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Re: Discussion Paper: Selected Issues about Hedge Accounting (Including IASB Exposure Draft, *Hedge Accounting*)

Dear Ms. Cosper:

Grant Thornton LLP appreciates the opportunity to comment on the FASB's Discussion Paper, *Selected Issues about Hedge Accounting (Including IASB Exposure Draft, Hedge Accounting)*.

#### General

Our primary concern with the IASB's hedge accounting proposal is its divergence from the FASB's proposal on the same topic (and vice versa). As we have noted in previous comment letters to the Boards, regarding both the FASB's financial instruments proposal and the IASB's Exposure Draft on hedge accounting, we believe the goal of developing converged guidance in this area is of utmost importance. Therefore, we encourage the Boards to continue deliberations on this topic and continue working toward convergence of the two proposals.

We generally support the proposed model put forth by the FASB in its proposed Accounting Standards Update (ASU), *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*, in particular its use of a "reasonably effective" threshold for applying hedge accounting. However, there are elements of the IASB's proposal that we believe would allow for greater flexibility in the application of hedge accounting, and we believe elements of both Boards' proposed hedge accounting models can be combined to develop an operational converged model that will mark a significant improvement to current models under U.S. GAAP and IFRS.

We support the goal of the IASB's proposal to align hedge accounting more closely with an entity's risk management activities. We believe that such alignment will benefit financial statement users by helping them understand an entity's economic objectives for establishing hedging relationships and how these relationships are reflected in the financial statements and notes. In addition, we support simplification of the hedge accounting guidance to make it easier for entities to align their reporting of hedge activity with their economic objectives behind implementing hedging strategies. As we note below, however, we believe that the FASB's proposed model provides a superior starting point for developing a converged, simplified

model. In addition, we have identified a number of operational issues with the IASB's proposed model, as noted in our responses to the questions set forth below, including potential issues regarding auditability.

#### Invitation to comment questions

**Question 1: When an entity uses financial instruments to manage risk exposures in economic hedges but those instruments are not designated in hedging relationships for accounting purposes, do you believe that the proposed guidance would provide useful information about all of the effects of an entity's risk management objectives?**

We believe that the disclosures that are required by FASB Statement 161, *Disclosures about Derivative Instruments and Hedging Activities – an Amendment of FASB Statement No. 133*, provide useful information about derivative instruments that are not designated in hedging relationships and should serve as the starting point for providing such information.

**Question 2: Do you believe that the proposed guidance and illustrative examples included in the IASB's Exposure Draft are sufficient to understand what is meant by risk management, how to apply that notion to determine accounting at a transaction level, and how to determine the appropriate level of documentation required? Why or why not?**

#### *What is meant by risk management*

We believe that the proposed guidance and illustrative examples included in the IASB's Exposure Draft are sufficient to understand what is meant by risk management. The Exposure Draft specifies that an entity's management undertakes risk management activities using financial instruments to "manage exposures arising from particular risks that could affect profit or loss." We believe that this description of risk management activities is sufficiently broad to encompass the types of hedged items and hedging instruments that we believe the IASB contemplated in drafting the proposed guidance.

#### *How to apply that notion to determine accounting at a transaction level*

We believe that additional guidance and illustrative examples should be provided to understand how to apply the notion of risk management to determine accounting at a transaction level. We believe that the proposed guidance would be easier to understand if illustrative examples related to determining whether a non-contractually specified risk component in a non-financial item is separately identifiable and reliably measureable were added. We also believe that additional guidance or illustrative examples related to hedging an aggregated exposure that includes a derivative should be provided.

#### *How to determine the appropriate level of documentation required*

We believe that the proposed guidance and illustrative examples included in the IASB's Exposure Draft are sufficient to understand how to determine the appropriate level of documentation required. The guidance in paragraph 19(b) appears to provide sufficient guidance regarding the content of an entity's hedge documentation without being overly prescriptive and, perhaps, burdensome.

