

April 27, 2011

Technical Director  
Financial Accounting Standards Board  
401 Merritt 7, PO Box 5116  
Norwalk, CT 06856-5116

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

**Re: Discussion Paper–Selected Issues about Hedge Accounting (Including IASB  
Exposure Draft *Hedge Accounting*)**

**(File Reference No. 2011-175)**

The New York State Society of Certified Public Accountants, representing more than 28,000 CPAs in public practice, industry, government and education, welcomes the opportunity to comment on the above captioned discussion paper.

The NYSSCPA's Financial Accounting Standards Committee deliberated the discussion paper and prepared the attached comments. If you would like additional discussion with us, please contact Mark Mycio, Chair of the Financial Accounting Standards Committee at (212) 838-5100 or Ernest J. Markezin, NYSSCPA staff at (212) 719-8303.

Sincerely,



Margaret A. Wood  
President

Attachment

**NEW YORK STATE SOCIETY OF  
CERTIFIED PUBLIC ACCOUNTANTS**

**COMMENTS ON**

**DISCUSSION PAPER—SELECTED ISSUES ABOUT HEDGE ACCOUNTING  
(INCLUDING IASB EXPOSURE DRAFT, *HEDGE ACCOUNTING*)**

**(FILE REFERENCE NO. 2011-175)**

**April 27, 2011**

**Principal Drafters**

**J. Roger Donohue  
Craig T. Goodman  
John J. McEnerney**

### **NYSSCPA 2010 – 2011 Board of Directors**

Margaret A. Wood, <i>President</i>	John Barone	J. Michael Kirkland
Richard E. Piluso, <i>President-elect</i>	Cynthia D. Barry	Mark G. Leeds
Joseph M. Falbo Jr., <i>Secretary/Treasurer</i>	S. David Belsky	Pei-Cen Lin
Scott M. Adair, <i>Vice President</i>	Ian J. Benjamin	Heather Losi
David R. Herman, <i>Vice President</i>	Robert W. Berliner	Anthony J. Maltese
Martha A. Jaeckle, <i>Vice President</i>	Anthony Cassella	Barbara A. Marino
Gail M. Kinsella, <i>Vice President</i>	Sherry L. DelleBovi	Avery E. Neumark
Joanne S. Barry, <i>ex officio</i>	Adrian P. Fitzsimons	Joel C. Quall
	Stephen E. Franciosa	Robert R. Ritz
	Jennifer R. George	Erin Scanlon
	Rosemarie A. Giovinazzo-	Robert E. Sohr
	Barnickel	George I. Victor
	Mitchell L. Gusler	Charles J. Weintraub
	John B. Huttlinger Jr.	Jesse J. Wheeler
	Nancy A. Kirby	F. Michael Zovistoski

### **NYSSCPA 2010 – 2011 Accounting & Auditing Oversight Committee**

Rita M. Piazza, <i>Chair</i>	Jay H. Goldberg	Mark Mycio
Anthony S. Chan	Jan C. Herringer	Michael A. Pinna
Sharon S. Fierstein	Edward P. Ichart	William M. Stocker III
	Elliot A. Lesser	

### **NYSSCPA 2010 – 2011 Financial Accounting Standards Committee**

Mark Mycio, <i>Chair</i>	Craig T. Goodman	Stephan R. Mueller
J. Roger Donohue, <i>Vice Chair</i>	Kenneth Gralak	Lingyun Ou
Ryan Crowe	Abraham E. Haspel	Kyle D. Pennacchia
Robert A. Dyson	Edward P. Ichart	Paul M. Ribaud
Deepak Doshi	Tamar Kadosh	Robert M. Rollmann
Roseanne T. Farley	Craig L. Kanzel	Sharon Sabba Fierstein
Vincent Gaudio	Michael D. Kasperski	Joseph Serra
John F. Georger Jr.	Anil Kumar	Mark Springer
Manish Gera	Ari Lasker	Elvira Tsvetanov
Hashim Ghadiali	Joseph Maffia	Matthew Uryniak
Jo Ann Golden	Sean Martell	Cyril Uy
Fred R. Goldstein	John J. McEnerney	Silvia S. Yehezkel

### **NYSSCPA Staff**

Ernest J. Markezin  
William R. Lalli

**New York State Society of Certified Public Accountants**  
**Financial Accounting Standards Committee**

**Comments on**

**Discussion Paper–Selected Issues about Hedge Accounting (Including IASB  
Exposure Draft, *Hedge Accounting*)**

**(File Reference No. 2011-175)**

We have reviewed the Financial Accounting Standards Board's Discussion Paper, and we appreciate the opportunity to provide our overall comments and responses to specific questions. We have responded to the 23 questions in the Discussion Paper. We did not respond to the questions set forth in the IASB Exposure Draft.

