Deloitte.

Deloitte & Touche LLP
Ten Westport Road
PO Box 820
Wilton, CT 06897-0820

Tel: +1 203 761 3000
Fax: +1 203 834 2200
www.deloitte.com

August 15, 2008

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

LETTER OF COMMENT NO. 94

File Reference No. 1590-100
Re: Proposed Statement, *Accounting for Hedging Activities* — an amendment of FASB Statement No. 133

Dear Mr. Golden:

Deloitte & Touche LLP is pleased to comment on the proposed FASB Statement, *Accounting for Hedging Activities* — an amendment of FASB Statement No. 133 (the "proposed Statement" or the "Exposure Draft").

We support the Board's efforts to simplify the accounting for hedging activities and to resolve major practice issues in its application. However, we do not support issuance of the proposed Statement in its current form because we do not believe that the proposed Statement's benefits will outweigh its costs or that it will improve financial reporting. Moreover, we do not believe the proposed Statement will simplify hedge accounting. Instead, we believe it will replace existing complexities with other complexities that will prove equally challenging in practice. Specifically, we do not support the proposed Statement's elimination of an entity's ability to hedge specific risks (with certain exceptions) or to dedesignate a hedge at its discretion. Also, we do not believe that the proposed Statement's concept of "reasonably effective" will be operational, particularly as it will be applied in qualitative effectiveness assessments.

The remainder of this letter does not respond to the specific questions posed in the Exposure Draft; rather, it addresses the aspects of the proposal we find most notable.

Practical Issues With the Proposed Model

Elimination of an Entity's Ability to Hedge by Risk

We share many of the concerns expressed in the proposed Statement's Alternative Views about the proposed elimination of an entity's ability to hedge specific risks (i.e., bifurcation by risk) and believe that such elimination may result in financial statement presentation that is inconsistent with an entity's risk management strategy. For example, as noted in the Alternative Views, an entity may enter into an interest rate swap to hedge interest rate exposures associated with a fixed-rate loan. Even though that swap may be highly effective at hedging interest rate exposure, it still may not qualify as a reasonably effective hedging instrument because it would do nothing to offset changes in fair value attributable to changes in the credit risk of the loan. Thus, the

financial statements would not reflect that the interest rate risk exposure has been effectively mitigated through the intended risk management strategy.

Even when an entity could demonstrate that a derivative, which only offsets one of the risks associated with the designated item, was reasonably effective at hedging all fair value or all cash flow changes of that designated item, the entity would not be able to appropriately reflect this economic relationship in the income statement because the guidance on financial statement presentation is currently insufficient to allow it to do so. We believe that before eliminating the bifurcation-by-risk hedge accounting model (including the full elimination of fair value hedge accounting for financial instruments by instituting the use of fair value for all financial instruments), the Board needs to address the associated financial statement presentation issues.

Eliminating bifurcation by risk also will place more focus on other areas of accounting that still need to be clarified, such as how to determine the fair value of an entity's own liability and how to appropriately model a perfect hypothetical derivative. The Board should resolve these practice issues before releasing a final Statement.

The Board also should consider whether financial reporting could be improved by extending the ability to bifurcate by risk to hedges of certain forecasted purchases or sales of nonfinancial items with explicitly indexed components. The Basis for Conclusions (paragraph 416) in FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, notes that hedging price risks associated with components of a nonfinancial item is not permitted because "changes in the price of an ingredient or component of a nonfinancial item generally do not have a predictable, separately measurable effect on the price of the item . . . ." For certain nonfinancial assets, however, we believe explicit or observable pricing elements may have predictable and separately measurable effects on the overall pricing of the nonfinancial assets. Furthermore, the fact that a determinable portion of a contract price or a price of a forecasted transaction for certain commodities is explicitly based, in part, on an established exchange index appears to overcome the Board's concern that changes in the price of a component of a nonfinancial hedged item would not have a predictable, separately measurable effect on the price of the item. For hedges of such nonfinancial items, the Board should consider permitting bifurcation by risk to better reflect the effects on the financial statements and to simplify the current hedge accounting model for nonfinancial items.

Hedge Effectiveness Assessment Requirements

The proposed Statement lowers the threshold for hedge qualification from highly effective to reasonably effective, stating that effectiveness must be assessed only at the inception of a hedging relationship unless "circumstances suggest that the hedging relationship may no longer be reasonably effective." Generally, the proposed Statement only requires qualitative effectiveness assessments (although a quantitative assessment may sometimes be necessary).

