



The Association for Accountants and Financial Professionals in Business

March 22, 2011

Sir David Tweedie,  
Chairman

International Accounting Standards Board 30  
Cannon Street London EC4M 6XH United  
Kingdom

Subject: ED/2010/13

Dear Sir David:

The Financial Reporting Committee of the Institute of Management Accountants ("we" or "FRC") is writing to provide its views on the International Accounting Standards Board's ("IASB" or "Board") Proposed Standard *Hedge Accounting* (the "ED") issued in December 2010. The FRC believes that the Board has crafted a reasonable standard that is responsive to many of the issues that have plagued application of hedge accounting for most of the past decade. While we have noted some suggested improvements below, there is no question that this document significantly improves the ability of companies to apply hedge accounting, while providing sensible principles to ensure that hedge accounting is used appropriately. We are hopeful that the FASB will embrace this model in the interests of a converged hedge accounting standard that better reflects how companies manage their risks than existing standards.

FRC is the financial reporting technical committee of the IMA. The committee includes preparers of financial statements for some of the largest companies in the world, representatives from the world's largest accounting firms, valuation experts, accounting consultants, academics and analysts. The FRC reviews and responds to research studies, statements, pronouncements, pending legislation, proposals and other documents issued by domestic and international agencies and organizations.

In considering our experience in applying hedge accounting under FASB Statement No. 133, two common themes have emerged that define how that standard affected practice in this area: (1) the difficulty in meeting the criteria to qualify for hedge accounting for worthy risk management practices (e.g., hedging of commodity prices), resulting in earnings volatility that did not reflect economic reality, and (2) the penalties for deficiencies in exacting documentation or ongoing testing requirements that were often disproportionate to the deficiencies and resulted in companies restating prior results for hedging relationships that were otherwise economically valid. In many cases, although certainly not all, those restatements were the result of changes in good-faith interpretations of the standard that were accepted in practice. In practice, the restrictive and difficult-to-apply provisions in that standard, combined with the harshness of the penalties for minor mistakes encouraged companies to abandon trying to qualify for hedge accounting, produced financial information that was often less useful to investors and gave rise

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March 22, 2011  
to the expanded use of pro-forma disclosures that simulated application of hedge accounting but without a common, defined framework.

We note that the FASB has issued this ED with a Discussion Paper, *Invitation to Comment— Selected Issues about Hedge Accounting* to solicit input on the IASB's Exposure Draft, *Hedge Accounting* (the "DP"), which seeks comments from respondents on key aspects of the proposal. Question 23 of the DP states the following:

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

The FRC believes that the ED is a superior starting point for any changes to US GAAP and we encourage the FASB to work with the IASB to establish a single model based on the ED. We support the IASB proposal because we believe that ED addresses many of the issues we have experienced with applying hedge accounting. Overall, the ED makes it easier for companies to qualify for hedge accounting for legitimate risk management purposes and it reduces the ongoing compliance burden of hedge accounting when a company's risk management activities qualify. The specific areas where we have had significant issues in the past include, but are not limited to, measuring hedge effectiveness, hedging risk components (particularly for non-financial items), hedging using options, late hedging, measuring ineffectiveness, and accounting for under- hedges.

The guidance in the ED (and IAS 39) regarding the application of fair value hedges accounting for hedges of a component of a coupon of a fixed rate assets or liabilities represents a significant improvement over US GAAP. Statement 133 requires a company that hedges changes in the fair value of a fixed rate financial asset or liability attributable to changes in the benchmark rate to consider all cash flows on the hedged item when determining the change in the fair value of the hedged item. That approach results in a company reporting ineffectiveness in earnings that are not related to the hedged risk. In contrast, the ED would permit (as IAS 39 permits) a company to consider only the cash flows associated with the component of the coupon it is hedging when determining the change in the fair value of the hedged item. The absence of this principle in US GAAP causes significant income statement volatility that is not reflective of the economics of the hedging relationship but rather the mechanics of hedge accounting. This false volatility can be eliminated relatively easily using the ED's principle to hedge a component of the coupon (whereby the component is the LIBOR portion of the coupon) and we believe that this is a better way of reflecting the actual results of the hedging activity. Any ineffectiveness that arises from actual differences between the hedged risk and the derivative used to hedge that risk will still be reported as such in earnings.

We believe there are a number of improvements that would make the proposal a more effective final standard. Our specific recommendations are:

1. **Intercompany Foreign Currency Transactions.** We believe that the final standard should permit hedge accounting for hedges of forecasted intercompany transactions (e.g., royalties) prior to the recognition of an asset or liability that exposes a company to foreign currency risk. While IAS 39 does not permit hedge accounting for those transactions, it is

March 22, 2011 why. A company that expects to receive foreign currency cash flows from a subsidiary is as exposed to changes in exchange rates as a company that has a highly probable forecasted transaction with a third party. Because the Board's approach in the ED is to permit common risk management techniques to qualify for hedge accounting, we see no basis to exclude hedges of certain forecasted intercompany foreign currency transactions while accepting others (see paragraph 17 of the ED).

