



November 29, 2016

Russell G. Golden
Chairman
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
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Submitted via electronic mail to director@fasb.org

Dear Chairman Golden,

The Committee on Corporate Reporting (CCR) of Financial Executives International's (FEI) appreciates the opportunity to provide its views on the proposed accounting standard update ("the Proposal") on derivatives and hedging (ASC 815).

FEI is a leading international organization of more than 10,000 members, including Chief Financial Officers, Controllers, Treasurers, Tax Executives and other senior-level financial executives. CCR is a technical committee of FEI, and reviews and responds to research studies, statements, pronouncements, pending legislation, proposals and other documents issued by domestic and international agencies and organizations. CCR member companies represent approximately \$5 trillion in market capitalization and actively monitor the standard setting activities of the FASB.

This letter represents the views of CCR and not necessarily the views of FEI or its members individually.

Executive Summary

We support the Boards efforts to improve the accounting for derivatives and hedging and see this proposal as an important first step toward achieving its goal of better alignment of the risk management strategies used by companies and the financial reporting and disclosure of the effects of those strategies for the benefit of investors. We therefore sincerely applaud the work of the Staff and Board to issue this

Proposal. Furthermore, we support the decision by the Board to keep the focus of this initial project narrow in order to complete it in a timely manner, and recommend the FASB consider our suggested revisions while finalizing these improvements as soon as possible.

As outlined in our previously issued comment letter¹ to the FASB on future agenda topics, we believe the FASB should add a second phase (“Phase 2”) of this project to its formal agenda with the intention of further expanding the use of hedge accounting to additional common risk management strategies.

A summary of the proposals that we support and those for which we offer suggested improvements is provided below. The Appendix to this letter contains further rationale and suggestions related to our proposed Phase 2 of this project.

Impact to Non-GAAP Reporting

We observe that the SEC’s recent renewed focus on non-GAAP reporting only highlights the need to address whether the current guidance, including the proposed updates, provides the appropriate framework for management to accurately disclose the impact and effectiveness of its existing risk management strategies. The lack of recognition within U.S. GAAP of many common risk management strategies contributes to an environment where non-GAAP disclosures are necessary to explain to investors the true risk management effects of its hedging activities (e.g., generally backing out unrealized gains and losses on those derivatives not qualifying for hedge accounting that were entered into as “economic hedges”).

Among other proposed simplification improvements we specifically support:

- The expansion of risk component hedging for nonfinancial items to allow for **contractually specified components** of a contract to purchase or sell a nonfinancial item to be designated as the hedged item
- The elimination of the benchmark interest rate concept for hedges of variable-rate instruments to allow for **contractually specified** non-benchmark interest rate risk to be designated as the hedged risk
- The removal of the requirement to separately measure and report hedge ineffectiveness for cash flow and net investment hedges, thus requiring the entire change in fair value of the hedging instrument to be presented in earnings in the same period as the earnings effect of the hedged item. However, we recommend certain presentation improvements as outlined further below.
- The simplification of certain documentation and assessment requirements, including the proposal to expand entities’ ability to subsequently assess hedge effectiveness qualitatively and allow entities to switch to the long-haul method of hedge accounting in situations where the

¹ Refer to <https://www.financialexecutives.org/getattachment/Influence/Comment-Letters/2016/CCR-Comment-Letter-FASB-s-Aagenda-Consultation/CL-FASB-ITC-Agenda-Consultation-Final-Clean.pdf.aspx?lang=en-US>

shortcut method was misapplied.

While we are supportive of these improvements we feel that certain adjustments should be made to these narrow scope improvements prior to finalizing as follows:

