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December 16, 2016

Mr. Russell Golden
Chairman
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-05116

Re: Proposed Exposure Draft, *Derivatives and Hedging (Topic 815)*

Dear Mr. Golden,

CFA Institute[1], in consultation with its Corporate Disclosure Policy Council ("CDPC")[2] is pleased to provide you with our perspectives on areas for consideration in connection with the Financial Accounting Standards Board's (FASB's or Board's) exposure draft on derivatives and hedging (hereafter referred to as the "ED").

Executive Summary

The use of derivatives by companies is widespread across both financial and non-financial institutions. Concurrently, the volatile economic environment of the last few years, including the significant commodity price fluctuations, has reinforced the importance of having financial statements that provide investors with the information to clearly assess the risk associated with the use of derivatives and to gauge management's effectiveness in employing these financial instruments for risk management purposes.

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[1] CFA Institute is a global, not-for-profit professional association of more than 137,000 investment analysts, advisers, portfolio managers, and other investment professionals in 157 countries, of more than 131,400 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 147 member societies in 73 countries and territories.

[2] 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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The ED proposes to revise hedge accounting[3] requirements with the objective of allowing entities to better reflect their underlying risk management strategies.

Overarching view on expanded hedge accounting requirements

The ED proposes several changes (including: expanding eligibility for hedge accounting for non-financial risk components; expanding interest rate benchmarks that can be allowed in the effectiveness testing; and permitting qualitative rather than quantitative tests for the retrospective hedge effectiveness testing), the overall effect of which is to expand the population of exposures that will qualify for hedge accounting.

High-level concerns on hedge accounting expansion: The complex nature and exception based characteristics of hedge accounting requirements can sometimes hinder rather than clarify investors understanding of risk management activities undertaken by companies. As a result, and as noted in our previous commentary[4] to both the IASB and FASB, we have general concerns about expanded application of hedge accounting if companies do not have accompanying robust disclosures and without a well-defined notion of what constitutes a "risk management activity". The lack of a definition for "risk management activity" alongside the expanded and optional application of hedge accounting can increase the potential for highly subjective and incomparable reporting by companies.

Support improving communication of risk management practices: Despite the above noted general concern, we recognize that the objective of the FASB in expanding eligibility for hedge accounting is to allow reporting entities to reflect a wider spectrum of hedging activities and better portray their risk management activities. We also recognize that many companies undertake legitimate economic hedging activities that do not qualify for hedge accounting (economic hedges). We are not opposed to reducing the number of legitimate economic hedges that do not currently qualify hedge accounting as this will enhance the comparability of reporting and minimize the need for the "economic versus accounting hedges" distinction that can be confusing for many. That said, we do not believe improving the communication of risk management by companies should be limited to issues around accounting hedges but should also include increased transparency on economic hedges.

[3] Hedge accounting is an approach allowed for financial instruments designated as being part of a hedging relationship for accounting purposes. The main aim of hedge accounting is to avoid reflecting earnings volatility for hedging instruments that are part of an effective hedging relationship. There are two main types of allowed hedge accounting approaches—fair value and cash flow. Net investment hedges, which have similar mechanics to cash flow hedges, relate to foreign subsidiaries but are less common and are less significant in magnitude compared with cash flow hedges.

[4] a) CFA Institute (2008) comment letter to FASB Exposure Draft Amendment to SFAS 133; b) CFA Institute (2010) comment letter to FASB Proposed Update to Accounting Standards on Financial Instruments and Revisions to Accounting for Derivatives and Hedging Activities; c) CFA Institute (2011) comment letter to IASB on Hedge Accounting. These past issued comment letters provide our detailed views on expanded hedged accounting proposal.

