

September 22, 2021

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Technical Director  
Financial Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
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By email: [director@fasb.org](mailto:director@fasb.org)

**Re: File Reference No. 2021-004, Invitation to Comment, Agenda Consultation**

Dear Ms. Salo,

The International Swaps and Derivatives Association's (ISDA)<sup>1</sup> Accounting Policy Committee appreciates the opportunity to provide feedback on the Financial Accounting Standards Board's (FASB or Board) future standard-setting agenda through the Invitation to Comment (ITC). Collectively, the Committee members have substantial professional and practical expertise addressing accounting policy issues related to financial instruments. This letter provides our organization's overall views and priorities on the standard-setting agenda.

#### *Overview*

ISDA supports the FASB's agenda consultation process and the opportunity to assist the Board in deciding where to focus its standard-setting efforts. The Committee believes there are a number of pervasive issues that have arisen in recent years due to changes and evolutions in the market that were not originally contemplated when developing U.S. Generally Accepted Accounting Principles (GAAP) and are included as topics in this ITC. The Committee has also submitted several agenda requests in recent years, which are referenced in the responses to the questions for respondents below and also included as appendices to this letter.

We strongly support the Board's mission to establish and improve financial accounting and reporting standards to provide useful information to investors and other users of financial reports, and to educate stakeholders on how to understand and implement those standards.

Please find below the Committee's responses to the questions for respondents.

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<sup>1</sup> Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 950 member institutions from 76 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: [www.isda.org](http://www.isda.org). Follow us on [Twitter](#), [LinkedIn](#), [Facebook](#) and [YouTube](#).

**Responses to FASB’s Questions for Respondents**

**Question 1:** Please describe what type of stakeholder you (or your organization) are from the list below, including a discussion of your background and what your point of view is when responding to this ITC:

The Committee is comprised of representatives from various financial institutions including banks, insurance companies and investment managers including private and public company preparers. As mentioned above, collectively, the Committee members have substantial professional and practical expertise addressing accounting policy issues related to financial instruments.

**Question 2:** Which topics in this ITC should be a top priority for the Board? Please explain your rationale, including the following:

- a. Why there is a pervasive need to change GAAP (for example, what is the reason for the change)
- b. How the Board should address this topic (that is, the potential project scope, objective, potential solutions, and the expected costs and benefits of those solutions)
- c. What the urgency is of the Board completing a project on this topic (that is, how quickly the issues need to be addressed).

The Committee believes there are several high priority items for the Board to incorporate. However, we believe improvements to hedge accounting through the Hedge Accounting – Phase 2 project on the FASB’s pre-agenda research is of the highest priority. Hedge accounting enables entities to portray the economics of their risk management activities and align financial reporting with risk management objectives more clearly.

Specifically, there are a number hedge accounting topics we believe the Board should consider adding to its agenda or accelerating the standard setting process. For each item below, we describe the topic as well as why there is a pervasive need to change GAAP and how the Committee recommends the Board address the topic. The Committee believes the topics related to cash flow hedge accounting, derivative accounting and FX hedging are the highest priority. Below these topics, we include a non-exhaustive list of other topics which the Committee would be supportive of addressing in a Hedge Accounting – Phase 2 Project.

Topic #	Description of topic	Why there is a pervasive need to change GAAP	How the Board should address this topic
<b>Cash flow hedging topics</b>			
1	Differentiating hedged item and hedged risk including application to cash flow hedges of pooled cash receipts or payments	Accounting Standards Update (ASU) No. 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities introduced the concept of changes in hedged risk for a	As noted below in our response to Question 5, the Committee believes the Board should prioritize its project on Codification Improvements – Hedge Accounting and incorporate

		<p>cash flow hedge. However, that ASU did not provide sufficient guidance on how to differentiate the hedged risk from the hedged item leading to the guidance often being inoperable. With LIBOR transition forthcoming, many entities with cash flow hedges of pooled cash receipts or payments will be challenged to continue applying hedge accounting once the relief provided by ASU 2020-04, Reference Rate Reform reaches its sunset date given the multiple interest rate environment that is likely to exist post-LIBOR transition.</p> <p>The guidance in ASC 2017-12 related to changes in hedged risk requires further clarification as the existing principles have led to differing interpretations among practitioners. For example, some practitioners hold the view that a change in the currency of a forecasted future fixed rate debt issuance that was originally hedged by a forward-starting interest rate swap indexed to an eligible benchmark interest rate pertaining to the originally planned currency of issuance automatically results in the transaction being deemed probable of not occurring (even though interest payments of the same quantum will occur). Additional clarifying guidance addressing common fact patterns involving a change in hedged risk, such as a change in currency of a forecasted debt issuance, would improve financial reporting and reduce diversity in practice.</p>	<p>feedback from the latest Exposure Draft to provide a final Accounting Standards Update that preparers can utilize for changes in hedged risk. This would both solve historical issues preparers have faced when hedged risks change (e.g., cash flow hedges of forecasted issuances of fixed rate debt) as well as new issues caused by emerging market events such as LIBOR transition.</p>
2	<p>Permit the continued application of hedge accounting for cash flow hedges so long as the hedged forecasted transactions remain probable and the hedging relationship is highly effective</p>	<p>We note that the Securities and Exchange Commission granted similar relief in relation to cash flow hedges for COVID-19 driven modifications. However, the Committee believes this should be considered for a permanent change to GAAP. The Committee</p>	<p>The Committee recommends the Board address this topic as part of its Hedge Accounting – Phase 2 project by permitting the continued application of hedge accounting for cash flow hedges if the timing changes</p>

		believes this is necessary because these hedges are not easily re-designated given their non-zero fair values at the time of re-designation. Further, the Committee believes that if the hedging relationship is both probable and highly effective there is no reason a slight mismatch in the original forecast should result in such a punitive outcome.	so long as the hedged forecasted transactions remain probable, and the hedging relationship is highly effective.
3	Applying existing GAAP for cash flow hedges post-LIBOR transition when the critical terms match or shortcut methods for assessing effectiveness are utilized	As noted above, post-LIBOR transition, the interest rate conventions of hedged forecasted transactions and hedging instruments in cash flow hedges may not align due to differences in market and fallback conventions. As such, the Committee believes there is a need to re-examine the existing models around qualitative methodologies for assessing effectiveness and providing relief such that preparers can continue to apply these methodologies post-LIBOR transition.	The Committee recommends the Board address this topic more immediately as part of its Reference Rate Reform project given the implications to new hedges of alternative reference rate instruments expected to begin in earnest in 2022 by allowing differences in de minimis terms like reset dates and payment dates to not invalidate an assumption of perfect effectiveness.
<b>Derivative accounting topic</b>			
4	Addressing the application of Derivatives Implementation Group (DIG) Issue A23: Definition of a prepaid interest rate swap to modified derivatives and the requirement to reperform the initial net investment assessment on interest rate derivatives	Please refer to the Committee’s response to Question 9 for an explanation as to why there is a pervasive need to change GAAP.	Please refer to the Committee’s response to Question 9 for our recommended solution to this topic.
<b>FX hedging related topics</b>			
5	The ability to designate common forecasted foreign currency-denominated transactions currently precluded as hedged items in ASC Topic 815, including forecasted issuances of foreign-denominated debt and business combinations	As noted in the Committee’s agenda requests dated June 19, 2018, the inability to hedge foreign currency transactions including forecasted issuances of debt and business combinations is a practice issue that is pervasive across industries, narrow in nature, and can be resolved in a short time frame.	Please refer to our agenda requests for proposed solutions (including proposed changes to the Accounting Standards Codification) for both topics.

