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Capital Markets  
Accounting Developments  
Advisory 2006 – 3  
November 10, 2006

***Statement 133 Implementation Issue No. G26:***

***Cash Flow Hedges: Hedging Interest Cash Flows on Variable-Rate Assets and Liabilities That Are Not Based on a Benchmark Interest Rate***

**Introduction**

On October 10, 2006, the Financial Accounting Standards Board (the "Board" or the "FASB") posted a tentative conclusion in DIG Issue No. G26, *Cash Flow Hedges: Hedging Interest Cash Flows on Variable Rate Assets and Liabilities That Are Not Based on a Benchmark Interest Rate*, "DIG G26". This issue clarifies that in a cash flow hedge of a variable-rate financial asset or liability, the designated risk being hedged cannot be interest rate risk unless the cash flows of the hedged transaction are explicitly based on that same benchmark interest rate. Comments on this issue are due on November 14, 2006.

**History and Tentative Guidance**

Due to the diverse views on the application of Statement 133 to situations where a floating interest rate is not explicitly based on **any** index, in February the Board added the project which has now resulted in the issuance of DIG G26.

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DIG G26 specifically discusses cash flow hedges of variable-rate financial assets or liabilities for which interest rates are not based solely on an index including situations in which an interest rate is reset through an auction process. This DIG Issue answers two questions:

- May the designated risk being hedged be the risk of overall changes in the hedged cash flows related to the variable-rate financial asset or liability?
- May the designated risk being hedged be the risk of changes attributable to interest rate risk as defined in Statement 133 even though the cash flows of the hedged transaction are not explicitly based on that designated benchmark interest rate?

First, DIG G26 confirms that if all of the other criteria for cash flow hedge accounting are met an entity is allowed to designate the total variability in cash flows as the hedged risk in a Statement 133 hedge for these variable rate assets or liabilities.

As it relates to the second question, DIG G26 concludes that in a cash flow hedge of a variable-rate financial asset or liability for which the interest rate of the hedged item is not based on any index, the designated risk being hedged cannot be the benchmark interest rate risk. For example, a variable-rate financial asset or liability whose rate is reset through an auction process is not explicitly based on a benchmark interest rate. Although the clearing rate in an auction may be described as a designated benchmark interest rate plus or minus an adjustment specified by a bidder, the clearing rate is effectively established by a bidding process that does not provide for transparent separation of interest rate risk and credit risk. Therefore, the Board concluded that the designated risk being hedged for an auction rate note cannot be interest rate risk as an auction rate note is not explicitly based on the benchmark interest rate being hedged.

In addition, DIG G26 re-emphasizes that the guidance in Statement 133 Implementation Issue No. G19, *Cash Flow Hedges: Hedging Interest Rate Risk for the Forecasted Issuances of Fixed-Rate Debt Arising from a Rollover Strategy*, "DIG G19", is not appropriate for variable-rate instruments. DIG G19 applies only to the forecasted issuance of fixed-rate debt, and it expressly prohibits characterization of variable-rate debt as fixed-rate debt that rolls over into another issuance of fixed-rate debt at each reset date.

**SFG Observation:**

**Paragraph 29 of Statement 133 states that the designated risk being hedged could not be "the risk of changes in its cash flows attributable to changes in the specifically identified benchmark interest rate if the cash**

***flows of the hedged transaction are explicitly based on a different index". Some constituents thought that since an auction rate was not explicitly based on any index, hedging only the interest rate risk of an auction rate security would be acceptable. In answering the question on hedging the interest rate risk in such situations, the FASB clarified their intent by stating in DIG G26 that "In a cash flow hedge of a variable-rate financial asset or liability, the risk being hedged cannot be designated as interest rate risk unless the cash flows of the hedged transaction are explicitly based on that same benchmark interest rate."***

### **Next Steps**

DIG G26 is currently open for public comments which are requested by November 11, 2006. Once this guidance is approved, its provisions are expected to become effective on the first day of the first fiscal quarter beginning after the date that the Board-cleared guidance is posted on the FASB website.

Additionally, based on Statement 133 Implementation Issue No. K5, *Miscellaneous: Transition Provisions for Applying the Guidance in Statement 133 Implementation Issues*, the accounting for the transactions in periods prior to the effective date of the new guidance should not be affected. However, entities that designated a qualifying hedging relationship that no longer qualifies for hedge accounting based on this guidance must dedesignate that hedging relationship prospectively at the effective date. The derivative's gain or loss for the period prior to the effective date shall remain in accumulated other comprehensive income (OCI) and be reclassified into earnings consistent with the provisions of paragraphs 32 and 33 of Statement 133.

### **Questions**

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