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2011-175  
Comment Letter No. 45  
233 N. Michigan Ave., Suite 2500  
Chicago, IL 60601

April 25, 2011

Via e-mail: [director@fasb.org](mailto:director@fasb.org)

Ms. Susan M. Cospers  
Technical Director  
Financial Accounting Standards Board  
401 Merritt 7  
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Norwalk, CT 06856-5116

File Reference No. 2011-175 — Discussion Paper, *Selected Issues about Hedge Accounting, including IASB Exposure Draft, Hedge Accounting*

Dear Ms. Cospers:

BDO USA, LLP appreciates the opportunity to offer comments on the above discussion paper (the DP). We welcome the Board's efforts to pursue improvements to the separate hedge accounting models proposed by it and the IASB and to find a converged solution. Consistent with our comments on other recent proposals, we believe that a key objective of any proposal issued at this time should be the development of converged "high" quality accounting standards. We are encouraged that the Board is soliciting comments on the IASB exposure draft (the ED) as part of its own work in improving, simplifying and converging hedge accounting. We observe that a converged hedge accounting model would be facilitated by a uniform classification and measurement framework for financial instruments and note that both Boards have made recent progress in this regard.

We believe the IASB's proposed comprehensive changes to hedge accounting with its stress on principles, rather than rules, provides a good starting point for changes to US GAAP. The current US GAAP hedge accounting requirements, as set out in ASC 815, *Derivatives and Hedging*, are rules-based. To achieve hedge accounting, an entity must meet a range of detailed requirements. These requirements, in practice, have evolved into "bright line" tests that may not reflect the underlying economic rationale for entering into hedges. In contrast, the ED proposes to link hedge accounting to the risk management approach adopted by an entity. This will provide for a wider range of eligible hedged items and hedging instruments, as well as the continuation of hedge accounting over the period that a "rebalanced" hedging relationship remains reflective of the risk management strategy. We conceptually agree with this different mechanism.

However, we believe that the innovative approach outlined in the ED is only a good starting point. There remain several conceptual and operational areas where we believe further consideration by both Boards is necessary. Our concerns include:

- Insufficient articulation of the linkage between risk management activities and hedge accounting;
- Prohibition of hedge accounting for risks that affect only Other Comprehensive Income;
- Restrictions on the designation of an inflation component as a hedged risk and the proposal to prohibit hedge accounting for hedges of credit risk using credit derivatives;



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- Prohibition of designating the layer component of a contract having a prepayment option as a hedged item;
- Mandatory rebalancing requirements;
- Prohibition of designating net internal derivative positions as hedged items;
- Prohibition on voluntary dedesignation of hedging relationships;
- Presenting too much detail on the face of the primary financial statements; and
- Requiring disclosures about risk management activities and forecasted exposures in the financial statements.

Further, assuming that the Boards move forward in a converged manner using the ED as a starting point, we believe that several key concepts of the ED will require additional clarification to ensure consistent application of the guidance in the manner intended. In particular, the ED notes that the objective of a hedging relationship is to produce an unbiased result and minimize expected hedge ineffectiveness. It would be helpful if the Boards clarify what is meant by “unbiased result” and “minimize expected hedge ineffectiveness” as these could be interpreted in an overly restrictive manner, thereby defeating the objective of the ED to apply hedge accounting in a more accessible, although objective, manner. Similarly, questions are likely to arise around the meaning of “other than accidental offsetting.”

We note that the ED is the first step in bringing improvements to hedge accounting under IFRS with the second phase, portfolio hedge accounting, still to be proposed. We acknowledge the IASB’s statements that conclusions reached in this first phase will not prejudice the conclusions that will be reached for portfolio hedge accounting. However, for some entities the conclusions reached in the second phase will have a significant effect. Although implementation may vary based on differing risk management objectives and strategy, under a principles based approach, the model for both open and closed portfolios should be based on an integrated framework of general principles. Consequently, decisions made in finalizing the second phase may have implications for the general hedge accounting model proposed in the ED. Therefore, we encourage that the second phase be finalized as soon as practicable, thereby eliminating any speculation in this regard, and prefer that the complete set of amendments be issued as a package.

