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LETTER OF COMMENT NO. 118

Mr. Russell G. Golden Director of Technical Application and Implementation Activities Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116 19 August 2008

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

Dear Mr. Golden:

We appreciate the opportunity to comment on the aforementioned proposed FASB Statement, Accounting for Hedging Activities, an amendment of FASB Statement No. 133 ("ED" or "proposed Statement"). While we support the Board's efforts to clarify and simplify the accounting for hedging activities, we do not believe that this ED accomplishes those objectives. Because the ED proposes such a sweeping change to the current hedge accounting model for interest rate risk, disallowing hedging by risk subcomponent, we do not believe that the approach proposed by the ED would achieve the Board's objectives of reducing complexity. The ED is based in part on the concept that, ultimately, reduction of complexity is harmonious with a "full fair value for all financial instruments" model. But this ED still preserves the mixed attribute model, only moving incrementally toward a full fair value model for all financial instruments.

As long as the Board maintains a mixed attribute model and permits hedge accounting, we urge the Board not to make complex, and likely temporary, changes to the hedge accounting model. The more sweeping proposals in the ED should instead be vetted through a joint FASB and International Accounting Standards Board ("IASB") project aimed at the appropriate conceptual model for hedging activities. We do support the proposed effectiveness requirements of paragraphs 6-12, and paragraph 27, because we believe these paragraphs represent clear improvements that will help facilitate convergence with International Financial Reporting Standards ("IFRS").

Hedging-by-financial-risk-components, which this ED proposes to virtually eliminate, is a fundamental component of hedge accounting under IFRS and the ED would introduce significant new divergence from IFRS. The IASB just recently affirmed the ability to designate a portion of the cash flows or fair value of a financial instrument as a hedged item in an amendment to IAS 39, *Financial Instruments - Recognition and Measurement* ("IAS 39"), which is effective for annual periods beginning on or after July 1, 2009. As it stands today, companies would potentially have to implement changes to derivative accounting two more times: first to the proposed Statement, and then to IAS 39. Companies understandably would have difficulty supporting the significant effort required to comply with the hedging changes in the ED, as currently drafted, if it is to have a short life span before a possible adoption of IFRS. Ultimately, we believe that the FASB should jointly participate with the



IASB in a financial instruments project that would develop a more permanent high-quality converged hedging standard.

We understand that the prohibition of hedging by benchmark interest rate component is intended to address users' desires for information on unhedged risks while fair value and cash flow hedge accounting is still permitted. For fair value hedges, that information is already provided in the disclosures. Furthermore, FASB Statement No. 161, Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No. 133 ("Statement 161"), will vastly improve the transparency of information on how derivatives and related hedged items affect an entity's financial position, results of operations, and cash flows when it becomes effective in the near future. Statement 161 should be given a chance to work to serve users' purposes for now, leaving the larger question of how to deal with hedge accounting in a joint project with the IASB.

We also disagree with the ED's proposal to eliminate the ability to execute cash flow hedges of intercompany royalties in consolidated financial statements, which we believe the 1998 Board clearly intended to permit in Statement 133, paragraphs 469-471. We are unsure of the genesis of this proposal as it was never discussed in a public meeting, and, accordingly, was never afforded the usual deliberation that accompanies most proposed practice changes.

Finally, we disagree with the proposal that would eliminate an entity's ability to remove the designation of an effective hedging relationship after it has been established. We do not understand the reasoning behind this change as it seems inconsistent with the principle of Statement 133 that hedge accounting is elective and a privilege for which one must qualify.

We believe that the lack of a clear majority for this amendment is indicative that this project may have gone too far, too fast, especially considering its potentially short shelf life if constituents are required to move to IFRS within the next few years. We believe that the Alternate View provides very effective reasoning as to why this ED does not hold together as a cohesive and comprehensive vision for moving Statement 133 forward into a less complex model. Accordingly, we believe that, if this project is moved forward, it should be abridged to retain only the following elements:

1. The new hedge effectiveness requirements of paragraphs 6-12, and paragraph 27. We believe these paragraphs reinforce the flexibility of hedge effectiveness assessment methods that were always present in Statement 133. These paragraphs would reduce and perhaps eliminate the need for companies to devote a disproportionate amount of resources to perform quantitative statistical analyses such as regression to prove the effectiveness of relationships that can be easily assessed qualitatively with a minimum amount of financial intuition. "False" hedge failures caused by the "small numbers phenomenon" when dollar offset is the method of assessing hedge effectiveness have contributed to the perception that Statement 133 can produce illogical results. ED paragraphs 12 and 27 are very helpful for practically dealing with slight timing differences that we had always believed original paragraph 63 adequately addressed, and these paragraphs would be very helpful to constituents. We are not particularly concerned that the Board has not defined "reasonably effective," and we hope that regulators and others would not seek to assign a specific mathematical range. We believe that hedgers are motivated by their own self-interest to construct hedge relationships that would be considered "highly effective,"



and we don't believe a relaxation of the standard would promote the proliferation of poor hedge designs that would place pressure on the need to define "reasonably effective."

- 2. The elimination of the short-cut method. The short-cut method is non-operational as long as the Board believes it must continue to include paragraph 68(e) in the guidance, which can always undermine any well-intentioned application of the short-cut method, allowing it to be second-guessed. With respect to elimination of the term "critical terms match," we do not necessarily object, given the mythology that has developed over time that somehow "critical terms match" was an explicit "method" that allowed an inappropriate assumption of no ineffectiveness. We do not believe that Statement 133 ever created such a methodology, and we always believed that a critical terms match approach was illustrative of an acceptable qualitative analysis, and we believe this ED will allow a similar qualitative approach. We note that ED paragraphs 9, 10, and 12 essentially preserve "critical terms match" concepts without using those words.
- 3. The elimination of Methods 1 and 3 from Statement 133 Implementation Issue G7 ("Issue G7") on permitted methods to measure the ineffectiveness of cash flow hedges. (We note that the staff proposes to supersede Issue G7 in its entirety, yet ED paragraph 23 essentially preserves Method 2 of Issue G7.) We agree that complexity would be reduced, and compliance with the documentation requirements of EITF Topic D-102 automatically enhanced, if entities were required to use the same method for measuring cash flow hedge ineffectiveness. The majority of constituents already use this method. The ED needs to clearly emphasize a commonly misunderstood point—that the correct hypothetical derivative originates with the hedge inception with a transaction price of zero, and that the hypothetical derivative can change over time as the expected timing and amounts of the hedged cash flows also change.

We do not support the remainder of the ED, and the remaining sections of the letter provide further elaboration.

Elimination of Ability to Hedge Individual Financial Risks

Statement 138 amended Statement 133 before it went effective to permit hedging of the benchmark rate in both fair value hedges and cash flow hedges. Statement 138, in our opinion, was largely responsible for removing significant complexities that would have occurred had Statement 133 been issued in its original 1998 form. This ED would reinstate many of the original complexities that confronted preparers before the Statement 138 effort in 1999-2000.

We do not believe the Board has justified why the assessment of the success or failure of a hedge relationship should not be based on how well the hedge accomplished what management designed the hedge to accomplish. By disallowing a bifurcation-by-risk approach and requiring companies to assess the effect of the *entire* change in fair value of the hedged item or the forecasted transaction, the ED significantly increases the operational challenges and complexities of measuring ineffectiveness, introduces more subjective interpretations in applying hedge accounting, and thus creates significant inconsistencies in the financial statement reporting between those entities that pursue hedge accounting and those that do not.



We believe that any effort on the part of FASB or of the IASB to address reduction of complexity for financial instrument accounting and derivatives must address a practical and rational way to deal with non-performance risk under Statement 157, Fair Value Measurements. Non-performance risk is the primary unhedged risk that this ED seeks to introduce as new ineffectiveness in financial hedges. When that non-performance risk is the issuer's own non-performance, there is not a derivative available in the marketplace that a counterparty would be willing to provide to a hedger, due to the "moral hazard" consideration mentioned in the Alternate View. The complexity of measuring non-performance risk is already proving to be problematic since the adoption of Statement 157 and this ED would just amplify the difficulty, spotlighting what is not being hedged (credit risk). We believe that users understand that credit risk, whether that of a third party or of the hedging entity, is rarely managed with derivatives.

For hedge relationships to work, under any standard, one must be able to expect that the derivative cash flows will occur as intended by the contract and the cash flows associated with the hedged item will also occur; in other words, that the non-performance risks, while present, are negligible. This principle is currently fundamental to Statement 133 and all hedgers should continue to be required to make such an assessment and constantly monitor it. Accordingly, we suggest that for all hedging activities, consideration of non-performance risk be at an overall comprehensive and largely qualitative level, and that if "passed," is not required to be included in the ongoing assessment of hedge effectiveness for any hedge, fair value or cash flow. Requiring the ongoing effect of changes of credit risk on the assessment of hedge effectiveness, while both elements of the hedge relationship are still within the spectrum of a high expectation of performance overall, is infinitely more complex, and arguably, of questionable benefit relative to the cost.

