



August 23, 2013

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

File Reference No. PCC-13-03

The Accounting Principles Committee of the Illinois CPA Society (Committee) appreciates the opportunity to provide its perspective on the proposed Accounting Standards Update, *Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps – a proposal of the Private Company Council*. The Committee is a voluntary group of CPAs from public practice, industry and education. Our comments represent the collective views of the Committee members and not the individual views of the members or the organizations with which they are affiliated.

Overall, we question the benefit of adding additional hedge accounting models to U.S. GAAP, given that there are already a number of alternatives—e.g. ‘shortcut,’ ‘critical terms match,’ ‘long-haul’ – and adding additional alternatives would add complexity.

The proposed ‘simplified hedge accounting approach’ appears to be just a repackaging of the existing shortcut approach where some of the criteria have been broadened – e.g. moving from ‘the repricing dates match’ to the repricing [...] dates [...] match or differ by no more than a few days.’ If the Board believes that the criteria for the existing shortcut approach are too narrow, then we believe that it should amend its criteria to provide relief for all entities as part of its current project on hedge accounting, rather than creating a new ‘even shorter shortcut’ approach.

In addition, we struggle with the conceptual basis for applying synthetic accounting under the proposed ‘combined instruments approach’, particularly when there are different counterparties to the swap and debt instrument. (See our response to question 7.)

We believe that there are other ways for the Board to provide significant relief for private companies without introducing additional hedge accounting models to U.S. GAAP in advance of the completion of the Board’s existing project on hedge accounting. For example:

- The Board could generally permit private companies to complete their hedge documentation within a few weeks of the hedge designation. Such relief would be available for all types of hedging relationships.¹ In our view, this would be a sensible accommodation to private companies that is justified by their limited resources.
- The Board could permit interest rate swaps (or potentially even all derivatives) to be measured at settlement value (i.e. excluding the effect of own and counterparty credit risk), rather than at fair value, as long as it is probable that both counterparties will perform under the contract based on a qualitative assessment. In our experience, one of the most challenging aspects of accounting for hedging activities for private companies is evaluating CVA/DVA adjustments in determining the fair

¹ Incidentally, the proposals would appear to only provide such relief under the ‘simplified hedge accounting approach’. Even if the ‘simplified hedge accounting approach’ is approved by the Board, we would support permitting private companies to complete their hedge documentation within a few weeks of hedge designation for all hedging relationships.

value of derivatives, particularly interest rate swaps. This challenge exists regardless of whether the company actually applies hedge accounting. Providing this relief would not require the introduction of a new hedging model, but could instead be approached similarly to the election that the Board previously allowed for entities to measure the fair value of certain interests in funds using the reported net asset value (NAV), as a practical expedient to measuring fair value.

We believe that providing relief along the lines described above would be of significant benefit to private companies, while adding less complexity to U.S. GAAP than the proposals and also avoiding the conceptual problems with ‘synthetic accounting.’

However, we have provided responses to the specific questions asked in the exposure draft should the Board decide to proceed with adding one or both of the proposed models to U.S. GAAP.

1. Please describe the entity or individual responding to this proposed Update.

The organization and operating procedures of the Committee are outlined in Appendix A to this letter. The majority of individuals on our Committee work for large, medium and small public accounting firms. Those individuals are mostly engaged in the area of auditing. Other individuals on our Committee are accountants that are investors, industry professionals, or academics.

2. Do you agree that the scopes of both the combined instruments approach and the simplified hedge accounting approach should exclude financial institutions described in paragraph 942-320-50-1, such as banks, savings and loan associations, savings banks, credit unions, finance companies, and insurance entities? If not, please explain why. Are there any other entities that should be excluded?

We agree that the scopes of the combined instruments and simplified hedge accounting approaches should exclude financial institutions. It is our view that most of the private companies that lack the expertise to qualify for cash flow hedge accounting and the resources to prepare the documentation concurrent with designating a hedge, and that would benefit from hedge accounting, are non-financial institutions. Therefore, we believe that the proposed scope appropriately targets the amended guidance to the entities that most need relief from current hedge accounting requirements.

3. Question 3: Should the Board consider expanding the scope of either the combined instruments approach or the simplified hedge accounting approach (or both) to other entities, such as publicly traded companies or not-for-profit entities? If the scope is expanded to other entities, what changes, if any, should the Board consider for these approaches? Please explain why.

We do not believe the Board should consider expanding the scope of the proposed guidance to other entities. We note that PCC undertook this project, along with others on its agenda, to respond specifically to concerns from private company preparers, based on a presumption that private and public companies are sufficiently different to warrant divergent accounting standards in certain areas. Therefore, we believe this question should be, and has been, addressed more broadly, as evidenced by the establishment of the PCC and the Private Company Decision-Making Framework.

