

PricewaterhouseCoopers LLP
400 Campus Dr.
Florham Park NJ 07932
Telephone (973) 236 4000
Facsimile (973) 236 5000
www.pwc.com

September 21, 2007

Mr. Russell G. Golden
Director of Technical Application & Implementation Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: File Reference: Proposed Issue E23

Dear Mr. Golden:

PricewaterhouseCoopers LLP appreciates the opportunity to respond to the guidance that the Financial Accounting Standards Board ("FASB" or the "Board") has proposed in Statement 133 Implementation Issue No. E23, *Issues Involving the Application of the Shortcut Method under Paragraph 68 (E23)*. We support the issuance of E23, and believe that the proposed amendments will clarify certain practice issues related to hedging relationships that qualify for the shortcut method. However, we recommend that the Board consider modifying the transition provisions and extending the effective date.

The proposed guidance in Issue E23 requires entities to assess preexisting hedging relationships to determine whether they meet the requirements of the revised guidance as of the inception of the hedging relationship. If entities designated a qualifying hedging relationship utilizing the shortcut method that does not qualify for the short method under this amendment, they must de-designate that hedging relationship prospectively. However, they may re-designate the hedging relationship using the long-haul method, provided that it meets the applicable requirements of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities (FAS 133)*. Our experience has been that re-designations of hedging relationships can create a number of complexities, particularly with respect to (1) assessing hedge effectiveness when the derivative instrument is off-market, (2) accounting for the basis difference in the hedged item arising from a prior fair value hedging relationship, and (3) determining the appropriate manner in which amounts in other comprehensive income will be released in future periods for a prior cash flow hedge. These complexities can create operational issues that could make applying the proposed prospective/re-designation transition approach very challenging for many entities, especially if the new guidance must be applied less than 90 days after it is finalized.

For these reasons, we recommend that the Board extend the effective date of the new guidance and consider alternative transition provisions to the proposed prospective/re-designation transition approach. We believe that the Board can achieve its transition objectives by allowing a transition approach under which an entity is allowed to perform a retrospective effectiveness assessment since the inception of the original hedging relationship. The retrospective effectiveness assessment method

used for this analysis should be applied consistently to the re-designated hedging relationship. If an entity can demonstrate that the original hedging relationship has been highly effective since its inception, the entity would not be required to de-designate the hedging relationship as of the effective date of the amendment. The ineffectiveness since the inception of the original hedging relationship should be recognized as a cumulative-effect adjustment to the opening balance of retained earnings. Although this approach will require a computation of the hedging relationship's cumulative amount of ineffectiveness since the original hedging designation, it will enable the entity to apply the long-haul method prospectively on the basis of the original hedging relationship and avoid the complexities of the proposed prospective/re-designation approach.

Other Comments

In addition to the transition discussed above, we recommend that the Board further clarify certain aspects of the guidance. We have prepared the following suggestions and observations for your consideration.

Settlement of Hedged Item Occurs Subsequent to Swap Trade Date

The proposed amendment to the introductory section of paragraph 68 allows for the marketplace convention that interest-bearing assets and liabilities are often priced on the trade date, but not settled (and recognized) until several days later. The proposed amendment states that the shortcut method may be applied to a firm commitment arising on the trade date if certain conditions are met. However, because the term "firm commitment" was not defined in FAS 133 with this issue in mind, we question whether it is suitable for use in paragraph 68. For example, can a floating-rate debt instrument be considered a firm commitment since it does not have a fixed price/interest rate? Is the presence of a material adverse change clause, which we understand is common in most financing agreements, inconsistent with the notion that the agreement must be considered binding on both parties?

We support the Board's objective of making an allowance for the trade date/settlement issue, but suggest that the Board not refer to the term "firm commitment" in the amending language. We recommend that the amendment to paragraph 68 clarify that, consistent with the discussion in the Basis for Conclusions, the shortcut method may be applied to hedging relationships that commence on either the trade date or the settlement date of the hedged item, provided that the difference between those dates is consistent with generally established conventions in the marketplace in which the transaction is executed.

Application of Paragraph 68(b) When the Transaction Price of Interest Rate Swap Is Zero

Issue E23 proposes amending paragraph 68(b) so that a hedging instrument can be "off-market" if the difference between the transaction price and the swap's fair value, as defined in FASB Statement No. 157, *Fair Value Measurements* (FAS 157), is attributable solely to differing prices within the bid-ask spread between the entry transaction and a hypothetical exit transaction. Rather than amending the language in paragraph 68(b) to incorporate the complexities of FAS 157, we recommend that the Board consider rephrasing the guidance in "plain English." We suggest amending paragraph 68(b) as follows:

The hedging instrument is (1) solely an interest rate swap that is entered into at the inception of the hedging relationship for no consideration (i.e., either in the form of cash or other rights and obligations) or (2) a compound derivative composed of an interest rate swap and mirror image call or put option (as discussed in paragraph 68(d)) that is entered into at the inception of the hedging relationship for consideration solely equal to the amount, if any, exchanged at the inception-acquisition of the hedged item for the embedded call or put option.

