Sent: Thursday, November 03, 2016 12:47 PM
To: Director - FASB <director@fasb.org>
Subject: Exposure Draft on Hedge Accounting

On September 8, 2016 the FASB issued an Exposure Draft on Derivatives and Hedging (Topic 815) proposing "Targeted Improvements to Accounting for Hedging Activities." While the FASB has requested comments on a number of issues, I am sending in this response to comment on just one issue; hedging the translation risk of foreign earnings.

In general, I believe the Exposure Draft will significantly improve the hedge accounting model by providing more transparency to an entity's risk management strategies and by allowing more common hedging relationships to qualify. I agree the "cost of hedging" concept outlined in the exposure draft and commend the FASB and FASB staff in their efforts to simplifying the application of the hedge accounting rules.

The Exposure Draft, however, did not add any new provisions on portfolio hedging which is how the risk foreign earning translation is viewed (a portfolio of risk exposures). In fact, there was only a brief acknowledgement of the portfolio hedging issue in the Background Information and Basis for Conclusions. Within the Comparison with International Financial Reporting Standards (IFRS), paragraph BC163 stated that;

"the IASB currently has a separate project on macro or portfolio hedge accounting. The project's objective is to develop an approach to reflect dynamic risk management strategies in the financial statements. The Board acknowledges that the IASB's project on macro hedging is broader in scope than the scope of this proposed Update. However, the Board will observe the IASB's deliberations and outcomes on that project."

Hedging foreign earnings is a significant risk exposure for many public reporting companies and I would agree that developing portfolio hedging rules is a complex project. However as an alternative to designing portfolio hedging rules for foreign earnings, a review of the functional currency concepts of FAS 52, Foreign Currency Translation (ASC 830) could be considered.

I have attached my review and rationale for moving from the functional currency concept to a single unit of measurement for determining foreign currency exposures. This is not a new concept; it was considered when FAS 52 was issued in 1981. However, as treasury and risk management activities continue to evolve and be centralized, it might an appropriate time to revisit this issue especially in light of the difficulties in understanding functional currency results and the restrictions on hedging foreign earnings translation. If the functional currency concept of FAS 52 were eliminated, the characterization of foreign earnings as a portfolio exposure is also eliminated.

Or perhaps, a more practical solution would be to allow multinationals the flexibility to elect their reporting currency as the functional currency for the entire reporting entity. In this case, a central treasury operation might be factor in allowing the election.

Thank you for the opportunity to comment on the Exposure Draft. I realize that portfolio hedging might be outside the scope of this project but hedging foreign earnings translation is a significant issue and if simplification of the hedging rules is the objective, this issue should be on the list of items to consider.

Note that my comments are my own and do not represent the views of Bloomberg LLC.

I would be interested in attending the December 2 round table session at the FASB.

Respectfully,

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Hedging Foreign Earnings – Is it time to Obviate Translation?

Robert Baer

Foreign Currency Headwinds

So far, 2015 has been a year of USD strength. A common theme contained in recent quarterly earnings calls and discussions has been the negative impact of expected or anticipated foreign currency headwinds.[1]

Kimberly-Clark - We absorbed significant currency headwinds. The total earnings drag from currency was approximately 0.25 per share or about 19 percent in the quarter, 4/21/15

Manpower Group - As expected, currency had a significant negative impact on our reported results. This headwind in our reported results in U.S. dollars will likely be something we'll see also going forward, 4/21/15

Levi Strauss– As anticipated, currency headwinds are indeed having a significant impact on our reported results, 4/14/15

Genuine Parts – we felt that the strength of the U.S. Dollar would be a significant headwind for us, 4/21/15

DuPont - Operating EPS included a $0.27 headwind from a stronger dollar, 4/21/15

The dollar has been strong for a year. Why did management not hedge the risk? The answer in many cases is the accounting rules. First, a direct hedge of foreign currency earnings does not qualify for hedge accounting (Accounting Standards Codification "ASC" 815, Derivatives and Hedging) which means any hedge is revalued on a mark-to-market basis through earnings regardless of when the underlying hedged foreign earnings are recorded. A hedge could create unpredictable volatility in the financial statements, which most public companies seek to avoid. The other less obvious factor is the accounting rules for foreign currency which rely on the functional currency and translation concepts (FAS 52, now ASC 830, Foreign Currency Matters).

