

August 23, 2013

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

**File Reference No. PCC-13-03**

Dear Ms. Cospers:

McGladrey LLP is pleased to comment on the Proposed Accounting Standards Update, *Derivatives and Hedging (Topic 815), Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps, a proposal of the Private Company Council* (the “proposed ASU”). We are supportive of the Private Company Council’s attempts to simplify the accounting for interest rate swaps which economically convert variable rate debt to a fixed rate debt. We believe however the scope of the proposed ASU should be expanded to include other types of entities and the criteria to use the two proposed methods should be modified in certain respects. Additionally, we believe this proposed guidance falls short of addressing some of the biggest issues smaller, less sophisticated entities face in applying the current accounting guidance related to derivatives. For example, even though FASB Statement No. 133 on Derivatives and Hedging has been in effect for well over ten years, it is not uncommon for such entities to overlook the timely election and detailed documentation requirements. The proposed ASU does little to address this issue, by continuing to require elections within a proscribed period of time (albeit within a few weeks rather than contemporaneously), as well as carrying over the existing detailed hedge documentation requirements for the simplified hedge accounting approach and leaving it up to interpretation as to the type of election that will suffice for the combined instrument approach. In the discussion that follows, we elaborate on these concerns and comment on the specific questions raised in the proposed ASU.

**Question 1:** *Please describe the entity or individual responding to this proposed Update.*

McGladrey LLP is a national CPA firm that serves hundreds of public companies and thousands of private companies in a variety of industries. We focus primarily on serving middle market companies and public sector entities.

**Question 2:** *Do you agree that the scopes of both the combined instruments approach and the simplified hedge accounting approach should exclude financial institutions described in paragraph 942-320-50-1, such as banks, savings and loan associations, savings banks, credit unions, finance companies, and insurance entities? If not, please explain why. Are there any other entities that should be excluded? (See also Question 3 below.)*

We believe the decision regarding whether or not to exclude any or all financial institutions from the scope of the proposed ASU should primarily be based on the needs and preferences of the users of the financial statements of the various types and sizes of entities that would fall within the definition of financial institutions. As documented in paragraph BC10, the decision to exclude all financial institutions was

based at least in part on the premise that such entities generally use numerous derivative instruments, and, therefore, introducing a special accounting model only for certain types of swaps would be confusing to users. As a firm with a significant number of financial institution clients including banks, credit unions, insurance entities and finance companies, we disagree with the generalization that such entities use numerous derivative instruments. In our experience, it is more the exception than the norm that private financial institutions and even small to mid-sized public financial institutions use any derivatives, much less numerous derivative instruments. Given the narrow circumstances in which the two approaches can be elected, the insignificant impact on the users of the financial statements and the resulting reduction in implementation costs and complexity, we believe it would be preferable to allow the entities themselves to determine what is appropriate for their financial statements given their specific facts and circumstances (subject to the needs and preferences of financial statement users as indicated above).

**Question 3:** *Should the Board consider expanding the scope of either the combined instruments approach or the simplified hedge accounting approach (or both) to other entities, such as publicly traded companies or not-for-profit entities? If the scope is expanded to other entities, what changes, if any, should the Board consider for these approaches? Please explain why.*

Similar to our response to Question 2 above, we believe the Board should consider expanding the scope of both approaches to all entities, private and public, allowing reporting entities to base the decision on their specific facts and circumstances. Given the narrow circumstances in which the two approaches can be elected, we do not believe the impact will be that significant to the users of the financial statements and would reduce implementation costs and complexity. Guidance would be necessary to extend the simplified approach to not-for-profit entities given their unique reporting considerations.

**Question 4:** *Do you agree with the required criteria for applying the combined instruments approach and the simplified hedge accounting approach, respectively? If not, please explain why.*

We have the following recommendations regarding the criteria for the proposed approaches:

- As it pertains to both the combined instruments approach and the simplified hedge accounting approach, rather than stating that the swap cannot be a forward starting swap, we recommend this criterion for each approach be modified to state the swap can be forward starting as long as the debt is outstanding (rather than forecasted) at the inception of the swap. This modification would enable either approach to be employed on debt for example that has a fixed rate for a few years before converting to a variable rate. We also recommend forward-starting swap be defined in the proposed ASU as we assume it is not the Board's intention that swaps which have an effective date that is within days of the trade date would be precluded from using either approach in the same fashion that swaps which have an effective date that is months or years after the trade date would.
- Similar to the simplified hedge accounting approach, we believe for the combined instruments approach, it should be sufficient if the term of the swap is equal to or less than the term of the borrowing, with disclosure of the unhedged period of time. We also believe that for the combined instruments approach, the swap should not have to be effective at the same time or within a few days of the borrowing.
- Consideration should be given to permitting the accounting for an existing swap to be continued under the selected approach in the event the debt is refinanced prior to original maturity with replacement debt meeting the relevant criteria for the approach selected.
- We also recommend that if the variable rate debt is a line of credit that is subject to renewal annually or a similar instrument, consideration be given to permitting the use of either approach

as long as the expectation is that the line will remain outstanding through the term of the swap and, in the event that did not occur, use of the approach would, of course, be discontinued.

