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15 August 2008

Mr. Robert Herz  
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**Re: *Exposure Draft: Accounting for Hedging Activities; an amendment of FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities***

Dear Mr. Herz,

The CFA Institute Centre for Financial Market Integrity (CFA Institute Centre),<sup>1</sup> in consultation with its Corporate Disclosure Policy Council (CDPC)<sup>2</sup>, appreciates the opportunity to comment on the exposure draft of amendments to FASB Statement No. 133, *Accounting for Derivatives Instruments and Hedging Activities*.

CFA Institute represents the views of its investment professional members, including portfolio managers, investment analysts, and advisors, worldwide. Central tenets of the CFA Institute Centre mission are to promote fair and transparent global capital markets, and to advocate for investor protections. An integral part of our efforts toward meeting those goals is ensuring that the quality of corporate financial reporting and disclosures provided to investors and other end users is of high quality. The CFA Institute Centre also develops, promulgates, and maintains guidelines encouraging the highest ethical standards for the global investment community through standards such as the *CFA Institute Code of Ethics* and *Standards of Professional Conduct*.

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<sup>1</sup> The CFA Institute Centre for Financial Market Integrity is part of CFA Institute. With offices in Charlottesville, VA, New York, Hong Kong, and London, CFA Institute is a global, not-for-profit professional association of more than 96,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 133 countries, of whom nearly 83,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 136 member societies in 57 countries and territories.

<sup>2</sup> The objective of the CDPC is to foster the integrity of financial markets through its efforts to address issues affecting the quality of financial reporting and disclosure worldwide. The CDPC is comprised of investment professionals with extensive expertise and experience in the global capital markets, some of whom are also CFA Institute member volunteers. In this capacity, the CDPC provides the practitioners' perspective in the promotion of high-quality financial reporting and disclosures that meet the needs of investors.



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## General Comments

We appreciate that hedge accounting was introduced to minimize the measurement and recognition inconsistencies that could arise between the accounting treatment applied to hedging instruments, such as derivatives, and the accounting treatment applied to the hedged risk. Nevertheless, it is widely recognized by both users and preparers of financial statements that the application of hedge accounting has contributed to the overall complexity, inconsistency, and reduced transparency of financial reporting information.

### Congruence with Fair Value

We have long held the position that the most significant improvement to the financial reporting of financial instruments, including derivatives, can best be attained by measuring all financial instruments at fair value and recording the changes in fair value through earnings. This view has been articulated in principle 3 of the Comprehensive Business reporting Model (CBRM)<sup>3</sup>, and reiterated through several recent comment letters. These include the 8 May 2006 comment letter on FASB Statement No. 159 *'Fair Value Option for Financial Assets and Financial Liabilities: Including an amendment of FASB Statement No. 115'* and the 31 October 2006 comment letter to Mr. Herz on fair value accounting. This view is further supported by the results of recent surveys of investment professionals. In particular, of the 2,006 respondents to a March 2008 survey of CFA Institute members on the topic, 79 percent believe that fair value improves financial institution transparency and understanding of risk profile, and 74 percent believe that it improves market integrity.

In addition to improving transparency of financial instruments, the widened application of fair value as a measurement basis would reduce the need for hedge accounting and the concomitant need to devote resources to improving hedge accounting. Nevertheless, we acknowledge current reality and therefore support the board's endeavour to reduce the complexity stemming from prevailing hedge accounting requirements. We would expect the proposed amendments to reduce the likelihood that financial statement preparers will apply different accounting methods to similar financial instruments. More consistent accounting treatment by preparers will in turn translate to more comparable financial statements across reporting entities and across different time periods. We also believe that the proposed changes represent some movement toward a better depiction of economic reality.

Yet within the framework of improving hedge accounting, more could be done to address some outstanding recognition and measurement anomalies as well as to improve supporting disclosures. There is also the broader question of whether amendments that primarily reduce the hedge accounting compliance burden are directionally consistent with the goal of full fair value. Anecdotal evidence would suggest that preparers view the application of hedge accounting and the use of the fair value option under SFAS 159 to be alternative methods of redressing measurement attribute inconsistencies. This raises the question of whether measures that encourage hedge accounting beyond current levels could have the unintended consequence of entrenching hedge accounting and increasing opposition to the movement to full fair value for all financial instruments.

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<sup>3</sup> A Comprehensive Business Reporting Model: Financial Reporting for Investors: July 2007.



