

Sir David Tweedie  
International Accounting Standards Board  
30 Cannon Street  
London  
EC4M 6XH

5 September 2008

## **Re: IASB Discussion Paper – Reducing Complexity in Reporting Financial Instruments**

Dear Sir

We are responding to your invitation to comment on the above discussion paper on behalf of PricewaterhouseCoopers. Following consultation with members of the PricewaterhouseCoopers network of firms, this response summarises the views of member firms who commented on the draft interpretation. ‘PricewaterhouseCoopers’ refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

We welcome the Board’s recognition of the need to reduce complexity in reporting financial instruments. Accounting standards should result in clear and transparent financial statements that faithfully represent the economic consequences of transactions and set results in the context of the entity’s business model. Since today’s businesses and transactions are complex, accounting standards cannot be over-simplified. At the same time, we believe the complexity of the accounting guidance should not be greater than the complexity the transactions warrant. Excessive complexity leads to interpretational difficulties and thus fails to achieve consistent application. Some level of simplicity in standard-setting is therefore both desirable and achievable.

Section 1 of the Discussion Paper identifies the many different measurement attributes for financial instruments as a key source of complexity for preparers and users. We acknowledge this but do not agree that it is the only reason why IAS 39 has been subject to criticism. IAS 39 was originally developed as an interim standard based on an amalgamation and adaptation of accounting requirements from US GAAP. Subsequent amendments have been introduced over the years to reflect the demands of different business models and environments. Additional unnecessary complexity has been created by the inclusion of a number of anti-abuse provisions. Examples include the tainting provisions relating to held-to-maturity assets, the requirements for the separation of embedded derivatives, some of the requirements related to own use contracts and the documentation and testing associated with hedge accounting. As a result, the standard contains a number of rules, exceptions and complex constructions with few underlying principles. Inevitably this has led to confusion and requests for further detailed

interpretation. A simplification of IAS 39 in advance of the next wave of IFRS adopters in 2011 is therefore a welcome improvement.

The improvement of existing standards is part of an evolutionary process that is justifiable if the benefits to preparers, users and other stakeholders significantly outweigh the costs. We believe that will be the case with this project if it achieves a significant reduction in the complexity of IAS 39.

We do not, however, believe that this is the right time to make a decision on the longer term solution to reporting financial instruments. The recent credit crisis has changed the economic environment and has challenged many of the underlying assumptions in IAS 39, including the use of fair values in illiquid markets. At the same time, the Board is working on a number of projects that mark a fundamental shift in accounting standards. In particular, completion of the work on the conceptual framework, performance reporting and fair value measurement is essential before the Board will be in a position to determine the best way to report financial instruments.

The longer term solution envisaged in Section 3 of the Discussion Paper is to measure all financial instruments using a single measurement attribute, most probably fair value. This solution would result in significant changes for preparers, users, regulators, auditors and other stakeholders. Any such change will need full acceptance from the financial reporting community and this can only be obtained after an extensive structured debate around the issues including those relating to the projects referred to above. Consequently, we believe the Board should not pre-empt that debate by assuming that the longer term solution is a single measurement attribute or by requiring greater use of fair values.

As an initial step in the evolution of reporting financial instruments, we support the simplification of the measurement and hedge accounting rules addressed in the Discussion Paper. Our detailed proposals in this area are summarised in our response to the questions in attached Appendix A. In the context of hedge accounting, we note that the FASB is undertaking a separate project with similar objectives. We do not believe that it is in the interests of users or preparers for there to be different hedge accounting rules under IFRS and US GAAP. We therefore encourage the two boards to work together to develop hedge accounting proposals that achieve simplicity without unduly impacting the ability of preparers to report the effectiveness of their risk management strategies. In this regard, we attach as Appendix B a copy of our comment letter to the FASB on their hedging proposals.

As a longer term initiative, we believe the Board should begin the debate around the longer term solution. As part of that debate, we believe the underlying objectives of reporting financial assets and liabilities should be addressed, with particular focus on the following questions:

- What are the financial reporting objectives?
- What type of information do users need in relation to financial instruments?
- What is the role of the entity's business model in determining measurement attribute? Is the same measurement attribute relevant for all financial instruments irrespective of the business purpose for which they are held?

- In a mixed measurement model where most non-financial assets are held at depreciated cost, is it appropriate to fair value financial liabilities used to fund those assets?
- Is ability to readily convert financial assets and liabilities to cash relevant in the selection of the appropriate measurement attribute?
- In the absence of a transfer market or intention to transfer is a market-based exit price the best way to value illiquid financial assets and non-derivative financial liabilities?
- Do preparers have sufficient valuation expertise to support increased use of fair values for financial instruments?
- Does the reporting model enable investors to distinguish fair value movements from core earnings where appropriate?
- To what extent can disclosure of assumptions and judgements overcome concerns about the reliability of fair value measures in illiquid markets?

We look forward to participating in this important debate.

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If you have any questions in relation to this letter please do not hesitate to contact Richard Keys, PwC Global Chief Accountant (+44 20 7802 4555), or Pauline Wallace (+44 20 7804 1283).

Yours faithfully



PricewaterhouseCoopers LLP

**Appendix A – Detailed responses**

**Section 1 Problems related to measurement**

***Question 1***

*Do current requirements for reporting financial instruments, derivative instruments and similar items require significant change to meet the concerns of preparers and their auditors and the needs of users of financial statements?*

*If not, how should the IASB respond to assertions that the current requirements are too complex?*

As we discussed in the cover letter, the current requirements for reporting financial instruments are complex and have created significant application and interpretation difficulties in practice. We therefore support the Board's initiative in eliminating any unnecessary complexity that currently exists in IAS 39. Our detailed proposals for simplification are summarised in our responses to the questions below.

**Section 2 Intermediate approaches to measurement and related problems**

***Question 2***

*(a) Should the IASB consider intermediate approaches to address complexity arising from measurement and hedge accounting? Why or why not? If you believe that the IASB should not make any intermediate changes, please answer questions 5 and 6, and the questions set out in Section 3.*

Yes. As part of the evolutionary process in improving the reporting of financial instruments, we support the simplification of the measurement and hedge accounting rules addressed in the Discussion Paper. Additionally, we believe it is important for the improvements to be effective by 2011, before the next wave of first time adopters, to maximise the benefits. We have these criteria in mind when developing our responses set out below.

