



Alcoa

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International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Subject: Comment letter on the Exposure Draft *Hedge Accounting*

Dear Sir/Madam:

We appreciate the opportunity to respond to the Exposure Draft on Hedge Accounting. Alcoa is the world's leading producer of primary aluminum, fabricated aluminum and alumina. Being a global industrial firm with significant exposure to commodity price and exchange rate movements, we engage in numerous hedging activities which are impacted by the Board's Exposure Draft. In general, we find the Board's objective of aligning the hedge accounting results more closely to the entity's risk management practices to be a significant improvement from existing hedge accounting practices. In particular, the provisions to allow hedging of risk components and net positions as well as the less prescriptive hedge effectiveness testing requirements are significant improvements from the current standards of both the IASB and the FASB. There are, however, two topics which are not addressed in the Exposure Draft which we would ask the Board to consider.

Two Month Deferral of Hedge Gains/Losses

Under cash flow hedge accounting, a derivative used to hedge a forecasted transaction is expected to settle in the same month of the underlying transaction. However, in any business environment, unforeseen and uncontrollable events may occur which cause a slight mismatch in settlement of the underlying derivative and the actual forecasted transaction. In many instances, it is impractical and uneconomical to enter into a new derivative for a slight (one or two month) mismatch. FASB Codification section 815-30-40-4 addresses this by permitting up to a two month window to defer gains/losses on settlement due to unforeseen circumstances thus allowing derivative settlement to be properly matched with the underlying transaction. We do not believe the proposed IASB hedge accounting model addresses this current practice. We would encourage the Board to permit a similar deferral for a reasonable amount of time to allow the settlement of derivatives to be appropriately matched with the underlying transaction when an unforeseen event causes a delay in the underlying transaction to occur.

Bifurcation of Embedded Derivatives

Although this issue could have been addressed in the deliberations on IFRS 9, paragraph 4.8 of that standard concluded that embedded derivatives in contracts that are not financial instruments are not within the scope of that standard and, as such, the requirement to separate the embedded derivative from the host contract and account for it separately still stands. Although, in the Hedge Accounting ED, the Board decided to allow risk components of non-financial contracts to be hedged similar to risk components of financial contracts, embedded derivatives in contracts that are not financial instruments are still treated differently than those in contracts that are financial instruments. We are concerned that this issue is not being addressed by either the IASB or the FASB as we have consistently struggled with it under US GAAP (whose provisions we believe are the same as those in IFRS). We believe this restriction does not allow us to properly reflect the business model under which we operate for many of our hybrid non-financial instruments, primarily power contracts. An example would best describe this point:

As energy is a very large component of our cost structure, some of our power contracts include pricing provisions that index the price of the power to the London Metal Exchange (LME) aluminum price. We are comfortable operating under these types of power contracts as this pricing provision serves as a “hedge” of a key component of our operating costs. As the LME price goes up, our power price goes up (with no or minimal lag) and vice versa when LME prices decline. Our economic view of these contracts is, as our revenues change based on movements in the LME a significant portion of our costs also change, providing a hedge of our operating margins. Our preference, therefore, would be to account for the “LME indexed” power cost consumed in a given month as the actual cost for that month (which it is). Our revenues will likewise reflect the same current impact of the movement in the LME, resulting in an accurate depiction of the intended economic consequences of the contract, i.e. as LME revenues go up, they are offset to an extent by higher power costs and, as LME revenues go down that negative impact is offset to an extent by lower power costs.

However, under IFRS and current US GAAP, the LME-linked pricing features are considered embedded derivatives and need to be analyzed for bifurcation. While power costs are a major component of our cost base, the price of aluminum on the LME is not “clearly and closely related” to the price of power and, therefore, does not qualify for that exemption from bifurcation. Accordingly, we are required to bifurcate the LME component of the power contract as an embedded derivative and account for it separately. In accounting for these embedded derivatives, we try to maintain and reflect the hedge relationship described above. The most appropriate way to do this under existing rules is to designate them as cash flow hedges of future sales of aluminum. A fair value for the embedded derivative is calculated, recorded to OCI and marked to market in future periods. As future sales of aluminum occur, the appropriate amounts are recycled out of OCI and recorded as an adjustment of revenue (not cost). In certain cases, due to the formula of the LME pricing provision, we are even precluded from this alternative and are required to mark the embedded derivative to market through net income.

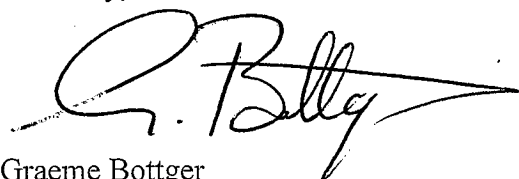
We do not believe the above accounting, which is required by IFRS and US GAAP, is the best depiction of the business model in which we utilize such contracts for the following reasons:

- The movements in the price of our power are reflected as an adjustment of revenue, as opposed to our operating costs, which is how we view them for managerial purposes.
- Our balance sheet is grossed up for the mark-to-market value of these embedded derivatives which do not, in our opinion, readily compare to the other assets and liabilities of the company.
- The movements in these recorded embedded derivatives frequently result in large adjustments to OCI or net income which does not necessarily provide a fair presentation of the economics of these transactions.
- Given the long duration and unique characteristics of these contracts, the associated embedded derivatives (which are extremely illiquid) are frequently difficult to value. We therefore question whether fair valuing these instruments (in most cases, using internal models) provides useful information.
- The accounting for these derivatives is extremely complicated, difficult to administer and difficult to explain to operating management, let alone to the readers of our financial statements.

We therefore would request that the Board reconsider the exemptions to bifurcations of embedded derivatives in hybrid non-financial instruments and include an exemption which allows a company not to bifurcate an embedded derivative if it believes it is not an appropriate reflection of the business objective of the hybrid instrument. Another approach to address this might be to expand the use of the "normal purchase/normal sale" exemption (which is presently quite restricted) if it more appropriately reflects the entity's business model. Your attention to this matter would be greatly appreciated and we would be pleased to consult further with the IASB or its staff should they desire a more thorough understanding of this issue.

We again express our appreciation for the opportunity to comment on this proposal and commend the Board on its efforts to improve accounting in the critical area of hedge accounting. Please feel free to contact us with any questions you may have.

Sincerely,

A handwritten signature in black ink, appearing to read "G. Bottger", with a long horizontal flourish extending to the right.

Graeme Bottger
Vice President & Controller