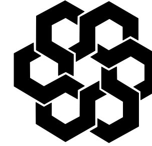

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These notes are based on the staff papers prepared for the IASB and FASB. Paragraph numbers correspond to paragraph numbers used in the joint IASB-FASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IASB/FASB Meeting: **21 October 2008, Norwalk**

Project: **Accounting for Hedging Activities**

Subject: **Comment letter analysis (Agenda paper 8A)**

PURPOSE OF MEETING

1. At the October 21, 2008 joint Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) education session, the staff will present to the Boards a summary analysis of the comment letters received for the Exposure Draft (ED) of the proposed Statement, *Accounting for Hedging Activities: an amendment of FASB Statement No. 133*. Attached is a summary of issues raised by respondents to the ED (which will be posted to the FASB website).

PLAN FOR REDELIBERATIONS

2. The Board's technical plan indicates that a final Statement will be issued in the first quarter of 2009. However, respondents to the ED overwhelmingly recommended that the FASB proceed with its hedging project on a joint basis with the IASB. In addition, the FASB and IASB are currently working jointly on a research project to reduce the complexity of the accounting for financial instruments. On March 19, 2008, the IASB issued a Discussion Paper, *Reducing Complexity in Reporting Financial Instruments*, which the FASB also published for comment by its constituents. One of the intermediate approaches to reducing complexity proposed in the Discussion Paper is the simplification of hedge accounting. As a result, at a future Board meeting, the staff plans to present to the Boards a number of approaches for addressing the issues in those projects, including an approach that would combine the FASB's hedging project with the project to reduce complexity of the accounting for financial instruments.

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

Number and Type of Respondents (by Occupation/Role)	
Type of Respondent	**Number**
Public Accounting	
Accounting Firm	3
Big 4 Accounting Firm	4
CPA Society	5
Industry Organization	1
Total Public Accounting	**13**
Preparer	
Entertainment	1
Financial	47
Health Care	2
Industry	12
Industry Organization	5
Insurance	7
Pharmaceutical	4
Real Estate	10
Technology	6
Transportation	1
Utilities	8
Total Preparer	**103**
User	
FASB Advisory Committee	1
Industry Organization	1
Total User	**2**
Other	
Regulator	2
Consulting	6
Other	1
Total Other	**9**
TOTAL	**127**

2. FASB Statement 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, dedesignating hedging relationships, designating the hedged risk, measuring the hedged item in a fair value hedging relationship, 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 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 hedgeable risks, (2) effectiveness threshold, (3) initial and ongoing assessment of hedge effectiveness for long haul relationships, (4) dedesignation, 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.

FAIR VALUE ACCOUNTING

Comments from Users and Preparers

8. Some respondents noted that the ED represents a move towards full fair value accounting. Preparers generally agreed that a broader project on the accounting for financial instruments would be a more appropriate way to achieve the goal of measuring all financial instruments at fair value instead of through changes to hedge accounting. Users expressed support for the adoption of full fair value for financial instruments.

    a. The CFA Institute (CL 68) stated that of the 2,006 respondents to a March 2008 survey of its members on the topic of fair value accounting, 70% believe that fair value improves financial institution transparency and understanding of risk profile, and 74% believe that it improves market integrity.

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

<u>Comments from Users</u>

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.

Hedge Accounting for Interest Rate Risk

34. Two of the questions posed by the ED are as follows:
    a. For situations in which interest rate risk is currently designated as the hedged risk for financial instruments but would no longer be permitted under this proposed Statement (except for an entity's own issued debt at inception), do you believe you would continue to qualify for hedge accounting utilizing your current hedging strategy?
    b. If not, would you (1) modify your hedging strategy to incorporate other derivative instruments, (2) stop applying hedge accounting, (3) elect the fair value option for those financial instruments, or (4) adopt some other strategy for managing risk?