We further note that the IASB’s deliberation of the macro hedging proposal in a separate phase gives both the Boards an opportunity to jointly deliberate and expose a converged final package, and we urge the Boards to avail themselves of this opportunity.

Given the significance of hedge accounting on the comparability of financial statements and the operational burdens for entities that carry out business in multiple jurisdictions requiring reporting under both US GAAP and IFRS, we also urge the Boards to align their schedules on this project to enable issuance of converged guidance or at the least, agree upon a harmonized framework of general principles. We would be supportive of the Boards taking additional time to develop high quality converged standards even if this means that the final guidance is delayed beyond the current timeline.



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We note that the Board has not exposed for comment detailed amendments to the US Accounting Standards Codification resulting from its current proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities—Financial Instruments (Topic 825) and Derivatives and Hedging (Topic 815)*. However, given the significance of this project, it seems likely that any final amendments will require a separate exposure period to mitigate unintended consequences that otherwise would only be identified and addressed through post implementation reviews or additional standard setting.

Our specific responses to the questions posed in the DP are set out in the attached Appendix. Our responses are provided in the context of the potential that the Boards will jointly redeliberate comments received on the DP.

\* \* \* \* \*

We hope that our comments are helpful and would be pleased to discuss them with the Board's staff. Please direct questions to Lee Graul, National Director of Accounting, at 312-616-4667 or [lgraul@bdo.com](mailto:lgraul@bdo.com); and Gautam Goswami, Senior Manager in the National Accounting Department at 312-616-4631 or [ggoswami@bdo.com](mailto:ggoswami@bdo.com).

Very truly yours,

*BDO USA, LLP*

BDO USA, LLP



## APPENDIX

### Risk Management

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

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

No. We note that no disclosures are required for those items which have not been designated in a hedging relationship, but are used for the purposes of hedging in the context of an entity's risk management strategy.

In certain cases entities enter into specific external contracts, often derivative instruments, for the purposes of risk management and do not designate these external contracts as hedging instruments in a qualifying (accounting) hedging relationship, even though it may be possible to do so. To an extent, this existing practice has been driven by the complex and onerous requirements of the current hedging guidance; if taken forward, the proposed ED may make hedge accounting more attractive and a wider range of entities may elect to apply hedge accounting. Regardless, we believe that it would be appropriate to require disclosures for these instruments and relationships, in order that entities undertaking the same or very similar risk management activities using specific hedging instruments do not have substantially different disclosure requirements simply because economic hedges have not been designated in or set up as an accounting hedge.

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

We do not believe that the proposed guidance and illustrative examples included in the ED are sufficient.

We suggest that the Boards further clarify "risk management," as the term is intended to be used in the ED. An entity's risk management strategy is critical in determining whether hedge accounting can be applied. For instance, the ED requires hedge accounting to be aligned with risk management and the hedging relationship to be dedesignated if it no longer meets the risk management strategy. To achieve consistency of application and to address the alternative views raised in paragraph AV5 of the ED, we believe that the Boards' intent and meaning must be clear. We also suggest that the Boards clarify whether the terms risk management "activities," "objectives" and "strategy" have different meanings or are intended to be used interchangeably in the ED.



To make the guidance operational, we suggest that the Boards specify whether the objective for undertaking a hedging relationship must be linked with the risk management activities at the transaction level or the entity-wide level. It also would be helpful if the Boards clarify the extent to which this linkage must be documented. For instance, if an entity's overall risk management strategy is to limit exposure to net foreign currency risk, would it be permissible to hedge only the foreign currency inflows or outflows instead of the net position? Although we do not believe it is necessary to link each hedging relationship to an overall entity-wide management strategy, we suggest that the Boards clarify whether hedge accounting is precluded in this instance or whether hedge accounting can be achieved by documenting the hedging relationship in a manner not wholly aligned with/linked to the entity-wide risk management strategy.

