



November 30, 2016

Technical Director
Financial Accounting Standards Board
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File Reference No. 2016-310 - Derivatives and Hedging (Topic 815) Targeted
Improvements to Accounting for Hedging Activities

The AICPA's Financial Reporting Executive Committee (FinREC) appreciates the opportunity to comment on the Proposed Accounting Standards Update (ASU), "Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities." The current hedging standard can be challenging for reporting entities to apply properly. Achieving hedge accounting for financial and nonfinancial risks under the current guidance has also proven to be very challenging.

FASB issued a proposed ASU in 2010 that attempted to address constituents' concerns. In response, FinREC issued a comment letter on September 10, 2010. In that letter, among other comments, we supported the proposal's provisions that would have continued to allow hedge designation by type of risk, allowed hedges to be reasonably effective rather than highly effective, and also would have permitted qualitative assessments to evaluate effectiveness, rather than only quantitative assessments.

We are pleased that the current Proposed ASU also includes provisions to address many of these concerns. Overall, we believe the proposal will improve and simplify the hedge accounting model, will better reflect the economics of risk management activities and will ease hedge documentation requirements.

The attached appendix responds to the Board's questions and offers our additional suggestions for the Board's consideration.

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We thank the Board for its consideration and would welcome the opportunity to further
discuss this matter with the Board members and their staff.

Sincerely,

James Dolinar
Chairman
Financial Reporting Executive Committee

Linda Bergen
Chairwoman
Financial Instruments Task Force

Below are the responses to the questions specifically raised in the proposed ASU:

Question 1: The Board decided it would allow an entity to designate the hedged risk as the variability in cash flows attributable to changes in a contractually specified component stated in the contract in a cash flow hedge of a forecasted purchase or sale of a nonfinancial asset. Do you agree with that decision? Please explain why or why not. If not, what specific alternatives should the Board consider? Please explain why those alternatives would be beneficial.

Response:

We agree with the Board's decision to allow an entity to designate the variability in cash flows attributable to changes in a contractually specified component as the hedged risk in a cash flow hedge of a forecasted purchase or sale of a nonfinancial asset, as this will align the accounting with management's reason for entering into the hedging relationship.

We also encourage the Board to consider a broader application of this decision in the future, such as allowing an entity to designate the variability in cash flows attributable to the changes in a component that may not be contractually specified, but are separately identifiable and reliably measurable as is allowed in IFRS 9. This would enable more effective hedging of certain relationships, for example:

- Hedging purchases or sales of jet fuel: Jet fuel contracts do not usually specify the underlying commodities embedded in the contract; as a result, this will preclude entities from designating a component of jet fuel as the hedged item. If the FASB conformed its requirement to the IASB's, entities such as airlines would benefit. Specifically, many airlines currently use Brent Oil, West Texas Intermediate Oil (WTI), heating oil or other commodities to hedge the price of jet fuel, because those commodities are traded on an established derivatives market, and move in the general direction of jet fuel prices, with Brent Oil typically being the commodity most closely correlated to jet fuel. However, because jet fuel is not perfectly correlated with Brent Oil, under today's guidance and under the proposed ASU, there is some inherent ineffectiveness that must be assessed and measured. In addition, in a few limited instances, these commodities have not been highly effective, even with the use of regression analysis and, therefore, did not qualify for hedge accounting. As such, we believe the FASB should monitor the IASB's implementation of their guidance in this regard to determine whether the concept of contractually specified components for non-financial assets can similarly be expanded in the future.

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Question 2: The Board decided that it would retain the concept of benchmark interest rates for hedges of fixed-rate financial instruments and forecasted issuances or purchases of fixed-rate financial instruments, maintain the existing list of permissible benchmark rates, and add the SIFMA Municipal Swap Rate to the list.

- a. Should the Board retain the current concept of benchmark interest rates for fair value hedges of fixed-rate financial instruments and for cash flow hedges of forecasted issuances or purchases of fixed-rate financial instruments?
- b. Please explain why or why not. If the Board continues to maintain the current concept of benchmark interest rates, should the Board consider within the concept expectations that a rate will become widely used?
- c. If the Board continues to maintain a list of rates, are there any other rates that should be added to the list? Please explain why a particular rate meets the definition of a benchmark rate.
- d. Are there other alternatives to the current concept of benchmark interest rates the Board should consider (for example, a principles-based approach)? Please describe those alternatives.

