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# Financial Services

## On-Call Accounting Alert

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### FASB Issues Exposure Draft to Amend SFAS 133 for Simplifying Application of Hedge Accounting

On June 6, 2008, the FASB issued an Exposure Draft of a proposed Statement of Financial Accounting Standards, *Accounting for Hedging Activities—an amendment of FASB Statement No. 133* (the “Exposure Draft”). The Exposure Draft proposes several significant changes to the current hedge accounting model set forth in SFAS 133, *Accounting for Derivative Financial Instruments and Hedging Activities* (“SFAS 133”) including the risks that can be hedged, and the methods for assessing and measuring hedge effectiveness. The proposed effective date of the guidance set forth in the Exposure Draft is for fiscal years beginning after June 15, 2009 (January 1, 2010 for calendar year companies), and interim periods within those fiscal years. Earlier adoption is not permitted. The comment period for the Exposure draft ends August 15, 2008.

### Objective of the Exposure Draft

The objective of the proposed Exposure Draft is to achieve the following:

- a. Simplify accounting for hedging activities,
- b. Improve the financial reporting of hedging activities to make the accounting model and associated disclosures more useful and easier to understand for users of financial statements,
- c. Resolve major practice issues related to hedge accounting that have arisen under SFAS 133, and
- d. Address differences resulting from recognition and measurement

- e. anomalies between the accounting for derivative instruments and the accounting for hedged items or transactions.

A summary of the key proposed amendments to SFAS 133 is noted immediately below.

### Eligible Hedged Items

Under SFAS 133 an eligible hedged item can be a recognized financial asset or financial liability, an unrecognized firm commitment, a probable forecasted transaction, or a net investment in a foreign operation. What constitutes an eligible hedged item will not change under the Exposure Draft.

### Risks That Can Be Hedged

SFAS 133 currently permits entities, for fair value or cash flow hedges involving forecasted and recognized financial instruments, to hedge specific risks including:

- Interest rate risk (i.e., changes in the designated benchmark interest rate),
- Foreign exchange risk,
- Credit risk,
- A combination of the above specified risks, or
- Overall price risk.

The Exposure Draft proposes to amend SFAS 133 by permitting companies only to hedge changes in the overall fair value of the hedged item, or changes in fair value of the hedged item attributable to only foreign currency exchange rates (for fair value hedges), and overall changes in the hedged cash flows or the risk of changes in functional currency-equivalent cash flows attributable to foreign currency exchange rates (for cash flow hedges). There are two exceptions to these proposed provisions, which are as follow:

- An entity can hedge changes in the fair value of hedged debt/borrowings (or a specific portion thereof) or variability in cash flows attributable to a benchmark interest rate or a combination of interest rate risk and foreign exchange risk if the entity designates the fair value or cash flow hedge **at the inception of**

**that debt.** After inception of the debt, an entity may not designate only interest rate risk or only a combination of interest rate risk and foreign exchange risk as the hedged risk.

- If the hedged item in a fair value hedge is all or a portion of a debt security (or a portfolio of similar debt securities) that is classified as held-to-maturity in accordance with FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (“SFAS 115”), or if the variable cash flows of a forecasted transaction in a cash flow hedge relate to a debt security that is classified as held to maturity in accordance with SFAS 115 the designated risk being hedged can only be the risk of changes in fair value or cash flows attributable to foreign exchange risk.

### Types of Permitted Hedges

Discussions held during preliminary stages of the FASB’s hedge accounting project may have resulted in the elimination of certain types of hedges. The FASB ultimately decided to retain all types of hedges currently permitted under SFAS 133, which are as follows:

- Cash flow hedges (including FX hedges)
- Fair value Hedges (including FX hedges)
- Net investment hedges

### Formal Hedge Designation and Documentation

The FASB decided to maintain the current requirement of formal contemporaneous, documentation of the following:

- Hedging instrument,
- Hedged transaction(s)/item(s),
- Nature of the risks that the entity is attempting to hedge, and
- Why the derivative is expected to be reasonably effective in offsetting the variability in the hedged transaction attributable to hedged risk(s).

## Designation/Dedesignation of a Hedging Relationship

Once a hedge qualifies and is designated in a qualifying cash flow or fair value hedge, it can not be de-designated unless:

- a) Hedging instrument is sold/terminated (including by entering into an offsetting derivative) or expires/matures,
- b) Hedge item is no longer probable of occurring, is sold, matures, or is otherwise extinguished, or
- c) Hedge is no longer expected to be reasonably effective.

This proposed requirement will affect companies that utilize dynamic hedging strategies and rebalance their portfolios by merely documenting the termination of an existing hedging relationship. The Exposure Draft will permit companies to enter into offsetting derivatives to effectively terminate a hedging relationship.

### Assessment of Hedge Effectiveness

At inception of a hedging relationship, entities must demonstrate qualitatively that:

- a) An **economic relationship exists** between the hedging instrument and the hedged item or hedged forecasted transaction and
- b) Changes in fair value of the hedging instrument are expected to be **reasonably effective** in offsetting changes in the hedged item's fair value or the variability in the hedged cash flows.

The Exposure Draft's most significant changes to SFAS 133 include rescission of the Shortcut Method (paragraph 68 of SFAS 133), and "critical terms match" method (paragraph 65 of SFAS 133 and DIG Issue G9). However, the Exposure Draft may replace the "highly effective" (i.e., 80 – 125% offset criterion) for qualifying for hedge accounting with the term "reasonably effective," which is expected to be a lower threshold than 80 – 125%.