2. **De-designation.** The ED would prohibit companies from de-designating a hedge if it still meets the risk management objective and strategy under which it originally qualified for hedge accounting. It is possible that the principles dealing with rebalancing or layering are intended to obviate de-designation. If so, the final standard should articulate that and provide additional guidance as to how that might work.

Companies need the ability to de-designate voluntarily in order to avoid the operational burden of hedge accounting when it is no longer required. A common example of when this is necessary under US GAAP involves hedging foreign currency cash flows through to the ultimate payment date. The approach to hedging foreign currency cash flows to the ultimate payment date under Statement 133 implementation Issue H-15 is operationally complex. Having the ability to de-designate on the date the company recognizes the foreign currency payable removes that complexity. Because of the complexity required to apply hedge accounting for such transactions under US GAAP, it is common practice to de-designate the hedge on the date that the foreign currency payable is recognized and then allow the fair value changes in the standalone derivative to mitigate the transaction gains and losses on the payable. A compromise solution would be to permit de-designation in such circumstances if it is something that is contemplated in the upfront hedge documentation (i.e., if the upfront strategy clearly states that dedesignation is contemplated at the point in time that the payable is recognized).

3. **Rebalancing.** The ED indicates that an entity should be required to rebalance a hedging relationship. It would appear that this requirement seeks to dictate risk management actions rather than accounting for them. While most large entities will elect to rebalance, a smaller entity may be content to accept a greater amount of volatility rather than incur the cost to put on another hedge. Since the underlying objective of the standard is to have the accounting mirror a company's risk management practices, if a company's risk-management practices do not require rebalancing, the financial statements should report that.

Further, the requirement to rebalance an individual hedge relationship may be inconsistent with a company's risk management policy. For example, a risk management policy that requires the interest rate profile of assets to match liabilities may be achieved with individual relationships that hedge only the liabilities. Each individual relationship must qualify for hedge accounting; however, rebalancing is less relevant for the individual relationship and more relevant to the overall risk management policy. It is not clear how additions and removals of individual derivatives from hedge relationships would be treated under the rebalancing guidance in the ED. It is unclear whether the duration matching objective would provide the basis for permitting this type of risk management activity in the context of principle of rebalancing.

We therefore believe the Board should a) permit, but not require, rebalancing and b) provide clarification on what is intended with the reference to the entity's risk management objective. If a company elects not to rebalance, we believe it should disclose that it either no longer applies hedge accounting or that it will recognize additional amounts of ineffectiveness because of whatever change resulted in decreased effectiveness. If the Board decides to keep this as a requirement, clarification may be necessary to help companies better understand at what point rebalancing is required.

4. **Hedging a Layer Component.** We are concerned that paragraph 36(e) of the ED would prohibit companies from hedging the risk of changes in the fair value of the first \$X of a pool of pre-payable fixed rate loans for changes in the benchmark interest rate because changes in the benchmark interest rate would affect the fair value of the prepayment option. As this is a common risk management

March 22, 2011  
Strategy, we are uncertain as to whether this is actually the Board's intent. If it is the Board's intent, we believe it should explain why it believes it appropriate to prohibit fair value hedge accounting in that circumstance. We agree that hedge accounting for the last layer of forecasted transactions should not be permitted as it cannot be identified upfront.

- 5. Effectiveness.** We fully support eliminating the quantitative threshold to qualify for hedge accounting, but it is not clear what the Board intends by the phrase "expected to achieve other than accidental offsetting". We understand that one Board member has interpreted this condition as lowering the threshold for hedge accounting so significantly as to unduly expand hedge accounting. We assume that the Board does not mean to permit hedge accounting for a derivative that offsets only a minor portion of the change in the fair value of the hedged item attributable to the hedged risk. If our assumption is correct, we believe the Board should explain why the condition does not lower the threshold for hedge accounting so significantly. In other words, at what point is the degree of offsetting so low as to be accidental? Paragraph B31 has what we think is the appropriate concept and perhaps could be moved to an earlier part of the standard.

Paragraph B37 of the ED indicates a company might have to change its method for assessing effectiveness if there are changes in circumstances that affect hedge effectiveness but it does not provide any guidance on what circumstances would require a change in the method of assessing effectiveness. We recommend that the Board provide application guidance on the types of circumstances that would warrant such a change to ensure that companies understand the principle.

The ED states that the time value of money should be taken into account when measuring hedge effectiveness. When hedging the spot risk in a foreign currency exposure (e.g., for a net investment hedge there is no defined maturity of the hedged item) in a subsidiary, the change in spot exchange rates is the defined risk. It is unclear how discounting would be factored in, given that there is no defined date for the hedged item. It could also possibly raise operational issues when only spot rate changes are hedged for transactional strategies.

