

April 25, 2011

Ms. Susan M. Cospers
Technical Director
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116



Via Email

File Reference No. 2011-175

Dear Ms Cospers:

We appreciate the opportunity to comment on the FASB's Discussion Paper *Selected Issues about Hedge Accounting*, (the "Discussion Paper"). We have numerous clients that seek to apply hedge accounting to derivative transactions for which we are counterparty. While we have some concerns on the application of some of the guidance and on the clarity of some of the wording in the IASB's Exposure Draft (the "Exposure Draft"), we believe the IASB's Exposure Draft is a significant improvement over existing US GAAP and IFRS hedge accounting standards and we would be supportive of the FASB adopting a similar framework for hedge accounting under US GAAP. We have separately provided comments on the Exposure Draft to the IASB.

The IASB's standard starts at the right place; that is by looking to the entity's risk management activities to determine whether or not a derivative is intended to hedge a particular exposure and thus, whether it should be eligible for hedge accounting. In addition, the Exposure Draft incorporates many of the improvements to Accounting Standards Codification (ASC) 815, *Derivatives and Hedging*, and IAS 39, *Financial Instruments: Recognition and Measurement*, that constituents have been calling for since their issuance – such as simplification of the effectiveness assessment and testing, the ability to hedge separately identifiable and reliably measurable risk components in non-financial assets and liabilities, and matching the time value of an option with the hedged transaction. Our main concerns center on the practical application of the linkage to risk management, as well as the notion of no-bias, and on required rebalancing.

Many of the specific questions asked by the FASB are around whether there is sufficient guidance in the Exposure Draft to understand what is being required or how to do something. It is in the nature of writing principles-based standards that there is less detailed guidance provided and therefore more judgment required. The plethora of detailed guidance in ASC 815 and its amendments have not in our opinion resulted in better financial reporting but rather just the opposite. While it is a radical change from what has heretofore existed, we believe that the very lack of detailed guidance and rules, the reliance on whether something is consistent with an entity's risk management strategy, and the expectation that reasoned judgment will be applied, are very positive changes that the FASB should seek to mirror.

Detailed comments on the Discussion Paper are set forth in Appendix A. We hope that you find them helpful. Please contact me in New York at 212-902-7052 if I can be of further assistance or if you have questions about our comments.

Sincerely,

Tim Bridges

Timothy J. Bridges
Managing Director

Cc Matthew Schroeder, Goldman, Sachs & Co.

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***Question 1:** When an entity uses financial instruments to manage risk exposures in economic hedges but those instruments are not designated in hedging relationships for accounting purposes, do you believe that the proposed guidance would provide useful information about all of the effects of an entity's risk management objectives?*

We believe that the proposed guidance would provide useful information about the effects of an entity's risk management strategies when an entity did not choose to designate a financial instrument in a hedging relationship. Hedge accounting should always be elective (as a means of eliminating the earnings volatility that would result from reporting changes in fair value in earnings). If an entity chooses to not identify (or fails to identify) a particular financial instrument or instruments as being in a hedging relationship or being consistent with a particular risk management strategy, changes in its fair value should be reported through earnings. There is no loss of usefulness from this just as there is currently no loss of usefulness from an entity not designating a derivative as a hedge under ASC 815.

***Question 2:** Do you believe that the proposed guidance and illustrative examples included in the IASB's Exposure Draft are sufficient to understand what is meant by risk management, how to apply that notion to determine accounting at a transaction level, and how to determine the appropriate level of documentation required? Why or why not?*

We agree with the proposed objective of hedge accounting to better align the reporting of hedging activity with an entity's risk management activities, but believe that it would be beneficial to clarify whether implementation of this objective would be expected to be on a macro basis, or on a more micro level, or at either level. For example, if the risk management objective is defined by a corporation as maintaining a current fixed-floating ratio of between 30% and 70%, we would contemplate that any derivative that resulted in a fixed-floating ratio within this range, or that moved the ratio closer to being in this range, would satisfy the requirement. Alternatively (but sub-optimally) the risk management strategy could be expressed as swapping a specific fixed rate liability to floating. We would observe that while a micro designation would likely be acceptable for many corporates that do not use derivatives extensively, it would be much more challenging for financial institutions and finance subsidiaries where risk management decisions are typically done on a portfolio or macro basis. Accordingly, we believe that either level should be permissible but clarification of this point would be beneficial.

