the option is a cost associated with a hedging relationship and, therefore, should be capitalized as a basis adjustment. Several of those stakeholders also express support for the ability to defer changes in the fair value of the time value of options in other comprehensive income. Those

respondents note that this treatment, currently allowed under U.S. GAAP, improves the information reported in financial statements.

55. A preparer respondent disagrees with the proposed guidance to capitalize the time value of an option as a basis adjustment of nonfinancial items. That stakeholder believes that allowing such treatment reduces comparability of the information in the financial statements. That stakeholder argues that if two identical assets are purchased at the same time and in the same way, but one is hedged and the other is not, then the assets should be recorded at the same initial carrying amount. The respondent notes that under the proposed guidance, the hedged and unhedged assets will be initially recorded at different carrying values, which reduces comparability.

56. While most auditors and preparers generally support the IASB's proposed guidance regarding time value of options, some express concern about the separate treatment for transaction-related items and time-period-related items. They argue that the separate treatment makes hedge accounting more complex and compliance more cumbersome. Some respondents suggest that the Boards explore a broader principle that accommodates both transaction-related and time-period-related items.

57. Additionally, some auditors and preparers believe that the terminology *aligned time value* is unclear. Those respondents maintain that this new terminology should not be introduced if existing terminology that is more widely understood conveys the same meaning and is still relevant. Therefore, those respondents suggest the use of *time value of the hypothetical derivative* instead of *aligned time value.*

58. Users do not support the proposed guidance to capitalize the time value of options. They believe that treatment will mismatch the expense with a period beyond the hedging period. Users assert that the IASB draws an inappropriate analogy between the time value of options and insurance premiums. They argue that accounting for insurance premiums as prepaid assets is appropriate because the premiums can be recovered from the insurer if the contract is cancelled. Unless an option premium can be recouped, users believe that it is inappropriate to capitalize the portion of the premium identifiable to the time value of the option.

Hedge Accounting Presentation and Disclosures (Questions 19–22)

For fair value hedges, the IASB's proposed guidance 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.

59. Most auditors, preparers, users, and regulators disagree with the proposed guidance to present gains and losses in other comprehensive income. Several of those respondents note that the Boards should undertake a joint project on the conceptual rationale for other comprehensive income before widely expanding its use. Other respondents are unsure how the proposed presentation requirements are superior to the current requirements and, therefore, those respondents do not view the cost-benefit trade off of the proposed presentation requirements as favorable. Those respondents contend that disclosures could provide adequate transparency without cluttering the face of the financial statements. Users note that while a common method for both fair value hedges and cash flow hedges is desired, they would prefer more gain or loss recognition to flow through earnings than through other comprehensive income.

The IASB's ED 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.

60. Most auditors, preparers, regulators, and accountancy bodies do not support the proposal to present changes in fair value attributable to the hedged risk as a separate line item in the statement of financial position. Those respondents reiterate concerns around undue clutter on the face of the financial statements, and that concern may be especially true for certain entities, such as financial institutions, that likely heavily invoke fair value hedging. Additionally, several of those respondents believe that the basis adjustment will be immaterial; thus, it is

unwarranted as a separate line item. Furthermore, some preparers argue that a basis adjustment does not meet the definition of an asset or liability and consequently should not be presented as a separate line item. Most auditor and preparer respondents suggest that basis adjustment information would be more useful if presented in disclosures.

The IASB's ED would require disclosures about the risks that an entity decides to hedge and for which hedge accounting is applied.

61. Many auditors and preparers raise concerns about the proposed disclosure requirements. One major concern of those stakeholders is the forecasted information required in paragraph 46 of the IASB's ED. Those respondents feel that forward-looking information is subjective and could lead to auditing challenges. Those respondents are also concerned by the proposal to disclose commercially sensitive information such as the hedged interest rates. Those disclosures may place entities that apply hedge accounting at a disadvantage compared to those that do not apply hedge accounting because the disclosures would apply only to entities that invoke hedge accounting.

62. To avoid adverse affects on entities that apply hedge accounting, an auditor suggests making the requirements in paragraph 46 of the IASB proposed guidance optional. Another alternative suggested by a preparer and also an accountancy body states that the forward-looking information required as part of the risk management disclosures would be more appropriate in the Management Discussion & Analysis (MD&A) section of an entity's financial report, which is beyond the scope of the audit, rather than in the notes to the financial statements.

