

Richard J. Schlueter Vice President & Chief Accounting Officer

8000 West Florissant Ave. P.O. Box 4100 St. Louis, MO 63136-8506

T (314) 553 2327

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Technical Director Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116

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Dear Director,

We would like to take this opportunity to comment on the Discussion Paper, Selected Issues about Hedge Accounting (Including IASB Exposure Draft, Hedge Accounting).

Summary

Emerson is a diversified Fortune 200 global manufacturing company. We believe reducing complexity in hedge accounting is necessary to provide a clear picture of an entity's results of operations and financial strength. At this stage in the convergence effort, any new US GAAP standards should be fully convergent with IFRS and we appreciate the FASB's invitation to comment on the IASB's Exposure Draft on Hedge Accounting to help attain that goal. In our view, current US GAAP hedge accounting is overcomplicated and implies a level of precision that is not present or practical. We favor many elements of the IASB proposal because the foundation is more principles-based and less complex, thereby producing results comparable to the economic risks and conveying information that is easier for financial statement users to understand.

Our key comments regarding the IASB and FASB exposure drafts:

- Bifurcation of embedded derivatives for normal purchase and sales contracts should not be required for host contracts denominated in commonly used "hard" currencies, such as the US dollar and euro.
- Entities should be able to hedge individual, identifiable risks that can be reliably measured, such as a market-quoted commodity element of a contract, even when those risks are not contractually specified.
- Periodic hedge effectiveness assessments should not be required unless changes in circumstances suggest the hedge will no longer meet the "reasonably effective" or "other than accidental offset" criteria.
- Shortcut and critical terms matching methods are efficient, practical methods to qualify for and apply
 hedge accounting, and logically should be retained in any effort to simplify the accounting model, but the
 application should be relaxed.
- Dedesignation of a hedging instrument is a legitimate and cost effective risk management tool and should not be eliminated.
- New hedge accounting guidance, from either Board, should only be issued if fully convergent and with the full support of both the FASB and IASB.

Embedded Derivatives in Nonfinancial Host Contracts

As part of the effort to establish fully convergent international accounting standards, we believe it is imperative that the guidance under IFRS for commonly-used currencies in nonfinancial host contracts should be incorporated into future FASB deliberations on derivatives accounting. The IFRS rules are much more practical and reflective of worldwide market realities in that bifurcation of an embedded foreign currency derivative from its nonfinancial host is not required if contract payments are denominated in a "hard" currency commonly used in the environment in which the transaction occurs. However, we recommend this be made even clearer and the rule should presume that normal purchases and sales contracts involving highly-liquid stable currencies with readily determinable market values (e.g., U.S. dollars, euros and perhaps Chinese renminbi in the future), are not speculative and that these embedded derivatives need not be bifurcated and separately marked-to-market. A list of acceptable currencies would aid in consistent accounting treatment. This approach recognizes that it is common practice to conduct business in widely-traded hard currencies where exchange restrictions do not allow free trading of the local currency (e.g., China) or where the local currency is weak or volatile. With continuing economic globalization and constant shifting of cross-border sourcing by manufacturers, it is not surprising that business transactions are denominated in hard currencies acceptable to all parties even when they are not the functional currency of either party to the contract. Accounting for these non-speculative contracts at fair value prior to recording the sale or purchase adds a high degree of complexity not warranted by the substance of the arrangements. Additionally, bifurcation imposes an undue administrative burden on operations personnel, contract administrators and financial statement preparers, and we believe it does not improve financial statement users' understanding of financial performance.

Risk Management and the IASB Proposal

We support the IASB's proposal to base hedge accounting on an entity's actual risk management activities and how exposures are managed and impact the financial statements, and in general believe the IASB proposal is a superior starting point for reconsideration of hedge accounting rules. This principles-based approach will align hedge accounting with a company's real economic exposures, simplify disclosures so they are more meaningful to financial statement users and employ a more practical method to apply hedge accounting. However, we do not support the IASB suggestion to require discussion of a company's risk management strategy in the footnotes. The real value of this disclosure is management's insight into its most pertinent risks and how the company attempts to mitigate those risks. Relocating these disclosures to the footnotes will subject them to the auditor's opinion and our concern is that these insightful disclosures will become boilerplate in order to allay auditor reservations about opining on subjective matters. To retain their value, risk management disclosures should continue to be governed by the Securities and Exchange Commission and included in the Risk Factors or Management Discussion and Analysis sections of regulatory fillings.