We believe it would also be helpful to provide clarification in the guidance, as follows:

- Whether either of the proposed new approaches can be used in circumstances when the interest payments on the variable rate debt can be deferred.
- Regarding the requirement for the variable rate on the debt and the swap to be based on the same index and rate, it is not evident if variable rate debt for which the borrower has the option to select from multiple interest rate indices would be eligible for either the combined instrument or the simplified approach. We recommend this be clarified and if such debt is not eligible, consideration should be given to allowing an entity to seek an amendment to existing debt at the time of initial adoption to eliminate the alternate rate options and through that, meet the criterion.
- We recommend that guidance be included that would help to illustrate the meaning of “*at or near zero*”, when referring to the fair value of the swap in paragraphs 815-20-25-131D and 815-50-15-2, as well as to illustrate when the term of the swap would be considered to *approximate* the term of the borrowing as used in 815-50-15-2. While we understand the merits of moving away from a rules based approach, in the absence of guidance, auditors will be forced to interpret which will result in inconsistently applied rules that do not have the benefit of being exposed to the public comment letter process.

**Question 5:** *Do you agree with the differences in criteria for applying the combined instruments approach versus the simplified hedge accounting approach? If not, please explain why.*

We do not see a reason for the differences and recommend the proposed differences be eliminated such that the criteria for the combined instrument approach are no more stringent than what is currently proposed for the simplified hedge accounting approach.

**Question 6:** *For applying the combined instruments approach, should additional criteria about management’s intent to hold the swap to maturity (unless the borrowing is prepaid) be included? Please explain why.*

We are not supportive of requiring additional criteria about management’s intent given the difficulty of auditing intent. With disclosure of the settlement value, it will be evident to the users of the financial statements what the ramifications will be in the event management decides to unwind the swap prior to maturity.

**Question 7:** *Under the combined instruments approach, should there be a requirement that there have been no adverse developments regarding the risk of counterparty default such that the swap is not expected to be effective in economically converting variable-rate borrowing to fixed-rate borrowing? Please explain why or why not.*

We are not supportive of including such a requirement. Given that the swap would not be recorded on the balance sheet as an asset under the combined instrument approach, we believe that disclosure of adverse developments would suffice rather than discontinuance of the combined instrument approach.

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**Question 8:** *Do you agree that the primary difference between settlement value (that is, the amount to be paid to or received from the swap counterparty to terminate the swap) and fair value is that generally the nonperformance risk of the swap counterparties is not considered in the settlement value? If not, please explain why.*

We are of the belief the primary difference between settlement value and fair value is nonperformance risk.

**Question 9:** *Would disclosure of the swap's settlement value (instead of its fair value) adequately provide users of financial statements with an indication of potential future cash flows if the swap were to be terminated at the reporting date? If not, please explain why.*

We believe the settlement value would provide an adequate indication of potential future cash flows if the swap were to be terminated at the reporting date.

**Question 10:** *Are the costs of obtaining and auditing settlement value significantly less than fair value? Please explain why.*

The proposed ASU defines settlement value as the amount to be paid to or received from the swap counterparty to terminate the swap. As expressed in BC29 of the proposed ASU, the belief of the PCC is that permitting the use of settlement value will reduce cost and complexity as settlement value is generally provided by the swap counterparty. We agree that if reporting entities could report the amount provided by the swap counterparty without the need to consider nonperformance risk and if the reported amount is otherwise an approximation of fair value, the costs to the reporting entity would be reduced. It is important to note, however, that valuations that are currently routinely provided by major swap counterparties are often labeled as not representing the amount at which the transaction could be closed out. As such, there may be a disconnection between settlement value and how it is defined in the proposed ASU and what amounts are routinely provided by swap counterparties. Such a disconnection, if indeed it exists, should be addressed by replacing settlement value in the proposed ASU with a term and definition that mirrors the amount that counterparties routinely provide.

