

KPMG LLP 757 Third Avenue New York, NY 10017 Telephone 212-909-5600 Fax 212-909-5699 Internet www.us.kpmg.com

February 2, 2007



LETTER OF COMMENT NO. 3

Mr. Lawrence W. Smith, Director Technical Application and Implementation Activities Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116

RE: Proposed DIG Issue H17, "Foreign Currency Hedges: Hedging Functional-Currency-Equivalent Proceeds to Be Received from a Forecasted Foreign-Currency-Denominated Debt Issuance"

Dear Mr. Smith:

We appreciate the opportunity to comment on the proposed DIG Issue H17, "Foreign Currency Hedges: Hedging Functional-Currency-Equivalent Proceeds to Be Received from a Forecasted Foreign-Currency-Denominated Debt Issuance" (proposed DIG Issue). While we understand the response included in the proposed DIG Issue, we believe there is a way to view a hedge of a forecasted issuance of foreign currency debt that provides evidence that such a forecasted transaction does impact reported earnings. We also believe the clarification of the Board's views on the requirements of paragraph 29(c) in this proposed DIG Issue may be different from what was originally intended in Statement 133 and may have broader implications that warrant further discussion and consideration, including the impact on foreign currency cash flow hedges of forecasted intercompany transactions. Lastly, if the Board decides to finalize the proposed DIG Issue as drafted, we recommend the transition be consistent with DIG Issue K5 as well as other recently cleared DIG Issues, such as DIG Issue G26.

Forecasted Issuance of Foreign-Currency-Denominated Debt

We concur that regardless of whether an entity issues the same amount of foreign-currency-denominated debt today or in the future, there is no earnings impact from the remeasurement of the debt under Statement 52 as it will be same in both instances. However, we believe that in a foreign currency cash flow hedge of a forecasted issuance of foreign-currency-denominated debt, the forecasted transaction has an impact on reported earnings through variability in the debt's functional-currency-equivalent interest payments. The goal of such a hedge relationship is to lock both the expected foreign



Mr. Lawrence Smith February 2, 2007 Page 2 of 5

currency and functional-currency-equivalent debt proceeds. One could view the impact of not hedging the exposure to changes in foreign exchange rates between the hedge inception and debt issuance as having to borrow a different amount of foreign currency proceeds to achieve a desired fixed amount of functional-currency-equivalent proceeds. This difference in foreign currency proceeds presents an exposure to variations in cash flows that affects reported earnings since it generates a difference in foreign-currency-denominated interest payments and also in functional-currency-equivalent interest payments.

For example, if a USD functional currency entity had the intention to borrow \$100 million at a time when the forward rate corresponding to the date of the expected borrowing was 1 FC: 1 USD, the entity could fix the forecasted borrowing at FC100 million and \$100 million. If the debt was later issued when exchange rates were 1.05 FC: 1 USD, the gain on the foreign currency hedging derivative would be FC 5 million (\$4.76 million). If interest rates were 6% at issuance, the resulting interest expense on the debt would be FC 6 million or \$5,714,286 (FC 100 mm * 6% * \$1 / FC 1.05), assuming no further changes in exchange rates. Please note that, consistent with the objective of the hedging relationship, the combination of the proceeds of the debt and derivative total FC 100 million and \$100 million and the interest payments are based on FC 100 million of debt even though foreign currency rates changed. If the entity had not hedged the forecasted borrowing it would have to borrow FC 105 million to get the desired \$100 million in proceeds, and the resulting interest expense would be FC 6.3 mm or \$6 mm (FC 105 mm * 6% * \$1 / FC 1.05), assuming no further changes in exchange rates. Thus, in this case the decision to hedge the forecasted issuance of foreign-currencydenominated debt results in a difference in interest expense per year of \$285,714 (\$6,000,000-5,714,286) or (FC 5 mm * 6% * \$1 / FC 1.05). We acknowledge that depending on the notional of the hedging instrument, changes in foreign currency during the term of the hedging instrument, and the tenor of the debt, the amount of the gain or loss and the reclassification of that gain or loss from accumulated other comprehensive income to earnings may provide results in earnings that may not be representative of fixing an effective interest rate on the foreign-currency-denominated debt. However, that is not the objective of the hedging relationship. In addition, we do note that there is an impact to earnings and since that appears to be the primary issue to be addressed in the proposed DIG Issue, we recommend further consideration of the above example as well our comments below related to the proposed clarification of paragraph 29(c) and how it may have broader implications than just a hedge of forecasted issuances of foreigncurrency-denominated debt.



Mr. Lawrence Smith February 2, 2007 Page 3 of 5

The proposed DIG Issue states that it is the Board's view that paragraph 29(c) requires the effect on reported earnings be directly related to the forecasted transaction as opposed to a tangential relationship. Paragraphs 402 and 403 in the basis for conclusions to Statement 133, discuss the requirement in paragraph 29(c) that a hedged forecasted transaction could impact reported earnings in order to be eligible for designation in a hedging relationship. We believe the requirement in Statement 133 for a hedged forecasted transaction to impact reported earnings is not as limiting as the proposed DIG Issue's interpretation of paragraph 29(c). In addition, the fact that Statement 133 provides the ability to hedge forecasted intercompany transactions denominated in a foreign currency raises further questions as to how paragraph 29(c) is proposed to be interpreted.

