INTRODUCTION

1. On May 26, 2010, the Board issued proposed Accounting Standards Update, Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities—Financial Instruments (Topic 825) and Derivatives and Hedging (Topic 815). The Board performed extensive outreach to obtain feedback on this Exposure Draft from all stakeholders, including users, preparers, auditors, and regulators.

2. The comment period for the Exposure Draft ended on September 30, 2010. The Board received 2,814 comment letters, which were posted to the FASB’s website. However, only 248 of those comment letters addressed the Board’s proposed changes to hedge accounting. The table below provides information on the types of respondents who submitted comment letters that addressed the proposed changes to hedge accounting.

<table>
<thead>
<tr>
<th>Type of Respondent</th>
<th>Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>Users</td>
<td>11</td>
</tr>
<tr>
<td>Accounting Firms and Associations</td>
<td>27</td>
</tr>
<tr>
<td>Preparers by industry:</td>
<td></td>
</tr>
<tr>
<td>Banking</td>
<td>80</td>
</tr>
<tr>
<td>Energy and Utilities</td>
<td>8</td>
</tr>
<tr>
<td>Insurance</td>
<td>12</td>
</tr>
<tr>
<td>Manufacturing / Commercial</td>
<td>21</td>
</tr>
<tr>
<td>Technology</td>
<td>17</td>
</tr>
<tr>
<td>Other industries</td>
<td>6</td>
</tr>
<tr>
<td><strong>Total Preparers</strong></td>
<td><strong>144</strong></td>
</tr>
</tbody>
</table>
3. Stakeholders also provided feedback on the Exposure Draft through the following channels:

(a) Investor questionnaires. The Board received questionnaires from 28 investors. The investor questionnaire allowed users to provide confidential feedback on the Exposure Draft. Many of those investors focused on sectors in which entities actively hedge their commodities risk, such as airlines and food producers. The table below provides a more detailed breakdown of investors who submitted questionnaires by type and sector coverage.

<table>
<thead>
<tr>
<th>Type of Respondent</th>
<th>Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sellside Total</td>
<td>13</td>
</tr>
<tr>
<td>By Sector:</td>
<td></td>
</tr>
<tr>
<td>Accounting</td>
<td>4</td>
</tr>
<tr>
<td>Airlines</td>
<td>2</td>
</tr>
<tr>
<td>Agricultural Producers</td>
<td>1</td>
</tr>
<tr>
<td>Financials</td>
<td>4</td>
</tr>
<tr>
<td>Food Manufacturing</td>
<td>1</td>
</tr>
<tr>
<td>Utilities</td>
<td>1</td>
</tr>
<tr>
<td>Buyside Total</td>
<td>11</td>
</tr>
<tr>
<td>By Sector:</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Industry associations by industry:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Banking</td>
<td>13</td>
</tr>
<tr>
<td>Energy and Utilities</td>
<td>1</td>
</tr>
<tr>
<td>Insurance</td>
<td>4</td>
</tr>
<tr>
<td>Manufacturing / Commercial</td>
<td>1</td>
</tr>
<tr>
<td>Real Estate</td>
<td>4</td>
</tr>
<tr>
<td>Other industries</td>
<td>1</td>
</tr>
<tr>
<td><strong>Total Industry Associations</strong></td>
<td>24</td>
</tr>
<tr>
<td>Regulators</td>
<td>8</td>
</tr>
<tr>
<td>Consultants</td>
<td>10</td>
</tr>
<tr>
<td>Individuals</td>
<td>6</td>
</tr>
<tr>
<td>Other</td>
<td>18</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>248</td>
</tr>
<tr>
<td>Airline</td>
<td>1</td>
</tr>
<tr>
<td>--------------</td>
<td>---</td>
</tr>
<tr>
<td>Financials</td>
<td>7</td>
</tr>
<tr>
<td>Beverages</td>
<td>1</td>
</tr>
<tr>
<td>Industrials</td>
<td>1</td>
</tr>
<tr>
<td>Insurance</td>
<td>1</td>
</tr>
<tr>
<td><strong>Credit Rating Agency Total</strong></td>
<td><strong>4</strong></td>
</tr>
<tr>
<td><strong>By Sector:</strong></td>
<td></td>
</tr>
<tr>
<td>Oil &amp; Gas</td>
<td>1</td>
</tr>
<tr>
<td>Airlines</td>
<td>2</td>
</tr>
<tr>
<td>Industrials</td>
<td>1</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>28</strong></td>
</tr>
</tbody>
</table>

(b) Field visits with preparers. The Board and staff completed eight field visits with various entities, on a confidential basis, to discuss the operability and the costs and benefits of the Exposure Draft. Field visit participants included banking institutions of various asset sizes, nonfinancial entities, and an insurance company.

(c) In-person meetings and conference calls. The Board and staff received feedback from more than 120 investors and other users of financial statements who are employed by more than 60 firms through face-to-face meetings and calls with individual investors and groups of investors representing a variety of perspectives. (Approximately 80 percent of those investors were buy-side analysts, with two thirds of those buy-side analysts investing on a long-only basis, and the remainder employing a long/short strategy. The remaining investors were sell-side analysts specializing in either (1) bank/insurance-related sectors or accounting or (2) ratings agencies analysts.) The Board and staff also received feedback from numerous preparers, auditors, valuation specialists, and regulators through face-to-face meetings or calls with individual organizations or professional associations.

(d) Public roundtable meetings. The Board held 5 public roundtable meetings with more than 65 participants, including users, preparers, regulators, auditors, and others representing various perspectives.

4. This document provides a summary of significant feedback received on the proposed changes to the hedge accounting guidance in the Exposure Draft. Users’ views are
disaggregated from views expressed by other stakeholders, including preparers, auditors, and regulators.

OVERVIEW

5. The proposed changes to the hedge accounting guidance in the Exposure Draft were largely consistent with the proposed changes in the Board’s June 6, 2008 Exposure Draft, *Accounting for Hedging Activities*, with the following notable exceptions:

   (a) In the May 2010 Exposure Draft, the Board decided that it would continue to allow an entity to designate particular risks in financial items as the risks being hedged in a hedging relationship and only recognize the effects of the risks hedged in net income (commonly referred to as bifurcation-by-risk).

   (b) In the May 2010 Exposure Draft, the Board did not carry forward its changes to the guidance for hedging forecasted intercompany transactions that were proposed in the June 2008 Exposure Draft.

   (c) In the May 2010 Exposure Draft, the Board did not carry forward the effective date and transition requirements from the June 2008 Exposure Draft.

   (d) In the May 2010 Exposure Draft, the Board did not carry forward a proposal to permit a one-time fair value option for servicing assets, liabilities, and financial instruments that were designated as hedged items on the date immediately preceding initial application of the proposed Statement.

   (e) In the June 2008 Exposure Draft, the Board invited comments on whether it should prescribe the presentation of hedging gains and losses. This question was not included in the May 2010 Exposure Draft.
(f) Although the proposed disclosure requirements in the May 2010 Exposure Draft did not differ from the June 2008 Exposure Draft, the comments on the June 2008 Exposure Draft related mainly to the interaction between the proposed disclosure requirements and the elimination of bifurcation-by-risk for financial items and, therefore, are not relevant to the May 2010 Exposure Draft.

6. The comment letter summary for the June 2008 Exposure Draft is attached as Appendix A. However, those respondents’ comments on the exceptions noted in the preceding paragraph were removed or struck through because they are not relevant to the May 2010 Exposure Draft.

Feedback Received from Nonuser Stakeholders

7. Feedback received from nonuser stakeholders was generally consistent with the feedback received from those stakeholders in response to the June 2008 Exposure Draft. The issues highlighted by nonuser stakeholders in both Exposure Drafts are summarized below (and elaborated further in Appendix A):

(a) Hedge effectiveness requirements. Nonuser stakeholders supported a move from a “highly effective” to a “reasonably effective” threshold. They also supported the move to qualitative assessments (quantitative, if necessary) of effectiveness at hedge inception and then qualitative or quantitative reassessments only when facts and circumstances indicated that the hedging relationship may no longer be reasonably effective. They noted that these changes would simplify the application of hedge accounting and provide cost savings. However, there were concerns that the term *reasonably effective* was unclear and that new quantitative thresholds would develop in practice (for example, 60—167 percent or 50—200 percent), potentially creating diversity in practice. Additionally, nonuser stakeholders were concerned that without clearer guidance for when quantitative assessments of effectiveness would be required, auditors and regulators would compel entities to perform quantitative assessments to prove qualitative assertions.
(b) Elimination of shortcut and critical terms match methods. Nonuser stakeholders were mixed in their reactions to the proposal to eliminate these qualitative hedge accounting methods. Those who supported the elimination of those methods cited compliance difficulties and the number of restatements caused by inappropriate application of the methods. Supporters of retaining those methods stated they were useful and cost-effective for entities that do not have the resources to employ the quantitative long-haul method of hedge accounting.