6	Ability to use float-for-float cross-currency swaps in a net investment hedge when the reset periods do not match	The Committee believes this change is necessary due to the impacts of LIBOR transition on interest rate conventions. For example, the Committee believes in certain float-for-float cross-currency swaps, certain interest rates will be set in advance (e.g., term rates) while other rates will be calculated in arrears (e.g., overnight rate compounded or averaged over a historical period). Such hedging instruments will not qualify for hedge accounting in the future given both legs of the swap will not have the same repricing intervals and dates pursuant to ASC 815-20-25-67(a)(2).	The Committee recommends the Board address this topic as part of its Hedge Accounting – Phase 2 project by removing the criterion in ASC 815-20-25-67(a)(2) and ASC 815-20-25-71d related to compound derivative exclusion.
7	Using non-derivative contracts as hedging instruments in accounting hedges of foreign exchange risk other than net investment hedges and firm commitments	The Committee believes this would allow entities to use existing economic foreign-exchange exposures to apply hedge accounting. In principle, there does not appear to be a good reason why GAAP limits the use of non-derivative contracts to hedge foreign exchange risk in only net investment hedges and fair value hedges of foreign currency denominated firm commitments.	The Committee recommends the Board address this topic as part of its Hedge Accounting – Phase 2 project by permitting the use of non-derivative contracts as hedging instruments in cash flow or fair value hedges of foreign exchange risk.

As noted above, the Committee believes the following topics should also be considered as part of a Hedge Accounting – Phase 2 project:

*Fair Value Hedge Accounting*

1. The ability to hedge interest rate risk on held-to-maturity securities
2. Using written options to hedge interest rate risk (including in a partial-term hedge scenario)
3. Expanding the portfolio-layer hedging concept to prepayable financial liabilities
4. Ability to apply shortcut method on forward-starting partial-term fair value hedges
5. Ability to hedge inflation as a hedged risk in a fair value hedge
6. Ability to hedge fixed rate equity-classified preferred shares for interest rate risk

*Cash Flow Hedge Accounting*

7. Ability to hedge floating rate equity-classified preferred shares for interest rate risk
8. Permit entities to hedge forecasted bond purchases where the risk being hedged may be defined as either the purchase price of a seasoned bond or the variability of fixed interest payments related to newly issued bonds in the same hedge relationship
9. Clarify guidance to allow hedges of interest rate risk to include fee income (or expense) in contracts that contain a contractually specified interest rate index
10. Consider revising the current guidance that forecasted transactions that are part of cash flow hedges must occur within 60 days of the original forecast by providing relief for continued hedge accounting as long as the forecasted transactions remain probable based on the facts and circumstances.
11. Ability to hedge inflation as a hedged risk in a cash flow hedge

*Net Investment Hedge Accounting*

12. Amending guidance on the accounting for off-market cross currency swaps designated as net investment hedges under the spot method
13. Expand current guidance for cross currency swaps to explicitly allow the exclusion of all other factors other than spot from the hedge relationship

**Question 3:** Are there topics in this ITC that the Board should not address as part of its future standard-setting efforts? Please explain your rationale, such as there is no pervasive need to change GAAP, the scope would not be identifiable, or the expected benefits of potential solutions would not justify the expected costs.

As indicated below, we believe questions 6-8, 14-15, 18-21 and 23-24 are lower priority items as they are not pervasive items that require immediate attention.

In addition, the Committee does not believe Codification Improvements—Financial Instruments—Credit Losses (Vintage Disclosure: Gross Writeoffs and Gross Recoveries) should be a high priority item for the Board’s future standard-setting efforts as we do not believe this would result in decision useful information and it would be extremely operationally intensive data to produce and disclose (i.e., the costs far outweigh the benefits), particularly for many consumer asset classes.

**Question 4:** Are there any financial reporting topics beyond those in this ITC that should be a top priority for the Board to address? Please describe:

- a. The nature of the topic
- b. The reason for the change
- c. Whether the topic is specific to a subset of companies, such as public companies, private companies, or NFPs, or specific to a certain industry
- d. How the Board should address this topic (that is, the potential project scope, objective, potential solutions, and the expected costs and benefits of those solutions)
- e. What the urgency is of the Board completing a project on this topic (that is, how quickly the issues need to be addressed).

One additional topic we believe the Board should consider addressing includes a fair value option for commodity inventories and executory contracts related to physical commodities.

Given the challenges and significant operational cost that exist with applying fair value hedge accounting to the substantial majority of these positions, entities continue to experience mark-to-market volatility related to legitimate risk management activities and, therefore, having an option to measure certain physical commodity inventories as well as related executory contracts at fair value would provide a practical and simplified solution. Currently, only under the AICPA Audit and Accounting Guide: Brokers and Dealers in Securities (“B/D Guide”) are any entities permitted to account for these types of contracts at fair value under US GAAP.

We believe this issue is pervasive, and absent a fair value option election, entities will continue to report volatility in earnings that are not consistent with their actual economic position and incur operational costs that could be avoided through the fair value option. Further, providing entities with the ability to elect the fair value option is in line with the objective of FASB Statement No. 159, The Fair Value Option for Financial Assets and Financial Liabilities, which is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions.

We believe the scope of the fair value option that is provided under Topic 825, Financial Instruments, should be expanded to include physical commodity inventories as well as executory contracts related to physical commodities (e.g., storage, transportation, non-derivative purchase or sale contracts) that are managed on a trading basis. Please refer to ISDA’s agenda request dated June 7, 2021 for further detail in Appendix B.

**Question 5:** The objective of this ITC and the related 2021 Agenda Consultation process is to ensure that the FASB continues to allocate its finite resources to standard-setting activities that fulfill its primary mission of improving financial accounting and reporting standards and that are of the highest priority to its stakeholders. Therefore, feedback on the prioritization of projects on the FASB’s technical agenda (see Appendix A) would be helpful. Do you have any feedback on the FASB’s technical agenda, including the following:

- a. Which projects on the FASB’s agenda should the Board prioritize completing? Please explain.
- b. Which projects, if any, should the Board deprioritize or consider removing from the agenda? Please explain.
- c. Which projects, if any, need to be redefined to improve the objective and/or scope? Please explain.

Please see the table below for ISDA’s view on how current agenda topics should be prioritized by the FASB, including commentary regarding any suggested improvements to the project objective/scope. For projects not listed in the table below, the Committee views these initiatives as a lower priority and has no specific commentary to provide.



Project	Description	Response
Projects Already on FASB's Technical Agenda		
Codification Improvements—Hedge Accounting	The objective of this project is to make certain Codification improvements raised by stakeholders on the amendments in Accounting Standards Update No. 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities.	<b>High Priority.</b> As noted above in our response to Question 2, this project is important both for LIBOR transition (e.g., pooled cash flow hedges of interest receipts or payments) and preparers trying to apply the model today (e.g., cash flow hedges of forecasted issuances of fixed rate debt). Given the often-inoperable guidance in ASU 2017-12 around changes in hedged risk, the Committee believes this is high priority both due to its pervasiveness and forthcoming impacts from LIBOR transition.
Fair Value Hedging—Portfolio Layer Method	The objective of this project is to expand the existing last-of-layer fair value hedging method from a single-layer model to a multiple-layer model and clarify the accounting for and disclosure of basis adjustments.	<b>High Priority.</b> The Committee believes the proposed improvements the Portfolio Layer Method are an improvement over existing GAAP. Please refer to our comment letter dated July 2, 2021 Re: File Reference No. 2021-002, Exposure Draft, Derivatives and Hedging (Topic 815).
Reference Rate Reform—Fair Value Hedging	The objective of this project is to monitor reference rate reform initiatives around the world to identify areas of GAAP that may need to be amended in response to those initiatives.	<b>High Priority.</b> As noted above, the Committee strongly supports the Board's continued work on Reference Rate Reform guidance. As the LIBOR Transition continues, and significant uncertainty is still ahead, we believe Reference Rate Reform related projects should remain a high priority for the board. Specifically, the Committee is supportive of extending the sunset date of the guidance in ASC 848, Reference Rate Reform to at least December 31, 2023 to allow for legacy securities tied to USD LIBOR to transition. The Committee is also aware that the FASB staff has been evaluating the approach for what qualifies as a benchmark interest rate and whether to use a principle-based instead of using a prescriptive approach. While we are supportive of the FASB's initiative and continued amendments to add new benchmark rates to the list, the Committee believes that the FASB's existing process to add benchmark rates is sufficient and moving to a broad principle is unnecessary and could lead to diversity and inconsistency in practice.



