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August 15, 2008

Technical Director
File Reference No. 1590-100
Financial Accounting Standards Board
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LETTER OF COMMENT NO. 102

PricewaterhouseCoopers appreciates the opportunity to comment on the Exposure Draft of the Proposed Statement of Financial Accounting Standards, *Accounting for Hedging Activities, an amendment of FASB Statement No. 133* (the Exposure Draft).

It is our expectation that public company financial reporting in the United States will move to International Financial Reporting Standards (IFRS) in the not-too-distant future. We therefore believe the Financial Accounting Standards Board (FASB or the Board) should primarily focus its standard-setting efforts on convergence matters and limit other changes in US Generally Accepted Accounting Principles (GAAP) to critical repairs and maintenance activities. Furthermore, any projects to address the accounting in problematic areas should be designed to provide a simpler solution that adequately reflects the economics of transactions and that do not create significant new differences with IFRS.

In view of the difficulties that practice has experienced with applying Statement No. 133, Accounting for Derivative Instruments and Hedging Activities (FAS 133), we support the Board's overall efforts to simplify the accounting for hedging activities and to improve transparency for users of financial statements. However, we are concerned that through this project, the Board could create additional US GAAP-IFRS differences. The International Accounting Standards Board (IASB) has issued a discussion paper, Reducing Complexity in Reporting Financial Instruments, that contemplates possible ways to simplify hedge accounting under IFRS. To minimize the risk of creating significant new differences between the two sets of standards, we recommend that the FASB and IASB work together on any major changes to hedge accounting.

We also have mixed views with respect to the specific amendments to FAS 133 proposed in the Exposure Draft. We expect that several of them will help reduce the complexity of qualifying for hedge accounting and improve the consistency and comparability in financial reporting. We support eliminating the high effectiveness threshold, as well as streamlining hedge documentation through the elimination of the initial and ongoing quantitative effectiveness assessment requirement. We also support the accommodation being proposed for the measurement of hedge effectiveness for cash flow hedges of a group of transactions that fall within a specific period. Practice has struggled with these aspects of applying hedge accounting and such changes should resolve some of the issues that have arisen.

However, we are not in favor of a number of other changes contained in the Exposure Draft. We are particularly concerned with the curtailment of the bifurcation-by-risk model for financial assets and liabilities, the lack of clarity surrounding the new "reasonably effective" threshold, the requirement to recognize the ineffectiveness associated with cash flow underhedges, and the change in the guidance for hedges of forecasted intercompany transactions.



#### Curtailment of the Bifurcation-by-Risk Model

In practice, companies design risk management strategies to mitigate risk exposures relevant to their business. Typically, strategies related to financial instruments are executed on a specific risk component basis. We believe the financial reporting model should be aligned with the risk management strategies companies employ, which is best reflected in the current bifurcation-by-risk approach for financial assets and liabilities. Information regarding the economics associated with unhedged risk components may be better conveyed to users through disclosures, rather than through earnings as proposed by the Board.

Additionally, the proposed curtailment of the bifurcation-by-risk approach would arguably increase the complexity of hedge accounting in many instances. Recording the fair value changes for the entire financial instrument or forecasted exposure would result in the recognition in earnings of the changes in fair value attributable to risk components not being hedged. A well-established market already exists for derivatives that can be effective hedges of interest rate risk, and information regarding the expected interest rates for future periods is generally available. In contrast, often no derivative exists to economically hedge other risk components, such as credit risk, and forecasted credit spread information is very limited. The absence of credit risk information for the full term of a planned debt issuance would make the application of hedge accounting for hedges of the interest costs associated with forecasted borrowings very difficult for some companies under the Board's proposed full-fair-value approach.

#### "Reasonably Effective" Threshold

Although we agree with the Board that the establishment of a quantitative threshold or bright-line is inappropriate for determining hedge effectiveness, we are concerned with the introduction of the "reasonably effective" threshold. The Exposure Draft does not define this term, nor provide much guidance on how it should be applied. In addition, paragraph A9 of the Exposure Draft notes that the determination of "reasonably effective" would depend on facts and circumstances and may be different depending on the objective, such as whether the fair value option is available for the hedged item. However, it is unclear why the effectiveness of a hedging relationship should be higher or lower depending on the availability of the fair value option. We are also concerned that in the absence of a better understanding of the Board's intent, practice will inevitably try to establish a bright line for assessing hedge effectiveness. As an alternative to establishing a threshold that might be misinterpreted as a new bright line, we believe the Board should provide a discussion of the factors to be considered in determining whether there is an adequate economic relationship between the hedged item and the hedging instrument that achieves the risk management strategy.