Comments from Preparers

35. Generally, preparers expressed concern that their current strategies to hedge interest rate risk may no longer qualify for hedge accounting, even under the reasonably effective threshold. Preparers noted that changes in the fair value of interest rate swaps may not correlate to changes in the overall fair value of the hedged item or hedged transaction, causing commonly used plain vanilla hedging strategies to no longer qualify for hedge accounting. Many preparers mentioned that credit spread, particularly in the current business environment, may preclude hedges of interest rate risk from qualifying for hedge accounting, or may create such volatility that preparers would be discouraged from applying hedge accounting even if the hedging relationships would qualify. However, other preparers believe that since their current hedging strategies qualify under the highly effective threshold, the strategies would continue to qualify under the

reasonably effective threshold, despite the inclusion of credit risk in the effectiveness assessment.

a. UBS (CL 76) stated that it believes a majority of hedges of the benchmark interest rate risk associated with a forecasted debt issuance using a treasury-lock or a forward starting swap would no longer qualify as effective under the proposed model, as there are key factors that impact the ultimate coupon on a debt issuance that are not incorporated in the hedging instrument. Specifically, the new issue premiums (driven by supply and demand dynamics on the date of issuance) and changes in the credit spread of the borrowers are not and may not be able to be effectively or efficiently hedged. Given new issue premiums are not price or index based, changes in cash flows related to them will not be able to be effectively hedged. Additionally, companies typically do not hedge their own credit risk due to concerns around self-dealing and reputational risk as well as enforceability.

b. Chatham Financial (CL 12) stated that it performed initial testing of the provisions of the ED on a random sample of 30 of its clients. The testing included analysis of both overall changes in cash flows of a hedge of a forecasted debt issuance and overall changes in fair value of a hedge or fixed-rate debt for a high credit quality borrower with relatively stable credit spreads and a lower credit quality borrower with less stable credit spreads. The results indicated that only 10 out of the 30 companies would have qualified for a hedge of overall changes in cash flows for a hedge of a forecasted debt issuance over the last 12-month period using regression analysis. One out of 30 would have qualified over the last 12-month period using cumulative dollar offset. These results were based on a lower standard of "reasonably effective" rather than the current standard of "highly effective" (the analysis considered an R-squared of only 0.5 and a slope of only -0.5 to -2.0 to be a passing grade for regression analysis, and a range of only 50% to 200% to be acceptable for dollar offset).

36. Many preparers did not address what they plan to do if their strategies no longer qualify for hedge accounting. Of those preparers who did address the question

posed in the ED, responses varied. A few respondents suggested that they may need to incorporate other derivative instruments into their hedging strategies to qualify for hedge accounting. Some respondents mentioned that due to the increased volatility related to derivatives that would no longer qualify for hedge accounting, they may reduce their use of hedging related to their debt, and instead adopt other risk mitigation strategies. Some preparers doubted they would apply the fair value option, noting that the irrevocable characteristic of the fair value option is unattractive as it reduces management's flexibility. Other preparers suggested that they may consider taking advantage of the fair value option if they would no longer qualify for hedge accounting. A number of respondents stated that they need to do a more thorough analysis of their risk management strategies and the impact of the proposed changes before they are able to determine what actions they would take if they no longer qualify for hedge accounting.

a. First Energy (CL 87) stated that it may reduce the amount of hedging related to its debt or adopt other risk mitigation strategies. First Energy does not believe that electing the fair value option is a realistic alternative to hedge accounting. One of the benefits of using hedge accounting is the relative ease and low cost of entering into an interest rate swap transaction and the ease in terminating the transaction. Under the irrevocable fair value option, an entity is required to continue to use fair value accounting for the debt as long as the debt remains in process. The cost and process required to offer new debt precludes ending the hybrid hedge accounting with the same efficiency, and results in higher risk overall.

Comments from Others

37. Reval.com (CL 85), a risk management consulting firm, provided a numerical illustration of an interest rate swap designated after the issuance of the debt that the firm expects would no longer qualify for hedge accounting, even under the reasonably effective threshold.

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.

<u>Comments from Users and Others</u>

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.

<u>Comments from Preparers</u>

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.

<u>Comments from Auditors</u>

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.

HEDGED RISK

55. The proposed Statement would amend the guidance in Statement 133 to require entities to designate, with two exceptions, the following risks as the hedged risk:

(a) the risk of changes in overall fair value of the entire hedged item or (b) the risk of overall changes in the hedged cash flows.

56. The Board decided to continue to permit an entity the ability to designate the following individual risks as the hedged risk in a fair value or cash flow hedge: (a) interest rate risk related to its own issued debt, if hedged at inception, and (b) foreign currency exchange risk. For those two exceptions, the financial statements would not reflect information about the risks that an entity chooses not to manage as part of a particular hedging relationship.

