financial executives
international

committee on corporate reporting

August 20, 2008

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

Re: File Reference 1590-100

Dear Mr. Golden:

The Committee on Corporate Reporting ("CCR") of Financial Executives International ("FEI") appreciates the opportunity to share its views on the proposed Statement of Financial Accounting Standards *Accounting for Hedging Activities: an amendment to FASB Statement No. 133* (the "ED"). FEI is a leading international organization of senior financial executives. CCR is a technical committee of FEI, which reviews and responds to research studies, statements, pronouncements, pending legislation, proposals and other documents issued by domestic and international agencies and organizations. This document represents the views of CCR and not necessarily the views of FEI or its members individually.

In the present environment, in which complexity in financial reporting is an important and highly visible issue, we commend the Board for addressing this subject. The Board's efforts notwithstanding, however, we find the Board's approach to simplifying FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* ("FAS 133") disappointing in the following important respects: (1) the amendment does not address many, if not most, of the complexities companies currently experience in applying the standard (e.g. scope, definition of a derivative, accounting for embedded derivatives, etc.); (2) with respect to aspects of FAS 133 complexity that the ED does address, it represents a mixed bag of helpful changes (e.g., qualitative assessments of effectiveness) and unnecessary fundamental changes (e.g., elimination of bifurcation by risk for many common hedging strategies) that undo previous efforts, including FASB Statement No. 138 *Accounting for Certain Derivative Instruments and Certain Hedging Activities-an amendment of FASB Statement No. 133* ("FAS 138") to make FAS 133 an operational standard; (3) the ED eliminates established and widely understood simplifying methodologies (i.e. short cut method and matched critical terms) and (4) the ED represents an overall movement to principles that diverge from, rather than converge to, IAS 39, *Financial Instruments: Recognition and Measurement* ("IAS 39"), especially at a time when many U.S companies are evaluating a move toward international financial

and reporting standards. Moreover, we do not find the explanations and rationale for these changes compelling both from a conceptual standpoint and in explaining how they help reduce complexity.

We believe that if the ED is finalized at or near its present form, fewer overall transactions will qualify for hedge accounting. In our view the important objective of the Board for simplifying hedge accounting is not met by the net elimination of items qualifying for hedge accounting treatment. Therefore, we strongly recommend that the project not proceed further and that efforts be put towards developing a plan to help U.S. companies transition to IAS 39, which we view as a simpler (albeit still complex) standard than FAS 133.

Listed below are the overriding concerns we have with the proposed changes. Our responses to the specific questions listed in the Notice for Recipients are provided in the Appendix to this letter.

Elimination of Bifurcation-By-Risk

We strongly support the views expressed by the two dissenting Board members to the ED as summarized in the Alternative View. Those Board members accurately predict that the elimination of the bifurcation-by-risk approach will cause companies to abandon very commonly applied risk management techniques that are both prudent and appropriate. The application of hedge accounting to many transactions which truly represent economic hedges would be eliminated. In an environment where the risk management and accounting approaches applied by financial institutions is currently under much scrutiny and critique and such companies are already experiencing financial distress, it would seem that the best course of action would be to adopt principles that facilitate, rather than hinder, prudent risk management.

As the Board is aware, the ED's requirement to fair value the entire hedged item introduces earnings volatility associated with credit spreads, which are typically not hedged. The Board's rationale for this change seems to be that reflecting the full fair value of the hedged item better reflects the economics of the hedging arrangement. We do not understand this view since the hedge is not economically designed to compensate for changes in credit risk. It would be clearer to say that the accounting reflects in earnings the economics of what is <u>not</u> being hedged and that also is problematic since those same risks are not being hedged in other assets and liabilities that are not designated as hedges. The effects of credit risk on those assets and liabilities are not reflected in earnings. We struggle to understand how this improves financial reporting. There is no compelling reason for a company to hedge the credit risk on its own debt - credit is not a risk to the company because presumably it intends to pay off the debt according to its scheduled maturity. However the elimination of bifurcation-by-risk requirement specified in the ED will result in one of two undesirable effects: either (1) less debt related interest rate and currency risk will be hedged because the cost of hedging the entire debt service stream will be too great or (2) companies will purchase derivatives that also hedge credit risk that as a practical matter is not applicable to the

company because of the intent to settle the underlying principle at the contractual settlement date(s).