<p>Fair Value Measurement of Equity Securities Subject to Contractual Sale Restrictions</p>	<p>The objective of this project is to reduce diversity in practice on measuring the fair value of equity securities that are subject to contractual sale restrictions.</p>	<p><b>High Priority.</b> Please see our response below about the related pre-agenda research project.</p>
<p>Distinguishing Liabilities from Equity Phase 2</p>	<p>The objective of this project is to improve and align the two existing indexation models in Topic 480 and Subtopic 815-40 that are used to evaluate financial instruments with characteristics of equity by developing an indexation principle to reduce inconsistencies.</p>	<p>The Committee believes existing GAAP is sufficiently clear and consensus exists on how to analyze most common complex instruments and features. As recent amendments to GAAP clarify a majority of the questions, the next phase of this project does not need to be a high priority.</p>
<p>Leases (Topic 842)— Lease Modifications</p>	<p>The objective of this project is to consider targeted improvements to Topic 842 related to lease modification accounting.</p>	<p>The Committee is aware there are existing practice issues around lease modification guidance, and this topic should remain on the FASBs standard setting agenda.</p>
<p>Pre-Agenda Research Projects</p>		
<p>Hedge Accounting— Phase 2</p>	<p>The objective of the research is to consider ways to further align hedge accounting with risk management activities.</p>	<p><b>High Priority.</b> As indicated above under Question 2, the Committee believes Hedge Accounting – Phase 2 should be the highest priority, as it will further align hedge accounting with risk management activities.</p>
<p>Effect of Sale Restrictions on Fair Value Measurements</p>	<p>The objective of the research is to study the types of restrictions that exist in practice on the sale of certain assets; to study whether there is diversity in practice in interpreting and applying the guidance within Topic 820, Fair Value Measurement, related to sale restrictions; and to consider whether additional standard setting is necessary.</p>	<p><b>High Priority.</b> If the project on Fair Value Measurement of Equity Securities Subject to Contractual Sale Restrictions results in new guidance that requires the fair value of these positions, we believe there should be an ability to capture the negative economic impact of the restrictions. For example, by allowing the Fair Value Option to be elected for such separate arrangements. As such, the Committee feels this project should be a high priority</p>

**Question 6:** Greater disaggregation and granularity of financial reporting information described in Chapter 1 have been identified as decision useful to investors. The following insights would be helpful to the FASB when considering this area:

- a. Investors and other financial statement users—Which, if any, of the areas described in Chapter 1 should be a top priority for the FASB to consider requiring greater disaggregation—on the income statement, the statement of cash flows, or the notes to financial statements? Would this information be most useful in the financial statements or in the notes to financial statements? How would this information be used to analyze a company and make capital allocation decisions?
- b. Preparers—What requests or questions does your company receive from analysts on the areas described within Chapter 1? Please explain any requests or questions your company has received.

Members of the Committee do not receive requests or questions regarding disaggregation or the granularity of the financial reporting information and do not believe the benefits of further disaggregating financial reporting information would outweigh the benefits.

**Question 7:** Investors and other financial statement users—What cash flow information, if any, required for your analysis is missing in a statement of cash flows prepared using the indirect method? How would this information influence your decisions and behavior? Please explain.

This question is not applicable for the Committee, as we are not investors and other financial statement users.

**Question 8:** Preparers—What requests or questions, if any, does your company receive from analysts on cash flow information? Please explain.

The members of the Committee do not typically receive questions from analysts on cash flow information.

**Question 9:** What challenges, if any, are there in applying the guidance on the definition of a derivative and the related derivative scope exceptions in Subtopic 815-10? Please explain the challenges and whether and how they could be addressed through standard setting.

Please refer to our response to Question 13 for the challenges the Committee has observed in applying the definition of a derivative and the related scope exceptions to embedded ESG features.

Existing US GAAP is unclear on the application of Topic 815 to modified derivatives and specifically interest rate and foreign currency derivatives. Entities modify interest rate derivative contracts in a variety of ways and for a variety of reasons. One common transaction involves extending the term of an existing derivative and blending its fixed rate with the fixed rate of an at-market interest rate derivative for the extended term (referred to in practice as a “blend and extend” trade), which usually results in no exchange of cash and no change to the fair value of the derivative contract after the modification. The significant volume of these extensions (particularly in light of the low interest rate environment caused by COVID-19) and resulting conclusions of the initial net investment test has led to questions about whether a modified derivative contract should continue to be accounted for as a derivative in its entirety, or if it should be accounted for as a hybrid debt instrument.

Any amendment to a critical term of a derivative is commonly interpreted as an extinguishment of the existing derivative, thus requiring a new evaluation of whether the amended derivative constitutes a derivative in its entirety, or a hybrid instrument. This evaluation hinges on what constitutes the initial net investment of the amended derivative. In a new derivative, this initial net investment is typically the amount of cash paid upfront to compensate for off market terms of the new transaction. In amended derivatives, generally there is no initial cash payment, however, the extinguished original derivative constitutes the “payment” for the off-market nature of the new transaction.

When a derivative modification occurs today, in the absence of a GAAP framework for modifications, some practitioners refer to ASC 815-10-55-148 through 55-168 (pre-codification DIG A23), as they would for a newly executed derivative. This approach presumes that derivative modifications de facto represent a termination of an existing derivative and that the DIG A23 guidance applies to derivative modifications and not just to newly executed derivatives.

Additionally, an entity will need to consider whether the future cash flows on the amended derivative should be reported in the financing section of the statement of cash flows (rather than operating cash flows). ASC 815-10-45-12 requires entities to report all cash flows associated with a derivative that contains an other-than-insignificant financing element at its inception as “cash flows from financing activities” in the statement of cash flows. This requirement relates to all cash flows from the derivative and not just the portion of the cash flows relating to the financing element of the derivative. Therefore, the periodic cash flows over the life of the derivative, as well as any cash flow at its inception, would be treated as cash flows from financing activities.

The Committee believes that rather than applying DIG A23 by analogy to such transactions, the Board should consider standard setting for when and how DIG A23 needs to be applied to derivatives. This would also potentially prevent financial reporting outcomes that do not produce decision useful information. For example, when modified derivatives fail the DIG A23 test today and entities elect the fair value option (which financial institutions frequently do in this outcome), cash flows are presented in the “financing activities” section of the statement of cash flows, the change in fair value due to “own credit risk” is required to be calculated and recorded in other comprehensive income, and the hybrid instrument is subject to the fair value disclosures of ASC 820 and ASC 825.

The Committee also suggests the FASB consider the derivative modification guidance under IFRS paragraphs BA.1 and BA.3 which has implementation guidance on how to treat derivatives that are modified including after initial recognition.

**Question 10:** Investors—How significant are holdings in digital assets, such as crypto assets, in the companies you analyze? What type of financial reporting information about holdings in digital assets do you use in your analysis of a company? How does that information influence your decisions and behaviors? If there is other financial reporting information about digital assets that would be decision useful, what is that information and why is it decision useful?

**Question 11:** Preparers and practitioners—Does your company (or companies that you are involved with) hold significant digital assets, such as crypto assets? What is the purpose of those holdings?

**Question 12:** If the Board were to pursue a project on digital assets, which improvements are most important, what types of digital assets should be included within the scope, and should this guidance apply to other nonfinancial assets?

The Committee has previously written<sup>2</sup> to the Board regarding the accounting for digital assets, such as crypto assets (please refer to ISDA’s agenda request dated June 7, 2021). To summarize, we believe the accounting and financial reporting challenges for digital assets have become a pervasive issue as there has been a significant increase in the companies and retail investors entering the market as well as many financial institutions and fintech companies creating a variety of new digital asset offerings. As a Committee of preparers and practitioners, while our companies do not hold significant digital assets including crypto assets, this matter is relevant to our clients and there is some expectation that we may have meaningful positions in the future to facilitate client activity. Also, the Basel Committee on Banking Supervision recently issued a public consultation<sup>3</sup> on preliminary proposals for the prudential treatment of banks’ crypto asset exposures, which speaks to the increased focus on this matter.