Elimination of Bifurcation-By-Risk (With 2 Exceptions)

57. The Board decided that the elimination of bifurcation-by-risk (with two exceptions) provides the best solution for resolving practice issues related to hedge accounting and for improving financial reporting to make the hedge accounting results more useful to those who make economic decisions. In addition, the proposed hedge accounting approach would no longer provide for different hedgeable risks for different types of hedged items or transactions. Because the proposed Statement generally does not permit a bifurcation-by-risk approach for financial instrument hedges, concerns expressed about inequities in the hedging model for nonfinancial items or transactions compared with financial instruments have been resolved.

58. The Board believes that an approach that permits hedging either all risks or only foreign currency risk for all hedged items or transactions better reflects the economics of the instruments than the bifurcation-by-risk approach currently permitted in Statement 133. Under the proposed approach, more information would be provided about both (a) risks that an entity manages or transforms and (b) risks that an entity does not manage or transform. An entity may choose to be exposed to certain risks or may not be able to identify a practical way to manage certain risks. The Board does not believe that it would be unfair to require entities to reflect as part of hedge accounting the economics of a hedged item associated with risks not managed or transformed by the hedging instrument. The Board believes it is just as important to reflect in the financial statements the economics

of unhedged risks in order to provide users with a more complete picture of an entity's financial position and results of operations from hedge accounting activities.

Comments from Users

59. Users support the elimination of the designation of individual risks as the hedged risk, stating that this proposed change would more comprehensively reflect risk exposures. Users also noted that this change would reduce the opportunity for inconsistencies in the accounting for hedging a financial asset or liability and the accounting for hedging a non-financial asset or liability.

60. Users stated that the Board should require the full amount of a hedged position to be fair valued, even if a company chooses to hedge only a portion of the hedged item or hedged transaction. For example, if a company chooses to hedge only 40 percent of the price risk in a particular commodity inventory, under hedge accounting, the company would only mark to market 40 percent of the hedged item, leaving the remaining 60 percent at the original historical cost. Investors may be more concerned about the effects on the company's operations of the unhedged risk exposure than they would the hedged 40 percent. By requiring an entity to fair value the full amount of the hedged position, investors can more clearly see the effects on a company's operations of the decision to hedge as well as the decision to not hedge and bear a portion of the risk.

61. Users want a clear understanding of the full risk exposure profile, including the full spectrum of hedged risk exposures, unhedged risk exposures, hedge accounting election exposures, and exposures excluded from hedge accounting treatment. Users noted that while Statements 133 and 161 address disclosures relating to recognition and measurement of derivative instruments and hedged risk gains and losses, they do not address the required disclosure of unhedged risk exposures. Similar to the hedged risk profile, the unhedged risk profile affects overall firm performance and is of great interest to investors. Users stated that a partial disclosure of the exposure can lead to a misleading view of a reporting firm's overall risk profile.

a. The Investors Technical Advisory Committee (CL 3) stated that no perfect hedge exists, and therefore, hedging transactions must subject the company to other than the target risks. Investors and users are better served by having relevant information on a company's complete exposure profile, consistent with full fair value reporting for financial instruments.

b. The CFA Institute (CL 68) stated that it is a fundamental distortion of economic reality for reporting entities to handle discrete risk types in isolation during the accounting for derivatives used for risk management purposes.

Comments from Preparers and Auditors

62. The majority of preparers and auditors disagreed with the proposal to eliminate the designation of individual risks as the hedged risk. Some preparers believe that they may not qualify for hedge accounting under the proposed change, while others believe that they may no longer apply hedge accounting, even if they would qualify, because they do not wish to report the resulting increased earnings volatility in their financial statements.

63. Many preparers and auditors argued that accounting results under the proposed change would be inconsistent with an entity's risk management strategies, as entities use derivatives to manage discrete risks. Other respondents stated that the elimination of bifurcation-by-risk would reduce the comparability of financial statements between entities that hedge and entities that do not hedge. For example, two entities may have exposure to the same unhedged risks. The unhedged risks would be reflected in the financial statements of the entity that hedges, but not in the financial statements of the entity that does not hedge. This inconsistency may cause users of the financial statements to come to the conclusion that the entity that hedges is exposed to more risk than the entity that does not hedge, when in fact the entity that hedges is actively managing its risks.

a. UBS (CL 76) stated that the current bifurcation-by-risk model accurately reflects an entity's ability to hedge individual risks. Requiring the measurement of the effect of unhedged risks will obfuscate the effectiveness of hedges on the hedged risk.