Response:

Yes, we think the Board should retain the current concept of benchmark interest rates for fair value hedges of fixed-rate financial instruments and for cash flow hedges of forecasted issuances or purchases of fixed-rate financial instruments, and we support the addition of the *Securities Industry and Financial Markets Association* (SIFMA) Municipal Swap Rate as an acceptable benchmark rate. We also believe there should be a process for the FASB to expedite considering additional benchmark rates that are expected to become widely used or become widely used, or removing rates that would no longer be appropriate. At this time, we are not aware of any other rates that should be added or deleted as benchmark rates, although we understand that the Alternative Reference Rate Committee, which was assembled by the Federal Reserve, has been tasked to identify potential alternative benchmark interest rates. While we support the Board's proposal to retain a specific list of benchmark interest rates in the United States, we would also support a more principles-based definition of benchmark interest rates if the Board were to reconsider this option.

Question 3: The Board decided that it would allow an entity to use either the full contractual coupon cash flows or the cash flows associated with the benchmark rate determined at hedge inception in calculating the change in the fair value of the hedged item attributable to interest rate risk, except when the current market yield of the financial instrument is below the benchmark rate at hedge inception. In that instance, the total contractual coupon cash flows would have to be used.

Do you agree with this decision? Please explain why or why not.

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Response:

We agree, since these changes will allow entities the flexibility to conform hedges to be more consistent with risk management activities. However, we question the Board's decision to prohibit entities from using the benchmark rate component of the contractual coupon cash flows to calculate the change in the hedged item's fair value attributable to changes in the benchmark interest rate when the current market yield of the hedged item is less than the benchmark interest rate at the inception of the hedge (commonly referred to as the "sub-LIBOR issue").

We note that a comparable limitation does not exist if an entity is seeking to hedge interest rate risk in a variable-rate financial instrument whose coupon payments are based on a contractually specified variable interest rate (e.g., LIBOR) less a fixed credit spread. In discussing its reasons for amending the guidance related to partial-term fair value hedges, the Board notes in paragraph BC 126 of the Proposed Update that many stakeholders believe "treasurers view risk management as managing cash flows (such as managing the fixed/floating cash flow profile) rather than managing instruments." With this view in mind, we are uncertain why the consideration of a negative credit spread should differ when hedging benchmark interest rate risk in a fair value hedge versus in a cash flow hedge, as in both instances entities are likely trying to manage their fixed/floating cash flow profile as noted above.

Question 4: In regard to hedging forecasted transactions, paragraph 815-30-40-5, as amended, states that "a pattern of determining that hedged forecasted transactions are probable of not occurring would call into question both an entity's ability to accurately predict forecasted transactions and the propriety of using hedge accounting in the future for similar forecasted transactions." What is your policy on what constitutes a pattern? Are there certain instances or scenarios in which missed forecasts should not be incorporated into the consideration of this pattern?

Response:

As an organization composed of many entities that prepare individual financial statements using varying accounting policies, FinREC is not able to comment with respect to any single policy as to what constitutes a pattern of determining that hedged forecasted transactions are not probable of occurring.

However, we believe the Board has an opportunity to simplify and improve the guidance regarding the implications of missed forecasts and whether they should be considered as contributing to a "pattern" of such activity. Specifically, the current guidance in paragraph 815-30-40-4 allows an entity to exclude a specific occurrence of a missed forecast from being part of a pattern if it meets the requirement of being a "rare case" of an extenuating circumstance that is related to the nature of a forecasted transaction and is outside the control or influence of the reporting entity.

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We believe that this requirement should be limited only to an assessment of whether the missed forecast was the result of events or circumstances that were outside the control or influence of the entity, and it should not be necessary for those events or circumstances to also qualify as “rare”, which is not a defined term.

Question 5: Are there hedging relationships that would be eligible to meet the requirements in the proposed amendments and IFRS 9, but the hedge results would be recognized and presented differently? If so, please describe the transaction and why it would be recognized and presented differently in accordance with IFRS 9.