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In this response, we do not intend to comment in detail on the concerns on all revisions that will expand the application of hedge accounting. Our principal views are as follows:

- We are not opposed to expanding hedge accounting eligibility for non-financial risk components and the expanded eligibility for interest rate benchmarks, in so far as there is adequate accompanying, contextualizing disclosures on these hedging strategies.
- We understand that the shift from quantitative to qualitative retrospective[5] testing is meant to simplify the implementation of hedge accounting. We are, however, concerned that a lower threshold of ineffectiveness testing may increase the likelihood of hedging relationships being misclassified as still being effective when they are not.
- As we discuss in a later section, hedge accounting requirements are highly complex and can contribute to increased incomparability in the reporting outcomes of companies. Hence, we emphasize the importance of enhanced presentation and disclosures that comprehensively communicates about companies' underlying risk and effectiveness of risk management activity. Such disclosures ought to help investors independently gauge
    - Types and levels of risk exposures;
    - Extent to which companies hedge these risk exposures;
    - Why companies are using derivatives;
    - The effects of derivative positions on corporate risk exposures;
    - Where and how derivative positions and value changes are reported in the financial statements;
    - Effectiveness of hedging programs;
    - Pre- and post-hedging effects on related financial statements line items for companies that pursue hedging programs; and
    - Differences, if any, in the earnings performance and cash flow trends, and statement of financial position asset and liability values for companies that hedge versus those that do not.

  The enhanced disclosures should cover all hedging activities regardless of whether they are accounting hedges. In other words, economic hedges should be within the scope of disclosure enhancements.

Please also refer to our 2008, 2010 and 2011 comment letters for a detailed commentary on the above issues.

Enhanced presentation and disclosure at heart of improving communication of risk management
With regard to the presentation and disclosure changes proposed in the ED, our views, and primary recommendations are as follows:

- *Deferral of hedge ineffectiveness (i.e. cash flow and net investment hedges):* The ED proposes to require the deferral of cash flow hedge ineffectiveness in other comprehensive income (OCI) rather than in the income statement in the period of occurrence as is currently reported. We are concerned that this proposal will reduce transparency in the reporting of hedge ineffectiveness for these relationships, compound exception reporting, and create further differences between fair value and cash flow hedges.

[5] Quantitative tests will only be required at inception.

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- *Aggregation of hedging and hedged items in income statement line item*: The ED proposes that changes in the fair value of the hedging instrument be recorded in the same income statement line item as the hedged item. We support this change as it will help enhance the information content of income statement line items that are subject to hedging transactions and their associated analytical ratios (e.g. gross margins). That being said, this proposed requirement makes it all the more important to have accompanying disclosures, such as those proposed in the ED, that can help investors to discern the pre-hedging and post-hedging profile of income statement line items.

- *Aggregation of discontinued hedging transactions in intended income statement line item*: The ED proposes to aggregate the gains or losses of **discontinued** cash flow and net investment hedging programs on the income statement line item that had been intended as the hedged item. The rationale for this approach is that the gains or losses of discontinued transactions are also considered a "cost of hedging" in respect of designated income statement line items notwithstanding the fact that the actual hedging transaction does not occur. In our view, the "cost of intending to hedge" is not equivalent to the cost of hedging. We are also concerned about the potential difficulty in discerning entity-wide, sub-optimal risk management choices if the aggregation of gains or losses of discontinued designated hedging instruments will be spread across multiple income statement line items.

We recommend the following disclosures:

- *Big-picture and contextualizing disclosures* – We recommend the enhancement of big picture, contextualizing disclosures including the following:
    - Description of risks that are being hedged;
    - Nature and extent of hedging – particularly if hedge accounting is expanded to include non-financial risk components; and
    - Sources of ineffectiveness.

  Our major concern with current reporting is that it is often impossible to discern even the direction of hedging, let alone the consequences.

- *Enhanced financial statement line item disclosures* – We strongly support the enhanced disclosure of the effects of hedging activities on the income statement and statement of financial position line items as outlined in the ED. These disclosures help to convey the before and after effects of hedging on reported performance, assets and liabilities. However, the ED does not address the cash flow effects of hedging activities and we recommend that FASB enhances disclosures of these.

We expand on these matters in the following sections.

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Discussion

Complexities of Hedge Accounting Model and Implications for Investors

As noted above, we have high-level concerns about the expanded application of hedge accounting. This is due in part to the following challenges and features associated with hedge accounting:

- *Comparability challenges*: Optional and judgment-intensive accounting requirements are more likely to result in increased incomparability across reporting entities. Contributing factors include: a) application of hedge accounting is optional; b) similar instruments can have different hedge accounting treatment (i.e., be treated as either cash flow or fair value hedges); and c) a significant number of preparer judgments are involved in the application of hedge accounting treatment (e.g., even at the level of determining which relationships should be designated for hedge accounting).