64. Many preparers and auditors expressed concern that the proposed change would require entities to include changes in their own credit risk in hedging effectiveness assessments, introducing valuation issues related to the market value of credit and the use of unobservable inputs to determine fair value. Respondents noted that there are few, if any, derivatives designed to manage an entity's own credit risk. Thus, entities would be required to report ineffectiveness related to changes in their own credit risk in their financial statements. Preparers note that the inclusion of credit risk in earnings would create counterintuitive gains when the entity's credit worsens and counterintuitive losses when the entity's credit improves.

    a. LNR Property Holdings (CL 5) stated that even if it was able to attempt to hedge its own credit risk, as a private company, determination of its own credit risk would be based on unobservable and unreliable inputs, thereby resulting in information which is not meaningful to the users of its financial statements. Further, LNR Property Holdings share the concerns expressed in the Alternate Views in the ED regarding the legal implications that would most certainly come with an attempt to hedge its own credit risk, including issues surrounding self-dealing and insider information.

65. Some preparers and auditors stated that the elimination of bifurcation-by-risk would increase operational complexities for preparers. One respondent suggested that before issuing a final statement, the Board should resolve the following practice issues: (a) how to determine the fair value of an entity's own liability, and (b) how to model a perfect hypothetical derivative.

Exceptions to the Elimination of Bifurcation-By-Risk

66. For situations in which an entity synthetically creates variable-rate debt or synthetically creates fixed-rate debt, the Board was concerned about incorporating the effect of an entity's own credit risk in (a) the measurement of the hedged item in a fair value hedge and (b) the measurement and reporting of ineffectiveness in a cash flow hedge. As a result, the Board decided to permit an entity to designate only interest rate risk as the hedged risk in a fair value or cash flow hedge

associated with an entity's own issued or borrowed debt if the hedging relationship is entered into at inception of the debt.

67. The Board believes that entering into the hedging relationship after inception of the debt would not result in synthetically creating variable-rate debt or fixed-rate debt, but would instead result in either (a) an entity transforming fair value risk to cash flow risk or vice versa for asset/liability management purposes or risk management purposes or (b) an entity taking a position on the future movement of interest rates.

68. The Board also believes that entering into the hedging relationship before inception of the debt would not result in synthetically creating variable-rate debt or fixed-rate debt, but instead would result in locking in a fixed rate prior to the issuance of the debt for asset/liability management purposes or risk management purposes.

69. In the situations in which an entity is not synthetically creating variable-rate debt or fixed-rate debt, the Board does not believe an exception from the general hedge accounting approach of designating all risks as the hedged risk should be permitted.

Comments from Users

70. Users disagreed with the two exceptions to the elimination of bifurcation-by-risk, stating that the two exceptions would allow an entity to underreport other risk exposures, such as counterparty risk, that would otherwise be reported under the ED. Some users stated that the two exceptions should only be an interim measure, as the usefulness of the financial statements are reduced when reporting entities are allowed to pick discrete risks to which they can apply hedge accounting.

    a. The Investors Technical Advisory Committee (CL 3) stated that counterparty risk would be recognized in all transactions except those covered by the two exceptions. Given that the effectiveness test for the two exceptions would include only the risk managed, and not other risks, ITAC is concerned that the financial statements would not reflect information about the risks that an entity

chooses not to manage as part of a particular hedging relationship. If companies synthetically convert issued debt to reflect the net terms that they desired when they issued the debt with related hedges, investors should have sufficient information disclosed to understand the effects on the financial statements of these synthetic transactions.

Comments from Preparers and Auditors

71. Preparers and auditors generally agreed with the two exceptions to the elimination of bifurcation-by-risk, and many of these respondents argued that the exceptions should be expanded. Many respondents suggested that the exception related to interest rate risk of an entity's own debt should be expanded to include situations in which the debt is hedged prior to, or subsequent to, inception of the debt. A few preparers suggested that the Board create exceptions to allow component and calendar year hedging, and the designation of commodity risk and inflation risk.