(c) Prohibition on voluntary dedesignation. Virtually all nonuser stakeholders disagreed with the proposal to prohibit voluntary dedesignation of hedges. Preparers and auditors stated that they had not seen any instances of abuse or earnings management due to voluntary dedesignations. Nonuser stakeholders noted that there are many valid hedging strategies today (for example, delta neutral) that would not be allowed under the proposal. Nonuser stakeholders also indicated that entering into a derivative that fully offsets future changes in the fair value or cash flows of the original derivative may be difficult to achieve and that certain hedging instruments are not commonly traded on exchanges. Therefore, some hedges cannot be easily terminated by entering into an offsetting position. They also questioned whether this prohibition would apply to net investment hedges in foreign operations because those hedges currently require periodic dedesignation and redesignation as the balance of the net investment changes.

8. Additionally, nonuser stakeholders highlighted specific areas of concern in response to the May 2010 Exposure Draft, as follows:

   (a) Measuring and reporting ineffectiveness in cash flow hedging relationships for underhedges

   (b) Hedged risks:

     (i) Benchmark interest rates

     (ii) Components of nonfinancial items.

   (c) Transition requirements

   (d) Disclosures.
Measuring and Reporting Ineffectiveness in Cash Flow Hedging Relationships for Underhedges

9. The guidance in the Exposure Draft would require that the measurement of hedge ineffectiveness be based on a comparison of the change in fair value of the actual derivative designated as the hedging instrument and the present value of the cumulative change in expected future cash flows of the hedged transaction. The balance of accumulated other comprehensive income would reflect the amount necessary to offset the present value of the cumulative change in expected future cash flows on the hedged transaction from inception of the hedge less the amount previously reclassified from accumulated other comprehensive income into net income. That would result in reporting ineffectiveness in net income regardless of whether either of the following occurs:

   (a) The cumulative change in fair value of the actual derivative exceeded the cumulative change in fair value of the derivative that would mature on the date of the forecasted transaction and provide cash flows that would exactly offset the hedged cash flows (referred to as an overhedge).

   (b) The cumulative change in fair value of the derivative that would mature on the date of the forecasted transaction and provide cash flows that would exactly offset the hedged cash flows exceeded the cumulative change in fair value of the actual derivative (referred to as an underhedge).

10. The majority of nonuser stakeholders disagreed conceptually with the proposed requirement to recognize in net income ineffectiveness for underhedges in cash flow hedging relationships because they asserted that the requirement would defer nonexistent gains or losses on a hedging instrument in other comprehensive income and recognize in net income offsetting nonexistent gains or losses. Those stakeholders stated that other comprehensive income would now reflect the results of a transaction that an entity did not enter into (the perfect hypothetical derivative) rather than reflecting the results of a transaction that the entity did enter into (the actual derivative used as the hedging instrument). Although those stakeholders agreed that the proposal would more closely align cash flow hedging with fair value hedging, they maintained that the proposed requirement for underhedges would not provide meaningful information about an entity’s hedging activities for users of the entity’s financial statements. Furthermore, those
stakeholders expressed support for the requirement and basis in current generally accepted accounting principles (GAAP), which requires only ineffectiveness on overhedges to be recognized in net income.

11. Some regulators agreed with the proposed requirement to recognize in net income ineffectiveness on underhedges because it would more closely align cash flow hedging with fair value hedging. Those regulators noted that the consistency would result in improved financial reporting. Other nonuser stakeholders either did not provide feedback on the proposed requirement to recognize in net income ineffectiveness for underhedges or stated that the proposed requirement was operable.

**Hedged Risks**

12. The Exposure Draft would not change the types of risks eligible as hedged risks under current GAAP. Many nonuser stakeholders recommended that the Board consider expanding the types of risks that could be hedged in both financial and nonfinancial items in a hedging relationship.

**Benchmark Interest Rate**

13. Many nonuser stakeholders, primarily financial institutions, stated that the eligible risks under current GAAP are too restrictive for hedging of interest-rate risk in financial items. When this Exposure Draft was issued, GAAP considered only the interest rates on U.S. Treasury obligations and the London Interbank Offered Rate (LIBOR) swap rate as benchmark interest rates for hedging interest-rate risk. (Note: The Federal Funds Effective Swap Rate or Overnight Index Swap Rate was added as a benchmark interest rate in July 2013.) Those stakeholders stated that entities are frequently exposed to market risks of other indexes and requested that the Board expand the definition of benchmark interest rate to include other common indexes such as the Federal Funds Effective Swap Rate, the Prime Rate, or the Securities Industry and Financial Markets Association Municipal Swap Index. Those stakeholders noted that expanding the definition of benchmark interest rate would increase the number of transactions that qualify for hedge accounting, which would result in a better reflection of an entity’s operations.
**Components of Nonfinancial Items**

14. Current GAAP allows an entity to designate particular risks in financial items as the risks being hedged in a hedging relationship and recognize only the effects of those risks in net income (commonly referred to as bifurcation-by-risk). Many nonuser stakeholders requested that the Board also permit bifurcation-by-risk for nonfinancial items. Those stakeholders stated that entities hedge nonfinancial items by components of risk similar to financial items. Furthermore, those stakeholders noted that bifurcation-by-risk for nonfinancial items would improve financial reporting by providing information about whether or not an entity was successful in managing the risk exposures it intended to manage.

15. Many of those stakeholders requested that the Board permit an entity to designate a risk that is separately identifiable and measurable as the risk being hedged for both financial and nonfinancial items. Those stakeholders stated that the approach would increase the number of transactions that would qualify for hedge accounting, reduce the complexity of current hedge accounting guidance, and converge with the International Accounting Standards Board’s (IASB) decisions on hedge accounting.

**Transition Requirements**

16. Many nonuser stakeholders stated that the Board should provide additional transition guidance, including the following:

   (a) Guidance on existing hedging relationships that are applying the shortcut method or the critical terms match method but would no longer qualify for hedge accounting under the proposed guidance or would measure ineffectiveness using the “long-haul” method

   (b) Guidance on how an entity should account for previously dedesignated and redesignated hedging relationships

   (c) Guidance on changing from a quantitative to qualitative effectiveness assessment.
17. Some nonuser stakeholders recommended that the Board allow existing hedging relationships to be “grandfathered” and, therefore, require the proposed guidance to be applied prospectively only.

**Disclosures**

18. To help users better understand the effect of applying fair value hedge accounting in Topic 815, Derivatives and Hedging, the Exposure Draft would require an entity to disclose information about the resulting adjustments to the carrying amount of a hedged asset or liability. The Exposure Draft would require disclosures about maturities and contractual and average interest rates associated with issued debt or other borrowings for which an entity designates interest-rate risk as the hedged risk in a hedging relationship.

19. The comments from preparers and auditors did not focus specifically on the hedging disclosure requirements but rather on disclosure issues regarding classification and measurement and impairment. Because the proposed changes to the accounting for financial instruments were comprehensive, a number of preparers and auditors urged the Board to review all financial instruments’ disclosures to eliminate redundancies and provide the most decision-useful information rather than use a piecemeal approach.

20. However, a few preparers and auditors commented that the issue of voluntary redesignation could be handled more effectively through enhanced disclosures rather than through a prohibition.

**Feedback Received from Users**

21. Only two users submitted comment letters in response to the June 2008 Exposure Draft. Comments received from those users are included in Appendix A as part of the comment letter summary on the June 2008 Exposure Draft.

22. The Board received feedback from additional users regarding the May 2010 Exposure Draft. As described in paragraphs 2 and 3 of this document, feedback on the May 2010 Exposure Draft was received from users through various channels, including comment
letters, investor questionnaires, in-person meetings and conference calls, and public roundtable meetings.