<u>Hedged Items - Risk Components</u>

We strongly support the IASB proposal to allow entities to identify a component of an exposure as a risk eligible for hedging. Further, we do not believe a risk needs to be contractually specified to be separately identifiable and contractual specificity bears no relationship to the economic substance of the exposure. Businesses have always hedged real economic exposures and are generally not concerned whether the hedge "perfectly" offsets all potential variability. Many companies currently hedge economically but forego trying to qualify for hedge accounting because it results in earnings volatility that is not reflective of the underlying economics and produces less meaningful information for investors. Likewise, the complexity and burden to document the relationship just to qualify for hedge accounting can be prohibitive. Making hedge accounting available for separately identifiable economic elements of larger transactions would appropriately move economic hedging under the hedge accounting umbrella, providing practical benefits to preparers and better information for users. Hedge accounting should follow the economics of the transaction and the actual risks of the entity. Allowing hedge designation of identifiable component risks will accomplish that goal. A derivative may not exist that can hedge all of the potential cash flow variability of an item that contains a significant commodity component, but an entity will likely be able to enter into a derivative that will exactly

match the pricing variability that stems from the market price of that commodity. Hedge accounting is currently available for hedges of benchmark interest rate fluctuations for debt while the credit risk element is ignored for effectiveness purposes. There is no substantive difference in hedging the separate risk from benchmark interest rates and hedging the individual risk from quoted commodity or other identifiable prices. The IASB proposal is a more practical approach and we strongly support allowing companies to hedge individually identifiable risk components, even if they are not contractually specified when it is obvious the price of the product adjusts with the price of the commodity contained therein.

Hedge Effectiveness

Hedge effectiveness is a perfect example of where a practical, principles-based rule-making approach should be utilized. We agree with both proposals that assessment of effectiveness should be more qualitative rather than quantitative. If structured properly, the FASB's proposed modification of the effectiveness threshold from "highly effective" to "reasonably effective" could result in a more practical application of the hedging rules and lead to improved consistency over reporting periods. Likewise, the IASB focus on a hedge meeting an entity's risk management strategy and achieving "other-than-accidental offset" is reasonable and practical. However, we are concerned demand will remain, primarily from auditors, for quantitative "proof" a hedging relationship is truly reasonably effective under either proposal because the requirement to measure and record ineffectiveness each reporting period remains. Some hedging relationships will obviously meet the reasonably effective threshold and a qualitative assessment will suffice, but it will be difficult to avoid a quantitative assessment for those relationships that are less obvious or where auditors demand quantitative proof for work paper support.

Neither proposal goes far enough in reducing the significant burden of periodic effectiveness assessment. It seems inconsistent to propose an initial qualitative assessment for future hedge effectiveness and an "only if circumstances change" reassessment model, but continue to demand quarterly identification and recording of ineffectiveness. The requirement to measure and record ineffectiveness each period essentially demands a quantitative analysis, so there will be no true reduction in effort. And without a genuine reduction in effort, the accounting model is not simpler to apply and is not easier for users to understand. Likewise, the IASB proposal to "rebalance" hedging relationships and record ineffectiveness each reporting period does not ultimately reduce quantitative demands. The rebalancing requirement seems to contradict the goal and underlying principle of the proposal to remove bright-lines and simplify the accounting. We believe if an exposure exists and a qualitative assessment indicates hedging will be reasonably effective, then hedge accounting should be permitted without having to track and record quarterly effectiveness, provided the entity can demonstrate that a hedge of this type has historically been reasonably effective and is expected to continue to be reasonably effective in the future.