*(b) Do you agree with the criteria set out in paragraph 2.2? If not, what criteria would you use and why?*

We agree with the criteria set out in paragraph 2.2 except for the requirement that any proposed change must be consistent with the long-term objective of a single measurement attribute based on fair value with changes recognised in profit or loss. As we discuss in the cover letter, any longer term solution should be the subject of an extensive structured debate. It is therefore inappropriate to impose this criterion as a constraint at this interim stage.

**Question 3**

*Approach 1 is to amend the existing measurement requirements. How would you suggest existing measurement requirements should be amended? How are your suggestions consistent with the criteria for any proposed intermediate changes as set out in paragraph 2.2?*

Measurement Categories

*1. Held-to-maturity*

We support reducing the number of measurement categories in IAS 39 for financial assets by removing the held-to-maturity category.

The removal of the held-to-maturity category would provide more relevant and more easily understandable information for users of financial statements. For example, under the current guidance, it is unhelpful to users of financial statements that certain sales or reclassifications out of the held-to-maturity category do not cause 'tainting' while others do. Additionally, the penalty resulting from the tainting rules makes financial statements more difficult to understand. The resulting simplification is expected to be significant enough to justify the cost of the change. We therefore consider that this proposal meets the conditions for reducing complexity for the interim solution.

We acknowledge that removing the held-to-maturity category will result in debt instruments that are quoted in an active market no longer being eligible to be carried at amortised cost. Under the current definition of loans and receivables an entity is not permitted to classify financial instruments that are quoted in an active market as loans and receivables. Recent market turmoil has revealed that 'quoted in an active market' is not the same thing as a liquid market. We believe the Board should reconsider the definition of an "active market" to reflect a liquidity principle. However, any such change in definition will require careful consideration, and therefore may only be achievable as part of the longer term project.

*2. Available-for-sale*

We support keeping the available-for-sale category at this stage but readdressing its relevance as part of the debate around the longer term solution. Eliminating the available-for-sale category would result in strategic equity investments and long term holdings of debt securities being recognised at fair value through profit or loss with unrealised gains and losses recognised in income. For many entities, the use of the available-for-sale category allows for a better reflection of the business model which includes holding investments in equity and debt securities as a medium to long term strategy. Requiring income statement recognition of the volatility resulting from fair value movements in such investments would make financial statements more difficult to understand.

Additionally, we believe the portion of the financial statement presentation project related to presentation of unrealised gains and losses of financial instruments needs to

be completed before the Board explores further whether the available-for-sale category should be eliminated.

The retention of the available-for-sale category inevitably means that it is not possible to eliminate one related source of complexity – the recognition and impairment of assets in that category. We discuss below our proposals for reducing the resulting complexity.

### *3. Fair value through profit and loss*

We also support the retention of the fair value option for all financial instruments. However we recommend the removal of restrictions on its use. The restrictions add a layer of complexity for preparers with many entities spending a significant amount of resources in demonstrating that their use of the option meets the criteria even though this is generally the case. This process is burdensome and costly to preparers and does not provide any benefits to the users of the financial statements. We recognise that these criteria were introduced to satisfy regulatory concerns. In practice we believe it is unlikely that removing them will significantly increase the use of the fair value option. On the other hand the removal of these restrictions would reduce the burden on preparers, and allow them to explain more clearly the rationale for their use of the option. We therefore consider that this proposal meets the conditions for reducing complexity for the interim solution.

### Reclassification Between Categories

We believe reclassification of financial assets or liabilities between categories should be prohibited after initial recognition with no exception. Reclassification makes financial statements more difficult to understand. It also inevitably requires the establishment of rules addressing when reclassification should be allowed and how to account for the difference between amortised cost and fair value. This creates unnecessary complexity for all constituents.

The prohibition on reclassification should not apply to derivative financial assets or liabilities that are de-designated or re-designated as hedging instruments.

### Impairment

A major source of complexity in reporting financial instruments arises from the different impairment models for each category of financial instruments. The current model is flawed and there is divergence in practice in its application. Although the Board does not propose any changes to the current model, we believe simplification in this area will provide significant benefits for all constituents.

Currently there are three different measurement models for impairment of financial assets:

- impairment losses on debt instruments carried at amortised cost (loans and receivables and held-to-maturity instruments) are recognised when the loss is incurred and measured using the original effective interest rate with subsequent reversals of impairment;

- impairment losses on available-for-sale debt instruments are also recognised when the loss is incurred but measured as the difference between fair value and amortised cost with subsequent reversals of impairment;
- impairment losses on available-for-sale equity instruments are recognised when there is a significant or prolonged decline in fair value and measured as the difference between fair value and cost with no subsequent reversal of impairment.

The existence of different impairment models creates application and interpretation problems for both preparers and users.

The impairment models for debt at amortised cost and available-for-sale equities are internally consistent: the former recognises losses only when there is a credit-related event and measurement is solely related to the impact of credit loss events on the contractual cash flows in the instrument. The latter recognises losses based on a significant decline in fair value and measures losses on the same basis. However, the impairment loss recognised for an available-for-sale debt instrument consists of the entire change in fair value including the impact of market factors (e.g. changes in interest rate and credit spread) in addition to credit loss events. This is inconsistent with the requirement for a credit-related event to trigger initial recognition of impairment and creates application difficulties in determining when subsequent impairment or reversals of impairment are recognised.

There are two ways to reduce complexity in this area. Under the first proposal, impairment on all debt instruments would be calculated on the same basis. Therefore, impairment losses on available-for-sale debt instruments would be measured based on the difference between the asset's carrying amount and the present value of estimated future cash flows using the original effective rate (the recoverable amount). The main advantage of this approach is that it is consistent with the incurred loss model which requires there to be objective evidence of the occurrence of a credit-related impairment event. It is also consistent with the requirement to measure interest income on all debt instruments on an effective interest rate basis, irrespective of whether they are carried at amortised cost or are classified as available-for-sale. A potential disadvantage is that companies would need to perform a separate calculation to compute the recoverable amount which may be less than fair value.

Under the alternative proposal, impairment for all available-for-sale financial assets would continue to be measured on a fair value basis. Impairment on debt instruments would only be recognised once a credit-related event has occurred as is currently the case. However, subsequently any fair value movement (increase or decrease) below amortised cost would be reflected in the income statement. The debt instrument would continue to be treated as impaired until the fair value again exceeded amortised cost. The advantage of this proposal is that it does not require any additional computation as the asset is already measured at fair value. The model does however have two disadvantages. Firstly, all fair value movements on any impaired debt instrument would be recognised in the income statement as impairment even though there is no change in the underlying recoverable amounts. And secondly, for interest income recognition purposes, the effective interest rate would need to be continually recast to the current market interest rate whenever an impairment loss is recognised or reversed.