We also do not find an explanation in the Basis tor Conclusions that helps us understand why the FAS 138 amendments were in error or misguided. We believe that the issues and concerns that led to the issuance of FAS 138 persist and are equally valid today.

Elimination of Ability to Hedge Forecasted Intercompany Transactions

We disagree with the modifications to paragraph 40 which suggest that the ability to achieve hedge accounting for forecasted intercompany FX transactions has been eliminated at the consolidated level because the FX impact does not carry through to the consolidated financial statements. Forecasted intercompany FX transactions do impact the consolidated financial statements at a point in time when the finished product is sold to a third party. For example, assume a EUR functional entity sells a product to a sister subsidiary which is USD functional entity in EUR for further production and refinement before the sister subsidiary entity sells to a third party denominated in USD. Any intercompany profits on the first intercompany transaction would be eliminated at the rate at which it was created until the USD entity sells it to a third party. As a result, the FX impact of the intercompany sale will result in lower or higher earnings at that point in time the sale to third party takes place. This is identical to the impact associated with how third-party purchases of a raw material would affect the costs of a product. Eliminating hedge accounting for forecasted intercompany transactions would be inconsistent to the treatment of an anticipated third party purchase of a component. Either both would need to be eliminated or both permitted. Given the intention of the original Board in paragraphs 482-487 of the original basis for conclusions and the direct reference to royalties in paragraph 40 of the standard, it is clear that hedge accounting for these types of transactions was originally intended to be permitted. For multinational corporations, intercompany transactions are voluminous and represent critical business processes. The ability/inability to hedge such intercompany transactions is frequently one of the important determinative considerations as to where to locate operations. Given that many large multinational companies have made business and capital spending decisions on this basis, we believe it is unfair to remove intercompany transactions from the scope of hedgeable activities especially considering that there has been no compelling change in the business environment and that the proposed change has no conceptual merit.

We are also troubled by the way in which this change was positioned in the ED: not as a change in principle but rather as a clarification/correction of what was always intended by the standard (and therefore could be effected without the benefit of public debate by the Board). The record supports that it was, in fact, the former. We also believe that a change of this magnitude should follow the Board's due process procedures and therefore be debated at a public Board meeting before making this decision.

Elimination of Short Cut and Matched Terms

We observe that both the short cut method and matched terms provisions of FAS 133 were practical accommodations intended to simplify and ease application of the standard. These provisions were necessary because requirements of the long haul approach were onerous and too complex for many organizations to apply. While we understand that the desire to qualify for the short-cut method and, to a much lesser extent the matched terms approach, has been the source of many restatements, we believe that these were precipitated by the view adopted by regulators that the correction necessarily required the loss of hedge accounting (the so called "death penalty"), rather than a flaw of the concepts themselves. Had the prevailing view allowed for the recording of any incremental ineffectiveness as the preferred correction, we believe many and perhaps most of the restatements could have been avoided.

We believe that removing the accommodations noted above actually runs contrary to the goal of this standard to simplify hedge accounting. On the contrary, we believe the Board's time would be better spent in identifying additional transactions that could potentially be covered by either the short cut or matched terms methodologies. We think the efforts in this area should be focused on clarifying that the remedy for inappropriate application of the short cut or matched terms method does not result in loss of hedge accounting when the economics are undeniable. Removing these accommodations makes this standard even more complex and less operable for many preparers. We do not see how those results are in line with the objective of simplifying the standard.