**Summary of Our Views on the IASB's Proposal**

We understand that a main objective of the proposal is for hedge accounting to reflect institutions' risk management better. While we acknowledge this effort, we have significant concerns about this approach. There are several reasons why we believe this objective will not produce meaningful results:

- The risk management practices of many institutions, including supposedly sophisticated financial institutions, proved to be of limited value during the recent financial crisis.
- Risk management practices vary in approach and ability which greatly reduces comparability between financial statements.
- Relying substantially on "risk management objectives" as a basis for accounting should to recognize that such objectives will usually differ from reality. Likewise, no entity creates a "risk management strategy" to lose money, but this may occur when events contravene.
- Business institutions want to present themselves in the best light to third parties. Consequently, if the IASB proposal is followed, we may expect financial results of relevant institutions to offer, at best, a positive approach and, at worst, potential significant misrepresentation. In either case, a risk management approach is unlikely to better reflect economic reality, which is the primary goal of accounting.

The IASB proposal allows institutions great latitude in hedge accounting. Two examples: 1) allowing or requiring the "rebalancing" of hedges (which may make hedge effectiveness a moving target); and 2) meeting hedge effectiveness by what an entity "is expected to achieve" rather than what is actually achieved. Hedge accounting should not

be left largely to the discretion of management for the same reason that accounting standards are not allowed to be determined on an internal basis at fair value. Keeping open the possible acceptance of macro-hedging raises another red flag.

The alternative view of John Smith (Section AV 1 of the IASB Exposure Draft) captures many of our concerns: the proposal "unduly relies on risk management" and its provisions "lack rigour" and "inappropriately expand the use of hedge accounting." Also, "risk management is not defined, it has no boundaries, and is not applied uniformly" while "risk positions are arbitrary." Mr. Smith argues that the proposal could "have the effect of eliminating all volatility in earnings." While stability may be a noble goal, it should not be arbitrarily created to mask problems. We understand the appeal of broad, flexible accounting standards to preparers, and consequently expect this to appear to be a rare popular proposal, but such sentiments do not justify this new approach. Instead, risk management objectives and strategies are better suited to disclosures in the financial statements.

The initial potential danger is in allowing larger institutions most heavily involved in hedge accounting to report financial results in line with their financial objectives. Over time, such practices could migrate to smaller institutions that may engage in hedges primarily for financial engineering so that financial results become increasingly more detached from reality.

A shift appears to have occurred in the latest proposals in transforming hedge accounting from an exception to be earned to a right deployed as management wishes. While we appreciate the difficulties of hedge accounting as initially required by Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*, we do not consider a much more permissible standard an improvement. We suggest that the FASB not use the IASB's latest proposal as a starting point; instead, begin with GAAP, and work with the IASB to create a converged standard which both reflects reality and requires a rigorous approach (*e.g.*, require at least an annual effectiveness evaluation—preferably a meaningful quantitative test). If both of these goals cannot be accomplished, accounting may be improved without hedge accounting rules which would only create results that overwhelm the financial statements.

If the IASB's latest proposal becomes the framework for a new standard, we envision the necessity of having a separate financial statement disclosure containing each entity's fiscal year-end balance sheet and income statement with all financial assets and liabilities at fair value to mitigate the proposal's shortcomings.

### **Our Approach to Responding to the Discussion Paper Questions**

From the views expressed above, we are in general disagreement with the IASB Proposals. Our responses to the 23 questions in the Discussion Paper, as set forth below, reflect these sentiments.

## **Risk Management**

**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?

**Response:** Yes, such information, if structured to reflect an entity's strategy rather than a listing of perceived risks, would complement the other hedging information and provide the reader with the overall picture of what the entity is trying to achieve (including the role of the financial instruments not designated in hedging relationships).

**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?

**Response:** The guidance seems to be comprehensive; however, it is not clear how effective the guidance would be in various more complex hedging arrangements. The guidance has to be expanded to provide information on strategy in addition to risk. Without the strategy, the significance of the risk is obscured.

**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?

**Response:** Obviously, changes would have to be made; however, the question is too broad to try to enumerate the extent of those changes and the specific procedures and documentation they would require. This would all depend on the information systems' structure of each entity. Depending on the entity's information system and investment policies and procedures, difficulties in making the change will probably be significant.

**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?

**Response:** As discussed in our views above, we do not believe assessment of risk management is viable, and auditing considerations would have to be directed toward management's strategy. Given that premise, we do not believe that management's strategy can be audited without employing significant expertise in financial industry accounting. This expertise might be internal, but many firms would have to rely on other

outside firms to provide the requisite expertise necessary to analyze hedging relationships and their potential risk. We do not believe the extent of this involvement has been adequately covered in the Discussion Paper.

### **Hedging Instruments**

**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?

**Response:** No, we do not believe that cash instruments provide an effective hedging vehicle, nor was the IASB's determination of going from cash to debt instruments in their description of the types of cash instruments clear. It was reminiscent of "cash equivalents," but, this would not seem to be a valid vehicle for hedging.

### **Hedged Items—Overall**

**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?

**Response:** Overall, what seems to be expected is much too broad to be measured. The proposed guidance seems to be sufficient. The guidance has been structured to follow the computational requirements on a step-by-step basis, and was designed to help an entity's personnel ascertain that the proposed hedged item meets all the necessary criteria. However, all of the various components combined with the differences in their terms *etc.* would seemingly make this an unmanageable task.