With respect to fair value hedges, non-performance risk associated with the derivative will never correlate with the non-performance risk associated with the hedged item. The credit risk exposure is fundamentally different for a "two-way" derivative than a "one-way" hedged item, which is why the all-in fixed rate of a interest rate swap will never match the fixed-rate of the hedged financial instrument, a truism noted in paragraph 69 of Statement 133. We have never believed that these unavoidable differences constitute hedge "ineffectiveness," yet a tremendous amount of resources are devoted in "long- haul" applications to capturing this "ineffectiveness," in an attempt to comply with paragraphs 120A-D of Statement 133. We advocate that the Board consider how IAS 39 accommodates hedging portions of risk, because IAS 39 avoids some of the complexity of Statement 133 by merely requiring that the portions of risk being designated as "the hedged risks" be separately identifiable and reliably measureable. Converging with the current IAS 39 model for partial risk hedging would also alleviate the complexities introduced by the removal of the short-cut method.

Our views on this topic are repeated in our answers to Issues #1 and #11 in the Notice to Recipients in Appendix I to this letter. Furthermore, in Appendix II to this letter, we illustrate how the requirement that non-performance risk be included in the commonly used cash flow hedge strategy of the forecasted issuance of debt can result in the reporting of phantom gains or losses, followed by the reversal of such phantom gains and losses through reclassifications out of OCI. We believe this illustration reinforces the 1998 Board's decision to treat "overhedges" and "underhedges" differently.



Intercompany Foreign Currency Cash Flow Hedges

The ED seeks to clarify that cash flow hedges of foreign currency exchange risk associated with forecasted foreign-currency-denominated intercompany royalty revenues are only permitted to the extent that the forecasted royalty revenues affect the income statement of the reporting entity. This decision would effectively disqualify cash flow hedge accounting for forecasted foreign-currencydenominated intercompany royalty revenues in consolidated financial statements, which is the only level of financial statements for which constituents seek such accounting. We question whether the Board's decision in this ED has been consistent with its original decision to permit such a hedged transaction in Statement 133. It is our understanding of the Board's original decision (as described in paragraphs 469-471, and 481-484 of Statement 133's Basis for Conclusions) that explicit linkage or a "direct, substantive relationship" between the costs incurred and the recovery of those costs from the third party is not required when hedging forecasted intercompany foreign currency transactions, because a forecasted intercompany transaction that is expected to be denominated in a foreign currency can be viewed as giving rise to the same kind of foreign currency risk as an intercompany transaction that is denominated in a foreign currency. A royalty payment effectively represents an actual transaction (as opposed to an internal allocation) between intercompany entities that combine the effect of an intercompany sale that is eventually replicated with a thirdparty and an intercompany expenditure (such as payroll) that also is eventually replicated with a third-party, and we believe the Board specifically intended consolidated financial statements to be afforded cash flow hedging of intercompany royalties.

We ask the Board to redeliberate the issue of hedging intercompany royalty streams, given this has not been a perceived practice problem and, in contrast to the ED's declaration in paragraph A38, appears to be working exactly as intended in Statement 133's original basis for conclusions.

De-designation of a Hedging Relationship

We are unaware that voluntary de-designations have ever been a practice problem, the source of diversity of applications, an issue with auditors and regulators, or an instance of abuse. Many dedesignations that the Board may believe are voluntary are not. We often see dynamic hedging strategies of portfolios of loans held for sale. Often these hedges are de-designated and redesignated every day. However, Statement 133 requires such de-designations if even one loan in the portfolio pays off or is sold, or if one new loan is added to the portfolio. We do not understand why the Board believes that voluntary de-designations can be used for "managing the classification of certain items reported in earnings." Any de-designation, voluntary or required, cannot possibly anticipate either the direction or amount of change in fair value of the derivative thereafter. The Board's reasoning here also seems inconsistent with the reasoning in paragraph A25 that would permit late term fair value hedges "in order to give preparers more flexibility to respond to changes in their evaluation of risks."