#### Ineffectiveness Associated with Cash Flow Underhedges

As stated in the Exposure Draft's Basis for Conclusions, hedge accounting largely results from the need to address differences in the way hedged items and hedging instruments are recognized and measured. We believe the primary objective of cash flow hedge accounting should be to defer the effective portion of the gains and losses associated with the actual hedging instrument for later recognition in earnings with the hedged forecasted transaction. It should not be to recognize ineffectiveness in earnings for hypothetical derivative instrument gains and losses that will never be realized or incurred. We therefore do not support the proposal to record in earnings the ineffectiveness related to underhedges in cash flow hedging relationships. Under that approach, the amount deferred in equity and ultimately recognized in earnings with the hedged transaction would reflect the hedging relationship as if the entire risk were perfectly hedged. We do not believe a portrayal of the combination of the hedged transaction and the hedging strategy as if the hedging instrument was perfect, when in fact it was less than perfect, is representationally faithful. This situation differs for overhedges, where it does not seem appropriate to defer hedging gains and losses that are more than what is needed to offset the hedged cash flows. If users require information about the extent to which a

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hedging strategy is less than perfect, that information should be provided through disclosures and not through the recognition of phantom gains and losses in earnings.

Hedges of Forecasted Intercompany Transactions

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The Exposure Draft proposes to amend the guidance related to foreign currency hedges of forecasted intercompany transactions to address differences between the intent of the guidance and how practice has developed. However, we do not believe that the proposed amendments adequately clarify the Board's intent. Based on our follow-up discussions with the FASB staff, it appears that whether a forecasted intercompany transaction qualifies for hedge accounting will depend on the ability to conclude that there is an earnings exposure that survives consolidation by linking that transaction to a third party transaction. We are concerned that this concept of linkage is not explained in the Exposure Draft especially given the different types of intercompany transactions that exist in practice and the varying degrees to which they may be linked to third party transactions. In the absence of this guidance, it is difficult for us to comment on whether we agree or have any specific concerns with the proposed amendment and its impact on practice. We therefore encourage the Board to undertake further research into the hedging strategies that multinational companies use to manage the foreign currency exposure associated with their forecasted intercompany transactions to ensure that the final standard clearly conveys a workable approach for the strategies typically employed.

Our responses to the specific questions contained in the Notice for Recipients, along with additional comments on the Exposure Draft, are attached in the Appendix to this letter.

We appreciate the opportunity to express our views on the Exposure Draft. If you have questions regarding our comments, please contact John Althoff at (973) 236-7288 or Michael Gallagher at (973) 236-4328.

Sincerely,



**APPENDIX** 

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

#### **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?

• We believe removing the ability to designate risk components of financial instruments would impair the usefulness of financial statements. Recording fair value changes for risk components that are not (and in some cases cannot be) hedged would not seem to faithfully represent the economic reality of hedging relationships. Generally, risk management strategies for financial instruments identify and strive to manage a specific risk component, such as interest rate risk. A wellestablished market already exists for derivatives that can be effective hedges of interest rate risk, and information regarding the expected interest rates for future periods is generally available. In contrast, often no derivative exists to economically hedge other risk components, such as credit risk, and forecasted credit spread information is very limited. The absence of credit risk information for the full term of a planned debt issuance would make the application of hedge accounting for hedges of the interest costs associated with forecasted borrowings very difficult under the Board's proposed full-fair-value-approach.

We believe the financial reporting model should be reflective of the risk management strategies companies employ, which is better reflected in a bifurcation-by-risk approach for financial assets and liabilities. The current hedge accounting model presents the results of hedge accounting in a manner that allows users to see how effective management was in achieving its risk management objectives. The inclusion of all risks would make it more difficult for financial statement users to determine the effectiveness of those risk management strategies. We believe any information regarding the economics associated with unhedged risk components may be better conveyed to users through disclosures.

### Issue 2: Do you believe the Board should continue to permit an entity to designate those individual risks as a hedged risk?

As noted in our response to Issue 1 above, we support a bifurcation-by-risk approach for financial
instruments. We do not see a compelling reason to eliminate the ability to designate individual
component risks as a hedged risk for financial assets and liabilities. Additionally, the proposed
curtailment of this approach would arguably increase the complexity of hedge accounting in many
instances.



#### **Hedge Effectiveness**

Issue 3: Do you foresee any significant operational concerns or constraints in calculating ineffectiveness for fair value hedging relationships and cash flow hedging relationships? Do you believe that the proposed Statement would improve or impair the usefulness of 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?

