20725 Valley Green Drive Cupertino, CA 95014 Direct: (408) 350-8580 Fax: (408) 350-8399 www.hedgetrackers.com



Russell G. Golden, Director Technical Application & Implementation Activities FASB 401 Merritt 7 PO Box 5116 Norwalk, CT 06856-5116

File Reference No. 1810-100

Dear Mr. Golden:

Thank you for the opportunity to participate in the process of reviewing and amending ASC 815 Accounting for Derivative Instruments and Hedging Activities. Since its initial adoption – and through subsequent years of interpretive guidance – special hedge accounting has remained a challenge for both practitioners and their accounting advisers. We applied both your outreach and intention to simplify hedge accounting, to improve compliance and to make financial reporting of hedge activities useful and transparent.

Hedge Trackers, LLC is a derivative accounting advisory practice and provider of derivative accounting outsourcing services. Since 2000 we have served 400 companies. Our clients generally execute plain-vanilla option or forward type contracts to protect their margins from currency, interest rate or commodity price fluctuations. The majority of our clients do not consider currency, interest rate or commodity risk core to their operations, but rather an input whose volatility requires management. Our reactions and responses to the proposed update reflect both our experience as a service provider and our understanding of our clients and their hedging requirements.

All of our comments are directed to the updates of ASC815 "Derivative Instruments and Hedging Activities". The proposed guidance provides greater flexibility and simplicity in establishing hedge relationships and appropriately focuses efforts on calculating and properly recording derivative gains and losses. We remain concerned with the proposal to report gains and losses on anticipated transactions in earnings. Overall, we believe the implementation guidance requires more details on practical application of both existing and proposed rules. Below please find our comments on areas in which we have a special interest, followed by responses to questions posed by the Board.

Specific Areas of Interest:

1. Hedging of Intercompany Transactions: The exposure draft did not mention intercompany currency hedging. We believe the FASB should 1) affirm that companies may hedge non-functional currency transactions that do eliminate in consolidation, perhaps inserting an additional requirement that the long/short currency position of the hedge be reflected in 3rd party transactions on the consolidated level or 2) offer a



functional currency election holiday. An overwhelming majority of US foreign subsidiaries are local currency functional. How that came to be is less important than the fact. A US corporation with costs in currency A, and sales through local functional subsidiaries in currency B would be senselessly exposed to currency risk in reported margin without the timing and geography benefits of hedge accounting. Similarly exposed are corporations with costs in currency C at local functional currency subsidiaries and sales through parent or sister companies in Currency D. In paragraph 482 of the originally issued FAS133, the Board recognized that selling to 3rd parties through intercompany subsidiaries were "in substance, direct foreign export sales" (noticeably missing from the ASC 815 are paragraphs 482-487 of FAS 133 outlining the interaction of derivative accounting and currency transaction accounting).

Mark to market accounting is untenable for US corporations intent on protecting margin exposed to currency risk. Corporations require the ability to 1) hedge non-functional intercompany currency transactions, or the ability to 2) change subsidiaries to USD functional (via a functional currency election holiday). Without hedge accounting, corporations with currency risk will be forced to choose between prudently hedging margin, while appearing imprudent as hedge gains and losses whipsaw earnings and ignoring the risk to cash flows from sales and costs commitments in differing currencies.

Current practice, paragraphs 482-487 and miscellaneous DIGs clearly permit the use of non-functional currency intercompany transactions as a proxy for hedging margin arising from consolidated 3rd party currency transactions. There has been some discussion that the FASB perceived the 2008 language precluding intercompany hedging as a clarification. We believe that any revival of the 2008 language would not be a clarification. A clarification would not provide transition provisions. A clarification would suggest existing broad based practice is incorrect and innumerable restatements may be necessitated. Abolishing forecasted intercompany transactions that eliminate in consolidation as a hedged item would be a change in risks eligible to be hedged. The update specifically stated in paragraph 111 a. "The types of items and transactions that are eligible for hedge accounting in Topic 815 would continue."

We recommend the FASB affirm hedging of anticipated intercompany activity as an elibible hedged item for designation under ASC815. Inserting additional language requiring a 3rd party exposure to the currency pair on a consolidated basis may allay the unspecified concerns of Board Members.