Although lowering the hedging threshold to reasonably effective on the surface appears to be a beneficial modification, the proposed Statement does not clearly establish a principle that one can uniformly apply to determine whether a hedging relationship is "reasonably effective." The Basis for Conclusions indicates only that "it is necessary to use judgment when determining whether a hedging relationship is reasonably effective." A number of examples in Appendix A of Statement 133 have been amended to illustrate how this effectiveness assessment might be performed, but the rationales for the conclusions reached in those examples do not sufficiently describe the analysis that an entity must perform to establish (1) whether it can determine qualitatively that a hedging relationship should be reasonably effective and (2) when a quantitative effectiveness

assessment must be performed. The lack of a guiding principle makes it unlikely that the proposed Statement will be operational (e.g., for any given hedging relationship, an entity will be unable to determine whether its qualitative assessment alone is sufficient to support its assertion that a hedging relationship will be reasonably effective). Without a guiding principle that would clarify the boundaries of reasonably effective or guidelines that explain what type or volume of evidence is sufficient to support a qualitative effectiveness assessment, it is likely that many preparers will continue to use today's parameters for highly effective when performing quantitative assessments to ensure that their hedging strategies are able to withstand regulatory challenge. In doing so, they would not realize the intended benefits of the proposed modification.

The following example highlights some of the challenges posed by the proposed Statement: Assume an entity enters into an interest rate swap to hedge the full fair value of an interest-bearing fixed-rate financial instrument (i.e., because bifurcation by risk is not permitted). In the current economic environment, many would question whether it is possible to qualitatively demonstrate that the hedging relationship will be reasonably effective because the hedging instrument (i.e., the interest rate swap) is not designed to offset the changes in fair value of the hedged item attributable to sources of volatility other than interest rate risk (e.g., credit risk volatility). Further, without commonly accepted criteria for what is reasonably effective, it is equally challenging to demonstrate quantitatively that this interest rate swap would be reasonably effective in offsetting the changes in overall fair value of the hedged item. Without more specific guidance from the Board, the entity may default to performing the effectiveness tests it performs under the existing model, using the currently accepted parameters for highly effective, not only at inception but for all future reporting periods for which the hedge exists.

Dedesignation

The proposed Statement eliminates an entity's ability to electively dedesignate a hedging relationship. The rationale for this elimination in the Basis for Conclusions is not persuasive. We are unaware of practice issues or abuses arising from elective dedesignation and disagree with changing current practice. Any concerns about entities abusing their ability to voluntarily dedesignate a hedging relationship could be addressed through enhanced disclosure requirements.

Elimination of the Shortcut and Critical-Terms-Match Methods

Eliminating the shortcut and critical-terms-match methods may simplify hedge accounting by removing exceptions to the general rules. However, the Board should provide additional guidance to address existing long-haul method practice issues, such as clarifying application of paragraph 120C of Statement 133 and determining the terms of a hypothetical derivative.

Other Comments (Including Editorial Items)

If the Board ultimately decides to issue the proposed Statement, it should clarify or revise a number of its provisions.

Hedge Effectiveness Assessments

1. Paragraph 6 of the proposed Statement notes that the qualitative assessment must demonstrate (1) the existence of an economic relationship between the hedging instrument and the hedged item or transaction and (2) that the hedging relationship is reasonably effective. It is unclear from this guidance, and from the proposed amendments to paragraphs 20 and 28, whether this requirement results in an additional documentation

requirement at hedge inception. Furthermore, paragraphs 20(a) and 28(a) of Statement 133 still would require an entity to document at hedge inception how hedge effectiveness will be assessed. The Board may want to clarify the level of specificity required for such documentation given that (1) the proposed amendments would require post-inception effectiveness assessments only if circumstances suggest that the hedging relationship may no longer be effective and (2) such assessments could be qualitative or quantitative depending on the circumstances.

2. Paragraph 10 of the proposed Statement requires an entity to identify the sources of volatility associated with the hedged item or forecasted transaction when it performs its qualitative assessment of hedge effectiveness. It is unclear (1) whether this provision creates a specific documentation requirement and (2) what the hedge accounting consequences would be if, post-inception, an entity realized that it had not identified and documented all sources of volatility.

