

Merck & Co., Inc.
One Merck Drive
P.O. Box 100
Whitehouse Station, NJ 08889-0100



August 15, 2008

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



LETTER OF COMMENT NO. 58

Re: **File Reference 1590-100**, Proposed Statement of Financial Accounting Standards,
Accounting for Hedging Activities, an amendment of FASB Statement No. 133.

Dear Mr. Golden:

Merck & Co., Inc. is a New Jersey based corporation with its principal place of business at One Merck Drive, P.O. Box 100, Whitehouse Station, New Jersey 08889-0100. The Company is a global research-driven pharmaceutical products organization that discovers, develops, manufactures and markets a broad range of innovative products to improve human and animal health. We are pleased to provide you with our comments on the Exposure Draft "*Accounting for Hedging Activities, an Amendment of FASB Statement No. 133*".

We support the Financial Accounting Standard Board's (FASB) efforts to simplify hedge accounting, improve the financial reporting of hedging activities, and resolve major practice issues which have arisen under Statement 133. While we support the proposed changes related to simplifying the evaluation of effectiveness by using primarily qualitative factors, we have concerns that eliminating the *Shortcut Method* and requiring complex "long-haul" calculations to account for hedge ineffectiveness, the proposed changes are merely shifting the nature of the complexity which may adversely impact the use of some of the more basic common hedging strategies. In addition, as discussed further below, we have significant concerns with the proposed amendment to eliminate a bifurcation-by-risk approach for hedges of a company's own debt that are not entered into at inception of the borrowing ("late hedges") as well as pre-issuance hedges of forecasted issuances of fixed-rate debt.

Elimination of the *Shortcut Method*:

The *Shortcut Method* was developed and incorporated into FAS 133 to simplify the computations and accounting for common and relatively simple interest rate risk management practices. There

were significant and valid concerns that the "long-haul" computation methods of assessing effectiveness and measuring ineffectiveness of a simple fair value or cash flow hedge of interest rate risk did not provide the appropriate balance between cost and benefit. One of the stated objectives of the proposed Statement is to simplify hedge accounting for hedging activities, however removal of this heavily relied upon simplification provision does not appear to accomplish this objective, but instead shifts the complexity from qualifying for hedge accounting to measuring and accounting for hedge ineffectiveness. We are concerned that the elimination of the *Shortcut Method* may significantly discourage prudent economical risk management practices, as companies try to avoid the complexities, administrative burdens, and costs imposed by using the long-haul method to measure and account for hedge ineffectiveness. It is also unclear whether users of the financial statements would receive commensurate benefits which would justify the cost/benefit criteria for eliminating the *Shortcut Method*.

Permitted Hedge Risks:

A common risk management strategy is for companies to enter into a hedge subsequent to the issuance of debt in response to actual or anticipated changes in interest rates or net interest rate exposure. Merck & Co., Inc. uses interest rate swap contracts on certain borrowing transactions to manage its net exposure to interest rate changes as well as to reduce its overall cost of borrowing. Based on risk management objectives and changing market conditions, some of these interest rate swap contracts are executed after the issuance of the fixed rate debt.

Under the proposed Statement, after inception of the debt, a company would not be permitted to designate only interest rate risk as the risk being hedged, but instead would have to designate the risk of changes in overall fair value of the debt, thus the proposed Statement would require changes relating to a company's own creditworthiness be recorded in the income statement. For those derivatives that qualify for fair value hedge accounting, the proposed amendment will create accounting results (additional earnings volatility primarily due to changing credit spreads) which are not only counterintuitive (credit downgrade results in financial statement gain) but also inconsistent with the objective of the risk management program and the overall purpose of the hedge which is to mitigate interest rate risk. Furthermore, due to a lack of suitable derivatives, it is unlikely that this credit component can be hedged, thus resulting in the recognition of credit risk in earnings which would not have been recognized if hedge accounting had not been elected. We believe that by allowing companies to designate only interest rate risk on late hedge interest rate swaps, which is a common risk management practice, the FASB is still achieving its intended objectives. Any proposed expansion of the use of a fair value accounting approach for hedge accounting should be developed further as a separate project in coordination with the International Accounting Standards Board.