Prohibition of Designation/Redesignation

The ED proposes to prohibit dedesignation of hedges but we are left wondering what underlying concern gives rise to this change. The ED simply states that since the economics of the hedge relationship have not changed, neither should the accounting. We do not believe this is an accurate view of what it means to manage risks. A more accurate view is that a company's risk position changes continuously and that the ability to dedesignate is integral to being able to adjust hedge positions to reflect market realities. For similar reasons, we struggle to understand the rationale for prohibiting redesignation of a derivative as a hedge, once it has been offset.

The elimination of the ability to de-designate will increase volatility for cash flow hedges of foreign currency forwards when receivables or payables have long collection or payment periods. For instance, if you have a receivable of a long-term nature, it will be remeasured each reporting period under FAS 52. At the time the receivable appears on the balance sheet, the FX forward is typically de-designated so that the fair value adjustments for the derivative instrument offset the FAS 52 FX adjustments naturally within the income statement. Disallowing the ability to de-designate will require fluctuations in the derivative's fair value to continue to be recognized within other comprehensive income, while the receivable or payable fluctuations due to currency risk will be recorded through the income statement. This will affect many in the construction industry who have long-term contracts.

Elimination of DIG Issue G20

We believe that this DIG Issue should be retained and do not understand the Board's rationale for why guidance in this area should be changed.

Delta Hedging

Delta hedging is a process where one would adjust their derivative position to maintain effectiveness between movements in a derivative relative to the underlying exposure. This is a very common practice when one tries to hedge a commodity where there doesn't exist a liquid derivative market, but a highly correlated derivative market exists for a very similar commodity such as those found in crude oil byproducts. This is often accomplished through a dedesignation of the old hedge relationship and a redesignation of a new one whenever a derivative is added to or reduced from the delta neutral strategy. Given that the ED would prohibit the redesignation of a hedge relationship, it would appear that the practice of delta hedging would have to be discontinued. Others view the ED differently noting that paragraph 14 states that 'adding a derivative to an existing hedging relationship that would not offset an existing derivative and would not reduce the effectiveness of the hedging relationship would not result in the termination of the hedging relationship'. When one adjusts the delta relationship by either adding a derivative or subtracting a derivative, the effectiveness of the hedging relationship would actually increase. As a result, those holding the alternative view believe that the criterion for a termination of the hedge relationship is not met.

Please see our responses to the specific questions listed in the ED's Notice for Recipients provided in the Appendix to this letter.

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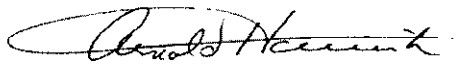
In conclusion we strongly recommend to the Board that the ED not be finalized and any project to change FAS 133 hedge accounting should be done via a convergence project with the IASB. We appreciate the Board's consideration of these matters and welcome the opportunity to discuss any and all related matters.

Sincerely,



Arnold C. Hanish
Chairman, Committee on Corporate Reporting
Financial Executives International

Appendix
Notice to Recipients

Issue 1: The Board decided to eliminate (with two exceptions) the ability of an entity to designate individual risks as the hedged risk in a fair value or cash flow hedge. That would result in the financial statements reflecting more information about the risks that an entity chooses not to manage or transform as part of its hedging strategy.

Do you believe that the elimination of the ability to designate individual risks would improve or impair the usefulness of the financial statements?

We believe the elimination of the ability to designate individual risks (beyond the two exceptions) would impair the usefulness of financial statements. In our view, the areas of corporate risk management most impacted by this change would be active (late) hedging associated with a company's own debt for the purposes of asset/liability management and hedges of forecasted debt issuances. Introducing earnings volatility associated with risks (e.g. credit risk) that are not part of a company's documented risk management objective and are not economically aligned with the hedging instrument would introduce a mixed valuation model for hedged items that are inherently the same (and in some circumstances part of the same debt issuance). As a result, the earnings synchronization intended and achieved by electing special accounting would be distorted and in some cases eliminated by fair market valuing the component of the hedged item related to a company's own credit.