Changes to the Hedge Accounting Model Present the Opportunity to Revisit Translation.

The Financial Accounting Standards Board (FASB) is moving towards issuing new hedge accounting rules[2] that are designed to simplify the hedge accounting model with targeted improvements. A hedge of

[1] Currency Volatility Took $32 Billion Chunk Out of First Quarter Results – highest level in years. North American and European companies told investors they struggled with foreign currency on quarterly conference calls and reported a 57% increase in hits to sales and earnings from currency movements (FIREApps) Emily Chasan, WSJ 6/6/15.

foreign earnings may be the most material foreign currency risk that a multinational corporation has to manage yet this hedging issue is not on the FASB's current agenda.[3] Perhaps, this is the right time for the FASB to address it.

Hedging Foreign Currency Earnings - Current Standards

A hedge of forecasted foreign currency earnings does not receive the benefits of hedge accounting[4] because the hedge accounting model has not yet fully addressed the complexity of portfolio hedging. The current rules focus on single transactional exposures or portfolios with similar exposures (the exposures react to market changes in a similar fashion). Foreign earnings are viewed as a diverse portfolio of exposures and therefore are ineligible. Indirect methods of hedging foreign earnings can sometimes be structured but often those hedges are costly or operationally inefficient.[5] A multinational may decide to hedge foreign earnings despite the accounting treatment but this may require supplemental financial statement disclosures explaining the resulting earnings volatility that might be difficult to understand or evaluate.

Is it Time to Obviate FX Translation?

Alternatively, and certainly a more drastic solution would be to revisit the functional currency concept of foreign currency accounting. As FAS 52 observed, **"If a foreign entity's functional currency is the reporting currency, remeasurement into the reporting currency obviates translation."[6]** A change to a single unit of measure would eliminate the process of translating foreign subsidiary financial statements and then all probable forecasted currency exposures (transactions not denominated in the reporting currency) could qualify for hedge accounting. Eliminating the functional currency concept of FAS 52 would be a significant change but as the global economy and centralized treasury management trends continue to evolve, it is worth considering. And it would eliminate many of the unusual accounting results that certain FASB Board members raised prior to issuing that statement.

Historical Perspective

FAS 52*, Foreign Currency Translation*, was issued in 1981 and became effective in 1983. The decision reached by the FASB to report based on functional currency rather than under a single unit of measure was approved by a slim 4-3 margin. In the 30 plus years that have passed since that statement was

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[2] FASB Project on Accounting for Financial Instruments – Hedge Accounting
[3] The ISDA comment letter to the FASB in April, 2011 commented on this deficiency when they said, "despite the Exposure Draft's aim to better align an entity's risk management objectives and hedge accounting, the Exposure Draft precludes the application of hedge accounting to certain common economic hedge strategies that reflect actual risk management (e.g., … hedging the foreign currency exposure of net income of a consolidated foreign subsidiary…"). We find this to be a significant shortcoming within the proposal. International Swaps and Derivative Association, Inc. comment letter to the FASB on the Financial Instruments – Hedging Project, 4/25/11
[4] Hedge accounting matches the results of the hedge instrument with the hedged exposure in the same accounting period.
[5] *Five Ways Treasurers Can Protect Earnings from FX Swings*, 2015, Association for Financial Professionals, Inc., Nilly Essaides
[6] Statement of Financial Accounting Standards No. 52, Foreign Currency Translation, paragraph 10

issued, technology and treasury management has evolved to where most multinational corporations run central treasury groups and manage foreign currency risk globally. Reviewing FAS 52 today, the dissenting view of FASB Board members is even more persuasive.