Dedesignation

1. Paragraphs 14 and 15 of the proposed Statement indicate that an entity may consider a hedging relationship "effectively terminated when an offsetting derivative instrument is entered into; however, concurrent documentation of such effective termination is required to terminate that hedging relationship."

   a. Some entities have multiple portfolios of derivatives (e.g., a trading portfolio of nondesignated derivatives and a hedging portfolio of derivatives appropriately designated as hedges). The proposed Statement should make explicit whether it is permissible for an entity to designate an existing portfolio derivative as the offsetting derivative in a hedge termination.

   b. Although paragraphs 14 and 15 state that an offsetting derivative can be entered into to effectively terminate a hedging relationship, it is unclear whether a derivative that only partially or substantially, but not completely, offsets the changes in the designated hedging derivative could result in effective termination. The proposal notes that an "offsetting derivative is expected to offset future changes in the cash flows of the original derivative," but it does not specify that the offset must be complete. For example, if an entity enters into a 12-month futures contract to offset the first 12 months of an existing 24-month hedging relationship, could the entity document that transaction as an effective termination of the original hedging relationship? What if, in this example, the hedging instrument were a 23-month futures contract? Does the offsetting derivative have to match the terms of the original derivative?

   c. It is unclear whether the dedesignation guidance would affect a hedging relationship for which an entity documents a defined hedging period at inception. For example, assume that an entity desires to hedge changes associated with a designated item for the first 15 days with a derivative that has a five-year term (i.e., the hedge is designated only for the first 15 days and the hedging instrument has a five-year term). If the entity could demonstrate that the hedging relationship was reasonably effective at hedge inception, would the planned termination of the hedging relationship before the maturity of the hedging derivative constitute an elective dedesignation that would require an offsetting derivative in order for the hedging relationship to be effectively terminated?

Could that same derivative be redesignated as a hedging instrument after expiration of the initial 15-day hedge period?

d. The proposed amendments to the delta-neutral hedging strategy example (paragraphs 85–87 of Statement 133) may cause confusion because it is unclear why the periodic sales of put options that are necessary to maintain the delta-neutral position will not result in elective dedesignations that are prohibited by the proposed amendments. The final standard should address why this activity is not inconsistent with the requirements of paragraph 14.

   A similar question arises for another common hedging strategy in which an electric generation owner enters into forward derivative transactions to effectively "lock in" the sales price on a portion of the power that it expects to generate (e.g., 65 percent of its expected generation). The entity executes this hedging strategy to ensure that the generation level being hedged is always "probable of occurring," as required by Statement 133. Stated differently, expected levels of electric generation will vary during the period the hedge is executed and designated until the date the forecasted transaction actually occurs. For the entity to hedge 65 percent of its expected generation, the owner must enter into additional (or offsetting) derivatives to maintain the appropriate hedged level, which may be accounted for as hedge dedesignations. How would the proposed Statement affect the application of cash flow hedge accounting for the initial hedging transaction and the additional (offsetting) derivatives? This question is further complicated by the proposed Statement's prohibition on redesignation of hedging derivatives that have been effectively terminated.

Hedged Risk

1. Paragraph 17 of the proposed Statement states that hedging relationships entered into "within a reasonably short period of time" after debt recognition may be considered to be designated at inception. The Board should provide additional guidance on this concept (e.g., use the same parameters as those in Statement 133 Implementation Issue No. E23, "Hedging — General: Issues Involving the Application of the Shortcut Method Under Paragraph 68").

2. There are inconsistencies between the wording in paragraphs 16 and 18 of the proposed Statement and the respective paragraphs in the amended Statement 133. To avoid confusion, the Board should consider updating the wording in paragraphs 16 and 18 to match the wording in the amended Statement 133.

Cash Flow Hedging Relationships

1. Paragraph A17 of the proposed Statement indicates that when the "designated hedged risk in a cash flow hedge is the risk of overall changes in interest payments to be received related to a variable-rate financial asset," the variability in "interest cash flows associated with default could be evaluated based on whether it is probable that the forecasted interest payments would occur." This concept is discussed only in the Basis for Conclusions. It would be helpful if the final standard provided an example that illustrates this concept.

2. Paragraphs 23 and 24 and the amendments to paragraphs 30(b) and 30(c) currently refer to the "present value of the cumulative change in expected future cash flows." It would be clearer if this phrase was replaced with the "cumulative change in present value of expected future cash flows."