Whilst both models meet the proposed conditions for simplification and both offer improvements over the existing model, neither is perfect. We believe this follows inevitably from a decision to retain the available-for-sale category and that the resulting complexity is outweighed by the need to protect the income statement from the volatility caused by fair value movements arising from non-operating assets.

Additionally, as far as equity investments are concerned, we recommend that the Board permits reversal of impairment losses for available-for-sale equity investments. Consequently all fair value movements below cost should be recognised in profit or loss once the impairment event (a significant or prolonged decline below cost) has occurred.

#### **Question 4**

*Approach 2 is to replace the existing measurement requirements with a fair value measurement principle with some optional exceptions.*

*(a) What restrictions would you suggest on the instruments eligible to be measured at something other than fair value? How are your suggestions consistent with the criteria set out in paragraph 2.2?*

*(b) How should instruments that are not measured at fair value be measured?*

*(c) When should impairment losses be recognised and how should the amount of impairment losses be measured?*

*(d) Where should unrealised gains and losses be recognised on instruments measured at fair value? Why? How are your suggestions consistent with the criteria set out in paragraph 2.2?*

*(e) Should reclassifications be permitted? What types of reclassifications should be permitted and how should they be accounted for? How are your suggestions consistent with the criteria set out in paragraph 2.2?*

We do not support Approach 2 for the following reasons:

- (i) We believe it would be premature to move to a fair value measurement principle before an extensive structured debate takes place with respect to the longer term objective;
- (ii) The need to establish a basis for exceptions under this approach is inconsistent with high quality principles-based standards;
- (iii) Approach 2 would be a significant change from current practice that may have unintended consequences. The effort involved in analysing financial instruments to determine the revised classification means that the proposal is unlikely to meet the condition in paragraph 2.2(d);

- (iv) The development of a significantly different model would increase the risk that the new standard would not be ready for 2011.

**Question 5**

*Approach 3 sets out possible simplifications of hedge accounting.*

*(a) Should hedge accounting be eliminated? Why or why not?*

No, we do not believe that hedge accounting should be eliminated. Reporting entities use derivatives and other hedging instruments as part of their business model to mitigate economic risks. A key objective of financial statements is to provide users with an understanding of the economic substance of a transaction or event in the context of the entity's business model. Requiring all derivatives to be measured at fair value through profit and loss would restrict the ability of users to understand the nature and extent of the reporting entity's risk management strategies.

*(b) Should fair value hedge accounting be replaced? Approach 3 sets out three possible approaches to replacing fair value hedge accounting.*

*(i) Which method(s) should the IASB consider, and why?*

*(ii) Are there any other methods not discussed that should be considered by the IASB? If so, what are they and how are they consistent with the criteria set out in paragraph 2.2? If you suggest changing measurement requirements under approach 1 or approach 2, please ensure your comments are consistent with your suggested approach to changing measurement requirements.*

Replacing fair value hedge accounting is likely to increase, rather than reduce, complexity for preparers. Fair value hedging is widely used in practice and many entities have incurred significant expenses in setting up systems to apply hedge accounting. We do not support any of the methods that the Board proposes to reduce the number of hedge accounting methods for the reasons set out below.

Substitution of a fair value option for instruments that would otherwise be hedged items:

A fair value option for financial instruments is already available to preparers where they can demonstrate an accounting mismatch. We are aware that certain reporting entities take advantage of this option in order to avoid the need to use fair value hedge accounting for some hedging strategies in spite of the disadvantages caused by the need to fair value the entire instrument and to designate at inception for the life of the instrument. The use is not widespread, however, as the approach causes volatility in the income statement relating to unhedged risks in the instrument (such as credit risk). It also fails to reflect the flexibility of many risk management strategies given the prohibition on subsequently deselecting the fair value option when hedging is no longer required. Furthermore it cannot be applied to hedges of non-financial assets such as commodities.

There may be ways to mitigate some of these drawbacks (for example the possibilities described in paragraph 2.40 of the discussion paper). However, these modifications to the fair value option would create problems as significant as those associated with the current fair value hedge accounting model. For example, extending its use to non-financial assets without additionally allowing it to be applied or disappplied after initial recognition would not reflect the flexibility associated with current risk management strategies; allowing it to be applied to portions of assets or risks would result in a new measurement attribute for balance sheet purposes which is neither cost nor fair value; and allowing application after initial recognition would either result in a new measurement attribute or create volatility arising from the initial restatement of the hedged item at fair value. Accordingly, we do not believe that this proposal meets the criteria set out for the interim solution.

Recognition outside earnings of gains and losses on financial instruments designated as hedging instruments (similar to cash flow hedge accounting)

This change reduces the number of hedge accounting models and eliminates the need to adjust the hedged asset or liability for movements in the hedged risk, thus removing a measurement attribute that is difficult for users to understand. However it would add additional complexity for preparers who would need to track adjustments in equity to ensure recycling occurs at the right time. We are therefore not convinced that any such change would meet the criteria for the interim solution.

Recognition outside earnings of gains and losses on financial instruments:

This proposal represents a fundamental change to the existing hedge accounting model and would require significant changes to systems to implement. It is not clear that the benefits for preparers would outweigh the costs, nor that it would be easier for users to understand. Consequently we do not support this proposal.

**Question 6**

*Section 2 also discusses how the existing hedge accounting models might be simplified. At present, there are several restrictions in the existing hedge accounting models to maintain discipline over when a hedging relationship can qualify for hedge accounting and how the application of the hedge accounting models affects earnings. This section also explains why those restrictions are required.*

*(a) What suggestions would you make to the IASB regarding how the existing hedge accounting models could be simplified?*

The existing hedge accounting models are unnecessarily complex and contain onerous requirements which are designed to restrict abuse rather than to reflect the economic substance of the risk management strategy. We therefore support the removal of the unnecessary complexity introduced by these anti-abuse requirements.

As noted in our covering letter, the IASB and FASB should work together to develop hedge accounting proposals that achieve simplicity without impairing the ability of

preparers to report the effectiveness of their risk management strategies. In that context we attach our response letter to the FASB's *Exposure Draft An Amendment to FAS 133* as Appendix B to this letter. The areas where we believe simplification could be achieved are described below.

#### Documentation

Firstly, we recommend simplification of the documentation requirements. Hedge accounting is elective and we believe it is important for entities to document this election. However, the current requirements are burdensome and failure to comply with every detail can lead to failed hedge accounting even though the hedging relationship is highly effective. We believe that documenting the following items is adequate to evidence the existence of an appropriate hedging relationship:

- The hedged item
- The hedging instrument, and
- A description of the economic relationship between the hedged risk and the hedging instrument, including how this is consistent with the company's risk management strategy and is thus intended to reduce volatility in fair values or cash flows.