- The absence of credit risk information for the full term of a planned debt issuance will likely make the measurement of ineffectiveness for hedges of the interest costs associated with forecasted borrowings very difficult.
- In view of the proposals to lower the effectiveness threshold, move to a qualitative assessment and
  provide an accommodation for the measurement of hedge effectiveness for cash flow hedges of a
  group of transactions that fall within a specific period, we would not object to removing the ability to
  assume no ineffectiveness using these two methods.

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

We support the elimination of the high effectiveness threshold, but have concerns regarding the lack of clarity surrounding the new reasonably effective threshold. We agree with the Board that the establishment of a quantitative threshold or bright-line is inappropriate for determining hedge effectiveness. However, the Exposure Draft does not define this term, nor provide much guidance on how it should be applied. In addition, paragraph A9 of the Exposure Draft notes that the determination of "reasonably effective" would depend on facts and circumstances and may be different depending on the objective, such as whether the fair value option is available for the hedged item. However, it is unclear why the effectiveness of hedging relationship should be higher or lower depending on the availability of the fair value option. We are also concerned that in the absence of a better understanding of the Board's intent, practice will inevitably try to establish a bright line for assessing hedge effectiveness. As an alternative to establishing a threshold that might be misinterpreted as a new bright line, we believe the Board should provide a discussion of the factors to be considered in determining whether there is an adequate economic relationship between the hedged item and the hedging instrument that achieves the risk management strategy.

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 you would continue to qualify for hedge accounting utilizing your current hedging strategy?

• We believe that many currently designated fair value hedges of interest rate risk for financial instruments and cash flow hedges of interest rate risk for forecasted debt issuances may no longer be permitted under the proposed amendment to FAS 133. However, the extent to which this occurs will depend on the expected volatility of the issuer's credit spread relative to the expected volatility of the benchmark interest rate, as well as the Board's clarification of the reasonably effective threshold. The lack of derivative instruments available to economically hedge a company's credit risk will likely preclude many companies from increasing the effectiveness of those hedging relationships that fail to meet the threshold under the new full fair value approach. Furthermore, in those situations where financial assets are aggregated and hedged as a portfolio, companies will experience operational difficulties because of the impact the inclusion of credit spreads will have on determining appropriate groupings of similar assets. This could lead to a decrease in the size of

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the asset portfolios and a corresponding increase in the number of individual hedge designations, which would be counter to the Board's overall efforts to reduce the complexity of applying hedge accounting.

Issue 5: Do you foresee any significant operational concerns in creating processes that will determine when circumstances suggest that a hedging relationship may no longer be reasonably effective without requiring reassessment of the hedge effectiveness each reporting period? Do you believe that requiring an effectiveness evaluation after inception only if circumstances suggest that the hedging relationship may no longer be reasonably effective would result in a reduction in the number of times hedging relationships would be discontinued? If so, why?

- We do not foresee any significant operational concerns assuming that the proposed "reasonably effective" threshold is clarified, as discussed in our response to Issue 4. We believe that companies will likely monitor those factors considered in their qualitative assessment at inception and the hedge accounting results (i.e., the amount of ineffectiveness) to determine whether circumstances suggest that the hedging relationship is no longer reasonably effective. However, it will be important to understand that this assessment will be far more judgmental than current practice and that inherently, not everyone will conclude that a particular hedging relationship may no longer be reasonably effective at the exact same point in time.
- We do not believe that requiring an effectiveness assessment after inception only if circumstances
  suggest the hedging relationship is ineffective would significantly reduce the number of
  terminations when compared with a quantitative assessment assuming the same hedge
  effectiveness threshold is applied. However, again it will be important to understand that this
  assessment will be more judgmental, and therefore, the timing of when the hedging relationship is
  terminated may differ under each approach.

Issue 6: Do you agree with the Board's decision to continue to require that hedge accounting be discontinued if a hedge becomes ineffective? Alternatively, should an effectiveness evaluation not be required under any circumstances after inception of a hedging relationship if it was determined at inception that the hedging relationship was expected to be reasonably effective over the expected hedge term?

We believe that hedge accounting should be discontinued if the hedging relationship is no longer
effective in achieving the risk management strategy. Therefore, there is a need to consider whether
circumstances have subsequently changed in such a way that the economic relationship between
the hedging instrument and the hedged item has deteriorated to the point where the hedge no
longer accomplishes the risk management strategy.

