



September 27, 2010

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

RE: Proposed Accounting Standards Update, “Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities” (File Reference No. 1810-100)

Dear Mr. Golden:

We appreciate the opportunity to comment on the proposed Accounting Standards Update, “Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities” (the “proposed ASU”).

We appreciate the Board’s efforts and, overall, agree with the Board’s stated objectives. However, we do not believe that the proposed ASU accomplishes those objectives as currently written. Additionally, we are troubled by the number and extent of conceptual and practical differences between the proposed ASU and IFRS. We believe that the FASB and IASB should work towards accounting standards which are more closely aligned. As written, the proposed ASU will significantly complicate financial reporting for entities with dual US GAAP and IFRS reporting requirements and entities that convert from US GAAP to IFRS.

We at ValSource Advisory Services, Inc. assist our clients with valuation and attendant financial reporting matters involving fair value measurement, including financial instruments and hedge accounting. The remainder of this letter provides our views on several key areas of the proposed ASU most important to our clients given our areas of specialization.

Overall

Measurement

We generally agree that if there is to be a primary measurement attribute for financial instruments then it should be fair value. We also agree that presenting fair value information

related to financial instruments is helpful to users of financial statements. However, we believe that fair value is not the most appropriate measurement for certain financial instruments, including most financial liabilities.

The objective of fair value measurement is to most accurately reflect the underlying risks of subject financial instruments on the face of the financial statements. As such, we believe that fair value is the appropriate measurement attribute where such measurement is most reflective of the underlying risks and potential cash flow volatility to which the reporting entity is exposed as result of holding the financial instrument, such as most financial assets and derivatives, and financial instruments held for trading or speculative purposes.

In contrast, most financial liabilities not held for speculative or trading purposes have a binary risk profile based upon default. If there is no default, then all the cash flows of the financial liability will be paid. Adjusting these cash flows for credit risk is not accurate because it is not likely that a liability will be repaid at the same rate as the probability of repayment of the liability. For those financial instruments that have contractual cash flows that are held for payment or collection, we believe that the appropriate measurement attribute is amortized cost. We believe it is important that the decision usefulness of fair value information for such financial instruments be retained by requiring the disclosure of such fair value information and discussion of the probability of the binary outcome in the financial statement footnotes.

We understand and agree in principle with the Board's objective for reducing complexity related to analysis of hybrid financial instruments. Consistent with our views on the accounting for financial liabilities described above, we do not agree with the Board's decision to require hybrid financial liabilities containing embedded features requiring separate accounting to be measured at fair value in their entirety. If a reporting entity's business strategy is to hold the instrument for payment of contractual cash flows, then the most appropriate measurement attribute for the host contract is amortized cost, with embedded features reported at fair value when required. We believe that this accounting model most closely reflects the underlying risks of such instruments.

Importantly, whether hybrid financial liabilities are measured at amortized cost or fair value, we believe that details of the nature and potential volatility of each of the embedded features should be included in the footnotes so as to ensure transparency of each of the underlying risks to which the reporting entity is exposed. Such disclosure will help ensure that measuring an overall hybrid instrument at fair value will not decrease the level of transparency for hybrid instruments with multiple underlyings. For example, if ABC Co. (US functional) issues debt agreement whereby they pay 5% interest in Euro and 200,000 barrels of WTI Crude Oil per day, measuring the entire hybrid contract with multiple embedded derivatives at overall fair value does not allow the user to differentiate the foreign currency risk or the commodity risk from the host liability.

Hedge Accounting

We support and agree with the Board's objective to simplify the accounting for hedging activities. However, we do not believe that the proposed ASU accomplishes that objective as currently written. While the proposed relaxation of the effectiveness threshold and procedural requirements should allow more hedge relationships to qualify for hedge accounting, the lack of specificity of how the proposed guidance is to be applied does little to alleviate the long standing grievance amongst preparers that the application of hedge accounting rules is prohibitively complex and subject to interpretation. Because the proposed ASU leaves practitioners with as many questions upon implementation as did currently effective accounting guidance, the lack of specificity will likely result in equal diversity in practice, or worse, cause reporting entities not to pursue the full benefit of the relaxed guidelines out of concern for regulatory or auditor interpretation or scrutiny. As such, we believe the proposed ASU should be modified to include implementation guidance which addresses these matters.