- **Risk Component Hedging**—We recommend the Board consider expanding of the use of risk component hedging by allowing companies to hedge components of both financial and nonfinancial items that are **implicit** in the total price of the item being hedged, particularly when such an implicit component price is widely recognized and quoted in an active market. This issue is discussed in further detail in the Appendix.
- **Fair Value Hedging Improvements—Accommodations for Fixed-rate Financial Instruments** – We recommend the Board reconsider the concept of an allowable list of benchmark rates within **fixed-rate financial instruments** in favor of a principle-based approach for what should constitute an appropriate benchmark rate, which would provide similar flexibility to fair value hedging that has been provided for cash flow hedges. This issue is discussed in further detail in the Appendix.
- **Presentation**—The guidance in the Proposal takes the approach that the entire change in fair value of the hedging instrument should be considered a cost (or benefit) of hedging and displayed in the same line item as the earnings effect of the hedged item. However, in certain instances this would not be an improvement as it would otherwise require elements that are not part of the hedging relationship to be required to be presented with elements of the hedging transaction. For example, companies often hedge forecasted purchases of inventory and may exclude forward points from the hedging relationship and separately recognize the cost of the forward points through income. However, the guidance would require the forward points be presented on the same income statement line item as the hedged transaction. A similar disconnect may also occur in a hedge of a forecasted transaction when the forecasted transaction does not occur but amounts are released from Accumulated Other Comprehensive Income (AOCI). The Proposal would require those amounts to be presented in the same line item as if the transaction had occurred. We believe that for excluded components, and for the release of amounts in AOCI when a forecasted transaction does not occur, the Board should retain the income statement classification guidance as a policy election with appropriate disclosure. In the absence of a policy election, we would recommend the Board consider deferral of the excluded components in accumulated other comprehensive income (AOCI) to better align with the effects of the hedged item.
- **Risk Management Disclosure**—The Proposal would require additional disclosure. For example, the Proposal requires disclosure of the cumulative basis adjustments for fair value hedges recognized on the balance sheet as of the reporting date, including disclosure of the component (if any) related to hedging relationships that have been previously discontinued. It would also require disclosure of quantitative hedge accounting goals, if any, that an entity sets when developing its hedge accounting objectives and strategies and whether it met those goals.

As noted in other comment letters, the Board should complete its Disclosure Framework Project, including the Board's Decision Process, prior to imposing new disclosure requirements on issuers while reexamining the fundamental premise of its disclosure framework. We believe it would be more appropriate to focus on defining more clear disclosure objectives that demonstrate what the required information will be used for, and how it will help financial statement users make investment decisions, while providing issuers the flexibility they need to disclose the information in the most meaningful way.

The cost and burden of complying with the additional disclosure requirements (e.g., cumulative basis adjustments for fair values hedges, disclosure of quantitative hedge accounting goals) outweigh the usefulness of this information. While we acknowledge the Board's desire to provide users with information to better understand the effect of fair value hedge accounting on the balance sheet, many organizations' current operational infrastructure does not support providing this information on both a historical and ongoing basis without significant system and process enhancements. Additionally, risk management strategies overall are dynamic (not static) and may change frequently in response to market dynamics making it difficult to disclose quantitative information about such goals.

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

We do not agree with the Board's decision to prohibit qualitative testing after an entity determines that a quantitative assessment of effectiveness is required in a given period. That is, we do not understand why the Board would preclude an entity from returning to assessing hedge effectiveness qualitatively without considering the specific facts and circumstances, nor do we understand what specific circumstance the Board was trying to address by prohibiting a company from going back to the qualitative assessment when facts and circumstances change such that the qualitative assessment is once again, sufficient to assert hedge effectiveness.

Missed forecast—We believe it is important for the FASB to reinforce, through its guidance, that there is no "bright line" in the application of the guidance on whether a missed forecast establishes a pattern. All circumstances for what causes a forecast to be missed are not equal, and some are the result of macro-economic conditions that are not expected to occur, or recur, and that would not call into question a company's ability to predict or forecast future transactions. All facts and circumstances should be considered, and each individual company should, and must, be able to develop their own accounting policy for how it considers what constitutes a "pattern." This issue is further discussed in the Appendix below.

If, in order to finalize the Proposal in a timely manner, the Board is unable to address these issues we

recommend the Board add these items to a secondary hedging phase as described further below.

Phase 2 project

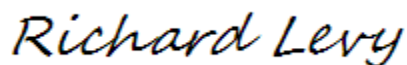
As stated previously, we believe the FASB should move forward with issuing final guidance after addressing the concerns identified above. However, we observe that there are other areas in which hedge accounting and risk management do not align and we strongly believe that the Board should pursue a Phase 2 project that addresses these areas.