Further, we note that paragraph 19(b) of the ED requires an entity to document how it will assess hedge effectiveness. It does not specify whether an entity also should contemporaneously document the method of measuring ineffectiveness (e.g. the "hypothetical derivative method", the "120C method"). We suggest that the Boards clarify whether this is a change from the current guidance, which requires the specific method of measuring ineffectiveness to be included in the contemporaneous documentation. We believe that such clarification would be helpful in making a converged standard operational. If an entity is not required to include it in the contemporaneous documentation, we suggest that the Boards specify that the method selected by the entity for measuring hedge ineffectiveness be consistently applied.

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

We believe that the risk management objective for many hedging relationships may have to be described more specifically than under current practice. Current GAAP requires that the entity's risk management objective and strategy for undertaking the hedge be documented. However, sometimes a generic description of the objective is stated in the contemporaneous hedge documentation, for instance, mitigating income statement volatility, instead of the underlying risk management strategy for undertaking the hedge. Although the same term "risk management objective" is used in the ED, we believe that the Boards intent is to reference the underlying economic objective (e.g., the risk management strategy of addressing the sources of volatility) rather than the desired accounting outcome." If this is the case, it would be helpful for the Boards to clarify.

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

Please see our responses to questions 1-3.



Further, we do not consider risk management strategies to be objectively measurable or auditable. The inclusion of an entity's risk management strategies in an audited footnote could create an expectation gap that the auditor is implicitly opining on the adequacy of an entity's risk management objectives. If the Boards move forward with the proposed requirement to disclose an entity's risk management strategies, we suggest that such disclosure be captioned "unaudited" similar to the US GAAP pro forma disclosures under ASC 805, *Business Combinations* and the unaudited supplementary financial information for oil and gas producing activities disclosed in accordance with ASC 932, *Extractive Activities - Oil and Gas*.

### Hedging Instruments

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

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

We agree that an entity should be permitted to designate a non-derivative financial asset or a non-derivative financial liability measured at fair value through profit or loss (FVTPL) as a hedging instrument. We note however, that under IFRS 9, *Financial Instruments*, the changes in fair value due to credit risk of nonderivative financial liabilities designated as FVTPL are permanently recognized in other comprehensive income. Since not all fair value changes for these instruments are recognized in profit or loss, we suggest that the Boards clarify whether such instruments will qualify as hedging instruments.

We separately recommend that terms used in the ED but not specifically included in any current US GAAP guidance be identified and defined in a manner that illustrates the difference between these new and currently defined terms. For instance, it would be helpful to clarify whether the term "cash instruments" as used in the ED is interchangeable with the term "financial instruments" as defined and used in current US GAAP. We believe that such jurisdictional clarification of terms would be helpful in making a converged standard operational.

### Hedged Items—Overall

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

Question 6: Do you believe that the proposed guidance is sufficient to understand what constraints apply when determining whether an item in its entirety or a component thereof is eligible to be designated as a hedged item (for example, equity instruments measured at fair value through profit or loss, standalone derivatives, hybrid



instruments, and components of instruments measured at fair value through profit or loss that are not permitted to be bifurcated)? If not, what additional guidance should be provided?

We agree that risk components should be eligible hedge components if the risk component is separately identifiable and reliably measurable. We believe that the ED's guidance is generally sufficient to understand the objective of what constraints apply when determining whether an item in its entirety or a component thereof is eligible to be designated as a hedged item. However, we continue to believe that the hedged forecasted transaction should be described with sufficient specificity so that when a transaction occurs, it is clear, without the benefit of hindsight, whether that is the hedged transaction or not. We suggest that this "specificity" principle be clarified in the ED, especially for hedges of layers and risk components that are not contractually specified.

Further, we do not agree with the proposed restriction relating to inflation, which would only be eligible to be designated as a risk component if it is contractually specified. We believe that "bright line" rules should be eliminated and it should be left to the entities to apply the principles and concepts of the ED in determining whether they meet the criteria.

We also note that the proposal to prohibit the designation of a layer component that contains a prepayment option is based on the premise that the risk component cannot be separately identified. Consistent with our views in the preceding paragraph, we believe the final standard should avoid specific rules. The question of prepayment options may also be important in the context of portfolio hedge accounting by financial institutions, and decisions made in finalizing the second phase on macro hedging may have implications in this regard.