Response:

There are differences in the timing of recognition and the presentation of ineffectiveness:

- The proposed ASU requires that hedge ineffectiveness be included in the same line as the income statement effects of the hedged item and hedging instruments, while IFRS 9 does not specify the income statement geography. In response to the 2010 Proposed ASU, the user community highlighted the need to keep net interest revenue “pure.” However, the Proposed ASU would result in changing the amount of net interest revenue and could result in volatility in the net interest margin. Please see our response to Question 6(a) for further discussion.
- Under IFRS 9, ineffectiveness of cash flow hedges is reported in earnings, while under the Proposed ASU hedge ineffectiveness is initially included in the total change in fair value of the hedging instrument that is reported as a component of other comprehensive income.

Question 6: Do you agree with the following Board decisions on presentation? Please explain why or why not. If not, what other alternatives should the Board consider?

- a. For qualifying fair value, cash flow, and net investment hedges, the proposed amendments would modify current GAAP by requiring the entire change in the fair value of the hedging instrument included in the assessment of hedge effectiveness to be presented in the same income statement line item in which the earnings effect of the hedged item is presented.
- b. For qualifying fair value, cash flow, and net investment hedges, the proposed amendments would retain current GAAP by requiring changes in the fair value of the hedging instrument excluded from the assessment of effectiveness to be recorded currently in earnings. For qualifying fair value and cash flow hedges, the proposed amendments would modify current GAAP by requiring changes in the fair value of the hedging instrument excluded from the assessment of effectiveness

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- to be presented in the same income statement line item in which the earnings effect of the hedged item is (or will be) presented. For qualifying net investment hedges, there will be no prescribed presentation requirements for changes in the fair value of the hedging instrument excluded from the assessment of effectiveness.
- c. For cash flow hedges in which the hedged forecasted transaction is probable of not occurring, the proposed amendments would retain current GAAP by requiring amounts recorded in accumulated other comprehensive income to be reclassified to earnings immediately. However, the proposed amendments would require presentation of reclassified amounts in the same income statement line item in which the earnings effect of the hedged item would have been presented had the hedged forecasted transaction occurred.

Response:

- a. We believe that reporting entities should have the flexibility to determine which income statement lines to use to report the effects of hedging activities. Thus, we believe entities should be allowed to make an accounting policy election to continue current practice, which does not prescribe income statement presentation of hedge accounting results. For example, where the asset/liability management objective of a hedge is to convert fixed-rate interest cash flows to a floating rate, the effects of which are manifested in net interest income, we believe that financial institutions should retain the flexibility to report the contractual interest paid or received related to the hedging instrument and hedged item within net interest income so that net interest income and yield, which are key metrics used by investors to evaluate the performance of a financial institution, are not distorted. The remaining changes in fair value of the hedging instrument and hedged item should be permitted to be recognized outside of net interest income.

While we support and appreciate that the proposed ASU will increase an entity's ability to design more specific hedges (e.g., via partial-term and/or benchmark-rate component cash flows for fair value hedges, and contractually specified components for cash flow hedges, etc.), these amendments will not eliminate the net volatility that will continue to arise due to factors not related to the risk being hedged. For example, in a fair value hedge of interest rate risk for a recognized asset or liability where the significant terms of the hedged item and hedging derivative may exactly match (e.g., notional, tenor, settlement dates, fixed interest rate, etc.), the fixed cash flows of the hedged item are usually discounted using the designated benchmark interest rate, while the change in the value of the hedging derivative will be based on the effects of discounting using an overnight rate (such as Fed Funds) if the derivative is collateralized or, alternatively, include

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adjustments to reflect the creditworthiness of the parties if it is not collateralized. This will result in periodic differences between the change in value of the hedged item and the hedging derivative, which should be captured in earnings in the periods in which they occur, but should not necessarily create volatility in net interest margin (for example) in a hedge of interest rate risk. This is because these valuation differences primarily relate to the riskiness of the future interest settlements and not to the current period interest accruals and, therefore, should not be seen as a “cost of hedging.” In other words, the differences arise because the valuation of the hedging derivative reflects a hypothetical transfer of the instrument (i.e., an exit price), which will not be realized in cash if the derivative is held to maturity as a hedging instrument.