**Question 3: Do you foresee an entity changing how it determines, documents, and oversees its risk management objectives as a result of this proposed guidance? If yes, what changes do you foresee? Do you foresee any significant difficulties that an entity would likely encounter in establishing the controls related to complying with the proposed guidance?**

We do not foresee entities changing how they determine, document, and oversee their risk management objectives as a result of this proposed guidance. We believe that entities will continue to determine their risk management objectives as they have in the past. In our view, most entities' risk management objectives are not influenced by accounting implications.

We do not foresee any significant difficulties that an entity would likely encounter in establishing controls related to complying with the proposed guidance.

**Question 4: Do you foresee any significant auditing issues arising from the proposed articulation of risk management and its link to hedge accounting? For example, is the information required to be disclosed regarding an entity's risk management strategies measurable and objective? Could the inclusion of an entity's risk management objectives create an expectation gap that the auditor is implicitly opining on the adequacy of an entity's risk management objectives?**

We foresee potentially significant auditing issues arising from the proposed disclosure requirements, particularly in relation to the types of hedged items that entities would disclose under the less-restrictive proposed hedge accounting criteria. For example, we believe that auditors will find it difficult to opine on disclosures that include information about the monetary amount or other quantity to which an entity is exposed for each subsequent period that a hedging relationship is expected to affect profit or loss (paragraph 46(a)). It is unclear whether the inclusion of an entity's risk management objectives will create an expectation gap as to whether the auditor is opining on the adequacy of those objectives.

**Question 5: Should cash instruments be eligible to be designated as hedging instruments? Why or why not? If yes, is there sufficient rigor to prevent an entity from circumventing the classification and measurement guidance in other relevant accounting guidance (for example, IFRS 9, *Financial Instruments*, and IAS 21, *The Effects of Changes in Foreign Exchange Rates*)? Are there any operational concerns about designating cash instruments (such as items within a portfolio of receivables) as hedging instruments?**

We generally support the IASB's proposal to align hedge accounting more closely with an entity's risk management activities. Therefore, we believe that cash instruments should be eligible to be designated as hedging instruments because such eligibility supports the objective of representing in the financial statements the effect of an entity's risk management activities. However, we are not aware of any significant demand among our clients for the ability to designate cash instruments as hedging instruments.

In our view, there is sufficient rigor under the proposed guidance to prevent entities from circumventing other relevant accounting guidance. For example, the criteria outlined in paragraph 19 of the IASB's Exposure Draft require that the hedging relationship must meet the objective of the hedge effectiveness assessment and must be expected to achieve other-than-accidental offsetting. We believe the process of ensuring these criteria are met would be sufficiently rigorous to prevent entities from using the proposed guidance to circumvent other applicable accounting guidance related to accounting for cash instruments.

We do not have any operational concerns with designating cash instruments as hedging instruments.

**Question 6: Do you believe that the proposed guidance is sufficient to understand what constraints apply when determining whether an item in its entirety or a component thereof is eligible to be designated as a hedged item (for example, equity instruments measured at fair value through profit or loss, standalone derivatives, hybrid instruments, and components of instruments measured at fair value through profit or loss that are not permitted to be bifurcated)? If not, what additional guidance should be provided?**

We believe that a potential issue exists related to designating as a hedging instrument a financial instrument that is measured at fair value through profit or loss to address an accounting mismatch. This is because the objective of such classification would be to align an instrument's measurement with that of a related asset or liability by classifying changes in the instrument's fair value through profit or loss – classification of this type of instrument as a hedging instrument in a cash flow hedge or a hedge of a net investment in a foreign operation would appear to be inappropriate, because changes in the instrument's fair value would no longer flow through profit or loss but, rather, into other comprehensive income. We believe that the proposed guidance should be amended to clarify that instruments measured at fair value through profit or loss to address an accounting mismatch would be ineligible for designation as a hedging instrument in a cash flow hedge or a hedge of a net investment in a foreign operation.

**Question 7: Do you believe that the proposed criteria are appropriate when designating a component of an item as a hedged item? If not, what criteria do you suggest? Do you believe that the proposed guidance and illustrative examples are sufficient to understand how to determine when the criteria of separately identifiable and reliably measurable have been met? If not, please describe what additional guidance should be provided?**

We do not believe that the proposed criteria are appropriate when designating a component of an item as a hedged item. In our view, the criteria should require that a risk component must be contractually specified to qualify for consideration as a hedged item. Without such a criterion, we believe that the proposed guidance will be sufficiently detrimental to comparability as to outweigh the benefits of its flexibility.