Reasons to Eliminate Translation

1. **The functional currency approach attempts to measure results in the primary economic environment in which an entity operates. Many public, multinational corporations manage their business on a global basis through a central treasury operation; a trend that continues to expand. As the FAS 52 dissent suggests, there was no persuasive reason to support the belief that external users want or need to know the amount of gains or losses as measured from the perspective of the manager of the foreign operation.**
2. **For investors and creditors, a single unit of measure will better assist in assessing future cash flows.**
3. **Individual assets and liabilities are subject to exchange rate risk rather than the parent's net investment. When exchange rates change between the reporting currency and a foreign currency, the value of any holdings of that currency changes and from a reporting currency perspective and the resulting gain or loss is real. Functional currency accounting can result in a division of the gain or loss into one component that is considered in measuring net income and the other that is considered as an equity, translation adjustment.**
4. **Real foreign currency gains and losses from translation can be deferred indefinitely.**
5. **Comparative financial results would improve with a single unit of measure.**

Global Management of the Treasury Function

Driven by technology advances and efficiency objectives, multinational corporations continue to centralize their treasury activities.[7] A centralized treasury can add value to the enterprise by becoming a strategic advisor as cash can be consolidated, pooled and netted which allows for more efficient liquidity management and investment decisions. Intercompany lending and centralized funding for raising debt capital can reduce borrowing costs.

Many multinationals have seen the benefits of centralizing policy setting, decision making and transaction execution. Contrary to the 1980s when multinational companies viewed treasury as a patchwork of local treasury operations, but the drive for efficiency and cost reduction has exposed the duplications of work and inconsistencies of a decentralized treasury.

There are also significant benefits for managing financial risk on a centralized basis. Exposures can be aggregated, netted and hedged reducing hedging transaction costs. But even with these hedging efficiencies, foreign currency exposures and hedging continue to expand. Consider the volume of the

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[7] "Optimizing the Treasury Function: The Time is now" , Financial Executive International, September, 2013, Robert J Baldoni

global foreign currency hedging market. As the chart below indicates, in 2013 OTC global foreign exchange derivatives volume has increased by 350% since 1998.[8]

Global foreign exchange market turnover

Net-net basis,[1] daily averages in April, in billions of US dollars — Table 1

Instrument	1998	2001	2004	2007	2010	2013
Foreign exchange instruments	1,527	1,239	1,934	3,324	3,971	5,345
Spot transactions	568	386	631	1,005	1,488	2,046
Outright forwards	128	130	209	362	475	680
Foreign exchange swaps	734	656	954	1,714	1,759	2,228
Currency swaps	10	7	21	31	43	54
Options and other products[2]	87	60	119	212	207	337
Memo:						
Turnover at April 2013 exchange rates[3]	*1,718*	*1,500*	*2,036*	*3,376*	*3,969*	*5,345*
Exchange-traded derivatives[4]	*11*	*12*	*26*	*80*	*155*	*160*

[1] Adjusted for local and cross-border inter-dealer double-counting (ie "net-net" basis). [2] The category "other FX products" covers highly leveraged transactions and/or trades whose notional amount is variable and where a decomposition into individual plain vanilla components was impractical or impossible. [3] Non-US dollar legs of foreign currency transactions were converted into original currency amounts at average exchange rates for April of each survey year and then reconverted into US dollar amounts at average April 2013 exchange rates. [4] Sources: FOW TRADEdata; Futures Industry Association; various futures and options exchanges. Foreign exchange futures and options traded worldwide.

The 2015 Global Corporate Treasury Survey from Deloitte[9] showed that 70% of respondents noted the following mandates from their CFOs:

1. Liquidity risk management
2. Efficient capital markets access
3. Steward for risk management company
4. Strategic advisor to the business
5. Value-add partner to the CFO in areas such as mergers and acquisitions
6. Leading, governing and driving working capital improvement initiatives.
7. Enhanced governance and control over domestic and overseas operations
8. Creation of scalable treasury organization to support company growth

In support of the functional currency approach, the FASB observed that, "Foreign operations are frequently conducted exclusively in foreign currencies and the flow of dollars to the parent enterprise is dependent upon the foreign currency net cash flows generated by the foreign entity and remitted to the parent." In today's global economy, this is now becoming the exception.