As the ED acknowledges, any entity can achieve a de-designation under the proposed guidance simply by terminating the derivative, and likely incurring an otherwise unnecessary transaction cost if the derivative could have been used in another hedging capacity, either formally designated or economic. We cannot perceive what benefit this new rule would provide to financial reporting that would exceed the cost.



We appreciate the opportunity to offer our comments, and we would be pleased to discuss these issues in more detail with the Board or staff at your convenience. In addition, Appendix I offers specific responses to the questions posed in the "Notice to Recipients."

Sincerely,

Ernst + Young LLP

We offer the following comments in response to each of the issues identified in the Proposed Statement's Notice for Recipients:

Issue 1: For the reasons stated in paragraph A16 of this proposed Statement, the Board decided to eliminate (with two exceptions) the ability of an entity to designate individual risks as the hedged risk in a fair value or cash flow hedge. As a result of that change, the financial statements would reflect information about the risks in the hedged item or transaction that an entity both chooses to manage and not to manage as part of a particular hedging relationship.

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?

As discussed in our letter, prohibition of bifurcation by financial-risk would not simplify hedge accounting; rather, it would increase operational complexities for preparers and introduce more opportunities for inconsistent interpretations of hedge accounting.

Issue 2: For the reasons stated in paragraphs A18-A20, the Board decided to continue to permit an entity the ability to designate the following individual risks as the hedged risk in a fair value or cash flow hedge: (a) interest rate risk related to its own issued debt (that is, its liability for funds borrowed), if hedged at inception, and (b) foreign currency exchange risk. For those two exceptions, the financial statements would not reflect information about the risks that an entity chooses not to manage as part of a particular hedging relationship.

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

As we have stated earlier, we do not understand how having the financial statements reflect information about the risks that an entity chooses not to manage provides better information for users to understand the effectiveness of management's hedging strategies. However, if our views are not adopted by the Board, we would support these two exceptions.

Issue 3: This proposed Statement would eliminate the shortcut method and critical terms matching. Therefore, an entity would no longer have the ability upon compliance with strict criteria to assume a hedging relationship is highly effective and recognize no ineffectiveness in earnings during the term of the hedge. As a result, when accounting for the hedging relationship, an entity would be required, in all cases, to independently determine the changes in fair value of the hedged item for fair value hedges and the present value of the cumulative change in expected future cash flows on the hedged transaction.

Issue 3/Question 3a: Do you foresee any significant operational concerns or constraints in calculating ineffectiveness for fair value hedging relationships and cash flow hedging relationships?

Issue 3/Question 3b: 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?

For reasons mentioned in our letter, we generally support the Board's decision to eliminate the shortcut method and references to "critical terms matching" in the literature, but only if hedging by risk components is preserved. We continue to believe that observing the extent to which critical terms of the hedging instrument and the hedged item continue to match, or no longer continue to match, are important elements to any qualitative analysis of an economic relationship to determine if it is "reasonably effective." We support the general statement that an entity should independently determine the changes in fair value of the hedged item for fair value hedges and the present value of the cumulative change in expected future cash flows on the hedged transaction. However, we also agree that the operational challenges cited by the Alternate View are substantial, particularly for cash flow hedges.

Issue 4: This proposed Statement would modify the effectiveness threshold necessary for applying hedge accounting from highly effective to reasonably effective at offsetting changes in fair value or variability in cash flows. Do you believe that modifying the effectiveness threshold from highly effective to reasonably effective is appropriate? Why or why not?

We support this modification for the reasons cited in our letter.

Issue 5: This proposed Statement always would require an effectiveness evaluation at inception of the hedging relationship. After inception of the hedging relationship, an effectiveness evaluation would be required if circumstances suggest that the hedging relationship may no longer be reasonably effective.

Issue 5/Question 5a: 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?

We do not foresee any significant operational concerns for constituents to create processes that will determine when circumstances suggest a hedging relationship may no longer be reasonably effective.

Issue 5/Question 5b: 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 believe the hedge effectiveness requirements of the Proposed Statement would result in a reduction in the number of times hedging relationships would be discontinued, but we believe this is a favorable development. We expect that the proposed effectiveness requirements would virtually resolve the "the law of small numbers" issue, which can occur during periods where the underlying to the hedge relationship is momentarily stable. Many companies today using dollar offset assessment methodologies sometimes must terminate their hedge relationships during these periods of stability, even though the economic relationship of the hedge and hedged item remain strong.