#### Hedged Items—Risk Components

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

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

We agree that an entity should be permitted to designate a component of an item as a hedged risk if it is separately identifiable and reliably measurable. As noted in our responses to Question 6 above, we believe that "bright line" rules should be eliminated and it should be left to an entity to apply the principles and concepts of the ED in determining whether they meet the criteria.

Additional examples to further illustrate the principles in paragraph B15 of the ED, in a manner that does not give rise to guidance that could be interpreted as bright-line thresholds, may be helpful.



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

No. See our responses to Question 7 above.

#### Hedged Items—Layer Component

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

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

We believe that the proposed guidance is generally sufficient to understand what constraints apply to determining a layer component from a defined population. However, we continue to believe that the hedged forecasted transaction should be described with sufficient specificity so that when a transaction *occurs*, it is clear, without the benefit of hindsight, whether that is the hedged transaction or not. We note that:

- Paragraph B20 of the ED refers to a specified percentage of a nominal amount of a loan. We assume that in such cases the nominal amount of the loan would need to be fixed, or there would need to be a hedging relationship that was rebalanced in the event that the nominal amount of the loan changed. It would be helpful for this to be made clear.
- Paragraph B21 (b) of the ED refers to part of a physical volume as a potential hedged item. While we agree that this is appropriate, the example given is not clear as it does not specify which 50,000 cubic meters are being referred to (for example, the first 50,000, the second 50,000 or some other layer).

#### Hedged Items—Aggregated Exposures and Groups of Items

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

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

We note that the proposal requires the effects of fair value hedge accounting to be presented separately from the hedged item. We believe that the hedged item and the



effects of the hedge should be considered on a combined basis before applying impairment guidance. This might require a change to current systems and controls and additional administrative work.

While we agree with the eligibility criteria to apply hedge accounting for aggregated exposures and groups of items, including net positions, we note that the deliberations on the second phase on macro hedging may identify more complexities in this area that may have operational implications.

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

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

If part of the entity's risk management strategy, we agree that an aggregated exposure as described should be eligible to be designated as a hedged item.

However, we are concerned that the proposal could be read by some as permitting synthetic accounting by aggregating a derivative and a non derivative instrument and, in consequence, permitting amortized cost accounting for derivatives. For example, a fixed rate foreign currency denominated debt instrument is combined with a cross currency interest rate swap to create a synthetic domestic currency variable rate instrument. While this is noted as being for risk management purposes, it may be interpreted by some as permitting amortized cost measurement of derivatives for accounting purposes as well. We suggest that it is made clear that all derivatives are required to be measured at fair value, regardless of how they managed.

When assessing hedging relationships for effectiveness or measuring ineffectiveness, the hypothetical derivative method is often a practical approach. It would be helpful if the final guidance includes an example illustrating the mechanics of designing the hypothetical derivative and applying this method in the context of hedging aggregated exposures.

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

We agree that an entity should be permitted to apply hedge accounting to a group of cash instruments or portions thereof that offset and qualify as a group. However, we believe that the concerns raised in paragraphs AV6 to 8 of the ED should be addressed before issuance of the ED in final form so that this guidance is not abused. We believe that the ED should provide further indicators on what can or cannot be included in a group. Decisions made in finalizing the second phase on macro hedging may also have implications in this regard.



We are concerned with the proposal that the cash flows of any offsetting positions of a group in a cash flow hedge must affect earnings in the same reporting period. By creating an artificial accounting barrier, this additional eligibility requirement undermines the general principle in the ED that allows hedge accounting for transactions for which the entity economically manages risk. We suggest that this additional eligibility requirement be redeliberated before finalizing the standard.

### Hedge Effectiveness

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

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

We note that the objective of a hedging relationship is to produce an "unbiased result" and "minimize expected hedge ineffectiveness." This might be viewed as being overly restrictive, as it would imply that an entity would need to select the most effective hedging instrument available. In practice, this may not be the case, either due to the type of hedging instrument that is normally available through market convention, or cost.

It is also not clear whether the requirements of paragraph B29 of the ED are wholly consistent with those of paragraph 19(c); it would be helpful to clarify what is meant by "the objective of the hedge effectiveness assessment." It would also be helpful for the Boards to clarify what is meant by "other than accidental offsetting."