As a first step, we recommend that the Board conduct outreach with risk management professionals to understand the nature of risk management strategies that are not contemplated by the amended hedge accounting guidance. We believe that this step will help inform the size and scope of a second phase project that the Board should add to its formal agenda, with the intention of making progress and expanding the use of hedge accounting.

While we believe that the Board's narrow scope project will bring about important improvements in application of the existing requirements, we believe that there is still more that can and should be done to better align hedge accounting standards with risk management strategies and we strongly support the Board undertaking a separate project that will address this area more comprehensively.

Should you have any questions, we welcome the opportunity to discuss our comments further.

Sincerely

A handwritten signature in blue ink that reads "Richard Levy". The signature is written in a cursive, slightly slanted style.

Richard Levy
Chairman, Committee on Corporate Reporting
Financial Executives International

Appendix

We have provided expanded discussion on selected items from above as follows:

1. Risk Component Hedging Expansion

As recommended above, the Board should consider expanding the use of risk component hedging by allowing companies to hedge components of both financial and nonfinancial items that are **implicit** in the total price of the item being hedged, particularly when such an implicit component price is widely recognized and quoted in an active market. Furthermore in most hedging relationships today, companies generally are not trying to hedge the total coupon of debt instruments or the total price of most commodities they are buying or selling. Instead, they are trying to hedge a component of those items because in many situations, there is no derivative product available to hedge the full price risk.

Many companies (e.g., airlines and manufacturers) engage in risk management activities to only hedge risk components that will not qualify under the proposed update for hedge accounting because the risk that is being hedged is not contractually specified. Hedging total changes in cash flows is often uneconomical or undesirable, and/or may be impossible when no suitable hedging instrument exists. For example, when hedging jet fuel purchases, airlines will typically use crude oil derivatives using benchmark prices such as West Texas Intermediate (WTI) or Brent to hedge a component of the jet fuel price. Crude oil would be described as a physical component of jet fuel. Given that crude oil has two benchmark prices that are both accepted in the market place, an airline could potentially hedge either WTI or Brent as a component. This identification would depend on the market structure in which the airline was operating. Although WTI and Brent are considered benchmark prices, in certain markets only Brent is or WTI is considered the benchmark price whereas in other markets they are both considered benchmark prices. Companies would have to ensure that in the particular market where they were purchasing jet fuel, they have identified the appropriate benchmark and documented their justification for this identification.

We observe that the Board described² its rationale for deciding not to allow non-contractually specified components to be designated as the hedged risk stating that in situations where a market convention exists, contracts could be rewritten to contractually specify the convention. We find this rationale to be flawed as there are many situations in which the hedged risk may be a forecasted transaction for which no formal contract exists (e.g., the purchase of a commodity in the spot market). Furthermore, we do not believe accounting standards should dictate, or provide incentives to companies to rewrite or restructure contracts simply for the purpose of accommodating a particular accounting treatment, particularly when the contracts would be substantively similar. Rewriting or amending contracts could be time consuming and costly, especially for entities that transact with many different counterparties. Furthermore, it is unclear whether counterparties would be willing to restructure a contract solely for the purpose of assisting a company in qualifying for a particular accounting treatment.

In addressing this topic the Board should consider adopting provisions similar to IFRS 9 which allows for

² Refer to paragraph BC50 of the Proposal

an entity to designate a risk component of a non-financial item as the hedged item in hedging relationships, provided the risk component is “separately identifiable and reliably measurable.” Such an approach, with appropriate parameters including when there is a general market convention to use the component as an underlying basis for determining the price of the overall product, enables many more common risk management strategies to qualify for hedge accounting, reduces the incentive or need for companies to use non-GAAP measures to explain differences in hedge accounting and risk management, and more accurately reflects the risk management operations of a business to investors.

By going to a model that allows greater flexibility to identify risk components, it would accommodate hedges involving fixed-price firm commitments of nonfinancial items which are not addressed by the board in this Proposal. For example, if addressed within the hedging standard, a manufacturer that has a fixed-price natural gas contract and is attempting to hedge the fixed price by converting that fixed price into a floating natural gas price, could potentially hedge the implicit price embedded within the fixed price natural gas contract by entering into a NYMEX based derivative. The NYMEX price acts as a “benchmark” component, similar to the effect that Treasuries or swap rates have on bonds. Similar examples exist in other commodities.