Issue 6: The Board considered but decided against eliminating any assessment of effectiveness after the inception of the hedging relationship. The Board believes that eliminating such an assessment of effectiveness could result in the continuation of hedge accounting even when situations suggest that the hedge relationship may no longer be reasonably effective. Some observe that an implication of the decision to not eliminate any assessment after the inception of the hedging relationship could be that hedge accounting results would be reflected in some reporting periods and not in other reporting periods throughout the life of the relationship. Also, in a hedge accounting model that generally does not permit hedging of individual risks, changes in the relationship between the individual risks being managed and those not being managed could increase the likelihood that the hedging relationship would no longer be reasonably effective. That would result in hedge accounting no longer being permitted for a portion of an expected hedge term. That "in and out" of hedge accounting would make it more difficult for users to interpret financial statements.

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 support the Board's decision to continue to require a reassessment of hedge effectiveness after inception if circumstances suggest that the hedging relationship may no longer be reasonably effective. Because a hedge must be expected to be reasonably effective over the life of a hedge relationship, and circumstances may change throughout the life of a hedge relationship that may affect its effectiveness, a subsequent reassessment of hedge effectiveness should be performed to ensure the hedge continues to be reasonably effective. In addition, we agree with the Board that hedge accounting should be discontinued if a hedge becomes ineffective.

Issue 7: In the statement of operations, Statement 133 does not prescribe the presentation of gains and losses associated with hedging instruments, including the effective portion, the ineffective portion, and any amounts excluded from the evaluation of effectiveness, such as forward points. Some have suggested that such a prescription would improve financial reporting by creating consistency in the presentation of these amounts across all entities. Others observe that FASB Statement No. 161, Disclosures about Derivative Instruments and Hedging Activities, requires disclosure about that information, and they question whether a prescriptive approach is appropriate given the diverse hedge accounting strategies employed by entities.

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 at this time that Statement 133 should be amended to prescribe the presentation of gains and losses associated with hedging instruments, given the imminent application of Statement 161. Depending on how satisfied the user community is with the Statement 161 disclosures, a prescriptive approach may be worth deliberating at a future time.

Issue 8: The Board's goal is to issue a final Statement by December 31, 2008. The Proposed Statement would require application of the amended hedging requirements for financial statements issued for fiscal years beginning after June 15, 2009, and interim periods within those fiscal years. Do you believe that the proposed effective date would provide enough time for entities to adopt the proposed Statement? Why or why not?

We do not believe the proposed effective date would provide sufficient time for companies to adopt the Proposed Statement if the prohibition of hedging by financial risk components is maintained because of the operational challenges noted by the Alternate View in constructing a hypothetical derivative to address unhedged non-performance risk. We do believe that if an abridged version of this ED is issued as we have recommended, the proposed effective date is viable.

Issue 9: The Board did not prescribe any specific transition disclosures upon the adoption of this Statement. Do you believe that there are specific disclosures that should be required during transition? If so, what? Please be specific as to how any suggested disclosures would be used.

We do not believe that there is a need for specific disclosures that should be required during transition.

Issue 10: The Board decided to permit an entity a one-time fair value option election under FASB Statements No. 156, Accounting for Servicing of Financial Assets, and No. 159, The Fair Value Option for Financial Assets and Financial Liabilities, for (a) servicing assets and servicing liabilities designated as a hedged item on the date immediately preceding initial application and (b) eligible financial instruments designated as a hedged item on the date immediately preceding initial application of this Proposed Statement.

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?

If the Board goes forward with its plan to prohibit hedging by financial risk components, we do believe it appropriate to allow a one-time fair value option at the initial adoption of this Proposed Statement. However, in the more abridged version of the ED that we are recommending, a one-time fair value option may not be necessary.

Issue 11: The objective of financial reporting is to provide information that is useful to present and potential investors, creditors, donors, and other capital market participants in making rational investment, credit, and similar resource allocation decisions. However, the benefits of providing information for that purpose should justify the related costs. The benefit-cost considerations considered by the Board are provided in paragraphs A43-A50 in Appendix B of this proposed Statement.

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?

We believe the Board has overestimated the benefits to financial reporting and underestimated the costs to construct hypothetical derivatives that capture non-performance risk. As we stated in our letter, we believe the financial statements should report the effectiveness of the hedge that management is attempting, rather than a hypothetical construct. We believe this principle facilitates comparisons among entities, particularly after Statement 161's beneficial disclosures go into effect. We question the benefit provided to financial reporting by requiring the statement of earnings to reflect the risks that are not managed or transformed by derivatives, particularly when such risks are generally not reported by entities that do not attempt formal hedge accounting.