A way to simplify hedge accounting and effectiveness assessment would be to retain the shortcut and critical terms matching methods, but with relaxed adherence to the principle so that exact perfection in critical terms matching is not required. Under the IASB proposal, periodic quantitative assessment would not be necessary when using critical terms match or shortcut, as long as there has been no change in circumstances or risk management policy. In reality, unrealized gains and losses for effective hedges ultimately net to a near zero realized amount when the underlying transaction occurs and a simplified model would recognize this. There is great benefit, both in terms of operating efficiency and user understanding, to be obtained from a simple accounting model that does not reflect hedging gains or losses until the underlying transaction occurs (again, with the expectation of effectiveness). This simple model would in no way sacrifice accurate reporting of the entity's operating performance, but would avoid the costly effort to calculate hedge ineffectiveness at a level of precision that is neither meaningful in the interim nor necessarily accurate.

Both proposals suggest a potential method to calculate ineffectiveness could be using a "hypothetical perfect derivative." We want to reiterate that we strongly disagree with this overly-theoretical method. The difficulty in applying the hypothetical perfect derivative model, with its inherent quantitative precision, is not practical and the computational burden will quickly eliminate any benefit from a simplified hedge effectiveness model. Therefore, rather than the proposals simplifying the process, a hypothetical perfect derivative requirement would actually add unwarranted complexity and would provide no incremental benefit for financial statement

users. Any reasonable and consistently applied methodology should be allowed when measuring hedge ineffectiveness, if the standard will continue to require measuring and recording ineffectiveness quarterly (which we oppose).

Changes to a Hedging Relationship

The IASB proposal would require hedge accounting to be discontinued if the entity changes its risk management strategy, but does not allow "dedesignation" of a hedge. What constitutes a change in risk management strategy is not clearly defined in the proposal and that definition could be blurred, resulting in a de facto method of dedesignation. In its own proposal, the FASB acknowledged the ability to dedesignate and redesignate is economically the same as closing out an existing contract and entering into a new derivative, and that it provides for more efficiency by avoiding repeat transaction costs and complexity. In any final rules, if rebalancing is allowed or required to maintain a hedging relationship, dedesignation and redesignation also should be permitted if business reasons change. Ultimately, an entity should have a practical means to hedge risk exposures and the flexibility to reflect changes in circumstances. We reiterate that the accounting rules should reflect the economics of the transaction only, and play no part in determining an entity's risk management approach or the types of transactions used to achieve its risk management objectives. If there is a sound conceptual basis for a risk management technique it should be allowed, and this is clearly the case for dedesignation and redesignation.

Under-Hedging

Consistent with the IASB proposal, we also strongly believe changes in the value of the underlying exposure in excess of changes in the value of the derivative should not be recorded for cash flow hedging and disagree with the FASB's proposal to record under-hedged amounts. The principle should remain that the entire change in value of the derivative is recorded but ineffectiveness is limited to the extent that the change in fair value exceeds the change in the underlying. In substance, a derivative is one-hundred percent effective if the change in underlying is equal to or greater than the change in the derivative because the entire change in value of the derivative meets the risk management objective of offsetting (or partially offsetting) market price fluctuations. The intended focus of the accounting should be on the derivative, not the anticipated underlying transaction. Otherwise, as stated in paragraph BC131 of the IASB proposal, recording under-hedged amounts leads to recognition of gains or losses that often do not yet exist because they relate to forecasted transactions, and effectively results in interim earnings impacts from market price changes in executory contracts, which is neither practical nor useful. We are also concerned this conclusion could lead to a future decision by the FASB that all executory contracts should be accounted for on an interim basis before the intended transaction actually takes place. Additionally, partial hedging of future cash flow variability of an anticipated transaction has appeal as a risk management approach and requiring interim gains or losses on under-hedged amounts could inappropriately cause companies to alter their risk management strategies either by not hedging or perhaps hedging more than previous comfort levels.

Hedge Items - Aggregated Exposures

We support the ability to collectively hedge a group of individually eligible hedged items as discussed in the IASB proposal. The ability to hedge items as a group is practical and logical when these items are considered collectively for risk management purposes. Allowing hedging of aggregated exposures will account for the substance of portfolio management without the rules dictating the form of hedging. Conversely, mandating individual hedging of portfolio items simply creates added cost and administrative burden.