#### Hedge effectiveness

We accept that hedge accounting should be restricted to those hedging relationships that can be expected to be effective in achieving a reduction in volatility in fair values or cash flows. The current requirements, however, are unnecessarily complex since they generally require a quantitative assessment of effectiveness both prospectively and retrospectively. Additionally, the imposition of a specified level of effectiveness makes it more difficult for entities to consistently apply hedge accounting and results in less comparable financial statements. For example, an entity may apply hedge accounting in one period when the hedging relationship is 81% effective. However, it is not permitted to apply hedge accounting in the next period if the hedging relationship is only 79% effective.

The only effectiveness test we propose is that entities should perform a qualitative prospective assessment at the inception of the hedging relationship which demonstrates the existence of an economic relationship between the hedged risk and the hedging instrument, and achieves the company's risk management strategy in reducing volatility in fair values or cash flows. In this context it would be helpful for the Board to provide a discussion of the factors to be considered in reaching such a determination.

We recommend the removal of the ongoing prospective and retrospective effectiveness tests and the requirement to be between 80% and 125% effective. The hedge effectiveness tests are unnecessary since all ineffectiveness is reflected in the income statement either during the life of the hedging relationship or, where cash flows are underhedged, when the hedged cash flows are recycled. The existence of the effectiveness band can result in failure to achieve hedge accounting as a result of minor deviations in expected cash flows and places undue emphasis on the method used to assess effectiveness. Entities frequently use different methodologies to assess

effectiveness than they use to measure ineffectiveness (for example regression analysis for the former and dollar offset for the latter) which adds to the administrative burden of applying hedge accounting. Entities would need to reassess their hedging relationship only if circumstances suggest that there is no longer an economic relationship, for example if a currency ceases to be pegged to the USD.

We support not recording ineffectiveness when the cumulative change in fair value of the hypothetical derivative exceeds the cumulative change in fair value of the actual derivative (i.e. underhedging) in a cash flow hedge relationship. Please see our response letter to the FASB on this point.

One further source of complexity in hedge accounting arises from the determination of the portions that can be designated for hedging purposes. Removing the requirement for hedges to be within 80% and 125% effective will reduce the pressure on the designation of portions, but this could be simplified further by establishing a principle for determining a portion. In our letter dated 7 January 2008 commenting on the exposure draft on exposures qualifying for hedge accounting we set out some principles that could be applied for this purpose. We do not support the removal of the ability to hedge portions.

*(b) Would your suggestions include restrictions that exist today? If not, why are those restrictions unnecessary?*

See our response to 6(a) above.

*(c) Existing hedge accounting requirements could be simplified if partial hedges were not permitted. Should partial hedges be permitted and, if so, why? Please also explain why you believe the benefits of allowing partial hedges justify the complexity.*

We believe partial hedges should continue to be permitted. Financial instruments are by their nature complex. Often a hedged financial instrument is subject to numerous risks, not all of which can be readily hedged. For example, purchasing a derivative that hedges the specific credit risk of a receivable is much more difficult than purchasing a derivative to hedge the foreign currency risk in such a receivable. Therefore, the need to hedge portions of a financial instrument is a function of the complexity of financial instruments.

Eliminating partial hedges would result in significant ineffectiveness being recorded for hedging relationships and would not provide relevant information to users about an entity's risk management strategy.

*(d) What other comments or suggestions do you have with regard to how hedge accounting might be simplified while maintaining discipline over when a hedging relationship can qualify for hedge accounting and how the application of the hedge accounting models affects earnings?*

See our response to 6(a) above.

*Question 7*

*Do you have any other intermediate approaches for the IASB to consider other than those set out in Section 2? If so, what are they and why should the IASB consider them?*

There are two other areas we believe the IASB should consider simplifying, namely own use contracts and embedded foreign currency derivatives.

Own use contracts

One of the most complex areas of IAS 39 in practice is paragraphs 5-7, often referred to as the 'own use exemption'. These paragraphs are both complex for preparers to apply as evidenced by the many questions we address on them, and complex for users to understand as evidenced by many of the entities most affected choosing to disclose non-GAAP measures or give lengthy explanations to highlight for users what they perceive to be more relevant information.

The anti-abuse provisions in paragraph 6(b) and 6(c) were intended to address circumstances where entities generate short term profit by entering into offsetting contracts or taking delivery of the underlying and selling it within a short period after delivery. We understand that the Board believes those contracts should be accounted for as derivatives. However, in practice, these anti-abuse provisions have brought normal, valid business transactions into the scope of IAS 39.

For example, paragraph 6(b) and (c) may result in derivative accounting for purchase orders for items such as ships and aircraft if the entity has sold similar orders in the past prior to delivery of the underlying ship or aircraft, e.g. due to concerns over the supplier's ability to deliver on time or due to reduced operating levels.

Another example where the anti-abuse provision in paragraph 7 fails to reflect economic substance is electricity/power contracts. Entities in the electricity industry frequently enter into contracts that permit one party to purchase electricity from another. The types of contracts generally used to buy and sell electricity are driven by the unique characteristics of the electric power industry in that electricity cannot be readily stored in significant quantities. As a result, contracts to buy and sell electricity contain volume flexibility to enable customers to take a variable amount to meet business needs. The prohibition of applying the own-use exemption to a written option may result in derivatives accounting for contracts to supply electricity during the normal course of business. This same issue arises in relation to other commodities, such as natural gas.

We believe simplification of these paragraphs would meet the conditions in paragraph 2(a), (c) and (d) of the discussion paper. Furthermore, this could be achieved by making fairly small changes to IAS 39, by:

- Deleting paragraphs 6(b), 6(c) and 7; and

- Extending paragraph 6(d) to include cases where the contract is readily convertible to cash (as well as when the non financial asset underlying the contract is readily convertible to cash).

Embedded foreign currency derivatives

The requirements in IAS 39 relating to embedded derivatives are a source of complexity but in most cases the complexity is necessary to ensure that risk is appropriately measured. However we believe that significant simplification could be achieved in the area of embedded foreign currency derivatives.