72. Many respondents stated that by limiting the interest rate risk exception to debt hedged at inception, similar transactions would be accounted for very differently depending solely on the timing of the designation of the hedge. Respondents further noted changes in credit spread may preclude hedges of an entity's own debt hedged before or after inception from qualifying for hedge accounting, creating additional disparity in the accounting treatment between hedging relationships designated before or after inception of the debt and hedging relationships designated at inception of the debt.

    a. Toyota Motor Credit Corporation (CL 100) stated that the ED leads to different accounting results for risk management strategies that focus on reducing interest expense volatility, based only on the timing of the execution of those strategies. The determination of when Toyota enters into a derivative contract to hedge interest rate risk for issued debt is primarily based on Toyota's overall asset and liability risk management strategy as well as forecasted interest rates over a selected time horizon.

    b. Credit Suisse (CL 106) stated that there should not be a limit on the ability to hedge interest rate risk at any point in the life of an instrument. The flexibility

to enter into a hedging relationship after inception is fundamental to the risk management process and financing realities of many entities. Many companies rely on the swap market to reduce interest cost during times when short term rates are very low. In that type of market, they have limited access to short term financing.

73. With respect to hedging an entity's own debt, the main concern of preparers and auditors appeared to be valuing and reporting an entity's own credit risk in the financial statements. Respondents noted that valuation of an entity's credit risk may be difficult and may rely on unobservable inputs. In addition, the inclusion of credit risk in the evaluation of a hedging relationship would reduce the quality of the financial statements. For example, when an entity's credit worsens, the financial statements will report a gain, and when the entity's credit improves, the financial statements will report a loss.

    a. Ernst & Young (CL 118) provided the following scenario to illustrate its objections to the inclusion of credit risk in evaluating a hedge of the forecasted issuance of an entity's debt. In the scenario of a widening credit spread between hedge inception and debt issuance, a hypothetical credit derivative (used in combination with a benchmark interest rate derivative) would have produced a gain (which is why the ED requires a credit to be reported in the income statement). But because the entity did not (and in actuality could not) use such a credit derivative, the entity reports a loss in the income statement. Over time, which may mean a period of up to 30 years for long-term debt, the hedging entity will recycle the gain out of OCI into the income statement as a reduction of interest expense, effectively reversing the loss reported years earlier during the anticipatory period. It was always a "phantom" loss, and, therefore, "phantom" gains must be reported such that the cumulative effect to retained earnings at the end of 30 years will eventually reflect zero. Interest expense will effectively be "wrong" for those 30 years, reflecting the hypothetical effect of a derivative that was never actually used, and a gain that was never actually realized, and for a period long past when the initial accounting will be remembered.

DISCLOSURES

74. To help users better understand the effect of applying fair value hedge accounting in Statement 133, the ED would require entities to disclose information about the resulting adjustments to the carrying amount of a hedged asset or liability. The ED would also 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 at inception of the debt.

Comments from Users and Others

75. Users support the proposed disclosures, and stressed the need for additional disclosures beyond those proposed in the ED or required by Statement 161. Respondents, composed of users and one banking regulatory agency, recommended specific disclosures to be included in the final Statement.

    a. The CFA Institute (CL 68) stated that membership surveys conducted over the last decade consistently show that the members of the CFA Institute believe there are significant quality gaps in the disclosures for derivatives, hedging activities, and risk exposures. The CFA Institute agrees with a March 26, 2008 Credit Suisse Research Report on Statement 161. This report identifies that, even with the changes in Statement 161, more useful disclosures for investors is required, including 1) the percentage of risks hedged, 2) how the percentage of risks hedged changes over time, and 3) the effect of derivatives on current period cash flows.

    b. The CFA Institute also recommended that, given the amendments in the ED that minimize bifurcation-by-risk and change hedge effectiveness, reporting entities should disclose 1) how they make hedge accounting elections, 2) how they assess hedge effectiveness (including providing details of the maturity of the derivative instruments designated as cash flow hedges), and 3) which risk exposures are hedged, but do not receive hedge accounting, and which risk exposures are unhedged.

c. The State of NY Banking Department (CL 6) suggested that the Board require disclosures of an entity's fiscal year-end Balance Sheet and Income Statement with all financial assets and liabilities at fair value.