We disagree with the Board's decision that reporting entities account for ineffectiveness arising from underhedging in a cash flow hedge because, consistent with Board's basis for conclusions in SFAS 133, we believe the recognition of gains or losses related to forecasted transactions is inappropriate and would not otherwise meet the requirements for revenue or expense recognition under other relevant accounting literature.

We strongly disagree with the Board's decision to prohibit the de-designation of a hedging relationship without terminating or completely offsetting the derivative hedging instrument. The proposed requirement results in an increase in transaction costs with no commensurate increase to the integrity of the hedge accounting model. Appropriate application of the currently effective de-designation guidance does not provide notable opportunity in practice for earnings management or arbitrage. In contrast, de-designation of hedging instruments is an essential component of many highly effective hedging strategies, and the de-designated derivatives are oftentimes re-designated in other highly effective strategies or utilized as economic hedges. Paragraphs 120 and 121 of the Proposed ASU appear to be slightly contradictory, and we would request increased clarity on these proposed changes. Paragraph 120 seems to indicate that dynamic hedging, or other actively managed portfolio hedge relationships which are re-balanced through the addition and deletion of derivative instruments and/or hedged items are no longer permitted hedge accounting strategies.

We also disagree with the amortization of option premiums. When recording options at fair value, the fair value is equal to the remaining premium. Showing a separate unamortized amount that will vary by rational method used does not provide additional information to the users and diminishes the point of fair valuing the option. The only information that amortizing an option premium provides to the user is the approximate time to expiration for the option or portfolio of options. This can be described more thoroughly through disclosure requirements that describe the sensitivity of options to volatility and time. The amortization of option premiums on a rational basis is neither informative to users nor does it accurately reflect the inherent risks of the instrument.



Finally, in keeping with the Board's objective to simplify hedge accounting, we believe the Board should seize the opportunity to reconsider hedgeable risks related to nonfinancial items. Current accounting guidance requires the designated hedged risk to be the changes in overall cash flows and prohibits the bifurcation of a pricing component as the hedged risk under the premise that there is not a predictable, separately measurable effect upon the price of the hedged item. Within the commodities markets, forecasted transactions are commonly priced based upon a mixed attribute model whereby the majority of the overall price is determined according to a price index, and other components associated with processing costs, transportation, basis, etc. may be added or subtracted to the pricing index to arrive at the overall price of the item. In these situations, the pricing index is typically an explicit and separable component in the contract, is referenced as common industry practice for pricing the subject asset, and is readily and objectively observable in the marketplace. In other words, many nonfinancial pricing indices may be established to have a predictable, separately measurable effect upon the price of the hedged item in a manner akin to interest rates or foreign currency risk, and would therefore be appropriately hedged as a separate underlying risk.

Should you have any questions regarding our comments, please contact me directly.
Sincerely,

Chandu Chilakapati



Appendix A: Response to Hedge Accounting Questions

Question 56: We agree with modifying the effectiveness threshold from highly effective to reasonably effective is appropriate. This will allow more preparers to adopt hedge accounting which will give users a more accurate view of the company's exposure to market risks. We believe that some greater clarification around what this threshold means would benefit the preparers and allow them to feel more comfortable utilizing hedge accounting.

Question 57: We believe that attaining hedge accounting makes a statement about the quality of earnings and the continued qualification gives users confidence in the earnings related to hedge accounting transactions. We do see the benefit from a preparer standpoint and believe that this can be preserved by requiring continued qualification, but on an annual basis with quarterly assessments only when there are significant fundamental market changes to the underlying of either the hedged item or hedging instrument.