Further, we believe that the current guidance on hedge accounting has been in place and accompanied by voluminous implementation guidance for a sufficient period that any amendments should be as narrowly scoped as possible until the FASB and IASB complete the derivatives and hedging phases of their projects on accounting for financial instruments.

4. Do you agree with the required criteria for applying the combined instruments approach and the simplified hedge accounting approach, respectively? If not, please explain why.

We believe that certain clarifications are necessary to ensure that the proposed criteria function properly.

First, we believe that the proposed criteria should address the risk of being in an overhedge position at any point during the term of the hedge. While the criteria for both the combined instruments and simplified hedge accounting approaches require the notional amount of the swap to be less than or equal to the principal amount of the debt at inception, it is unclear what happens if, for example, the debt amortizes and the swap does not, leading to a future position where the notional amount of the swap is greater than the principal amount of the debt.

Second, it is unclear whether the duration of the indexed variable rate must be the same for the derivative and the hedged item. The first criterion for both the combined instruments and the simplified hedge accounting approaches uses 1-month LIBOR as an example. We believe the proposed guidance should make clear whether an arrangement where the variable rate on the swap is based on 1-month LIBOR and the variable rate on the debt is based on 3-month LIBOR would satisfy the first criterion under either of the proposed approaches.

5. *Do you agree with the differences in criteria for applying the combined instruments approach versus the simplified hedge accounting approach? If not, please explain why.*

We agree with the differences in criteria between the two approaches.

6. *For applying the combined instruments approach, should additional criteria about management's intent to hold the swap to maturity (unless the borrowing is prepaid) be included? Please explain why.*

We do not believe that additional criteria about management's intent to hold the swap to maturity should be included for applying the combined instruments approach. In our view, adding such criteria would require additional guidance around the 'tainting' notion for applying the combined instruments approach. We believe that the objective of this scope exception is sufficiently clear that additional guidance about management's intent is unnecessary, and that indications that management's intent in applying the combined instruments approach is something other than synthetically creating a fixed-rate debt instrument can be evaluated on a case-by-case basis by companies and their auditors.

In addition, we are not concerned that situations would become prevalent where entities flip in and out of the combined instruments approach provided that our understanding is correct that the proposed guidance specifies the subsequent accounting for arrangements that no longer qualify for the scope exception, and that the criteria as currently proposed would prohibit a swap or debt instrument that was subject to the combined instruments approach but was later disqualified from being 'redesignated' in a new combined instruments arrangement. For example, if an entity prepaid its debt subject to the combined instruments approach and then entered into another borrowing, it would be unable to apply the combined instruments approach to the new borrowing and the pre-existing swap because the two instruments have different terms and became effective at different dates.

7. *Under the combined instruments approach, should there be a requirement that there have been no adverse developments regarding the risk of counterparty default such that the swap is not expected to be effective in economically converting variable-rate borrowing to fixed-rate borrowing? Please explain why or why not.*

We believe that the proposed guidance should consider the issue of differences between the risk of counterparty default for the swap and the hedged debt. One way to address this issue would be to

limit the scope of the combined instruments approach to arrangements where the lender is also the swap counterparty. Another way to address this issue would be to add a requirement that management periodically assess whether there have been adverse changes in the risk of counterparty default such that the swap no longer effectively converts the variable rate borrowing to a fixed rate borrowing.

We believe that the scope of the combined instruments approach should be limited to arrangements where the lender is also the swap counterparty.

One of the main benefits of the combined instruments approach is that it does not require periodic effectiveness assessments. By introducing a requirement to consider changes in counterparty default risk, we believe that entities applying the combined instruments approach would be subject to some form of ongoing effectiveness assessment, and that the cost versus benefit analysis of the combined instruments approach should be reconsidered to determine whether it sufficiently reduces complexity to warrant its introduction to U.S. GAAP for private companies.

We also believe that the premise for the combined instruments approach is that an entity has economically entered into a fixed rate borrowing, although the arrangement is structured as two instruments: a variable rate note and an interest rate swap. We believe there is a fundamental difference between an arrangement where a lender provides a variable rate loan and another counterparty enters into an interest rate swap with the borrower, and an arrangement where a lender provides a variable rate loan and also acts as the swap counterparty to effectively provide a fixed rate loan. When the lender and the swap counterparty are the same, the swap counterparty's risk of default is mitigated by the borrower's ability to withhold payments on the debt in lieu of cash settlement on a swap that is in an asset position from the borrower's perspective, and this effect will remain in place as long as both instruments are outstanding. An arrangement where the swap counterparty is not the lender, on the other hand, is subject to future changes in default risk that cannot be mitigated by lending relationship, and therefore is unlike a fixed rate borrowing, despite the fair value of the swap being zero at inception of the hedge.

