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PCC-13-03
Comment Letter No. 27

Ms. Susan M. Cospers
Technical Director
Financial Accounting Standards Board
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23 August 2013

Proposed Accounting Standards Update, *Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps*, a proposal of the Private Company Council (File Reference No. PCC-13-03)

Dear Ms. Cospers,

We appreciate the opportunity to comment on the Private Company Council's and Financial Accounting Standards Board's (FASB or Board) Proposed Accounting Standards Update, *Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps* (the proposed Update).

We support providing relief to private companies under US GAAP while continuing to provide relevant information to users of private company financial statements. We support the Board's overall objective of simplifying hedge accounting for interest rate swaps that allow companies to economically convert variable-rate borrowings to fixed-rate borrowings. Although we believe both of the approaches described in the proposed Update would support the Board's overall objective, we support the simplified hedge accounting approach because it is more aligned with existing GAAP and has more widespread application. In contrast, we question whether the combined instruments approach (i.e., accounting for the swap and a borrowing as a single financial instrument) should be permitted.

The Board has had a long-standing view that derivative instruments should be recognized separately in the financial statements. We do not believe that the Board has presented a sufficiently compelling basis for reversing this key principle of Topic 815. We believe that derivatives meet the definitions of assets or liabilities and, as such, should be reported in financial statements. Derivatives have a significantly different economic profile from debt and their existence should be transparent to the financial statement user. We believe that the combined instrument approach, which is in effect synthetic instrument accounting, would reduce transparency in this area and could be a step backwards for financial statement users.

We also observe that the FASB staff stated in its discussion paper¹ on the private company decision-making framework that the FASB and the Private Company Council (PCC) are using to determine whether and when to provide alternatives for private companies under US GAAP, that it doesn't intend

¹ Invitation to Comment on a Private Company Decision-Making Framework, *A Framework for Evaluating Financial Accounting and Reporting Guidance for Private Companies*

to create “an entirely new conceptual framework that would lead to a basis for preparing financial statements of private companies that is fundamentally different from the basis for preparing financial statements of public companies.” We believe the combined instruments approach would, in fact, provide a different hedge accounting framework for private companies.

Furthermore, we do not understand the basis for applying the combined instruments approach for a loan and a swap with different counterparties. We believe a key requirement of a synthetic instrument approach should be that the loan and the swap have the same bank counterparty and the company has the right to offset if the counterparty defaults. While we could support the combined instruments approach if certain changes were made, as more fully described in the Appendix to this letter, we generally believe that if the FASB wants to pursue the combined instruments approach, it should do so as part of its broader hedge accounting project.

Simplified hedge accounting approach

We support the simplified hedge accounting approach as a reasonable alternative to the current hedge accounting model for private companies. We believe it would address concerns that private companies have about the complexity of applying hedge accounting while at the same time keep intact the principles of hedge accounting that are outlined in Topic 815. We generally support providing a qualitative method to assess hedge effectiveness, similar to what is already outlined in ASC 815-20-25-102 through 25-111 and ASC 815-20-55-71 (formerly paragraph 68 of Statement 133).

The simplified hedge accounting approach also would allow private companies to apply hedge accounting to interest rate hedges that don’t use benchmark rates defined in Topic 815. We believe this would provide greater flexibility for private companies and would at least partially converge US GAAP with IFRS. The simplified hedge accounting approach could be further enhanced to apply to other hedging relationships such as refinancings of existing debt or forecasted issuance of floating rate debt, hedged with a forward starting swap.

We do, however, have some concerns with the simplified hedge accounting approach that we discuss in the Appendix to this letter, where we provide our detailed responses to the Board’s specific *Questions for Respondents*. We also believe the simplified hedge accounting approach, especially allowing interest rate hedges of non-benchmark interest rate indexes, should also be considered for public companies.

Consideration for other entities

We believe that not-for-profit entities, which also have concerns about the costs and complexity of applying hedge accounting, should be able to apply the proposed Update.

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We would be pleased to discuss our comments with the Board or its staff at your convenience.

Very truly yours,



Responses to specific questions raised in the Proposed Accounting Standards Update, *Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps*

Question 1:

Please describe the entity or individual responding to this proposed Update. For example:

- a. Please indicate whether you primarily are a preparer, user, public accountant, or other (if other, please specify).
- b. If you are a preparer of financial statements, please indicate whether your entity is privately held or publicly held and describe your primary business and its size (in terms of annual revenue, the number of employees, or other relevant metric).
- c. If you are a public accountant, please describe the size of your firm (in terms of number of partners or other relevant metric) and indicate whether your practice focuses primarily on public entities, private entities, or both.
- d. If you are a user of financial statements, please indicate in what capacity (for example, lender, investor, analyst, or rating agency) and whether you primarily use financial statements of private entities or those of both private entities and public entities.

