



September 30, 2010

Mr. Russell G. Golden  
Technical Director  
Financial Accounting Standards Board  
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P.O. Box 5116  
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Via Email

**File Reference No. 1810-100, Proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities***

Dear Mr. Golden:

We appreciate the opportunity to comment on the FASB's Proposed Accounting Standards Update *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* (the "Proposed ASU"). Our comments are confined to the provisions dealing with derivative instruments, hedging activities and convertible bonds.

We have numerous clients that will be impacted by the guidance in the Proposed ASU. We appreciate the Board's intention to simplify the application of hedge accounting and believe that some of the proposed changes, such as those regarding assessing hedge effectiveness, represent a positive step toward simplification. However, the complexities of hedge accounting stem from three main factors, only one of which the Board has addressed in the Proposed ASU.

1. The effectiveness test – which the Board has addressed;
2. Computing the change in fair value of the hedged item in a fair value hedge;
3. Computing the change in hedged cash flows in a cash flow hedge.

By eliminating the assumption of no ineffectiveness, including the Shortcut Method, rather than simplifying the criteria for assuming no ineffectiveness, the Proposed ASU merely changes the areas of complexity in most hedging relationships. Further, we believe that, with a bolder approach, the Board could further simplify many of the complexities caused by ASC 815 without changing its core concepts. Specifically, we believe that the Board should expand the bifurcation by risk approach to non-financial assets and liabilities where there is a clear direct relationship between the hedged risk and the hedging instrument. Similarly, we believe the Board should consider allowing an entity to designate any widely recognized interest rate index as the hedged risk in an interest rate risk hedging relationship, rather than prescribing two benchmark interest

rates, and either simplify the matched terms concept or simplify the computation of hedge ineffectiveness by changing the way the fair value/variable cash flows of a hedged item are calculated.

In addition, the changes to the mechanics of cash flow hedge accounting will result in phantom gains and losses being recognized – the first time we can recall gains and losses being recognized in earnings for transactions that were not executed.

We also believe that the application of the guidance in the Proposed ASU could, in some cases, create less consistent accounting treatment for certain instruments (e.g. convertible bonds). This inconsistent treatment of economically similar instruments will make it more difficult for users of financial statements to understand the earnings power and financial position of issuers of these instruments.

Detailed comments on the Proposed ASU are set forth on the following pages. Please contact either myself at 212-902-7052 or Nora Joyce at 212-357-8391 if we can be of further assistance or if you have questions about our comments.

Sincerely,

*Tim Bridges*

Timothy J. Bridges  
Managing Director

Cc Nora Joyce, Goldman Sachs & Co.  
Matthew Schroeder, Goldman, Sachs & Co.

### Bifurcation by Risk

We agree with the Board's decision to retain the ability for companies to hedge individual risks in financial instruments and would encourage the Board to expand the ability to hedge individual risk components to non-financial assets and liabilities where there is a clear direct relationship between the hedged risk and the hedging instrument. For example, if a company incurs fuel surcharges on its cost of shipping items, and the fuel surcharges are based on changes in the price of gasoline, the company should be able to hedge only the portion of the change in transportation costs attributable to the fuel surcharge, rather than having to try and incorporate unhedgeable components in the total change in its transportation cost such as the number of delivery location stops. While a lower threshold for qualifying for hedge accounting will facilitate more commodity hedges being eligible for hedge accounting, entities will still need to model up the projected hedged cash flows each period in order to compute hedge ineffectiveness. Absent a bifurcation by risk approach, these projections will require the company to incorporate unhedgeable (and frequently unpredictable) factors that will have no impact on how well the hedge works economically. We have a significant number of clients who believe that a bifurcation by risk approach is needed for non-financial assets.