Comments from Preparers

76. A few preparers disagreed with the proposed disclosures, stating that the new disclosures required under Statement 161 are adequate to address the needs of financial statement users. Some preparers stated that the FASB should wait until Statement 161 is effective before they decide whether additional disclosure requirements are warranted. Other preparers recommended that disclosures may be able to replace the need for the other amendments in the ED, such as the elimination of the designation of individual risks as the hedged risk.

a. Colgate-Palmolive (CL 17) stated that Statement 161 was recently released and has yet to take effect, and requires robust new disclosures of an entity's hedging activities. The preparer recommends removing any additional disclosure requirements from the ED and merely amending accounting requirements with this proposed Statement.

b. The Institute of Management Accountants (CL 29) stated that the proposed disclosures would not provide significant benefit to users beyond the disclosures that are required in Statement 161.

c. Wells Fargo (CL 83) stated that if the Board believes that financial statement users require additional information regarding unhedged risks, the preparer recommends accomplishing that objective by amending existing derivative disclosure requirements rather than by eliminating bifurcation-by-risk. The Board should address the issue by disclosing that information through the existing disclosure framework set forth in Statement 107 or Statement 161. The Board should first evaluate how users accept the substantive disclosure changes made by Statement 161, and modify these disclosures prior to overhauling the hedge accounting model.

d. Equity Residential (CL 13) stated that a more appropriate solution to address the Board's concerns, should it continue with the this ED (and the elimination of the ability of an entity to designate individual risks as the hedged risk), would be to add an expanded disclosure or discussion in the Quantitative and Qualitative Disclosures About Market Risk sections of the Form 10-Q/10-K to provide insight to the reader of the financial statements about the inherent unhedged risks surrounding future debt maturities.

Comments from Auditors

77. Some auditors requested that the FASB provide examples, similar to those provided in Statement 161, that illustrate the proposed disclosure requirements. A number of auditors agreed with preparers, stating that the FASB should accomplish the objectives of the ED through additional disclosures, rather than through the other amendments proposed in the ED.

    a. Deloitte (CL 94) stated that the Board should provide examples illustrating the disclosure requirements in paragraph 44G in a manner similar to the examples provided in Statement 161. This could help preparers and auditors to understand the Board's intent for these new disclosure requirements.

    b. PWC (CL 102) stated that the inclusion of all risks would make it more difficult for financial statement users to determine the effectiveness of those risk management strategies. Any information regarding the economics associated with unhedged risk components may be better conveyed to users through disclosures.

    c. The AICPA AcSEC (CL 111) stated that the Board's proposed approach of recording fair value changes related to the risks not being hedged is not the best way of informing users about these risks. Instead, expanded disclosures would be a more beneficial approach. In Statement 161, the Board considered, but decided against, requiring information about how all risks are managed. The Board decided instead to address this concept in an overall disclosure standard project. The Board should continue to address this concept in a separate overall financial instrument disclosure standard in coordination with

the IASB, rather than making changes to the accounting that will change the way entities manage risks.

d. The AICPA AcSEC also recommended that the FASB expand or clarify the requirements in Statement 161 to disclose an entity's accounting policies and attributes (qualitative and quantitative) governing its assessment of its hedges' reasonable effectiveness both at and after inception, as well as the circumstances that may suggest that a particular hedging relationship may no longer be reasonably effective.

EFFECTIVE DATE AND TRANSITION

Effective Date

Comments from Users

78. Users agreed with the proposed effective date of annual reporting periods beginning after June 15, 2009, stating that the effective date would provide sufficient time if managers choose to adjust their hedging programs or financial reporting standards. One user group noted that the ED aims to significantly reduce the compliance requirements for preparers; therefore there should be minimal implementation hurdles to the adoption of the new amendments.

Comments from Preparers and Auditors

79. A number of preparers believe the proposed effective date would provide adequate time to implement the proposed Statement. However, many preparers and a majority of auditors stated that the proposed Statement would not provide enough time to adopt the proposed statement. Many respondents recommended that the proposed Statement not be effective for at least a year after it is issued. These respondents argued that the ED contains significant changes to hedge accounting and accounting for hedged items. Entities will need additional time to adjust their risk management strategies, processes and internal controls to comply with the new guidance.