23. The feedback received from users through in-person calls and meetings preceding and following issuance of the May 2010 Exposure Draft was significantly different in some areas from the feedback in comment letters received from users in response to both the 2008 and the 2010 Exposure Drafts. The staff believes this can be attributed to the investors’ perspectives (buyside versus sellside and sector emphasis) as well as their knowledge of the intricacies of hedge accounting. The in-person outreach was performed with investors that may not have had a deep understanding of hedge accounting. Their comments were based on their understanding of hedging transactions and hedging accounting’s effects on reported results, as well as the education that was provided to them about issues such as effectiveness testing and hedging risk components. Those who wrote comment letters seemed to have a deeper understanding of hedge accounting and its requirements.

24. The feedback from users below is additional to the feedback included in Appendix A because the proposed guidance in the May 2010 Exposure Draft is largely consistent with the proposed guidance in the June 2008 Exposure Draft. The summary of significant feedback received from users on the changes to the hedge accounting guidance in the May 2010 Exposure Draft is organized as follows:

(a) Overall comments

(b) Hedged risks

(c) Hedge effectiveness requirements

(d) Prohibition on voluntary dedesignation of hedging relationships

(e) Measuring and reporting ineffectiveness in cash flow hedging relationships for underhedges

(f) Disclosures.
Overall Comments

25. Most users agreed with the Board’s goal of simplifying hedge accounting. However, responses differed between financial and nonfinancial sector users about how and why hedge accounting should be simplified.

26. For most nonfinancial sector users, managing the cost of an input and protecting revenue were often the targeted goals of risk management strategies. In this regard, many users acknowledged the idea that hedging does not eliminate risk but rather transforms risk and, thus, the objective of hedge accounting and related disclosures should be to improve a user’s understanding of an entity’s risk management strategy. For example, many of the users emphasized that they value predictability. They highlighted that commodities have been increasingly volatile over the last few years. Many noted that any reduction in this volatility is good risk management. An entity might decide that it ultimately will increase its overall cost relative to an entity that has not managed its risk. However, if it can increase its predictability, there is value in doing so. This is obviously a trade-off and depends on the extent to which costs and margins might be negatively affected by the strategy. Most financial and nonfinancial users commented that a specialized accounting model that allows for qualifying changes in derivatives to be deferred on the balance sheet and recognized in earnings along with the underlying balance sheet item would be a benefit to financial reporting. Therefore, most of the nonfinancial users noted that the expansion of hedge accounting generally would be an improvement to financial reporting because it would better represent the economics of the underlying transaction—a derivative being purchased to hedge/fix future price fluctuation. However, many of the users who analyze financial services companies were generally concerned about the expansion of hedge accounting due to the current analytical complexity presented by bifurcation-by-risk and a lack of understanding of reported hedge ineffectiveness.

27. Most financial users said that they do not make standard adjustments for hedging transactions that do not qualify for hedge accounting. Those who do stated that it is a difficult process to get to non-GAAP results. They typically try to exclude mark-to-market accounting on a derivative that did not qualify for hedge accounting or was not elected but is effective at reducing risk. Some investors also adjust net income for qualifying hedging
transactions. Those investors said that they try to identify either (a) closed out positions that were deemed to be effective and remain in other comprehensive income waiting to be recognized in net income (when the hedged item affects earnings) or (b) open positions for which the volatility may have been recognized in net income as ineffectiveness but it has the potential to be reversed in future periods. The process is difficult because preparers often do not disclose detailed information on ineffectiveness reported on the income statement. They assume this is because it is immaterial and/or is included within other income and expense. They still believe ineffectiveness should be reported immediately and are concerned that entities would abuse hedge accounting to speculate if ineffectiveness was not accurately measured and recorded each period.

28. Based on discussions with nonfinancial sector users, the most common adjustment made to reported hedging results is to exclude the mark-to-market effect of hedging transactions that did not qualify for hedge accounting treatment from reported net income. Those users informed the staff that management will often include this volatility in the press release so it is generally easy to remove. Similar to financial users, some nonfinancial users also adjust net income for qualifying hedging transactions. Those investors stated that they try to identify open positions for which volatility may have been recognized in net income as ineffectiveness but may be reversed in future periods over the life of the hedging relationship. Many of those nonfinancial sector users also stated that they see ineffectiveness for cash flow hedges as part of the “total cost” of the input that should be disclosed each period but recognized when the hedged item affects net income.

29. Some users, particularly those who analyze financial services companies, stated that the current hedge accounting guidance is too complicated, obscures risks, and should not be allowed. Some of those users recommended that the Board require all financial instruments to be measured at fair value. Those users argued that measuring both the hedged item and the hedging instrument at fair value results in increased transparency about risks because of an entity’s hedging activities and risks due to economic and market conditions that affect the entity. Those users also noted that measuring all financial instruments at fair value would reduce the need for complicated hedge accounting guidance.
30. One user stated that better comparability and transparency would be achieved if hedge accounting were mandatory rather than optional. That user stated that this approach to hedge accounting would more closely align financial reporting with the economic substance of business activities.

31. Some users stated that they would prefer more transparent disclosures on an entity’s hedging strategies, including information about management’s intent when entering into hedging relationships, how the hedging relationship is managed, and whether or not the hedging relationship is effective.

**Hedged Risks**

32. Most nonfinancial users mentioned that risk management strategy should qualify for special accounting as long as it has a valid business purpose. Nonfinancial users in particular were frustrated by the inability to obtain hedge accounting for certain hedges that reduce price volatility. They noted that management would not be motivated to undertake additional risk disguised as risk management. They stated that the market would penalize entities if they hedged risks that were not obvious in reducing overall risk or once those strategies did not perform well. They continued that good disclosure about the risk management strategies and linkage to underlying risk would be critical in their evaluations of the risk management strategies. Most maintained that risk components should not be precluded from qualifying for special accounting as long as the hedging strategies meet effectiveness tests.

33. Financial users supported specialized accounting for risk management activities and were comfortable with the risk component hedging that exists today. However, most financial users were uncomfortable expanding hedging to components that are not specifically identified in a contract. They stated that doing so might allow for too much financial engineering, which might be difficult for the users to understand and analyze.

**Hedge Effectiveness Requirements**

34. Most users supported the change to a reasonably effective threshold from highly effective and the use of qualitative effectiveness assessments. Those users stated that those proposed
changes would improve financial reporting because they would increase the number of hedging relationships that would qualify for hedge accounting and reduce artificial volatility in net income caused by accounting mismatches, resulting in more consistent presentation of hedging relationships over time. Those users added that entities that currently have chosen not to apply hedge accounting because of the costs and complexities associated with the current effectiveness guidance in GAAP may be able to apply hedge accounting as a result of the proposed changes.

35. A few users did not support the proposed changes to the effectiveness assessment. Those users stated that the proposal would increase complexity because reasonably effective is not clearly defined and, therefore, may not be applied consistently in practice. Additionally, some users noted that the circumstances that would require a qualitative versus quantitative assessment of hedge effectiveness are unclear. Furthermore, those users noted that transparency would be reduced because the proposed changes would increase the number of less effective economic hedges that would qualify as hedges under the accounting guidance, resulting in a deferral of derivative gains and losses.

Prohibition on Voluntary Dedesignation of Hedging Relationships

36. Most users agreed that hedge accounting should not be allowed to be terminated at will without termination of the underlying hedging relationship (either through sale, effective termination, or proof that the hedge is no longer effective).

37. One user disagreed with limiting dedesignation and redesignation because it would prohibit an entity from reflecting a change in strategy or particular risk management due to changes in economic cycles or changes in management’s business and risk preferences.

Measuring and Reporting Ineffectiveness in Cash Flow Hedging Relationships for Underhedges

38. One user commented on the proposed requirement to recognize in net income ineffectiveness for underhedges. That user agreed with consistent treatment for both overhedges and underhedges and stated that it would better reflect economic hedge ineffectiveness for cash flow hedging relationships. Generally, however, users have not
supported the recognition of hypothetical gains and losses in other comprehensive income arising from the “perfect hedge.”