8. *Do you agree that the primary difference between settlement value (that is, the amount to be paid to or received from the swap counterparty to terminate the swap) and fair value is that generally the nonperformance risk of the swap counterparties is not considered in the settlement value? If not, please explain why.*

It is our understanding that the primary difference between the settlement value and fair value of a swap is typically due to the nonperformance risk of the swap counterparties. However, we note that the settlement value depends on the inputs and assumptions of the swap counterparty, which might differ from those that a market participant would use in valuing the swap. Therefore, there may be situations where a significant difference between settlement value and fair value results from factors other than nonperformance risk.

9. *Would disclosure of the swap's settlement value (instead of its fair value) adequately provide users of financial statements with an indication of potential future cash flows if the swap were to be terminated at the reporting date? If not, please explain why.*

We believe that, generally, disclosure of the swap's settlement value would provide similar information to users of financial statements as would disclosure of the swap's fair value. However, we believe that in certain situations where the swap counterparty's credit position deteriorates subsequent to inception of the swap, disclosure of the swap's settlement value would not adequately inform users.

10. *Are the costs of obtaining and auditing settlement value significantly less than fair value? Please explain why.*

We believe that the costs of obtaining the settlement value are significantly less than the costs of obtaining fair value. However, we do not believe that the costs of auditing the settlement value are significantly less than the costs of auditing fair value. It is our understanding that the settlement value provided by the swap counterparty is not intended to represent the amount of cash that would be transferred at the reporting date to settle the swap. Therefore, we believe that auditors will have to undertake procedures to understand and assess measurement of the settlement amount, which could involve similar procedures as those to audit third party fair value measurements.

11. *Do you agree that the following should be disclosed if the combined instruments approach is applied and that no additional disclosures should be required? If not, please explain why.*
- a. *The settlement value of the swap (along with the valuation method and assumptions)*
 - b. *The principal amount of the borrowing for which the forecasted interest payments have been swapped to a fixed rate and the remaining principal amount of the borrowing that has not been swapped to a fixed rate*
 - c. *The location and amount of the gains and losses reported in the statement of financial performance arising from early termination, if any, of the swap*
 - d. *The nature and existence of credit-risk-related contingent features and the circumstances in which the features could be triggered in a swap that is in a loss position at the end of the reporting period.*

We agree with the proposed disclosure requirements.

12. *Do you agree that the current U.S. GAAP disclosures, including those under Topics 815 and 820 should apply for a swap accounted for under the simplified hedge accounting approach and that the settlement value may be substituted for fair value, wherever applicable? If not, please explain why.*

We agree that the current disclosures required under ASC 815 should apply for a swap accounted for under the simplified hedge accounting approach. However, we are concerned that the disclosure requirements in ASC 820 might be difficult to apply by simply substituting settlement value for fair value. For example, it is unclear how an entity would make the “leveling” determination (i.e. Level 1, 2, or 3) based on a swap’s settlement value.

13. *Do you agree with providing an entity-wide accounting policy election for applying the combined instruments approach? If that policy election is availed, should this approach be applicable for all qualifying swaps, whether entered into on or after the date of adoption or existing at that date? If not, please explain why.*

We agree with applying an entity-wide accounting policy election for applying the combined instruments approach, and we believe that it should be applicable to all qualifying swaps.

14. *Do you agree that the entity-wide accounting policy election to apply the combined instruments approach must be made upon adoption of the amendments in this proposed Update or, for entities that do not have existing eligible swaps, within a few weeks after the entity enters into its first transaction that is eligible for the accounting policy election? If not, please explain why.*

We agree that the entity-wide accounting policy election to apply the combined instruments approach must be made upon adoption of the proposed guidance or within a few weeks of the entity entering into its first eligible arrangement.

15. *Do you agree that the simplified hedge accounting approach could be elected for any qualifying swaps, whether existing at the date of adoption or entered into on or after the adoption date? If not, please explain why.*

We agree that the simplified hedge accounting approach could be elected for any qualifying swaps.

16. *Do you agree that the election to apply the simplified hedge accounting approach to an existing qualifying swap must be made upon adoption of the amendments in this proposed Update? If not, please explain why.*

We agree that this election should be made for existing qualifying swaps upon adoption of the proposed guidance.

17. *Do you agree that the formal documentation required by paragraph 815-20-25-3 to qualify for hedge accounting must be completed within a few weeks of hedge designation under the simplified hedge accounting approach? If not, please explain why.*

We agree with allowing private companies a few weeks from the designation date to prepare formal hedge documentation.

18. *Do you agree that entities within the scope of this proposed Update should be provided with an option to apply the amendments in this proposed Update using either (a) a modified retrospective approach in which the opening balances of the current period presented would be adjusted to reflect application of the proposed amendments or (b) a full retrospective approach in which financial statements for each individual prior period presented and the opening balances of the earliest period presented would be adjusted to reflect the period-specific effects of applying the proposed amendments? If not, please explain why.*

We agree with the proposed transition options.