In determining the functional currency of a foreign operating unit, the FASB outlined several factors that should be considered including cash flows, sales prices and financing transactions. In general, an extensive interrelationship between the operations of the foreign entity and the parent company

[8] Bank for International Settlements, OTC foreign exchange derivatives turnover, by currency
[9] 2015 Global Corporate Treasury Survey, Deloitte Touche Tohmatsu Limited, January 2015

indicates that the parent company's currency should be the functional currency. It can be suggested that the growth and trend to move to central treasuries creates that extensive interrelationship for most multinational corporations.

Does anyone care about functional currency results?

FASB proponents of the functional currency approach suggested that "only by retaining the functional currency relationships of each operating entity is it possible to portray aggregate performance in different operating environments for purposes of consolidation".[10] Do investors and creditors care about net equity contributions in foreign currency or would they prefer better information in the reporting currency. Under the single currency approach, a US reporting company's operating performance would be measured in dollars which is of primary importance to investors and creditors because that is the currency in which the enterprise pays dividends. Single currency reporting can better assist US investors and creditors in assessing future cash flows. External users do not want or need to know financial results in functional currency.

Take the case of McDonald's Corporation's 10K disclosure for the fiscal year ended December, 31, 2014. While they do provide information on geographic business segments, functional currency operating results are not disclosed. And like many multinational corporations, there are limited practical alternatives in addressing earnings translation risk. A creative approach taken by McDonalds and other multinationals is to provide **constant currency reporting of financial results** which offers a view of foreign operations that translation obscures. The McDonald's disclosure provides:

> "In analyzing business trends, management reviews results on a **constant currency basis** and considers a variety of performance and financial measures… Constant currency results exclude the effects of foreign currency translation and are calculated by translating current year results at prior year average exchange rates. Management reviews and analyzes business results in constant currencies and bases most incentive compensation plans on these results because we believe this better represents the Company's underlying business trends."

If McDonalds were able to hedge their translation risk, perhaps their constant currency disclosures would not be necessary.

Lost in Translation - Unusual Accounting can Result

Under functional currency accounting, **transaction gains or loss in earnings** result from converting non-functional currency transactions into a foreign subsidiary's functional currency and **translation gains or loss** in equity result from converting the functional currency balance sheet into the reporting currency. Dividing foreign currency exchange rate changes between transaction and translation can result in accounting results that decrease the comparability of financial statements and consolidated earnings. Two examples below illustrate the results that can occur.

[10] Statement of Financial Accounting Standards No. 52, Foreign Currency Translation, Appendix C, paragraph 74

<u>Foreign Currency Exposures in a Functional Currency Entity</u>

Take a very simple example of a US multinational that has a functional currency subsidiary (FC1) with cash or other monetary assets in another currency (FC2). Current rules can result in a transaction gain reported in earnings of the foreign entity when their F2 currency asset strengthens in relation to their functional currency F1 even if that currency F2 has weakened in terms of the reporting currency (RC). The gain would be reported in consolidated net earnings despite the fact that it does not exist in the RC and can never provide increased cash flows to RC investors and creditors.

In **Example 1**, assume a GBP functional entity is holding a EUR asset (cash) of EUR 10,000,000. Assume that in relation to the USD reporting currency, the EUR has weakened from 1.09 to 0.90 resulting in a real currency loss of $1,900,000 vs the USD. If a single unit of measure model, earnings would reflect a loss of $1,900,000, the actual decrease in expected USD cash flows if the EUR asset were converted to USD and paid to the US entity.

However, under the functional currency model, because the asset is held in a GBP functional entity and the EUR strengthened vs GBP, a transaction gain is reported in GBP earnings which carries over to consolidated earnings while the loss in value from a USD perspective is reflected in equity as translation adjustment. The impact on consolidated equity is the same (a decrease of 1.9 million) but the consolidated income statement reflects a gain of $561,000 and the offsetting loss is recorded in equity as a translation adjustment of 2,461,000. This offsetting loss is potentially deferred indefinitely as it will only be recorded in earnings when, or if, the GBP subsidiary is sold or liquidated. And this is likely to be in an accounting period long after the EUR monetary asset exists.