3. Paragraph A30 of the proposed Statement notes that "[t]he Board believes that ineffectiveness should be reported in earnings if an entity enters into a derivative that would not mature on the date of the forecasted transaction and provide cash flows that would exactly offset the hedged cash flows . . . ." For groups of forecasted transactions, however, paragraph 27 allows ineffectiveness to be measured "by comparing the change in fair value of the actual derivative . . . with the change in fair value of a derivative that **would settle within a reasonable time period of the cash flows related to the hedged transactions**" (emphasis added). For cash flow hedging relationships in which a single hypothetical derivative is used as a proxy for measuring ineffectiveness for a group of forecasted transactions, it would not be uncommon for certain forecasted transactions to settle before the maturity modeled for the hypothetical derivative (e.g., assume that some of the forecasted transactions settle before a reporting date and that the maturity modeled for the hypothetical derivative is after the reporting date). In such circumstances, the entity presumably would need to "true-up" the terms of the hypothetical derivative (e.g., the notional amount) to avoid adjusting other comprehensive income for risk exposures that no longer exist. To avoid possible diversity in practice, the Board should consider explicitly addressing this matter in the final standard.

4. The last two sentences of paragraph A31 state:

> The guidance in this proposed Statement for reporting ineffectiveness in a cash flow hedge would be consistent with other areas of cash flow hedge accounting in Statement 133. In addition, this approach also is consistent with the guidance in [IAS 39, *Financial Instruments: Recognition and Measurement*,] for cash flow hedge accounting.

   The last sentence does not appear to be correct, since paragraph 96 of IAS 39, in describing the accounting for cash flow hedges, states that the separate component of equity associated with the hedged item should be adjusted to the lesser of (1) "the cumulative gain or loss on the hedging instrument from inception of the hedge" or (2) "the cumulative change in fair value (present value) of the expected future cash flows on the hedged item from inception of the hedge." The requirements in IAS 39 are consistent with current U.S. GAAP.

Disclosures

1. Paragraph 44G(a) of Statement 133 (paragraph B1(i) of the proposed Statement) suggests that an entity may only use an interest rate swap to convert its issued debt from fixed rate to variable rate or variable rate to fixed rate. However, an entity may use other hedging instruments (e.g., forwards or futures contracts) to convert issued debt to fixed rate or variable rate. The provision should clarify that interest rate swaps are just an example.

2. Paragraph 44G(c) of Statement 133 (paragraph B1(i) of the proposed Statement) requires disclosure of "[t]he overall weighted-average interest rate on a contractual basis and including the effects of derivatives." To avoid confusion, the Board should consider

changing the amendment to this paragraph to conform to the wording in paragraph 29(c) of the proposed Statement.

3. The Board should consider providing examples illustrating the disclosure requirements in paragraph 44G (in a manner similar to the examples provided in FASB Statement No. 161, *Disclosures About Derivative Instruments and Hedging Activities*). This could help preparers and auditors understand the Board's intent for these new disclosure requirements.

4. It would be helpful if the disclosure example in paragraph B1(fff) of the proposed Statement were expanded to provide examples of the types of activity that would be included in the "All Other Fair Value Adjustments" column. On the basis of the nature of the line items included in the example, it is unclear what fair value adjustments other than hedging adjustments would be permitted by existing GAAP. For example, is the disclosure designed to capture impairment write-downs or adjustments arising from application of a fair value option? Because the disclosure does not appear to be designed as a rollforward table (i.e., the 2009 "Amount Prior to Cumulative Fair Value Adjustments" does not equal the 2008 "Balance Sheet Amount"), preparers would now seem to be required to keep track of a new "cost basis" for these line items solely for disclosure purposes. The Board should consider providing a more detailed example to clarify its intent on this issue.

Other Amendments to Statement 133

1. The Board made several other amendments to paragraphs 13, 40, and 61(e) of Statement 133 but did not fully explain the rationales for those amendments in the Basis for Conclusions. In the final Statement, the Board should clarify why these changes were made.

   The amendment to paragraph 13 of Statement 133 (included in Paragraph B1(a) of the proposed Statement) may cause confusion because it appears to conflict with guidance in Statement 133 Implementation Issue No. B16, "Embedded Derivatives: Calls and Puts in Debt Instruments." As amended, paragraph 13 provides guidance on embedded derivative instruments in which the only underlying is an interest rate or interest rate index. In its analysis of whether the put option in debt issued at par that is puttable at par if the issuer has an initial public offering (IPO) is clearly and closely related to the debt, Example 7 in Implementation Issue B16 states, "Further analysis under paragraph 13 of Statement 133 is required." This reference to paragraph 13 does not seem appropriate because the term "underlying," as defined in Statement 133, includes the occurrence or nonoccurrence of a specified event. Stated differently, the puttable debt referred to in Example 7 of Implementation Issue B16 appears to have two underlyings — its interest rate and the IPO contingency. Thus, it appears that paragraph 13 would not apply to this situation.