Disclosures

39. The following are disclosures that most users said they would find useful:

   (a) An entity’s gross exposure to a particular risk. Most stated that they already have a sense of this based on their knowledge of the entities they cover. For example, in the airline industry, analysts and investors typically have estimates of what fuel consumption is expected to be over the next few years. This is helpful because it gives the investor a sense of which risks exist and they can evaluate what types of actions management is or is not taking to manage those risks.

   (b) Which risks are or are not being managed. Some discussion of how risks are being managed (derivatives, natural hedges, and so forth) would be helpful, but analysts were concerned about boilerplate information. Most analysts also mentioned that they have a general sense of the most significant risks to which an entity is exposed so that when a management team does not discuss its risk management plans, the assumption is that the particular risk is not being managed. This information would help an investor determine how hedging has transformed the risks that the entity has managed and/or to analyze the risks that are unmanaged.

   (c) What percentage of the total exposure is being hedged and over what time periods? For example, 100 percent of the expected exposure for the next 2 years and 50 percent for Years 3 and 4. In particular, investors would benefit from better linkage of the underlying exposures to the contracts (with an appropriate level of detail) used to hedge those exposures. This helps an investor determine the future exposure to a particular risk.

   (d) How will the hedges affect the future income statement and cash flows, by period, based on today’s prices? How much of the amounts in other comprehensive income have been realized and unrealized? For example, how much gain or loss recorded in other comprehensive income is the result of a derivative position that has been closed out but will not be recognized in net income until the hedged item affects
earnings (for example, the sale of inventory)? This helps an analyst evaluate the future earnings and cash flow based on existing prices.

(e) How will the hedges affect the future income statement and cash flows if underlying prices change? This helps an analyst evaluate the future earnings and cash flow based on sensitivity to potential future price changes.

(f) What would the financial statement effect have been absent hedging? This helps an analyst determine whether the hedging was positive or negative to an entity’s earnings and cash flows, by period.

(g) How effective or ineffective were the hedges? Disclosure and more detailed qualitative and quantitative explanations of the success of the risk management strategy. This helps an investor determine whether or not the risk management strategies worked the way they were supposed to and, if not, what were the effects of the failure of the risk management strategy.

Appendix A

A1. Below is the comment letter summary for the Board’s June 2008 Exposure Draft, *Accounting for Hedging Activities*, which was posted on the project page of the FASB website. Comments received related to the items noted in paragraph 5 above are removed or struck through because those comments are not relevant to the Board’s May 2010 proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities—Financial Instruments (Topic 825) and Derivatives and Hedging (Topic 815).*

**ACCOUNTING FOR HEDGING ACTIVITIES**

**COMMENT LETTER SUMMARY**

**OVERVIEW**

1. The comment period ended on August 15, 2008. As of October 5, 2008, comment letters were received from 127 respondents, summarized below.

**Respondent Profile**
<table>
<thead>
<tr>
<th>Type of Respondent</th>
<th>Number</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Public Accounting</strong></td>
<td></td>
</tr>
<tr>
<td>Accounting Firm</td>
<td>3</td>
</tr>
<tr>
<td>Big 4 Accounting Firm</td>
<td>4</td>
</tr>
<tr>
<td>CPA Society</td>
<td>5</td>
</tr>
<tr>
<td>Industry Organization</td>
<td>1</td>
</tr>
<tr>
<td><strong>Total Public Accounting</strong></td>
<td><strong>13</strong></td>
</tr>
<tr>
<td><strong>Preparer</strong></td>
<td></td>
</tr>
<tr>
<td>Entertainment</td>
<td>1</td>
</tr>
<tr>
<td>Financial</td>
<td>47</td>
</tr>
<tr>
<td>Health Care</td>
<td>2</td>
</tr>
<tr>
<td>Industry</td>
<td>12</td>
</tr>
<tr>
<td>Industry Organization</td>
<td>5</td>
</tr>
<tr>
<td>Insurance</td>
<td>7</td>
</tr>
<tr>
<td>Pharmaceutical</td>
<td>4</td>
</tr>
<tr>
<td>Real Estate</td>
<td>10</td>
</tr>
<tr>
<td>Technology</td>
<td>6</td>
</tr>
<tr>
<td>Transportation</td>
<td>1</td>
</tr>
<tr>
<td>Utilities</td>
<td>8</td>
</tr>
<tr>
<td><strong>Total Preparer</strong></td>
<td><strong>103</strong></td>
</tr>
<tr>
<td><strong>User</strong></td>
<td></td>
</tr>
<tr>
<td>FASB Advisory Committee</td>
<td>1</td>
</tr>
<tr>
<td>Industry Organization</td>
<td>1</td>
</tr>
<tr>
<td><strong>Total User</strong></td>
<td><strong>2</strong></td>
</tr>
<tr>
<td><strong>Other</strong></td>
<td></td>
</tr>
<tr>
<td>Regulator</td>
<td>2</td>
</tr>
<tr>
<td>Consulting</td>
<td>6</td>
</tr>
<tr>
<td>Other</td>
<td>1</td>
</tr>
<tr>
<td><strong>Total Other</strong></td>
<td><strong>9</strong></td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>127</strong></td>
</tr>
</tbody>
</table>

2. FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, establishes the requirements for hedging activities. In the Exposure Draft (ED) the Board agreed that the objectives of the project are to achieve the following:

a. Simplify accounting for hedging activities

b. Improve the financial reporting of hedging activities to make the accounting model and associated disclosures more useful and easier to understand for users of financial statements
c. Resolve major practice issues related to hedge accounting that have arisen under Statement 133

d. Address differences resulting from recognition and measurement anomalies between the accounting for derivative instruments and the accounting for hedged items or transactions.

3. Statement 133 provides special accounting for hedging activities to address differences in accounting for derivative hedging instruments and hedged items or transactions. Those differences relate to recognition and measurement anomalies between hedging instruments and hedged items and a desire of entities to manage cash flow risk as well as the timing of recognition in income of gains and losses on hedging instruments. The guidance in the ED would change the requirements for hedge accounting while continuing to address those differences.

4. The guidance in the ED also would affect the hedge accounting requirements of Statement 133 for assessing effectiveness, redesignating hedging relationships, designating the hedged risk, measuring the hedged item in a fair value hedging relationship\(^1\), and measuring and reporting ineffectiveness in a cash flow hedging relationship.

5. Below is a summary of significant issues raised by respondents to the guidance proposed in the ED.

INTERNATIONAL ACCOUNTING CONVERGENCE

Comments from Users, Preparers, and Auditors

6. Respondents overwhelmingly expressed concern that many of the amendments proposed in the ED would create further divergence in hedge accounting under U.S. GAAP and IFRS. A majority of respondents recommended that the FASB and IASB work together on a joint project to improve hedge accounting. Other respondents suggested that the FASB adopt IAS 39 now, or delay the hedging project until the U.S. adopts IFRS.

7. A number of respondents noted that if the FASB issues the proposed amendments without IASB involvement, companies would be required to implement the proposed changes and, upon international accounting convergence in a few years, implement a different hedge accounting model under IFRS. The transition between multiple accounting methods would

---

\(^1\) The staff notes that the May 2010 ED did not propose to change existing U.S. GAAP related to the eligible hedged risks or measuring the hedged item in a fair value hedging relationship.
impose additional implementation costs upon preparers and auditors and interpretation costs upon users. Respondents questioned whether the costs of implementing a new hedge accounting standard would be offset by the benefits of the new standard if that standard will only be in effect for a limited number of years.

a. The CFA Institute (CL 68) stated that both Boards should ensure the compatibility of any hedge accounting modifications. The scope of the ED is limited relative to the proposals put forward in the IASB intermediate approach. The IASB is considering whether to simplify or eliminate the amendments to hedge accounting. If the amendments to hedge accounting undertaken by the IASB and FASB are not conceptually consistent, it may result in multi-phase changes to the current derivative accounting requirements when convergence occurs. This will impose additional implementation and interpretation costs.

b. Wells Fargo (CL 83) identified the following changes proposed in the ED that are divergent from existing IFRS when convergence currently exists: changes to (1) permitted hedgable risks, (2) effectiveness threshold, (3) initial and ongoing assessment of hedge effectiveness for long haul relationships, (4) designtation, and (5) ineffectiveness measurement for cash flow hedges. Wells Fargo identified one proposed change that would be convergent with IFRS: the elimination of the shortcut method and critical terms matching.

