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



LETTER OF COMMENT NO. 112

File Reference No. 1590-100

Dear Mr. Golden,

We would like to take this opportunity to comment on the Proposed Statement, "Accounting for Hedging Activities." While we agree with the proposed lowering of the effectiveness threshold from "highly effective" to "reasonably effective" and the elimination of prospective and retrospective assessments, we believe the proposed amendment of FAS 133 does little to reduce complexity and fails to achieve the stated objectives of simplifying hedge accounting and resolving major practice issues. Our perspective is from that of a manufacturing company that utilizes cash flow hedges for the anticipated purchase of commodities (e.g., copper, aluminum, nickel, etc...) and hundreds or even thousands of components that contain commodities with varying grades, the price of which is very elastic with changes in market prices for the metal portion of the component. Under this proposal, hedge accounting will continue to be overly complex and rules based and will continue to require very burdensome quantitative ineffectiveness calculations.

#### Summary

We agree with the two dissenting Board members that the proposed Statement does not significantly simplify the application of FAS 133, produces accounting results that are inconsistent with risk management strategies and adds to the differences between U.S. and international hedging standards.

We recommend that:

- Hedge accounting should be made more operational and practical, and less theoretical;
- The principle should be that if a company has a basis to expect that the hedge will be "reasonably effective" then hedge accounting should be permitted without having to measure ineffectiveness – this level of precision is extremely difficult to measure, and should not be expected;
- The shortcut method and critical terms matching should be expanded (by relaxing the requirements), rather than eliminated, to alleviate measuring ineffectiveness;
- Measuring the change in value of hypothetical derivatives for hundreds or thousands of underlying exposures is not operational, and cannot be cost justified;
- The ability to apply hedge accounting to individual risks within an underlying should be expanded, rather than eliminated;
- Hedge accounting for forecasted intercompany transactions should not be eliminated;

- The ability to dedesignate a hedge should not be eliminated;
- If this rule is passed as proposed, changes in the value of the underlying in excess of changes in the value of the derivative should not be recorded to earnings as ineffectiveness.

Hedge accounting is a perfect example of where a practical “principles based” approach should be utilized. If an exposure exists, even if it is just a portion of an underlying, hedge accounting should be permitted without having to track effectiveness as long as the entity can demonstrate that the hedge has historically been reasonably effective and is expected to continue to be in the future.

Under the current rules, companies qualify for hedge accounting only on the simplest of underlying exposures and mark-to-market to earnings other derivative contracts because of the difficulty in tracking changes in value of the underlying exposures. It is extremely burdensome to analyze and update at least quarterly perhaps thousands of purchase components (spread across numerous locations worldwide) that contain varying grades of commodity metal and have fabrication and other costs, and re-determine a current spot price to be used to create a cumulative cash flow change or present value of a “hypothetical derivative”. This theoretical exercise creates massive complexity, is not practical or warranted, distorts reported financial results, and leads to confusion for financial statement users. The result is financial performance (i.e. earnings) is distorted as unrealized gains and losses fluctuate each reporting period. We believe unrealized hedging gains and losses on cash flow hedges should not be reflected in earnings but rather in equity until realized.

Hedge accounting may be achieved for some underlying exposures related to straight-forward, centralized purchases of a large volume (e.g., purchase of a raw commodity). However, many companies must mark-to-market more complicated situations (e.g., purchase of components containing commodities) since the accounting model is not practical. The result is two different accounting answers reported in the financial statements for the same economic risks. We believe this accounting model is flawed since we fundamentally oppose reporting unrealized gains and losses in earnings, particularly when an offsetting exposure will be recorded later.

### **Recommended Model**

The proposed rule assumes a level of precision that does not, and should not be expected to exist. Our recommended approach for hedge accounting would eliminate complexity and the vast amounts of time and costs involved with the current rules. To re-iterate, our approach is simple: mark-to-market all cash flow hedge positions to equity and defer gains and losses until realized as long as an entity can demonstrate that hedges are expected to be reasonably effective.

At inception of a hedge relationship, an entity would determine that the hedge is expected to be reasonably effective. During the term of the hedging relationship, changes in the fair value of the hedging instrument would be marked-to-market on the balance sheet while the unrealized gains/losses are deferred in equity. No further assessment of effectiveness, including measurement of ineffectiveness, would be necessary unless a change in circumstances warrants reassessment during the hedge term. Upon maturity of the hedging instrument and occurrence of the hedged item, the gain/loss previously deferred in equity would be recognized in earnings at the same time as the hedged item. Our approach would eliminate determining the change in value of underlying transactions that do not have a readily available market price. Determining the value of underlyings for hundreds or even thousands of transactions and processing the complex calculations of the present value of the cumulative change in expected future cash flows of a hypothetically perfect derivative is impractical, and the volatility to earnings from unrealized gains and losses distorts operational performance of the business. The balance sheet would still reflect the value of the hedge contract with unrealized gains and losses included in equity and thus providing the user the critical information regarding hedge positions.

More broadly, the accounting rules need to get practical and less theoretical and diverge from the idea that there is only one conceptual model that can be applied in accounting. Accounting is about communicating

information and there needs to be room in the model to have differences to reduce complexity no one understands. The perfect theoretical model is not the objective but rather the objective should be to communicate useful information that can be understood and that is not cost prohibitive to create. No business person needs the information in the form and manner required by the current hedge accounting rules to run the business in an economically prudent manner.

