

August 14, 2008

Mr. Russell G. Golden
Director of Technical Application and Implementation Activities
Financial Accounting Standards Board
of the Financial Accounting Foundation
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116



Re: File Reference Number 1590-100, Proposed Statement of Financial Accounting Standards, Accounting for Hedging Activities, an amendment to Statement No. 133

Dear Mr. Golden:

The Association for Financial Professionals (AFP) welcomes the opportunity to comment on the FASB's proposed amendment to FAS 133, Accounting for Derivative Instruments and Hedging Activities. We strongly support the efforts of the FASB to steward the development of accounting standards that are useful and meaningful.

AFP represents approximately 16,000 finance and treasury professionals from over 5,000 corporations, including Fortune 1,000 and the largest of the middle market companies. Our membership includes a significant number of corporate treasurers who are responsible for the protection and management of corporate cash and cash flow requirements, including hedging activities for their companies, and for the oversight of cash management and investments, both short-term and long-term.

AFP disagrees with the proposed amendments to FAS 133 for the following reasons: 1) they don't simplify the application of the statement as promised-- testing is substantially simplified, but reducing bifurcated risk increases substantially the complexity; 2) the accounting results will not fairly reflect risk management strategies and may obscure operating results; and 3) the amendments represent a further departure from IAS 39 when US companies are preparing for an ultimate convergence to that standard.

AFP disagrees with eliminating the ability to de-designate a derivative from a hedge relationship, which has not been an area of significant complexity in practice. The intentions are unclear considering that dedesignating a hedge relationship is not permitted while termination of a hedging relationship by entering into an offsetting position is permitted. The second approach to hedge termination achieves the same result but with additional cost and complexity.

The following comments respond specifically to the issues presented by FASB staff in the Exposure Draft.

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# **Hedged Risk**

### Issue 1

AFP believes that several very simple and effective hedging strategies will be disallowed under the proposed amendments. What and how corporate America hedges certain risks using derivatives contracts is driven by the financial derivative instruments that are available in the market to hedge specific risk. In most cases, this means derivative contracts that are based on interest rates such as LIBOR or Treasury, or commodity prices as those that are published by the NYMEX. As expected, the fair value for index-related derivative instruments rises and falls relative to the prevailing market rates as reported by the index and their associated forward curve. However, the fair value of the hedged item rises and falls for a variety of reasons when fair value is driven by the index (hedged) and credit spread and a potentially infinite number of variables unique to each business situation (not hedged). Should the amendments ultimately disallow the designation of the hedge-able risk, every single hedging relationship will be inaccurately represented in the financial statements with varying degrees of ineffectiveness.

From a financial statement reader's perspective, the resulting ineffective portion reported would not be meaningful or conclusive in understanding the financial condition of the reporting entity. Business risks that influence fair values are managed by means other than standard derivative contracts, such as additional collateral, adjusted pricing, or reducing business exposure. These risk mitigation efforts are not measured and reported in the financial statements at fair value.

### Issue 2

If these changes are implemented as proposed the result will be (1) greatly reduced use of common, effective and prudent hedging strategies, which will mean more risk is born by investors and (2) when hedging strategies are employed, the accounting changes will produce results that do not reflect the hedging strategy or operating results, producing counterintuitive and misleading results in financial statements.

Consider the practical application of the proposed amendment when companies have a forecasted debt issuance and wish to lock in a forward index rate, such as swap spreads, LIBOR or Treasury. The proposal would eliminate of the ability to designate interest rate risk as the risk being hedged. Instead, the company must designate the overall change in cash flows as the hedged risk. Because the credit margin in addition to index rate on which the company has a rate lock is yet to be determined, and the hedge is fixing only one aspect of the total rate, the hedging relationship will be ineffective and produce volatility in earnings. Bifurcation of risk would reduce this perceived exposure by management.

Many companies actively manage their interest rate exposures through the use of interest rate swaps designated as fair value hedges. The risk management objective is to protect shareholders from changes in interest rates—not credit spread. Serious concerns over insider information and self dealing effectively prohibit hedging a firm's own credit spread. As proposed, fair value hedges and forecasted debt issuance hedges would require recognition of changes in credit spread in income, assuming the impact of such changes do not disqualify the use of hedge accounting. We believe the hedge accounting model should not introduce income volatility for risks unrelated to the risk management objective, particularly when unhedged debt is not marked-to-market for such changes and when such changes do not represent cash flows or economic impacts.

