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May 3, 2011

Susan M. Cosper
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FASB
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Re: February 9, 2011 Invitation to Comment, *Selected Issues about Hedge Accounting* (Including IASB Exposure Draft, *Hedge Accounting*) [File Reference No. 2011-175]

Dear Ms. Cosper:

One of the objectives that the Council of the American Institute of Certified Public Accountants (AICPA) established for the PCPS Executive Committee is to act as an advocate for all local and regional firms and represent those firms' interests on professional issues, primarily through the Technical Issues Committee (TIC). This communication is in accordance with that objective. These comments, however, do not necessarily reflect the positions of the AICPA.

TIC has reviewed the Invitation to Comment (ITC) and is providing the following comments for your consideration.

GENERAL COMMENTS

The Committee's December 9, 2010 comment letter on the FASB ED, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*, focused on hedge accounting for the "plain vanilla" interest rate swap, which is commonly used by private entities to manage interest rate risk. TIC had supported the proposed qualitative criteria for evaluating hedge effectiveness at the inception of the hedge but had expressed concerns about the proposed subsequent measurement criteria, including the proposed elimination of the critical-terms-match method. Ultimately, TIC was seeking a hedge accounting methodology that would be cost effective and practical. TIC's comment letter advocated an outcome that would reflect fair value changes of the swap in other comprehensive income unless a triggering event occurred that called the effectiveness of the swap into question. The letter also indicated that some TIC members believed that hedge accounting for cash flow hedges should be eliminated completely if the proposed requirements relating to subsequent measurement could not be simplified.

After reviewing the IASB's *Hedge Accounting* ED, TIC has once again focused its attention on interest rate swaps. Now, after further deliberations, the majority of TIC members have decided that the best course of action for smaller private entities is to prohibit hedge

accounting for interest rate swaps that are sold to private companies as an integral part of a lending arrangement. (In some, but not all, cases, lenders will insist that such swaps be entered into as a condition of borrowing.)

The borrower's primary financial statement user is generally the lender that has sold the borrower the swap. The financial statement user therefore understands the intent of the swap and the financial statement effect of changes in the fair value of the swap. The financial statement effect of these derivatives is generally easy to predict since the objective of the swap is to achieve level interest payments over the course of a long-term loan. If the swap is effective throughout its term (which is generally the case), the user disregards the fair value changes and therefore will not care whether the changes are classified within other comprehensive income or the income statement. A number of private entities have already opted to forego hedge accounting to avoid the onerous documentation requirement and the need for effectiveness testing. TIC members have observed that financial statement users quickly adapted to non-hedge accounting. The majority of TIC members therefore believe that eliminating hedge accounting for these specific instruments is the most cost-efficient and transparent course of action.

Another key issue with hedge accounting is the volume and complexity of the related disclosures. If hedge accounting is eliminated for interest rate swaps that are sold to private entities as a condition of a loan, then all of the disclosures that would apply when hedge accounting is used would be unnecessary.

TIC acknowledges that certain sophisticated private companies have the expertise to develop risk strategies and enter into their own hedges, which could involve interest rate swaps or other instruments. In those cases, TIC would agree that hedge accounting is appropriate and is largely satisfied with the hedging criteria proposed in the ED. However, when hedge accounting does apply, TIC opposes inclusion of risk management disclosures in the notes, especially for private entities.

For private companies, TIC especially appreciates the provisions that move the evaluation of hedge effectiveness to a more qualitative approach and that eliminate the need for retrospective testing of hedge effectiveness.

TIC's specific comments below relate solely to those arrangements that would qualify for hedge accounting.

SPECIFIC COMMENTS

Risk Management

The IASB's proposed guidance would rely substantially on an entity's risk management objectives as a basis for hedge accounting. Paragraph 1 of the IASB's Exposure Draft states that, "The objective of hedge accounting is to represent in the financial statements the effect of an entity's risk management activities that use financial instruments to manage exposures arising from particular risks that could affect profit or loss."