Many risk management strategies use Treasury rate locks and forward starting swaps to hedge the impact of market interest rates on a forecasted future issuance of fixed rate debt. The proposed Statement eliminates the bifurcation-by-risk approach, therefore the hedge relationship must consider total changes in cash flows, which includes a company's own forecasted credit risk as well as new issue premium. Developing a hypothetical derivative that includes total changes in cash flows adds significant complexity due to the inclusion of a company's new issue premium, for which data is unobservable, and forecasted credit spread. Furthermore, the proposed guidance also creates additional earnings volatility (due to changing credit spreads), which is inconsistent with the objective of the risk management program and the overall purpose of the hedge.

Based on the above, we do not believe the proposed change that eliminates the bifurcation-by-risk approach achieves the Board's objective to simplify hedge accounting and may have the

unintended consequence of discouraging prudent economical risk management practices. In the event the Board decides to proceed with the interim changes included in the proposed Statement (see comment below regarding deferring the interim changes proposed in the Exposure Draft due to expected IFRS adoption), we request the FASB consider extending the exception provided in the proposed Statement that allows the hedged risk to be designated as interest rate risk, foreign currency exchange risk, or both, to include hedges of forecasted issuances of fixed rate debt.

International Convergence / IFRS Adoption:

We share the same concerns expressed by the two Board members in the Alternative Views section of the Exposure Draft. In light of the FASB's and the International Accounting Standard Board's (IASB's) convergence efforts and the likelihood that U.S. public companies will adopt IFRS in the foreseeable future, it seems impractical to request companies to understand, interpret, and implement the requirements of the proposed Statement only to adopt the International Accounting Standard on hedging (IAS 39) in a few years. We encourage the Board to reconsider whether the benefits of interim changes to try and simplify FAS 133 significantly exceed the costs.

Other Items:

The proposed Statement's elimination of dedesignation of a hedge at the company's election will make it more difficult for companies to execute their hedging programs. For instance, many risk management programs include "restriking" which involves the simultaneous dedesignation of deep out-of-the-money put options and the purchase of a new put option at current market levels. The proposed change to prohibiting dedesignation would result in companies having to sell these options at the time of "restriking", thus economic decisions would be driven by compliance with the proposed accounting rules. Dedesignation appropriately enables companies to enter into effective hedge strategies such as "restrikes" while enabling companies to determine the best time to sell the dedesignated hedge. We therefore request the Board reconsider this proposed change.

In addition to the items discussed above, we recommend the Board further clarify certain other aspects of the guidance. We have included the following items below for your consideration.

- Paragraph 6b of the Exposure Draft changes the hedge assessment requirements from "highly effective" to "reasonably effective". Reasonably effective may be broadly interpreted and the FASB may want to consider providing clarification of what it considers reasonably effective as this will allow for more consistent application in practice.
- With respect to measuring and reporting ineffectiveness in a cash flow hedge relationship, for hedges of forecasted transactions occurring within a specified time period, the hypothetical derivative would be one that settles *within a reasonable time period* of the exposure. Specifically, Paragraph 27 of the Exposure Draft states:

"That time period is reasonable if the difference is minimal between the forward rate on that derivative and the forward rate on a derivative or derivatives that would exactly offset the changes in cash flows of the forecasted transactions".

This guidance appears to have been developed in the context of forward contracts and the FASB may want to consider clarifying whether this guidance can also be analogized to plain vanilla put option contracts.

Thank you for the opportunity to provide comments on the Exposure Draft. We would be pleased to discuss our views with you at your convenience.

Sincerely,

/s/ John Canan

John Canan
Vice President, Controller
Merck & Co., Inc.

cc: M. E. McDonough - Vice President and Treasurer