2. Fair Value Hedging Improvements - Accommodations for Fixed-rate Financial Instruments

We recommend the Board reconsider the concept of an allowable list of benchmark rates within **fixed-rate financial instruments** in favor of a principle-based approach for what should constitute an appropriate benchmark rate, which would provide similar flexibility to fair value hedging that has been provided for cash flow hedges. The Board should also simplify the measurement of the hedged item under a fair value hedge by allowing companies the same flexibility that is allowed under the cash flow hedging model.

Both strategies (cash flow and fair value hedging) involve entering into a derivative contract to manage interest rate risk by adjusting exposure to interest (i.e., fixing or floating such interest payments). However, there is no consistent principle for what is an appropriate benchmark interest rate. Furthermore, the concept of an allowable list of benchmark rates is not principle-based and may subject the Board to requests for further standard setting to recognize future changes in benchmark conventions as markets evolve (e.g., addition of Overnight Index Swap Rate in 2013 and now SIFMA Municipal Swap Rate in 2016).

In addressing this concern the Board should consider a principle-based approach that provides appropriate parameters for widely-used market-based rates that aligns with the principle for cash flow hedges.

When a fair value hedge does not qualify for the short-cut method, significant valuation issues can occur because it entails separating changes in fair value of the hedged item associated with risks designated as hedged risks (e.g., interest rate risk) from other changes in fair value (e.g., credit risk). Under the proposed guidance a company could use either the cash flows associated with the benchmark interest rate or the total coupon cash flows in calculating the change in fair value of the hedged item attributable to the change in benchmark interest rates. However, if the market yield of the financial instrument is

less than the benchmark interest rate (also referred to by some as the “sub-LIBOR” issue) on the date of hedge designation, a company would be required to use the total coupon cash flows. This creates unnecessary complexity and misinformation when an entity is in fact perfectly hedging its interest rate risk. The Board should simplify the proposed guidance by allowing companies to identify a risk component regardless of whether the market yield is above or below benchmark.

Furthermore, the Board should also consider addressing differences in the required discount rates used to determine cumulative changes in fair value of interest rate swaps and hedged item cash flows to eliminate arbitrary ineffectiveness attributable to the use of different yield curves for measuring cash flows related to the hedged item and the hedging instrument. Under today’s cash flow hedging model there is no requirement to include unhedged components (e.g. variability in cash flows due to changes in credit spreads) which often results in little to no difference between the variable leg of the swap and the variable rate of the instrument (hedge item). The Board should consider a similar approach to fair value hedging to eliminate unnecessary ineffectiveness. This is highlighted further in the discussion in the section title, “Fair value hedging improvement – expanded use of hypothetical-derivative method.”

3. Missed forecasts

In accordance with existing guidance, if it is probable that the hedged forecasted transaction will not occur either by the end of the originally specified time period or within the additional two-month period of time (except in certain rare circumstances as described in existing guidance), any derivative gain or loss reported in accumulated other comprehensive income is required to be reclassified into earnings immediately. Existing guidance further states that a pattern of determining that hedged forecasted transactions are probable of not occurring would call into question both an entity’s ability to accurately predict forecasted transactions and the propriety of using hedge accounting in the future for similar forecasted transactions.

A pattern of missed forecasts has been interpreted in practice to mean as few as three missed forecasts (i.e., three separately hedged forecasted cash flows that were later deemed probable to not occur). Some, including most large accounting firm guidance has suggested that while one or even two missed cash flow forecasts may not constitute a pattern, a second incorrect forecast should cause the entity to challenge its forecasts for existing and new similar hedge relationships. The line has therefore been drawn definitively at three missed forecasts.

We believe it is important for the FASB to reinforce, through its guidance, that there is no “bright line” in the application of this guidance and that the words should not be interpreted to mean there is a definitive number or “red-line” that constitutes a pattern. All circumstances for what causes a forecast to be missed are not equal and some are the result of macro-economic conditions that are not expected to recur and would not otherwise call into question a company’s ability to predict or forecast future transactions. We believe such scenarios should ordinarily be ignored, while also considering a company’s policy for handling such events, when determining whether a “pattern” has developed. All facts and circumstances should be considered, and each individual company should and must be able to develop their own accounting policy for how it considers what constitutes a “pattern.”