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?*

Yes. Many entities enter into derivative and non-derivative contracts specifically for hedging purposes, but do not apply hedge accounting because the standard is either too complex or too cost prohibitive for the related benefit. In many cases, there are sufficient critical terms matching up that it's quite obvious that the hedge is effective, but the accounting does not reflect such.

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?*

There are many useful illustrations throughout Appendix B. For example, the illustrations in paragraph B15(a) and B15(b) are very helpful in identifying components that are "separately identifiable and reliably measurable." However, such items may be more difficult to assess in practice. Although the standard cannot reasonably address all possible scenarios, the two illustrations provided seem insufficient to demonstrate these concepts. For example, the illustrations provided are from the perspective of purchase contracts, but should also be expanded to address the sales side of the contract. Additional illustrations of negative examples where information cannot be "separately identifiable and reliably measurable" should also be included.

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?*

This is not an easy yes or no question. In many cases, the answer will be no. Entities typically make strategic decisions based on the true economic benefit of a hedging relationship regardless of how the accounting will be reflected in the financial statements. However, when the accounting takes place, there are instances in which the entity's management realize from the accounting questions that the hedging instruments may contain more risk or exposure than was originally considered.

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?*

TIC believes the proposed disclosures present a number of auditing issues.

In many cases, matching an entity's risk management strategies to a hedging instrument is not difficult to assess, unless non-derivative instruments (such as the cash instruments noted in question 5 below) are allowed.

However, TIC believes that disclosure of an entity's risk management objectives and strategies would cause financial statement users to erroneously assume that the auditor is implicitly opining on risk management information and providing assurance as to a favorable outcome. Effectively hedging risk does not always result in an economic benefit. For example, hedging against changes in variable interest rates with an interest rate swap may effectively hedge risk against rising interest rates, but may not result in less interest expense being paid over the life of the debt instrument. Financial statement users could easily misunderstand the intent of the disclosures.

Furthermore, TIC believes risk management disclosures should be limited to a general overview rather than a detailed explanation of each category of risk exposure. Details about the strategies should not be disclosed so as to retain the confidentiality of the entity's proprietary business strategies.

Another audit issue that concerns TIC is a perceived trend in this ED toward the disclosure of forward-looking information in the notes to the financial statements. Auditing standards for nonissuers are based on historical financial statements, which is information derived primarily from an entity's accounting system about past economic events or economic conditions existing as of a certain point in the past. However, the data for some of the proposed note disclosures (e.g., the entity's risk management strategy) would originate from non-accounting systems.

Of most concern is the ability to audit the information required by paragraph 46 related to the effect that hedging transactions have on subsequent periods, including "risk exposure" in subsequent periods and, in quantitative terms, how the hedging activity changes the risk exposure. In TIC's experience, many smaller private entities simply do not maintain adequate supporting evidence for these types of disclosures, and the information is often so speculative and imprecise that auditors cannot increase the credibility of such information. TIC believes such disclosures are more consistent with the concept of forward-looking analysis, rather than the historical financial information on which an auditor expresses an opinion, and their inclusion and expectations by users of verifiability would serve to increase the expectation gap between what auditors can actually achieve and what users believe they should be able to expect from the auditor's association.

The proposed disclosure effectively brings Management's Discussion & Analysis (MD&A) into the notes to the financial statements, which TIC would oppose. Forward-looking information is outside of the scope of the audit of financial statements and should be reserved for the MD&A section of the annual report for public companies. Such disclosure is unnecessary for private entities since financial statement users can contact management directly if such information were needed.

However, if the Boards decide to adopt any type of forward-looking disclosure, which TIC would strongly oppose, the final standard should specify that suitable caveats would be

incorporated into the disclosure to clarify that statements made concerning forward-looking information:

- represent management's current judgment about possible future events;
- are not guarantees of any events or financial results; and that
- actual results may differ materially from management's plans and strategies and may not have a favorable outcome.