The rule for separation of foreign currency embedded derivatives in IAS 39.AG33(d) is clearly drafted for anti-abuse purposes, yet we do not believe that the currency of denomination of commercial contracts has in practice been used by companies to obscure speculative trading positions. The requirement in IAS 39 often leads to results that can cause confusion for both users and preparers. For example, a Euro functional currency entity that sells goods in US dollars to a USD functional currency entity would not have to separate an embedded derivative whereas a company selling the same goods to a GBP-functional entity might have to do so. From the seller's perspective there is no economic difference in these two transactions and therefore they should achieve the same accounting result. The analysis of foreign currency embedded derivatives (which has significant cost in terms of time and effort) yields very little benefit to users. Accordingly, we believe that it would be appropriate to eliminate the requirement to separate foreign currency embedded derivatives in business contracts that are simply denominated in a foreign currency. We would require separation of only those foreign currency embedded derivatives that are (a) leveraged, (b) option-based or (c) inconsistent with a purchasing/sales strategy that an average market participant would rationally undertake for transactions of a similar nature.

We note that this issue is partially addressed in the Improvements exposure draft issued in August 2008, however our proposal is more wide-ranging and would achieve a greater reduction in complexity.

**Section 3 A long-term solution—a single measurement method for all types of financial instruments**

***Question 8***

*To reduce today's measurement-related problems, Section 3 suggests that the long-term solution is to use a single method to measure all types of financial instruments within the scope of a standard for financial instruments.*

*Do you believe that using a single method to measure all types of financial instruments within the scope of a standard for financial instruments is appropriate? Why or why not? If you do not believe that all types of financial instruments should be measured using only one method in the long term, is there another approach to address measurement-related problems in the long term? If so, what is it?*

We do not believe the case is yet made for a single measurement method for all financial instruments. As indicated in our covering letter, financial reporting should not be oversimplified: it should reflect the complexity of the instrument (e.g. complexity due to the uncertainty of amount and timing of future cash flows) and the different ways in which an entity uses financial instruments in its business model in order to achieve representational faithfulness. This is one of the questions that we believe needs to be addressed as part of the debate which we urge the Board to undertake prior to concluding on the appropriate longer term solution for financial instrument reporting.

## **Question 9**

*Part A of Section 3 suggests that fair value seems to be the only measurement attribute that is appropriate for all types of financial instruments within the scope of a standard for financial instruments.*

*(a) Do you believe that fair value is the only measurement attribute that is appropriate for all types of financial instruments within the scope of a standard for financial instruments?*

*(b) If not, what measurement attribute other than fair value is appropriate for all types of financial instruments within the scope of a standard for financial instruments? Why do you think that measurement attribute is appropriate for all types of financial instruments within the scope of a standard for financial instruments? Does that measurement attribute reduce today's measurement-related complexity and provide users with information that is necessary to assess the cash flow prospects for all types of financial instruments?*

As discussed in our covering letter we do not believe the case is yet made for a single measurement model for all financial instruments. Measuring all financial instruments at fair value is a solution that first needs an extensive structured debate around the issues. There are potentially other measurement attributes that would be more appropriate for certain types of financial instruments. For example a settlement model may be more relevant than a transfer model for non-derivative financial liabilities. Consequently we do not believe that this is the right time to make a decision on the longer term solution to reporting financial instruments.

## **Question 10**

*Part B of Section 3 sets out concerns about fair value measurement of financial instruments. Are there any significant concerns about fair value measurement of financial instruments other than those identified in Section 3? If so, what are they and why are they matters for concern?*

We agree with the concerns expressed in Section 3, particularly in the light of current market conditions. These concerns should be addressed as part of the structured debate proposed above.

***Question 11***

*Part C of Section 3 identifies four issues that the IASB needs to resolve before proposing fair value measurement as a general requirement for all types of financial instruments within the scope of a standard for financial instruments.*

*(a) Are there other issues that you believe the IASB should address before proposing a general fair value measurement requirement for financial instruments? If so, what are they? How should the IASB address them?*

*(b) Are there any issues identified in part C of Section 3 that do not have to be resolved before proposing a general fair value measurement requirement? If so, what are they and why do they not need to be resolved before proposing fair value as a general measurement requirement?*

In addition to these issues which all need to be resolved before proposing a general fair value measurement requirement, the IASB should address the objectives of financial reporting for financial instruments before concluding that a single measurement attribute is appropriate for financial instruments. In particular the IASB should focus on the questions that we address in our covering letter.

***Question 12***

*Do you have any other comments for the IASB on how it could improve and simplify the accounting for financial instruments?*

In the longer term, we recommend that the standard be rewritten using simple language. This is a relevant consideration for all accounting standards but we note that many of the interpretational difficulties result from the complexity of the language in IAS 39. A clear statement of the underlying principles using plain language would eliminate much of the confusion.

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PricewaterhouseCoopers appreciates the opportunity to comment on the Exposure Draft of the Proposed Statement of Financial Accounting Standards, *Accounting for Hedging Activities, an amendment of FASB Statement No. 133* (the Exposure Draft).

It is our expectation that public company financial reporting in the United States will move to International Financial Reporting Standards (IFRS) in the not-too-distant future. We therefore believe the Financial Accounting Standards Board (FASB or the Board) should primarily focus its standard-setting efforts on convergence matters and limit other changes in US Generally Accepted Accounting Principles (GAAP) to critical repairs and maintenance activities. Furthermore, any projects to address the accounting in problematic areas should be designed to provide a simpler solution that adequately reflects the economics of transactions and that do not create significant new differences with IFRS.

In view of the difficulties that practice has experienced with applying Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (FAS 133), we support the Board's overall efforts to simplify the accounting for hedging activities and to improve transparency for users of financial statements. However, we are concerned that through this project, the Board could create additional US GAAP-IFRS differences. The International Accounting Standards Board (IASB) has issued a discussion paper, *Reducing Complexity in Reporting Financial Instruments*, that contemplates possible ways to simplify hedge accounting under IFRS. To minimize the risk of creating significant new differences between the two sets of standards, we recommend that the FASB and IASB work together on any major changes to hedge accounting.

We also have mixed views with respect to the specific amendments to FAS 133 proposed in the Exposure Draft. We expect that several of them will help reduce the complexity of qualifying for hedge accounting and improve the consistency and comparability in financial reporting. We support eliminating the high effectiveness threshold, as well as streamlining hedge documentation through the elimination of the initial and ongoing quantitative effectiveness assessment requirement. We also support the accommodation being proposed for the measurement of hedge effectiveness for cash flow hedges of a group of transactions that fall within a specific period. Practice has struggled with these aspects of applying hedge accounting and such changes should resolve some of the issues that have arisen.

However, we are not in favor of a number of other changes contained in the Exposure Draft. We are particularly concerned with the curtailment of the bifurcation-by-risk model for financial assets and liabilities, the lack of clarity surrounding the new "reasonably effective" threshold, the requirement to recognize the ineffectiveness associated with cash flow underhedges, and the change in the guidance for hedges of forecasted intercompany transactions.