2. Question 56 - Limited Effectiveness Testing: We believe that eliminating short-cut and match term treatments together with eliminating burdensome statistical analysis substantially reduces restatement risk, meeting the objective of consistent special hedge accounting treatment. The implementation guidance provided in both the ASC and the proposed update has inadequate examples of measuring effectiveness in highly effective, but not perfectly effective relationships. Please provide real examples across



risk categories that include appropriate strategies for estimating forward pricing on exposure inputs that are illiquid and not publically available.

We strongly support including the discussion in BC219 in the final update. This will be a reminder to regulators and auditors that reasonably effective testing is most appropriate when there is concern that hedge accounting may be misapplied in cases where there is little or no reason to assume a reasonable offset in the relationship.

3. Question 61 - Recording Overperformance of Hedged Item: FAS133 originally distinguished between the earnings effects of firm commitments and anticipated transactions. We are surprised to find the FASB recommending the recording of gains & losses on anticipated transactions in earnings; a result of recognizing the underperformance of a derivative in a hedge relationship. We remain convinced that recording only the effective change in a derivative in OCI is appropriate but recognize that this may not be viable when coupled with the reduced effectiveness requirements.

We are very concerned about the substantial increase in audit fees and possible Type 3 valuation disclosures that may be a natural extension of the need to support the earnings and OCI effects of commodity or other "overall" change in cash flow hedges where the underlying is often impacted by noisy, illiquid and non-transparent components of the change in value. We recognize this dramatic shift in approach results from the move to permit reasonably effective relationships to qualify for hedge accounting. The current structure limiting earnings impacts to overperformance of the derivative would likely lead hedgers to routinely designate substantially larger underlyings, thereby ensuring the derivative would never outperform the underlying. Note that a substantially larger underlying would still need to meet "probable" guidelines and would generally result in a substantially reduced risk of overhedging, which is not necessarily a bad thing.

The cost of recording overperformance of the hedged item only intensifies the need for the Board to offer bifurcation of risk for exposures that are separately identifiable.

4. Option Amortization: Please provide an example of the requirement to amortize the option premium "in a rational manner". Please confirm that in an include time value 6-month currency option a corporation would first record the cash and derivative asset values. At each subsequent month end, the change in the derivative fair value would be recorded to the balance sheet and the P&L. The effective change from a hypothetical option* would be recorded in OCI & P&L. In addition 1/6th of the option premium inception value would be recorded in P&L and OCI (not appropriate to adjust fair value). If this logic is extrapolated to a 6-month cap, would the premium amortization for that cap at the end of first month equal 1/6th of the 6th month caplet, 1/5th of the 5th month caplet, 1/4th of the 4 month caplet, 1/3rd of the 3 month caplet, ½ of the 2 month caplet plus the first month caplet?

*assume a different inception value and different change in the hypothetical derivative



5. Voluntary Dedesignation: Paragraph 121 suggests that rather than dedesignations and redesignations, changes in a hedge relationship might be addressed by amendments or "updates" to the inception documentation. Modification of the critical terms of a hedging instrument would generally be considered a de/redesignation event currently. Please distinguish between circumstances that would result in (involuntary) dedesignation of a hedge relationship and those circumstances that would require an amendment to inception documentation. Please consider providing an example of using an underlying borrowing with 1M, 3M and 6M Libor offerings.

Given diversity in interpretation please consider clarifying ASC 815-20-25-35 as follows: "If two separate hedges are designated, the cash flow hedge **relationship** would terminate (that is, be dedesignated as **qualifying criteria are no longer met**) when the hedged sale or purchase occurs and the foreign-currency-denominated receivable or payable is recognized." (Suggested additions in bold.) This would clearly communicate that voluntary dedesignation would not be required for cash flow hedges of sales or purchases on credit.

Please elaborate with illustrations how hedged item definitions might be used to limit the term of a hedge relationship where both an economic exposure continues and the derivative continues, yet the hedge relationship qualifying criteria are no longer met. Would inception documentation detailing the relationship between the derivative and hedged item as limited to 3-months result in dedesignation and no longer qualify for hedge accounting treatment at the 3-month date. If not, how should net investment hedgers dedesignate and redesignate debt balances or long dated derivatives to meet the H7 requirement to quarterly designate the proportion of the net investment hedged? How should fair value hedgers designate a proportion of an exposure as being hedged, when that exposure is volatile (inventory)? How would groups of derivatives be designated as hedging a percent of total inventory? Currently in practice relationships are de/redesignated daily to maintain appropriate proportional relationships.