### Reasonably Effective Effectiveness Threshold

We are generally supportive of the proposed modification of the effectiveness threshold from highly effective to reasonably effective and from a quantitative to a qualitative threshold. We also agree with the elimination of the ongoing effectiveness test. We have some concerns that there could be differing interpretations of reasonably effective by regulators and auditors, but believe that if all parties are willing to allow for reasonable judgment as opposed to a bright line, then such a threshold will simplify the application of hedge accounting.

We believe that a simple illustration of the concept would help to illustrate what the Board intends. For example, Company A issues a 10 year bond with a coupon of 6%. It enters into a receive fixed, pay 3 month Libor swap whose duration and qualitative characteristics reasonably approximates that of the bond. It is therefore able to conclude that the swap is a reasonably effective hedge.

We believe that such an illustration would be useful as otherwise we fear companies will have to perform a quantitative analysis (for example, of credit spread volatility versus interest rate volatility) in order to justify the conclusion that the hedge is reasonably effective.

### Elimination of the Shortcut and Critical Terms Matching Methods

We believe that the proposed elimination of the Shortcut Method and Critical Terms Matching will impair the usefulness of financial statements and make hedge accounting more complex. We would support elimination of the shortcut guidance if the concept of Critical Terms Matching were simplified and extended to interest rate swaps hedging

extant debt. We believe that an enunciation of a simple principal that if the significant economic terms of an exposure (for example, terms in a bond to which an investor would ascribe meaningful value) are matched, then an assumption of no ineffectiveness is appropriate. We believe that the end result is simpler while being at least as useful and representationally faithful of the actions of the enterprise than an artificial calculation of ineffectiveness arising from the mechanics of long haul hedge accounting for interest rate risk.

If the Board does eliminate the Shortcut and Critical Terms Matching Methods we would encourage the Board to change the prescribed methodology for calculating the change in fair value of a bond due to changes in interest rates to converge with IFRS. Under the current US GAAP guidance, an issuer must discount the contractual cash flows of the bond, which includes the credit spread, a component that is typically not hedged. Conversely, the IFRS guidance allows issuers to exclude the unhedged component (such as the portion of cash flows on the bond attributable to the issuer's spread over the benchmark rate), and include only the hedged interest rate component of the cash flows. This calculation is simpler and more representationally faithful of the actions of an enterprise that has executed an interest rate swap to hedge the change in fair value of a bond attributable to changes in the benchmark interest rate.

### Benchmark Interest Rates

#### *Expanding the Benchmark Interest Rates*

We believe the FASB should consider expanding the permitted interest rates that can be designated as the hedged risk to any widely recognized interest rate index. Currently, when an entity enters into an interest rate risk hedging relationship they may only designate two prescribed interest rates – in the US, US Treasury and LIBOR – as the risk being hedged. Any entity that does not or cannot enter into a derivative based on one of those two indices will have hedge ineffectiveness, not due to a mismatch between the swap and the hedged item, but simply because current guidance prohibits an entity from designating a rate other than US Treasury or LIBOR as the risk being hedged in the hedged item / cash flow.

For example, an entity that hedges the interest rate risk in its fixed rate debt with a cash collateralized swap could have a mismatch between the rate curve used to calculate the fair value of the swap (Fed Funds if the swap is cash collateralized in U.S. dollars) and the rate used to calculate change in the fair value of the bond due to changes in interest rates (LIBOR because Fed Funds currently is not a Benchmark Interest Rate). This issue is already becoming widespread as pursuant to Dodd-Frank, more and more swaps are cleared on exchanges with collateral requirements. For example, we understand that swaps executed on the London Clearing House (LCH) are valued using a Fed Funds curve for U.S. dollar denominated swaps.

### *Hedging Cash Flow Variability Attributable to Non-Benchmark Indices*

Currently, if an entity wishes to hedge the variability in cash flows on floating rate assets or liabilities that vary based on a non-benchmark index (for example Prime), it has to hedge the entire variability caused by not only the index but other factors, such as credit spread changes. This leads to complex analyses and at times can preclude an entity from qualifying for hedge accounting. Consistent with our comments on bifurcation by risk for non-financial assets and liabilities, we believe that a company should be able to designate as the hedged risk a component of variability in cash flows where this component can be specifically isolated.

