



LETTER OF COMMENT NO. 14



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financial executives
international

committee on corporate reporting

September 20, 2007

Mr. Russell Golden
Director of Major Projects and Technical Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

File Reference: Proposed Issue E23

Dear Mr. Golden:

The Committee on Corporate Reporting (“CCR”) of Financial Executives International (“FEI”) wishes to share its views on the Financial Accounting Standards Board’s (the “Board”) proposed implementation issue E 23 (“DIG E23”) clarifying the application of “short cut method” provided for in Statement of Financial Accounting Standards No. 133, *Accounting for Derivatives and Hedging Activities* (“SFAS 133”). CCR does not support the issuance of this implementation issue because it fails to provide helpful guidance on the application of the short cut method. Instead, it amends SFAS 133 in a way that will eliminate many valid hedge accounting relationships, further limiting the ability of companies to apply hedge accounting. FEI is a leading international organization of 15,000 members, including Chief Financial Officers, Controllers, Treasurers, Tax Executives and other senior financial executives. CCR is a technical committee of FEI, which reviews and responds to research studies, statements, pronouncements, pending legislation, proposals and other documents issued by domestic and international agencies and organizations. This document represents the views of CCR and not necessarily the views of FEI.

We believe that it is evident from the public record that the impetus for DIG E23 is the dramatic increase in hedge accounting restatements over the past 3 years. What is less clear is whether issuance of this proposed guidance would help resolve the underlying issue. From a preparer standpoint, the issuance of these additional rules appears to support the current view that application of the short-cut method is prohibited unless it is explicitly permitted under the growing list of conditions and criteria in the standard. Evidence of this view is provided in two recent restatements related to application of the short cut method, which resulted from a circumstance in which the notification periods in the hedged item did not precisely match those of the derivative. The standard does not specify notification periods as a critical term and we

believe that practice is relatively uniform in not requiring such matching to apply the shortcut method. This matter is not addressed in proposed DIG E23 and one approach to responding to this development would be to add specific guidance to the final document that indicates that notification periods are not critical terms for purposes of applying the short cut method. However, we believe that this will simply perpetuate the cycle of issuing detailed interpretations in order to resolve matters that should instead be left to professional judgment.

The shortcut method was developed in response to cost/benefit concerns over the complexities of long-haul methods for measuring ineffectiveness and to simplify the computations and accounting for common interest rate risk management practices, recognizing that if the critical terms of the hedged item and hedging instrument matched, a company was able to successfully change the economic profile of an interest bearing financial instrument from fixed to floating, or vice versa. The underlying economic premise is that both instruments are priced (and valued) off the same interest rate curve and therefore possess the exact same economic profile even though the actual marks differ over time primarily due to coupon differences. The popularity of the short-cut method stems from the extreme difficulty that preparers have in applying the long haul method: the degree of accounting and valuation sophistication required to comply with all of the effectiveness testing requirements is significant and beyond the ability of many accountants and their auditors to perform. Moreover, in many cases the amount of ineffectiveness that would be recorded is so insignificant that it fails any cost-benefit test. We are aware of one circumstance in which the cost of performing the long haul effectiveness tests (hours applied by SFAS 133 experts) actually exceeded the dollar amount of ineffectiveness recorded. We believe that these types of issues provide a clear indication that the standard is not functioning in practice as it was originally intended.

We understand the regulatory concern that inappropriate application of the shortcut method could potentially mask ineffective hedges or avoid recognition of material amounts of ineffectiveness. However, we believe that the majority of the restatements in this area have been for highly effective hedging relationships for which unrecorded ineffectiveness was not material. Moreover, these restatements are not helpful to investors, as they remove the financial statement effect of hedge accounting in order to satisfy a nuanced interpretation of highly complex rules that ignores the economic reality that the company has achieved a highly effective hedging relationship. Investors do not understand the reasons for such restatements, nor do they deem them important, which explains why such restatements have historically generated no noticeable market effect when announced.