Such caveats should be similar to those found in a public company's MD&A section.

Hedging Instruments

The IASB's proposed guidance would permit an entity to designate as hedging instruments nonderivative financial assets (for example, cash instruments such as debt securities) and nonderivative financial liabilities measured in their entirety at fair value through profit or loss.

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?*

When management has a relevant and reasonable strategy utilizing cash instruments as hedging instruments, hedge accounting should be allowed. In many cases, it will be transparent that such cash instruments relate to a specific commitment, such as purchasing foreign currency to hedge against exchange rate changes for commitments to purchase foreign supplies or equipment. Hedge accounting should not be allowed if there is insufficient documented evidence of the underlying commitments.

Hedged Items—Overall

Under the IASB's proposed guidance, a hedged item can be a recognized asset or liability, an unrecognized firm commitment, a highly probable forecast transaction, or a net investment in a foreign operation.

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?*

No. Paragraphs 12 and 18 describe the types of hedged items, and paragraphs B7-B11 provide some illustrations. However, the application guidance in Appendix B does not seem to adequately address illustrations of unrecognized firm commitments, highly probable forecast transactions and net investment in foreign operations that involve strategic hedging.

In addition, the standard should establish criteria for determining when a highly probable forecast transaction qualifies for recognition in hedge accounting, and the appendix should provide illustration of walking through such criteria.

Hedged Items—Risk Components

The IASB's proposed guidance would specify that a portion (referred to as a "component") of an item can be designated as a hedged risk if it is separately identifiable and reliably measurable. Examples in the IASB's Exposure Draft illustrate that a hedged item could be a component that is not contractually specified or a component that is inferred.

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.*

Yes, the criteria that a component must be "separately identifiable and reliably measurable" to be eligible as a hedged item are appropriate. The illustrations in paragraphs B15(a) and B15(b) are very helpful in identifying components that are "separately identifiable and reliably measurable."

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

Yes. The effectiveness of the hedging relationship cannot be adequately assessed when there is no contract specified. For example, in the illustration in paragraph B15(b), futures contracts of oil were purchased in order to hedge fuel prices. Although oil was determined to be "separately identifiable" and to have a direct relationship on fuel prices in the illustration, it will be difficult for the entity to provide sufficient evidence of effectiveness as there is no contractual obligation on which to base the assessment.

QUESTION 9 - THE INVITATION TO COMMENT DID NOT CONTAIN A QUESTION 9.

Hedged Items—Layer Component

The Exposure Draft would permit a layer component of the nominal amount of an item to be eligible for designation as a hedged item. A layer component may be specified from a defined, but open, population or from a defined nominal amount. However, a layer component of a contract that includes a prepayment option would not be eligible as a hedged item in a fair value hedge if the option's fair value is affected by changes in the hedged risk.

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?*

The concept of a “layer component” is appropriately defined, and the examples in B21 are very helpful. However, it’s difficult to determine in practice what the “defined” component of a “defined, but open population” might be. Hedges of layer components are common in practice as many entities desire to minimize exposure, but not eliminate exposure entirely. In many cases, the hedged instrument is easily identifiable, but in some cases, the timing of the future contract may not coincide with the timing of the use of the hedging instrument. For example, an entity may purchase a foreign currency to cover a portion of a commitment to purchase a specified amount of foreign inventory over time. If exchange rates are in the entity’s favor for using its own currency rather than the foreign currency, the entity might apply its own currency at the beginning of the contract, and then use the foreign currency later in the contract. In this example, it may be difficult to assess the “defined” component of the open population.