63. Other respondents, however, call for additional disclosure requirements. Users and one auditor believe that the proposed disclosures lack specificity and fail to require disclosure of the entity's full risk management strategy. Those respondents argue that certain items, such as unhedged risks, economic hedging activities for which hedge accounting is not elected, and hedge effectiveness testing methodologies are not required to be disclosed under the proposed guidance.

Targeted changes to U.S. GAAP versus convergence with the IASB's model

64. The FASB proposed several targeted changes to hedge accounting guidance as part of its proposed Update. The FASB also proposed some additional disclosures related to derivatives and hedging. In summary, the proposed Update encompassed the following principal changes to current U.S. GAAP:

    (a) Lowering the current *highly effective* threshold for qualifying for hedge accounting to *reasonably effective.*

    (b) Replacing the current requirement for quantitative-based assessments of hedge effectiveness with qualitative-based assessments for many hedging relationships.

    (c) Eliminating the short-cut method and critical terms match method for assessing hedge effectiveness.

    (d) Reducing the required frequency of hedge effectiveness assessments after inception of a hedge from quarterly (at a minimum) to only when a change in circumstances suggests that a hedging relationship may no longer be reasonably effective.

    (e) Removing an entity's current ability to discontinue hedge accounting treatment by simply dedesignating the hedging relationship.

    (f) For cash flow hedges, expanding the current requirement to recognize ineffectiveness in profit or loss for "over hedges" also to apply to "under hedges" (similar to foreign exchange hedges). (For hedges that are not foreign exchange hedges, current U.S. GAAP requires ineffectiveness to be recognized in profit or loss only when the cumulative change in fair value of the actual derivative exceeds the cumulative change in fair value of the hypothetical derivative. The proposed Update also would require ineffectiveness to be recognized in profit or loss when the cumulative change in fair value of the actual derivative is less than the cumulative change in fair value of the hypothetical derivative.)

65. All of the following main features of the derivative instruments and hedging activities guidance in Topic 815 are retained by the proposed guidance:

    (a) The types of items and transactions that are eligible for hedge accounting in Topic 815 would continue to apply.

    (b) An entity would be able to continue to designate particular risks in financial items as the risks being hedged in a hedging relationship.

    (c) The types of risks eligible as hedged risks in Topic 815 would continue to apply.

66. Stakeholders' feedback on the targeted changes in the proposed Update is largely consistent with the broad themes represented in feedback received on the ITC. Convergence is an extremely important priority for stakeholders. Stakeholders support a simplified hedge accounting model that is less rules-based than current U.S. GAAP. Stakeholders support an expansion of bifurcation by risk to include additional benchmark interest rates and, in some cases, nonfinancial items. Those stakeholders believe that the expansion of the bifurcation by risk approach to additional risk components of both financial and nonfinancial items would better align financial reporting with the entity's risk management strategy. Finally, many stakeholders comment that the Board should undertake a joint effort with the IASB to address portfolio hedging and macro hedging.

67. Generally, stakeholders are very supportive of lowering the threshold for hedge effectiveness from *highly effective* to *reasonably effective.* In addition, stakeholders support a more qualitative-based approach for testing hedge effectiveness. Those stakeholders note that the proposed changes to hedge effectiveness testing would relieve some operational complexities in complying with hedge accounting requirements.

68. Many stakeholders also support limiting diversity in practice in hedge accounting application, such as measurement of cash flow hedge ineffectiveness. Stakeholders broadly support mandating the use of the hypothetical derivative method. Nevertheless, stakeholders do not support the recognition of ineffectiveness for

cash flow under hedges, as stipulated by the proposed Update, because of the creation of a “phantom” gain or loss in other comprehensive income. Numerous auditors and preparers remark that recognition of cash flow under hedges reflects the results of a hypothetically perfect hedge in other comprehensive income, rather than the results of the executed transaction. Many auditors and preparers note that cash flow over hedges (excess ineffectiveness) accurately reflect actual gains/losses arising from the hedging derivative.

69. Generally, stakeholders do not support the elimination of the short-cut and critical terms match methods for qualifying for hedge accounting. In addition, stakeholders do not agree with, or understand, the conceptual basis for prohibiting voluntary dedesignation. Stakeholders note that those elements of the proposed Update seem arbitrary and would impede and limit the related operational burdens qualifying for hedge accounting.