Response:

Ernst & Young LLP is one of the largest firms auditing both public and private entities. We currently audit approximately 3,000 private entities, ranging from small start-ups and family-owned enterprises to large privately held multinational corporations.

Question 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? (See also Question 3 below.)

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.

Response:

As noted in our cover letter, we believe this proposal should apply to not-for-profit entities. We share the Board's concern about relaxing the hedge accounting requirements for financial institutions.

We believe the Board should explore whether to allow public companies to apply a simplified hedge accounting model. As noted in our cover letter, we also believe that, if the Board wants to pursue the combined instruments approach, it should do so as part of its broader hedge accounting project.

Question 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.

Question 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.

Question 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.

Question 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.

Response:

As noted in our cover letter, we question whether the combined instruments approach should be permitted, especially when the loan and swap have different counterparties because that would be fundamentally different from existing GAAP.

If the Board ultimately decides to include the combined instruments approach in any final guidance, we believe that the following criteria should be added:

- ▶ All of the terms of the interest rate swap and the variable rate debt should match, including the counterparties. We believe there should be a high hurdle to apply synthetic instrument accounting. Given that the interest rate swap contract is generally structured in contemplation of specific variable-rate debt, we do not believe that this would be an onerous requirement.
- ▶ Management's intent to hold the swap to maturity (unless the borrowing is prepaid) should be required and early termination of a swap without a corresponding prepayment of the borrowing should be very infrequent (as discussed in paragraph BC14). Allowing one instrument to be terminated before the other would violate the synthetic instrument principle that allows two instruments to be accounted for as one. However, we would support termination of the derivative if there were credit concerns with the derivative counterparty.

- ▶ Entities should be required to consider the risk of counterparty default in the initial and continued qualification for hedge accounting. This would be similar to the current requirements under Topic 815.

If the Board decides to permit early termination of only the swap, the resulting gain or loss should be reported in a manner that does not permit an entity to manage earnings by harvesting gains or losses from derivatives. We question whether instead of recognizing gains and losses on terminated swaps designated in the combined instrument approach currently in earnings, they should instead be amortized over the remaining term of the hedged debt consistent with current GAAP for dedesignated cash flow hedges when the forecasted cash flows are still probable.

We also have the following suggestions for the simplified hedge accounting approach:

- ▶ Because many entities do not wait until their existing facility terminates before refinancing and extending the term of the borrowing, we believe entities should be allowed to refinance their debt and still be able to apply the simplified hedge accounting approach, if all other criteria are met.
- ▶ We believe the Board should consider permitting application of the simplified hedge accounting approach to forward starting receive-variable, pay-fixed interest rate swaps designated to hedge forecasted floating rate interest payments. Companies often use a forward starting swap to hedge the forecasted interest payments that will occur when they extend borrowings under a facility that hasn't yet matured with a new facility. Bank facilities are typically extended up to two years before maturity to ensure the required financing isn't interrupted. We believe that, as part of this project or a future project, the Board should consider allowing the simplified hedge accounting approach for this common risk management strategy.
- ▶ Any final ASU should specifically address current cash flow hedge accounting issues presented by typical terms of floating rate loans made by banks in the US. The following typical terms could raise questions about whether most floating rate loans would meet proposed criteria a., c. and g. to qualify for both of the simplified proposed approaches.
 - ▶ Banks typically allow borrowers to prepay principal at par on each interest rate reset date. Under current US GAAP, companies must assert that it is probable that they will reject this option or will issue new debt to replace the prepaid debt so they can meet the cash flow hedge accounting requirement that the likelihood of hedged forecasted cash flows occurring is probable. Any final ASU should address how a simplified approach would apply to floating rate loans that give the borrower this option. Consideration should also be given to the impact if the debt is unexpectedly prepaid at par.
 - ▶ Borrowers often have the option to select the interest rate reset index (e.g., LIBOR, US Treasury, Prime, or an "Alternate Base Rate," as defined in the debt agreement) and/or the reset frequency (e.g., monthly, quarterly, semi-annually). Such variable-rate bank debt is sometimes referred to as "you-pick-'em" debt because of the flexibility provided to the borrower. The final ASU should address how a simplified approach would apply to this type of debt.