In addition, paragraphs 36(e), B23, and BC69 state that an item with a prepayment option would not qualify as a hedged item in a fair value hedge if the option’s fair value is affected by changes in the hedged risk. The standard, the application guidance, and the basis for conclusion discuss this issue without providing illustrations. An illustration would be helpful to establish an understanding of this concept. Many hedged items have prepayment options, but it is not the entity’s intention to exercise the option as evidenced by entering into a hedging instrument. In such cases, when the entity demonstrates the ability and intent to not exercise the option, hedge accounting may be more appropriate. A disclosure detailing the accounting treatment, management’s intent, and the contingent outcome if the option were to be exercised could be sufficient.

Hedged Items—Aggregated Exposures and Groups of Items

The IASB’s proposed guidance would permit an entity to apply hedge accounting to aggregated exposures and groups of items, including net positions.

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?*

TIC does not have a response to this question.

The proposed guidance would define an aggregated exposure as a combination of another exposure and a derivative. The proposed guidance would permit an entity to recognize changes in the fair values of derivatives that are part of the aggregated exposure to be reflected in other comprehensive income rather than through profit or loss.

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?*

Yes. In many cases an entity's risk management strategy is to minimize, but not eliminate entirely, exposure. In such cases, the aggregated exposures may provide a better overall picture of the strategy and related effectiveness.

The proposed guidance would permit net offsetting positions involving only cash instruments to be accounted for as a hedge if certain requirements are met.

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?*

Yes. If an entity's objective is to hedge components that collectively minimize exposure, then it seems appropriate to allow the group to apply hedge accounting. The illustration at paragraph B24 is very helpful in determining when a group component would not be appropriate for hedge accounting.

Hedge Effectiveness

To qualify for hedge accounting, the IASB's proposed guidance would require that the hedging relationship (a) meets the objective of the hedge effectiveness assessment (that is, to ensure that the hedging relationship will produce an unbiased result and minimize expected hedge ineffectiveness) and (b) is expected to achieve other-than-accidental offset.

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?*

TIC believes it will be very difficult for an auditor to assess whether a hedge achieves other-than-accidental offset if the phrase is not defined, either explicitly or through a more detailed explanation of what comprises accidental offsetting. The applicable application guidance in proposed paragraph B31 states that the required assessment would include "an analysis of the possible behavior of the hedging relationship during its term to ascertain whether it can be expected to meet the risk management objective." This (along with other requirements) suggests that an auditor will need to assess and conclude on a company's risk management objectives, which extends beyond the scope of an audit of the financial statements.

Furthermore, paragraphs IN 43-44 of the IASB ED seem to require net-cash-settled transactions for commodities, raw materials, etc., that are used in the ordinary course of business to be accounted for and disclosed in accordance with this standard if they were entered into "in accordance with the entity's fair value-based risk management strategy." It is unclear how management would conclude that such a transaction was not a part of a risk management strategy, thus subjecting these transactions to significantly more complex accounting and disclosure requirements. If this is the Boards' intent, TIC believes the benefit of the related accounting and disclosure would not exceed the costs, particularly for a small-to-mid-sized private entity.

The IASB's proposed guidance would require an entity to assess hedge effectiveness on a prospective basis in an ongoing manner.

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?*

Yes. The proposed guidance is sufficient. The guidance provided in paragraphs B27–B39 is very helpful. In particular, for many private and nonprofit entities, the ability to assess effectiveness based on qualitative aspects, such as critical terms (as outlined in paragraphs B33 and B34), is very relevant and helpful. In addition, as outlined in paragraph B32, the ability to assess ongoing effectiveness at either the reporting date or upon a significant change in the circumstances affecting the hedge effectiveness requirements is also very relevant for private and nonprofit entities.

Changes to a Hedging Relationship

The IASB's Exposure Draft would permit and sometimes require an entity to "rebalance" an existing hedging relationship and continue to account for the revised hedging relationship as an accounting hedge. However, when there is a change in the entity's risk management objective for a hedging relationship or a hedge ceases to meet the qualifying criteria, the IASB's Exposure Draft would require the entity to discontinue hedge accounting.