[Paragraph 8 relating to fair value accounting was removed from this comment letter summary because the feedback received is not relevant to the May 2010 Exposure Draft.]
HEDGE EFFECTIVENESS REQUIREMENTS

9. In the ED the Board decided to amend the hedge effectiveness guidance to no longer require (a) that a hedging relationship be highly effective, (b) a quantitative assessment of the effectiveness of a hedging relationship, or (c) ongoing effectiveness testing. The proposed guidance would also eliminate the shortcut method and critical terms matching.

10. The ED would require a qualitative assessment of the hedging relationship’s effectiveness at inception of the hedging relationship to demonstrate that (a) an economic relationship exists between the hedging instrument and the hedged item or hedged forecasted transaction, and (b) changes in fair value of the hedging instrument would be reasonably effective in offsetting changes in the hedged item’s fair value or the variability in the hedged cash flows. In certain situations, a quantitative assessment may be necessary at the inception of a hedging relationship. After inception of the hedging relationship, an entity would need to qualitatively (or quantitatively, if necessary) reassess effectiveness only if circumstances suggest that the hedging relationship may no longer be reasonably effective.

11. In the ED, the Board decided to amend the hedge effectiveness requirements in Statement 133 to reduce the complexity of qualifying for hedge accounting, make it easier for entities to consistently apply hedge accounting, and provide comparability and consistency in financial statement results. For example, under the current requirements in Statement 133, an entity may apply hedge accounting in one period because the hedging relationship is deemed highly effective, and then fail the highly effective criteria in the next period, resulting in hedge accounting being applied inconsistently from period to period. Alternatively, an entity may not apply hedge accounting to a hedging relationship that it believes is highly effective because it is unable to demonstrate that the hedge will meet a specified level of effectiveness in each reporting period of the hedging relationship. The Board believes that amending the hedge effectiveness threshold to reasonably effective would reduce the frequency of both those occurrences. In addition, by not requiring effectiveness testing after inception of a hedging relationship unless circumstances suggest that a hedging relationship may no longer be reasonably effective, the Board believes that the costs of compliance would be reduced because entities would not have to develop sophisticated quantitative statistical models to prove a hedging relationship is effective in situations in which it is obvious that a hedging relationship is effective.
**Qualitative Assessment**

**Comments from Users**

12. Users disagreed with the move away from a quantitative analysis of hedge effectiveness. While users acknowledged the benefits of allowing qualitative assessments, including reduced compliance costs for preparers and a possible reduction in restatements, they believe that the proposal would increase the overall complexity and reduce the transparency of financial reporting.

   a. The CFA Institute Centre for Financial Market Integrity (CL 68) stated that while they are sympathetic with the desire to move away from rigid quantitative thresholds and bright lines, an open ended definition of effectiveness, coupled with inadequate levels of note disclosure on the criteria of hedge effectiveness, is likely to impair the ability of users to make comparisons of the effectiveness of risk management strategies across firms and across different time periods.

   b. The CFA Institute also noted that the proposal might reduce the number of effective economic hedges that would not be hedge compliant (Type I error), but it is also likely to increase the number of ineffective economic hedges that are deemed to be hedge accounting compliant (Type 2 error). Given the requirement to fair value all derivative contracts, a Type I error at worst results in the economic timely recognition of derivative gains and losses. However, a Type II error, in the case of cash flow hedge accounting, can result in the inappropriate deferral of derivative gains and losses. Hence, this proposal would likely reduce overall derivative transparency.

**Comments from Auditors and Preparers**

13. Auditors and preparers generally expressed support for the elimination (with certain exceptions) of quantitative effectiveness assessments. These respondents noted that providing entities with the ability to assess effectiveness through qualitative measures would simplify and reduce the costs of hedge accounting. However, some preparers noted that the cost savings would be limited for those entities which already have developed the models and infrastructure necessary to perform quantitative effectiveness assessments.

   a. Citizens Financial Group (CL 56) stated that the requirement for entities to quantitatively assess the effectiveness of their hedges is the primary contributor to the cost and complexity of Statement 133.
b. Mortgage Bankers Association (CL 57) noted that its members have already invested millions of dollars in infrastructure costs to comply with Statement 133 effectiveness testing for MSRs and loans held-for-sale. With this costly infrastructure already in place, the net impact of moving to a simpler model is not as appealing as it would have been years ago.

14. Many auditors and preparers requested additional guidance from the Board regarding situations in which a qualitative assessment of effectiveness is sufficient in determining a hedging relationship is expected to be reasonably effective. Types of guidance requested include examples of situations in which a qualitative assessment would be adequate and criteria to determine when a quantitative assessment would be necessary.
   a. KPMG (CL 39) and BDO Seidman (CL 110) requested additional guidance in determining when a quantitative (as opposed to a qualitative) assessment of effectiveness is required.
   b. Morgan Stanley (CL 52) advised that, in order to make the proposed amendment operational, the Board should provide additional examples for common hedging strategies (including common interest rate hedging strategies for both assets and liabilities) demonstrating when a qualitative assessment is sufficient.

15. Some preparers expressed concern that, absent additional clarification from the Board, auditors and regulators may not be satisfied with a qualitative assessment, and would thus require preparers to perform quantitative assessments in situations for which the Board would have allowed qualitative assessments. While some preparers stated that the ability to utilize qualitative assessments would provide simplification and operational benefits, other preparers noted that these benefits may not be realized unless auditors and regulators are willing to accept the use of qualitative, rather than quantitative, assessments of effectiveness.
   a. Morgan Stanley (CL 52) stated that in lieu of additional guidance, “auditors and regulators will likely develop their own criteria or will require a quantitative assessment on an on-going basis….”
   b. Cardinal Health (CL 62) stated that the absence of clear guidance will likely mean that the company will hold itself to the strictest possible interpretation in order to protect against future restatements. Cardinal Health emphasized that without greater clarity on
when a quantitative assessment of effectiveness is or is not required, the Board’s goal of simplifying hedge accounting will not be realized.

16. One preparer expressed doubts about the usefulness of qualitative effectiveness assessments. 
   a. Pepsi Bottling Group (CL 69) stated that “a qualitative assessment can do nothing more than describe the qualities of the hedging instrument and the hedged item or cash flows. It can be used to make general observations about the behavior of a given financial instrument and about the hedged item. Moreover, we do not believe auditors will accept general statements about the qualities of these items as proof of effectiveness in offsetting changes in cash flows or fair value.”

**Economic Relationship**

17. The Board decided that the qualitative assessment shall demonstrate that an economic relationship exists between the hedging instrument and the hedged item or hedged forecasted transaction.

**Comments from Auditors**

18. A few auditors requested additional guidance from the Board regarding the determination of when an economic relationship exists. Types of guidance requested include examples that illustrate the application of the criteria of the establishment of an economic relationship and a discussion of the factors to be considered in determining whether there is an adequate economic relationship.
Reasonably Effective

19. The Board decided that the qualitative assessment shall demonstrate that changes in the fair value of the hedging instrument would be reasonably effective in offsetting changes in the hedged item’s fair value or the variability in the hedged cash flows.

20. The Board decided not to define reasonably effective for purposes of determining when hedge accounting could be applied and when it could not be applied. The Board believes that it is necessary to use judgment when determining whether a hedging relationship is reasonably effective. That judgment should include a holistic consideration of all the facts and circumstances that led an entity to enter into a hedging relationship. That would include, for example, consideration of whether the objective of applying hedge accounting was to compensate for accounting anomalies or to achieve a fair value measurement option for items not currently eligible for fair value measurement.

Comments from Users

21. Users did not support the proposed reduction in effectiveness threshold. Users objected to the proposed change, noting the following concerns: the term reasonably effective is not clearly defined; a lower threshold may permit greater deferral of derivative gains and losses from earnings under cash flow hedging; a reduced threshold may increase preparer opposition in the future towards a movement to full fair value; and if the purpose of the reduced threshold is to reduce the occurrence of ‘in and out’ hedging, that concern can be dealt with by moving toward full fair value rather than reducing the threshold.

a. The CFA Institute (CL 68) noted that the proposal might reduce the number of effective economic hedges that would not be hedge compliant (Type I error), but it is also likely to increase the number of ineffective economic hedges that are deemed to be hedge accounting compliant (Type II error). Given the requirement to fair value all derivative contracts, a Type I error, at worst, results in the economic timely recognition of derivative gains and losses. However, a Type II error, in the case of cash flow hedge accounting, can result in the inappropriate deferral of derivative gains and losses.

b. The Investors Technical Advisory Committee (CL 3) stated that to the extent that the reduction in the effectiveness threshold may be fueled by concern about the ‘in and out’ problem of hedge accounting as a result of the changes in hedge effectiveness over time, the ITAC believes this concern is misplaced. The ‘in and out’ problem is merely an
artifact of the rather arbitrary provisions of hedge accounting that full fair value measurement would eliminate.

