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Russell Golden, Technical Director File Reference No. 1810-100 Financial Accounting Standards Board 401 Merritt 7 PO Box 5116 Norwalk, CT 06856-5116

Dear Mr. Golden,

We appreciate the opportunity to respond to the Exposure Draft on Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities. Alcoa is the world's leading producer of primary aluminum, fabricated aluminum and alumina. Being an industrial firm, we are not as impacted as financial institutions are by certain of the more contentious provisions in the Exposure Draft such as the extensive use of fair value measurements. There are, however, a number of provisions in the Exposure Draft which would impact us significantly and for which we provide our comments below.

In general, we believe the current and proposed rules, in many cases, restrict a company's ability to accurately reflect the economic consequences which result from its use of financial instruments. Therefore, we strongly support the views of the dissenting Board members Ms. Seidman and Mr. Smith who highlight the need to simplify the financial instruments accounting literature... "in a manner that reflects the nature of the instruments and the way they are used by the reporting entity". We believe management's business reasons for holding these instruments are very important considerations in determining the appropriate accounting treatment for their classification and measurement. Similar to the approach the IASB appears to be taking on a number of aspects of its Financial Instruments Project, we would encourage the Board to also include the consideration of an entity's business model as a significant factor in determining the appropriate accounting for the use of financial instruments or other contracts (i.e., power contracts) that, under current and proposed interpretations, could be treated as financial instruments.

In our response, we mention a number of circumstances in which the existing and proposed rules restrict us from clearly reflecting our business model. These situations can be quite complex and we would therefore welcome the opportunity to discuss in more detail with the Board or its staff the specific practical issues we have encountered in applying the existing standards and those which we foresee with the use of the proposed standards. Should the Board choose to field test certain portions of the proposed standard prior to issuance of the final standard, we would be very willing to participate in that effort, as appropriate.

In a similar context, we would also agree with the financial institution respondents who support the use of amortized cost for financial instruments held for their contractual cash flows. We would also agree with them that the IFRS 9 approach for financial instrument classification and measurement, which utilizes both amortized cost and fair value measurement based on an enterprise's business model, is a more appropriate framework. We believe the "default" measurement of financial instruments at fair value, as outlined in the proposed ASU, will diminish the relevance of an entity's financial results and obscure the true measures of operational performance. We recognize, in certain cases, such as when measuring financial liabilities at fair value would create a mismatch, amortized cost may be elected under the proposed ASU. However, that election can only be used if "bright line" criteria (< 50% of assets being measured at fair value) are met. This reintroduces the inherent problems previously experienced with quantitative criteria, such as a drastic change in an entity's accounting policies which will result simply from the movement from 49% to 50% of a company's recognized assets being measured at fair value. Therefore, we would join others who encourage the Board to conform to the overall principles-based "business model" framework in IFRS 9.

We also would strongly encourage both the IASB and the FASB to work diligently to harmonize the different approaches to financial instruments accounting which remain under the Boards' existing literature and current proposals. Accordingly, we have also provided our views as to which Board's approach we believe to be most appropriate.

Our more detailed comments are provided below, beginning with those items in the proposed ASU which we believe will not appropriately reflect the economics of the business model under which we use various financial instruments. We also include remarks on additional areas in the proposed ASU with which we have concern.

"BUSINESS MODEL" COMMENTS

Bifurcation by Risk for Non-Financial Elements

The inability to bifurcate by risk for non-financial contracts presents us with difficulties in accounting for a number of significant transactions.

For example, the pricing of our primary aluminum products are frequently based on the London Metal Exchange (LME) aluminum price plus regional premiums for transportation differentials. We can readily hedge the LME component of our product pricing through the use of LME forward contracts. However, we are either not able to hedge or choose not to hedge the regional premiums. Under existing rules, this requires us to record, in current period net income, the ineffectiveness for the regional premium component of our pricing. We believe it would be a better reflection of our business intent if we were able to bifurcate the risk which we are easily able to hedge, the LME risk, and not distort current net income with the ineffectiveness related to movements in the regional premium, which we are generally not able to hedge.