Transition Disclosures

Comments from Users

80. Users recommended that the Board require disclosures related to the adoption of this proposed statement.

    a. The Investors Technical Advisory Committee (CL 3) suggested that the transition disclosures should provide information on:
        (1) Transfers between the HTM and the AFS or trading categories
        (2) Redesignation of hedged items to fair value accounting under FAS 156 or FAS 159
        (3) The amount of adjustments made to the carrying values of assets or liabilities
        (4) Changes to hedge relationships or elections to apply hedge accounting as a result of the application of the proposed Statement
        (5) The effects on comparability of reported results across periods.

    b. The CFA Institute recommended that entities disclose the basis of their decision to opt for either the fair value option under Statement 156 or Statement 159 or to opt for the amended hedge accounting under Statement 133.

Comments from Preparers and Auditors

81. Some preparers and auditors stated that it is not necessary for the Board to prescribe specific transition disclosures. However, a few preparers and a number of auditors recommended specific transition disclosures.

    a. The American Gas Association (CL 96) suggested disclosures about (a) hedging relationships that were in place under the prior guidance that did not qualify for hedge accounting due to the effectiveness testing standard, (b) hedging relationships that were dedesignated, and (c) hedging relationships that now qualify for hedge accounting due to the lower reasonably effective threshold.

b. McGladrey & Pullen (CL 60) recommended a principles-based disclosure requirement to describe any material impact of the adoption of the proposed Statement and any related effects of the one-time fair value option election on the financial statements.

Fair Value Option

82. The Board decided to permit a one-time fair value option under Statement 156 and Statement 159 for servicing assets, servicing liabilities, and financial instruments that were designated as hedged items on the date immediately preceding initial application of the proposed Statement.

Comments from Users

83. Users expressed support for the one-time fair value option, noting their belief that all financial assets and liabilities should be reported at fair value. Users recommended that any gains and losses related to the one-time fair value option should be recognized in earnings and disclosed in the footnotes. One user group expressed conditional support for the application of the fair value option to nonfinancial assets and liabilities, as this would be directionally consistent with the adoption of full fair value.

    a. The Investors Technical Advisory Committee (CL 3) stated that gains and losses on assets and liabilities, regardless of their source, voluntary or mandatory, should not be permitted to escape immediate and full recognition in net income. Allowing any such loopholes reduces the integrity of financial reporting for all users of financial statements.

Comments from Preparers and Auditors

84. The majority of preparers and auditors supported the one-time fair value option. Many preparers and auditors suggested that the option should be expanded to allow entities to reevaluate all items for the election, whether associated with a hedging relationship or not. These respondents noted that entities may have made different elections at the initial election date of Statement 159 if the changes proposed in this ED were in effect at that time. Other respondents noted that the

ED is strictly targeted to hedge accounting relationships, thus it is appropriate to limit the fair value option to those transactions. One preparer recommended that the ED should also include a one-time option to reverse a previous fair value election.

a. Credit Suisse (CL 106) suggested that the Board provide an option to remove the fair value option. Credit Suisse has applied the fair value option in cases where hedge accounting did not always result in highly effective hedges and the operational burden of effectiveness testing, dedesignation and redesignation was not cost beneficial. Under the reduced effectiveness threshold, Credit Suisse may prefer to apply hedge accounting to those items.

85. One preparer objected to the fair value option due to consistency and comparability issues related to the limitation on what assets and liabilities would qualify for the fair value option.

a. The Stanley Works (CL 42) argued that individual asset and liability measurements should be based on their individual merits and classification as an asset or liability, not based on implementing a new hedge accounting standard. By allowing a company to report assets and liabilities at fair value due to that entity having risks that qualify for hedge treatment, while an entity with no exposure or different risk management objectives accounts for the same type of underlying asset or liability at book value, creates significant comparability issues between entities.

PRESENTATION OF HEDGING GAINS AND LOSSES

86. The ED invited comments as to whether the Board should prescribe the presentation of hedging gains and losses. Statement 133 does not prescribe the presentation of gains and losses associated with hedging instruments, including the effective portion, the ineffective portion, and any amounts excluded from the evaluation of effectiveness, such as forward points.