Assume only asset of GBP Sub is the EUR A/R = EUR 10,000,000

Exchange Rates	1/1/2015	12/31/2015
GBP/USD	1.5500	1.2000
EUR/USD	1.0900	0.9000
GBP/EUR	1.4220	1.3333

Single Unit of Measure			
	USD Parent	GBP Subsidiary	Consolidated (USD)
Balance Sheet (Beginning) 1/1/15			
EUR A/R		**€ 10,000,000**	$10,900,000
Equity		$10,900,000	$10,900,000
Income Statement 2015			
EUR A/R valued at peiod end rate		**€ 10,000,000**	$9,000,000
Transaction Gain/(Loss)		($1,900,000)	**($1,900,000)**
Balance Sheet (Ending) 12/31/15			
EUR A/R		**€ 10,000,000**	$9,000,000
Equity		$9,000,000	**$9,000,000**

Functional Currency			
	USD Parent	GBP Subsidiary	Consolidated (USD)
Balance Sheet (Beginning) 1/1/15			
EUR A/R		€ 10,000,000	
GBP Equivalent		£7,032,258	$10,900,000
Equity		£7,032,258	$10,900,000
Income Statement 2015			
EUR A/R valued at peiod end rate		£7,500,000	
Transaction Gain/(Loss)		£467,742	
USD Equivalent			**$561,290**
Balance Sheet (Ending) 12/31/15			
EUR A/R		€ 10,000,000	
GBP Equivalent		£7,500,000	$9,000,000
Equity *		£7,500,000	**$9,000,000**

*** Equity Changes in 2015**			
Beginning Equity Balance	$10,900,000		**$10,900,000**
USD Equivalent GBP 2015 Income	$561,290		**$561,290**
USD Net Investment before Translation	$11,461,290		
USD Net Investment after Translation	$9,000,000		
Translation Gain (Loss)	**($2,461,290)**		**($2,461,290)**
USD NetEnding Consolidated Equity			**$9,000,000**

<u>Holding Reporting Currency Assets in a Functional Currency Operation; Hedging that Net Investment</u>

Example 2 illustrates the functional currency accounting results that occur when: 1) a functional currency entity has a balance sheet exposure in the parent's currency (assume the reporting currency) and, 2) when the entities enter into hedging transactions of their exposures.

Assume a USD parent has a Brazilian functional currency (BRL) subsidiary. Also assume that the BRL subsidiary has a net monetary asset in USD (cash, accounts receivable) of $100 million. Example 2, Base Case, reflects the net results of functional currency accounting in two scenarios of USD/BRL: BRL stronger (3.4846 to 3.000) and BRL weaker (3.4846 to 4.000).[11]

In the **Base Case** (no hedge), if BRL is stronger, the consolidated income statement will reflect a loss in earnings of 16 million as the USD asset is a transaction exposure that has to be revalued to BRL on the BRL income statement. This revaluation gain or loss carries over to consolidated earnings. In the case where BRL weakens, the BRL entity reflects a revaluation gain of approximately 13 million.

Obviously, the USD consolidated reporting entity does not have any real economic exposure from holding a USD asset which is the result under a single unit of measure. As illustrated in the Base Case, functional currency accounting reflects the offsetting gain or loss in translation to be offset in earnings when the BRL entity is liquidated or sold. In managing this accounting exposure, a company might decide to maximize the USD assets held by the BRL subsidiary if there was concern that BRL would weaken against USD. In this case, there would be BRL remeasurement gains and an offset to weaker income statement results from the BRL operating unit.

In the case of **Offsetting Hedges**, assume the BRL entity hedges it USD exposure and the US Parent also hedges its BRL net equity exposure as a net investment hedge in completely offsetting hedging transactions. The economic results obviously offset and there would be no impact under a single unit of measure. But the accounting results under the functional currency model are not offsetting.

First, realize that under current economic conditions, when the BRL entity sells USD and buys BRL, they pick up the positive interest rate differential between the two currencies which is reflected in the forward points (approximately 41 points). In the offsetting net investment hedge, these same forward points are a cost, but, if the US Parent elects the forward method[12] for their net investment hedge, this cost would be reflected in equity. The net result using the same rate assumptions shows that the consolidated entity has increased earnings when BRL strengthens (converting a 16 million loss to a 13 million gain) and decreases their positive earnings marginally when the BRL weakens (13 million gain to 10 million).