We believe the Board should clarify the proposed requirement for both approaches that the swap's fair value at inception be at or near zero. As drafted, the proposal suggests that companies could apply the simplified approach to swaps that have been structured "off-market," (e.g., to include fees or to include an initial up-front payment that is "near zero").

We do not support application of the simplified approach to "off-market" swaps or swaps with initial upfront payments due to "off-market" terms. We suggest the Board include in any final ASU language similar to the following excerpt from Statement 133 Implementation Issue No. E23:

The fair value of the swap may be other than zero at the inception of the hedging relationship only if the swap was entered into at the relationship's inception, the transaction price of the swap was zero in the entity's principal market (or most advantageous market), and the difference between transaction price and fair value is attributable solely to differing prices within the bid-ask spread between the entry transaction and a hypothetical exit transaction.

Question 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.

Question 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.

Question 10:

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

Question 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.

Question 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.

Response:

Settlement value versus fair value

We have concerns about the proposal's use of the term "settlement value," because this measurement objective is not defined in US GAAP. In addition, we note that the amount to be paid to or received from the swap counterparty to terminate the swap will not necessarily be equal to the fair value of the instrument excluding its nonperformance risk. A swap's termination value may take into account other adjustments, such as the cost to fund early settlement or payout.

We suggest that the FASB simply describe the measurement objective for derivatives accounted for under the simplified hedge accounting approach as fair value excluding any consideration of nonperformance risk, if this is the Board's intent. This measurement objective could also be used for disclosure purposes under the combined instrument approach if the FASB chooses to pursue that approach.

We could support the use of the settlement value measurement objective in situations where the counterparty to the swap is also the lender and there is an agreement in place that allows for the netting of the two instruments upon default. However, we question the exclusion of counterparty credit risk in the measurement of the derivative instrument in situations where the counterparty to the swap is not the lender.

In addition, we recommend that any final ASU not include a suggestion that the lender "provides the swap's value to the entity for reporting purposes," as the proposal states in paragraph BC7. We do not believe that swap valuation statements provided by banks to their customers are intended to meet the financial reporting measurement objective, whether that objective is fair value, settlement value, termination value or another objective.

Disclosures

We support providing a simpler measurement alternative under Topic 820 for certain end-users of derivatives. However, as noted above, we don't believe the swap's settlement value, as defined in the proposal, would necessarily provide the swap's termination value at the reporting date, and disclosing the settlement value without providing additional context about why it could differ from termination value may be misleading.

It is also not clear whether the cost of obtaining and auditing settlement value would be significantly less than the cost of obtaining fair value, given that valuing plain vanilla interest rate swaps within the context of Topic 820 is generally well understood in practice.

Otherwise, we agree with the disclosure requirements for both approaches.

Question 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.

Question 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.

Response:

We do not believe that applying the combined instruments approach should be an entity-wide election. Instead, we believe it should be applied on an instrument-by-instrument basis, similar to what is proposed for the simplified hedge accounting approach. This would align the accounting election with the evaluation criteria, which requires each instrument to be evaluated separately. An entity-wide election could result in entities structuring their derivative contracts in ways that would not qualify when they do not want to apply the combined instruments approach (e.g., by executing the swap more than a few days after the effective date of the borrowing).

Question 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.

Question 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.

Response:

We generally support allowing the simplified hedge accounting approach to be applied to any qualifying swaps, whether existing at the date of adoption or entered into on or after the adoption date. For any existing swaps, we believe that this election should be made upon adoption.

Question 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.

Response:

If the Board has received feedback from preparers indicating that additional time is needed to complete hedge accounting documentation, we would generally support providing private companies with additional flexibility. However, we question whether this aspect of the proposal would inappropriately provide management with time to look back on the performance of the derivative and then decide whether to apply hedge accounting under the proposed Update.

Question 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.

Response:

While we could support the proposed transition approaches, we generally believe that the amendments in this proposed Update should be applied only on a prospective basis for qualifying new or redesignated hedging relationships. Hedge accounting is an election and Topic 815 and the proposed amendments require formal designation and documentation of the hedging relationship before hedge accounting may be applied. Allowing retrospective application, while a practical approach, would appear to be fundamentally different from the contemporaneous hedge documentation requirement.

Question 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.

Question 20:

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

Response:

We believe early adoption should be allowed and, given that the proposed Update would simplify the accounting in this area, the time needed to implement the proposed Update would likely not be significant.

Question 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 will answer this question in our upcoming comment letter on the FASB's Proposed Accounting Standards Update, *Definition of a Public Business Entity*.