We see no conceptual difference between designating a hedge at inception and "late hedging." Therefore, we do not understand why the proposed statement requires different accounting for the two similar hedges. In both inception hedging and "late hedging", the company is synthetically creating floating-rate debt from fixed-rate debt for the same purpose – cash flow matching. In paragraph 357 of the original Basis for Conclusions of FAS 133, the Board recognized that narrowly defining an entity's economic strategies for risk reduction as either "fair value risk" or "cash flow risk" would not be consistent with the allowance of hedge accounting under the Standard for both and would make an objective assessment of entity-wide risk reduction mechanically impossible in most situations. Thus FAS 133 affords the ability to designate only the hedged risk in both situations (fair value and cash flow) recognizing that risk reduction from an entity-wide perspective is often managed in differing ways given differing business models etc. The proposed changes regarding the hedged risk are inconsistent with the Board's original thought process noted above. By introducing earnings volatility due to risks not managed or hedged, the true benefit of electing special hedge accounting (earnings synchronization of the hedged item and hedging instrument) is afforded only in a narrow, restrictive definition of risk reduction – hedging at inception. As a result, the proposed restrictions in regards to the hedged risk will impair the usefulness of financial statement analysis as company's earnings from derivative hedging activities will reflect different valuation attributes for substantially the same risk management activity and objective (i.e., at inception vs. "late").

We believe the inability to designate individual risks will introduce complexity and challenges in assessing hedge effectiveness and measuring hedge ineffectiveness under the proposed standard. Due to the bespoke or personalized nature of certain debt/loan agreements, there will be significant uncertainty in determining the full fair market value of numerous financial and non-financial terms embedded in each agreement (e.g. pre-payment features associated with tax or estate events). The absence of observable market prices for such terms, combined with the fact that most commercial loans are not actively traded instruments, will most likely prevent companies from achieving the "reasonably effective" assessment criteria. Assuming the assessment criteria can be met, calculating full fair market value of the hedged item, with perhaps the exception of the most plain vanilla debt /loan agreements, will be too costly and in some circumstances not possible to successfully implement. We also believe that the lack of specific guidance on how to determine full fair value in all circumstances will lead to inconsistency in this regard across preparers of financial statements.

Issue 2: The Board decided to continue to permit an entity the ability to designate (a) interest rate risk as the hedged risk in a fair value or cash flow hedge related to its own issued or borrowed debt and (b) foreign currency exchange risk in a fair value or cash flow hedge.

Do you believe the Board should continue to permit an entity to designate those individual risks as a hedged risk?

We agree with the Board's decision to continue to permit an entity to designate foreign currency exchange risk as the hedged risk in a fair value or cash flow hedge and encourage the Board to provide a similar permission for commodity exposures where there is an immaterial basis difference between the hedge and the hedged item. As noted in our response to the question posed under Issue 1, we agree with the proposed continuation of designation of interest rate risk in a cash flow or fair value hedge related to a company's own debt when hedged at inception of the debt. Furthermore we recommend the continuation of permission to designate interest rate risk as the hedged risk in a cash flow or fair value hedge when hedged post inception of the debt/asset for the same reasons as stated in our response to Issue 1.

Issue 3: This proposed Statement would eliminate the shortcut method and critical terms matching. Therefore, an entity would no longer have the ability upon compliance with strict criteria to assume a hedging relationship is highly effective and recognize no ineffectiveness in earnings during the term of the hedge. As a result, when accounting for the hedging relationship, an entity would be required, in all cases, to independently determine the changes in fair value of the hedged item for fair value hedges and the present value of the cumulative change in expected future cash flows on the hedged transaction.

Do you foresee any significant operational concerns or constraints in calculating ineffectiveness for fair value hedging relationships and cash flow hedging relationships? Do you believe that the proposed Statement would improve or impair the usefulness of financial statements by eliminating the shortcut method

and critical terms matching, which would eliminate the ability of an entity to assume a hedging relationship is highly effective and to recognize no ineffectiveness in earnings?