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[11] Beginning USD/BRL observation and forward rates as of 8/11/15; Ending rates are assumed for illustration purposes, however, BRL has actually weakened over the second half of 2015. For illustration, assume the income statement translation rate is also equal the period end exchange rate. Also note that the movement in spot is approximately equal in the stronger and weaker currency scenarios.

[12] A net investment hedge can use the spot method or forward method to assess the effectiveness of the hedge. Assuming the hedge is 100% effective; all changes in value including the forward points are reflected in equity (as part of the translation adjustment) under the forward method. The alternative spot method reflects the forward points in current earnings.

As expected under the functional currency approach, translation reflects a consolidated equity balance equal to the equity balance that would be reported under the single unit of measure but the impact to consolidated earnings in this example is arguably much more favorable.

Example 2
USD Asset Held by BRL Functional Subsidiary

Summary	**Net Income**	**Equity US Parent**	**Consolidated Equity (with BRL Earnings)**
BRL Stronger			
Functional Currency			
Base Case	($16,153,333)	$116,153,333	$100,000,000
With Offsetting Hedges	$13,556,667	$86,443,333	$100,000,000
BRL Weaker			
Functiona Currency			
Base Case	$12,885,000	$87,115,000	$100,000,000
With Offsettting Hedges	$10,167,500	$89,832,500	$100,000,000
Single Currency	**$0**	**$100,000,000**	**$100,000,000**

Functional Currency

BRL Stronger			
Assume	**Beginning**	**Ending**	
USD/BRL Spot	3.4846	3.0000	
Forward Points to Ending Date	0.4067		
All In Forward Rate	3.8913		
Base Case			
USD Cash Asset	$100,000,000	$100,000,000	
In BRL	BRL 348,460,000	BRL 300,000,000	
Remeasurement Gain (Loss) in BRL		(BRL 48,460,000)	
Remeasurement Gain (Loss) in USD		($16,153,333)	
Equity at US Parent		$116,153,333	(BRL 348,460,000 / 3.0000)
With Offsetting Hedges			
Income			
Remeasurement Gain (Loss) in USD		($16,153,333)	
Hedge Gain (Loss)		$29,710,000	
Net Income		$13,556,667	
Equity			

Equity at US Parent		$116,153,333	(BRL 348,460,000 / 3.0000)
Hedge Gain (Loss)		($29,710,000)	
Equity at US Parent With Hedge		$86,443,333	

Functional Currency			
BRL Weaker			
Assume	**Beginning**	**Ending**	
USD/BRL Spot	3.4846	4.0000	
Forward Points to Ending Date	0.4067		
All In Forward Rate	3.8913		
Base Case			
USD Cash Asset	$100,000,000	$100,000,000	
In BRL	BRL 348,460,000	BRL 400,000,000	
Remeasurement Gain (Loss) in BRL		BRL 51,540,000	
Remeasurement Gain (Loss) in USD		$12,885,000	
Equity at US Parent		$87,115,000	(BRL 348,460,000 / 4.0000)
With Offsetting Hedges			
Income			
Remeasurement Gain (Loss) in USD		$12,885,000	
Hedge Gain (Loss)		($2,717,500)	
Net Income		$10,167,500	
Equity			
Equity at US Parent		$87,115,000	(BRL 348,460,000 / 3.0000)
Hedge Gain (Loss)		$2,717,500	
Equity at US Parent With Hedge		$89,832,500	

The current hedge accounting model allows the parent company to hedge its net investment (a portfolio of assets and liabilities) and the functional currency subsidiary to hedge its earnings risk based on the individual assets and liabilities held. The net investment exposure is similar to a foreign earnings exposure but under current accounting rules only the portfolio of net foreign equity is eligible to benefit from the hedge accounting timing rules.

Conclusion

More meaningful consolidated accounting results are attained by measuring foreign currency exposures from a single unit of measure; the reporting currency. Corporate treasury functions are no longer being managed on a separate, stand-alone basis. Investors and creditors are more interested in cash flows and net income in the reporting currency than in other currencies. And finally, portfolio hedge accounting rules for hedging foreign earnings and equity would not be necessary if the functional currency model were replaced by a single unit of measure.