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## **Outstanding Recognition and Measurement Anomalies**

### *Fair Value Hedge Accounting*

We have particular concerns relating to the last sentence of paragraph 24 of Statement 133 as it could result in the deferral of amortization of gains and losses of an entity's own debt. This statement stipulates that '*An adjustment of the carrying amount of a hedged interest-bearing financial instrument shall be amortized to earnings; amortization shall begin **no later than** when the hedged item ceases to be adjusted for changes in its fair value attributable to the risk being hedged*'. We are concerned that the proposed amendments in the exposure draft do not address the measurement inconsistencies that can arise from the current language. For example, measurement inconsistencies can arise when a reporting entity has issued fixed rate debt and uses a 'receive fixed and pay floating' interest rate swap to hedge the interest rate risk. The 'no later than' stipulation can result in the deferral of the debt amortization gains/losses until the reporting entity stops hedging or settles the debt. The deferral of amortization is often applied by reporting entities to bypass the need to adjust the carrying amount of the debt, as this affects the effective interest rate calculation of the hedged item (i.e. own debt). With this language there is an option on when to amortize the carrying amount.

The above anomaly could be remedied by the adoption of full fair value and by elimination of the accounting requirement of the held to maturity category for financial instruments. We do recognize that these are long-term objectives. Hence, we propose that, as an intermediate measure, the Exposure Draft (ED) amendments should delete the 'no later than' phrase contained in paragraph 24, which would eliminate the option to defer the recognition of issuer debt amortization gains and losses. Alternatively, if the literature remains unchanged, the required disclosures should be expanded. Companies should also have to disclose the fact that they are not amortizing debt, as well as the amount of the adjustment to the debt that is not being amortized and whether they have adopted the same policy for all instruments and, if not, for all instruments, companies should disclose the characteristics of the ones for which they have adopted the same policy.

### *Cash Flow Hedge Accounting*

We believe that more needs to be done to reduce the distortion of economic reality and overall complexity that is created by current cash flow hedge accounting requirements. In contrast to fair value hedge accounting, cash flow hedge accounting adjusts the derivative accounting treatment to conform to that of the hedged item. The optionality and inconsistency between cash flow and fair value hedge accounting can result in differing accounting treatments for the same derivative risk instruments and essentially the same risk exposure<sup>4</sup> depending on the asserted nature of risk transformation being undertaken. The deferral and subsequent recycling of gains and losses of derivative instruments necessary to achieve the effects of cash flow hedge accounting is both complex and uneconomic. These concerns regarding cash flow hedge accounting are further exacerbated by the proposal to enable preparers to use a 'reasonably

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<sup>4</sup> For example, a received fix and pay floating interest rate swap will have differing accounting treatments if it is used to hedge fair value risk of a fixed rate debt asset or liability, from its accounting treatment when used to hedge, cash flow risk of a floating rate debt asset or liability.



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effective' rather than 'highly effective' threshold to qualify for hedge accounting. Other troubling aspects of current cash flow hedge accounting rules include:

- Lengthy deferral periods: A number of recent high profile restatements have illustrated how the current cash flow hedge accounting requirements can result in the delayed recognition of realized derivative losses. For example, a Bloomberg article<sup>5</sup> cites the case of Freddie Mac applying cash flow hedge accounting on the derivatives used to hedge its own debt. In the process, there has been the deferral of gains and losses for periods of up to 26 years. A study<sup>6</sup> of Dow Jones constituent companies found that the deferral periods ranged from 6 months to 30 years, and this variability contributes to the interpretive difficulties in understanding what lies in and what is transferred from the AOCI. Hence, the current deferral requirements contribute to investors' difficulties in understanding the income and cash flow effects of derivatives designated for cash flow hedge accounting purposes.
- Flawed anticipation of hedge effectiveness: The rules of Statement 133 require the forecast of AOCI adjustments for the next 12 months. Results of the study<sup>7</sup> on the application of Statement 133 by Dow Jones constituent companies showed that there is significant, average forecast error (63%) in the AOCI adjustment, where the forecast error is measured as between anticipated and actual AOCI adjustment. Cash flow hedge accounting is premised on managerial intent, and the existence of significant forecast error shows that managerial anticipation of hedge effectiveness is often inaccurate.
- Asymmetrical treatment of ineffective hedges: The anomaly of an asymmetrical treatment of over and under hedges, where only over hedges are recognized as ineffective but not under hedges, is acknowledged by the board in its proposal to include both over and under hedging in the recognition of ineffective hedges through the income statement. We appreciate that this is being addressed in the ED.
- Ignoring the time value component of options: Hedge ineffectiveness could be masked due to the deferral of changes in fair value of a purchased option associated with its time value component (i.e., ineffectiveness related to the time value component of options used for cash flow hedge accounting is amortized rather than immediately recognized through the income statement- see paragraph A33).

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<sup>5</sup> Bloomberg article by Jonathan Weil dated December 5, 2007.