***Question 3:** Do you foresee an entity changing how it determines, documents, and oversees its risk management objectives as a result of this proposed guidance? If yes, what changes do you foresee? Do you foresee any significant difficulties that an entity would likely encounter in establishing the controls related to complying with the proposed guidance?*

We do not see any fundamental changes to how an entity determines, documents and oversees its risk management objectives as a result of the proposed guidance provided both micro and macro risk management objectives are considered acceptable. If this is not the case, then individual entities may be required to make changes.

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Question 4: *Do you foresee any significant auditing issues arising from the proposed articulation of risk management and its link to hedge accounting? For example, is the information required to be disclosed regarding an entity's risk management strategies measurable and objective? Could the inclusion of an entity's risk management objectives create an expectation gap that the auditor is implicitly opining on the adequacy of an entity's risk management objectives?*

We are not an auditing firm and therefore have limited ability to comment on this. However, we would observe that there is required documentation and disclosure of risk management objectives under ASC 815 in order to qualify for hedge accounting. The information regarding risk management objectives is certainly objective as long as it has to be documented, which is a pre-requisite, and far more objective than impairment, for example. It is measurable by a number of different metrics.

Question 5: *Should cash instruments be eligible to be designated as hedging instruments? Why or why not? If yes, is there sufficient rigor to prevent an entity from circumventing the classification and measurement guidance in other relevant accounting guidance (for example, IFRS 9, Financial Instruments, and IAS 21, The Effects of Changes in Foreign Exchange Rates)? Are there any operational concerns about designating cash instruments (such as items within a portfolio of receivables) as hedging instruments?*

We agree that non-derivative financial instruments measured at fair value through profit or loss should be permitted as eligible hedging instruments. If an entity chooses to manage a risk exposure by using a cash instrument, the effects of this risk management strategy should also be afforded hedge accounting. We do not see any operational concerns and are not aware of any arising from cash instruments being designated as hedges of a net investment under ASC 815.

Question 6: *Do you believe that the proposed guidance is sufficient to understand what constraints apply when determining whether an item in its entirety or a component thereof is eligible to be designated as a hedged item (for example, equity instruments measured at fair value through profit or loss, standalone derivatives, hybrid instruments, and components of instruments measured at fair value through profit or loss that are not permitted to be bifurcated)? If not, what additional guidance should be provided?*

We believe that the proposed guidance is sufficient to understand what constraints apply when determining whether an item in its entirety or a component thereof is eligible to be designated as a hedged item

Question 7: *Do you believe that the proposed criteria are appropriate when designating a component of an item as a hedged item? If not, what criteria do you suggest? Do you believe that the proposed guidance and illustrative examples are sufficient to understand how to determine when the criteria of separately identifiable and reliably measurable have been met? If not, please describe what additional guidance should be provided.*

We believe that the proposed criteria are appropriate when designating a component of an item as a hedged item. We agree with the IASB's decision to allow the designation of separately identifiable and reliably measurable risk components as the hedged item in hedges of both financial and non-financial assets and liabilities. Many of our clients have struggled with the fact that hedge accounting is not permitted for separately identifiable risk components of non-financial assets (and only certain components of financial assets). The IASB's change should eliminate needless complexity and align the accounting with the entity's risk management activities, as we believe it should be.

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For example, an entity incurs fuel surcharges, based on changes in the price of gasoline, in its shipping costs. Under the current model, the hedged risk must be the total shipping costs, which often incorporate unhedgeable (and frequently unpredictable) factors such as the number of delivery location stops. Since these factors are not incorporated into the hedging derivative, at best they cause hedge ineffectiveness and at worst prevent the application of hedge accounting, despite the fact that the derivative would be considered highly effective if it is designated as a hedge of the fuel surcharge component only. They also make measuring ineffectiveness extremely complex. We believe the ability to designate risk components as hedged items will allow many more risk management hedges of non-financial items to qualify for hedge accounting and (most critically) provide far more meaningful information for end-users of financial statements than the misleading volatility that results from the current overly complex and burdensome criteria.