We do not believe that the proposed guidance and illustrative examples are sufficient to understand how to determine when the criteria of separately identifiable and reliably measurable have been met. For example, we are concerned that the illustrative example related to hedges of jet fuel purchases by reliance on valuation inferred from cracking spreads might be misleading. The example seems to be based on an assumption that differences in location and grade of nonfinancial items such as crude oil, gas oil or jet fuel are not relevant. The implications of this inference and assumption may be far reaching in assessing effectiveness of hedges of nonfinancial items. We believe that the proposed guidance should clarify whether such an assumption is appropriate as part of an entity's evaluation of its hedging activities.

**Question 8: Do you believe that “separately identifiable” should be limited to risk components that are contractually specified? Why or why not?**

Yes – please see our response to question 7.

**Question 9: Not included in “Questions for Respondents.”**

**Question 10: Do you believe that the proposed guidance is sufficient to understand what constraints apply to determining a layer component from a defined, but open, population? (For example, do you believe that the sale of the last 10,000 widgets sold during a specified period could be designated a layer component in a cash flow hedge?) If not, what additional guidance should be provided?**

We do not believe that the proposed guidance is sufficient to understand what constraints apply to determining a layer component from a defined, but open, population. In particular, the proposed guidance does not make clear whether an entity could designate the top layer component of a defined, but open, population as the hedged item. We believe that permitting such designation would be problematic because a top layer component of a defined, but open, population cannot be identified as the hedged item until the end of a specified period, which would be after the transaction occurs. We believe that the proposed guidance should expressly prohibit designation of a top layer component in a defined, but open, population as the hedged item.

**Question 11: Do you foresee any operational concerns applying other guidance in IFRS (for example, guidance on impairment, income recognition, or derecognition) to those aggregated positions being hedged? For example, do you foresee any operational concerns arising when an impairment of individual items within a group being hedged occurs? If yes, what concerns do you foresee and how would you alleviate them?**

We believe that there are several issues that could pose operational difficulty in terms of portfolio hedging. As the IASB is separately addressing portfolio hedging, we expect that significant operational concerns will be addressed as part of that project. However, we note that the matter of applying impairment guidance to individual items within a group being hedged could be addressed in a variety of ways. For example, we believe that the issue could be dealt with as part of the proposed hedge rebalancing guidance, whereby an entity would periodically

consider whether the hedging relationship ceases to meet the objective of the hedge effectiveness assessment, or is expected to do so. As part of the rebalancing process, an entity would consider whether its recorded investment in a group of assets has changed on account of impairment, and therefore warrants rebalancing. Depending on the nature and magnitude of the impairment, it may be necessary for an entity to discontinue hedge accounting. We believe this possibility could be addressed in the context of the proposed guidance in paragraph 24 of the IASB's Exposure Draft.

**Question 12: Do you believe that the proposed guidance on aggregated exposures will provide more transparent and consistent information about an entity's use of derivatives? Why or why not?**

We believe that the proposed guidance on aggregated exposures will provide more transparent and consistent information about an entity's use of derivatives because this proposed guidance aims to reflect an entity's risk management activities in its hedge accounting. We believe that aligning the hedge accounting guidance with the manner in which entities undertake their risk management activities will benefit users by enhancing transparency about an entity's use of derivatives.

**Question 13: Do you believe that an entity should be permitted to apply hedge accounting to a group of cash instruments or portions thereof that offset and qualify as a group under the proposed guidance and satisfy the proposed hedge effectiveness criteria? Why or why not?**

We believe that an entity should be permitted to apply hedge accounting to a group of cash instruments or portions thereof that offset and qualify as a group under the proposed guidance and satisfy the proposed hedge effectiveness criteria. As we noted in our response to question 5, we believe that cash instruments should be eligible to be designated as hedging instruments. Additionally, as expressed in our responses to questions 11 and 12, we are supportive of guidance that allows entities to apply hedge accounting to aggregated positions and exposures.