Comments from Preparers and Auditors
22. The majority of preparers and auditors expressed support for the proposed change in effectiveness threshold from ‘highly effective’ to ‘reasonably effective.’ Some of these respondents stated that the change in threshold would increase the number of hedging relationships that qualify for hedge accounting, improving the comparability of financial statements and encouraging the use of risk management strategies. Other respondents anticipate that the change in threshold would simplify the application of hedge accounting and provide operational benefits to preparers. A few respondents noted that the reasonably effective threshold is a positive move towards principles based standards.

23. Some preparers and auditors believe that the proposed change in effectiveness threshold (considered in isolation) would increase the number of hedging relationships that qualify for hedge accounting. The respondents expect that more entities would elect to apply hedge accounting to their hedging strategies, resulting in improved comparability of the financial statements between entities that currently apply hedge accounting and entities that currently do not apply hedge accounting but still utilize derivatives in their risk management strategies. The respondents also note that the current highly effective threshold disqualifies, and therefore discourages, the use of derivatives to manage certain risks for which there are few highly reliable hedge instruments available. The reasonably effective threshold may encourage entities to enter into derivatives to manage these risks, as such derivatives might qualify for hedge accounting under a reduced threshold. However, many of the respondents expressed concern that for certain hedging relationships, the reduced effectiveness threshold would likely not be able to offset the additional measure of ineffectiveness introduced by the proposed elimination of the designation of individual risks as the hedged risk. Specifically, these respondents questioned whether most hedging instruments that are related to interest-rate risk and qualify under the current highly effective threshold would still qualify under the proposed reasonably effective threshold. Despite these concerns, the respondents expressed support for the proposed change to the effectiveness threshold.

a. The Association for Financial Professionals (CL 26) stated that the proposed modification of the effectiveness threshold will theoretically expand the situations in
which certain risks may be hedged. The easing of the effectiveness measure will allow other hedging relationships to be considered.

b. PPL (CL 43) expressed their support of the reasonably effective threshold, noting that many derivative contracts that provide a significant offset to changes in the hedged exposure do not qualify under the current effectiveness threshold. Hedges that are essentially identical in effectiveness can receive very different accounting treatment depending on whether the quantitative assessment of effectiveness meets the threshold. PPL stated that the financial statements would have more transparency and clarity if similar hedging activity received the same accounting treatment.

c. Grant Thornton (CL 72) stated that modifying the effectiveness threshold to reasonably effective is appropriate because it will improve the usefulness of financial statements for entities that enter into derivative transactions to hedge risks. The reasonably effective threshold should result in more entities that enter into derivatives to hedge risks electing to apply hedge accounting, which will facilitate comparisons. The fact that hedge ineffectiveness is recognized in earnings mitigates concerns associated with moving from a highly effective threshold to a reasonably effective threshold.

d. Wells Fargo (CL 83) stated that many companies will likely not be able to apply hedge accounting for certain hedging relationships, even under a reasonably effective standard, that otherwise would qualify under the current hedging model.

24. Many preparers anticipate that the change in threshold would simplify the application of hedge accounting and provide operational benefits to preparers. The respondents stated that the reduced effectiveness threshold would enable many effectiveness assessments to be performed qualitatively, thereby simplifying and reducing the cost of the effectiveness assessment process. However, other respondents expressed concern that the benefits of the reduced effectiveness threshold would be limited.

a. The Mortgage Bankers Association (CL 57) stated that the qualitative standard of reasonably effective would eliminate a large number of practice issues.

b. Western Union (CL 14) stated that the proposed change would enable effectiveness assessments to be performed qualitatively, which would simplify the application of hedge accounting by avoiding the use of complex statistical analysis for relationships that would generally seem effective.
c. Regions Financial Corporation (CL 98) stated that the modification of the effectiveness threshold could lead to significant costs (for example, documentation and support for auditors) due to the judgment that will be necessary to determine whether a hedging relationship is reasonably effective.

d. Agribank (CL 97) stated their support for the lowered effectiveness threshold. However, they believe that any attempts to simplify effectiveness assessments at inception of hedging relationships by reducing the effectiveness threshold are nullified by the significant changes to the bifurcation-by-risk approach.

25. A few preparers and auditors stated that the reasonably effective threshold is a positive move towards principles-based standards. Other respondents expressed doubt that the reasonably effective threshold would remain principles-based, stating that practice would likely develop rules-based guidance for the new effectiveness threshold.

a. UBS (CL 76) stated that the move to a principles-based threshold for designation is welcomed and appropriate. UBS believes that moving to a principled application will result in challenges by auditors and regulators and will involve additional documentation burden to justify effectiveness and ineffectiveness determinations. However, these additional steps will be offset by cost savings from no longer having to perform extensive effectiveness testing.

b. McGladrey & Pullen (CL 60) noted that both highly effective and reasonably effective are principles-based thresholds. Under current practice, highly effective has evolved into an unstated (within GAAP) but well known rule that when the effectiveness assessment result is between 80%-125%, the hedge is considered highly effective. The firm believes that practice would develop a similar rule (albeit with a broader range) to define reasonably effective.
26. A majority of preparers and auditors requested additional guidance and clarification from the Board on how to determine whether a hedging relationship is reasonably effective. However, one auditor stated that it was not concerned that the Board has not defined reasonably effective.

   a. Ernst & Young (CL 118) stated that they are not particularly concerned that the Board has not defined reasonably effective, and the firm hopes that regulators and others would not seek to assign a specific mathematical range. The firm believes that hedgers are motivated by their own self-interest to construct hedge relationships that would be considered highly effective, and the firm does not believe a relaxation of the standard would promote the proliferation of poor hedge designs that would place pressure on the need to define reasonably effective.

27. Types of guidance requested by respondents include a definition of the term reasonably effective and examples indicating what would and would not be reasonably effective. Some preparers suggested that the Board declare that specific types of hedging relationships are declared to always be reasonably effective to prevent inconsistency among firms in determining whether the relationships are reasonably effective. Other preparers, concerned that their judgment may be overruled by auditors and regulators, recommended that the final standard clarify that management’s judgment of all relevant facts and circumstances is a key determinant in assessing whether a hedging relationship is reasonably effective.

   a. Agribank (CL 97) recommended that the FASB declare the following fair value hedge relationships as reasonably effective:

      (1) Fair value hedge relationships that consist of receive fixed and pay LIBOR interest rate swaps that are hedges of an entity’s own debt issuances, where the maturity date is the same between the swap and the bond and the notional amount of the swap equals the notional amount of the bond issue.

      (2) Hedges of existing debt that are hedged after inception of the debt due to a need to restructure the amount and/or maturity of the fixed rate debt.

   b. The AICPA AcSEC (CL 111) recommends that the Board provide additional examples that show that hedging the predominant risk can result in a determination that the hedging relationship is reasonably effective.
28. Preparers and auditors expressed concern that without additional guidance on the term *reasonably effective*, the change in effectiveness threshold would create diversity in practice and would likely develop its own bright lines. Some preparers mentioned that 50% - 150% and 50% - 200% are bright lines that practice is currently considering for the proposed effectiveness threshold. Some preparers anticipate that if the FASB does not provide guidance in the amendments to Statement 133, a regulatory body may choose to provide guidance at some point in the future. These preparers are concerned that they would have to construct methodologies based on their interpretation of reasonably effective, and then be forced to change their methodologies once a regulatory body issues a definition of reasonably effective at a later date.

   a. KeyCorp (CL 41) stated that if final guidance is issued without a definition of *reasonably effective*, entities as well as public accounting firms will need to make their own interpretations. This will result in inconsistent methodologies, differences in judgment decisions between entities and their auditors, potential restatements if regulators have a different interpretation, and the burden for entities to reconstruct their methodology if a regulatory body issues a statement at a later date with the definition of reasonably effective.

   b. Pepsi Bottling Group (CL 69) anticipates that bright lines will develop. The preparer recommended the FASB provide guidance so that the inevitable bright lines are at least consistent and subjected to appropriate due process.