We do not agree with the preclusion on hedging credit risk if it is separately identifiable and measurable. We believe that the broad principle should be applied to all risk components.

Question 8: *Do you believe that “separately identifiable” should be limited to risk components that are contractually specified? Why or why not?*

We do not believe that “separately identifiable” should be limited to risk components that are contractually specified. From a risk management standpoint, contractual specification is an artificial distinction which should not be relevant to whether hedge accounting is applied. To illustrate, consider the following example:

Product A has as one of its ingredients a gallon of crude oil but is priced as a single item. Nevertheless, due to its composition, the price of Product A fluctuates based upon the change in the price of a gallon of crude oil, among other factors. Product B is identical to Product A in all respects except that in its pricing it specifies the cost of each component.

Beyond a desire to make hedging rules overly complex, we do not see a compelling reason to allow hedging of a risk component in Product B but not in Product A. Current US GAAP would require the hedger of Product A to fair value its hedging instrument through earnings with no offset. We believe the more representationally faithful approach is to allow the hedger of Product A to match the timing of gains and losses on its hedges with recognition of the costs of buying Product A. We have over the years seen hedge accounting for risk-reducing hedges of non-financial items precluded on numerous occasions because of the overly restrictive and complex limitations imposed and believe that the IASB has reached the right conclusion in this regard.

Question 9 – not used by FASB

Question 10: *Do you believe that the proposed guidance is sufficient to understand what constraints apply to determining a layer component from a defined, but open, population? (For example, do you believe that the sale of the last 10,000 widgets sold during a specified period could be designated a layer component in a cash flow hedge?) If not, what additional guidance should be provided?*

We believe that the proposed guidance is sufficient to understand what constraints apply to determining a layer component from a defined, but open, population. It has never made sense to us that hedging the last n sales in a period is precluded given that at the end of the period the last n are clearly known and there has been designation at hedge inception of what is being hedged

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(the last n items sold) so there is no potential for retroactive designation which would be a concern.

Permitting the designation of a layer component of the nominal amount as the hedged item will help to allow entities to apply hedge accounting in the same way they are managing risk. Currently, IAS 39 F.2.17 permits partial term hedging - for example of the interest rate risk for the first 2 years of a 5 year bond (unlike ASC 815). Absent the ability to hedge a layer component, if an entity wants to hedge interest rate risk for the first two years of a five year fixed-rate bond and achieve hedge accounting, they would be compelled to execute (1) a five year swap to floating which is designated as a fair value hedge of the bond, and (2) a two year forward starting three year swap to fixed (which from a risk perspective nets with swap 1 to a two year swap to floating) which is either not designated as a hedge or designated as a cash flow hedge of an unrelated exposure. Continuing the guidance in F.2.17 in the new Standard we believe is critical. It would be more reflective of the entity's risk management strategy, not to mention simpler, to allow hedge accounting for the risk the entity is economically hedging, namely the interest rate risk for the first two years of the five year bond.

We also believe that the ability to hedge a top or bottom layer is a more sensible approach than the proportional approach. However, we do not believe that the existence of a prepayment option should preclude an item from being eligible to be included in a fair value hedge when the option's fair value is affected by the hedged risk, provided the entity is able to measure and quantify the effect of the prepayment option or it is an option to prepay at an amount that is in excess of par. To illustrate, an entity may own a mortgage security which contains a prepayment option. However, it is able to model the speed with which that security will prepay under different market circumstances. It may choose to hedge its main exposure to prepayment risk by hedging only the bottom layer with an option-based strategy (because that was the first layer that could get prepaid). Alternatively, it may define a top layer with little or no prepayment risk and be able to institute a fair value hedge of the interest rate risk of that portion (which would behave very similar to a bullet bond) with a forward-based derivative. We do not believe either strategy should be precluded.

Question 11: *Do you foresee any operational concerns applying other guidance in IFRS (for example, guidance on impairment, income recognition, or derecognition) to those aggregated positions being hedged? For example, do you foresee any operational concerns arising when an impairment of individual items within a group being hedged occurs? If yes, what concerns do you foresee and how would you alleviate them?*

We do not see any issues applying other guidance in IFRS (for example, guidance on impairment, income recognition, or derecognition) to aggregated positions being hedged.