Most cryptocurrencies, including the most common, Bitcoin and Ethereum, are classified as intangible assets and are accounted for under Topic 350, Intangibles—Goodwill and Other. Per the FASB ASC Master Glossary intangible assets are defined as assets (not including financial assets) that lack physical substance. The AICPA Guide states crypto assets generally would not meet the definitions of other asset classes within GAAP, therefore accounting for them as other than intangible assets may not be appropriate. However, the committee does not believe crypto assets should automatically be classified under ASC 350 because they do not meet the definition of other asset classes. As described below, the accounting model for intangible assets is not suitable for crypto assets. Under Topic 350, digital assets would be initially measured at cost, then tested for impairment. Under the current model, companies will only have the ability to write down the value of crypto assets and will not have the ability to recognize any gains until the assets are transferred to another party. This is misleading and not a faithful representation of these assets to users of financial statements. as the balance sheet will not reflect the true liquid nature and value of these assets.

Further, as new crypto products continue to arise, the current model may be confusing to users of the financial statements and create opportunities for accounting arbitrage. For example, investment vehicles, such as trusts that hold cryptocurrency, may issue shares that meet the definition of a financial instrument. As a result, investors in these instruments that are backed only by

<sup>2</sup> Please refer to Appendix A for a copy of the letter.

<sup>3</sup> <https://www.bis.org/bcbs/publ/d519.pdf>

cryptocurrency holdings may carry the shares at fair value, while being unable to recognize any changes in the value of cryptocurrencies held directly on the balance sheet.

We believe an accounting model should be designed to properly reflect the nature, liquidity and value of crypto assets. The accounting model should be consistent with the economic reality that entities and individuals are trading and investing in these products for their inherent value. As indicated in our letter in Appendix A, we believe a more appropriate accounting model for highly liquid crypto assets that would meet the definition of readily convertible to cash, similar to the derivative definition, would be to allow the fair value option. However, we would also support permitting the fair value option for all crypto assets. Guidance in the appropriate classification of such assets on the balance sheet would also be beneficial.

The Committee believes this is a topic worthy of reconsideration by the Board.

**Question 13:** Are there common ESG-related transactions in which there is a lack of clarity or a need to improve the associated accounting requirements? Please describe the specific transactions and why standard setting is needed.

We believe the Board should consider adding a new derivative scope exception to ASC Topic 815 such that ESG features would more commonly remain embedded in the host or create a new scope exception specific for ESG features. We believe this solution should be sufficiently specific so it could be applied in practice while not changing existing treatment under GAAP of other types of features. For example, a scope exception could be introduced for ESG features that affect the instrument's cash flows where it defines the feature as "contracts with underlyings based on social, environmental / sustainability or governance factors that impact the reporting entity's operations and/or profit and loss would be considered related to the specific volumes or sales or service revenues of one of the parties to the contract".

We note the FASB staff has recently published an educational paper<sup>4</sup> stating that ESG matters cover a broad range of topics well beyond the topics covered by financial accounting standards and providing examples of how an entity may consider the direct or indirect effects of material environmental matters when applying current GAAP. However, the examples provided by the FASB are intended to be illustrative and do not include considerations around embedded derivatives.

The Committee wrote a white paper on the accounting for ESG features<sup>5</sup>, specifically around how these features are identified, analyzed and reported when embedded in a host contract. To summarize the whitepaper, ESG features typically require bifurcation from the host instrument, as they are not viewed to be clearly and closely related to the borrower's credit worthiness pursuant to ASC 815-15-

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<sup>4</sup>[https://fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175836268408&blobheader=application%2Fpdf&blobheadername2=Content-Length&blobheadername1=Content-Disposition&blobheadervalue2=333644&blobheadervalue1=filename%3DFASB\\_Staff\\_ESG\\_Educational\\_Paper\\_FINAL.pdf&blobcol=urldata&blobtable=MungoBlobs](https://fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175836268408&blobheader=application%2Fpdf&blobheadername2=Content-Length&blobheadername1=Content-Disposition&blobheadervalue2=333644&blobheadervalue1=filename%3DFASB_Staff_ESG_Educational_Paper_FINAL.pdf&blobcol=urldata&blobtable=MungoBlobs)

<sup>5</sup> <https://www.isda.org/2021/09/07/accounting-analysis-for-esg-related-transactions-and-the-impact-on-derivatives>

25-46. However, given these features are new and evolving, there is complexity in evaluating such features which could result in diversity and inconsistencies in practice.

Further, ESG features typically do not meet any scope exceptions under Topic 815, including a those for non-exchange-traded contracts with underlyings based on:

- 1) A climatic or geological variable or other physical variable (such as number of inches of rainfall or snow in a particular area and the severity of an earthquake as measured by the Richter scale),  
or
- 2) Specified volumes of sales or service revenues of one of the parties to the contract.

This is because the ESG features are generally specific to an entity, and not just a climactic variable, and the features are not directly related to a company's revenues.

Additional accounting and operational challenges are introduced once it is determined that an ESG feature requires bifurcation. Principally, ESG features are currently difficult to value due to subjective, unobservable inputs that are often solely derived by management that will determine the timing and magnitude of the impact on cash flows. Due to the level of estimation and assumptions required, the valuation may not result in decision useful information for users of financial statements. In practice, many entities view these features as having de minimis or immaterial value today, and therefore do not recognize the embedded derivative at fair value with changes in fair value through earnings. Consequently, the operational burden of analyzing, bifurcating and valuing these features does not result in useful information to the issuers or the users of financial statements.

There are differing views as to whether reporting for an entity's ESG-related activities should be governed by accounting or other regulatory guidance. However, to the extent that a reporting entity engages in ESG activities that give rise to financial transactions (e.g. expenditures specifically intended to address "climate change"), the FASB would contribute to consistency, comparability and transparency in financial reporting, and would contribute to stakeholders' interest in how entities are responding to these issues, by addressing appropriate financial statement presentation, disaggregation, and related disclosures.

**Question 14:** Are there common financial KPIs or metrics—either widely applicable to all companies or industry specific—that would provide decision-useful information if they were defined by the FASB? Please explain.

**Question 15:** If the FASB were to define certain financial KPIs or metrics, should all companies be required to provide those metrics or should providing those metrics be optional?

The Committee believes the current disclosures required under U.S. GAAP provide for decision-useful information applicable to all entities. There are a wide variety of KPIs and financial metrics that are considered internally by preparers, as well as other KPIs that may be considered by users of the financial statements. Many KPI's are developed by management to measure how effectively the business is achieving its objectives and may be entity specific as they are tailored to an entity's specific business and goals. The introduction of new KPIs would likely create an operational burden for many entities who do not already leverage those KPIs for internal reporting purposes.

**Question 16:** If the Board were to pursue a project on the recognition and measurement of government grants, should the FASB leverage an existing grant or contribution model (such as the models in IAS 20 or Subtopic 958-605) or develop a new model? If you prefer leveraging an existing model, which would be most appropriate and why? If the FASB were to develop a new model, what should the model be?

**Question 17:** The FASB has encountered challenges in identifying a project scope that can be sufficiently described for government grants. If the Board were to pursue a project on the recognition and measurement of government grants, what types of government grants should be included within the scope and why (for example, narrow or broad scope)?

Questions 16 and 17 are not directly applicable to the Committee as government grants are not commonly received amongst our members. If the FASB does in fact decide to take up a project on this matter, we believe the scope should be very clear and narrow to avoid unintended consequences. That said, the current environment of COVID-19 and its pervasive impact on industry is reason alone to ensure that guidance be clear related to reporting and disclosure, to ensure the significance of a reporting entity's reliance on government grants (especially for the purpose of immediate financial support) is transparent within financial statement reporting. Where material, EPS could be reported gross and net of government grants, to assist stakeholders in evaluating the impact of decisions related to continuing or discontinuing such government support.