70. The final question in the ITC relates to whether stakeholders prefer a “targeted approach” to hedge accounting reform, such as that proposed by the FASB in its proposed Update, or a more substantial overhaul of hedge accounting guidance, such as that proposed by the IASB’s proposed guidance.

71. The majority of respondents to the ITC emphasize the importance of convergence. Some respondents encourage the Board to undertake an effort to limit differences between current U.S. GAAP and IFRS in the basic model for derivative accounting (particularly regarding the definition of a *derivative instrument* and the exceptions to derivative accounting) to ensure that true hedge accounting convergence is achievable. In response to the final question in the ITC, many stakeholders note that one approach should not develop into a prevailing approach. Instead, many stakeholders believe that the positive aspects of both the FASB’s and the IASB’s approaches could be merged into a comprehensive improvement of hedge accounting guidance. Those stakeholders note that the Boards share a fundamental objective of simplification of the hedge accounting model.

72. Most auditors and preparers applaud the IASB’s broader scale effort to address hedge accounting, especially with respect to a more principles-based approach.

Nearly all respondents support the removal of “bright lines” in hedge effectiveness criteria and quantitatively driven hedge effectiveness testing.

73. Most respondents support a hedge accounting framework that builds off of an entity’s existing economic hedging and risk management programs. Auditors and preparers also emphasize the importance of both Boards addressing macro hedging. In addition, most auditors and preparers encourage the Board to develop guidance on hedging risk components (including credit risk and prepayment risk) in both financial and nonfinancial items. Although regulators may be critical of the IASB’s methodology in achieving a wider reaching hedge accounting model, they are supportive of broader revisions than those in the FASB’s proposed Update. Users generally do not support changes to hedge accounting that would result in an increase in the amount of hedging relationships being reported in the financial statements without additional information on all aspects of risk management, including risk management activities outside of accounting hedges.

74. Some auditors and preparers prefer only “targeted changes” because those respondents contend that the exiting hedge accounting model is not fundamentally flawed and requires only modest revisions to simplify and improve it. Those respondents acknowledge that the core principles of hedge accounting are well understood in the preparer and auditor community. Those respondents are concerned that the IASB’s proposed guidance would introduce unnecessary complexity and ambiguity to the accounting model. In other terms, those respondents believe that the costs associated with the ambiguity (that is, lack of comparability and potential for abuse) around main criteria in the IASB’s hedge accounting model outweigh the potential benefits of simplification. Some preparers suggest that the FASB move forward in the short term with targeted changes that would focus on hedge effectiveness and risk component hedging, which would relieve operational complexity and provide an opportunity for convergence in the long term.

Miscellaneous Feedback Received

75. Stakeholders also raised some miscellaneous concerns that are not directed at any particular question in the ITC.

76. Some auditors and preparers encourage the IASB and the FASB to take this opportunity to address existing differences between U.S. GAAP and IFRS in derivative accounting, such as the definition of a *derivative instrument* and the normal purchases and normal sales scope exception to derivative accounting. Stakeholders contend that true convergence related to hedge accounting cannot be achieved unless the Boards address broadly some existing differences in derivative accounting.

77. Many stakeholders note that the definition of a *derivative instrument* under IFRS may be broader than under U.S. GAAP. For example, U.S. GAAP requires a contract to contain a notional amount (or payment provision) and an underlying. IAS 39 does not include a notional amount requirement. In addition, U.S. GAAP requires derivatives to have a net settlement feature, whereas IFRS does not.

78. Several preparers raise concerns about the ultimate resolution of a current difference between U.S. GAAP and IFRS related to the "normal purchases and normal sales scope exception," as it is referred to under U.S. GAAP. IFRS refers to it as the "own use exception."

79. The normal purchases and normal sales scope exception relates to contracts for the physical delivery of a nonfinancial item for the purposes of an entity's own use. The exception is intended to exclude conventional physical supply arrangements from derivative accounting treatment. A critical existing difference is that under U.S. GAAP the scope exception is effectively elective because the Board created certain documentation requirements that must be met to qualify for the exception; an entity could always choose not to complete the documentation for a derivative contract that otherwise would qualify for the normal purchases and normal sales scope exception, thereby allowing the contract to be accounted for as a derivative (rather than under accrual basis accounting). Under IAS 39, an entity is required to account for the contract under the accrual basis of accounting if it meets the criteria

for an own use contract. Therefore, no inherent option for derivative accounting is available under IAS 39.