Question 12: *Do you believe that the proposed guidance on aggregated exposures will provide more transparent and consistent information about an entity's use of derivatives? Why or why not?*

We believe that the proposed guidance on aggregated exposures will provide more transparent and consistent information about the manner in which an entity's uses derivatives to hedge its risk management exposures.

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Question 13: *Do you believe that an entity should be permitted to apply hedge accounting to a group of cash instruments or portions thereof that offset and qualify as a group under the proposed guidance and satisfy the proposed hedge effectiveness criteria? Why or why not?*

We agree that non-derivative financial instruments measured at fair value through profit or loss should be permitted as eligible hedging instruments. If an entity chooses to manage a risk exposure by using a cash instrument, the effects of this risk management strategy should also be afforded hedge accounting.

Question 14: *Do you foresee any significant operational concerns, including auditing issues, in determining how to assess whether a hedge achieves other-than-accidental offset? If yes, what concerns do you foresee and how would you alleviate them?*

Our understanding of other than accidental would be that there is an economic linkage between a hedge underlying and a risk component of the hedged item. Reinforcing the notion of “other than accidental” by some illustrative examples may be useful in order to convey the notion that the Board intends. In particular, we believe that it is intended to be primarily a qualitative assessment.

Question 15: *Do you believe that the proposed guidance and illustrative examples are sufficient to understand how to analyze hedge effectiveness (for example, how to measure the change in the value of the hedged item attributable to the related hedged risk for nonfinancial items)? If not, what additional guidance is needed?*

We agree with the decision to simplify the assessment of hedge effectiveness and in particular to eliminate the quantitative 80 – 125% “bright line” test for qualifying for hedge accounting. We also agree with the decision to permit both qualitative and quantitative analyses for determining whether the qualifying criteria for hedge accounting have been met. Many hedging relationships can be determined to be effective on a qualitative basis based on the critical terms and as such, it does not seem necessary to perform a periodic quantitative analysis. The standard of other than accidental offset we believe is appropriate and consistent with the principle of basing hedge accounting on an entity’s risk management objectives. As discussed above, reinforcing the notion of “other than accidental” by some illustrative examples may be useful.

We also recommend the IASB consider adopting a similar provision to that contained in the FASB’s proposed ASU, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* to eliminate an on-going assessment of hedge effectiveness.

We do not understand what is meant by the notion of “unbiased” in the Exposure Draft. It could be interpreted to mean only a perfect hedge qualifies (which would be contrary to the overall thrust of the Exposure Draft) as it indicates that any bias is not acceptable at inception and on subsequent assessments. The notion of no bias also has the potential to add considerable busy work (constantly checking whether the hedging relationship has developed some bias over time) and this runs contrary to the objective of simplifying the hedge accounting framework. We believe that the over-riding principle of hedge accounting being driven by the entity’s risk management strategy should render the use of such a phrase redundant. For example, if an entity’s risk management strategy on a hedge is documented as being to swap the first 5 years of \$150mm of a \$200mm fixed rate bond to floating for 5 years, then the hedge relationship (i.e. how much of the bond is hedged) has already been defined.

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Question 16: *Do you foresee any significant operational concerns or constraints in determining whether (a) a change to a hedging relationship represents a rebalancing versus a discontinuation of the hedging relationship or (b) an entity's risk management objective has changed? If yes, what concerns or constraints do you foresee and how would you alleviate them?*

We strongly support the notion that if rebalancing occurs, it should be viewed as a continuation of the existing hedging relationship. Treating such an event as a termination of one hedging relationship and the commencement of a new one has added considerable complexity and “busy work” to hedge accounting. However, we do not believe that rebalancing should be required and as discussed above believe that the notion of no bias, which is integral to required rebalancing, should be eliminated.