**Question 18:** The FASB has encountered challenges in identifying a project scope that can be sufficiently described for intangible assets. If the Board were to pursue a project on intangible assets, what types of intangible assets should be included within the scope and why? Within that scope, should a project on intangible assets be primarily focused on improvements to recognition and measurement or to disclosure?

**Question 19:** What challenges, if any, exist in applying the capitalization thresholds in Subtopics 350-40 and 985-20? What improvements, if any, could be made to the software capitalization guidance to overcome those challenges? Should there continue to be a capitalization threshold when accounting for software depending on whether it is for internal use or whether it is to be sold, leased, or otherwise marketed? Please explain.

The Committee would support a project to clarify and simplify accounting for intangible assets. However, we believe the conclusions around recognition, measurement and disclosure reached should be consistent with current practice.



**Question 20:** Should the Board prioritize a potential project on current and noncurrent classification of assets and/or liabilities in a classified balance sheet? If yes, what should be the scope? Please explain.

While the Committee would support a project targeted at simplifying the current and noncurrent classifications of assets and/or liabilities at the balance sheet date, we do not believe this is a high priority to which the Board should allocate its finite resources.

**Question 21:** Should the Board prioritize a potential project to simplify the consolidation guidance in Topic 810? Please explain why or why not. If yes, should the approach focus on targeted improvements or a holistic review of Topic 810?

We believe the consolidation model is complex by necessity given the complex nature of transactions that require evaluation and, therefore, do not believe such a project should be a high priority for the Board. Targeted improvements should be approached cautiously to avoid any unintended consequences. Instead, we believe the Board should focus on finalizing the “Consolidation Reorganization and Targeted Improvements” project, which we believe will make the guidance more user-friendly and address concerns raised by stakeholders

If the FASB does take up such a project, there are two areas of the consolidation model that we believe could be improved:

- Effect of puts and calls held by investors in potential variable interest entities (VIEs) and the effect of such puts and calls in determining whether the entity (investee) is a VIE. For example, some Big 4 accounting firms believe that the existence of puts and calls on the equity of the investee entity automatically result in the investee entity being a VIE while other accounting firms would require the reporting entity to evaluate the nature and terms of puts and calls. Diversity in practice can lead to disparate conclusions on VIE assessments which could lead to different consolidation and disclosure conclusions.
- De facto agent relationships. In scenarios where there is complex financing of a potential VIE being evaluated for consolidation, the requirement to consider whether a de facto agent relationship exists based on one party obtaining its interest in the VIE through financing by another party involved with the VIE is complex and can lead to unintended consequences. For example, we are aware that certain accounting firms have concluded off-market terms of capital investments can be a form of financing that gives rise to a de facto agent relationship.

**Question 22:** What challenges, if any, exist in accounting for debt modifications in accordance with the guidance in Subtopic 470-50, Debt—Modifications and Extinguishments? Please explain the challenges and how they could be overcome through standard setting.

The Committee does not currently experience any issues with respect to applying the modification and extinguishment guidance in Subtopic 470-50. However, the Committee would be supportive of additional qualitative guidance which would preclude an entity from having to perform a quantitative assessment for every modification. The Committee also supports having a bright-line percentage as it makes the guidance clear and easy to apply. Many of our members have operationalized the existing

guidance including the 10% cash flow test and as such would not be supportive of any additional standard setting in this area.

Separately, as it relates to market making activities in one's own debt in the context of bank holding companies, acknowledgement that such activities do not result in the extinguishment of the debt held would reduce the complexity observed in practice.

**Question 23:** Stakeholders noted many challenges in applying the liabilities and equity guidance, but they had mixed views on how the Board should improve the accounting for financial instruments with characteristics of equity. The Distinguishing Liabilities from Equity Phase 2 project is intended to align the two existing indexation models in Topic 480 and Subtopic 815-40. Should the Board continue pursuing this project in its current scope and objective, or does the Board need to reevaluate this project? Please explain why or why not and if the project scope and objective need to be reevaluated, what should the approach be?

The Committee does not believe the Board should continue pursuing this project, as discussed above. We believe existing GAAP is sufficiently clear and practice has developed on how to analyze complex instruments. As such, the Committee does not believe there is any need to further refine the existing indexation principle because the current guidance generally results in accounting that is consistent with the economics of transactions and we do not believe there are pervasive inconsistencies in applying the guidance.

**Question 24:** How helpful would it be in evaluating disclosure materiality if the materiality guidance in paragraph 105-10-05-06 that “the provisions of the Codification need not be applied to immaterial items” was repeated in the Disclosure Section of each Codification Subtopic? Please explain.

The Committee does not believe the repetition of paragraph 105-10-05-06 would be helpful. As preparers already do not spend additional time or effort on disclosures for immaterial items.

**Question 25:** Which, if any, of the FASB processes described in Chapter 4 of this ITC could be improved? Please explain your rationale for each, including the following:

- a. Why that process needs improvement
- b. How the FASB should improve that process
- c. What the urgency is of that process improvement.

The Committee believes the FASB should establish a process that would provide more timely interpretations of existing GAAP that would not require amendments or standard setting. As noted in the ITC, the IFRS Interpretations Committee has a clear process to assist stakeholders that are seeking interpretations of IFRS Standards, particularly in circumstances in which a stakeholder is merely seeking a confirmatory answer rather than a formal change to current guidance. While the FASB has

the Emerging Issue Task Force (EITF), we note that this has historically been underutilized and limited in its purview. As such, the Committee would be supportive of establishing a new interpretive process either utilizing the existing EITF or by expanding the technical inquiry process including question and answer publication. Regardless of the solution, the Committee believes such interpretations need to be published in writing to ensure consistent application. Further, the Committee believes that this is an urgent process improvement, given the existing standard setting process frequently takes time and may not be responsive to emerging market conditions. For example, after the issuance of ASU 2017-12 there were a variety of interpretive issues such as how to deal with off-market derivatives in net investment hedges.

### *Closing*

We hope you find ISDA's comments and responses informative and useful. Should you have any questions or desire further clarification on any of the matters discussed in this letter please do not hesitate to contact the undersigned.

Jeannine Hyman  
Citigroup Inc.  
Chair, North America Accounting Committee

Antonio Corbi  
ISDA, Inc.  
Director, Risk and Capital

## Appendix A

June 7th 2021

Ms. Hillary Salo  
Technical Director  
Financial Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, CT 06856-5116

By email: [director@fasb.org](mailto:director@fasb.org)

**Re: Agenda Request: Investors accounting for crypto assets**

Dear Ms. Salo,

The International Swaps and Derivatives Association's ("ISDA")<sup>6</sup> Accounting Committee (the "Committee") appreciates the opportunity to provide an agenda request to the Financial Accounting Standards Board ("FASB" or the "Board"). Collectively, the Committee members have extensive professional expertise and practical experience addressing accounting policy issues related to financial instruments and specifically derivative financial instruments.

The Committee requests that the FASB consider a topic to its Technical Agenda involving practice issues regarding investors or holders accounting for crypto assets. The Board has previously decided against adding a project on digital currencies to the technical agenda. Overall, and as further described below, the Committee believes this practice issue involving the accounting for cryptocurrency have become far more pervasive across industries and can be resolved in a short-time frame. This letter provides the Committee's formal agenda request and overall views on why this topic should be added to the agenda.

### **Overview**

On October 21, 2020, the Board addressed the issue of accounting for crypto assets (including "cryptocurrencies") after receiving three agenda requests. All three agenda requests shared a common concern that crypto assets are accounted for as indefinite-lived intangible assets. Currently, crypto assets generally do not meet the definitions of cash, inventory, or financial assets in current guidance, and therefore, cryptocurrencies would be accounted for as indefinite-lived intangible assets. The Board concluded at that time that the concerns raised in the crypto currency agenda requests were not pervasive and therefore decided not to add a project to its agenda.

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<sup>6</sup> Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 950 member institutions from 76 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: [www.isda.org](http://www.isda.org). Follow us on [Twitter](#), [LinkedIn](#), [Facebook](#) and [YouTube](#).