We recommend the Board permit entities the flexibility to present income statement impacts of their fair value hedging activities in a manner that aligns financial reporting of hedging results with their risk management activities, while at the same time requiring transparent disclosure of the hedging effects in the financial statement footnotes.

- b. We agree with the Board’s proposal to retain current GAAP by requiring changes in the fair value of a hedging instrument that are excluded from the assessment of effectiveness to be recorded currently in earnings for qualifying fair value, cash flow and net investment hedges. However, similar to our response in paragraph a. above, we do not believe that the income statement geography of such presentation should be prescribed.
- c. For cash flow hedges in which the hedged forecasted transaction is probable of not occurring, we agree with the proposed amendments to retain current GAAP by requiring amounts recorded in accumulated other comprehensive income to be reclassified to earnings immediately. However, similar to our responses in paragraphs a. and b. above, we do not believe the income statement geography of such presentation should be prescribed.

Question 7: Do you agree with the proposed disclosure amendments in (a), (b), and (c) below? Please explain why or why not.

- a. Cumulative basis adjustments related to fair value hedges
- b. Quantitative hedge accounting goals, if any, that an entity sets when developing its hedge accounting objectives and strategies and whether it met those goals
- c. Revised tabular disclosure for fair value and cash flow hedges that would focus on the effect of hedge accounting on income statement line items.

Response:

We agree with items (a) and (c) above; however, we have concerns about the operability, usefulness and cost benefit of item (b). Adding such quantitative disclosure will be onerous for entities that have multiple types of hedges and varying objectives and strategies. This is not only because hedging strategies and goals may dynamically change based on many factors, but also because entities may not be exposed to similar risks or to similar risks to the same degree.

Hedge programs may be considered to be individual “units” of risk management, but the extent to which hedge programs are utilized may be fluid, based on inter-dependencies between programs (e.g., hedge more fixed-rate AFS securities and less fixed-rate loans in a particular period), and as a response to changes in macro, entity-level exposures that could include naturally offsetting assets and liabilities or other combinations of factors that are unique to the entity. As a result, this quantitative information is not likely to be comparable and in certain circumstances would be considered proprietary. Therefore, it is not clear how this disclosure would provide decision-useful information to a financial statement user. To the extent that hedging strategies are material to a reporting entity, this information more appropriately belongs in the entity’s MD&A.

As has been the Board’s custom in many recently issued ASUs, no distinction has been made between the disclosures required in an entity’s annual financial statements vs. its interim financial statements. There is a considerable cost to prepare and report these interim disclosures. We believe the purpose of interim financial statements is to provide information about significant changes in financial condition since the entity’s most recent annual report. We believe the Board should limit the required interim disclosures to reflect only significant changes in the entity’s hedging programs and hedge effectiveness.

Question 8: Unless the hedging relationship meets one of the exceptions that assumes perfect offset at hedge inception, an entity would be required to perform an initial quantitative test of hedge effectiveness and would be allowed to perform subsequent hedge effectiveness assessments qualitatively unless facts and circumstances change.

Do you agree with this proposed change? Please explain why or why not.

Response:

We agree with the change allowing use of a qualitative assessment of hedge effectiveness subsequent to the initial quantitative assessment as this offers entities a less complex means of demonstrating hedge effectiveness.

We also support the Board’s decision allowing designation of an alternative long-haul hedge effectiveness testing methodology at inception of a hedge that qualifies for the short-cut or critical terms match method. If it subsequently becomes apparent that previous use

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of the short-cut method was inappropriate, we support treating the reversion to the designated alternative long-haul method as an accounting error. However, in the instance where the criteria for the short-cut method are no longer met prospectively (for example, where there is a significant amount of defaults in a loan portfolio being hedged), while the hedge may still be effective under the alternative long-haul method, we believe the change to the long-haul method should be treated as a change in accounting estimate, rather than an accounting error. Moreover, we believe the Board should clarify the guidance that if circumstances requiring the need to revert to the alternative method occur in the *current period*, the impact of the change in the effectiveness testing methodology should not be considered an accounting error.