We are concerned that the practical effect of proposed DIG E23 will be the elimination of hedge accounting for a broad array of essential hedging strategies because companies are not capable of applying the long-haul method to their interest rate hedges. These strategies, which rely on the use of late hedging, are essential to the effective use of derivatives in commonly applied risk management strategies. While we acknowledge that there are cases where the requirements outlined in paragraph 68 were inappropriately applied, we believe that these are an isolated number of cases and that many of the restatements involve judgments that were reasonable and consistent with the original intent of the guidance. We strongly believe that the original objective of the shortcut method must be preserved until such time as the Board completes its work on simplifying SFAS No. 133. In addition, to the extent the availability of the shortcut method is further restricted, we believe the Board needs to concurrently developing a simplified approach

to implementing the long-haul method in order to assist preparers in being able to continue to apply hedge accounting.

Our specific comments on the proposed DIG issue follow.

Late Hedging

We believe that SFAS No. 133 clearly contemplated that the shortcut method could be applied in circumstances in which the debt is issued prior to the inception of the hedging arrangement (“late hedges”) and therefore strongly agree with the alternative views expressed by the three board members that dissented to the issuance of DIG E23. We offer the following to support our views:

- Consistent with the views of the dissenting Board members, a requirement that the fair value of the hedged item must equal the par value at inception is fundamentally inconsistent with the current guidance in SFAS 133. Paragraph 68 of SFAS 133 does not include any specific prohibition for late hedges, and more importantly, paragraphs 114 and 115 of the standard state, respectively, that ‘amortization of any purchase premium or discount on the liability must also be considered’, and ‘[trade date and borrowing date] need not match for the assumption of no ineffectiveness to be appropriate’. Thus, SFAS 133 has always expressly permitted late hedging situations in which the trade date does not match the borrowing date. Any decision by the Board to prohibit late hedging would represent a significant amendment to SFAS 133.
- Paragraph 68(e) specifically states “any other terms in the interest-bearing financial instruments or interest rate swaps are typical of those instruments and do not invalidate the assumption of no ineffectiveness.” (emphasis added) The fact that a company acquires an interest bearing financial instrument after issuance, or makes the decision to hedge a financial instrument at a point in time after issuance where the fair values are not equal to par, does not change the terms of the underlying financial instrument. While we agree that the amount of actual ineffectiveness resulting from application of hedge accounting to fixed rate financial instruments whose fair value is not at par will be greater in some cases, we do not believe it was the Board’s intent that such circumstances, by themselves, would preclude an entity from applying the shortcut method.
- The shortcut method allows an entity to assume no ineffectiveness will result in a hedge of benchmark interest rates that meets the prescriptive criteria included in paragraph 68. However, as acknowledged by the FASB in paragraph 70, most hedges that qualify for the shortcut method would actually generate some amount of ineffectiveness (if required to be recorded). This ineffectiveness is primarily due to the credit spread that exists between the fixed rate coupon of the instrument being hedged versus the fixed rate leg of the interest rate swap used as the hedging instrument (often described as coupon mismatch). We do not understand why the FASB would eliminate application of the shortcut method for late hedging when the actual amount of ineffectiveness inherent in the hedging relationship would often be far less than exists in companies with sizeable credit spreads hedging fixed rate debt at the time of issuance.

We also observe that most companies manage structural interest rate risk dynamically. Frequently, a company will seek fixed rate funding and subsequently determine that it needs to

be swapped to floating to address a change in their asset/liability mix. In these cases, we acknowledge the debt would most likely have a fair value different from par, principally as a result of changes in market interest rates since the debt was issued. Requiring the long-haul method to be employed in these late hedging situations only creates operational burden and a different kind of compliance risk (i.e., proper application of all facets of the long haul method) for hedges that are highly effective from an economic standpoint. We have difficulty in understanding the theoretical basis of why late hedging is an issue in applying the shortcut method.