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Our concerns are only heightened when considering that the outcome of this decision for hedging debt will result in losses from improvements in credit spread and gains as credit spreads widen. AFP is concerned with this outcome and the misleading and counter-intuitive impacts on income. For example if a company's credit spread widens, the so called fair value of its debt would decrease creating an increase in earnings regardless of the fact that the company still owes the original principal and will have to pay accordingly conversely if the credit spreads tighten, the value of the debt would increase and earnings would fall. This creates an incentive to decrease credit ratings / increase risk and provides a lever for companies to manipulate earnings. The result of the loss of bifurcation of risk will be that some hedges will not qualify for hedge accounting at all due to changes in credit spread, and for transactions that do qualify for hedge accounting, the ineffectiveness will produce significant earnings volatility from risks a company isn't attempting to hedge and has no ability to hedge.

Limiting the ability to hedge the benchmark interest rate only to "at inception hedges" of a company's own issued debt places undue constraints on companies that manage interest rate risk on an ongoing basis on behalf of their shareholders. Such risks change over time and accounting rules should not provide a disincentive to prudent and flexible risk management practices. Furthermore, the ability to average in over time is a prudent approach when entering into financial instruments, including hedges.

With respect to foreign currency hedging, we think that the Board should address qualifying intercompany hedge activity to permit the designation of hedges in other than the functional currency. As it stands today, a number of managers are addressing currency exposure from foreign subsidiaries much like third party currency risk exposures. Management of US companies should be permitted to hedge economic long foreign currency positions on a consolidated basis using a derivative short position designated as hedging a non-functional currency intercompany transaction. We urge FASB to more fully address this problem in the final amendments to the standard.

## **Hedge Effectiveness**

# Issue 3

Arguably most controversy surrounding FAS 133 has been on the subject of hedge effectiveness. On this point, numerous DIGs have been issued and auditors have changed opinions and interpretations. Inevitably, when the effectiveness is in question there exists a chance for unintended recognition and distortions to reported earnings.

Over the years, one of the few qualifying assurances on which financial executives have come to rely has been the shortcut method and critical terms matching. Both of these methodologies were designed to simplify hedge accounting and have generally worked well in practice. The FASB's stated goal for this project is to simplify hedge accounting, but removing the two most heavily relied upon simplification provisions is counter to that goal. Shortcut method provides the most clear and accurate representation of financial results: it is less prone to error and far less expensive to implement than long haul methods. Conversely, the long-haul methodology is not consistently applied absent better guidance in the literature. The notion that long-haul is accurately capturing ineffectiveness missed by shortcut is not well supported.

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We think that the requirement to use long-haul for fair value hedges will add unnecessary complexity and administrative burden when the objective of the hedge was to simply manage interest rate risk. The shortcut method aids significantly in the ongoing administration of hedge relationships. While the use of the proposed "reasonably effective" standard should assist in simplifying the assessment of effectiveness, it does not provide the simplifying benefit in measuring ineffectiveness that is allowed under the shortcut method. We favor the shortcut method because it is an objective standard in an area of financial reporting where subjective criteria has proven to be risky, and could result in unintended consequences. If the FASB would like to enhance this simplified approach, it should make it clear that shortcut requires matching of only critical terms and not insignificant terms.

For reasons stated above, we disagree with the FASB's plans to eliminate the shortcut method and critical terms matching. Our concern is heightened when eliminating the bifurcation of risk is also under consideration by FASB. Consider that the proposed amendment, those hedging arrangements that once qualified for shortcut method, when terms matched identically, will be considered ineffective nonetheless. We urge the FASB to retain shortcut method and critical terms matching, recognizing the value in retaining objective standards within an already extremely complex accounting rule.

### Issue 4

The proposed modification to effectiveness testing from "highly effective" to "reasonably effective" will theoretically expand the situations in which certain risks may be hedged. After several years of accommodating the more strict approach to effectiveness testing, the easing of the effectiveness measure allows other hedging relationships to be considered. We are reluctant to wholly endorse the change without more information about how the subjective "reasonably effective" measure would be applied.