Notwithstanding this decision by the Board, the Committee believes the issue is pervasive and that standard setting is necessary to provide an accounting model that can be consistently applied to more appropriately reflect the economics and intent of trading, investing, and transacting in crypto assets:

- Bitcoin and Ethereum, the two most common cryptocurrencies, have a market capitalization as of May 2021 of approximately \$838 billion<sup>7</sup> and \$400 billion<sup>8</sup>, respectively. Combined, this is approximately 12% of gold's total market capitalization (~\$10 trillion) compared to \$215 and \$44 billion, respectively in October 2020.
- There is a growing number of banks and financial institutions offering crypto asset related products and services. Specifically, similar to the increasing number of fintech companies offering crypto related services and products, banks<sup>9</sup> are also setting up trading desks to provide customers with exposure to crypto assets. This includes buying and selling crypto assets, as well as derivatives, structured notes and other transactions that reference crypto assets. Over the past year, the Office of the Comptroller of Currency (OCC) issued statements related to digital assets, such as allowing national banks to provide custody services for digital assets.<sup>10</sup> Certain companies have also begun to offer crypto asset lending in which the holder of cryptocurrency can lend their assets to a borrower in order to earn interest. Not only have new derivatives products and financial arrangements linked to cryptocurrency been introduced to the market, but consumer products are also being made available. Companies are also creating investment vehicles, such as trusts, in order to give market participants an opportunity to invest in digital assets through traditional investment products. The increased volume in crypto asset related transactions is not limited to retail investors or speculators but also includes institutional investors. For example, Deutsche Bank plans to create a trading and token issuance platform, bridging digital assets with traditional banking services, and managing the array of digital assets and fiat holdings in one easy-to-use platform.<sup>11</sup> Coinbase, the largest cryptocurrency exchange in the US went public on April 14, 2021.
- There are a wide variety of products that are now being offered and used by market participants, market makers, and investors. The Chicago Board Options Exchange ("CBOE") offered the first Bitcoin futures contracts in 2017. The size of the futures market has also grown considerably over the past year. Global open interest stood at \$3 billion on January 7, 2020, of which the Chicago Mercantile Exchange ("CME") contributed just 7% or \$224 million. As of January 6, 2021, the global open interest increased to \$11 billion of which CME contributed \$2.1 billion.<sup>12</sup> In 2021, not only are large exchanges such as CBOE and CME offering derivatives on crypto assets, but traditional banking and brokerage companies<sup>13, 14</sup> are beginning to offer crypto derivative products as well.
- Investors and users of cryptocurrency platforms are being offered credit and debit card type products in order to use the cryptocurrency held in their accounts to make purchases for everyday transactions. Further, over the past few years we have seen acceptance of initial coin offerings, which is the cryptocurrency industry's equivalent to an initial public offering. A

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<sup>7</sup> [Bitcoin Price | BTC Price Index and Live Chart — CoinDesk 20](#)

<sup>8</sup> [Ethereum Price | ETH Price Index and Live Chart — CoinDesk 20](#)

<sup>9</sup> [Goldman Sachs Relaunching Crypto Trading Desk After 3-Year Pause - CoinDesk](#)

<sup>10</sup> [Interpretive Letter 1170, Authority of a National Bank to Provide Cryptocurrency Custody Services for Customers \(occ.gov\)](#)

<sup>11</sup> [Deutsche Bank Quietly Plans to Offer Crypto Custody, Prime Brokerage- CoinDesk](#)

<sup>12</sup> [CME Becomes Biggest Bitcoin Futures Exchange as Institutional Interest Rises - CoinDesk](#)

<sup>13</sup> [Cryptocurrency Trading | TD Ameritrade](#)

<sup>14</sup> [Goldman Sachs Offering Bitcoin Derivatives to Investors - CoinDesk](#)

company looking to raise money to create a new coin, app, or service launches an initial coin offering as a way to raise funds.

- Many investors, speculators, and other market participants have been entering into the crypto market through a various number of products for reasons such as an investment opportunity, or to use crypto assets for the purchase and sale of goods. U.S. businesses and American entrepreneurs are investing billions of dollars in this important innovation. Business intelligence software provider MicroStrategy Incorporated, for example, had acquired and was holding a total of 70,469 bitcoins as of December 31, 2020, which had an approximate market value of \$2.0 billion at the time, yet the bitcoin were reflected on its year-end balance sheet as having a carrying value of only \$1.1 billion due to the accounting treatment under GAAP currently in effect. In addition, Grayscale Investments now has bitcoin holdings in its Bitcoin Trust of over \$30 billion, of its \$36 billion in assets under management, as of March 17. Jack Dorsey, CEO of Twitter and Square, recently partnered with musician and entrepreneur Jay Z to create a \$23 million bitcoin trust. These are some very recent examples of large digital asset investments by public companies and others. In the past the longevity of the crypto market was very uncertain. However, considering the number and type of market participants, wide array of products that are now offered in the market, and the increasing and sustained value of crypto assets is proving this has become a pervasive issue.

### **Committee View**

As noted above, crypto assets generally do not meet the definitions of cash, inventory, or financial asset, as there is no right to receive cash or another financial instrument from a second entity. Certain ‘stable coins’ have their value linked to a specific asset or commodity (e.g. the US Dollar) and may meet definition of a financial instrument in certain circumstances, for example when the stable coin is redeemable from the issuing entity for cash. However, most cryptocurrencies, including the most common, Bitcoin and Ethereum, currently meet the definition of an intangible asset and are accounted for under Topic 350, *Intangibles—Goodwill and Other*. Stakeholders refer to the AICPA Practice Aid, *Accounting for and Auditing of Digital Assets*, when determining the appropriate accounting treatment of digital assets. The Practice Aid states that cryptocurrencies (a subset of digital assets) would meet the definition of intangible assets and would generally be accounted for under Topic 350, and asserted that cryptocurrencies did not meet the definitions for cash or cash equivalents, financial instruments or financial assets, or inventory. Under the Practice Aid (and Topic 350), digital assets would be initially measured at cost, then tested for impairment. However, if the reporting entity is within the specialized guidance for investment companies or broker dealers, the assets would be accounted for at fair value.

Accounting for crypto assets as an intangible under Topic 350 is an issue for many participants who treat crypto assets as a means for investment and active trading and does not appropriately reflect the economics of the assets in the financial statements.

Under the current model, companies will only have the ability to write down the value of crypto assets and will not have the ability to recognize any gains until the assets are transferred to another party. This is misleading and not a faithful representation of these assets to users of financial statements. as the balance sheet will not reflect the true liquid nature and value of these assets. For example, companies who have been invested in Bitcoin over the past year would have had to have impaired their assets to a price of \$4,000 per Bitcoin. At points in 2021, these companies would now reflect the current market value in excess of \$50,000. The inability for companies to reflect this change in value of a liquid asset that is held for trading could be misleading to users of the financial statements.

Further, as new crypto products continue to arise, the current model may be confusing to users of the financial statements and create opportunities for accounting arbitrage. For example, investment vehicles, such as trusts that hold cryptocurrency, may issue shares that meet the definition of a financial instrument. As a result, investors in these instruments that are backed only by cryptocurrency holdings may carry the shares at fair value, while being unable to recognize any changes in the value of cryptocurrencies held directly on the balance sheet.

As a result, we believe an accounting model should be designed to properly reflect the nature, liquidity and value of the crypto assets and is consistent with the economic reality that entities and individuals are trading and investing in these products for their inherent value. A more appropriate accounting model for highly liquid crypto assets that would meet the definition of readily convertible to cash, similar to the derivative definition would be to allow the fair value option. Since derivatives, an instrument that is readily convertible to cash and tied to an underlying, is accounted for at fair value, we believe similar instruments such as crypto assets should be permitted as well.

The Committee believes a framework should be developed that will allow all entities, and not just investment companies and broker dealers, to account for crypto assets at fair value. Accounting for crypto assets at fair value would better reflect the economics and intent for why companies are transacting and investing in these products. We believe these views are consistent with the letter from Congress to the FASB on May 12, 2021, regarding the need for authoritative guidance in accounting for these assets.