Inception at Recognition of Hedged Item—Effect of the Normal Market Convention of Rounding the Coupon Rate

E23's Basis for Conclusions indicates that the amortization of an initial difference between the fair value and par value of the hedged interest-bearing financial instrument would create ineffectiveness that would violate paragraph 68(e). The Board decided to make an exception for a difference attributed solely to a premium or discount resulting from rounding the coupon of the hedged item at issuance due to market convention, and provided an example in paragraph 68(e) to illustrate this point. However, there may be other circumstances in which the fair value and par value of the hedged interest-bearing financial instrument differ at the inception of the hedging relationship but the shortcut method should be allowed. For example, paragraph 68(b) allows the shortcut method to be applied in circumstances where there is an upfront premium paid or received as a result of embedding a prepayment option in the hedged interest-bearing financial instrument. Additionally, paragraph 68(j) discusses the application of the shortcut method to a floating-rate financial instrument that is subject to a cap or floor and requires the interest rate swap to have a comparable cap or floor on its variable leg to qualify for the shortcut method. Although paragraph 68(b) does not explicitly mention this scenario as requiring the premium for the comparable cap or floor embedded in the interest rate swap to be paid or received in the same manner as the cap or floor embedded in the hedged item, this could be another circumstance where the Board believes it is acceptable for fair value and par value of the hedged interest-bearing financial instrument to differ at the inception of the hedging relationship. We recommend that the Board clarify the guidance in paragraph 68(e) accordingly.

Terms of Swap and Hedged Item Must both Be Typical and Not Invalidate the Assumption of No Effectiveness (Paragraph 68(e))

The proposed amendment to paragraph 68(e) clarifies that the terms of the swap and the interest-bearing financial instrument must both be typical for those instruments, and must not invalidate the assumption of no ineffectiveness. Therefore, any hedging relationship in which either the hedged interest-bearing financial instrument or the interest rate swap contain terms that are considered atypical of those instruments will not qualify for the shortcut method, regardless of whether those terms invalidate the assumption of no ineffectiveness. In those situations, the long-haul method of assessing hedge effectiveness must be applied.

DIG Issue No. G7, *Measuring the Ineffectiveness of a Cash Flow Hedge under Paragraph 30(b) When the Shortcut Method is Not Applied* (G7), addresses the application of the long-haul method for cash flow hedges and provides three methods for calculating the ineffectiveness of the hedging relationship. One of those methods is the hypothetical derivative method. DIG Issue G7 defines the perfect hypothetical derivative as the instrument that satisfies all of the applicable conditions in paragraph 68 necessary to qualify for use of the shortcut method, except for criterion 68(dd). Because paragraph 68(e) is not specifically included as an exception, it appears that the hypothetical derivative method should only be applied to hedging relationships involving interest rate swaps and interest-bearing financial instruments with terms that are typical of those instruments. Therefore, in those circumstances where the interest rate swap completely offsets all changes in cash flows for the hedged interest-bearing instrument, but contains atypical terms, the hypothetical derivative method should not be applied because it will not satisfy the criterion in paragraph 68(e). We do not believe that this was the Board's intention. Therefore, we recommend that the Board consider amending the definition of a hypothetical derivative in G7.

Transition Provisions

In adopting FAS 133 and FASB Statement No. 138, *Accounting for Certain Derivative Instruments and Certain hedging Activities, an amendment of FASB Statement No. 133* (FAS 138), some entities may have applied the shortcut method to previously existing hedging relationships. Pursuant to the



guidance in DIG Issue No. J9, *Use of the Shortcut Method in the Transition Adjustment and upon Initial Adoption* (J9), they were allowed to apply paragraph 68(b) as of the original inception date of the hedging relationship (i.e., pre-adoption of FAS 133/138). In view of the proposed guidance in E23 to effectively disallow the application of the shortcut method if the hedging relationship is designated after the issuance date of the interest-bearing financial instrument, we recommend that the proposed transition guidance in E23 be modified (much like J9) to allow the assessment of hedging relationships that existed prior to the adoption of FAS 133/138 to be applied as of the inception of the original hedging relationship.

Please contact John Lawton (973-236-7449) or John Althoff (973-236-7288) with any questions regarding our comments.

Sincerely,

PricewaterhouseCoopers LLP