19. *Do you agree that an entity within the scope of this proposed Update should be permitted to early adopt the proposed amendments? If not, please explain why.*

We agree that early adoption should be permitted.

20. *How much time is needed to implement the proposed amendments? Please explain.*

We do not believe a significant amount of time would be needed to implement the proposed guidance.

21. *The scope of this proposed Update uses the term publicly traded company from an existing definition in the Master Glossary. In a separate project about the definition of a nonpublic entity, the Board is deliberating which types of business entities would be considered public and would not be included within the scope of the Private Company Decision-Making Framework. The Board and PCC expect that the final definition of a public business entity resulting from that project would be added to the Master Glossary and would amend the scope of this proposed Update. The Board has tentatively decided that a public business entity would be defined as a business entity meeting any one of the following criteria:*

- a. *It is required to file or furnish financial statements with the Securities and Exchange Commission.*

- b. It is required to file or furnish financial statements with a regulatory agency in preparation for the sale of securities or for purposes of issuing securities.*
- c. It has issued (or is a conduit bond obligor) for unrestricted securities that can be traded on an exchange or an over-the-counter market.*
- d. Its securities are unrestricted, and it is required to provide U.S. GAAP financial statements to be made publicly available on a periodic basis pursuant to a legal or regulatory requirement.*

Do you agree with the Board's tentative decisions reached about the definition of a public business entity? If not, please explain why.

We believe this question should be addressed in response to the proposed Accounting Standards Update, *Definition of a Public Business Entity: An Amendment to the Master Glossary*.

We appreciate the opportunity to offer our comments.

Sincerely,

Scott G. Lehman, CPA
Chair, Accounting Principles Committee

Amanda M. Rzepka, CPA
Vice-chair, Accounting Principles Committee

APPENDIX A

ACCOUNTING PRINCIPLES COMMITTEE
ORGANIZATION AND OPERATING PROCEDURES
2013-2014

The Accounting Principles Committee of the Illinois CPA Society (Committee) is composed of the following technically qualified, experienced members appointed from industry, education and public accounting. These members have Committee service ranging from newly appointed to more than 20 years. The Committee is an appointed senior technical committee of the Society and has been delegated the authority to issue written positions representing the Society on matters regarding the setting of accounting standards. The Committee's comments reflect solely the views of the Committee and do not purport to represent the views of their business affiliations.

The Committee usually operates by assigning Subcommittees of its members to fully study and discuss exposure documents proposing additions to or revisions of accounting standards. The Subcommittee ordinarily develops a proposed response that is considered, discussed and voted on by the full Committee. Support by the full Committee then results in the issuance of a formal response, which at times includes a minority viewpoint. Current members of the Committee and their business affiliations are as follows:

Public Accounting Firms:

Large: (national & regional)

Ryan Brady, CPA	Grant Thornton LLP
Todd Briggs, CPA	McGladrey LLP
Brian Chmiel, CPA	Crowe Horwath LLP
Frank Dery, CPA	PricewaterhouseCoopers LLP
John Hepp, CPA	Grant Thornton LLP
David Jamiolkowski, CPA	Baker Tilly Virchow Krause, LLP
Scott Lehman, CPA (Chair)	Crowe Horwath LLP
Elizabeth Prossnitz, CPA	BDO USA LLP
Robert Sledge, CPA	KPMG LLP

Medium: (more than 40 professionals)

Timothy Bellazzini, CPA	Sikich LLP
Christopher Cameron, CPA	Kutchins Robbins & Diamond Ltd
Michael Kidd, CPA	Mowery & Schoenfeld LLC
Gary Mills, CPA	Frost Ruttenberg & Rothblatt PC
Tad Render, CPA	Miller Cooper & Company Ltd
Steven Roiland, CPA	Kessler Orlean Silver & Co., PC
Jeffery Watson, CPA	Miller Cooper & Company Ltd

Small: (less than 40 professionals)

Peggy Brady, CPA	Selden Fox, Ltd.
Brian Kot, CPA	Cray Kaiser Ltd CPAs

Industry:

Rose Cammarata, CPA	CME Group Inc.
Farah Hollenbeck, CPA	Abbott Laboratories
Joshua Lance, CPA	N Pritzker Capital Management LLC
Marianne Lorenz, CPA	AGL Resources Inc.
Michael Maffei, CPA	GATX Corporation
Anthony Peters, CPA	McDonald's Corporation
Amanda Rzepka, CPA (Vice Chair)	Jet Support Services, Inc.
Richard Tarapchack, CPA	Navistar International Corporation

Educators:

Martin Coe, CPA	Western Illinois University
James Fuehrmeyer, Jr., CPA	University of Notre Dame

Staff Representative:

Gayle Floresca, CPA	Illinois CPA Society
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