*Curtailment of the Bifurcation-by-Risk Model*

In practice, companies design risk management strategies to mitigate risk exposures relevant to their business. Typically, strategies related to financial instruments are executed on a specific risk component basis. We believe the financial reporting model should be aligned with the risk management strategies companies employ, which is best reflected in the current bifurcation-by-risk approach for financial assets and liabilities. Information regarding the economics associated with unhedged risk components may be better conveyed to users through disclosures, rather than through earnings as proposed by the Board.

Additionally, the proposed curtailment of the bifurcation-by-risk approach would arguably increase the complexity of hedge accounting in many instances. Recording the fair value changes for the entire financial instrument or forecasted exposure would result in the recognition in earnings of the changes in fair value attributable to risk components not being hedged. A well-established market already exists for derivatives that can be effective hedges of interest rate risk, and information regarding the expected interest rates for future periods is generally available. In contrast, often no derivative exists to economically hedge other risk components, such as credit risk, and forecasted credit spread information is very limited. The absence of credit risk information for the full term of a planned debt issuance would make the application of hedge accounting for hedges of the interest costs associated with forecasted borrowings very difficult for some companies under the Board's proposed full-fair-value approach.

*"Reasonably Effective" Threshold*

Although we agree with the Board that the establishment of a quantitative threshold or bright-line is inappropriate for determining hedge effectiveness, we are concerned with the introduction of the "reasonably effective" threshold. The Exposure Draft does not define this term, nor provide much guidance on how it should be applied. In addition, paragraph A9 of the Exposure Draft notes that the determination of "reasonably effective" would depend on facts and circumstances and may be different depending on the objective, such as whether the fair value option is available for the hedged item. However, it is unclear why the effectiveness of a hedging relationship should be higher or lower depending on the availability of the fair value option. We are also concerned that in the absence of a better understanding of the Board's intent, practice will inevitably try to establish a bright line for assessing hedge effectiveness. As an alternative to establishing a threshold that might be misinterpreted as a new bright line, we believe the Board should provide a discussion of the factors to be considered in determining whether there is an adequate economic relationship between the hedged item and the hedging instrument that achieves the risk management strategy.

*Ineffectiveness Associated with Cash Flow Underhedges*

As stated in the Exposure Draft's Basis for Conclusions, hedge accounting largely results from the need to address differences in the way hedged items and hedging instruments are recognized and measured. We believe the primary objective of cash flow hedge accounting should be to defer the effective portion of the gains and losses associated with the actual hedging instrument for later recognition in earnings with the hedged forecasted transaction. It should not be to recognize ineffectiveness in earnings for hypothetical derivative instrument gains and losses that will never be realized or incurred. We therefore do not support the proposal to record in earnings the ineffectiveness related to underhedges in cash flow hedging relationships. Under that approach, the amount deferred in equity and ultimately recognized in earnings with the hedged transaction would reflect the hedging relationship as if the entire risk were perfectly hedged. We do not believe a portrayal of the combination of the hedged transaction and the hedging strategy as if the hedging instrument was perfect, when in fact it was less than perfect, is representationally faithful. This situation differs for overhedges, where it does not seem appropriate to defer hedging gains and losses that are more than what is needed to offset the hedged cash flows. If users require information about the extent to which a



hedging strategy is less than perfect, that information should be provided through disclosures and not through the recognition of phantom gains and losses in earnings.

*Hedges of Forecasted Intercompany Transactions*

The Exposure Draft proposes to amend the guidance related to foreign currency hedges of forecasted intercompany transactions to address differences between the intent of the guidance and how practice has developed. However, we do not believe that the proposed amendments adequately clarify the Board's intent. Based on our follow-up discussions with the FASB staff, it appears that whether a forecasted intercompany transaction qualifies for hedge accounting will depend on the ability to conclude that there is an earnings exposure that survives consolidation by linking that transaction to a third party transaction. We are concerned that this concept of linkage is not explained in the Exposure Draft especially given the different types of intercompany transactions that exist in practice and the varying degrees to which they may be linked to third party transactions. In the absence of this guidance, it is difficult for us to comment on whether we agree or have any specific concerns with the proposed amendment and its impact on practice. We therefore encourage the Board to undertake further research into the hedging strategies that multinational companies use to manage the foreign currency exposure associated with their forecasted intercompany transactions to ensure that the final standard clearly conveys a workable approach for the strategies typically employed.

Our responses to the specific questions contained in the Notice for Recipients, along with additional comments on the Exposure Draft, are attached in the Appendix to this letter.

We appreciate the opportunity to express our views on the Exposure Draft. If you have questions regarding our comments, please contact John Althoff at (973) 236-7288 or Michael Gallagher at (973) 236-4328.

Sincerely,

*PriceWaterhouseCoopers LLP*

**Exposure Draft**  
**Proposed Statement of Financial Accounting Standards**  
***Accounting for Hedging Activities, an amendment of FASB Statement No. 133***

**Hedged Risk**

**Issue 1: Do you believe that the proposed Statement would improve or impair the usefulness of financial statements by eliminating the ability of an entity to designate individual risks and requiring the reporting of the risks inherent in the hedged item or transaction?**

- We believe removing the ability to designate risk components of financial instruments would impair the usefulness of financial statements. Recording fair value changes for risk components that are not (and in some cases cannot be) hedged would not seem to faithfully represent the economic reality of hedging relationships. Generally, risk management strategies for financial instruments identify and strive to manage a specific risk component, such as interest rate risk. A well-established market already exists for derivatives that can be effective hedges of interest rate risk, and information regarding the expected interest rates for future periods is generally available. In contrast, often no derivative exists to economically hedge other risk components, such as credit risk, and forecasted credit spread information is very limited. The absence of credit risk information for the full term of a planned debt issuance would make the application of hedge accounting for hedges of the interest costs associated with forecasted borrowings very difficult under the Board's proposed full-fair-value-approach.

We believe the financial reporting model should be reflective of the risk management strategies companies employ, which is better reflected in a bifurcation-by-risk approach for financial assets and liabilities. The current hedge accounting model presents the results of hedge accounting in a manner that allows users to see how effective management was in achieving its risk management objectives. The inclusion of all risks would make it more difficult for financial statement users to determine the effectiveness of those risk management strategies. We believe any information regarding the economics associated with unhedged risk components may be better conveyed to users through disclosures.