This past year has seen credit spreads of highly rated companies narrow and expand in highly volatile movements, while still remaining highly credit-rated. In hedges of forecasted debt issuances, changes in the hedging entity's own credit risk during the anticipatory period between the entrance into the hedging instrument and the issuance of the debt is the primary risk the ED would require the entity to reflect as hedge ineffectiveness, assuming it qualified in the first place under the "reasonably effective" criteria, given the volatility of such spreads.

As the Alternate View points out, the hedging entity is unable to enter into a derivative to hedge changes in its own credit risk. The ED would have the entity measure the unhedgeable effects of changes in its credit spread (plus other timing risks such as changes in the supply/demand dynamic for corporate debt) during the anticipatory period leading up to the debt issuance, recording a debit in the income statement and credit in other comprehensive income ("OCI") as its credit spread widens (worsens), and a credit in the income statement and debit in OCI as its credit spread narrows (improves).

How would this model actually work? In the scenario of a widening credit spread between hedge inception and debt issuance, a hypothetical credit derivative (used in combination with a benchmark interest rate derivative) would have produced a gain (which is why the ED requires a credit to be reported in the income statement). But because the hedging entity did not (and, in actuality, could not) use such a credit derivative, the entity reports a loss in the income statement. Over time, which may mean a period of up to 30 years for long-term debt, the hedging entity will recycle the gain out of OCI into the income statement as a reduction of interest expense, effectively reversing the loss reported years earlier during the anticipatory period. Of course, it was never a "real" loss. It was always a "phantom" loss, and, therefore, "phantom" gains must be reported such that the cumulative effect to retained earnings, at the end of 30 years will eventually correctly reflect zero. Interest expense will effectively be "wrong" for those 30 years, reflecting the hypothetical effect of a derivative that was never actually used, and a gain that was never actually realized, and for a period long past when the initial accounting will be remembered. Paragraph A30 of the ED states that "there is no conceptual basis for providing special accounting for cash flow hedges other than achieving a synthetic instrument accounting result." Without entering into that debate, we challenge how the proposed new cash flow hedge model is not worse from a conceptual viewpoint.

What new information does the proposed cash flow hedge model provide? The income statement now reports the effect of the credit spread movement between hedge inception and debt issuance and the all-in interest expense that the hedger could have and would have experienced had the user actually been able to use a credit derivative to hedge its own non-performance risk. In fact, the hedging entity will report a reduced interest expense for the next 30 years as if it really had used such a credit derivative. However, because the hedging entity really did not use such a derivative, it reports a loss during the anticipatory period. While this is interesting information from a retrospective perspective, we question how useful this information is for users of the financial statements to project future cash flows. With respect to existing financial items, the credit risk component of the fair value of such financial instruments does have informative value in the sense that it is indicative of the "replacement risk/reinvestment risk" of that instrument should the instrument, whether it be an asset or a liability, be extinguished. However, with respect to a forecasted issuance of, or investment in, a financial instrument, that same informative value is not present. It does not even reflect on the astuteness of management for making a decision to hedge or

not hedge non-performance risk, because no one will provide a derivative to management to even allow them to hedge their non-performance risk if they wanted to.

We believe our simple example illustrates the wisdom of the decisions made originally in Statement 133 to create a different construct for cash flow hedging, and to treat overhedges differently from underhedges. Overhedges, where the derivative's actual fair value movements exceed those of the hedged cash flows, produce true, current unrealized gains or losses from actual instruments, reflect actual cash flows, and such ineffectiveness should be reflected in the income statement. Underhedges, as our examples illustrate, create phantom gains and losses that in theory represent lost opportunities. Such information is of questionable forward-looking benefit to the user, and does not seem to represent meaningful information with respect to management's performance from a backward-looking perspective.

We also agree with the Alternative View's arguments that the cash flow hedge model that does not allow financial component hedging is not operational, but we wanted to present a different argument that challenges the reasoning for drafting the proposed model in the first place. We do believe that because of the operational challenges laid out so well by the Alternate View, the ED if finalized would likely lead to the end of anticipatory debt issuance hedging, probably the most common hedging strategy used in the United States.