

June 8th 2021

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

By email: 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")¹ 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 basis². 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

¹ 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. Follow us on [Twitter](#), [LinkedIn](#), [Facebook](#) and [YouTube](#).

² 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.

a practical and simplified solution. Currently, only under certain specialized industry guidance, such as the *AICPA Audit and 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.³ 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 challenging). Alternatively, entities could

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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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