**Issue 2: Do you believe the Board should continue to permit an entity to designate those individual risks as a hedged risk?**

- As noted in our response to Issue 1 above, we support a bifurcation-by-risk approach for financial instruments. We do not see a compelling reason to eliminate the ability to designate individual component risks as a hedged risk for financial assets and liabilities. Additionally, the proposed curtailment of this approach would arguably increase the complexity of hedge accounting in many instances.

**Hedge Effectiveness**

**Issue 3: 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 absence of credit risk information for the full term of a planned debt issuance will likely make the measurement of ineffectiveness for hedges of the interest costs associated with forecasted borrowings very difficult.
- In view of the proposals to lower the effectiveness threshold, move to a qualitative assessment and provide an accommodation for the measurement of hedge effectiveness for cash flow hedges of a group of transactions that fall within a specific period, we would not object to removing the ability to assume no ineffectiveness using these two methods.

**Issue 4: Do you believe that modifying the effectiveness threshold from highly effective to reasonably effective is appropriate? Why or why not?**

- We support the elimination of the high effectiveness threshold, but have concerns regarding the lack of clarity surrounding the new reasonably effective threshold. We agree with the Board that the establishment of a quantitative threshold or bright-line is inappropriate for determining hedge effectiveness. However, the Exposure Draft does not define this term, nor provide much guidance on how it should be applied. In addition, paragraph A9 of the Exposure Draft notes that the determination of "reasonably effective" would depend on facts and circumstances and may be different depending on the objective, such as whether the fair value option is available for the hedged item. However, it is unclear why the effectiveness of hedging relationship should be higher or lower depending on the availability of the fair value option. We are also concerned that in the absence of a better understanding of the Board's intent, practice will inevitably try to establish a bright line for assessing hedge effectiveness. As an alternative to establishing a threshold that might be misinterpreted as a new bright line, we believe the Board should provide a discussion of the factors to be considered in determining whether there is an adequate economic relationship between the hedged item and the hedging instrument that achieves the risk management strategy.

**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?**

- We believe that many currently designated fair value hedges of interest rate risk for financial instruments and cash flow hedges of interest rate risk for forecasted debt issuances may no longer be permitted under the proposed amendment to FAS 133. However, the extent to which this occurs will depend on the expected volatility of the issuer's credit spread relative to the expected volatility of the benchmark interest rate, as well as the Board's clarification of the reasonably effective threshold. The lack of derivative instruments available to economically hedge a company's credit risk will likely preclude many companies from increasing the effectiveness of those hedging relationships that fail to meet the threshold under the new full fair value approach. Furthermore, in those situations where financial assets are aggregated and hedged as a portfolio, companies will experience operational difficulties because of the impact the inclusion of credit spreads will have on determining appropriate groupings of similar assets. This could lead to a decrease in the size of

the asset portfolios and a corresponding increase in the number of individual hedge designations, which would be counter to the Board's overall efforts to reduce the complexity of applying hedge accounting.

**Issue 5: 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?**

- We do not foresee any significant operational concerns assuming that the proposed "reasonably effective" threshold is clarified, as discussed in our response to Issue 4. We believe that companies will likely monitor those factors considered in their qualitative assessment at inception and the hedge accounting results (i.e., the amount of ineffectiveness) to determine whether circumstances suggest that the hedging relationship is no longer reasonably effective. However, it will be important to understand that this assessment will be far more judgmental than current practice and that inherently, not everyone will conclude that a particular hedging relationship may no longer be reasonably effective at the exact same point in time.
- We do not believe that requiring an effectiveness assessment after inception only if circumstances suggest the hedging relationship is ineffective would significantly reduce the number of terminations when compared with a quantitative assessment assuming the same hedge effectiveness threshold is applied. However, again it will be important to understand that this assessment will be more judgmental, and therefore, the timing of when the hedging relationship is terminated may differ under each approach.

**Issue 6: Do you agree with the Board's decision to continue to require that hedge accounting be discontinued if a hedge becomes ineffective? Alternatively, should an effectiveness evaluation not be required under any circumstances after inception of a hedging relationship if it was determined at inception that the hedging relationship was expected to be reasonably effective over the expected hedge term?**

- We believe that hedge accounting should be discontinued if the hedging relationship is no longer effective in achieving the risk management strategy. Therefore, there is a need to consider whether circumstances have subsequently changed in such a way that the economic relationship between the hedging instrument and the hedged item has deteriorated to the point where the hedge no longer accomplishes the risk management strategy.

#### **Presentation of Hedging Gains and Losses**

**Issue 7: Do you believe that Statement 133 should be amended to prescribe the presentation of these amounts? For example, the Statement could require that the effective portion of derivatives hedging the interest rate risk in issued debt be classified within interest expense and that the ineffective portion and any amounts excluded from the evaluation of effectiveness be presented within other income or loss.**

- We do not believe it is necessary to prescribe the presentation of hedging gains and losses in the financial statements. Practice has developed over time and, where significant, companies disclose their accounting policies. However, the Board may wish to address the presentation of hedge ineffectiveness if it retains the proposed recognition of ineffectiveness associated with underhedges in cash flow hedging relationships. Under FAS 133, hedge ineffectiveness is not

required to be presented in a manner consistent with the presentation of the effective portion of hedging gains and losses. If the hedged transactions will be reflected as if they are perfectly effective regardless of the actual effectiveness of the hedging relationship, it may be more appropriate to require that ineffectiveness be presented in a consistent manner.

**Effective Date and Transition**

**Issue 8: Do you believe that the proposed effective date would provide enough time for entities to adopt the proposed Statement? Why or why not?**

- As discussed in the cover letter, we believe the FASB should work with the IASB to ensure that no new significant differences are created between the two sets of standards. Given that the IASB is at an earlier stage in its deliberations, we would expect the FASB to delay the final statement to enable the FASB and IASB to proceed jointly.

**Issue 9: Do you believe that there are specific disclosures that should be required during transition? If so, what?**

- We do not believe any specific disclosures are required during transition. However, we are concerned about the transition provisions for those prior hedging relationships that must be redesignated using the new qualifying criteria. Because of a significant movement in market prices since the inception of the original hedging relationship, it is possible for the new hedge to fail to qualify for hedge accounting (i.e., it is not expected to be reasonably effective) due to the then off-market element in the derivative instrument. We recommend that the Board consider modifying the proposed transition requirements to allow the effectiveness assessment of previously existing hedging relationships to be applied as of the inception of the original hedging relationship instead of the effective date of the new guidance. By doing this, only an off-market element that was present in the derivative instrument at the date of the prior election of hedge accounting, as well as all other basis differences between the derivative instrument and the hedged item using the new qualifying criteria, would be considered in determining whether the hedging relationship is reasonably effective and therefore eligible for hedge accounting going forward. A similar type of transition accommodation was provided for in DIG Issue No. J9, *Use of the Shortcut Method in the Transition Adjustment and upon Initial Adoption*, where paragraph 68(b) (i.e., the interest rate swap had a zero fair value at inception) was allowed to be applied as of the original inception date of the hedging relationship upon transition to FAS 133.