Specifically, paragraph 402 states: "... a change in the fair value of a hedge item or variation in the cash flow of a hedged forecasted transaction attributable to the risk being hedge must have the potential to change the amount that could be recognized in earnings." (emphasis added). Paragraph 403 states: "[s]ome respondents to the Exposure Draft asked the Board to permit some transactions that create an exposure to variability in cash flows to qualify as hedgeable transactions even though they could not affect reported earnings. They asserted that hedges of those transactions successfully reduce an entity's cash flow exposure. The Board decided to retain the criterion of an earnings exposure because the objective of hedge accounting is to allow the gain or loss on a hedging instrument and the loss or gain on a designated hedge item or transaction to be recognized in earnings at the same time. Moreover, without an earnings exposure, there would be no way to determine the period in which the derivative gain or loss should be included in earnings to comply with this Statement." Paragraph 484 of Statement 133 indicates that forecasted intercompany foreign currency transactions are eligible as hedged items "because, pursuant to Statement 52 as amended by this Statement, an intercompany transaction that is denominated in a currency other than the entity's functional currency gives rise to a transaction gain or loss if exchange rates change. A forecasted intercompany transaction that is expected to be denominated in a foreign currency can be viewed as giving rise to the same kind of foreign currency risk."

By limiting the hedgeable cash flow exposures as indicated in the proposed DIG Issue, hedging strategies would be precluded from receiving hedge accounting treatment in Statement 133 that otherwise have a exposure to variability in functional-currency-equivalent cash flows, can be shown to impact reported earnings, and for which the forecasted transaction impacts earnings after the hedging relationship ceases. This subsequent impact to earnings provides a way to determine the period in which the derivative gain or loss should be included in earnings.

For example, as described above, the forecasted issuance of a foreign-currency-denominated debt has an exposure to variability in functional-currency-equivalent cash flows, can be shown to impact earnings, and once the debt is issued, there is a way to



Mr. Lawrence Smith February 2, 2007 Page 4 of 5

determine the periods in which the derivative gain or loss should be included in earnings (i.e., consistent with the way the debt impacts reported earnings through interest accruals).

The following discusses a fact pattern where the Board appears to have previously concluded that there is a foreign currency exposure that satisfies all the cash flow hedge criteria, but for which we do not see a direct impact to earnings as described in the proposed DIG Issue. Consider the situation that is described in DIG Issue H13, where there is a forecasted intercompany sale transaction between Subsidiary B, which has the Euro as its functional currency, and Subsidiary C, which has the Yen as its functional currency. If Subsidiary B forecasts a sale of product to Subsidiary C in Yen and chooses to enter into a forward contract with a third-party to hedge the Yen exposure in that forecasted intercompany sale transaction, it is contemplated in DIG Issue H13 that Subsidiary B has a foreign currency exposure that is eligible to be hedged. However, that foreign currency exposure only results in foreign currency transaction gains/losses that impact consolidated earnings once the Yen denominated receivable is recognized by Subsidiary B and foreign exchange rates change subsequent to the sale, which is after the hedge relationship is terminated. The change in value of the hedging instrument does not have a direct relationship on these subsequent changes. Furthermore, the changes in fair value of the foreign currency forward contract used by Subsidiary B to hedge the Yen denominated sale has no relationship on the impact to earnings of the sale that subsequently occurs by the Yen subsidiary in Yen (i.e., there is no earnings impact to Subsidiary C or the consolidated entity for the third-party sale as that sale is in the same currency as the functional currency of the entity making the sale).

We recommend clarifying how forecasted intercompany transactions denominated in a foreign currency (as contemplated in paragraphs 36 and 40 and DIG H13) and other common foreign currency hedging strategies are impacted by the clarifying guidance related to paragraph 29(c) in the proposed DIG Issue.

Transition

If the Board decides to finalize the proposed DIG Issue as drafted, we recommend the transition be consistent with DIG Issue K5 as well as other recently cleared DIG Issues, such as DIG Issue G26. According to DIG Issue K5, an entity that had followed hedge accounting for a hedging relationship that no longer qualifies for hedge accounting based on newly issued cleared implementation guidance must dedesignate that relationship prospectively. For a cash flow hedge, the derivatives gain or loss for the period prior to the effective date shall remain in other comprehensive income and be reclassified into earnings consistent with the provisions of paragraph 33 (e.g., over the remaining life of the debt).

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Mr. Lawrence Smith February 2, 2007 Page 5 of 5

If you have any questions about our comments or wish to discuss any of the matters addressed herein, please contact Enrique Tejerina at (212) 909-5530.

Sincerely,

KPMG LLP