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15 August 2008



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

LETTER OF COMMENT NO. 38

Re: File Reference No. 1590-100

Exposure Draft: Proposed Statement of Financial Accounting Standards "Accounting for Hedging Activities, an amendment of FASB Statement No. 133"

#### Dear Technical Director:

We appreciate the opportunity to respond to the proposed Statement of Financial Accounting Standards, "Accounting for Hedging Activities, an amendment of FASB Statement No. 133," dated 6 June 2008.

Air Products serves customers in industrial, energy, technology and healthcare markets worldwide with a unique portfolio of atmospheric gases, process and specialty gases, performance materials, and equipment and services. Air Products has annual revenues of \$10 billion, operations in over 40 countries, and 22,000 employees around the globe.

We believe that FASB Statement No. 133, "Accounting for Derivative Instruments and Hedging Activities," and the Derivative Implementation Group (DIG) issues have evolved into a workable hedge accounting framework. Over the years, we and other companies have spent a significant amount of time, effort, and resources on developing processes and systems to comply with the extensive administrative and monetary resources associated with the current standard. The adoption of this proposed standard contains material changes that would require all of us to change our systems and re-train our talent resources. The accounting for hedging activities in this proposed statement diverges from the hedge accounting currently contained in IAS 39, "Financial Instruments: Recognition and Measurement." Since the FASB and IASB are collaborating on a project to obtain convergence of accounting standards internationally, we ask that the Board postpone the implementation of this proposed standard. We believe that requiring entities to implement the standards of this proposal now, and then again in the near future when convergence occurs, would cause unfair administrative burden and cost to reporting entities.

We are concerned with the requirements in this standard and feel that the elimination of the short-cut and critical terms matching approaches, and the disallowance of the bifurcation by risk with respect to the benchmark interest rate hedges, are contrary to the Board's stated objective of simplifying hedge accounting. We feel that if this proposal is adopted without modification, the risk management

strategies that we employ to manage interest rates would create financial statement volatility which would be contrary to the economic impact of the hedging strategies, which would not be in the best interest of the users of our financial statements.

## **Hedged Risk**

Issue 1: Do you believe that the proposed Statement would improve or impair the usefulness of financial statements by eliminating the ability of an entity to designate individual risks and requiring the reporting of the risks inherent in the hedged item or transaction?

Under the proposal, changes in fair value of a derivative must be expected to reasonably offset all changes in fair value of a forecasted purchase or recognized debt instrument for the relationship to qualify for hedge accounting. It is likely that in many cases, the interest rate swap, which is one of the most commonly used risk management strategies, will no longer qualify for hedge accounting when effectiveness is required to be compared not only to interest rate movements but also to credit spread changes. We feel that the determination of the "perfect hedge" is a theoretical concept that is not possible in practice. Interest rate swaps are designed to manage interest rate risk against a benchmark interest rate, such as LIBOR, and can be constructed to be perfectly effective in doing so. They are not designed to provide protection against individual company credit spread changes. There are no derivative instruments in the market that would allow us to achieve a perfect hedge. In addition, we believe that it would be a challenge to obtain a fair value for the derivative and assign a value to credit ratings.

We appreciate the Board's position that the financial statement should reflect the economics of hedged items associated with risks to provide users with a more complete picture of an entity's financial position. However, we believe that the requirement in this proposal would not achieve that stated objective. Instead, the proposed changes would cause the timing of the profit and loss associated with hedging to move further away from the true economics of the transaction. The earnings volatility caused by the resulting ineffectiveness of the changes in credit spreads, which have nothing to do with the hedge, would be reflected in income and would not be representative of the economic purpose or reality of the underlying transaction.

### **Hedge Effectiveness**

Issue 3: Do you foresee any significant operational concerns or constraints in calculating ineffectiveness in fair value hedging relationships and cash flow hedging relationships? Do you believe that the proposed Statement would improve or impair the usefulness of the financial statements by eliminating the shortcut method and critical terms matching, which would eliminate the ability of an entity to assume a hedging relationship is highly effective and to recognize no ineffectiveness in earnings?

We believe that the calculation for ineffectiveness proposed in the exposure draft for cash flow hedges is not operational. It is not possible to perfectly align the hedged cash flow to the future expected cash flow. For example, a simple forward rate swap to lock in the interest rate to be received must now consider such non performing risks as the credit risk of the company in assessing effectiveness. Consequently, the

change in that credit spread would equate to ineffectiveness which must be reported in earnings. Further, we are concerned with the requirement to include ineffectiveness due to "under-hedges" in income. Companies use under-hedging as a strategy as it may choose to accept some risk. This risk is often offset by other strategies such as adjusting selling prices. We understand the Board's objective of improving comparability of financial statements between companies by requiring that each company report all of their risks in the income statement. However, reporting ineffectiveness from under-hedging into earnings would mislead the users of financial statements. We ask that the Board considers the basis of conclusion in Statement 133 which states that "the reason for not recording ineffectiveness on under-hedges is that only ineffectiveness due to excess expected cash flows on the derivative should be reflected in earnings because otherwise a nonexistent gain or loss on the derivative would be deferred in other comprehensive income and recognized in earning," and exclude this requirement from the proposal.