It might be argued that the extent to which a hedging relationship is ineffective is unimportant, provided all hedge ineffectiveness is recorded in earnings and hedge accounting is aligned with the entity's risk management activities. In this case, there would appear to be little need for the extent to which a hedging relationship is expected to be effective to be included within the qualifying criteria. We believe that as drafted, the proposal would give rise to questions about how effective a hedging relationship needs to be before it qualifies to be designated as a hedging relationship for accounting purposes. If it is considered that a (non bright line) threshold is needed, then it would be appropriate to explain why it is necessary, and to provide principles for determining where that threshold lies. The "reasonably effective" threshold in the separate hedge accounting model proposed by the Board may be a good starting point for redeliberations on this matter in case a threshold is required.

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

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



As indicated in our responses to Question 14 above, the key hedge effectiveness concepts of “unbiased result,” “minimize expected hedge ineffectiveness,” “other than accidental offsetting,” and the linkage between these terms needs to be better illustrated. Until the concepts and terminology in the ED are clarified in a manner that is capable of being objectively measurable or determinable, significant audit issues may arise.

### Changes to a Hedging Relationship

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

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

We agree that voluntary, proactive, rebalancing should be permitted. This would permit an entity’s hedge accounting to be consistent with its risk management strategy in the event of changes in the hedging relationship.

However, we disagree that an entity should be prohibited from voluntarily discontinuing a hedging relationship. In our experience, entities rarely de-designate hedge relationships voluntarily, except in response to changes in circumstances or as an overall hedge strategy. We believe that there should be a free choice of when to discontinue hedge accounting similar to the proposed free choice as to when to elect hedge accounting. We do not think dedesignation has been used as a tool for changing measurement attributes and/or managing the classification of certain items reported in earnings in practice. An entity might determine, after electing hedge accounting, that the cost or administrative burdens of regular effectiveness testing outweigh the benefits obtained from the accounting effect. In such cases, we believe that dedesignation should be permitted. It is possible that this is intended from the guidance, since the lack of an effectiveness test would mean that not all of the qualifying criteria set out in the ED would be met. If this is the case, it would be helpful for the Boards to clarify.

We also disagree with the mandatory rebalancing requirements. We do not believe that accounting guidance should dictate an entity’s risk management activities by mandating rebalancing. Further, we believe that as drafted, the proposal would give rise to questions about how effective a hedging relationship needs to be before a rebalancing is required to maintain hedge effectiveness. If an entity’s risk management activities do not require rebalancing, it might be argued that the extent to which a hedging relationship becomes ineffective is unimportant, provided all hedge ineffectiveness is recorded in earnings.

If the Boards move forward with the proposal as drafted, we believe that there are significant concerns relating to application of the guidance and also in determining whether a change to a hedging relationship represents a rebalancing or a discontinuation.



We believe that allowing an entity to have a free choice of when to discontinue hedge accounting would mitigate some of these concerns. Our concerns include:

(a) Proactive rebalancing:

- a. Lack of guidance regarding what management must do to support its determination that a proactive rebalancing is necessary, which may lead to diversity in practice.
- b. Lack of clarity as to whether management would have to undo the proactive rebalancing if it is subsequently determined that management assumptions were incorrect.

(b) Mandatory rebalancing:

- a. Lack of clarity on what the consequences would be if an entity is required to, but does not, rebalance a hedging relationship. It would appear that, unless the effectiveness became only "accidental," hedge ineffectiveness would simply be recorded in earnings.
- b. Lack of clarity as to whether mandatory rebalancing meets the objective of hedge accounting, since it results in an accounting exercise rather than reflecting risk management activities.
- c. Mandatory rebalancing requirements may be more burdensome to comply with than the current practice of determining whether the hedging relationship is "highly effective."

Unless these operational concerns are addressed by the Boards, there may be diversity in practice and improper application of the proposal.

Further, the ED illustrates rebalancing with reference to a change in volume of either the hedged item or hedging instrument. We suggest that the Boards clarify whether other strategies, for instance, entering into additional hedging instruments, would be considered a rebalancing or would it lead to a discontinuation of the hedging relationship.