[http://www.bloomberg.com/apps/news?pid=20601039&refer=columnist\\_weil&sid=ahoxGPj68WN0](http://www.bloomberg.com/apps/news?pid=20601039&refer=columnist_weil&sid=ahoxGPj68WN0)

<sup>6</sup> Hamlen and Largay III (2005), 'Has SFAS 133 made derivatives reporting more transparent? A look at the Dow Jones 30', Journal of Derivative Accounting.

<sup>7</sup> Hamlen and Largay III (2005), 'Has SFAS 133 made derivatives reporting more transparent? A look at the Dow Jones 30', Journal of Derivative Accounting.

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As stated earlier, if full fair value for all financial instruments were adopted we believe that cash flow hedge accounting would necessarily be eliminated. In the interim we would recommend the following:

- a) Immediate recognition of all derivative gains and losses through the income statement. Derivative instruments are financial assets and financial liabilities held by reporting entities and they can be monetized. Fair value measurement and immediate recognition of gains and losses through the income statement is the most effective way of reflecting this economic reality. Besides, as implied in the deferral adjustment requirements, there is often a maturity mismatch between the hedging instrument and the anticipated transaction, and therefore the presumed lock-in of risk factors, in relation to the hedged item is often hypothetical.
- b) If the board retains the deferral requirement:
  - It should not defer the recognition of changes in fair value in earnings related to the time value component of a purchased option when making ineffectiveness adjustments, and,
  - It should require greater disclosure, to enable users to identify where there is basis risk, due to mismatches of maturity or underlying derivative risk factors in relation to anticipated transactions

### **Enhanced Disclosure**

It is important for the board to incorporate user concerns in its efforts to simplify hedge accounting, and in particular, to improve their ability to fully understand the risk exposures, risk management strategies and the effectiveness of risk management strategies of the reporting firms. Membership surveys we have conducted over the last decade consistently show that our members believe there are significant quality gaps<sup>8</sup> in the disclosures for derivatives, hedging activities and risk exposure. The 2007 and 2003 corporate disclosure surveys showed quality gaps of -1.1 and -1.3 for derivatives and hedging activities, respectively. The same surveys showed quality gaps in risk exposures of -1.0 and -1.3. These survey findings show that users require the enhanced disclosure of derivative use in tandem with the proposed measures related to hedge accounting recognition and measurement.

CBRM principle 12 enumerates on the principle and key elements of disclosure, as follows:

*Disclosures must provide the additional information investors require to understand the items recognised in the financial statements, their measurement properties, and their risk exposures. The role of disclosure is to provide a comprehensive explanation of events and transactions that have been recognised, including:*

- *the models, estimates, assumptions, and principles that were applied to measure the effects*
- *and the sensitivity of the reported information to changes in those principles and assumption*

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<sup>8</sup> Quality gaps are differences in the rating of quality and importance (a five-point scale was used, with 5 as very important and high quality). A wide, negative gap is a quality deficit indicating that the information quality is deficient relative to its importance.

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We also concur with the comprehensive framework for assessing the disclosures required for hedging that Stephen G. Ryan has provided in his text<sup>9</sup>. Ryan states that there are four questions that users of financial reports are trying to answer, when looking at a reporting entity:

1. *What are its aggregate exposures?*
  - *What are the magnitude and nature (including sensitivity) of its aggregate exposure to changes in market prices?*
  - *What are the remaining lives of these exposures?*
2. *What derivatives does it use to modify the risk of its aggregate exposures?*
  - *Is it economically hedging or speculating?*
  - *Is any hedge or speculation one sided or two sided?*
  - *Is it attempting to modify fair value or cash flow variability? If cash flow variability, does this make sense?*
  - *Are the amounts, sensitivities and maturities of its derivatives reasonable given its risk exposure?*
3. *What are the threats to hedge effectiveness?*
  - *Non linearity?*
  - *Basis risk?*
  - *Unknown exposure?*
4. *How does the entity account for its derivatives and hedging?*
  - *Do its derivatives qualify as accounting hedges?*
  - *If so, are they fair value hedges or cash flow hedges?*
  - *What are the limitations of the accounting?*

We laud the board in its efforts to enhance disclosure through FASB Statement No. 161, *Disclosures about Derivative Instruments and Hedging Activities*, and we particularly appreciate both the proposals that will improve the transparency of the effects of derivative instruments held, and those relating to the presentation of recycled adjustments. We welcome the proposals to incorporate the disclosure of counterparty credit risk for derivative contracts, as stipulated in FASB Statement No. 107, *Disclosures about Fair value for Financial Instruments*. However, the disclosure of derivative information has plenty of room for improvement. Based on the disclosure principles defined in the CBRM, we would concur with the observations contained in the *26 March 2008 Credit Suisse Research Report on SFAS 161 'Derivatives Emerging from the Shadows'*. This report identifies that, even with the changes in SFAS 161, more useful disclosure for investors is required, including:

- The percentage of risks hedged,
- How the percentage of risks hedged changes over time,
- The effect of derivatives on current period cash flows.