## **Conclusion**

Based on the views expressed above, the Committee believes this is a topic worthy of reconsideration by the Board. The Committee members appreciate the Board's consideration of this issue and would welcome the opportunity to discuss it further. Should you have any questions or desire further clarification on any of the matters discussed in this letter please do not hesitate to contact the undersigned.



**Appendix B**

June 7th 2021

Ms. Hillary Salo  
Technical Director  
Financial Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, CT 06856-5116

By email: [director@fasb.org](mailto:director@fasb.org)

**Re: Agenda Request: Fair Value Option for commodity inventories and executory contracts related to physical commodities**

Dear Ms. Salo,

**Executive Summary**

The International Swaps and Derivatives Association’s (“ISDA”)<sup>15</sup> Accounting Committee (the “Committee”) appreciates the opportunity to provide an agenda request to the Financial Accounting Standards Board (“FASB” or the “Board”). Collectively, the Committee members have extensive professional expertise and practical experience addressing accounting policy issues related to financial instruments and specifically derivative financial instruments and other similar instruments.

We respectfully request that the Board consider expanding the scope of the fair value option that is provided under Topic 825, *Financial Instruments*, to include physical commodity inventories as well as executory contracts related to physical commodities (e.g., storage, transportation, non-derivative purchase or sale contracts) that are managed on a fair value basis<sup>16</sup>. Given the challenges and significant operational cost that exist with applying fair value hedge accounting to the substantial majority of these positions, entities continue to experience mark-to-market volatility related to legitimate risk management activities and, therefore, having an option to measure certain physical commodity inventories as well as related executory contracts at fair value would provide a practical and simplified solution. Currently, only under certain specialized industry guidance, such as the *AICPA Audit and*

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<sup>15</sup> Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 950 member institutions from 76 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association’s website: [www.isda.org](http://www.isda.org). Follow us on [Twitter](#), [LinkedIn](#), [Facebook](#) and [YouTube](#).

<sup>16</sup> This concept would be consistent with the same under IAS 39 and IFRS 9 (e.g., manage and evaluate performance on a fair value basis, in accordance with a documented risk management or investment strategy). For example, this would include where positions are economically hedged and risk managed collectively, including as part of trading and market making businesses.

*Accounting Guide: Brokers and Dealers in Securities* (“B/D Guide”), are any entities permitted to account for the former at fair value under US GAAP, though even for these entities, fair value accounting for the latter is generally not permitted. We believe this issue is pervasive, and absent a fair value option election, entities will continue to report volatility in earnings that are not consistent with their actual economic position and incur operational costs that could be avoided through the fair value option. Further, providing entities with the ability to elect the fair value option is in line with the objective of FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, which is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions.

## **Accounting Mismatch**

### **Inventory**

Entities that hold and engage in a significant level of transactions involving physical commodities typically maintain an economically hedged or “matched” book of business wherein they hold futures and other derivatives contracts against certain portions of their physical commodity inventory. Given the nature of these hedging instruments, the “normal purchases and sales” scope exception in ASC 815, *Derivatives and Hedging* (“ASC 815”) generally does not apply (as opposed to managing risk through fixed-price physically-settled purchase and sale contracts) and are therefore generally accounted for as derivatives and measured at fair value. Further, fair value hedge accounting is often difficult to apply (see below for further discussion). As a result, where fair value measurement of the physical commodity inventory is not permitted, the net economic exposure for all outstanding activities is not appropriately captured in the financial statements because there are accounting mismatches that result in gains/losses that are not consistent with the economics of the activity. Further, we believe that measuring physical commodity inventory at fair value better reflects the expected economic outcome and future cash flows than the lower of cost or net realizable value. In addition, hedge accounting requirements are burdensome and expensive, especially for inventory that changes daily and must be dedesignated, redesignated, reassessed for effectiveness, and documented on a daily basis.

### **Executory Contracts**

In addition to holding physical commodity inventory, entities also enter into arrangements that provide for the right or obligation to transport and/or store those commodities which do not meet the definition of a derivative and are accounted for on an accrual basis. Given location, seasonality and time can impact the current and future values of the commodities that correspond to these arrangements, it is generally the case that these arrangements can have value where, for example, the differential between the prices of a commodity at points A and B exceed the fixed and variable costs associated with the arrangement. For example, assume an entity has the obligation to ship natural gas from point A to point B for \$0.10 per MMBtu. If the price to purchase natural gas at point A is \$2.00 and the price to sell natural gas is \$2.10, simplistically, the contract would have no intrinsic value. However, if the price at point B increases (e.g., because it resides in a location that experienced a significant drop in temperatures, which caused a spike in demand for natural gas used for heating purposes), the contract would have positive

intrinsic value as the entity would buy natural gas for \$2.00 (assume point A is not effected as it is in a different location), pay \$0.10 to ship and then sell for an amount greater than the total “cost” of \$2.10. Given the potential volatility associated with these arrangements (positive or negative) an entity may choose to financially hedge their exposure, for example, by entering into a fixed-price derivative to purchase at point A and a fixed-price derivative to sell at point B (or this may be combined into a basis swap as a function of the differential between these two locations). As a result, these arrangements can be thought of as various forms of basis contracts, and to that end, it is not uncommon for entities to economically hedge their exposure to such arrangements by, for example, entering into futures contracts aligned with the points of receipt and delivery.<sup>17</sup> Similar to hedges of physical commodity inventory outright, historically it has been challenging to achieve hedge accounting for these risk management activities for various reasons and, therefore, these entities generally have experienced earnings volatility which is not reflective of the overall economics of its activities. For example, as a result of market dynamics associated with the availability of storage capacity for certain commodities as a function of the initial responses to the COVID-19 pandemic, it may have been that an entity hedged its storage arrangement at a time when there was significant positive value. As markets stabilize and the value of storage declines, the entity generally would have then recognized mark-to-market gains on their hedges that were not offset by mark-to-market losses on the storage arrangement despite having potentially meaningful *economic* losses. This approach is not meaningful or transparent to investors and other users of the financial statements as compared to the proposal.

### **Fair Value Hedge Accounting**

While we believe allowing fair value treatment of commodities through the fair value option would be preferable, as noted above, another option historically considered is the application of fair value hedge accounting. Given that Topic 815 does not have a concept of focusing only on the “benchmark” components of nonfinancial assets in fair value hedging context (e.g., price of commodities deliverable into highly liquid exchange-traded contracts), it is often difficult to apply these rules in practice as some form of basis typically exists in the relationship. For example, physical commodity inventory may be held at a location and/or have physical attributes (e.g., purity, grade) that differ to the commodities underlying financial indices and, therefore, the correlation of the relationship suffers. And while this basis may not be significant enough to preclude hedge accounting as a technical matter, the cost of administering such relationships is often prohibitive given the requirements to model and quantitatively assess the basis, which may also require frequent rebalancing and adjusting hedge ratios to maintain effectiveness (i.e., if not disaggregating portfolios by grade, etc., which itself can be operationally

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<sup>17</sup> For example, assume an entity has the obligation to ship natural gas from point A to point B for \$0.10 per MMBtu. If the price to purchase natural gas at point A is \$2.00 and the price to sell natural gas is \$2.10, simplistically, the contract would have no intrinsic value. However, if the price at point B increases, the contract would have positive intrinsic value as the entity would buy natural gas for \$2.00, pay \$0.10 to ship and then sell for an amount greater than the total “cost” of \$2.10. Given the potential volatility associated with these arrangements (positive or negative) an entity may choose to financially hedge their exposure, for example, by entering into a fixed-price derivative to purchase at point A and a fixed-price derivative to sell at point B (or this may be combined into a basis swap as a function of the differential between these two locations).

challenging). Alternatively, entities could execute bespoke derivative contracts to address basis, but this is often cost prohibitive and is an uncommon risk management strategy in general.

