



LETTER OF COMMENT NO. 6

Mr. Larry Smith
Director of Technical Application & Implementation Activities
Financial Accounting Standards Board

Via Email

February 2, 2007

Dear Mr. Smith:

Thank you for the opportunity to comment on the tentative conclusion reached by the FASB in DIG Issue H17, *Hedging Functional-Currency-Equivalent Proceeds to Be Received from a Forecasted Foreign-Currency-Denominated Debt Issuance*. We have numerous derivative counterparty clients that seek hedge accounting for instruments which lock in the functional-currency-equivalent proceeds in foreign-currency debt issuances and believe Statement 133 does permit hedge accounting for such hedging relationships.

We disagree with the FASB Staff's assertion that the variability in functional-currency-equivalent proceeds which an entity will receive in a foreign-currency debt issuance (or at a minimum, the variability in forecasted functional currency interest payments to service the debt) is a risk that does not impact reported earnings. We also disagree with the assertion that there needs to be a direct relationship between the gain or loss on the hedging instrument and the earnings effect of the hedged transaction. We agree with the three Board members who disagree with the conclusion in Proposed Issue H17. A company that needs to raise a specified amount of functional-currency-equivalent proceeds by issuing foreign-currency-denominated debt is exposed to earnings volatility by virtue of the fact that the amount of foreign-currency-denominated debt issued depends on currency exchange rates.

The earnings impact of a foreign-currency debt issuance is illustrated by looking at a very common hedging relationship which has been called into question since the issuance of Proposed Issue H17. At issue is whether a company is able to apply hedge accounting to a hedge of a foreign-currency debt issuance at the date of pricing, the date at which all of the terms of the debt issuance have been set. It has been contended by analogy to the guidance in Proposed Issue H17, that hedge accounting is only available once the debt has settled. We can examine the issue by looking at an example that isolates changes in foreign exchange rates.

A company prices €100 million 5.00% debt on January 10, which will settle three days later on January 13. The exchange rate is \$1.30: €1 on the pricing date and \$1.32: €1 on the settlement date. The expected annual interest expense based on the foreign-exchange rate at the date of pricing is \$6,500,000 ((€100million x 5.00%) x 1.30). In contrast, the

expected annual interest expense based on the foreign-exchange rate at settlement date is \$6,600,000 ((€100million x 5.00%) x 1.32). One can clearly see that the change in the forecasted interest expense, which will impact earnings, is due to the change in the foreign-exchange rate between the pricing date and the settlement date.

This risk can be perfectly offset, both economically and from a hedge effectiveness standpoint, if the company executes a cross currency swap and designates it as a hedge of the change in the forecasted interest payments attributable to changes in foreign-currency risk concurrent with the debt pricing, wherein the company will:

- Pay €100 million and receive \$130 million in the initial exchange,
- Pay 5.00% on \$130 million and receive 5.00% on €100 million over the life of the swap (and debt) – we have assumed for the sake of simplicity that USD and Euro interest rates are the same
- Receive €100 million and pay \$130 million at maturity of the swap (and debt)

The cross-currency swap would result in annual net interest payments of \$6,500,000 (\$130 million x 5.00%) regardless of where foreign exchange rates move. If hedge accounting can be applied at the date of pricing, which we believe it should, this would also be the annual interest expense.

We do not understand the conclusion in the “Effect on Earnings” section that debt service to be paid after the debt is issued is only a tangential relationship to earnings, when, as noted in the subsequent paragraph, Implementation Issue No. G18 specifically notes that future interest payments have a direct impact on earnings and are eligible for cash flow hedge accounting. We do not believe that there is a difference between hedging the variability in **forecasted interest payments** due to changes in interest rates (as discussed in Issue G18) and hedging the variability in forecasted **functional-currency equivalent interest payments** due to changes in FX rates; paragraph 40 of FAS 133, as amended, specifically permits cash flow hedge accounting of “the foreign currency exposure to variability in functional currency equivalent **cash flows** associated with a forecasted transaction.”

It is clear from our example that the forecasted issuance of foreign-currency debt does create **direct** earnings exposure, and hence presents a hedgeable risk, and that the gain or loss on a hedging instrument would have a direct relationship with the earnings effect of the hedged transaction. Nevertheless, we also wish to note that we disagree with the assertion in Proposed Issue H17 that there needs to be a direct relationship between the gain or loss on the hedging instrument and the earnings effect of the hedged transaction. We do not believe this is a requirement contained in FAS 133. Rather, the requirement is for a hedge to be highly effective. Paragraph 28 (b) of Statement 133 requires an entity applying hedge accounting to have an expectation that a hedge will be highly effective in achieving offsetting cash flows to apply hedge accounting. Paragraph 65 repeats this requirement. The Background to Implementation Issue F5 notes:

The Statement does not specify the method to be used in assessing the hedge's effectiveness in achieving offsetting changes in fair values nor does it specify how the expectation of highly effective offset should be determined.

Finally, if the FASB votes to retain the conclusion in Proposed Issue H17 we do not believe the FASB Staff has fully answered constituents' questions. Proposed Issue H17, as currently drafted, only addresses the question of whether a single hedge designation – a hedge of the variability in functional-currency-equivalent proceeds expected to be received from the forecasted issuance of debt denominated in a currency other than the entity's functional currency – is permissible. We believe a more common designation may be to designate a derivative as a hedge of the variability in forecasted foreign-currency interest payments, associated with a forecasted foreign-debt issuance, due to changes in currency rates. This designation is analogous to the designation used by companies hedging forecasted interest payments, associated with a forecasted debt issuance, due to changes in interest rate risk.

Again, as we illustrated in our example, there is both a clearly hedgeable risk created by changes in foreign exchange rates, and a direct relationship between the gain or loss on the hedging instrument and the effect on earnings of the hedged transaction.

If you would like to discuss our comments or any other issues further you can contact me at 212-902-7052 or Nora Joyce at 212-357-8391.

Sincerely,

Timothy J. Bridges
Managing Director

Copy: Nora Joyce