**Question 11:** *Do you agree that the following should be disclosed if the combined instruments approach is applied and that no additional disclosures should be required? If not, please explain why.*

- a. *The settlement value of the swap (along with the valuation method and assumptions)*
- b. *The principal amount of the borrowing for which the forecasted interest payments have been swapped to a fixed rate and the remaining principal amount of the borrowing that has not been swapped to a fixed rate*
- c. *The location and amount of the gains and losses reported in the statement of financial performance arising from early termination, if any, of the swap*
- d. *The nature and existence of credit-risk-related contingent features and the circumstances in which the features could be triggered in a swap that is in a loss position at the end of the reporting period.*

We are in agreement with the above disclosure requirements and do not believe that any additional disclosures are necessary.

**Question 12:** *Do you agree that the current U.S. GAAP disclosures, including those under Topics 815 and 820 should apply for a swap accounted for under the simplified hedge accounting approach and that the settlement value may be substituted for fair value, wherever applicable? If not, please explain why.*

We are in agreement with retaining the current disclosure requirements under Topics 815 and 820 for swaps accounted for under the simplified hedge accounting approach and that settlement value should be permitted to be substituted for fair value. We would, however, recommend that a swap accounted for

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under the simplified hedge accounting approach, not be considered a derivative instrument under topic 815 for the purpose of applying the scope exception of paragraph 825-10-50-3. We do not believe that the expanded fair value disclosures should be required as a consequence of having interest rate swaps used to achieve a fixed rate on variable rate debt if an entity meets all other applicable exceptions.

**Question 13:** *Do you agree with providing an entity-wide accounting policy election for applying the combined instruments approach? If that policy election is available, should this approach be applicable for all qualifying swaps, whether entered into on or after the date of adoption or existing at that date? If not, please explain why.*

We are in agreement that if the combined instruments approach is elected, it should be applied consistently for all qualifying swaps.

**Question 14:** *Do you agree that the entity-wide accounting policy election to apply the combined instruments approach must be made upon adoption of the amendments in this proposed Update or, for entities that do not have existing eligible swaps, within a few weeks after the entity enters into its first transaction that is eligible for the accounting policy election? If not, please explain why.*

We have significant concerns with the proposed requirement. Our understanding of the proposed guidance is, if an entity does not make an election at the appropriate time, the entity would be prohibited from ever making such an election, which seems highly punitive. We are concerned that the less-sophisticated entities for which these more simple alternatives have been designed may overlook the new guidance in its entirety and/or the accounting policy election. Unfortunately even though formal hedge elections have been required to qualify for hedge accounting for over ten years with the effective date of FASB Statement No. 133, there are still a significant number of entities that are unaware of the formal documentation requirements, such as entities undergoing an audit for the first time and/or entities using an interest rate swap for the first time. As such, we would similarly expect unsophisticated entities to overlook the need to elect the combined approach on a timely basis. While the proposed ASU does permit the election to be made within a few weeks of new eligible transactions (for those entities that don't have eligible transactions at the adoption date), in our viewpoint, a few weeks does not address the problem. Practically speaking, entities may remain unaware of the new guidance, its effective date or the need to make an accounting policy election until the year end audit. Additionally, it is not evident from the proposed ASU what the accounting policy election should entail. If an entity does not record a qualifying swap on its balance sheet, has the entity effectively elected the combined approach? As a substitute to requiring the election at adoption or within weeks of eligible transactions, we recommend the election should be allowed to be made any time prior to the issuance of the annual financial statements covering the period of adoption or the inception of the swap, but once it is elected, it must be applied consistently to all qualifying swaps.

**Question 15:** *Do you agree that the simplified hedge accounting approach could be elected for any qualifying swaps, whether existing at the date of adoption or entered into on or after the adoption date? If not, please explain why.*

We are in agreement with permitting election of the simplified hedge accounting approach for any qualifying swaps, without requiring the election to be made for all qualifying swaps.

**Question 16:** *Do you agree that the election to apply the simplified hedge accounting approach to an existing qualifying swap must be made upon adoption of the amendments in this proposed Update? If not, please explain why.*

We are in agreement that the election of whether or not to apply the simplified hedge accounting approach to an existing qualifying swap should be made upon adoption of the new standard. As noted in

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our response to Question 14, we do not believe there should be a stated timeframe for making the election.