- 6. Certain Third Party FX Debt Revaluation to OCI: We applaud the recognition of foreign currency changes in value of 3rd party debt being recorded in OCI. Foreign currency debt even that held at the parent company is generally repaid with proceeds from foreign operations. Recording currency gains and losses in OCI supports this "natural hedge" relationship without forcing the parent to hedge the remeasurement gain/loss on the debt, thereby nullifying the economic hedge and necessitating cash flow hedges to re-establish the relationship between the debt and the revenue.
- 7. Bifurcation of Additional Risks: We would invite the FASB to reconsider the current inability to bifurcate separately identifiable commodity and other risks. We expect increased audit and regulatory scrutiny related to capturing the changes in fair value of un-hedged and generally un-hedgeable risks that make up the "overall"



changes in cash flows or fair value. This will be increasingly critical as the exposure draft changes amounts in OCI from overperformance risk in the derivative to the change in hedged item that will impact earnings when outperforming the derivatives. Disclosure numbers reflecting changes in forward rates associated with un-hedged risks, will be difficult to capture and will obfuscate rather than clarify the effectiveness of hedge activity. Level 3 disclosures describing internal "models" used to forecast future changes in unobservable inputs associated with hedged underlyings seem to be the next step.

Questions

56: Is modifying the effectiveness threshold from highly to reasonably effective appropriate?

A: See Item 2 above.

57: Should no effectiveness evaluation be required?

A: We concur with the limited effectiveness evaluations proposed to preclude abuses.

58: Would hedge relationships be discontinued less frequently if ongoing assessment were only required when circumstances warranted?

A: Yes. More importantly derivatives would be much less likely to fall out of hedge accounting for non-economic purposes.

61: Do you foresee significant operational concerns in calculating effectiveness for cash flow hedge relationships?

A: Yes. See Items 3 & 7 above. We anticipate substantial increases in audit and valuation fees (without economic return) associated with the spot, forward rates and volatilities associated with illiquid, non-transparent elements of hedged items, specifically those associated with "overall change" relationships. These valuations of hedged items, specifically Type 3 valuations will add substantially to the cost of hedging and provide nothing in return for the investor in terms of usefulness or transparency.

We also anticipate undue emphasis on the appropriate "date" within a month that most appropriately reflects the maturity of the perfectly effective hypothetical derivative in the periods leading up to the anticipated transaction. There will be no economic value to the company and no apparent value to investors if a specific day in a month must be validated and supported as "the date" for the maturity. The Board might consider expanding paragraph 126 to ensure that the maturity of the derivative representing the hedged item would not need to be revisited if the hedged transaction took place anytime within the appropriate fiscal month.

62: Do you foresee significant operational constraints in creating processes to identify when hedge relationships should be re-assessed?

A: No.



63: Do you foresee significant operational constraints if voluntary dedesignation prohibited?

A: Yes. See Item 5 above. There would be operational constraints for hedge relationships that are currently subject to periodic (daily, quarterly, etc.) re-designation to appropriately define the proportion that that the hedge or pool of hedges is hedging of a fluid exposure or pool of fluid exposures (inventory). We see no value to investors as a result of forcing a company into two market transactions when one piece of paper and no market transactions would accomplish the same objective.

64: Do you foresee significant operational constraints if compensating trades must be concurrently designated as such?

A: No.

68: Do you agree with the transition provision in this proposed Update? If not, why? A: The Board might consider an earlier effective date for provisions specific to hedge accounting.

Conclusion:

We appreciate the opportunity to share our thoughts on the proposed update. We would welcome the opportunity to provide practical examples and case studies from corporate portfolios to improve the quality of examples in the guidance, specifically around capturing and measuring ineffectiveness. We look forward to additional clarity and remain optimistic that the final standard will indeed simplify hedge accounting and provide additional clarity to users of financial statements.

Sincerely,

Helen M. Kane President Hedge Trackers LLC 408.350.8580

late the ten