When Statement 133 was issued, it provided the short cut method as a simplified accounting model for companies to swap fixed rate debt to floating rate debt. By affording companies this option, it enabled sound economic transactions to manage interest rate risk to be accounted for in a reasonable manner consistent with the transaction intent and economics, without creating excessive work for the company or potential confusion for readers of the financial statements. The elimination of the short cut method and the critical terms matching will remove a majority of those benefits at a significant cost to companies in the form of money, time, and resources. In addition, the accounting result will further diverge from the economics of the hedging transaction. For the reasons stated above, the short cut and critical terms matching methodologies should not be eliminated from current practice.

Issue 4: Do you believe that modifying the effectiveness threshold from highly effective to reasonably effective is appropriate? Why or why not?

The modification of effectiveness threshold from highly effective to reasonably effective would be appropriate if the Board could further clarify the definition of "reasonably effective."

For situations in which interest rate risk is currently designated as the hedged risk for financial instruments but would no longer be permitted under this proposed Statement, (except for an entity's own issued debt at inception), do you believe that you would continue to qualify for hedge accounting utilizing your current hedging strategy? If not, would you modify your hedging strategy to incorporate other derivative instruments, (b) stop applying hedge accounting, (c) elect the fair value option for those financial instruments or (d) adopt some other strategy for managing risk?

Under these proposed changes, we would no longer qualify for hedge accounting since we rarely do swaps at inception. Requiring a company to enter into an interest rate swap at the time the debt is issued is ignoring the economics of why companies enter into swaps in the first place. It is the risk management policy of many companies to maintain a certain ratio of fixed rate debt versus floating rate debt. As outstanding debt issuances mature, it becomes necessary for a company to swap existing fixed rate debt to floating rate debt to maintain these ratios and effectively

manage its interest rate risk. If a company is able to swap out the appropriate notional amount of debt with interest rate reset dates and indices matching those of the fixed rate debt on a date after settlement, the hedging relationship will be equally as effective in hedging interest rate risk as a swap entered into on day one. Because we no longer qualify, we would have to evaluate the potential adverse impact of the earnings volatility created by the accounting rule change against the benefit of using our current hedging strategy to determine if we would retain, change or discontinue our current strategy.

#### Effective Date and Transition

If the amendments were affirmed in their current state, the required effective date for fiscal years beginning after 15 June 2009 is unreasonable. Adoption of this new guidance would require substantial system and process changes which would need to be thoroughly tested before implementation. Many companies at this point are already struggling to comply with the two new standards (SFAS no. 157, "Fair Value Measurement," and SFAS no. 161, "Disclosures about Derivative Instruments and Hedging Activities-an amendment of FASB Statement 133"). For us and other non-calendar year filers, this effective date would allow us only a small window of time to comply with these requirements.

We believe that the proposed statement should only be applied to derivatives entered into prospectively. This would be more consistent with the transition provisions of most accounting rules. We understand that in certain instance the new accounting rules would apply to arrangements that will continue indefinitely so that the new rules must be applied to existing arrangements. However, in this instance, we are dealing with debt agreements and interest rate swaps that have finite lives and believe that applying the new rules to existing derivatives with finite lives is inappropriate, since the accounting treatment for the hedge is one of the considerations at the time the hedge is placed.

# **Benefit-Cost Consideration**

We believe that the current standard for hedge accounting and the various DIG implementation issues have evolved into a workable model. We and other companies have already spent millions of dollars to produce systems and processes to comply with the existing standard. We believe that this proposed statement requires significant, additional cost while offering little benefit. With the imminent convergence with IFRS, we believe that to require us to expend administrative and monetary resources now to implement this proposal, and requiring companies to do so again in the near future, is unfair and would be a great burden on us and other companies.

### Clarification/ Additional Guidance

The Board should consider the development of additional guidance on the calculation of fair value to avoid the risk of companies using different methodologies, thereby impacting the comparability these rules strive to achieve.

We ask that the Board clarify the intent of the designation/de-designation rule on hedges for capital equipment. Often companies would use one forward exchange contract to hedge a series of cash flows over the span of a project. As the payments become due, that portion of the hedge is de-designated and the company enters into

a contract for an offsetting position. The guidance is unclear as to whether a company could effectively terminate a portion of a derivative by entering into an offsetting derivative instrument. If this provision in the exposure draft only pertains to the entire derivative contract, the company would be forced to enter into a derivative contract for each individual cash flow. The cost of doing so would be uneconomical and prohibitive.

## Summary

We do not agree with the requirements of this proposal. We are concerned that the proposal will impair the usefulness of the financial statement, increase financing costs and discourage financial risk management techniques. We ask that the Board consider the business intent in which derivatives are utilized and modify the proposal to reflect accurately the economic objective of accounting for derivatives. With the imminent convergence with international standards, we ask that this proposed interim standard be postponed until that time. We believe that Statement 133 and the subsequent DIG implementation issues have evolved into a workable framework that reflects the true economic intent of hedge accounting. We would be distressed to make these proposed moves which would diverge from the business intent of our risk management strategies. We are certain that there have been times when preparers have not fully applied the principles of hedge accounting. However, that does not mean we need more rules. It does mean that the auditors and reviewing authorities need to be more diligent in their enforcement of the principles.

We appreciate your consideration of our views of the exposure draft on hedge accounting. We would be pleased to further discuss our comments with you.

Respectfully,

Paul E Huck

Sr. Vice President & Chief Financial Officer