Question 17: *Do you foresee any significant operational concerns or constraints relating to the potential need to rebalance the hedging relationship to continue to qualify for hedge accounting? If yes, what concerns or constraints do you foresee and how would you alleviate them?*

We do not agree with the requirement that a hedging relationship should be required to be rebalanced when the hedging relationship no longer meets the objective of the hedge effectiveness assessment but the risk management objective for the hedging relationship remains the same. While we would note that this is consistent with the notion of no de-designation, we believe that hedge accounting should be elective first and foremost. We believe that if a hedge ceases to achieve other than accidental offset, hedge accounting will have to cease unless the entity chooses to rebalance. As noted earlier we do not support the notion of no bias, and this notion seems to be a driver of the requirement to rebalance. As hedge accounting is applied prospectively, there is no ability to hardwire a particular outcome through de-designation or through what we believe the Board means by “bias”. In many cases, entities will choose to rebalance a hedging relationship that no longer meets the objective of the hedge effectiveness assessment, or that is being less effective than desired. However, we believe that rebalancing should be voluntary. Mandatory rebalancing would produce significant operational concerns.

Question 18: *Do you believe that capitalizing the time value of an option as a basis adjustment of nonfinancial items (in other words, marking the asset or liability away from market) will improve the information that is provided in an entity's statement of financial position? Why or why not?*

We agree with the IASB's decision to mirror the treatment of option time value with that of the hedged transaction and to distinguish between the treatment of option time value associated with transaction related hedged items and option time value associated with time period related hedge items.

We believe the IASB's model in the Exposure Draft reflects the economics of option hedges. In transaction related hedges, an entity is typically hedging the risk of an adverse change in the price of a forecasted transaction. It is logical in this circumstance, to reflect the cost of the protection in the basis of the non-financial asset or liability acquired or in the period the forecasted transaction impacts earnings. Similarly, it is logical to recognize the cost of protecting against changes in a time period option hedge by amortizing the premium over the protection (option) period similar to the treatment of an insurance premium. However, we believe that the Board should clarify that the key principle is the matching of the option expense with the period in which the hedged transaction or item impacts earnings. For example, some believe that if a company is hedging the forecasted issuance of a ten year bond in six months' time with a purchased option, the premium must be expensed over the period of time that the hedge is in

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place (6 months). We believe that the appropriate treatment is to recognize the premium cost over the period of time that interest expense will impact earnings (ten years).

We would suggest for the sake of clarity replacing the phrase “aligned time value” with “the time value of the hypothetical derivative”.

***Question 19:** Do you believe that the proposed presentation of the gains and losses in other comprehensive income will provide users of financial statements with more useful information? Why or why not?*

We agree with the change to the mechanics of fair value hedge accounting. Separate balance sheet presentation of the cumulative change in fair value due to a fair value hedging relationship will provide more clarity for users by not distorting the carrying value of the hedged item. In addition, we agree that having the effective portion of fair value hedges presented in other comprehensive income will be helpful to users. This way they will not have to hunt through various financial statements to ascertain an entity’s hedge accounting results. We would however also find retaining the current treatment of fair value hedges to be acceptable.

However, as discussed in the answer to question 20 below, we do not support the Exposure Draft’s proposal that the gain or loss on each hedged item (attributable to the hedged risk) should be presented as a separate line item in the statement of financial position.

***Question 20:** Do you believe that the proposed presentation of a separate line item in the statement of financial position would increase the transparency and the usefulness of the information about an entity’s hedging activities? Why or why not?*

We do not support the Exposure Draft’s proposal that the gain or loss on each hedged item (attributable to the hedged risk) should be presented as a separate line item in the statement of financial position. We do not believe that this provides any benefit but will add further crowding to already cluttered financial statements. While we support linked presentation on the balance sheet conceptually, we believe that this may be better achieved by having single line items within assets and liabilities representing hedged accounting adjustments to assets and liabilities, with the analysis of the components of the linked items being provided in the footnotes as opposed to on the face of the balance sheet. Alternatively, the current approach to adjusting the carrying value of the hedged item on the face of the statement of financial position could be retained, with the detailed analysis of the linked items provided in the footnotes.