**Question 17:** *Do you agree that the formal documentation required by paragraph 815-20-25-3 to qualify for hedge accounting must be completed within a few weeks of hedge designation under the simplified hedge accounting approach? If not, please explain why.*

As expressed in our responses to the preceding questions, we are concerned with the time limit on the documentation requirement given that it is not uncommon for unsophisticated entities such as those who are entering in to a swap for the first time and those who are undergoing an audit for the first time to be unaware of formal and timely documentation requirements. Additionally, one of the major issues associated with the current documentation requirements contained within paragraph 815-20-25-3 is the vastly different views over what constitutes acceptable documentation. Given that a major objective of the proposed ASU is to reduce complexity and given that the transactions eligible for the new simplified hedge accounting approach will be very similar to one another, our recommendation would be that the documentation requirements be limited to identifying the debt and swap for which the election is being made.

**Question 18:** *Do you agree that entities within the scope of this proposed Update should be provided with an option to apply the amendments in this proposed Update using either (a) a modified retrospective approach in which the opening balances of the current period presented would be adjusted to reflect application of the proposed amendments or (b) a full retrospective approach in which financial statements for each individual prior period presented and the opening balances of the earliest period presented would be adjusted to reflect the period-specific effects of applying the proposed amendments? If not, please explain why.*

We are in agreement with providing the two above-mentioned options for adoption.

**Question 19:** *Do you agree that an entity within the scope of this proposed Update should be permitted to early adopt the proposed amendments? If not, please explain why.*

Yes. We are in agreement with permitting early adoption.

**Question 20:** *How much time is needed to implement the proposed amendments? Please explain.*

We believe that a year from issuance of a final standard is a reasonable time period to allow for implementation of the proposed amendments, assuming that allows sufficient time for swap counterparties to be able to make whatever system changes may be necessary to provide settlement amounts as defined, along with descriptions of the methodologies used and significant assumptions. A year should allow sufficient time for less sophisticated entities to become aware of the new guidance, understand it, evaluate it and make decisions.

**Question 21:** *The scope of this proposed Update uses the term **publicly traded company** from an existing definition in the Master Glossary. In a separate project about the definition of a nonpublic entity, the Board is deliberating which types of business entities would be considered public and would not be included within the scope of the Private Company Decision-Making Framework. The Board and PCC expect that the final definition of a **public business entity** resulting from that project would be added to the Master Glossary and would amend the scope of this proposed Update. The Board has tentatively decided that a public business entity would be defined as a business entity meeting any one of the following criteria:*

- a. *It is required to file or furnish financial statements with the Securities and Exchange Commission.*

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- b. *It is required to file or furnish financial statements with a regulatory agency in preparation for the sale of securities or for purposes of issuing securities.*
- c. *It has issued (or is a conduit bond obligor) for unrestricted securities that can be traded on an exchange or an over-the-counter market.*
- d. *Its securities are unrestricted, and it is required to provide U.S. GAAP financial statements to be made publicly available on a periodic basis pursuant to a legal or regulatory requirement.*

*Do you agree with the Board's tentative decisions reached about the definition of a public business entity? If not, please explain why.*

The question regarding the definition of a public business entity is a key question from a scoping standpoint that will be relevant for all PCC proposals. As the Board subsequently issued the proposed guidance referred to in this question as currently being deliberated, Proposed Accounting Standards Update, *Definition of a Public Business Entity, An amendment to the Master Glossary*, on August 7, 2013 with comments due by September 20, 2013, we will address this issue as part of our comment letter on that proposed Update.

A key question for all PCC proposals that exclude public business entities from their scope will be how private entities should make the transition from an accounting standpoint to being a public entity if they adopted an alternative accounting treatment. We believe the answer to this question could vary depending on the particular proposal. With regards to the proposed alternatives for interest rate swaps, since the combined method could significantly affect comparability to other public entities, we believe it may be appropriate to require the private entity transitioning to a public entity to recast its financial statements for prior periods to include the settlement value of the swaps on the balance sheet and in effect substitute the simplified method for the combined method. Given the difficulty an entity would have however in attempting to newly qualify for hedge accounting with swaps that do not have a zero fair value under the current requirements in ASC 815, we believe the entity should be able to continue to assume there is no hedge ineffectiveness through the remaining terms of the swaps for which simplified approaches were elected as a private entity, as long as the conditions to apply the simplified approaches otherwise continue to be met.

We appreciate this opportunity to provide feedback on the proposed guidance and would be pleased to respond to any questions the Board or its staff may have concerning our comments. Please direct any questions to Rick Day (563-888-4017) or Faye Miller (410-246-9194).

Sincerely,



McGladrey LLP