The ED discusses the use of hypothetical derivatives to measure the effective portion of a hedge. It is unclear whether other methods are permitted. Under US GAAP, DIG Issue G7 permits the change in variable cash flows and change in fair value methods in addition to the hypothetical derivative method. If the Board agrees that other methods may be used, it should make a statement to that effect.

- 6. Written Options.** Paragraph 11 of the ED states "two or more instruments (or proportions of them) may be designated as the hedging instrument only if none of them is a written option or a net written option." (emphasis added) If a company enters into a separate cap and floor, one will be a written option even though the combined exposure is not a net written option. Given the wording in paragraph 11, that strategy would not be permitted hedge accounting, which seems to undermine the Board's objective. We recommend that the Board rephrase the second sentence of paragraph 11 to state "two or more instruments (or proportions of them) may be designated as the hedging instrument if the combination is not, in effect, a net written option."
- 7. Presentation of Fair Value Hedges.** We are not persuaded that presenting gains and losses on the hedged item on a separate line item in the financial statements improves the ability of investors to understand the hedging strategy. The ED states presenting the gain or loss on a separate line item "eliminates the mixed measurement for the hedged item". In reality, it does not actually change the mixed measurement (we assume that this separate amount would be considered in impairment assessments of the related asset). The accounting model still calls for a partial fair value adjustment of the hedged item but prescribes a different presentation of that adjustment in the financial statements. This approach also creates an inconsistency with hedges of firm commitments, where the gain or loss continues to be recognized as a basis adjustment.

The proposal also is ambiguous as to whether each type of hedging derivative is presented in its own balance sheet caption or in an aggregate hedge adjustment caption. If the former, then hedge accounting adjustments could substantially increase the number of captions in the balance sheet making it unreadable for users. If on the other hand it is all combined into a single caption for assets and liabilities then users will most likely want a separate note that reconciles these balances to the original hedged items.

8. **Partial Term Hedging.** We believe that such hedges are permitted but the language in the ED is somewhat confusing and we would recommend that it be clarified.
9. **Nil Net Positions.** We found the discussion in paragraph 39 of the ED on "nil net positions" confusing. It is not clear how a company can designate a hedging relationship that does not include a hedging instrument and we request the Board clarify its intent with respect to this topic.

We assume the Board intends to permit an entity to apply hedge accounting to a group of items managed on a net basis, even in periods when the exposure relating to the identified risk nets to zero, as long as the entity intends to enter into derivatives when the exposure relating to the identified risk does not net to zero. This facilitates not having to transition in and out of hedge accounting when the net exposure in the hedged item group changes

from zero to positive or negative. Further, the language in paragraph BC 182 is useful and could be moved up to an earlier part of the standard.

10. **Hedge Ratio.** Paragraph B16 of the ED indicates that a company would need to determine a hedge ratio to ensure that the hedging relationship "will produce an unbiased result and minimize expected hedge ineffectiveness". While more sophisticated users probably do this already, it is likely that less sophisticated end-users do not. This would appear to require them to change how they enter into hedges. This may place an unwarranted burden on such companies. Paragraph B36 of the ED makes the same point as paragraph B16.
11. **Transition.** We think it would be more operational if the assessment of whether a derivative provides other than accidental offsetting is based on the fair value of the derivative at inception (depending on how the Board clarifies other than accidental offsetting). If a derivative has a fair value at the effective date, that would seem to affect its ability to offset changes in the fair value of the hedged item.
12. **Other Observations.** Included below are other points the Board's may wish to consider as it redeliberates the proposal.

- We are unclear as to what the ED is trying to convey in the area of hedge accounting for credit risk.
- We note the use of "highly probable" to qualify for hedging forecasted transactions. Under US GAAP, we use probable. Some may interpret the ED to impose a higher threshold than what we have under existing US GAAP.
- We sense there may be a need for incremental guidance on hedging a noncontractual risk component of a non-financial item (e.g., crude oil component of jet fuel).
- There may be a need for clarification in hedging portfolios of diverse items.
- We disagree with the prohibition of hedge accounting for items that are reported in Other Comprehensive Income.

Sir David Tweedie

Page 6

March 22, 2014 The proposed disclosures are fairly extensive. We ask the Board to consider whether all of them are necessary in the context of the financial statements taken as a whole. In addition, we do not understand the basis for some disclosures, such as the proposed requirement to disclose all forecasted transaction amounts (e.g., foreign currency sales) when only a portion of them are being hedged. We observe that disclosures that are too extensive sometimes obscure the truly important information.

To reiterate, we strongly support the ED as a better approach to hedge accounting than the model we have today and we strongly encourage the FASB to work with the IASB to develop a converged model in this area. We appreciate the Board's consideration of these comments. We are available to discuss these matters at your convenience.

Sincerely, Allan Cohen

Chairman, Financial Reporting Committee Institute of Management Accountants

cc: FASB Board Members