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Technical Director

FASB

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I do not believe the approach proposed by the IASB for hedging and hedge accounting will provide more useful or understandable information in financial statements. However, I believe the preparers' and auditors' enthusiasm for the expanded list of hedgable items, risks and hedging instruments, the effective elimination of measuring hedge ineffectiveness and the reduced criteria for hedge accounting qualification will force the FASB (based on their recent decision making) to adopt something like the IASB has proposed.

Therefore, my comments will focus on how to improve the information in the financial statements while accepting much of what has been proposed. Please remember that risk of changes in fair value and cash flows always exist. The effect of those risks on the reporting entity's resources and claims to those resources ultimately are reported in the statement of performance. However, managing risk using derivatives, asset/liability mix, underwriting and/or pricing power does modify the results of those risks. Information about all of those risk management techniques needs to be provided in the financial statements.

Although paragraph 21 of the IASB exposure draft states that there are 3 types of hedging relationships, I believe the accounting should be divided into the following 4 types:

Full Fair Value

Partial Fair Value

Cash Flow (both full and partial)

Foreign Currency (including the net investment in a foreign operation).

I believe the following accounting for each of these types of hedging relationships will provide useful information in both the statement of financial position and comprehensive income (and much more understandable information than that proposed by the IASB).

Full Fair Value

Report both the hedged items and hedging instruments at fair value with both adjustments to fair value reported in net income. The hedged items (by type) should be separately reported in the balance sheet from items of the same type that are not fully hedged by hedging instruments for fair value changes. The hedging instruments also should be separately reported in the balance sheet with their hedging relationship identified. The statement of comprehensive income should report both the hedged items' adjustment in fair value and the hedging instruments' adjustment in fair value in separate line items in a hedging section that is part of net income.

The balance sheet will reflect the hedged items and hedging instruments using their relevant measurement basis. The effectiveness and ineffectiveness of hedging with hedging instruments will be evident in the statement of comprehensive income.

Partial Fair Value

If reporting entities are using hedging instrument to modify part of the risks affecting hedged items' fair value, the rest of the risks affecting the hedged items changes in fair value are being managed by other ways-such as asset/liability mix, underwriting and/or pricing power or those risks are not being explicitly modified but still exist. I believe the use of a Partial Fair Value risk management approach using hedging instruments demonstrates that fair value is the relevant measurement basis for the hedged items.

Report both hedged items and hedging instruments at fair value with both adjustments to fair value reported in OCI until the hedged items are derecognized. As with Full Fair Value, the hedged items (by type) should be separately reported in the balance sheet from items of the same type that are not Partially Fair Value hedged. The hedging instrument also should be separately reported in the balance sheet with their hedging relationship identified. The statement of comprehensive income should report both the hedged items' adjustment in fair value and the hedging instruments' adjustment in fair value in separate line items in a hedging section that is part of OCI until the hedged item is derecognized.

The balance sheet will reflect hedged items and hedging instruments using their relevant measurement basis. The hedged item balance sheet amounts and the OCI section reporting the adjustments in fair value will provide a clear picture as to how much of the hedged items' risks affecting fair value are being modified by hedging instruments. Other disclosures in the footnotes should explain how the other risks are being managed. Remember, not explicitly managing a risk is also a risk management strategy. Using OCI to report changes in fair value until the hedged items are derecognized allows the financial statements to reflect the modification by using hedging instruments of the specific risk until the rest of the risk management strategy is reported.

The use of the “hypothetical derivative” approach set forth in the exposure draft's paragraph B44 will “only by accident” reflect the hedge items’ partial fair value change caused by a specific hedged risk. As we have seen in financial statements since Statement 133 has been applied, trying to determine the actual fair value impact of a specific hedged risk is complex, easily misstated and, most important, not consistent with a “hypothetical derivative” calculation. I believe that is why the FASB has proposed to eliminate the “critical terms match” and “short-cut method” in their exposure draft. It also is why the IASB’s discussion of “credit risk only” in paragraph IN 46 is at odds with their endorsement of the “hypothetical derivative” approach for measuring a specific risks’ impact on a hedged item for ineffectiveness assessment.

The number determined by the use of the “hypothetical derivative” approach that is proposed to be reported as a separate line item next to the Partial Fair Value hedged line item that is based on another measurement basis does not provide a describable or useful number. I expect that number to be the same as the hedging instruments adjustment to fair value. Why would a reporting entity not eliminate the effort, or risk, of measuring for ineffectiveness by not having the “hypothetical derivative” be a replication of the hedging instrument-especially with the ability to “rebalance” the hedge relationship and no retrospective ineffectiveness assessment?

Cash Flow (both full and partial)

and

Foreign Currency (including the net
investment in a foreign operation)

I would retain current U.S. GAAP guidance for these types of hedging relationships with one major change. I would use basis adjustment for the hedge item to report and keep up with the affect of the hedging instruments modification of risk. I admit that using basis adjustment makes the describability of the hedged items' measurement basis more complex (and effectively much like a synthetic item). However, I believe it produces more understandable information (and better controlled information) than a standalone number in the OCI section of equity.

The hedged items (by types) should be separately reported in the balance sheet from items of the same type that are not hedged. The hedging instruments also should be separately reported in the balance sheet with their hedging relationship identified.

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Please contact me at 203-358-8274 or ewtrott@gmail.com if you would like to discuss my suggestion. Edward W. Trott