29. Preparers and auditors believe that without additional guidance on the term *reasonably effective*, the change in effectiveness threshold would not be operational and some preparers may continue using the current highly effective threshold to ensure their hedging strategies can withstand regulatory challenge. Many preparers expressed concern that they may have differences in judgment from their auditors and regulators.

   a. Deloitte (CL 94) stated that the lack of a guiding principle makes it unlikely that the proposed Statement will be operational (for example, for any given hedging relationship, an entity will be unable to determine whether its qualitative assessment alone is sufficient to support its assertion that a hedging relationship will be reasonably effective). Without a guiding principle that will clarify the boundaries of reasonably effective or guidelines that explain what type or volume of evidence is sufficient to support a qualitative
effectiveness assessment, it is likely that many preparers will continue to use today’s parameters for highly effective when performing quantitative assessments to ensure that their hedging strategies are able to withstand regulatory challenge. In doing so, they would not realize the intended benefits of the proposed modification.

b. Cardinal Health (CL 62) stated that although the revision to the effectiveness standard is appropriate, the absence of clear guidance as to the meaning of reasonably effective will likely mean that the firm will hold itself to the strictest possible interpretation in order to protect against future restatements. Given this ambiguity, the Board’s goal of simplifying hedge accounting will not be realized.

30. A few auditors noted that paragraph A9 of the ED states that the determination of whether a hedging relationship is reasonably effective may include consideration of whether the objective of applying hedge accounting was to achieve a fair value measurement option for items not currently eligible for fair value measurement. The respondents requested clarification from the Board to explain whether this wording implies that the effectiveness of a hedging relationship may be higher or lower depending on the availability of the fair value option.

31. Some auditors, who expressed support for the reasonably effective threshold, recommended that if the Board decides to retain hedging of individual risks, then the Board should also retain the highly effective threshold so as to prevent abuses of hedge accounting.

32. One preparer recommended that the Board eliminate any type of effectiveness test, and only require that a hedging relationship meet the economic relationship test in order to qualify for hedge accounting. The preparer further clarified that the elimination of an effectiveness assessment would mean that prospective evaluations of effectiveness would not be required. However, a hedging relationship would be discontinued if the economic relationship ceased to exist.

a. PG&E Corporation (CL 90) stated that in the absence of a clear definition of reasonably effective, the company recommends eliminating the reasonably effective test but keeping the economic relationship test. Since the term reasonably effective is undefined, the company believes that the reasonably effective assessment will inevitably result in a quantitative analysis, which would be inconsistent with an approach towards a more qualitative assessment.
Comments from Others

33. Reval.com (CL 85), a risk management consulting firm, also disagreed with the reasonably effective threshold, predicting that the change in threshold would cause confusion and inconsistency in the application of hedge accounting. In addition, the respondent noted that the change in effectiveness threshold would create further divergence from IFRS.

[Paragraphs 34 to 37 relating to hedge accounting for interest-rate risk are removed from this comment letter summary because the feedback received is not relevant to the May 2010 Exposure Draft.]

Shortcut Method and Critical Terms Matching

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

Comments from Users

39. Users strongly supported the elimination of the shortcut method and critical terms matching, noting that the proposed changes would more fully reflect company exposures and risk profiles, enhance consistency and comparability in reporting for hedging transactions within companies across time and across different companies, and reduce complexity in financial reporting.

a. The CFA Institute (CL 68) stated that the proposed changes would enhance consistency of financial reporting information by reducing the instances through which economically similar transactions can be accounted for differently, depending on managerial intent. The shortcut method can result in the selection of derivative instruments for administrative convenience rather than for the economic optimality of the selected risk management strategy. At the same time, it leaves investors susceptible to unanticipated risk exposures in situations where management has selected sub-optimal hedging strategies driven by their desire to qualify for the shortcut method.
Comments from Preparers

40. Preparers varied in their reaction to the elimination of the shortcut method and critical terms matching. A number of preparers agreed with the elimination of the shortcut method and critical terms matching, stating that they find the shortcut and critical terms matching requirements to be onerous and risky, and no longer use the methods. Some respondents stated that the methods result in complexities in application and inconsistencies in practice, and expressed support for a single method of assessing effectiveness.

   a. UBS (CL 76) stated that it believes the elimination of the shortcut method and critical terms matching would improve the usefulness of the financial statements. Due to the number of restatements as a result of the complexities associated with hedge accounting, UBS welcomes the efforts of the Board to simplify hedge accounting. UBS agrees that it is inappropriate to assume perfect effectiveness, as other attributes may contribute to ineffectiveness. This step, while requiring some additional operational efforts, ensures that any ineffectiveness is recognized while at the same time reduces the risk of restatement.

41. A number of preparers disagreed with the elimination of the shortcut method and critical terms matching, stating that the shortcut method creates significant cost and time savings. Some respondents noted that the elimination of the shortcut method would increase costs for preparers but result in very little benefit to users, as the additional ineffectiveness recorded under these changes would be insignificant.

   a. Merck (CL 58) stated that the removal of this heavily relied upon simplification provision does not appear to accomplish the simplification objective of the ED, but instead shifts the complexity from qualifying for hedge accounting to measuring and accounting for hedge ineffectiveness. The elimination of the shortcut method may significantly discourage prudent economic risk management practices, as companies try to avoid the complexities, administrative burdens, and costs imposed by using the long-haul method. It is unclear whether users of the financial statements would receive commensurate benefits would which justify the cost/benefit criteria for eliminating the shortcut method.

   b. United Technologies Corporation (CL 92) stated that the long-haul method of assessing an interest rate swap is extremely complex and will require costly models to be developed by professionals to appropriately comply with the requirements. UTC does not believe
this will improve the quality of financial reporting – rather it will only make it more complex and costly for users. The elimination of the shortcut method will have such a burdensome effect on companies that it will far outweigh the benefit of elimination of the quarterly effectiveness testing requirement.

Comments from Auditors

42. Auditors also varied in their reaction to the elimination of the shortcut method and critical terms matching. Some auditors supported the elimination of these methods, noting that incorrect use of the methods has resulted in restatements in the past. However, a number of auditors objected to the elimination of the methods, noting that many medium and small firms and private companies rely on the simplification that the methods provide. Some respondents argued that the elimination of the shortcut method would likely create operational issues in the calculation of ineffectiveness for cash flow hedges, since it might be difficult to obtain fair value information for a derivative that exactly offsets the forecasted cash flows. For example, the incorporation of credit risk into a hypothetical derivative might require the use of complex models.

a. Grant Thornton (CL 72) stated support for the elimination of the shortcut method and critical terms matching. Grant Thornton sees this change as a possible operational concern for smaller businesses, but believes the change eliminates a source of complexity that has resulted in numerous restatements from improper application of hedge accounting. The benefit of requiring all preparers to measure the amount of ineffectiveness for all hedges outweighs these operational concerns. Measuring ineffectiveness is a key concept in hedge accounting, and the elimination of the shortcut method and critical terms matching will ensure that preparers have a greater understanding of this concept. Eliminating these methods will also result in greater convergence with IAS 39.

Ongoing Effectiveness Assessments

43. The proposed Statement would require an effectiveness evaluation at inception of the hedging relationship. After inception of the hedging relationship, an effectiveness evaluation would be required if circumstances suggest that the hedging relationship may no longer be reasonably effective. The Board considered but decided against eliminating any assessment
of effectiveness after the inception of the hedging relationship. The Board believes that eliminating such an assessment of effectiveness could result in the continuation of hedge accounting even when situations suggest that the hedge relationship may no longer be reasonably effective.