#### Presentation of Hedging Gains and Losses

Issue 7: Do you believe that Statement 133 should be amended to prescribe the presentation of these amounts? For example, the Statement could require that the effective portion of derivatives hedging the interest rate risk in issued debt be classified within interest expense and that the ineffective portion and any amounts excluded from the evaluation of effectiveness be presented within other income or loss.

We do not believe it is necessary to prescribe the presentation of hedging gains and losses in the
financial statements. Practice has developed over time and, where significant, companies disclose
their accounting policies. However, the Board may wish to address the presentation of hedge
ineffectiveness if it retains the proposed recognition of ineffectiveness associated with
underhedges in cash flow hedging relationships. Under FAS 133, hedge ineffectiveness is not



required to be presented in a manner consistent with the presentation of the effective portion of hedging gains and losses. If the hedged transactions will be reflected as if they are perfectly effective regardless of the actual effectiveness of the hedging relationship, it may be more appropriate to require that ineffectiveness be presented in a consistent manner.

#### **Effective Date and Transition**

Issue 8: Do you believe that the proposed effective date would provide enough time for entities to adopt the proposed Statement? Why or why not?

As discussed in the cover letter, we believe the FASB should work with the IASB to ensure that no
new significant differences are created between the two sets of standards. Given that the IASB is
at an earlier stage in its deliberations, we would expect the FASB to delay the final statement to
enable the FASB and IASB to proceed jointly.

### Issue 9: Do you believe that there are specific disclosures that should be required during transition? If so, what?

We do not believe any specific disclosures are required during transition. However, we are concerned about the transition provisions for those prior hedging relationships that must be redesignated using the new qualifying criteria. Because of a significant movement in market prices since the inception of the original hedging relationship, it is possible for the new hedge to fail to qualify for hedge accounting (i.e., it is not expected to be reasonably effective) due to the then offmarket element in the derivative instrument. We recommend that the Board consider modifying the proposed transition requirements to allow the effectiveness assessment of previously existing hedging relationships to be applied as of the inception of the original hedging relationship instead of the effective date of the new guidance. By doing this, only an off-market element that was present in the derivative instrument at the date of the prior election of hedge accounting, as well as all other basis differences between the derivative instrument and the hedged item using the new qualifying criteria, would be considered in determining whether the hedging relationship is reasonably effective and therefore eligible for hedge accounting going forward. A similar type of transition accommodation was provided for in DIG Issue No. J9, Use of the Shortcut Method in the Transition Adjustment and upon Initial Adoption, where paragraph 68(b) (i.e., the interest rate swap had a zero fair value at inception) was allowed to be applied as of the original inception date of the hedging relationship upon transition to FAS 133.

Issue 10: Do you agree with the Board's decision to allow a one-time fair value option at the initial adoption of this proposed Statement? Do you agree with the Board's decision to limit the option to assets and liabilities that are currently designated as hedged items under Statement 133?

• We agree with the Board's decision to allow a one-time fair value option at the initial adoption of the final standard. However, we do not believe that election should be limited to only those items that are in a hedging relationship immediately prior to adoption of the final statement. The changes being proposed could impact companies' risk management strategies for other assets and liabilities not currently in hedging relationships, but which are candidates for hedging in the future. In addition, because FAS 133 allows late term hedging of the interest rate risk component, companies could enter into a hedging relationship prior to the effective date of the new standard to be eligible for the one-time fair value option. We do not believe companies should have to consider incurring the cost of entering into a hedging relationship shortly prior to the effective date to qualify for the fair value option so that they avoid any potential adverse effects arising from the application of the new standard.



#### **Benefit-Cost Considerations**

Issue 11: Do you believe the Board identified the appropriate benefits and costs related to this proposed Statement? If not, what additional benefits or costs should the Board consider?

• In the Basis for Conclusions, paragraph A16 states, "The Board believes it is just as important to reflect in the financial statements the economics of unhedged risks in order to provide users with a more complete picture of a company's financial position and results of operations resulting from hedge accounting activities." As previously discussed, we do not support eliminating bifurcation-by-risk and disagree with the view that the effects of risks not being hedged should be reflected in earnings. If users require information about risks that are not hedged, we believe that disclosures would provide better transparency. It is unclear whether the benefits of such disclosures have been considered by the Board as an alternative to recording the effects of hedging strategies companies did not employ.