Paragraph 68(e)

We are concerned with the use of the term *typical* in paragraph 68(e) as redefined in the proposed DIG issue. Markets constantly evolve along with the terms of the underlying financial instruments. What may be considered atypical today may become typical in the future. Interest rate swaps that contain interest deferral features are a good example of this phenomenon. We know the current view in practice is that financial instruments that contain interest deferral features cannot be hedged under shortcut even if the hedging instrument contains the mirror image features. However, these types of instruments and related interest rate swaps are becoming increasingly common in the marketplace given the increase in hybrid and longer-dated funding issuances. We question whether it is the Board's intent that as complex terms become commonplace that the use of the shortcut method should be expanded to include such features. The term "typical" is far too vague to be operational as markets and financial instruments evolve.

Moreover, use of the term in this way will precipitate another wave of restatements as preparers and their auditors reach conclusions that are different from regulators about the conditions under which an instrument feature meets that criterion. We believe that the criterion should be removed and that the emphasis should be on whether the term in question could generate more than a de minimis amount of ineffectiveness. If the term in question could not generate more than a de minimis amount of ineffectiveness, the term would not be considered critical.

Amortizing Instruments

We understand the Board's view that shortcut cannot be applied to instruments subject to unscheduled prepayments and we believe that a practice is largely consistent with the Board's intent. However, we are unclear as to whether entities will be permitted to continue to hedge term debt under the shortcut method using interest rate swaps that amortize on a predefined basis (i.e., the total amount of debt stays fixed over time). Under these arrangements, the notional amount of the actual hedge is reduced over time as the interest rate swap amortizes on a predetermined basis. We believe that this type of strategy should continue to be appropriately hedged under the shortcut method as long as the documentation at inception explicitly identifies how the notional amount changes and when those reductions are to occur.

Transition

While it is our strong desire that DIG E23 not be issued, we wish to share our thoughts related to transition if the Board decides to proceed to a final document. First, we believe many companies will want to continue to apply hedge accounting to instruments that will no longer qualify for shortcut. However, the de-designation and re-designation events will lead to significant added complexity by requiring consideration of the value of the derivative in a cash flow relationship and fair value of the hedged item in a fair value relationship as of the date of the "re-

designation.” We therefore believe that, at a minimum, the transition provisions should grandfather existing hedging relationships.

We also wish to reiterate and emphasize our concern that application of the long-haul method is extremely complex and requires a significant operational investment (both technical accounting and information systems resources). Many companies do not currently have the information systems capability or personnel capacity to make a switch in the short-term. There are very few practitioners who are sufficiently knowledgeable on the technical requirements for hedge accounting and also possess the valuation knowledge required to apply the effectiveness testing requirements of SFAS 133. It also is unclear whether such a transition approach should be necessary given the highly effective nature of the hedging relationships that would be affected by this change.

If the Board ultimately decides to finalize DIG E23, many companies will need additional time to build this infrastructure to apply long-haul hedge accounting. Otherwise, companies will be forced to either abandon prudent risk management strategies or present income statement volatility that does not reconcile with their underlying net risk exposure. Based on the above, we ask the Board to consider delaying the effective date of DIG E23, if issued, until January 1, 2009, to give companies the necessary time to address these needs. We also urge the Board to reach out to constituents to better understand the implications of the proposed transition method.

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We believe that this proposal will not assist practitioners with application of the standard, but rather has the potential to exacerbate restatements in the future by reinforcing the notion that application of the short cut method in circumstances that are not explicitly permitted are, in fact, prohibited. We believe it would be more constructive and helpful if the Board were to focus its resources on the simplification of SFAS 133. The Board has the opportunity to completely transform this standard from being the prime example of a complex and rigid rules-based standard to a principles based standard whose application would be driven by economic substance and indicative of how companies actually manage risk. We appreciate the Board’s consideration of our concerns and would welcome the opportunity to discuss any and all related matters.

Sincerely,



Arnold C. Hanish
Chair, Committee on Corporate Reporting
Financial Executives International