Comments from Users

87. Some users support a prescriptive approach to the presentation of gains and losses related to hedging instruments, noting that such an approach could improve the usefulness of financial statements and would facilitate the disclosure of useful information in an XBRL format. Other users believe that new disclosures required by Statement 161 will provide sufficient information to users, making prescription of the presentation of gains and losses unnecessary.

    a. The CFA Institute (CL 68) stated that a prescriptive approach can improve the transparency of hedge accounting, as it can make visible the effects of financial risk associated with derivatives financial reporting data across reporting firms and across time periods. A 2007 Corporate Disclosure survey revealed that 77 percent of respondents supported a standardize approach so as to ensure comparability.

Comments from Preparers

88. The majority of preparers recommended that the Board not prescribe the presentation of gains and losses associated with hedging instruments. These respondents argued that the prescription of the presentation of derivative gains and losses would be difficult, as derivative use varies among entities. The respondents advocated a principles-based approach that requires preparers and auditors to apply judgment in determining the presentation of derivative gains and losses. Many preparers stated that the Statement 161 disclosures would provide transparency for financial statement users. In contrast, a couple of preparers recommended specific presentation requirements that the Board should include in the final Statement.

    a. Nationwide (CL 45) stated that the exclusion of prescriptive guidance on the presentation of gains and losses is appropriate. Derivative use varies widely among companies and industries, so the presentation requirements should be principles based. Statement 161 will provide the needed transparency into the classification of derivatives.

b. Freddie Mac (CL 86) stated that it would be helpful to amend Statement 133 to allow for the presentation of realized gains and losses on derivatives not in hedging relationships in net interest income separate from unrealized gains and losses on the derivatives. Guidance on this issue would be useful, particularly for entities where net interest margin is an important measure.

c. Eaton Corporation (CL 113) stated that a proposed split between interest expense and other income makes sense based upon the intent of placing the hedge. The effective portion of the hedge would be the offset to the interest rate risk (intent of hedging) and belongs within interest expense. Meanwhile, the 'other' non-specific changes in fair value of the hedged item not intended to be hedged are more appropriately classified as other income or loss.

<u>Comments from Auditors</u>

89. Auditors generally agreed that the Board should not prescribe the presentation of gains and losses associated with hedging instruments, while a few auditors recommend that the Board prescribe the presentation of the ineffective portion of these gains and losses.

a. PWC (CL 102) stated that it is not necessary to prescribe the presentation of hedging gains and losses, as practice has developed over time and, where significant, companies disclose their accounting policies. However, the Board may wish to address the presentation of hedge ineffectiveness if it retains the proposed recognition of ineffectiveness associated with underhedges of cash flow hedging relationships. If the hedged transactions will be reflected as if they are perfectly effective regardless of the actual effectiveness of the hedging relationship, it may be more appropriate to require that ineffectiveness be presented in a consistent manner.

b. The AICPA AcSEC (CL 111) expressed agreement with the Board's decision not to prescribe the presentation of gains and losses associated with hedging instruments. Statement 161 appropriately addresses the disclosure of where these amounts are included in the financial statements.

c. Ernst & Young (CL 118) stated that depending on how satisfied the user community is with Statement 161 disclosures, a prescriptive approach may be worth deliberating at a future time.

FORECASTED INTERCOMPANY TRANSACTIONS

90. The ED amends paragraph 40 of Statement 133 to clarify the guidance for the hedging of forecasted intercompany transactions. The ED requires that a forecasted transaction present an exposure to variations in cash flows that could affect reported earnings at the level being reported on. For example, in the financial statements of a consolidated entity, there would need to be a potential earnings effect that survives consolidation.

Comments from Preparers and Auditors

91. Preparers and auditors requested guidance of the proposed clarification to paragraph 40 of Statement 133 that requires an intercompany forecasted transaction to have a potential earnings effect that survives consolidation in order to qualify for hedge accounting. Respondents stated that interpretations of the proposed change vary. Some interpret that the change will fundamentally alter and limit the types of intercompany transactions that can be designated as hedged risks. Others interpret the change to be merely clarifying guidance that is not meant to change the types of transactions eligible for hedge accounting. The latter interpretation is driven by the summary section of the ED which states that "the same types of items and transactions currently eligible for hedge accounting would continue to be eligible under this proposed Statement."

92. Respondents noted that the Board's deliberations on the project did not mention proposed changes in the area of hedging forecasted intercompany transactions at the consolidated level. Some respondents suggested that if this proposed amendment would result in significant changes in current practice, the Board should re-expose the proposed amendment with examples of how it would affect current practice.