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<sup>9</sup> Financial Instruments & Institutions: Accounting and Disclosure Rules- Second Edition. Page 309.



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In addition, given the amendments included in the exposure draft that minimise bifurcation by risk and change hedge effectiveness, reporting entities should disclose:

- How they make hedge accounting elections,
- How they assess hedge effectiveness (including providing details of maturity of derivative instruments designated as cash flow hedges), and
- Which risk exposures are hedged, but do not receive hedge accounting and which risk exposures are unhedged.

Overall, we suggest the board re-introduce the 13 presentation and disclosure requirements that were outlined in the original FASB Statement No. 133 Exposure Draft.

### **Hedge Accounting Amendments and Convergence**

We view the ED and the IASB discussion paper on '*Reducing Complexity for Financial Instruments*' as intermediate measures towards the full adoption of fair value for all financial instruments. These proposed amendments occur against the backdrop of the approaching convergence of U.S. GAAP and IFRS. Hence it is important for both boards to ensure the compatibility of any hedge accounting modifications.

We are concerned that the scope of hedge accounting amendments seems limited relative to the proposals put forward in the IASB intermediate approach. The IASB is considering whether to simplify or eliminate hedge accounting and is also reviewing the classification criteria of financial instruments. In the event that the amendments to hedge accounting, undertaken by the IASB and FASB are not conceptually consistent, it may result in multi-phase changes to the current derivative accounting requirements, when convergence occurs. This will impose additional implementation and interpretation costs.

We elaborate on our views to specific questions in the remainder of this letter.



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## Specific Comments

### Hedged Risk

*Issue 1: The board decided to eliminate (with two exceptions) the ability of an entity to designate individual risks as the hedged risk in a fair value or cash flow hedge. As a result of that change, the financial statements would reflect information about the risks in the hedged item or transaction that an entity both chooses to manage and not manage as part of a particular hedging relationship.*

***Do you believe that the proposed statement would improve or impair the usefulness of financial statements by eliminating the ability of an entity to designate individual risks and requiring the reporting of the risks inherent in the hedged item or transaction?***

We are cautiously supportive of the decision to eliminate the bifurcation by individual risk (with the exception of interest rate risk of own debt at inception and foreign currency exchange risk) for the purposes of electing to apply hedge accounting. We are supportive because this proposal takes cognisance of the economic reality of the interaction and interconnectedness of different types of risk (e.g. market, counterparty and liquidity risk). Hence, it is a fundamental distortion of economic reality for reporting entities to handle these discrete risk types in isolation, during the accounting for derivatives used for risk management purposes. From an accounting perspective, this decision has the further merit of reducing the opportunity for inconsistencies in the accounting for similar derivative instruments. For example, we agree that there should be no difference between the accounting treatment for a derivative instrument used to hedge financial assets and financial liabilities, and the accounting treatment for the same derivative instrument when it is used to hedge non-financial assets and liabilities. Eliminating the bifurcation by individual risk for hedge accounting has the added attraction of reducing possible, non-transparent, structuring opportunities that can arise when managers have the option to choose which risks receive hedge accounting treatment.

However, from a user perspective, the incremental utility of the proposed modification has to be assessed by whether the modification allows users to be more informed than they previously were about the basis that reporting entities elect to apply hedge accounting. Users need to have a clear understanding of the full risk exposure profile, including the full spectrum of:

- Hedged risk exposures
- Un-hedged risk exposures
- Hedge accounting election exposures
- Exposures excluded from hedge accounting treatment

While SFAS 133 and 161 address disclosures relating to recognition and measurement of derivative instruments and hedged risk gains and losses, they do not address the required disclosure of un-hedged risk exposures. Similar to the hedged risk profile, the un-hedged risk profile affects overall firm performance and is of great interest to investors. A partial disclosure of the exposure can lead to a misleading view of a reporting firm's overall risk profile.





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*Issue 2: The board decided to continue to permit an entity the ability to designate the following risks as the hedged risk in a fair value or cash flow hedge: a) interest rate risk related to its own issued debt (that is, its liability for funds borrowed), if hedged at inception and b) foreign currency exchange risk. For those two risks, the financial statements would not reflect information about the risks that an entity chooses not to manage as part of a particular hedging relationship.*

***Do you believe that the board should continue to permit an entity to designate those individual risks as a hedged risk?***

We are cognizant of the board's articulated rationale for allowing interest rate risk of own debt at inception and foreign currency exchange risk as the only two individual risk types that can be designated for both fair value and cash flow hedge accounting. In paragraphs A13-A22, the ED states that the board decided to permit an entity to designate only interest rate risk as the hedged risk in a fair value or cash flow hedge associated with its own debt, if the hedging relationship was entered into at the inception of the debt. We understand the board's rationale for this is to avoid incorporating the effect of an entity's own credit risk into the measurement of a hedging relationship. The board has also allowed the designation of foreign currency exchange risk due to the consequences of not doing so, specifically the need to revise FASB Statement No. 52, *Foreign Currency Translation*.