- *Analytical complexity*: Hedge accounting requirements are inherently complex and this can hinder, rather than help, investors' ability to assess the effectiveness of risk management practices. For example, the notion of cash flow and fair value hedges are not intuitive economic concepts but are simply accounting classification concepts, and the designation of similar hedging relationships as either cash flow or fair value hedge can result in differing reporting outcomes[6]. Another example of complexity is the choice to defer and amortize the time value of options when not considered in the effectiveness assessment for option derivatives instruments.

- *Exception-based accounting*: Hedge accounting treatment is an exception to the requirement that all fair value changes of derivatives be recognized in the income statement in the period of occurrence. It is also an exception in that it is one of the few accounting standards that permits linkage of the recognition and measurement of

[6] Below are two examples of differing hedge accounting designation for the same underlying derivatives instruments

- Reval, 2011, Hedge Accounting: Cross Currency Interest Rate Swaps- Minimising P& L Volatility - Consultancy firm Reval's white paper illustrates that companies can elect a hedge accounting approach (i.e. either fair value or cash flow hedges) for different components of Cross Currency Interest Rate Swaps so as to influence the reported ineffectiveness. The white paper illustrates that hedge accounting designation can influence the level of reported hedge ineffectiveness. The same economic hedge but with a different hedge accounting choice can effectively result in different reported ineffectiveness.

- Another example of differing hedge accounting designation for the same derivatives instruments is when 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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interrelated line items.[7] As we understand it, hedge accounting is simply a practical expedient aimed at minimizing mismatches in the accounting treatment of hedging instruments and their hedged exposures to minimize income statement volatility and differentiate the effects of hedging versus non-hedging on income statement earnings. In other words, hedge accounting is an exception based accounting approach.

While we have always taken the position that disclosures are not a substitute for recognition and measurement within financial statements, the aforementioned concerns and inherent complexity of hedge accounting emphasize the need to enhance the overall disclosures of derivatives and hedging activities as the main solution towards enabling reporting entities to effectively communicate and reflect their risk management strategies[8].

Accordingly, the remainder of our letter focuses on the aspects of the ED that affect presentation and disclosure of hedge accounting activities.

Specific Comments and Suggestions on Presentation and Disclosure

Deferral in OCI of Cash Flow and Net Investment Hedge Ineffectiveness

The ED proposes to defer the ineffective portion of cash flow and net investment hedges in OCI, rather than reporting it in the income statement in the period that it occurs, as is currently required. As we understand it, the rationale for discontinuing separate accounting for hedge ineffectiveness is to enable users to see the entire impact of a hedging program on the relevant income statement line items (e.g., interest income or cost of goods sold) at the maturity of the contract.

We are, however, concerned by this proposal to defer in OCI the cash flow hedge ineffectiveness for the following reasons:

- *Reduced transparency of ineffectiveness of cash flow and net investment hedges.* The proposed approach is meant to reflect the cumulative effect of a hedging program (i.e. cash flow and net investment hedges) on income statement line items at the point of maturity or termination of the hedging relationship. We are not sure whether the proposed presentation in OCI of cash flow and net investment hedging instrument gains or losses, prior to the maturity of these instruments, will also require disclosures with an adequate disaggregation of the ineffective portion versus the re-measurements associated with effective hedges during the reporting period. And we are also not sure if, whenever these hedging line items are reclassified from OCI to the income statement, there will be disclosures that separately identify the cumulative hedging ineffectiveness, re-measurements of effective hedges, and re-measurements of discontinued hedging relationships.

[7] For example, the conceptual framework and accounting standards do not require matching of the recognition and measurement of assets and related liabilities. The matching principle is also generally not applied in recognizing interrelated income statement line items.

[8] CFA Institute, 2013, User Perspectives on Financial Instruments Disclosures Under IFRS−Derivatives and Hedging Activities − In this publication, we argued for enhanced disclosures as a means of improving the communication of risk management.

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Without these disclosures, we anticipate a loss of transparency and information regarding both the period-to-period and the cumulative ineffectiveness of these hedging relationships. This concern can be addressed, however, by enhancing disclosure of ineffectiveness gains or losses, accompanied by robust disclosures of the underlying sources of ineffectiveness.