For example, if a company hedges a portfolio of loans that bear interest at Prime plus a spread, and due to the use of the “First Payments Received” technique, the spread composition of the underlying loans is subject to change, under current guidance the company has to undertake complex analysis of the potential spread composition in order to compute hedge ineffectiveness, even though the purpose of the strategy is not to hedge credit spread variability. The current hedge accounting model overstates ineffectiveness by incorporating the effects of unhedged risks even when specific components of variability can be isolated. We believe that where specific components of variability can be identified, a company should be able to specifically hedge only that component.

### Prohibition on De-designation

We do not agree with the prohibition on ceasing hedge accounting by de-designation of a hedging relationship. This provision completely contradicts a basic tenet of FAS 133 – hedge accounting is elective. We are not aware of any abuse (for example, in terms of changing the timing of income statement recognition) that can be caused by the ability to de-designate a derivative. Conversely, by imposing such a restriction, companies would at worst lose the flexibility to actively adapt to a changing risk profile and at best would face added complexity in their designation and hedge monitoring.

The Proposed ASU will allow de-designation if a company enters into a fully offsetting derivative and concurrently documents that the offsetting derivative is effectively terminating an existing derivative. We would encourage the FASB to consider extending this treatment to on-market swaps executed to offset an existing swap, even though an offsetting on-market swap will not be fully offsetting. For example, assume a company executes an interest rate swap in which they receive 4.00% and pay LIBOR +2.00% to hedge a fixed rate liability. Subsequently they execute an offsetting on-market trade in which they pay 4.00% and receive LIBOR +1.00%. If the existing swap can be de-designated only changes in the value of the 1.00% annuity created by the two swaps would be recorded at fair value through earnings. On the other hand, if the existing swap cannot be de-designated, the on-market offsetting swap will be recorded at fair value through earnings, while hedge accounting would have to continue to be applied for the existing swap. We are concerned that the offsetting transaction in this example would not be considered to be fully offsetting.

Change to the Mechanics of Cash Flow Hedge Accounting

Currently only over-hedges (excess ineffectiveness) in cash flow hedges impact earnings. We believe that this makes sense as it reflects the actual gains/losses arising from the hedging derivative. Under the changes in the Proposed ASU, all cash flow ineffectiveness will impact earnings. Consider the two squares highlighted in yellow in the following table.

Hedge Result	Perfect Hedge Result	P/L Impact under Current Guidance	P/L Impact under Proposed ASU Model
\$8 gain	\$10 gain	\$0 (\$8 gain in OCI)	\$2 loss (\$10 gain in OCI)
\$12 gain	\$10 gain	\$2 gain (\$10 gain in OCI)	\$2 gain (\$10 gain in OCI)
\$8 loss	\$10 loss	\$0 (\$8 loss in OCI)	\$2 gain (\$10 loss in OCI)
\$12 loss	\$10 loss	\$2 loss (\$10 loss in OCI)	\$2 loss (\$10 loss in OCI)

In the first highlighted square, the company executed a hedge that generated a gain of \$8. The hypothetical derivative indicates that the perfect hedge would have generated a gain of \$10. The proposed changes would result in a **loss** of \$2 being recognized in earnings even though the hedge generated a gain. This loss represents the change in the present value of future cash flows (for example forecasted sales) not offset by the hedge. In the second highlighted square, we see that the company would record \$2 of income when it actually lost \$8. Thus we have income statement recognition of the effect of changes in hedged forecasted cash flows, as opposed to the recording in OCI of the effect of the hedge. To put it another way, the balance in OCI will now reflect the results of a transaction the company did not do (the perfect hedge) rather than the results of a transaction that it did execute. We find this perplexing and believe that it will cause confusion for investors. (“The hedge lost money but not as much as it should have so you booked a gain?”).