The FASB's proposal to eliminate short cut and critical terms matching will eliminate aspects of the current model that a number of companies find cost effective. An operational burden will arise from having to create hypothetical derivatives and measure ineffectiveness for all the hedge relationships, including the most straightforward effective ones. For the programs currently under a long haul methodology the benefits expected to accrue from simplifying the effectiveness assessment methodology will be more than offset by costs associated with the increased complexity and volume of measurement quantifications.

The proposed changes in addition to being operationally burdensome are also not expected to significantly improve the usefulness of financial statements. The changes may cause undue periodic variability in the financial statements not easily comprehensible to the users. The challenges may arise as a result of the following:

(a) Inclusion of credit risk could prove challenging when there is credit spread volatility or an inability to obtain cost effective derivatives to hedge credit risk

(b) Inconsistencies will result from risk management strategies where credit risk is not generally hedged using derivatives

(c) Absence of a well developed credit derivative market for asset or liability classes will force companies to hedge the overall fair value using interest rate derivatives which will cause issues/inconsistent application around effectiveness and give rise to questions around the reasonably effective threshold (volatility in the credit markets will force companies to constantly monitor the market condition changes)

(d) Inclusion of credit risk for hedge relationship purposes will require a credit adjustment at the instrument level, which conflicts with recent guidance under FASB Statement No. 157, *Fair Value Measurements* where the credit adjustment is allowed at a portfolio level for derivatives based on netting arrangements and other collateral agreements.

Issue 4: This proposed Statement would modify the effectiveness threshold necessary for applying hedge accounting from highly effective to reasonably effective at offsetting changes in fair value or variability in cash flows.

Do you believe that modifying the effectiveness threshold from highly effective to reasonably effective is appropriate? Why or why not? For situations in which interest rate risk is currently designated as the hedged risk for financial instruments but would no longer be permitted under this proposed Statement (except for an entity's own issued debt at inception), do you believe you would continue to qualify for hedge accounting utilizing your current hedging strategy? If not, would you (a) modify your hedging strategy to incorporate other derivative instruments, (b) stop applying hedge accounting, (c) elect the fair value option for those financial instruments, or (d) adopt some other strategy for managing risk?

While the change from highly to reasonably effective makes it more favorable to seek hedge accounting, we feel that the definition of reasonably effective is too vague and will still leave preparers open to second guessing by auditors and regulators. As such, a preparer may continue to employ quantification in order to protect themselves against being second-guessed. Moreover, we believe that circumstances where it is considered "obvious" (as used in the ED's Basis for Conclusions) that the relationship will be effective may be limited due to the restrictions being put on a preparer's ability to bifurcate risks and hedge only a portion of the underlying risk. For example, consider a company that wants to hedge the interest component of an item and the most cost effective (or only available) derivative instrument is for the benchmark rate. Because the credit risk on the hedged item could be highly volatile, and beyond the company's control, "reasonably effective" is likely not a sufficient threshold for a company to discontinue ongoing quantitative hedge effectiveness testing. Accordingly we do not view this as a significant simplification of the accounting. We do believe the move to reasonably effective could be a significant simplification if the Board were to retain the ability to bifurcate and hedge specific risk components. Alternatively, we recommend that the Board consider including additional language that would make it less likely that companies would be second-guessed as long as a clear rationale is documented at inception. In addition, as discussed in the response to Issue 1, we are unclear whether any late-term hedge can be reasonably effective given the recent volatility in credit spreads.

Issues 5: This proposed Statement always would require an effectiveness evaluation at inception of the hedging relationship. After inception of the hedging relationship, an effectiveness evaluation would be required if circumstances suggest that the hedging relationship may no longer be reasonably effective.

Do you foresee any significant operational concerns in creating processes that will determine when circumstances suggest that a hedging relationship may no longer be reasonably effective without requiring reassessment of the hedge effectiveness each reporting period?

Do you believe that requiring an effectiveness evaluation after inception only if circumstances suggest that the hedging relationship may no longer be reasonably effective would result in a reduction in the number of times hedging relationships would be discontinued? If so, why?