- *Deferral of cash flow and net investment hedge ineffectiveness compounds exception reporting*. As noted, a core recognition and measurement principle is to recognize the fair value of all derivatives in both the income statement and statement of financial position. The exception accorded to derivatives designated as cash flow hedges (i.e., deferral of re-measurements of effective hedges) is currently permitted to avoid a recognition mismatch between the hedging instrument and hedged item (forecasted transactions) for effective hedging relationships in a manner that effectively creates artificial earnings volatility. That is, this approach eliminates earnings volatility in situations where an underlying hedging relationship is effective.

  That said, the income statement presentation of the fair value changes associated with the **ineffective** portion of hedging instruments does not create artificial earnings volatility, as there is no related accounting mismatch. Therefore, in our opinion, the ineffective portion of hedges ought not to be afforded the same exception as effective hedges (i.e., OCI deferral). In effect, the proposed OCI deferral will likely compound the exception-based reporting associated with hedge accounting.

- *Further inconsistencies between cash flow and fair value hedges*: The proposed approach also seems likely to result in further inconsistencies between fair value and cash flow hedge accounting approaches, given that ineffectiveness of fair value hedges will still be reflected on a period-to-period basis rather than on a cumulative basis. Furthermore, at the termination of a hedging program, a fair value hedge income statement line item will not reflect cumulative ineffectiveness but a cash flow or net investment hedge income statement line item will. As noted, it is beneficial for investors to be aware of the period-to-period ineffectiveness of a hedging program, regardless of whether the hedged item is either an asset or liability or forecast transaction.

For the above reasons, we do not support the proposed deferral in OCI of cash flow and net investment ineffectiveness

<u>Aggregation of hedging and hedged items on income statement line items</u>
The ED proposes a requirement that changes in the fair value of the hedging instrument be recorded in the same income statement line item as the hedged item. We support this change as it will help reflect the effect of hedging programs on income statement line items and enhance the information content of income statement line items subject to hedging transactions and associated analytical ratios (e.g. gross margins). That being said, this proposed requirement makes it all the more important to have accompanying disclosures, such as those proposed in the ED, that can help investors to discern the pre-hedging and post-hedging profile of income statement line items.

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Aggregation of discontinued hedging transaction on intended hedged income statement line items

Gains or losses of a designated hedging instrument for a **discontinued** hedging transaction will also be presented on the same income statement line item as the item that was intended to be hedged. We are concerned by this particular change for the following reasons:

- *Difficulty discerning entity-wide sub-optimal risk management choices*: If a company has multiple ineffective and discontinued hedging programs, the individual effects will be spread across individual income statement line items in a manner that can conceal the fact an entity is undertaking sub-optimal hedging programs.

- *Cost of intending to hedge ≠ Cost of hedging*: The inclusion of gains or losses of discontinued hedging instruments on the originally designated income statement line item seems more like the reflection of the cost of intending to hedge rather than reflecting the actual cost of hedging.

- *Presentation should not reflect management intent*: While we understand that the Board's objective is to reflect the effects of designated hedging programs on income statement line items, the inclusion of intended but discontinued hedging programs within income statement line items can potentially distort the reporting outcomes as it will reflect management's intended outcome rather than actual economic reality[9].

- *Possibility of timing the representation of discontinued transactions on designated income statement line items*: The proposed change seems to grant companies the possibility of timing the release of discontinued hedges in a manner that could manipulate income statement line items.

Disclosures

We strongly support the enhanced disclosures of the before and after effects of hedging activities on income statement line items. We also strongly support the statement of financial position line item disclosure of the cumulative fair value hedging adjustment included in the carrying amount of the respective line item. However, the ED does not adequately address cash flow statement effects of derivatives and hedging activities. We recommend that FASB enhance the overall

[9] Consider a firm that has an unhedged line item exposure such as sales in year(t) but concurrently has hedged its export sales for year (t+5) using a foreign currency forward contract. If it discontinues the year (t+5) hedge, then under the ED's proposed presentation as we understand, the gains or losses of the hedging instrument (foreign currency forward contract) will be reflected in year (t) sales. This approach could misleadingly portray the unhedged year (t) sales as effectively being hedged. Conversely, if the valuation change of the foreign currency contract is in the same direction as the foreign currency related rise/fall in the amount of year (t) sales, then year (t) sales will appear to be more volatile than is actually the case. In addition, we question whether discontinuing the year (t+5) hedge ought to be considered a cost of hedging for year (t).