### Issue 5

We understand that the proposal will ease the burden of quarterly effectiveness evaluations. Under the current standard, effectiveness is evaluated at inception with an attendant hedge designation memo, which includes how the hedging relationship will be assessed for effectiveness going forward. The standard requires that these relationships be reassessed each reporting period to confirm effectiveness as expected at inception. We support a proposal that eliminates the ongoing reassessments, and instead requires an evaluation when circumstances have changed so that the hedging relationship may no longer be effective. We think that this application along with the "reasonably effective" standard will result in fewer hedging relationships failing an effectiveness test.

### Issue 6

The proposal still requires companies to make assessments of the effectiveness of hedging relationships. This continued requirement is consistent with other aspects of hedge accounting, relying on management to assert and document the hedging relationship in order to qualify for hedge accounting. We endorse the decision not to discontinue assessments following the inception of a hedging relationship. This position is intended to conform and not contradict our earlier stated position in support of qualitative assessments of hedge effectiveness and the reasonably effective standard put forward in this amendment.

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# Presentation of Hedge Gains and Losses

#### Issue 7

The proposed amendment directs financial statement preparers on the financial statement presentation of gains and losses associated with hedging instruments, including the effective and ineffective portions and any amount that is excluded from effectiveness testing. We think that the disclosure requirements of the newly adopted standard, FAS 161, requires similar information for disclosure purposes and that additional direction adds to the complexity of the standard.

## **Effective Date and Transition**

### Issue 8

The effective date for this proposal will be for fiscal years beginning after June 15, 2009. We think that this would be too soon if the Board decides to disallow bifurcation by risk. The consequences of that particular decision complicate the adoption of amendments that are intended to simplify FAS 133. We expect more ineffectiveness in hedging relationships will be measured, resulting in unpredictable earnings consequences, and we are unsure about the definition of reasonably effective. Given these critical uncertainties, we think that the transition period should be more generous.

#### Issue 9

Adoption of these amendments should involve disclosures. We expect that the effectiveness testing and explanations of what management considers "reasonably effective" would be included in the disclosures. Also, if the Board disallows the bifurcation by risk on hedging relationships, then the consequences of the hedge and hedged item mismatch need to be addressed. We expect that the disclosures would explain the additional unrealized gains and losses recognized in GAAP net income, the effect on earnings per share and related guidance provided to the capital markets.

#### Issue 10

We support the transition guidance that permits a one-time allowance to report at fair value certain assets and liabilities that would qualify for a hedging relationship. The consequence eliminates income recognition that we think would otherwise distort reported earnings.

## **Benefit and Cost Considerations**

### Issue 11

Each company that has adopted FAS 133 has done so at a great cost, especially in relation to the reporting of other assets and liabilities. For many companies, subject matter experts have been hired and additional external auditor resources have been needed to cover derivatives accounting. An additional consideration would be the cost of restatements for those companies whose derivatives relationships were not deemed "highly effective" by the terms of the original standard. Please know that the new rules will require significant compliance efforts from corporate finance, treasury and accounting departments. Implementation will necessitate new hedge designations, revised valuation methodologies, long haul models, retraining of staff, and revisions to procedure manuals, internal controls and systems. This will in turn increase auditing costs and create more resource burdens.

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Users of financial statements will not receive a benefit through an improvement to the financials, as many of these changes make the statements less transparent and more confusing. Shareholders will not be served by the additional cost and confusion this creates, or more importantly by the reduction in the prudent use of risk management practices utilized by management (more risk will be born by investors as a result of these changes). As a practical matter, financial statement users often disregard unrealized gains and losses, and prefer non-GAAP performance metrics to EPS because of the derivatives accounting distortions.

While consensus supports derivatives representation on the balance sheet as an asset or a liability, preparers and users alike are not supportive of the distortions to EPS created by random changes in market indices. AFP believes, absent several changes requested herein, that the benefits to hedge accounting contained within the proposed amendments do not offset the great costs of this standard to corporate America, the confusion among the users of financial statements and the increased risks to investors.

Thank you for the opportunity to comment. Please feel free to contact Jeff A. Glenzer, CTP, Managing Director, at (301) 961-8872 for follow up questions about our remarks stated herein.

Sincerely,

June M. Johnson, CPA, CTP

Chair of the AFP Financial Accounting and

Investor Relations Task Force

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