**Question 14: Do you foresee any significant operational concerns, including auditing issues, in determining how to assess whether a hedge achieves other-than-accidental offset? If yes, what concerns do you foresee and how would you alleviate them?**

We do foresee significant operational issues with determining how to assess whether a hedge achieves other-than-accidental offset.

First of all, we question whether, despite the apparent elimination of a requirement to retrospectively assess hedge effectiveness, the requirement to determine whether a hedge achieves other-than-accidental offset represents a de facto requirement to perform a retrospective analysis. Further, if that is the case, then it seems entities might use current retrospective effectiveness evaluation methods to determine whether a hedge achieves other-

than-accidental offset, thereby limiting the effect of what would otherwise appear to represent a simplification of the hedge accounting guidance.

Second, we believe that the proposed guidance presumes some baseline level of an economic relationship between a hedged item and a hedging instrument, and thus we would prefer that, if such a presumption exists, it is reflected in the hedge effectiveness requirements. For example, we note that the FASB's proposed ASU would require a hedging relationship to be reasonably effective in achieving offsetting changes in fair values or cash flows attributable to the hedged risk during the period of the hedging relationship. In our view, a "reasonably effective" threshold would be more operational than an other-than-accidental threshold because it is more in-line with promoting the application of hedge accounting to relationships that are consistent with the objective of hedge accounting. Further, we can envision situations in which a hedge would achieve other-than-accidental offset despite high levels of hedge ineffectiveness that might indicate hedge accounting should be precluded. Accordingly, we believe that a higher threshold than other-than-accidental is appropriate.

Finally, we note that paragraph B31 suggests that a statistical relationship might not be sufficient to support an expectation of other-than-accidental offset. While we agree that a statistical relationship might not always be sufficient evidence of other-than-accidental offset, we believe that there might be situations where a statistical evaluation provides the best evidence for an effective hedging relationship, and that the proposed guidance should acknowledge this.

**Question 15: Do you believe that the proposed guidance and illustrative examples are sufficient to understand how to analyze hedge effectiveness (for example, how to measure the change in the value of the hedged item attributable to the related hedged risk for nonfinancial items)? If not, what additional guidance is needed?**

We believe that the proposed guidance would benefit from additional illustrative examples demonstrating how hedge effectiveness would be analyzed under the proposed model, although we acknowledge that the proposed guidance is responding to a call for a more principles-based approach to standard setting that is less prescriptive than existing guidance, particularly under U.S. GAAP. We note that paragraphs B33 through B39, which address methods for assessing whether the hedge effectiveness requirements are met, contain some guidelines but few illustrations of how an evaluation might be performed under the proposed guidance.

**Question 16: Do you foresee any significant operational concerns or constraints in determining whether (a) a change to a hedging relationship represents a rebalancing versus a discontinuation of the hedging relationship or (b) an entity's risk management objective has changed? If yes, what concerns or constraints do you foresee and how would you alleviate them?**

We believe the proposed guidance should address circumstances that require rebalancing a hedging relationship. The proposed guidance seems to imply that entities must identify and select the best hedge ratio to "minimize expected hedge ineffectiveness" and such requirements

might be inconsistent with an entity's risk management strategy. We also believe the proposed guidance should address situations in which an entity fails to rebalance a hedge and whether such action (or inaction) on the part of an entity might constitute voluntary dedesignation, despite voluntary dedesignation being prohibited under the proposed guidance. Otherwise, we do not foresee any significant operational concerns or constraints in these areas.

**Question 17: Do you foresee any significant operational concerns or constraints relating to the potential need to rebalance the hedging relationship to continue to qualify for hedge accounting? If yes, what concerns or constraints do you foresee and how would you alleviate them?**

Yes – please see our response to question 16.

**Question 18: Do you believe that capitalizing the time value of an option as a basis adjustment of nonfinancial items (in other words, marking the asset or liability away from market) will improve the information that is provided in an entity's statement of financial position? Why or why not?**

We agree with the IASB's insurance premium view and also with the conclusion that, for transaction related hedged items, such costs would be capitalized into the carrying amount of a nonfinancial asset or liability, recognition of which results from the hedged item.