In addition, we have similar situations for sales of fabricated aluminum products and purchases of raw materials, such as fuel oil components in freight contracts.

Bifurcation of Embedded Derivatives

The proposed ASU continues the existing GAAP practice of analyzing embedded derivatives in hybrid non-financial instruments for bifurcation. Over the years of applying FAS 133 (now ASC 815), we have consistently struggled with this requirement as we believe current GAAP does not allow us to properly reflect the business model under which we operate for many of our hybrid non-financial instruments. An example would best describe this point:

As energy is a very large component of our cost structure, some of our power contracts include pricing provisions that index the price of the power to the London Metal Exchange (LME) aluminum price. We are comfortable operating under these types of power contracts as this pricing provision serves as a "hedge" of a key component of our operating costs. As the LME price goes up, our power price goes up (with no or minimal lag) and vice versa when LME prices decline. Our economic view of these contracts is, as our revenues change based on movements in the LME a significant portion of our costs also change, providing a hedge of our operating margins. Our preference, therefore, would be to account for the "LME indexed" power cost consumed in a given month as the actual cost for that month (which it is). Our revenues will likewise reflect the same current impact of the movement in the LME, resulting in an accurate depiction of the intended economic consequences of the contract, i.e., as LME revenues go up, they are offset to an extent by higher power costs and, as LME revenues go down that negative impact is offset to an extent by lower power costs.

However, under current GAAP and the proposed ASU, the LME-linked pricing features are considered embedded derivatives and need to be analyzed for bifurcation. While power costs are a major component of our cost base, the price of aluminum on the LME is not "clearly and closely related" to the price of power and, therefore, does not qualify for that exemption from bifurcation. Accordingly, we are required to bifurcate the LME component of the power contract as an embedded derivative and account for it separately. In accounting for these embedded derivatives, we try to maintain and reflect the hedge relationship described above. The most appropriate way to do this under existing rules is to designate them as cash flow hedges of future sales of aluminum. A fair value for the embedded derivative is calculated, recorded to OCI and marked to market in future periods. As future sales of aluminum occur, the appropriate amounts are recycled out of OCI and recorded as an adjustment of revenue (not cost). In certain cases, due to the formula of the LME pricing provision, we are even precluded from this alternative and are required to mark the embedded derivative to market through net income.

We do not believe the above accounting, which is required by GAAP and now in the proposed ASU, is the best depiction of the business model in which we utilize such contracts for the following reasons:

- The movements in the price of our power are reflected as an adjustment of revenue, as opposed to our operating costs, which is how we view them for managerial purposes.
- Our balance sheet is grossed up for the mark-to-market value of these embedded derivatives which do not, in our opinion, readily compare to the other assets and liabilities of the company.
- The movements in these recorded embedded derivatives frequently result in large adjustments to OCI or net income which do not necessarily provide a fair presentation of the economics of these transactions.
- Given the long duration and unique characteristics of these contracts, the associated embedded derivatives (which are extremely illiquid) are frequently difficult to value. We therefore question whether fair valuing these instruments (in most cases, using internal models) provides useful information.
- The accounting for these derivatives is extremely complicated, difficult to administer and challenging to explain to operating management, let alone to the readers of our financial statements.

We therefore would request that the Board reconsider the exemptions to bifurcations of embedded derivatives in hybrid non-financial instruments and include an exemption which allows a company not to bifurcate an embedded derivative if it believes it is not an appropriate reflection of the business objective of the hybrid instrument. Another approach to address this might be to expand the use of the "normal purchase/normal sale" exemption (which is presently quite restricted) if it more appropriately reflects the entity's business model. Your attention to this matter would be greatly appreciated and we would again repeat our offer to work with the FASB or its staff should they desire a more thorough understanding of this or other issues mentioned above.

ADDITIONAL COMMENTS

Impact of Changes in Own Credit on Financial Liabilities

Under the FASB Exposure Draft, changes in the fair value of liabilities due to changes in an entity's own credit would be recorded in net income but separately disclosed. Under the IASB approach, these changes would be recorded in OCI with no recycling to net income. We believe the counterintuitive result of a company's financial liabilities' fair value actually decreasing when its credit rating declines is more appropriately reflected in OCI as opposed to impacting the primary metric of net income.