### **Hedge Effectiveness**

While we agree with the proposed modification of the effectiveness threshold from “highly effective” to “reasonably effective”, we still foresee significant operational concerns in calculating ineffectiveness and believe that the proposed elimination of the shortcut method and critical terms matching does not simplify hedge accounting. We agree that assessment of effectiveness should be more qualitative rather than quantitative and that hedge accounting should be discontinued if the hedge is no longer effective. However, the proposal does not go far enough in reducing the burden of effectiveness assessment. Retaining the requirement to calculate the amount of ineffectiveness each period is essentially doing a quantitative effectiveness evaluation each period so there really is no reduction in effort. We believe if an entity has a reasonable basis to assume that the hedge will be effective, it should be allowed to assume no ineffectiveness and not have to calculate the amount of ineffectiveness during the term of the hedge.

If this rule is passed, changes in the value of the underlying should not be recorded in excess of changes of the derivative. We believe the principle should remain that the change in value of the underlying to be recorded is limited to the change in value of the offsetting derivative.

In addition, although the FASB decided to not define “reasonably effective,” we have already seen various accounting firms using a numerical range (50%-150%) rather than judgment based on a holistic consideration of all facts and circumstances to define “reasonably effective.”

### **Hedged Risk**

We believe the proposed Statement would impair the usefulness of financial statements by totally eliminating the ability of any entity to designate any individual risks. We agree with the Board members who stated that derivatives are generally designed to manage discrete risks, and not all risks. We believe that hedge accounting should follow the economics of the transactions and the actual risks of the preparer. Accordingly, we believe the ability to hedge individual risks should be expanded, rather than eliminated.

Businesses have always hedged real economic exposures and are not concerned whether the hedge “perfectly” offsets all potential variability. An entity should be allowed to hedge the commodity content of a purchased item rather than having to hedge the entire cash flows of the purchased item. A hedge instrument may not exist that can hedge all of the potential cash flow variability of an item that contains copper, but an entity can enter into a commodity contract that matches the variability of the portion of the item’s price that changes based on the market price of copper.

For example, if items containing copper are purchased, under current rules hedge accounting must be applied to the all-in-price of the items and not just the copper content, even if the invoice separately specifies the price and units for copper content apart from the price of fabrication costs. The company anticipates these purchases and hedges the copper content that will vary with the associated risk in market prices, a very reasonable economic hedge. The fabrication cost might vary as well but that will be driven by the cost of labor, fuel and other items. In other cases the specific copper price may not be specified on the invoice but the component price fluctuates with the change in market price for copper, and historical correlations show good effectiveness. This is where the rules could be made practical such that ineffectiveness does not need to be calculated or recorded. It simply is not worth the time, effort and cost to track thousands of items and perform the overly complex calculations for what should be an immaterial difference. Our strong recommendation is: if the company can demonstrate that good correlation exists, the hedge was (or would have been) “reasonably

effective” based on historical transactions or other data, and there is no reason to believe it will not continue to be effective in the future, then hedge accounting should be permitted without measuring ineffectiveness.

In addition, the proposal significantly changes current practice regarding hedging of intercompany transactions. The addition of two sentences in Appendix B (amendment to paragraph 40 of FAS 133) appears to eliminate the ability to hedge certain intercompany transactions. Paragraphs 482-484 in the Basis For Conclusion of FAS 133 clearly show that the foreign currency risk from a forecasted intercompany transaction is eligible for designation as a hedged transaction. For example, intercompany purchases/sales, and the related payables/receivables, between related entities with different functional currencies can create a real economic foreign currency risk even though the amounts are eliminated in consolidation.

#### **Ability to Dedeignate a Hedging Relationship**

Entities should have the ability to remove a hedge designation. Legitimate business reasons may exist for dedesignating or re-designating a hedging relationship. The accounting rules should not dictate an entity’s hedging strategy, rather the accounting rules should account for the business economics of the transactions. Further, since the proposed change could be circumvented by closing out the existing derivative contract and entering into a new derivative, dedesignating provides a more efficient method to achieve the same economic result. In addition, we do not believe the proposed change to eliminate dedesignation of hedging relationships is practical if it applies to hedges of a net investment in a foreign operation. For example, if non-U.S.-denominated debt is designated as a hedge of a net investment, the proposed change would seem to imply repayment of the debt is required in order to cease the hedging relationship.

#### **Presentation of Hedging Gains and Losses**

No, we do not believe that FAS 133 should be amended to prescribe the presentation of hedging gains and losses. The presentation of hedging gains and losses would be better determined during an overall assessment of financial reporting such as the Board’s current financial statement presentation project.

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

We believe that the proposed changes do not simplify hedge accounting and that the disclosure requirements continue to outweigh the perceived benefits of providing an ever increasing quantity of information. The volume of disclosures related to financial instruments and hedging contracts is overly burdensome for preparers and is difficult for users to comprehend. In addition, companies should not have to measure ineffectiveness as it is likely immaterial and not cost justified.

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

We do not believe that this proposal should be adopted because of the issues identified above. In addition, the changes are not significant improvements to hedge accounting and they create additional differences between U.S. and international standards. If the Board goes forward with this proposal, the effective date should be for fiscal years beginning after December 15, 2009, and interim periods within those fiscal years; with early adoption possible. Such an effective date would allow preparers sufficient time for system and procedural changes, particularly considering the number of new accounting pronouncements being adopted over the next few years.

#### **Conclusion**

In conclusion, we urge the Board to re-consider the proposal and implement changes to make accounting less complex, and operational to apply by permitting individual risks to be hedged and by eliminating the overly burdensome effectiveness calculations. This together with the exhaustive disclosures for derivatives conveys the important and useful information to users of the financial statements.

We appreciate the opportunity to respond to the Exposure Draft and trust that our comments will be seriously considered in future deliberations on this issue.

Sincerely,

A handwritten signature in black ink that reads "Richard J. Schlueter". The signature is written in a cursive style with a large, prominent initial "R".

Richard J. Schlueter  
Vice President & Chief Accounting Officer

Cc: Walter J. Galvin  
Senior Executive Vice President & Chief Financial Officer