***Question 21:** Do you believe that there is sufficient guidance to specifically link the hedging adjustments to the hedged assets and liabilities that compose a hedged net position with respect to presenting a separate line item in the statement of financial position?*

We refer to our comments above regarding showing linked presentation in the statement of position. Where a net position is presented, we believe that it would be presented as an adjustment to either the net asset or net liability being hedged, and believe that there is sufficient guidance as to how to specifically link the hedging adjustments.

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Question 22: *Do you foresee any significant auditing issues arising from the inclusion of risk management disclosures in the notes to the financial statements? If yes, what issues do you foresee and how would you alleviate them? Do you believe that it is appropriate to include risk management disclosures in the notes to the financial statements rather than in other information in documents containing financial statements? Why or why not?*

We refer to our response to question 2. We would also expect that any disclosure regarding strategy would be at a reasonably high level.

Question 23: *Do you believe that the changes proposed by the IASB provide a superior starting point for any changes to U.S. GAAP as it relates to derivatives and hedging activities? Why or why not? Should the FASB be making targeted changes to U.S. GAAP or moving toward converging its overall standards on derivatives and hedging activities with the IASB's standards?*

In our comment letter on the FASB's Proposed Accounting Standards Update *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*, we observed that the Board was addressing only one of the factors that made hedge accounting so complex and that a bolder approach was needed. We believe that the IASB has taken such a bolder approach and that the IASB's Exposure Draft is a significant improvement over the existing US GAAP and IFRS hedge accounting standards. We would be supportive of the FASB adopting a similar framework for hedge accounting under US GAAP

Additional Comments on the Exposure Draft

Combination of another exposure and a derivative

We agree with the principle of permitting the designation of an aggregated exposure that is a combination of another exposure and a derivative as a hedged item. If an entity chooses to modify an existing risk management strategy by overlaying an additional derivative, the effects of this adjusted risk management strategy should be afforded hedge accounting consistent with the objectives of providing for hedge accounting.

Discontinuing Hedging Relationships

Prospective discontinuation

We agree that hedge accounting should be discontinued on a prospective basis when the hedge relationship no longer meets the qualifying criteria. However, we believe that implicit in these criteria is that if an entity changes its risk management objective such that it no longer wishes to hedge the designated item, it should be able to (and in fact would be required) to de-designate a hedging relationship. Prospective discontinuation also precludes the ability to cherry pick when hedge accounting is applied.

Prohibition on de-designation

We do not agree with the prohibition on ceasing hedge accounting by de-designation of a hedging relationship. This provision completely contradicts a basic tenet of IAS 39 and ASC 815 – hedge accounting is elective. We are not aware of any abuse (for example, in terms of changing the timing of income statement recognition) that can be caused by the ability to de-designate a

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derivative. By imposing such a restriction, companies will face added complexity in their hedging strategies.

For example, one very common foreign currency risk hedging strategy is to hedge a forecasted foreign currency transaction as a cash flow hedge through the expected payment date and then de-designate the hedging relationship upon recognition of the transaction. This widely used hedge accounting strategy would no longer be permitted as it requires the company to de-designate a hedging relationship that would not meet the requirements for discontinuation of hedge accounting in the Exposure Draft. Providing the company's risk management strategy provided for this, we believe that de-designation should be permitted.

Contracts on non-financial items

The IASB's Exposure Draft proposes to allow certain commodity contracts to be accounted for as a derivative. Specifically, it proposes that contracts that are entered into for the receipt or delivery of a non-financial item that can be settled net can be accounted for as derivatives if it is in accordance with an entity's risk management strategy. We generally support this concept provided it is elective. If the entity identifies such a contract as being used in a fair value based risk management strategy, then derivative accounting would be appropriate. We do believe that making this accounting elective (i.e. it is only triggered if the entity identifies such a contract) is critical to avoid many of the issues around the definition of a derivative that arose under ASC 815. Provided it would be elective, we believe the Board should consider expanding the option to contracts that do not contain a net cash settlement alternative.

Hedging FX Risk in Intercompany Transactions

We disagree with the decision to prohibit hedge accounting of FX risk for certain forecasted intercompany transactions, such as royalties. We do not believe that such a change is consistent with the functional currency models in IAS 21 and ASC 830. Further, such a change would have a drastic effect on the ability of companies following to hedge their foreign exchange exposures.