Question 9: The Board decided that an entity may elect at hedge inception to perform subsequent assessments of effectiveness qualitatively. However, certain changes in the facts and circumstances associated with the hedging relationship in subsequent periods may require a quantitative assessment of effectiveness to be performed. Once an entity determines that a quantitative assessment of effectiveness is required, the entity would be prohibited to return to qualitative testing in periods after this determination is made.

Can situations arise in which an entity no longer may assert qualitatively that the hedging relationship continues to be highly effective but when tested quantitatively would be highly effective? If so, please describe those circumstances.

Should an entity be allowed to return to qualitative testing after such a significant change in facts and circumstances precluded it in a prior period? If so, please discuss the factors that an entity should consider to justify a reasonable expectation that the hedge will once again be highly effective on a qualitative basis.

Response:

We believe an entity should be able to return to using a qualitative assessment subsequent to failing to meet the qualitative testing criteria, if conditions have restabilized such that a qualitative methodology could demonstrate that the hedge is again expected to be highly effective. An analysis of facts and circumstances should be allowed to determine whether moving back to a qualitative analysis method is appropriate.

Question 10: Do you agree with the proposed amendment that would allow an entity to perform the initial quantitative testing portion of hedge documentation at any time between hedge inception and the quarterly effectiveness testing date using data applicable as of the date of hedge inception? Please explain why or why not.

Response:

We believe extending the period for an entity to perform the initial quantitative testing portion of hedge documentation as specified in the Proposed ASU is a sensible change. We also agree that the events listed in the proposed ASU are reasonable events that should

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trigger the documentation completion. However, we believe that it would be appropriate for the Private Company Council (PCC) to consider whether the suitable timeframe for private companies to complete the initial quantitative testing portion of hedge documentation should be different as part of their agenda.

Question 11: The proposed amendments related to the timing of the preparation of hedge documentation and subsequent qualitative testing apply to both public entities and private companies. Are there valid reasons why the content of or the timing of the preparation of hedge documentation should be different for public entities and private companies? If so, please describe the specific types of transactions for which different treatment should be considered.

Response:

Hedging is elective and many entities that make this election should be able to select a method of testing hedge effectiveness within the timeframe proposed in the ASU. However, we encourage the Board to conduct outreach to private companies to understand the effect of the Proposed ASU on hedge documentation requirements and work with the PCC in understanding the perspectives of private companies. We also believe that it would be appropriate for the PCC to consider whether the suitable timeframe for private companies to complete the preparation of hedge documentation and subsequent qualitative testing should be different as part of their agenda.

Question 12: Should the effective date be the same for both public business entities and entities other than public business entities?

Response:

We believe that the effective date should be delayed one year for entities other than public business entities to enable them to observe best practices.

Question 13: How much time is needed to implement the proposed amendments? Should entities other than public business entities be provided more time? If so, how much more time?

Response:

Reporting entities that currently elect to use accounting hedges should be able to implement the proposed amendments quickly, since the changes simplify existing hedge requirements. Therefore, we believe the Board should allow an election to early adopt the ASU.

However, depending on when the standard is issued, the Board should take into consideration that several major standards will become effective (e.g., Leasing, Credit Losses, and Revenue Recognition) in the next few years. More time may be needed just to process the volume of accounting and system changes to collectively adopt these

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standards. Therefore, again, we would not object if additional time was granted (e.g., one year) for nonpublic companies as long the FASB also allows early adoption.

Question 14: Do you agree with the proposed transition method and disclosures in paragraph 815-20-65-3? Do you agree with the Board's decision not to allow a retrospective transition approach? Please explain why or why not.

Response:

We agree with the Board's decision not to allow a retrospective adoption method, which would require reevaluating all hedge relationships for prior periods presented in the financial statements and reevaluating hedge effectiveness under the Proposed ASU's provisions. This would be very burdensome and operationally challenging and would not provide users of the financial statements with useful information.

We note that the proposed modified retrospective transition method would result in certain cash flow hedge ineffectiveness that was previously recognized in earnings being recorded in other comprehensive income and again being recognized in earnings when the hedged item's cash flows are recognized in earnings under the Proposed ASU. However, we also note that a prospective transition method would result in some hedges recorded under the old standard and some under the new standard – a result we find unacceptable. Thus, we support use of a modified retrospective transition approach.