Short Term Receivables and Payables

We note the Board is proposing that short term receivables and payables which are due in the customary terms not exceeding one year be recorded at amortized cost. We agree with this approach but would add that we prefer that <u>all</u> receivables and payables (whether less than one year or not) that are held for collections or are intended to be paid under normal terms be recorded at amortized cost, as required by IFRS 9. We believe the measurement of these receivables and payables at amortized cost is an accurate presentation of their anticipated economic benefit or cost. Subjecting receivables and payables which exceed a year to the provisions of the proposed ASU would significantly increase the cost of accounting for these items without providing any significant additional informational value to the reader. We also would ask that the Board clarify whether this treatment applies to prepayments and deferred revenues. We do not believe these are intended to be in the scope of this ED but would appreciate confirmation of that conclusion in the final document.

Credit Impairment of Financial Assets

While this issue is generally confined to credit impairment on accounts receivables for Alcoa, we would agree with the financial institution respondents who recommend that the impairment testing on financial instruments should not be limited to consideration of only past events and existing conditions but also take into consideration future conditions, as proposed by the IASB. It would appear to us that the FASB's model would result in unnecessary volatility and over-conservative recognition of impairment reserves, particularly in economic situations similar to the current one in which current 10% unemployment rates might not be considered a fair depiction of expected economic conditions over the life of the financial asset. The Board should also ensure the decisions made in this area are consistent with those related to the impact of credit quality in the Revenue Recognition project.

Financial Statement Presentation

Under the proposed ASU, for financial instruments measured at fair value through net income, the following amounts must be shown on the face of the statement of financial position:

- Fair value of the instrument
- Amortized cost of the entity's own debt.

For financial instruments measured at fair value through other comprehensive income, the following must all be presented on the face of the statement of financial position:

- Amortized cost
- Allowance for credit losses on financial assets
- The accumulated amount needed to get to fair value all must be shown on the balance sheet
- Fair value

We believe the presentation of these various amounts on the face of the financial statements will cause considerable confusion to readers of the financial statements. We would prefer that these "supplemental" amounts not be presented on the balance sheet but instead be shown in the footnotes, which essentially is the approach taken in IFRS 9.

Perhaps this issue, which effectively deals with the significance of parenthetical information on the face of the financial statements, should also be given more consideration in the Financial Statement Presentation project.

Pre FAS 133 Grandfathering of Embedded Derivatives

As the Board is aware, contracts entered into prior to the issuance of FAS 133 were exempt from the review for embedded derivatives. We would assume this exemption still stands and would request the Board's clarification of this in the final document. In our industry, it is common to have 20-25 year contracts so this exemption is still very important to us.

Hedge Accounting

Overall, we are supportive of the simplified approach to accounting for derivatives and hedging and we view the proposals as a significant improvement to current GAAP. However, we would agree with other respondents in requesting that the Board consider eliminating the requirement for a quantitative assessment of effectiveness to be necessary in certain circumstances. We share their concern that this will lead to more frequent usage of quantitative assessment than is intended by the Board, as a way of "proving" the qualitative assessments. The Board recognized this concern in FAS 167 with respect to variable interest entities. A qualitative-only approach will be very effective on its own and will greatly simplify the requirements of hedge accounting.

Equity Method and Cost Method Accounting

In order to use the equity method of accounting under the proposed ASU, an entity must have significant influence <u>and</u> the operations of the investee must be related to the investor's consolidated operations. Otherwise, these investments are carried at fair value. Requiring that the operations of the investee be related to the investor's consolidated operations creates a divergence between equity accounting and consolidation guidance which has never previously existed. We do not believe this change, as well as the elimination of the cost method of accounting for investments of less than 20%, should be made prior to a more full consideration as part of the Consolidation project.

We again express our appreciation for the opportunity to comment on this proposal. Please feel free to contact us with any questions you may have.

Sincerely

Graeme Bottger

Vice President & Controller