Application of the Financial Instruments Model to Convertible Debt

Based on our reading of the Financial Instruments Model, the accounting for a convertible bond obligation will depend on the specific structure executed.

Convertible bonds with the following features will be carried at fair value with changes recorded in earnings:

Bonds that will be settled in shares upon conversion (if-converted bonds),

Bonds which the issuer has the option, but not the obligation, to settle the principal amount in cash upon conversion (Instrument X bonds), and

### Bonds with an embedded derivative that requires bifurcation (bonds with a contingent interest feature or parity trigger)

However, convertible bonds which do not contain an embedded derivative that has to be bifurcated and for which the issuer must settle the principal amount in cash upon conversion (Instrument C bonds) could be carried at either fair value with changes recorded in other comprehensive income or amortized cost provided the requirements for those classifications are met. This will produce dramatically different accounting treatment for instruments that have immaterial differences. For example, we estimate the difference in value between identical Instrument C bonds, one of which contains a parity trigger (thus would have to be carried at fair value with changes recorded in earnings) and one that does not (could be carried at fair value with changes recorded in OCI or amortized cost), to be immaterial (i.e., less than 0.1% of the issue price). The same would be true for convertible bonds with a contingent interest feature.

This is not an improvement to financial reporting and would introduce even more complexity to an already complex area of accounting. The accounting for convertible bonds (and most equity instruments) has evolved in a piecemeal fashion that has introduced an enormous amount of guidance that must be considered. Application of the Proposed ASU will add further complexity without making any progress on a comprehensive, principles-based framework for instruments with components of both liabilities and equity. For this reason, we believe convertible bonds should be scoped out of the Proposed ASU and any changes to the accounting for convertible bonds should be decided by the Board in the context of its Liabilities & Equity Project.

We would also note that the proposed accounting for convertible bonds would likely dissuade the vast majority of companies from issuing these securities (other than Instrument C bonds) given the resulting earnings volatility. It would also cause companies to resort to alternative structures (such as straight debt and warrants sold as separable units) that attempt to achieve a similar corporate finance result with less adverse accounting but more economic friction costs. Given the importance of convertible financing for many companies, it would not be prudent to effectively increase the cost or decrease the efficiency of this source of financing through implementation of piecemeal accounting standards that introduce arbitrary lines between economically similar instruments.

### Hybrid Instruments and Bifurcation

The Proposed ASU requires changes in the fair value of all hybrid instruments to be recorded in earnings, and does not permit bifurcation and separate accounting for embedded derivatives that are not clearly and closely related. We do not believe that this provision should be applied to instruments which contain embedded derivatives that are insignificant in terms of their value. For example, many instruments contain features which are designed to protect investors, such as change in control puts at a premium to par or parity triggers in convertible bonds. The value of these features is insignificant but,

because their terms typically result in them being considered not clearly and closely related, would force an issuer to record its own debt at fair value with changes recorded in earnings. We believe that requiring changes in the fair value of the entire hybrid financial instrument to be recorded in earnings because of such insignificant embedded features will not provide useful information to investors as the main impacts recorded in earnings will be the impact of changes in interest rates and the issuers' credit on the bond, impacts which would be recorded in OCI (or not at all for many issuers) for almost identical instruments that do not contain such terms. We believe that separate accounting for such features should still be permitted.

#### Hedging FX Risk in Intercompany Transactions

Lastly, we understand the FASB Staff may be contemplating a change regarding hedging the FX risk of forecasted intercompany transactions. When a similar proposal was made in the FASB's 2008 proposed amendment of Statement 133 we commented that we do not believe that such a change is consistent with the functional currency model in Statement 52. Further, such a change would have a drastic effect on the ability of companies following US GAAP to hedge their foreign exchange exposures. If such a change is again being contemplated, we would urge the FASB to include it in the Proposed ASU in order to allow for appropriate public exposure and comment. We do not believe such a significant amendment to a standard should be made through a FASB Staff Position.