Furthermore, in the rationale for allowing the designation of interest rate risk of own debt at inception, the board has stated its objections to accounting methods that are not neutral, for example, an entity taking a position on the future movement of interest rates. Based on this articulated rationale, it can be inferred that the board is aiming to create standards that are neutral, in as far as they do not aim to influence economic outcomes. We concur with the objective of accounting being neutral, as we have stated in the Comprehensive Business Reporting Model. On this basis, it seems paradoxical to allow accounting methods that encourage the synthetic creation of desirable interest rate levels and it is not clear that this could preclude speculative intent at inception.

With regards to foreign currency risk, we are sympathetic to the overall implementation hurdles and acknowledge that the consequences for FASB Statement No. 52 cannot be ignored. As stated earlier, we support the changes that restrict the bifurcation of individual risk except the two risk types, as these represents some movement along the continuum of desirable transparency. However, this ought to be an interim measure, as it simply reduces the permutations of discrete risks at the disposal of management for election purposes, but it does not eliminate the opacity that arises when reporting entities can cherry pick discrete risk to which they can apply hedge accounting. We also reiterate that the most meaningful improvement would be the adoption of full fair value for all financial instruments, as this would significantly reduce current complexity.

### **Hedge Effectiveness**

*Issue 3: The proposed statement would eliminate the shortcut method and critical terms matching. Therefore an entity would no longer have the ability upon compliance with strict criteria to assume a hedging relationship is highly effective and recognise no ineffectiveness in earnings during the term of the hedge. As a result, when accounting for the hedging relationship, an entity would be required, in all*

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*cases, to independently determine the changes in fair value of the hedged item for fair value hedges and the present value of the cumulative change in expected future cash flows on the hedged transaction.*

***Do you foresee any significant operational concerns or constraints in calculating ineffectiveness for fair value hedging relationships and cash flow hedging relationships? Do you believe that the proposed statement would improve or impair the usefulness of financial statements by eliminating the shortcut method and critical terms matching, which would eliminate the ability of an entity to assume a hedging relationship is highly effective and to recognise no ineffectiveness in earnings?***

We strongly support the decision to eliminate the shortcut and critical terms matching methods. This proposal will enhance consistency of financial reporting information by reducing the instances through which economically similar transactions can be accounted for differently, depending on managerial intent. The shortcut method can result in the selection of derivative instruments for administrative convenience rather than for the economic optimality of the selected risk management strategy. At the same time, it leaves investors susceptible to unanticipated risk exposures in situations where managers have selected sub-optimal hedging strategies driven by their desire to qualify for the shortcut accounting treatment. For example, the documented case<sup>10</sup> of GE having to restate \$381 million in its earnings in 2005, after an audit review showed that there was a misclassification of interest rate swaps as eligible for shortcut hedge accounting treatment.

It is difficult to envisage any operational concerns that can only arise after the inception of derivative contracts. The use of derivative contracts for risk management purposes should be based on the ability of managers to anticipate and identify risk exposures, select appropriate derivative instruments, and thereafter to value the derivative instrument and underlying risk exposure, on an ongoing basis.

*Issue 4: This proposed statement would modify the effectiveness threshold necessary for applying hedge accounting from highly effective to reasonably effective at offsetting changes in fair value or variability in cash flows.*

***Do you believe that modifying the effectiveness threshold from highly effective to reasonably effective is appropriate? Why or why not? For situations in which interest rate risk is currently designated as the hedged risk for financial instruments but would no longer be permitted under this proposed statement (except for an entity's own issued debt at inception), do you believe you would continue to qualify for hedge accounting utilising your current hedging strategy? If not, would you a) modify your hedging strategy to incorporate other derivative instruments b) stop applying hedge accounting c) elect the fair value option for those financial instruments or d) adopt some other strategy for managing risk***

We understand that the adoption of a qualitative threshold, 'reasonably effective' instead of a quantitative threshold (i.e. 80-120%) 'highly' effective as a test of hedge effectiveness has several attractions. These include lowering the compliance costs for financial statement preparers and possibly reducing their frequency of restatement.

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<sup>10</sup> 'Accounting for Derivatives' - Juan Ramirez- 2007, John Wiley & Sons.