   There are other inconsistencies between Implementation Issue B16 and paragraphs 13 and 61(d) of Statement 133 that the Board also should address. For example, the Board should consider deleting the following sentence in paragraph 61(d):

   > Thus, if a substantial premium or discount is not involved, embedded calls and puts (including contingent call or put options that are not exercisable unless an event of default occurs) would *not* be separated from the host contract.

Deleting this sentence would remove the inconsistency with step 3 of the decision sequence described in Implementation Issue B16. Step 3 notes that if the host debt does not involve a substantial premium or discount, "further analysis . . . under paragraph 13 is required to determine whether the call or put is clearly and closely related to the debt host contract." In making its amendments to paragraph 13 of Statement 133, the Board should review paragraph 61(d) and Implementation Issue B16 to ensure that there are no inconsistencies in the guidance.

The proposed Statement amends paragraph 40 of Statement 133 to clarify 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." The Exposure Draft also notes that Statement 133 Implementation Issue No. H13, "Foreign Currency Hedges: Reclassifying Into Earnings Amounts Accumulated in Other Comprehensive Income Related to a Cash Flow Hedge of a Forecasted Foreign-Currency-Denominated Intercompany Sale," will need to be revised to reflect this clarifying guidance. As noted previously, the Basis for Conclusions does not provide a detailed rationale for this proposed amendment. Because intercompany foreign currency hedging transactions are fairly common, the final Statement should expand its discussion about this change and the principle underlying the change. It also should provide detailed examples of what types of intercompany foreign currency hedging strategies are permissible and what types are not. Also, it would be helpful if the final standard stated whether its requirement to have an exposure that could affect reported earnings is consistent with paragraphs 80 and AG99A of IAS 39.

Transition

1. The Board should consider revising the first sentence in paragraph 34 of the proposed Statement as follows (changes are indicated in strikethrough or underline):

   > [A]n entity shall adjust the balance in accumulated other comprehensive income ~~to equal~~ by the difference, if any, between the fair value of a derivative that would provide cash flows that would exactly offset the hedged cash flows and the amount in accumulated other comprehensive income related to the hedge just prior to initial application"

2. The Board should consider revising the second sentence in paragraph A42 of the proposed Statement as follows (change indicated in underline):

   > For cash flow hedging relationships, an entity should record in retained earnings and accumulated other comprehensive income the difference, if any, between the fair value of a derivative that would exactly offset the hedged cash flows and the current amount in accumulated other comprehensive income related to the hedge.

Examples in Appendix B

1. Appendix B of the Exposure Draft proposes a number of amendments to the examples in Statement 133. The revised illustrations, beginning with the amendments to paragraph 74 of Statement 133, indicate when it is more appropriate to use a qualitative method rather than a quantitative method for effectiveness assessments and vice versa. However, the amendments do not clearly state the principle underlying those judgments and include guidance that may appear contradictory.

For example, paragraph 74 of Statement 133 presents an example in which "[t]he price of Company A's natural gas inventory in West Texas and the price of the natural gas that is the underlying for the futures it sold will differ as a result of regional factors (such as location, pipeline transmission costs, and supply and demand)." The proposed Statement amends paragraph 74 to state that a qualitative effectiveness assessment is possible because the notional amounts are the same and "changes in the fair value attributable to the regional factors have not been significant when compared with the overall changes in fair value." The amendment to paragraph 79, however, states that it is not possible to qualitatively assess whether a forward contract to sell rubber will be reasonably effective at hedging exposures to changes in the fair value of a tire inventory because there are significant components other than rubber that are used in producing a tire. It is difficult to differentiate between the factors that make it possible to qualitatively determine that the regional-factor components of the price of natural gas will not generate significant ineffectiveness and the factors that indicate that it is not possible to qualitatively determine whether the nonrubber components of tire inventory will generate significant ineffectiveness. In the absence of a clearly articulated principle that is consistently applied in the illustrations, constituents may find the guidance in the proposed Statement difficult to apply.

*****

Deloitte & Touche LLP appreciates the opportunity to comment on the proposed Statement. If you have any questions concerning our comments, please contact Mark Bolton at (203) 761-3171.

Yours truly,

Deloitte & Touche LLP

cc: Bob Uhl