Question 58: Yes, we believe that requiring an effectiveness evaluation after inception only if circumstances suggest the hedging relationship may no longer be reasonably effective would result in a reduction in the number of times hedging relationships would be discontinued. This is especially beneficial to companies using the dollar offset method for assessing effectiveness. A greater impact to reducing discontinued hedging relationships is the lowering of the effectiveness threshold.

Question 61: There are significant operational concerns and constraints in calculating ineffectiveness specifically for non-financial instruments in cash flow hedging relationships. Under the proposed rules, more companies would qualify for hedge accounting with a lower correlation between hedging instrument and hedged item (regardless of whether a quantitative test was administered). This would mean that there are greater differences between the hedged item and hedging instrument for which many of them are not likely transparent risks. This will require companies to project taxes, transportation, and other costs associated with the hedged item forward into the future which is difficult and inaccurate. Similar issues may occur on financial instrument where the risk being hedged is not a benchmark interest rate.

We would alleviate this constraint by allowing companies to bifurcate by risk where the risk is exchange traded and all other aspects of the contract are fixed aside from taxes. These types of contracts are over the counter and have various names, but Exchange for Physical (EFP) is common. These types of contracts fix the price of future cash flows when combined with an exchange traded contract. The company knows exactly the price it will pay or receive for the

non-financial asset, yet the accounting rules cause ineffectiveness due to potential changes in the fixed basis portion of the EFP contract. This is similar to hedging a benchmark interest rate where the transparent risk is hedgeable and the accounting model would be simple to transfer to non-financial instruments.

Question 62: We believe that greater clarity by the Board is necessary to explain reasonably effective and examples of common relationships and the changes in circumstances that might suggest that a hedging relationship is no longer reasonably effective. One of the concerns that we hear from our clients that do not use hedge accounting is that the risk of applying hedge accounting and then having an accounting adjustment due to the varied interpretation of the hedge accounting rules is too great. Creating diversity in practice will cause fewer companies to utilize it out of fear of not having leading practices or processes.

Question 63: We have assisted 100's of clients with designation and de-designation of hedge relationships over the past 10 years. We have yet to encounter a situation where a company has abused the de-designation at any time election. For the past 2 years, experts have been predicting that that interest rates cannot go any lower, which would have been an opportunity to abuse the dedesignation at any time election. We have not seen the election used and it was a good thing, because long term interest rates did continue to go down. The market is volatile and unpredictable and if a company chooses to de-designate hedge accounting because it expects to be able to predict the market, we believe that they can disclose the election to discontinue hedge accounting and users will understand the risk and reward associated with changes in the hedging instrument that is no longer being designated despite the underlying hedged item continuing to exist.

We believe that retail companies that have a large number of customers that each represent small market risk exposures with unpredictable volumes will have a difficult time complying with the rules without the possibility of de-designating certain instruments. The nature of their business makes the hedged item slightly variable which requires constant management of their portfolio of hedging instruments. The proposed standard is unclear between paragraph 120 where dedesignation of the hedge relationship is only allowed when the hedging instrument is fully offset by another instrument. Whereas in paragraph 121 an entity may modify the existing hedging relationship by adding a derivative to the existing hedge relationship that would not fully offset the existing hedging instrument and would not reduce the effectiveness of the hedge relationship. Paragraph 121 seems to be slightly contradictory unless this was written to allow changes to the hedge instrument volume based on changes to the hedged item forecasts such that these changes do not decrease the effectiveness of the hedge relationship without a formal dedesignation of the hedge relationship as it may have required under the current ASC 815 requirements. These two paragraphs are extremely important to preparers and auditors who have portfolio hedging considerations and requires clarity related to application. Specifically, does this require a quantitative test to demonstrate the change in hedge relationship did not reduce the effectiveness of the hedge relationship? Also, can purchases and sales (long positions and short positions) exist in the same portfolio designated



as a net hedge instrument of a forecasted exposure?

Question 64: We do not see any significant operational constraints arising from the required concurrent documentation of the effective termination of a hedging derivative attributable to the entity's entering into an offsetting derivative instrument.



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Comment Letter No. 1498
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