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However, we are concerned that, from a user standpoint, this proposal would increase the overall complexity of financial reporting for hedging activities, despite reducing compliance burdens for preparers. This is likely to be compounded by an increase in the opacity of corporate derivative use. The increased opacity is likely to result, in part, from the absence of a definition of 'reasonably effective'. While we are sympathetic towards the desire to move away from rigid quantitative thresholds and bright lines, it is surprising that, given the 8-10 years of implementation practice, the board has not opted to put forward a robust, qualitative criterion, as an alternative to the current practice. Paragraphs 10, 11 and 12 of the Exposure Draft delineate some elements that could go into determining effectiveness, including consideration of counterparty risk as part of hedge effectiveness testing. But the overall thrust, articulated by the board in paragraph A9, is to steer clear of providing any guidance on what reasonably effective means and this leaves it rather open ended. An open ended definition of effectiveness, coupled with the inadequate levels of note disclosure on the criteria of hedge effectiveness, is likely to impair the ability of users to make comparisons of the effectiveness of risk management strategies across firms and across different time periods.

Within the framework of improving hedge accounting, it is unclear what issue related to the effectiveness threshold the board aims to remedy. Is it: a) the measurement error related to modelling hedge effectiveness or b) misclassification risk due to a predefined and restrictive 80-120% threshold?

- **Model error:** Does the proposal aim to assist preparers to bypass their use of imperfect models that signal effective hedges at inception, yet retrospectively result in ineffective hedges? If that is the case, then evidence of imperfect hedging relationships has information content for users and should have the same for the management team. That outcome raises questions about management's capabilities to originate and apply derivative financial instruments for risk management purposes.
- **Misclassification risk:** Are the concerns due to the frequency of restating ineffective hedge accounting due to misclassification at inception? If so, the question arises how pervasive is the misclassification of designated effective and ineffective economic hedges attributable to a predefined quantitative range and does this proposal address that problem in its entirety?

From the standpoint of corporate managers aiming to qualify for hedge accounting, this proposal might reduce the number of effective economic hedges that would not be hedge accounting compliant (Type I error), but it is also likely to increase the number of ineffective economic hedges that are deemed to be hedge accounting compliant (Type II error). Given the requirement to fair value all derivative contracts, a Type I error at worst results in the economic timely recognition of derivative gains and losses. However a Type II error, in the case of cash flow hedge accounting, can result in the inappropriate deferral of derivative gains and losses. Hence, this proposal would likely reduce overall derivative transparency.

There is also the question of whether this proposal is directionally consistent with full fair value. At an aggregate level, the latitude granted to managers, by effectively lowering the threshold of hedge effectiveness is likely to encourage the greater use of hedge accounting. By implication, the increased use of hedge accounting could further entrench hedge accounting and likely impose greater rather than lower financial statement preparer opposition to the full adoption of fair value as a measurement basis. The

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expectation of the likely opposition to full fair value can be inferred from anecdotal evidence<sup>11</sup> that suggests preparers' view hedge accounting and the fair value option under FASB Statement No. 159 to be alternative treatments in addressing measurement attribute inconsistencies.

*Issue 5: This proposed statement would require an effectiveness evaluation at inception of the hedging relationship. After inception of the hedging relationship, an effectiveness evaluation would be required if circumstances suggest that the hedging relationship may no longer be reasonably effective.*

***Do you foresee any significant operational concerns in creating processes that will determine when circumstances suggest a hedging relationship may no longer be reasonably effective without requiring reassessment of hedge effectiveness each reporting period? Do you believe that requiring an effectiveness evaluation after inception only if circumstances suggest that the hedging relationship may no longer be reasonably effective would result in a reduction in the number of times hedging relationships would be discontinued? If so, why?***

We have reservations on the proposal to move from the periodic reassessment of hedge effectiveness to a judgemental, discretionary reassessment of risk management effectiveness. As noted earlier (in *comments on issue 4*), any amendment that only aims to ease administrative compliance with hedge accounting without having a corresponding impact on transparency for users may not be directionally consistent with the goal of full fair value. Fair value, as a financial reporting measurement basis, is desirable for investors as it necessitates a periodic reassessment and disclosure of the value of held assets and liabilities. Such disclosure contributes to the transparency of a reporting firm's performance prospects and underlying risk exposures. This reasoning can be extended to the assessment and disclosure of risk creation and management strategies deployed by firm managers in their use of derivative instruments.

The proposed amendment stipulates that an effectiveness test should be conducted when warranted by facts and circumstances, as judged by management. This proposal seems to be aimed at reducing compliance hurdles. In principle, users do not oppose measures that ease the processing of financial reporting information, as long as the proposal also improves transparency of the underlying risk exposures, risk management strategy and risk management effectiveness. We are concerned that the *de facto* reduced frequency of effectiveness testing and subsequent disclosure of risk management derivative gains and losses can be influenced by factors other than the economic effectiveness of the hedging instrument. This proposal may provide managers with some 'wobble room' to hide derivative losses, particularly for cash flow hedges, when it suits them. Besides, experience has shown that voluntary disclosure requirements for financial reporting information rarely result in widespread compliance.