Accounting for Time Value of Options

If the time value of an option is separated from its intrinsic value and only the intrinsic value is designated as a hedge, we favor an approach that allows the choice to either amortize the premium into earnings over the life of the option ratably or on a time decay basis, or expense the premium immediately. Recognizing the premium ratably or on a time decay basis is more representative of the economics of the transaction and provides a practical and efficient means to recognize the decline in time value. While the IASB proposal

allows for amortization into earnings for time period-related options, but not transaction-related options, from a practicality standpoint, ratable amortization for all options is more operational for preparers and easier to understand and communicate to financial statement users. A single approach chosen by the entity produces more consistent results and less complex accounting.

Accounting for Fair Value Hedges

We believe that changes in the value of derivatives used to hedge fair value exposures should continue to be recognized in earnings each period and not deferred in accumulated other comprehensive income. The current accounting for fair value hedges is well understood and accepted. There is no need to change to a more complicated method of accounting when there has been no conceptual change; especially given the IASB proposal introduces, in effect, a third approach that differs from the current accounting for cash flow hedges.

Financial Statement Presentation of Interim Valuation Adjustments

In our view, adding a line item to the balance sheet to separately present changes in fair value attributable to hedged risks, as proposed by the IASB, does not provide a substantive benefit for financial statement users and simply clutters the balance sheet. The level of detail, both quantitative and qualitative, required for hedge accounting is already very granular and not significantly meaningful to the average investor. This granularity is perhaps helpful for analysis of financial institutions and others engaged in trading derivatives, but for the majority of companies that use derivatives exclusively for legitimate risk management purposes, the average investor does not derive significant benefit. Detailed disclosures of policies and practices, amounts recognized in other comprehensive income, amounts reclassified to earnings, ineffectiveness, notional values and fair value already provide significant information on potential exposures and the impact on earnings and the balance sheet. Under deferral accounting, the baseline assumption is that changes in fair value or pricing of the hedged item are offset by changes in fair value of the hedging instrument. Adding lines to the balance sheet needlessly complicates hedging disclosures and unnecessarily highlights figures that will ultimately have a near net zero impact on the financial statements.

Conclusion

In conclusion, we support many elements of the IASB proposal, which is principles-based and potentially offers a simplified approach to hedge accounting that could be more operationally efficient for preparers, comparable among companies and useful to financial statement users. Changes to hedge accounting would meet these goals by permitting individually identifiable risks to be hedged, eliminating overly burdensome effectiveness calculations, retaining a relaxed form of the critical terms matching and shortcut methods and allowing dedesignation and redesignation of hedges. Additionally, eliminating interim mark-to-market on embedded derivative contracts would remove a high degree of accounting complexity for which true exposure does not exist.

However, the envisioned "simplified" hedge accounting models will never truly be simpler if quarterly measurement of hedge effectiveness remains a requirement, given the inherent quantitative analysis such a requirement demands. Further, adding a hypothetical perfect derivative requirement for effectiveness analysis will only increase the administrative and analytical demands on preparers which belies the Boards' shared goal of simplifying the accounting model. We believe the best way to achieve simplicity is to develop a qualitative model that recognizes the basic hedging relationship but does not require interim gain or loss recognition, augmented by meaningful disclosures of derivative positions, fair values and impacts on earnings and cash flow.

Last, we urge the FASB to continue deliberations with the IASB so that final rules on hedge accounting are fully converged. If the final FASB standard is not fully converged with IFRS, it will be a waste of resources and effort to adopt a new GAAP standard and then change again for IFRS convergence. This adverse cost-benefit profile continues to be a significant issue for preparers.

We appreciate the opportunity to respond to the Discussion Paper and trust that our comments will be seriously considered in future deliberations on these issues.

Sincerely, Richard A. Schlueten

Richard J. Schlueter

Vice President & Chief Accounting Officer

Cc: Frank J. Dellaquila

Senior Vice President and Chief Financial Officer