For risk management, see our responses to Questions 1 to 4 above. We also suggest that the Boards address whether discontinuation can be "achieved" depending on how specifically the risk management strategy was initially documented in the contemporaneous hedge documentation. For instance, if the risk management objective and strategy was documented at the transaction level, it may be simple to subsequently assert that the objective for the transaction has changed, thereby achieving "voluntary" discontinuation.

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

See our responses to Question 16 above.



### Accounting for the Time Value of Options

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

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

We are neutral as to whether an entity should capitalize the time value of an option as a basis adjustment of nonfinancial items or reclassify such amounts from other comprehensive income when the hedged item affects earnings.

We conceptually agree that the initial time value of options should be part of the hedging relationship and related accounting. However, some entities may find the requirement to distinguish between "time period" and "transaction related" items and account for them separately to be onerous and complex. As a practical expedient, we recommend that entities have a policy choice to recognize all changes in time value directly in earnings, instead of recording the aligned portion of such changes initially in other comprehensive income.

Further, if the Boards move forward with the proposal, as drafted, we suggest that the guidance simply state that the effective portion of the time value be recognized in earnings whenever the hedged item affects earnings and any ineffective portion be recognized immediately, instead of differentiating between time period and transaction related items. We believe that this terminology change would preserve the concepts in the ED regarding time period and transaction related items as well as make it operationally simpler to understand and apply.

US constituents commonly apply the guidance in DIG Issue G20 (codified in ASC 815), *Assessing and Measuring the Effectiveness of a Purchased Option Used in a Cash Flow Hedge* when using options in hedging relationships. We suggest that the background conclusions in the final standard discuss and compare the proposed guidance with the DIG Issue G20. We believe that this would be helpful in making a converged standard operational.

### Hedge Accounting and Presentation

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

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



We do not believe the proposed presentation of the gains and losses in other comprehensive income will provide users of financial statements with more decision-useful information than the current practice of presenting these changes in earnings and are not aware of any user concerns in this regard. Further, in the absence of principles that articulate why some items should be recorded in net earnings, while others should not, and the relative importance of one category to the other, we do not see a compelling reason to disrupt practice on this point. Rather, we believe the Boards would need to develop a conceptual framework for the role of other comprehensive income before issues of presentation can be settled. This would include resolving differences between the Boards about “recycling” amounts from other comprehensive income into earnings.

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

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

We acknowledge that the combination of changes in the fair value of a component of a hedged item with other components that are measured at amortized cost means that the item is presented at an amount which is neither fair value nor amortized cost. However, we consider that the proposed approach would risk including too much detail on the face of the primary statement. We suggest that the detail is included in the notes to the financial statements.

The proposed changes in the presentation also may lead to operational complexities, including a change to the current systems and controls and additional administrative work, when assessing and monitoring the hedged items for impairments and to ensure derecognition at the same time as the items to which they relate.

Further, in the absence of a cost-benefit study, we are unable to comment on whether any potential benefits justify the costs of a change in presentation.

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

See responses to Question 20 above.

### Disclosures

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

**Question 22: Do you foresee any significant auditing issues arising from the inclusion of risk management disclosures in the notes to the financial statements? If yes, what**



issues do you foresee and how would you alleviate them? Do you believe that it is appropriate to include risk management disclosures in the notes to the financial statements rather than in other information in documents containing financial statements? Why or why not?

We believe that an overriding principle of any disclosures in the notes to the financial statements is that they be objectively auditable. We believe that the Boards should redeliberate the proposed disclosures, especially the requirements to disclose an entity's risk management strategy and forward looking information related to forecasted exposures, in this context. We also understand that many respondents have raised concerns regarding the commercial sensitivity of some of the proposed disclosures, for instance disclosing the hedged rates.

Further, we believe the unprecedented volume of proposed disclosures in current and recent standard setting has reached a point of diminishing marginal returns and therefore question whether all the disclosures are required. We suggest that the following might be used as principles to determine the information that is ultimately required:

- What is being hedged?
- Why is it being hedged?
- How effective/ineffective has the hedge been?
- What is the effect on the primary financial statements?

#### Other

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

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

Please see our covering letter.