**Question 19: Do you believe that the proposed presentation of the gains and losses in other comprehensive income will provide users of financial statements with more useful information? Why or why not?**

We do not believe that the proposed presentation of gains and losses in other comprehensive income will provide users with more useful information. In our view, users benefit from having gains and losses recognized in profit or loss, accompanied by disclosure of the gains and losses associated with the hedged item and hedging instrument, as well as any ineffectiveness associated with the hedge.

Changing the way that fair value hedge accounting is accounted for and presented will increase the costs for those entities currently using this method of hedge accounting. The benefits from this change are not immediately apparent to us. We also struggle to see a clear principle behind the proposed new treatment.

**Question 20: Do you believe that the proposed presentation of a separate line item in the statement of financial position would increase the transparency and the usefulness of the information about an entity's hedging activities? Why or why not?**

We believe this proposed presentation would provide information that is more useful to the financial statement users. Where fair value hedge accounting is applied to an instrument that would otherwise be accounted for at amortised cost, the current requirements result in the hedged item being measured at a mixture of amortised cost and fair value. Such a measurement

basis is difficult for the user of the financial statements to understand. The proposed approach of not adjusting the hedged item for the gain or loss on the risk being hedged, and instead presenting that gain or loss as a separate line item, should add transparency to the statement of financial position and make the financial statements more understandable to the user.

**Question 21: Do you believe that there is sufficient guidance to specifically link the hedging adjustments to the hedged assets and liabilities that compose a hedged net position with respect to presenting a separate line item in the statement of financial position?**

We believe that there is sufficient guidance to specifically link the hedging adjustments to the hedged assets and liabilities that compose a hedged net position, although, as noted in our response to question 20, we disagree with the separate line item presentation for fair value hedges.

**Question 22: Do you foresee any significant auditing issues arising from the inclusion of risk management disclosures in the notes to the financial statements? If yes, what issues do you foresee and how would you alleviate them? Do you believe it is appropriate to include risk management disclosures in the notes to the financial statements rather than in other information in documents containing financial statements? Why or why not?**

We do foresee auditing issues related to some of the proposed disclosures – please see our response to question 4. However, in general, we do believe it is appropriate to include risk management disclosures in the notes to the financial statements. We believe that disclosure of such information greatly benefits financial statement users by helping them understand an entity's economic objectives for establishing hedging relationships, and how these relationships are reflected in the financial statements and notes.

**Question 23: Do you believe that the changes proposed by the IASB provide a superior starting point for any changes to U.S. GAAP as it relates to derivatives and hedging activities? Why or why not? Should the FASB be making targeted changes to U.S. GAAP or moving toward converging its overall standards on derivatives and hedging activities with the IASB's standards?**

We believe that the Boards should focus on converging guidance in this area rather than separately adopting changes that would result in greater divergence in hedge accounting. Having divergent guidance in this area will only further complicate matters, and ultimately we believe that users will be better served by having converged hedging guidance that is (a) simpler for entities to apply and (b) reflective of entities' risk management activities. Therefore, we encourage the Boards to continue their work on reconciling the major differences between their proposals and focus on a converged solution that incorporates the best elements of both proposals.

We believe that the FASB's proposed amendments to the hedging and derivatives guidance in U.S. GAAP provides a superior starting point although elements of the IASB's proposal should be incorporated into a converged solution. As mentioned above, we favor the FASB's "reasonably effective" threshold for determining whether an entity can apply hedge accounting, and believe that the FASB's amendments move further toward simplifying the hedge accounting guidance than the IASB's proposal. Given that a primary concern among preparers is the complexity and inflexibility of current guidance related to hedging, we believe that the FASB's proposal will provide a more favorable starting point.

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We would be pleased to discuss our comments with you. If you have any questions, please contact Mark K. Scoles, Partner, Accounting Principles Consulting Group ([Mark.Scoles@us.gt.com](mailto:Mark.Scoles@us.gt.com) or 312.602.8780).

Sincerely,

/s/ Grant Thornton LLP