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LETTER OF COMMENT NO. 22

September 21, 2007

Technical Director
File Reference No. 1530-100
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

RE: Proposed Statement 133 Implementation Issue E23 – Issues Involving the Application of the Shortcut Method under paragraph 68 (File Reference No.: 1530-100)

Dear Technical Director:

We appreciate the opportunity to respond to the proposed Statement 133 Implementation Issue E23, Issues Involving the Application of the Shortcut Method under paragraph 68. While we agree with the Board that certain practice issues have caused implementation difficulties in the application of paragraph 68 of Statement 133 (the shortcut method), we believe the root cause of such practice issues extends beyond what can be contemplated in a DIG issue; and we do not believe a DIG issue can adequately address the underlying shortcomings of the shortcut method. We believe the shortcut method is fundamentally flawed in that it attempts to establish a simplistic "rules-based" or "checklist" approach to transactions with financial instruments that are complex and continually evolving. Accordingly, we believe consideration should be given to replacing the shortcut method with a principle-based approach that would allow an entity not to assess high effectiveness or record ineffectiveness if, at inception of a hedging relationship and on an ongoing basis, it can be concluded that the relationship would generate de minimus ineffectiveness. This conclusion may be reached by an evaluation of the terms of the relationship components, including stress tests under various economic scenarios. This approach could be included in the Board's current project to simplify hedge accounting, which we support. Alternatively, consideration should be given to converging with IAS 39, Financial Instruments: Recognition and Measurement. This alternative would require assessment of high effectiveness and long-haul calculations of ineffectiveness.

If the second alternative is chosen, or if the proposed DIG Issue is adopted and, as we believe, a significant number of hedging relationships no longer meet the criteria for the shortcut method, consideration should be given to providing additional guidance on how



to perform long-haul calculations of ineffectiveness. These calculations can be very complex, especially when the interest rate swap and/or the hedged item have a fair value other than zero at the inception of the hedge. We believe the complexity of the long-haul calculations and the lack of guidance on how to perform them have led entities to apply the shortcut method when possibly such relationships were not intended by the Board to be shortcut compliant.

If the Board decides to adopt the proposed DIG Issue, we believe clarifications need to be made. These clarifications are needed because of the current rules-based approach of the shortcut method. Our specific comments on the proposed DIG Issue are set forth below.

Typical vs. Not Typical

Subparagraph 68 (e) - The proposed DIG Issue would amend subparagraph 68(e) to allow the shortcut method when any other terms in the interest bearing financial instruments or interest rate swaps are <u>both</u> typical of those instruments <u>and</u> do not invalidate the assumption of no hedge ineffectiveness. We believe current practice in this area is mixed and many entities' interpretation is that the shortcut method is precluded only when any atypical term also invalidates the assumption of no ineffectiveness. The proposed amendment will put pressure on the determination of what constitute "typical" terms since not being typical alone would disqualify a relationship from the shortcut method. We believe this determination will be judgmental and subjective, and may change over time as instruments with more complex terms become "typical". Absent improved guidance on what constitute "typical" terms, we believe this amendment will add to the uncertainty and complexity of applying the shortcut method and will result in diversity in practice. We suggest that the "typical" term requirement in subparagraph 68(e) be eliminated such that the focus is on whether the terms invalidate the assumption of no ineffectiveness.

Evaluation of "Any Other Terms" - We believe the Board should clarify what is meant by "any other terms" in subparagraph 68(e). Specifically, the Board should clarify whether it is necessary to reevaluate the terms that have already been considered separately under subparagraphs 68(a)-68(dd) and 68(f)-68(k) to determine whether they are 'typical'. The Basis for Conclusions in the proposed DIG Issue indicates such reevaluation is required; however, the use of "any other terms" in subparagraph 68(e) seems to indicate that there is no such requirement.

Par Value Equal to Fair Value

We believe the amendment to subparagraph 68(e) should be clarified to indicate whether the requirement that the fair value of an interest bearing instrument equal its par value applies both to fair value and cash flow hedges. Subparagraph 68(e) provides no mention



of cash flow hedges; however, Item 5 of the proposed DIG Issue speaks generally of a "hedged item" without excluding cash flow hedges. Similarly, we believe Item 6 in the Proposed DIG Issue that addresses subparagraph 68(e) should explicitly address whether the requirement also applies to cash flow hedging relationships. Currently, Item 6 only provides that a *fair value* hedging relationship that begins subsequent to initial recognition of the hedged item would not meet the criterion of subparagraph 68(e). Additionally, we believe that the fair value in this requirement is fair value based on changes in the benchmark rate and not other changes such as credit. This should be clarified in the final DIG Issue.

We do not understand the rationale provided in Item 7 of the proposed DIG Issue as to why a hedge of a zero-coupon bond does not qualify for the shortcut method. The Board should consider clarifying the rationale. We suggest that a simpler reason for not qualifying for the shortcut method is that the fair value of the bond is not equal to its par value at the inception of the relationship as required in the amendment to subparagraph 68(e).