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?*

It is difficult to predict all possible scenarios, but, in many cases, there will likely be some transparent change in circumstance that will trigger an entity to reconsider the effectiveness of the hedging relationship. It would seem, in most cases, the triggering event that changes the circumstances will be an actual transaction that alters the hedging relationship rather than a change in management's objectives.

The IASB's proposed guidance would require an entity to assess hedge effectiveness at every reporting date (at a minimum). Depending on that assessment, an entity may be required to rebalance its hedging relationship to continue to qualify for hedge accounting.

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?*

No foreseen issues.

Accounting for the Time Value of Options

For transaction-related hedged items, the IASB's Exposure Draft would require an entity to capitalize the time value of an option as a basis adjustment of the hedged item if the hedged item subsequently results in the recognition of a nonfinancial asset or liability.

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?*

No. Capitalizing the time value of an option will add more subjective judgment into the accounting treatment and will create unnecessary complexities. It is expected that when management determines a risk objective, that the time value will be included in the consideration of the hedging relationship.

Hedge Accounting and Presentation

For fair value hedges, the IASB's Exposure Draft would change the recognition of gain or loss on the hedging instrument and hedged item (for changes in the hedged risk). Those gains or losses would be recognized in other comprehensive income rather than through profit or loss. An entity would be required to measure ineffectiveness and transfer any ineffective portion of the gain or loss from other comprehensive income to profit or loss.

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?*

Yes. When hedge accounting applies, classifying such gains and losses in other comprehensive income will allow users of the financial statements to analyze the effect of the hedge, but will not skew the results of operations.

The IASB's Exposure Draft would change the presentation of fair value hedges in the statement of financial position. The hedged items would no longer be adjusted for changes in fair value attributable to the hedged risk. Rather, those changes would be reflected as a separate line item in the statement of financial position, presented next to the line item that includes the hedged asset or liability.

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?*

No. Such a presentation will likely add confusion. Disclosure in the notes to the financial statements is a better place to present the balance of the components, where it coincides with the explanation of those components. Netting the hedging instruments in the statement of financial position provides a more useful picture of the hedged items' fair values.

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?*

As noted in question 20, this will likely be a more confusing presentation. That said, the narrative guidance appears adequate to explain the proposed presentation.

Disclosures

The Exposure Draft would require disclosures about the risks that an entity decides to hedge and for which hedge accounting is applied.

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 that 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?*

Yes, TIC believes the proposed disclosures present a number of auditing issues. Please see the response to Question 4 above for details.

Other

The Exposure Draft proposes changes to certain aspects of accounting for derivatives and hedging activities beyond just those linked to financial instruments. There are many other aspects that differ between U.S. GAAP and IFRS relating to the accounting for derivatives and hedging activities.

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?*

Yes. With the exception of the carve out discussed above for certain interest rate swaps that are entered into as part of a borrowing arrangement, TIC believes the IASB's proposal represents a superior starting point that should be adopted by the FASB. As noted in question #1, many private entities and nonprofits have very transparent hedging strategies as it relates to hedging interest rate, foreign exchange and commodities risks. However, many entities don't apply hedge accounting, or they improperly apply hedge accounting, because the ongoing effectiveness assessments are too complex, and in many cases, too cost prohibitive for the related benefit. In these cases, the changes in market value make it difficult for users of the financial statements to assess the results of operations. The principles-based approach proposed by the IASB that allows for quantitative assessments of effectiveness and only periodic prospective assessments based on actual reporting dates or change in circumstances is much more relevant.

TIC appreciates the opportunity to present these comments on behalf of PCPS member firms. We would be pleased to discuss our comments with you at your convenience.

Sincerely,

A handwritten signature in black ink that reads "Philip J. Santarelli". The signature is written in a cursive style with a long horizontal line extending to the right.

Philip J. Santarelli, Chair
PCPS Technical Issues Committee

cc: PCPS Executive and Technical Issues Committees