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disclosures including several "big picture" and contextualizing disclosures as follows: (see earlier comments)

- *Big picture, contextualizing disclosures for all types of hedges*: We recommend the requirement of enhanced "big picture" and contextualizing disclosures including the following:
    - *Description of risks that are being hedged*: Investors must be informed of the risk exposure (income, cash flows, balance sheet) that the company wishes to change.

    - *Extent of hedging*: Disclosure of the extent of hedging is necessary particularly if hedge accounting is expanded to include non-financial risk components. Such disclosure can be part of the overall description of the risk management policy if it is difficult to do so for multiple transactions.

    - *Sources of ineffectiveness*: The importance of disclosing sources of ineffectiveness is illustrated in a Reval white paper[10]. The white paper reviews the hedging of foreign currency borrowing by corporations, using cross currency interest rate swaps (CCIRS), and the nature of ineffectiveness arising from this hedging strategy. The paper highlights how specific valuation input factors (e.g. coupon reset date and currency basis that reflects cross country credit risk) may have differing impacts on the valuation of the underlying hedged item (i.e. foreign currency debt) and hedging instrument (i.e. CCIRS). It also shows how different elements of the valuation mismatch between the hedged item and hedging instrument can translate into sources of reported hedge ineffectiveness. This example is an illustration of why it is important to disclose to investors the nature of underlying sources of reported hedge ineffectiveness. Such disclosure will help investors to better understand any reported ineffectiveness on the income statement and to discern where seemingly similar economic hedges applied across different companies are comparable in their reported ineffectiveness.

- *Fair value hedges disclosure enhancements*: We strongly support the ED's proposed disaggregation of the statement of financial position of the carrying value of the hedged item and the cumulative fair value adjustments of the hedging instrument.

- *Cash flow hedges disclosure enhancements*: We advocate the following cash flow hedge disclosure enhancements:
    - *Disaggregation that distinguishes "true rather than intended" hedging effects*: We recommend the disaggregation of gains or losses differentiating clearly between amounts due to hedge ineffectiveness; termination, selling, or exercising of derivative contracts; and voluntary de-designation. This disclosure will help investors discern the "true rather than intended" hedging related impacts on income statement line items.

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[10] Reval, 2011, Hedge Accounting: Cross Currency Interest Rate Swaps- Minimising P& L Volatility

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- *Disaggregation by risk type:* We support the disclosure that is proposed by the ED-and as shown in the illustrative examples.[11]

- *Contextual information on hedging strategy including more informative maturity analysis:* To be fully informative, cash flow hedge disclosures should describe the hedging strategy and show how the maturity of the cash flow hedging instrument matches the maturity of the hedged item's expected cash flows. Such disclosures, which link the maturity of the cash flow hedging instrument to that of the hedged item, are currently not provided. We recommend FASB require this disclosure.

- *Cash flow statement effects*: There is a need for disclosures that show how derivatives, whether they are used for hedging or not, impact the operating, financing and investment cash flows of a company. The principle of cohesiveness between the income statement and cash flow statement line items should guide the cash flow statement classification.

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Thank you again for the opportunity to comment on the ED. If you or your staff have questions or seek further elaboration of our views, please contact Vincent Papa, Ph.D., CPA, CFA by phone at +44.207.330.9521, or by e-mail at vincent.papa@cfainstitute.org.

Sincerely,

/s/ Vincent Papa

Vincent Papa, Ph.D., CPA, CFA
Interim Head, Financial Reporting Policy
Standards & Advocacy Division
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/s/ Tony Sondhi

Tony Sondhi, Ph.D.
Chair
Corporate Disclosure Policy Council

cc: Sandra Peters, CPA, CFA; Head Financial Reporting Policy

[11] CFA Institute, 2015 – Analyzing Bank Performance: Role of Comprehensive Income – In a review of cash flow hedge disclosures for financial institutions, we found that most reporting entities fail to disaggregate reported cash flow hedge OCI amounts by risk type. The aggregated amount that is normally reported by banks conceals information on how various risk factors (e.g., interest rate, foreign currency fluctuation) individually affect the cash flow hedge gains or losses. In so doing, the aggregated amounts limit the ability of investors to observe how period-to-period patterns of cash flow hedge gains or losses vary relative to period-to-period changes in macroeconomic factors (e.g., interest rate, foreign currency).