Comments from Users and Others
44. Users disagreed with the proposed change to only require post-inception effectiveness evaluations if circumstances suggest that the hedging relationship may no longer be reasonably effective. Users recommended that the Board retain the periodic effectiveness assessment requirement, noting that the entities have to measure and report the values of hedges and hedged items each period, and an effectiveness assessment would require little additional effort. Users expressed concern that this proposal may provide managers with the ability to hide derivative losses, particularly for cash flow hedges.

a. The CFA Institute (CL 68) stated that users don’t oppose measures that ease the processing of financial reporting information, as long as the proposal also improves transparency of the underlying risk exposures, risk management strategy, and risk management effectiveness. The CFA Institute is concerned that the de facto reduced frequency of effectiveness testing and subsequent disclosures of risk management gains and losses can be influenced by factors other than the economic effectiveness of the hedging instrument. This proposal may provide managers with some ‘wiggle room’ to hide derivative losses, particularly for cash flow hedges, when it suits them. Experience has shown that voluntary disclosure requirements for financial reporting information rarely result in widespread compliance.

b. The State of NY Banking Department (CL 5) believes the proposed changes will likely make subsequent evaluations of effectiveness rare events, and recommends that effectiveness evaluations be conducted at least annually.

Comments from Preparers
45. Preparers generally agreed with the change to require effectiveness assessments after inception of a hedging relationship only if circumstances suggest that the hedging relationship may no longer be reasonably effective. Most preparers do not foresee operational concerns in creating processes to identify such circumstances. However, some
preparers believe that the proposed change would not result in simplification, as preparers would need to create new processes to determine if assessment tests are needed.

46. A few preparers expressed concern that auditors and regulators may second-guess the preparers’ judgment or that the change will result in diversity in practice. Some preparers requested that the Board provide examples or specific events that would require an effectiveness assessment. Other preparers suggested that the Board clarify that subsequent assessments are only necessary after inception when the critical terms of the hedged item, hedged transaction, or hedging instrument are modified.

a. National City (CL 27) stated that new tests would need to be designed and performed on a periodic basis to justify why an effectiveness test was not performed. This proposal appears to add a new layer of complexity to the process. National City is concerned that these new tests would be subject to challenge by auditors and regulators. Given that we have already established the infrastructure to perform regular effectiveness tests, it would be simpler for us to continue to perform our ongoing effectiveness tests.

47. A number of preparers believe that the proposed change, together with the reduction in the effectiveness threshold, would result in a reduction in the number of times hedging relationships would be discontinued. These respondents stated that companies that discontinue hedge accounting at an early stage in situations where the possibility of falling outside an effectiveness range of 80 to 125 percent may no longer discontinue hedge accounting under the proposed changes if they expect that the current environment is temporary. One preparer stated that the change would result in an accounting model that is more closely aligned with the nature of the risk management strategy, as it would require more management judgment to assess whether a hedge relationship remains reasonably effective.

48. A few preparers believe that the changes would not result in a reduction in the discontinuation of hedging relationship. These respondents stated that most discontinued hedging relationships result from significant changes in circumstances which change the effectiveness of the hedge relationship. Such significant circumstances would be evident, and would result in an effectiveness assessment.

Comments from Auditors
49. Auditors generally agreed with the proposed change to only require post-inception effectiveness evaluations if circumstances suggest that the hedging relationship may no longer be reasonably effective. These respondents requested that the Board include additional guidance and examples of circumstances that would suggest that a hedging relationship may no longer be reasonably effective. Some respondents expect that the proposed change would result in a reduction in the number of times hedging relationships would be discontinued, as it would resolve the ‘law of small numbers’ issue, which can occur during periods where the underlying to the hedge relationship is momentarily stable. Under the current hedge accounting requirements, entities sometimes must terminate their hedge relationships during these periods of stability, even though the economic relationship of the hedge and hedged item remain strong.

DEDESIGNATION

50. The Board decided that an entity would not be permitted to discontinue fair value hedge accounting or cash flow hedge accounting by simply dedesignating (or removing the designation of) the hedging relationship. The Board decided hedge accounting shall be discontinued only if any criterion in paragraphs 20 and 21 of Statement 133 is no longer met for a fair value hedge, if any criterion in paragraphs 28 and 29 of Statement 133 is no longer met for a cash flow hedge, or the hedging instrument expires, is sold, terminated, or exercised. The Board believes that discontinuing the special accounting that is permitted under hedge accounting is not appropriate for situations in which an entity simply decides to remove the designation of the fair value or cash flow hedge. Since the economics of the relationship between the hedging instrument and hedged item or hedged forecasted transaction have not changed, the Board believes that the accounting should not change. The Board acknowledges that entities could override the special accounting under fair value and cash flow hedges by terminating the derivative designated as the hedging instrument and entering into a similar new derivative. However, the Board does not believe that dedesignation should be used as a tool for changing measurement attributes and/or managing the classification of certain items reported in earnings.

Comments from Users
51. One user respondent, the CFA Institute (CL 68), expressed agreement with the restriction on voluntary dedesignation.

Comments from Preparers and Auditors

52. Preparers and auditors opposed changes that would disallow voluntary dedesignation of a hedging instrument. While the ED allows entities to terminate a hedging relationship at any time by entering into an offsetting derivative position, respondents argued that preparers would have to incur significant expenses to transact an offsetting derivative and at the same time enter into a new derivative arrangement. In addition, the economic impact of such transactions would result in little to no difference from the results of a voluntary dedesignation. Some preparers noted that certain hedge instruments are not commonly traded on exchanges, and therefore cannot be easily terminated by entering into an offsetting position. A few preparers and a number of auditors requested clarification of the proposed changes to dedesignation. In particular, respondents requested guidance regarding what constitutes an offsetting derivative, as well as guidance on dedesignation when the derivative is not a hedging instrument. A few respondents were unsure as to how the proposed changes would affect delta-neutral hedging strategies.

53. Some preparers and auditors asserted that the change is especially restrictive for entities that manage risks at an entity level through a portfolio of derivatives. These respondents noted that ordinary changes in business can change the risk profile of the underlying hedged exposure, creating a need to remove, add, or change existing hedging relationships. The ED allows, in some cases, the addition of hedging instruments to a portfolio, but does not allow hedging instruments to be dedesignated from the portfolio without entering into an offsetting derivative.

54. Some preparers disagreed with the Board’s view that entities can manage earnings through dedesignation. Other preparers and some auditors believe that entities do not abuse the current ability to voluntarily dedesignate hedging instruments, and any concerns about abuse could be addressed through enhanced disclosure requirements. These respondents stated that entities use hedge accounting to cover particular periods of uncertainty and manage a dynamic hedging process.

a. Morgan Stanley (CL 52) stated that accounting designations must be made in advance of market movements. The firm does not agree with the Board that the ability to
dedesignate a hedge can result in the manipulation of earnings in a given period, given the effects of applying hedge accounting must be amortized to the income statement over the remaining life of the previously hedged item or transaction, so long as the item or transaction continues to exist or is still expected of occurring.

b. Ernst & Young (CL 118) stated that voluntary dedesignations are not a practice problem, the source of diversity in applications, an issue with auditors and regulators, or an instance of abuse.

c. PWC (CL 102) stated that dedesignations are not common across practice. Those that do occur are likely reflective of companies that manage their risks on an enterprise-wide basis, but must apply hedge accounting on a transaction-by-transaction basis. Also, it is common for companies that hedge forecasted transactions for foreign exchange risk through to the expected payment date to dedesignate the hedging relationship upon recognition of the transaction.

[Paragraphs 55–73 relating to eligible hedged risks were removed from this comment letter summary because the feedback received is not relevant to the May 2010 Exposure Draft.]

[Paragraphs 74–77 relating to disclosures were removed from this comment letter summary because the feedback received is not relevant to the May 2010 Exposure Draft. Although the disclosure requirements did not change from the June 2008 Exposure Draft, the context of the comments differed because many of the comments on the June 2008 Exposure Draft related to the interaction of the elimination of bifurcation-by-risk with the disclosure requirements. ]

[Paragraphs 78–81 relating to effective date and transition were removed from this comment letter summary because the feedback received is not relevant to the May 2010 Exposure Draft.]

[Paragraphs 82–85 relating to a one-time fair value option election immediately preceding the initial application of the proposed standard were removed from this comment letter summary because the feedback received is not relevant to the May 2010 Exposure Draft.]
Paragraphs 86–89 relating to presentation of hedging gains and losses were removed from this comment letter summary because the feedback received is not relevant to the May 2010 Exposure Draft.

Paragraphs 90–92 relating to forecasted intercompany transactions were removed from this comment letter summary because the feedback received is not relevant to the May 2010 Exposure Draft.