Refer to our comments in Issue #4 above. Since the exposure draft does not sufficiently explain what is considered reasonably effective, it is not clear when many hedging relationships, particularly those that require inclusion of credit risk as the hedged risk, would meet the test of being reasonably effective at inception and during the subsequent term of the hedge.

While the proposed lowering of the hedge effectiveness threshold from the current "highly effective" to reasonably effective suggest that the number of discontinued hedges might decrease, the requirement to hedge all cash flow or fair value changes (with some limited exceptions) would have the impact of increasing hedge ineffectiveness sometimes

quite significantly. It is therefore not clear whether the exposure draft would result in the future decrease or increase of the overall number of discontinued hedging relationships.

Issues 6, and 7:

We agree with the Board's proposals.

Issue 8: The Board's goal is to issue a final Statement by December 31, 2008. The proposed Statement would require application of the amended hedging requirements for financial statements issued for fiscal years beginning after June 15, 2009, and interim periods within those fiscal years.

Do you believe that the proposed effective date would provide enough time for entities to adopt the proposed Statement? Why or why not?

We believe that the proposed elimination of critical terms matching and the requirement to measure ineffectiveness for ALL derivatives would create significant upfront data change set-up time and costs. We do not support this change and believe that, if enacted, implementation would need to be postponed to fiscal years beginning after November 15, 2010.

Issue 9: The Board did not prescribe any specific transition disclosures upon the adoption of this Statement.

Do you believe that there are specific disclosures that should be required during transition? If so, what? Please be specific as to how any suggested disclosures would be used.

We believe that no specific transition disclosures would be required upon the adoption of this Statement, given the current language of the ED.

We believe, however, that the proposed Statement should further clarify the transition treatment for the fair value hedges per Para 33 and A42 of the ED. In particular, we recommend that the statement provide further guidance for the treatment of the basis adjustment on the hedged item in fair value hedges that will be dedesignated and concurrently redesignated anew at the time of initial application of the proposed Statement.

***Issue 10: The Board decided to permit an entity a one-time fair value option* election under FASB Statements No. 156, Accounting for Servicing of Financial Assets, and No. 159, The Fair Value Option for Financial Assets and Financial Liabilities, for (a) servicing assets and servicing liabilities designated as a hedged item on the date immediately preceding initial application and (b) eligible financial instruments designated as a hedged item on the date immediately preceding initial application of this proposed Statement.**

***Do you agree with the Board's decision to allow a one-time fair value option* at the initial adoption of this proposed Statement? Do you agree with the Board's decision to limit the option to assets and liabilities that are currently designated as hedged items under Statement 133?**

Because of the significant impact the statement, as proposed, will have on risk management strategies that involve all of an entities' financial assets and liabilities, a one-time fair value option should be allowed for assets and liabilities that qualify as a hedged item under FAS 133, regardless of whether they have actually been designated as such at the time of the initial application of this proposed Statement. However, we propose that entities electing the fair value option would be required to disclose which instruments the election applies to and why that election was made.

Issue 11: The objective of financial reporting is to provide information that is useful to present and potential investors, creditors, donors, and other capital market participants in making rational investment, and similar resource allocation decisions. However, the benefits of providing information for that purpose should justify the related costs. The benefit-cost considerations considered by the Board are provided in paragraphs A43-A50 in Appendix B of this proposed Statement.

Do you believe the Board identified the appropriate benefits and costs related to this proposed Statement? If not, what additional benefits or costs should the Board consider?

We believe that the proposed Statement shifts the complexity from assessment to measurement and costs of implementing the measurement are under-estimated. Enhancing systems to develop a perfectly effective hypothetical derivative offsets any benefits and cost-savings of not performing a quantitative assessment.

Further, we remain unconvinced that the quantitative assessment will not be required in practice to support the "reasonably effective" assessment, especially given the lack of clarification of this term in the ED and the expansion in included risks.