Phase 2 Project

While we appreciate the efforts the Board has made to improve hedge accounting overall, we feel that there are other key financial reporting issues that are important to the risk management function of a Company that are not addressed by the Proposal, but that are in need of further attention by the Board to further align hedge accounting standards with risk management strategies used by companies in today's market environment.

When taking on Phase 2 of derivatives and hedging, we recommend the Board also focus on **principles-based** guidance. Existing guidance in accordance with ASC 815 continues to be extremely rules-based, in many cases creating arbitrary bright lines preventing some of the most common risk management strategies to be allowed.

We also recommend the Board conduct **additional outreach** to determine where existing rules can be replaced with principles designed to achieve the objective of accurately disclosing a company's hedging activities.

Additional practice issues that we recommended the Board consider during Phase 2 are discussed further below:

1. Fair value hedging improvement – expanded use of hypothetical derivative method

As stated above, we believe the Board should consider expanding the use of the hypothetical-derivative or allowing other methods to eliminate unnecessary ineffectiveness in fair value hedges including hedges of foreign currency risk. While ineffectiveness is not present in a cash flow hedge because US GAAP allows for the use of the hypothetical derivative method, ineffectiveness is often present in an identical (although inverse risk) fair value hedge simply as a result of the method by which the changes in fair value of the hedged item is measured. Even though the Board is accommodating for some of this difference by allowing the benchmark method for fair value hedging, we observe that artificial ineffectiveness is often still present as a result of other items such as credit risk (i.e., CVA or DVA).

Artificial ineffectiveness can also be present as a result of currency basis spreads in fair value hedging relationships of foreign currency denominated assets or liabilities (i.e., issue or purchase of a foreign-currency denominated debt instruments in foreign capital market). In such a scenario, a debt instrument may be issued or held by entities whose functional currency is different than the denomination of the debt instrument, exposing these entities to foreign currency risk and potentially also interest rate risk. A common approach to hedging foreign currency risk involves the use of foreign currency derivatives, such as cross-currency swaps, cross-currency interest rate swaps or forward foreign currency derivatives. Although a hedge can be designed to virtually eliminate the economic exposure to foreign currency risk, a fair value hedge of foreign currency risk will experience artificial ineffectiveness caused by volatility in foreign currency basis spreads ("currency basis spreads"). This difference is the result of asymmetric

treatment of the currency basis spreads in the fair value measurement of the hedged item and the hedging instrument which creates ineffectiveness even though the foreign currency risk exposure is perfectly hedged economically. We recommend the Board explore solutions including permitting the use of a cross currency basis discount curve to discount the foreign currency denominated cash flows of the hedged item in a fair value hedging relationship involving foreign currency risk, or expanding the use of the hypothetical-derivative method to fair value hedges of foreign currency risk. We observe that the IFRS 9 permits recognition of the change in fair value of the hedging instrument attributable to changes in currency basis spreads in accumulated other comprehensive income with systematic recognition in earnings.

2. Hedge of Purchase of a Business in Foreign Currency

US GAAP expressly prohibits hedge accounting for economic hedges of the foreign currency risk inherent in a firm commitment to purchase a business at a foreign currency-denominated purchase price, but IFRS does not. This is a common strategy used by companies to hedge against the movement in currency for the purchase of a foreign business. The guidance regarding hedging the foreign currency risk associated with a business combination is dramatically different between US GAAP and IFRS. This difference would affect yet-to-be-consummated business combination transactions in which the price has been fixed in a non-functional currency from the viewpoint of the buyer (but likely to be the currency denomination that is desired by the seller). The buyer has a real economic risk in the period leading up to the closing of the transaction. US GAAP prohibits the application of hedge accounting to this risk, in part because current guidance considers the business combination as a discrete event and also because it would be difficult to determine when the deferred effect of the gain or loss on the hedge should be recognized in earnings. In contrast, IFRS 9 focuses on the ability to separately identify and measure the foreign currency component of that same risk, and permits hedge accounting. We urge the Board to consider adopting a similar approach to that of IFRS 9.