#### **Other Comments**

• The Exposure Draft proposes to amend paragraph 40 of FAS 133 by stating that "the requirement in paragraph 29(c) that the forecasted transaction presents an exposure to variations in cash flows that could affect reported earnings must still be met at the level being reported on. (For example in the financial statements of a consolidated entity, there would need to be an earnings effect that survives consolidation.)" The Basis for Conclusions explains that the purpose of amending the guidance related to foreign currency hedges of forecasted intercompany transactions is to address differences between the intent of the guidance and how practice has developed. However, no further explanation is provided as to the nature of the differences nor how this amended guidance would change practice. Additionally, the proposed amendment could be interpreted to restrict hedge accounting to a very narrow set of intercompany transactions.

Based on our follow-up discussions with the FASB staff, it appears that whether a forecasted intercompany transaction qualifies for hedge accounting will depend on the ability to conclude that there is an earnings exposure that survives consolidation by linking that transaction to a third party transaction. We are concerned that this concept of linkage is not explained in the Exposure Draft especially given the different types of intercompany transactions that exist in practice and the varying degrees to which they may be linked to third party transactions.

In the absence of this guidance, it is difficult for us to comment on whether we agree or have any specific concerns with the proposed amendment and its impact on practice. We therefore encourage the Board to undertake further research into the hedging strategies that multinational companies use to manage the foreign currency exposure associated with their forecasted intercompany transactions to ensure that the final standard clearly conveys a workable approach for the strategies typically employed.

We do not view the current ability to dedesignate hedging relationships to be problematic or an area of abuse. Hedge accounting by its nature is elective, and therefore, the ability to discontinue it is consistent with this notion. Furthermore, we do not believe that dedesignations are common across practice. Those that do occur are likely reflective of companies that manage their risks on an enterprise-wide basis, but must apply hedge accounting on a transaction-by-transaction basis. Also, it is common for companies that hedge forecasted transactions for foreign currency risk through to the expected payment date to dedesignate the hedging relationship upon recognition of the transaction for administrative ease. From a practical perspective, not allowing dedesignation would, in our view, result in unnecessary additional cost to preparers. As the Exposure Draft points

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out, companies would still be allowed to terminate a derivative instrument designated in a hedging relationship and immediately enter into a new identical derivative.

- Paragraph 14 of the Exposure Draft states that adding a new derivative to an existing hedging relationship that does not offset an existing derivative and does not reduce the effectiveness of that relationship would not be deemed a dedesignation. While this appears to be intended to accommodate dynamic hedging strategies, it is not entirely clear since it does not address other aspects of those strategies, such as the removal or offset of one of the hedging instruments to increase the overall effectiveness of the hedging relationship. We believe that dynamic hedging strategies should be eligible for hedge accounting and recommend that the Board clarify the guidance accordingly.
- The Exposure Draft also proposes certain additional amendments to FAS 133 that are unrelated to the objective of simplification. However, the intent of these other changes is not always apparent. For example, the purpose of removing the words "publicly traded" from paragraph 61(e) and changes to paragraph 13 of DIG Issue No. B16, Calls and Puts in Debt Instruments, are not explained. We believe each of these changes should be brought to constituents' attention and explained to ensure that the implication of the change is understood and appropriately considered upon adoption of the final standard.
- Paragraph 27 of the Exposure Draft provides for the measurement of ineffectiveness on a cash
  flow hedging relationship using a derivative that would settle in a reasonable time relative to the
  hedged cash flows, provided that differences between the forward rate on that derivative and the
  forward rate on derivatives that would exactly offset the hedged cash flows are minimal. We
  recommend that the reference to "minimal" be replaced with "de minimus" in this paragraph to
  better convey the intent of the guidance. Furthermore, the Board may wish to consider clarifying
  that the guidance may be applied to both forward and option-based hedging strategies.
- The Exposure Draft states that a hedging instrument may be considered effectively terminated when an offsetting derivative instrument is entered into. However, it is unclear how differing counterparty credit risks in the "offsetting" derivative instruments should be considered in determining whether they offset and are thus terminated. We suggest the Board consider clarifying the impact that different counterparty credit risk may have on determining whether a derivative instrument has been terminated with an offsetting instrument.
- One area of complexity and diversity in practice that is not covered in any of the proposed amendments to FAS 133 relates to the calculation of the change in a hedged item's fair value attributable to changes in the benchmark interest rate for a specific period in a fair value hedge. This is especially challenging where the derivative and hedged item are not naturally effective, such as when a debt instrument has been issued at a substantial discount. Currently, a particular method for calculating the change in a hedged item's fair value attributable to changes in the benchmark interest rate is not prescribed. If the Board retains the bifurcation by-risk hedge accounting model as we have recommended, it would be helpful if the Board would address this area of confusion in practice, perhaps by providing examples of how to perform this calculation.