80. Auditors and preparers largely support the IASB's proposed guidance to allow an election for derivative accounting for own use contracts if it eliminates or significantly reduces an accounting mismatch. Those respondents believe that a derivative accounting election for these contracts is most consistent with the IASB's overall objective to align the accounting model to an entity's risk management strategy. In addition, respondents believe that the IASB's proposed guidance is more similar to current U.S. GAAP than the guidance in IAS 39. Preparers contend that the election for derivative accounting for these contracts should be available on a contract-by-contract basis to accommodate the various products, services, and risks inherent in those transactions.

Private Company Feedback Received

81. The Board received only two comment letters representing the views of private company preparers and auditors. Those letters were received from the Private Company Financial Reporting Committee (PCFRC) and the Technical Issues Committee of the AICPA Private Companies Practice Section (TIC). This section of the document summarizes private company issues and concerns related to hedge accounting, broadly, and the IASB's proposed guidance on hedge accounting.

82. Private companies are primarily concerned about cash flow and fair value hedging strategies that employ interest rate swaps. In connection with long-term, variable-rate borrowing arrangements, private companies often concurrently enter into variable-to-fixed interest rate swaps with the lenders who sell those swaps to borrowers as an accommodation to the borrowers. (While borrowers prefer fixed long-term loans, lenders are unwilling to issue loans on those terms; therefore, borrowers take out variable-rate loans, and concurrently enter into variable-to-fixed swaps to mitigate their long-term variable interest rate exposure. Those swaps with the lender as the counterparty are advantageous for the borrower because the collateral posted on the underlying note also serves as the collateral for the swap;

thus, in the event the swap moves against the borrower's favor, the borrower does not need to post additional collateral.) Private company respondents state that those swaps are usually held to maturity. Additionally, those respondents note that financial statement users are concerned about cash flow because, in those loan-and-swap arrangements, the periodic net cash flow of the loan and interest rate swap represents the net fixed interest payments. Private company respondents indicate that the entities who lend to the private companies are the primary users of the private companies' financial statements, and, as the counterparty to the swaps, they therefore understand the nature of the swaps and disregard the fair value adjustments.

83. Private companies contend that hedge accounting, in the interest rate swap situations described above, does not provide relevant information to private company financial statement users because those users "back out" the fair value adjustments of those swaps. Therefore, it is not relevant to those users whether the adjustments are reported in earnings or comprehensive income. Those stakeholders believe that applying hedge accounting to those instruments is operationally burdensome, especially regarding effectiveness testing and complying with documentation requirements.

84. The two letters from private company stakeholders suggest different alternatives for addressing this issue. In one comment letter, the PCFRC urges the Board to develop a simplified approach to hedge accounting for interest rate swaps. The PCFRC prefers a simplification of hedge effectiveness testing, such as qualitative triggers and a lower effectiveness threshold. That respondent contends that disclosure of the borrowing commitment and the related termination liability on the swap would provide sufficient decision-useful information for users and, thus, prefers disclosure to accounting that would create volatility in the statement of comprehensive income.

85. TIC suggests the prohibition of hedge accounting for interest rate swaps that are sold to private companies as an integral part of a lending arrangement. As discussed in paragraph 82 above, private company borrowers typically enter into

variable-to-fixed interest rate swaps with the lender serving as the counterparty. Because the primary users of the financial statements are the counterparty to the swap and, therefore, understand the nature of the swap and disregard the fair value adjustments, TIC suggests prohibiting hedge accounting for those specific instances to ease the burden on private company preparers to comply with hedge accounting requirements. TIC also advocates an outcome that would reflect fair value changes of the swap in other comprehensive income unless a triggering event occurred that called the effectiveness of the swap into question.

86. Private company respondents generally support the principles-based approach for hedge accounting set forth by the IASB's proposed guidance. Those stakeholders welcome qualitative criteria for effectiveness testing and also support the elimination of retrospective hedge effectiveness testing.

87. Private companies do not support the IASB's proposed disclosure requirements. They believe those disclosures are too extensive and overly complex. They are also concerned that disclosure of risk management strategies may become "boiler plate" to prevent the erosion of competitive advantage through disclosure of proprietary information.