Even where basis can be addressed (i.e., through additional administration and/or bespoke arrangements), as fair value hedge accounting only permits identifying *closed* portfolios, it can remain administratively burdensome to maintain relationships where, for example, inventory turnover is more elevated. Further, it can be an onerous, sometimes manual process to track historical cost basis and hedge basis adjustments at the individual unit level to support certain financial statement disclosures. Also, complexities arise with regard to tracking these items in the context of intercompany sales, where different outcomes may arise for standalone and consolidated reporting purposes. As a result, often times it is the case that entities forego hedge accounting altogether, and in certain cases will disclose non-GAAP measures to the extent the accounting mismatch is significant.

We believe a preferable outcome would be to amend the accounting rules to allow for measurement at fair value so that the full economics of these risk management activities is made clear and transparent to users of the financial statements. That is, under the current framework, valid economic hedging activities create an accounting mismatch and, therefore, the users of the financial statements only see one side of the equation (i.e., earnings volatility despite having offsetting risk). However, if entities were permitted to measure both the commodity position and its economic hedge at fair value, the net risk is clearer and any lack of precision with the entity's risk management strategies would be transparent to users real-time, as well as the cost of such strategies. This approach acknowledges that the fair value option and fair value hedge accounting are ultimately driving at the same goal of addressing accounting mismatches and reporting a more accurate representation of the entity's exposure as well as the effects of their risk management activities – but reduces the operational burden and practical “hurdles” to achieving this outcome that are inherent in the hedge accounting alternative. Further, it aligns the accounting models for financial and certain non-financial assets where the objectives of each portfolio may be virtually identical from the preparer's perspective.

### **Pervasiveness**

Some financial institutions hold physical commodity inventory for proprietary trading and market making activities in entities that apply the B/D Guide and, therefore, are generally able to fair value such positions. However, this does not necessarily capture executory contracts related to physical commodities, and it is more common that physical commodity inventory and/or related executory contracts are held in entities that do not apply the B/D Guide (e.g., depository and lending institutions holding precious metals). Even for entities that do apply the B/D Guide, there could still be executory contracts that might not get fair value treatment (for example transportation type contracts) and there is diversity in practice in whether those contracts are accounted for at fair value. Outside of financial institutions, as entities across many industries have increased focus on the environmental impact of their businesses, they often seek to execute transactions related to renewable energy. While it may be possible to avoid an accounting mismatch for certain transactions, we observe some entities engaging in a broader range of activities, including hedging the value of renewable energy credits where fair value measurement is not achieved for all elements of the overall transaction. As there are more and more

incentives to facilitate transactions in the renewable energy space, having an ability to address this mismatch may help to expand the activities in this space and help further accelerate the trend.

### **Historical Projects**

It is acknowledged that the concept of measuring certain nonfinancial assets at fair value has been considered in the past – for example, as part of the proposed FASB Staff Position (FSP) to amend ARB No. 43, *Restatement and Revision of Accounting Research Bulletins*, which would have required that inventories included in an entity’s trading activities be initially and subsequently measured at fair value with changes in fair value recognized in earnings – but that such efforts were discontinued after receiving mixed support. However, this proposal addresses many of the concerns raised, including that measurement at fair value not be a requirement in all circumstances. More generally, we observe that many of those that responded were generally supportive of fair value, with the diversity related to the best model or approach to achieve this outcome.

That said, we are sensitive to the concern that elective accounting models provide entities with opportunities for “cherry-picking” earnings recognition and/or booking holdings gains. We suggest that the Board might consider, requiring that the election is made at a portfolio or legal entity level and applied consistently (though we have not seen the aforementioned concerns manifest in practice with regard to the fair value option for *financial* instruments). In fact, it may be that use of a fair value option as a broader policy is most practical for entities regardless, particularly where inventory turnover is meaningful and/or specific identification of a physical commodity is not practical (e.g., the specific molecules of a barrel of oil held in a large tank). As a result, we believe that a fair value option applied at a portfolio or legal entity level would still provide entities sufficient ability to address accounting mismatches that result from its risk management activities.

Finally, in terms of other historical projects and efforts related to this request, it is noted in paragraph A4 of the Basis for Conclusions for FAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, highlighted the potential for a “Phase 2” that would consider permitting the fair value option to be elected for certain nonfinancial assets and liabilities. Therefore, our request would seem to align with the original intent of the Board.

### **Other Considerations**

#### **Simplification Initiative**

We believe this initiative would fit within the Board’s general focus on simplification initiatives given that, as noted previously, the cost and complexity associated with attempting to achieve hedge accounting can be significant, to the point where use of this guidance is rare absent very simple facts and circumstances. Further, we believe the proposed solution would in fact increase transparency for users of the financial statements, both as it relates to understand the true economic value of certain positions as well as having the effects of the entity’s risk management strategies captured directly in the financial statements.

### Refine Hedge Accounting if no Fair Value Option

Absent expansion of the fair value option, another alternative would be to amend and simplify fair value hedge accounting for nonfinancial instruments by relaxing effectiveness assessment requirements in exchange for additional disclosures regarding the nature of the hedging activities. For example, if this concept was eliminated in its entirety (i.e., no need to meet a quantitative effectiveness threshold), fair value hedge accounting of nonfinancial assets would function similar to a fair value option, albeit with an ability to de-designate and, therefore, discontinue fair value measurement in part (which may be suboptimal versus an irrevocable election).

While this may be a meaningful leap from the current framework, we observe historically there have been other significant changes to the hedge accounting framework. The elimination of the concept of ineffectiveness for certain cash flow hedges via ASU 2017-12 *Targeted Improvements to Accounting for Hedging Activities* may be a more extreme notion, as any economic mismatch would be recognized immediately in the context of a fair value hedge, as opposed to being deferred in equity.

Further, for the reasons below, we do not believe these rules would be subject to abuse, such as using derivatives that are unrelated to the arrangements to “hide” speculative activities (e.g., hedge with an equity-linked derivative). One, the fair value measurement of the hedged item and corresponding derivative hedges would be classified within the same line item on the income statement within a hedge accounting framework and, therefore, the effect of risk management strategies would be transparent, with limited ability to mask unwarranted activities from users of the financial statements. Two, disclosure would be required to articulate the nature of risks to which the entity is exposed and the hedging instruments employed; the method(s) used to determine fair value for the arrangements; and the extent of offset that exists in the relationship (i.e., by way of disclosing the changes in fair value observed for the hedged item and hedging instrument).

If necessary, this approach could be supplemented by a requirement to describe the key drivers of mark-to-market movements where there is a significant disconnect observed in the hedging relationship (e.g., an offset that is outside of the 80-125% dollar-offset range generally used to assess effectiveness). This would be another mechanism to provide users transparency, both on the application of hedge accounting as well as their overall risk management activities.

Another alternative would be to explore a benchmark commodity price concept for fair value hedges of non-financial assets for the purpose of the hedge effectiveness assessment. That is, retain the requirement to demonstrate the relationship is highly effective initially and prospectively, but allow such approach to focus on only a portion of the change in fair value of the position. We understand this concept was explored for cash flow hedge accounting as part of the deliberations for ASU 2017-12, but as noted above, we believe the “risk” associated with taking this approach for fair value hedges is notably less given all mark-to-market is recognized currently in earnings and, therefore, any mismatch would be clearly observable and recognized immediately. One potential approach for defining a benchmark concept could be to look at the prices of commodities that are deliverable into exchange-traded futures and forward contracts. Further, to the extent there are multiple contracts that correspond to commodities (e.g., WTI crude v. Brent crude), the entity would need to elect one and apply this consistently. Assuming

the relationship is highly effective, it could also be the case that the commodity is still marked-to-market entirely through earnings (i.e., total changes in fair value), which would reduce the risk of defining a benchmark directly as a function an exchange-traded contract that effectively creates a “perfect” hedge (i.e., one with no accounting mismatch).

## **Conclusion**

Based on the views expressed above, the Committee believes this is a topic worthy of reconsideration by the Board. The Committee members appreciate the Board’s consideration of this issue and would welcome the opportunity to discuss it further. Should you have any questions or desire further clarification on any of the matters discussed in this letter please do not hesitate to contact the undersigned.

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