We do not see that there should be any significant operational concerns. As stated in the response to *issue 3*, the use of derivative contracts for risk management purposes should only occur when corporate managers have the expertise and operational processes and capabilities to value the derivative instrument and underlying risk exposure, at inception and on an ongoing basis. Also, to the extent we are evaluating

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<sup>11</sup> 26<sup>th</sup> March 2008 Credit Suisse Research Report on SFAS 161 'Derivatives Emerging from the Shadows' cites the cases of companies such as General Mills simply opting out of hedge accounting in favor of just using the fair value option.



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fair value hedges and we are on full fair value, the information already exists to show whether the hedge is effective.

*Issue 6: The board considered but decided against eliminating any assessment of effectiveness after the inception of the hedging relationship. The board believes that eliminating such an assessment of effectiveness could result in the continuation of hedge accounting even when situations suggest that the hedge relationship may no longer be effective. Some observe that an implication of the decision to not eliminate any assessment after inception of the hedging relationship could be that hedge accounting results would be reflected in some reporting period and not in other reporting periods throughout the life of the relationship.*

*Also, in a hedge accounting model that generally does not permit hedging of individual risks, changes in the relationship between the individual risks being managed and those not being managed could increase the likelihood that the hedging relationship would no longer be reasonably effective. That would result in hedge accounting no longer being permitted for a portion of an expected hedge term. That “in and out” of hedge accounting would make it more difficult for users to interpret financial statements.*

***Do you agree with the Board’s decision to continue to require that hedge accounting be discontinued if a hedge becomes ineffective? Alternatively, should an effectiveness evaluation not be required under any circumstances after inception of a hedging relationship if it was determined at inception that the hedging relationship was expected to be reasonably effective over the expected hedge term?***

As per our *comments on issue 5*, we would require the reassessment of hedge effectiveness on a periodic basis. For that reason the decision not to eliminate any assessment, but to have a reassessment when circumstances necessitate, is only partially satisfactory. Nevertheless, we welcome the restriction of designation in situations other than the termination, selling or exercising of derivative contracts as outlined in paragraph 14.

### **Presentation of Hedging Gains and Losses**

*Issue 7: In the statement of operations, Statement 133 does not prescribe the presentation of gains and losses associated with hedging instruments, including the effective portion, the ineffective portion, and any amounts excluded from the evaluation of effectiveness, such as forward points. Some have suggested that such a prescription would improve financial reporting by creating consistency in the presentation of these amounts across all entities. Others observe that FASB Statement No. 161, Disclosures about Derivative Instruments and Hedging Activities, requires disclosure about that information, and they question whether a prescriptive approach is appropriate given the diverse hedge accounting strategies employed by entities.*

***Do you believe that Statement 133 should be amended to prescribe the presentation of these amounts? For example, the Statement could require that the effective portion of derivatives hedging the interest rate risk in issued debt be classified within interest expense and that the ineffective portion and any amounts excluded from the evaluation of effectiveness be presented within other income or loss.***



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We would support a prescriptive approach to financial statement presentation that enhances the quality of disclosure and the presentation of such information in a fashion that is comprehensible to users. A prescriptive approach can improve the transparency of hedge accounting as it can make visible the effects of financial risk associated with derivative use on firm performance. A prescriptive approach will improve the comparability of derivatives financial reporting data across reporting firms and across time periods. Our survey results<sup>12</sup> show that our membership is largely in favour of a standardised presentation of financial reporting information so as to ensure comparability. Moreover, we believe that a prescriptive approach would facilitate the disclosure of useful information in an XBRL format.

In principle, we support enhanced disaggregation in the presentation of derivative gains and losses proposed under FASB Statement No. 161. We would support the differentiation between the effective, ineffective and excluded portion (e.g. time value of option contracts) of derivative gains and losses. We would strongly recommend the inclusion of all of the thirteen presentation and disclosure provisions that were outlined in the original Exposure Draft of FASB Statement No. 133 as part of the disclosure requirements.

### **Effective Date and Transition**

*Issue 8: The Board's goal is to issue a final Statement by December 31, 2008. The proposed Statement would require application of the amended hedging requirements for financial statements issued for fiscal years beginning after June 15, 2009, and interim periods within those fiscal years.*

***Do you believe that the proposed effective date would provide enough time for entities to adopt the proposed Statement? Why or why not?***

The proposed adoption date of June 15, 2009 provides sufficient adoption lead time. The amendment proposals aim to significantly reduce the compliance requirements that financial statement preparers face in relation to current hedge accounting. Therefore, there should be minimal implementation hurdles to the adoption of the new amendments.