We do not agree that the amortization of the initial difference between the fair value and par value of a hedged item (the premium/discount) creates ineffectiveness as noted in the example included in the proposed amendment to subparagraph 68(e). The amortization is due to the passage of time; and thus not a component of the change in fair value of the hedged item or part of the measurement of ineffectiveness. Ineffectiveness is created by the change in fair value of the premium/discount due to changes in the benchmark rate.

We believe the guidance in the amendment to subparagraph 68(a) that addresses when hedging relationships that include amortizing hedged items and swaps qualify for the shortcut method is unclear. As we interpret the proposed amendment, a cash flow hedge and fair value hedge could both be structured to provide identical cash flows at identical dates, but based on the criterion in the amendment only the cash flow hedge would qualify for the shortcut method. The fair value of a swap is based on its future cash flows; thus we do not understand the distinction being made in the amendment.

Generally Established Conventions

Trade Date vs. Settlement Date - The proposed DIG Issue would allow the shortcut method for an otherwise qualifying fair value hedge when the relationship is designated on the trade date of both the swap and the hedged item even though the hedged item is not recognized until its settlement date. While we agree with the Board's decision, we believe the proposed DIG Issue should recognize that generally established conventions for the time between trade date and settlement date may be up to 30 days or longer; currently the Basis for Conclusions states such difference is "several days". In addition, the Board may want to consider including a concept of the shortest period possible for



settlement of the hedged item to resolve implementation issues when more than one tradesettlement date period exists. It is also our understanding that in many international markets there may not be generally established conventions. We would suggest that the final DIG issue address whether an entity is automatically precluded from using the shortcut method in such instances where there are no generally established conventions.

The Basis for Conclusions states that the Board decided to allow the use of the shortcut method when a relationship is established at the settlement date of the hedged item even though the swap, which was entered into at the trade date of the hedged item, has a fair value other than zero, and the hedged item has a fair value not equal to par. This conclusion is not included in the proposed amendments to paragraph 68 and would be inconsistent with the criterion of subparagraph 68(b). We recommend that the Board clarify its intention in this matter.

Change in Fair Value of Hedged Item — We believe the proposed DIG Issue should clarify the treatment of the change in fair value of the firm commitment between the trade date and the settlement date. We believe that any change in the fair value would be included as part of the basis of the hedged item upon its recognition, e.g., the debt's settlement date.

Rounding Coupon Rates – In the Basis for Conclusions, the discussion of subparagraph 68(e) references the clarification that "significant" discounts or premiums are an example of a term that would invalidate the assumption of no ineffectiveness. Our interpretation of the proposed revisions to subparagraph 68(e) is that *only* discounts or premiums attributable solely to the market convention of rounding the coupon rate would be allowable. The significance of the discount or premium has no bearing on the determination of whether the discount or premium invalidates the assumption of no ineffectiveness. Accordingly, we believe the term "significant" should be removed from the Basis for Conclusions.

Other

Hedging a Proportion – We suggest inserting the word "designated" prior to "principal" in the first sentence of the proposed amendment to subparagraph 68(a) so as not to preclude the use of the shortcut method for hedging relationships of a proportion of a hedged item, e.g., \$5 million of a \$12 million debt.

Transition

The proposed DIG Issue would require entities to assess previous hedging relationships to determine whether they met the new requirements for the shortcut method as of the inception of the hedging relationships. The guidance would be effective the first day of



the first fiscal quarter beginning after the date the DIG Issue is approved. Entities with existing hedging relationships that previously qualified for the shortcut method but do not qualify when applying the revised requirements of the proposed DIG Issue to the hedging relationships at their inception would have to dedesignate the hedging relationships prospectively. While the proposed DIG Issue would allow entities to redesignate the hedging relationships, such redesignation would require the entities to complete complex and time consuming long-haul ineffectiveness calculations. The Board should give consideration to the effort that will be required by entities to retroactively determine whether a hedging relationship met the revised requirements for shortcut and also whether such information will be available to make such determinations. Further, the Board should give consideration to the effort and potential system changes that may be required to complete the required long-haul ineffectiveness calculations. We believe the transition period provided in the proposed DIG Issue is not long enough for entities to undertake such a process. The Board may want to consider grandfathering previously qualifying relationships and applying the proposal guidance for new hedging relationships.

Fair Value Option - We believe the Board should consider allowing entities to elect the fair value option under Statement 159, The Fair Value Option for Financial Assets and Financial Liabilities, for items that no longer qualify for shortcut as a result of adopting the guidance in the proposed DIG Issue. We believe the availability of the fair value option could simplify transition as entities would be able to approximate the desired accounting offset without the requirement to recreate long-haul hedge ineffectiveness calculations.

Basis Adjustments - The Board should provide clarification on the appropriate treatment of the hedged item's basis adjustment subsequent to dedesignation of a hedging relationship that no longer qualifies for the shortcut method. We believe that if a hedging relationship is discontinued and the original hedged item is redesignated in a relationship hedging the same risk, amortization is not required to begin at that point(because the item continues to be hedged for changes in fair value attributable to the same risk).

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If you have any questions about our comments or wish to discuss any of the matters addressed herein, please contact Enrique M. Tejerina at (212) 909-5530.

Sincerely,