**Issue 10: 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?**

- We agree with the Board's decision to allow a one-time fair value option at the initial adoption of the final standard. However, we do not believe that election should be limited to only those items that are in a hedging relationship immediately prior to adoption of the final statement. The changes being proposed could impact companies' risk management strategies for other assets and liabilities not currently in hedging relationships, but which are candidates for hedging in the future. In addition, because FAS 133 allows late term hedging of the interest rate risk component, companies could enter into a hedging relationship prior to the effective date of the new standard to be eligible for the one-time fair value option. We do not believe companies should have to consider incurring the cost of entering into a hedging relationship shortly prior to the effective date to qualify for the fair value option so that they avoid any potential adverse effects arising from the application of the new standard.

**Benefit-Cost Considerations**

**Issue 11: 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?**

- In the Basis for Conclusions, paragraph A16 states, “The Board believes it is just as important to reflect in the financial statements the economics of unhedged risks in order to provide users with a more complete picture of a company’s financial position and results of operations resulting from hedge accounting activities.” As previously discussed, we do not support eliminating bifurcation-by-risk and disagree with the view that the effects of risks not being hedged should be reflected in earnings. If users require information about risks that are not hedged, we believe that disclosures would provide better transparency. It is unclear whether the benefits of such disclosures have been considered by the Board as an alternative to recording the effects of hedging strategies companies did not employ.

**Other Comments**

- The Exposure Draft proposes to amend paragraph 40 of FAS 133 by stating that “the requirement in paragraph 29(c) that the forecasted transaction presents an exposure to variations in cash flows that could affect reported earnings must still be met at the level being reported on. (For example in the financial statements of a consolidated entity, there would need to be an earnings effect that survives consolidation.)” The Basis for Conclusions explains that the purpose of amending the guidance related to foreign currency hedges of forecasted intercompany transactions is to address differences between the intent of the guidance and how practice has developed. However, no further explanation is provided as to the nature of the differences nor how this amended guidance would change practice. Additionally, the proposed amendment could be interpreted to restrict hedge accounting to a very narrow set of intercompany transactions.

Based on our follow-up discussions with the FASB staff, it appears that whether a forecasted intercompany transaction qualifies for hedge accounting will depend on the ability to conclude that there is an earnings exposure that survives consolidation by linking that transaction to a third party transaction. We are concerned that this concept of linkage is not explained in the Exposure Draft especially given the different types of intercompany transactions that exist in practice and the varying degrees to which they may be linked to third party transactions.

In the absence of this guidance, it is difficult for us to comment on whether we agree or have any specific concerns with the proposed amendment and its impact on practice. We therefore encourage the Board to undertake further research into the hedging strategies that multinational companies use to manage the foreign currency exposure associated with their forecasted intercompany transactions to ensure that the final standard clearly conveys a workable approach for the strategies typically employed.

- We do not view the current ability to dedesignate hedging relationships to be problematic or an area of abuse. Hedge accounting by its nature is elective, and therefore, the ability to discontinue it is consistent with this notion. Furthermore, we do not believe that dedesignations are common across practice. Those that do occur are likely reflective of companies that manage their risks on an enterprise-wide basis, but must apply hedge accounting on a transaction-by-transaction basis. Also, it is common for companies that hedge forecasted transactions for foreign currency risk through to the expected payment date to dedesignate the hedging relationship upon recognition of the transaction for administrative ease. From a practical perspective, not allowing dedesignation would, in our view, result in unnecessary additional cost to preparers. As the Exposure Draft points

out, companies would still be allowed to terminate a derivative instrument designated in a hedging relationship and immediately enter into a new identical derivative.

- Paragraph 14 of the Exposure Draft states that adding a new derivative to an existing hedging relationship that does not offset an existing derivative and does not reduce the effectiveness of that relationship would not be deemed a dedesignation. While this appears to be intended to accommodate dynamic hedging strategies, it is not entirely clear since it does not address other aspects of those strategies, such as the removal or offset of one of the hedging instruments to increase the overall effectiveness of the hedging relationship. We believe that dynamic hedging strategies should be eligible for hedge accounting and recommend that the Board clarify the guidance accordingly.
- The Exposure Draft also proposes certain additional amendments to FAS 133 that are unrelated to the objective of simplification. However, the intent of these other changes is not always apparent. For example, the purpose of removing the words “publicly traded” from paragraph 61(e) and changes to paragraph 13 of DIG Issue No. B16, *Calls and Puts in Debt Instruments*, are not explained. We believe each of these changes should be brought to constituents’ attention and explained to ensure that the implication of the change is understood and appropriately considered upon adoption of the final standard.
- Paragraph 27 of the Exposure Draft provides for the measurement of ineffectiveness on a cash flow hedging relationship using a derivative that would settle in a reasonable time relative to the hedged cash flows, provided that differences between the forward rate on that derivative and the forward rate on derivatives that would exactly offset the hedged cash flows are minimal. We recommend that the reference to “minimal” be replaced with “*de minimus*” in this paragraph to better convey the intent of the guidance. Furthermore, the Board may wish to consider clarifying that the guidance may be applied to both forward and option-based hedging strategies.
- The Exposure Draft states that a hedging instrument may be considered effectively terminated when an offsetting derivative instrument is entered into. However, it is unclear how differing counterparty credit risks in the “offsetting” derivative instruments should be considered in determining whether they offset and are thus terminated. We suggest the Board consider clarifying the impact that different counterparty credit risk may have on determining whether a derivative instrument has been terminated with an offsetting instrument.
- One area of complexity and diversity in practice that is not covered in any of the proposed amendments to FAS 133 relates to the calculation of the change in a hedged item’s fair value attributable to changes in the benchmark interest rate for a specific period in a fair value hedge. This is especially challenging where the derivative and hedged item are not naturally effective, such as when a debt instrument has been issued at a substantial discount. Currently, a particular method for calculating the change in a hedged item’s fair value attributable to changes in the benchmark interest rate is not prescribed. If the Board retains the bifurcation by-risk hedge accounting model as we have recommended, it would be helpful if the Board would address this area of confusion in practice, perhaps by providing examples of how to perform this calculation.