### **Transition Disclosures**

*Issue 9: The Board did not prescribe any specific transition disclosures upon the adoption of this Statement.*

***Do you believe that there are specific disclosures that should be required during transition? If so, what? Please be specific as to how any suggested disclosures would be used.***

Reporting entities should disclose the basis of their decision to opt for either the fair value option under FASB Statement No. 156 and FASB Statement No. 159 or to opt for the amended hedge accounting under FASB Statement No. 133. However, we do not support the proposal to pass the accumulated net effect adjustment directly to equity. Such a treatment will result in a by-pass of recognition through the income statement and further contribute to the opacity by concealing the income effects of derivative

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<sup>12</sup> In the 2007 Corporate Disclosure survey, 77% of the respondents supported a standardised presentation.

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instrument use. Gains and losses should be always recognised through the income statement and we would request that the board reconsider this proposal. The gains and losses would be typically ‘below the line’ as a change in accounting principle.

### **Fair Value Election Option**

*Issue 10: The Board decided to permit an entity a one-time fair value option election under FASB Statements No. 156, Accounting for Servicing of Financial Assets, and No. 159, The Fair Value Option for Financial Assets and Financial Liabilities, for (a) servicing assets and servicing liabilities designated as a hedged item on the date immediately preceding initial application and (b) eligible financial instruments designated as a hedged item on the date immediately preceding initial application of this proposed Statement.*

***Do you agree with the Board’s decision to allow a one-time fair value option at the initial adoption of this proposed Statement? Do you agree with the Board’s decision to limit the option to assets and liabilities that are currently designated as hedged items under Statement 133?***

We would give conditional support to the board decision to allow a one-time fair value option under FASB Statement No. 156 and FASB Statement No. 159 for hedged items. We would like to see all gains and losses recognized in earnings rather than OCI if the fair value option is elected under this standard. That view is based on the belief that such reporting is an intermediate solution to the adoption of fair value. As articulated in our 31 October 2006 comment letter to Mr. Herz, we oppose the use of alternatives in financial reporting, because they reduce comparability and result in financial reporting that is based on managerial intent.

*‘We have supported the Board’s efforts over the years to increase the use of fair values in financial reporting. We have recognised difficulties and supported the Board’s decisions to take a step by step approach. Despite our general aversion to the provision of alternative choices for financial reporting, we gave our conditional support for the Fair Value Option for financial instruments in the expectation that such a step would serve as a near term bridge to the mandating of fair value reporting in the financial statements for all financial instruments.’<sup>13</sup>*

On the premise of a fair value option as an intermediate solution, we would give conditional support to its application beyond the spectrum of hedged items and within the spectrum of hedged items (i.e. non financial assets and liabilities). This would be on the understanding that such option is directionally consistent with the adoption of full fair value. However, we must note that we have been disappointed with the lack of progress in extending fair value to all financial instruments.

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<sup>13</sup> 31<sup>st</sup> October 2006 CFA Institute Centre comment letter to FASB on fair value.



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### **Benefit-Cost Considerations**

*Issue 11: The objective of financial reporting is to provide information that is useful to present and potential investors, creditors, donors, and other capital market participants in making rational investment, credit, and similar resource allocation decisions. However, the benefits of providing information for that purpose should justify the related costs. The benefit-cost considerations considered by the Board are provided in paragraphs A43–A50 in Appendix B of this proposed Statement.*

***Do you believe the Board identified the appropriate benefits and costs related to this proposed Statement? If not, what additional benefits or costs should the Board consider?***

The board has appropriately identified the benefits associated with reduced hedge accounting complexity. The board's cost-benefit analysis of the proposed amendments would be more complete if it included an outline of any incremental user interpretation costs due to the proposed changes.

We urge the board to consider costs to users as well as preparers. Inadequate financial reporting requires that analysts and other financial market intermediaries devote significant resources to try to understand the underlying economics of reporting entities. To the extent that such efforts fall short of success, the resulting inefficient allocation of capital imposes costs on financial markets in general.

### **Closing Remarks**

If you, other board members or your staff have questions or seek further elaboration of our views, please contact either Vincent T. Papa, CFA, by phone at +44.207.531.0763, or by e-mail at [vincent.papa@cfainstitute.org](mailto:vincent.papa@cfainstitute.org), or Patrick Finnegan, CFA, by phone at +1.212.754.8350, or by e-mail at [patrick.finnegan@cfainstitute.org](mailto:patrick.finnegan@cfainstitute.org).

Sincerely,

*/s/Kurt N. Schacht*

Kurt N. Schacht, CFA  
Managing Director

*/s/ Gerald I. White*

Gerald I. White, CFA  
Chair, Corporate Disclosure Policy Council

cc: Corporate Disclosure Policy Council