The Exposure Draft provides that in certain situations, a quantitative assessment may be necessary at the inception of a hedging relationship to

conclude that changes in fair value of the hedging instrument would be reasonably effective in offsetting changes in fair value of the hedged item or variability in cash flows of the hedged transaction. After inception of the hedging relationship, an entity shall qualitatively (or quantitatively, if necessary) reassess effectiveness only if circumstances suggest that the hedging relationship is no longer expected to be reasonably effective in offsetting the hedged risk.

For option hedging strategies, when measuring ineffectiveness to be reported in earnings, an entity may use total changes in the option's cash flows or may include only changes in the option's intrinsic value. If the entity chooses to measure the total changes in the option's cash flows (similar to DIG Issue G20), it would need to reclassify from other comprehensive income to earnings each period on a **rational basis** an amount that adjusts earnings for the amortization of the cost of the option.

### Measurement of Hedged Item in and Related Hedge Effectiveness of a Fair Value Hedge

For fair value hedges, the guidance for measuring the hedged item and measuring hedge effectiveness is essentially unchanged from SFAS 133's requirements (e.g., paragraph 120C of SFAS 133 will remain unchanged). Hedged item must be adjusted during the hedging period for changes in fair value attributable to hedged risk, which will generally be the overall risk, unless the hedge involves an entity own debt (and a benchmark interest rate is the hedged risk) or the designated risk being hedged is the foreign exchange risk, as discussed above.

### Measuring and Reporting Ineffectiveness in Cash Flow Hedging Relationships

The measurement of hedge ineffectiveness must be based on a comparison of the change in fair value of the actual derivative designated as the hedging instrument and the present value of the cumulative change in expected future cash flows on the hedged transaction (or a derivative that would mature on the date of the forecasted transaction, be priced at market, and provide cash flows that would exactly offset the hedged cash flows). Any ineffectiveness ("over" hedging or "under" hedging) must be recognized in earnings in the current period. This is a significant change from current practice, as "under"

hedging is not recognized in current earnings as ineffectiveness. The amount of gain or loss on the hedging instrument that is to be reported in accumulated other comprehensive income is the lesser of:

- a. The cumulative change in fair value of the actual derivative designated as the hedging instrument and
- b. The present value of the cumulative change in expected future cash flows on the hedged transaction

## Disclosures

The Exposure Draft proposes additional interim and annual disclosures. In annual and interim reporting periods, an entity must disclose for assets and liabilities reported within a single line item in the statement of financial position for which the carrying amount includes fair value adjustments related to SFAS 133 fair value hedging:

- a) The carrying amount of the assets or liabilities included within the line item,
- b) Cumulative fair value adjustments related to SFAS 133 fair value hedging relationships,
- c) Cumulative fair value adjustments other than those related to SFAS 133 fair value hedging relationships, and
- d) The carrying amount of the assets or liabilities excluding any fair value adjustments.

In annual and interim reporting periods, an entity that designates interest rate risk in a hedging relationship of its own issued debt or other borrowings must disclose as part of its debt disclosure:

- a) Its use of derivative contracts (interest rate swaps) to convert a portion of its fixed-rate debt to variable-rate debt or variable-rate debt to fixed-rate debt or both
- b) The relationship of the maturity structure of the derivatives to the maturity structure of the debt being hedged
- c) The overall weighted-average interest rate both including and excluding the effects of derivatives designated as a hedge of its debt or the related interest payments.

## Effective Date and Transition

### *General*

The proposed effective date of the guidance set forth within the Exposure Draft is for financial statements issued for fiscal years beginning after June 15, 2009 (January 1, 2010 for calendar year companies), and interim periods within those fiscal years. Earlier application is not permitted. A summary of the key transition provisions is immediately below.

### *Hedge Designation*

At the date of initial application, an entity must dedesignate all hedging relationships designated under SFAS 133, except for when the hedged risks are permitted both before and after the effective date of Exposure Draft (such as benchmark interest rate risk hedges of an entity's own debt). If an entity chooses to apply hedge accounting at initial adoption of the Exposure Draft, it must designate all hedging relationships anew using the criteria set forth in the Exposure Draft.

The proposal provides a relief to existing hedges of benchmark interest rate risk of an entity's own debt initiated prior to transition. For those hedges, the designation need not begin at inception of the debt. As such, upon initial adoption, no dedesignation is required. However, if an entity was utilizing the Short Cut Method, it would need to measure hedge effectiveness each period, as shortcut method is no longer permitted under the Exposure Draft,

### *Cash Flow Hedges*

For cash flow hedging relationships that were either not dedesignated as a result of the initial application of this Statement or dedesignated and concurrently designated anew (thus effectively continuing the hedging relationship) at the time of initial application, an entity must adjust the balance in accumulated other comprehensive income to equal the difference, if any, between the fair value of a derivative that would provide cash flows that would exactly offset the hedged cash flows and the amount in accumulated other comprehensive income related to the hedge just prior to initial application. The net effect of the adjustment to accumulated other

comprehensive income must be recorded directly to retained earnings.

### *Fair Value Option*

Also, at the date of initial application, an entity may elect to account for any servicing assets or servicing liabilities that were designated as a hedged item on the date immediately preceding initial application of the Exposure Draft at fair value under FASB Statement No. 156, *Accounting for Servicing of Financial Assets* (“SFAS 156”). Also at the date of initial application, an entity, any financial instrument designated as a hedged item on the date immediately preceding initial application of this Statement at fair value under FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (“SFAS 159”). If an entity elects to account for any assets or liabilities at fair value under the under SFAS 156 or SFAS 159, the carrying amount of those assets and liabilities shall be adjusted to fair value at the date of adoption with the net effect of the adjustment recorded directly to retained earnings.

Please find a link to Exposure Draft on the FASB’s website immediately below.

[http://www.fasb.org/draft/ed\\_hedging\\_amendment\\_st133.pdf](http://www.fasb.org/draft/ed_hedging_amendment_st133.pdf)

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