### **Hedged Items—Risk Components**

**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.

**Response:** Conceptually, yes, the IASB Exposure Draft, *Hedge Accounting*, is structured to provide an extensive amount of detail for hedging overall, and each of the separate issues (Introduction and Invitation to Comment; Proposals for hedge accounting;

Appendix A and Appendix B that give definitions and background information, a separate section to explain the basis for the conclusions, and illustrative examples). However, we question its practicality and believe more extensive guidance is needed to ascertain the criteria for designating a component.

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

**Response:** Yes, we believe that at least one of the risk components should be contractually specified. A risk component would not have to be contractually specified to be “separately identifiable;” however, we believe not being contractually specified allows for too wide a spectrum in ascertaining whether the “hedged item” would function as a separately identifiable risk component, or whether future circumstance could change that and make the instrument ineffective as a hedge.

### **Hedged Items—Layer Component**

**Question 10** (The Discussion Paper does not have a Question 9): 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?

**Response:** No, we do not believe the guidance is adequate to identify all of the factors necessary in making such a decision.

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

**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?

**Response:** We are not aware of appropriate current guidance on this type of hedging activity. Prior to the issuance of FASB Statement 133, certain transactions were hedged using multiple financial instruments in a group.

**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?

**Response:** Yes, with the proposed disclosures, hedging aggregated exposures will provide more information, and will make the strategy more transparent to the reader of

the financial statements. While we are convinced it will be more transparent, we are not sure it will be more understandable or meaningful.

**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?

**Response:** No. We don't believe cash instruments are effective for hedging in this situation.

### **Hedge Effectiveness**

**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?

**Response:** No, we do not foresee any significant operational concerns as this appears to be part of assessing hedging effectiveness. We are contending with a different level of hedging, but the basic concept is the same. Page 4 of the Discussion Paper, Item 13 indicates the IASB did not define "other-than-accidental offset." We believe "other-than-accidental" is meant to indicate that there is some minimum intended level of offsetting. In our thinking, there is a hedging mechanism here that will offset the hedged item and not just in certain circumstances.

**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?

**Response:** Yes, between the discussions in the FASB Discussion Paper and IASB Exposure Draft, the information is sufficient to understand and analyze hedge effectiveness. However, it does not help with identifying the hedging factors as being manipulated for the benefit of the entity, while in reality, the results will differ.

### **Changes to a Hedging Relationship**

**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?

**Response:** There is sufficient guidance in the Discussion Paper and Exposure Draft to distinguish between rebalancing and discontinuance of the hedging relationship and to ascertain when the entity's risk management objective has changed. There should not be

any significant operational concerns by following the guidance. One concern is the rebalancing has not been structured to avoid what otherwise would have been losses, and in the future, those losses might have to be realized.

**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?

**Response:** Yes, we foresee significant operational concerns and constraints from the standpoint of strategy. Changes could be sudden and near the date for rebalancing. Under the proposed guidance, the hedged amount, no longer hedged after the rebalancing, would be considered discontinued. Operationally, this could cause a certain conservative approach to hedging not intended when proposing a rebalancing. The objective of the proposal was to make the hedging relationship more effective on an ongoing basis.

### **Accounting for the Time Value of Options**

**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?

**Response:** No, the valuation at market has been the linchpin for most of the hedging transactions, and a departure from this practice would cause confusion. Further, this would not enhance transparency. The objective of the Exposure Draft is to provide guidance on hedging using somewhat flexible requirements, and to provide transparency in disclosing an entity's hedging activity. This does not meet those objectives.

### **Hedge Accounting and Presentation**

**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?

**Response:** No, we believe many users of financial statements do not understand the interrelationship between recording gains and losses through profit and loss or recording them as Comprehensive Income and transferring them from Other Comprehensive Income to Profit and Loss afterwards. We find that more sophisticated financial statement users tend to understand the difference, but view Comprehensive Income in total.

**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?

**Response:** We doubt whether a separate line item in the statement of financial position would help transparency. Further, such a measure would require additional analysis, and the information is not apparent because there is a separate line item. Disclosure in the notes to the financial statements would seem to be the more effective way of disclosing the information that is believed to be important to financial statement users.

**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?

**Response:** We believe the guidance is sufficient, but complicated. As indicated in our response to Question 20, a separate line item will not achieve improvement in the user's awareness of the transaction.

### **Disclosures**

**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?

**Response:** Yes, we foresee significant auditing issues arising from the inclusion of risk management disclosures in the notes to the financial statements. We do not believe it is feasible to audit management risk in and of itself. The disclosure has to be of management's strategy for hedging management risk from the standpoint of obtaining the information from the client, assessing whether the description of the strategy is consistent with the information we have been provided by the client, and our other observations relating to the hedging. A problem arises as there may be the presumption by financial statements users that our audit of risk management represents our approval of the entity's risk management assessment when it is the strategy that should be emphasized. Disclosure in the notes to financial statements would be appropriate.

### **Other**

**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?

**Response:** No, we believe that the FASB should use GAAP as the starting point for any changes to U.S. GAAP as it relates to derivatives and hedging activities. From that point, consideration should be given by both IASB and the FASB to the converged accounting for hedging.