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## *FASB Issues an Exposure Draft of the FAS 133 Amendment*

### Summary

On June 6, 2008, the Financial Accounting Standards Board ("FASB" or the "Board") released the Exposure Draft "Accounting for Hedging Activities an amendment of FASB Statement No. 133" ("ED") for comment. Comments on the ED will be accepted until August 15, 2008. The ED would amend FASB Statement 133 "Accounting for Derivatives and Hedging Activities" ("FAS 133" or the "Standard") and other related literature. The main objectives of the ED are to:

- Simplify accounting for hedging activities;
- 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;
- Resolve major practice issues related to hedge accounting that have arisen under FAS 133; and
- Address differences resulting from recognition and measurement anomalies between the accounting for derivative instruments and the accounting for hedged items or transactions.

Some of the major modifications to FAS 133 proposed in the ED include:

- Changing the hedge accounting model from a bifurcation-by-risk model to a full fair value model with limited exceptions;

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- Eliminating the shortcut and critical terms match methods;
- Changing the effectiveness criteria required to achieve hedge accounting from "Highly Effective" to "Reasonably Effective";
- Eliminating the requirements to quantitatively assess effectiveness at inception and on an ongoing basis;
- Requiring that ineffectiveness be booked for "underhedges" in cash flow hedge relationships;
- Prohibiting entities from dedesignating a hedge relationship by simply removing the designation; and
- Requiring entities to meet the exposure to earnings requirement of paragraph 29(c) for foreign currency cash flow hedges at every reporting level in which hedge accounting is applied.

These changes along with the other guidance provided in the ED are discussed in detail in this advisory.

**FICG Observation:** The FASB's proposed amendments will simplify certain key aspects of hedge accounting that many companies have found very challenging. However, it will also limit or eliminate other aspects of the current model that some companies have found beneficial. The impact of the Board's proposal will depend on the nature of company's hedging strategies. For example, some industrial companies looking to expand their hedging programs in light of recent commodity price volatility may be pleased with the simplified effectiveness assessment and lower "reasonably effective" threshold. However, financial institutions will likely be disappointed that benchmark interest rate risk hedges for financial assets are eliminated. These companies will be required to hedge the total variability in fair value, including the credit risk. This could prove challenging when there is credit spread volatility or an inability to obtain cost-effective derivatives to hedge credit risk.

Companies should consider how their hedging strategies, systems, processes, and internal control policies and procedures will need to be modified under the proposed guidance.

## **Background**

FAS 133 was released in 1998 and established standards of financial reporting and accounting for derivative instruments and hedging activities. FAS 133 was issued in response to (1) the need to address differences in the way hedged items and hedging instruments were recognized and measured and (2) the desire of entities to manage cash flow risk as well as the timing of the recognition in income of gains and losses on derivative hedging instruments.

**FICG Observation:** Complying with the requirements of FAS 133 has been challenging for many companies. There have been numerous restatements associated with hedge accounting and a number of practice issues have arisen in the detailed application of the Standard.

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The FASB has noted a number of specific areas where issues have arisen and companies have exerted significant efforts to comply with the standard, including:

- Quantitatively assessing effectiveness of hedging relationships;
- Incorporating the impact of credit risk as required by FAS 157 into FAS 133 assessments; and
- Measuring the change in fair value (or cash flows) of a hedged item attributable to the changes in the hedged risk.

In addition, many companies have improperly interpreted and applied the shortcut and critical terms match methods.

Because of the many implementation issues that have resulted from FAS 133, the Board decided to add a project to its agenda in May 2007 with the goal of (1) simplifying the accounting for hedging activities to make it easier for preparers of financial statements to comply with guidance, and (2) improving the financial reporting of hedging activities to make the hedge accounting results more useful and transparent to investors and other users of financial information.

Since May 2007, the Board has held numerous meetings in which the FASB staff has presented alternatives and recommendations to address current FAS 133 implementation issues. Through these meetings, the Board determined the project's objectives as discussed above.

A majority of the Board members believe that the ED will be beneficial because under the proposed guidance: 1) an entity's financial statements would be more representative of the economics of the instruments utilized in hedge accounting, 2) the transparency of the effects of hedging activities on an entity's statements of financial position, performance, and cash flows would be achieved, and 3) the comparability of financial statements between entities would be improved.

**FIGG Observation:** The FASB's project objective was to simplify US GAAP hedge accounting rather than to converge with IFRS. In March 2008, the IASB issued a Discussion Paper, "Reducing Complexity in Reporting Financial Instruments," to solicit input on various simplification proposals, including on the IFRS hedge accounting model. One of the IASB Discussion paper proposals is similar to the hedge accounting model in the proposed FASB standard. At this stage, it is uncertain whether the IASB project will result in further convergence with US GAAP. While the FASB's proposed standard eliminates some differences with IFRS, such as the use of the shortcut method, many other differences will persist. In fact, the proposed standard's threshold of "reasonably effective" represents a divergence from current IFRS, which, consistent with current US GAAP, requires that the hedging relationship be highly effective in order to qualify for hedge accounting.

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## Changes to the Hedge Accounting Model

### Bifurcation-by-Risk Model

The ED changes the hedge accounting model from a bifurcation-by-risk model to a full fair value or cash flow model with limited exceptions. The current bifurcation-by-risk model allows a company to hedge specific risks that exist in certain hedged items.

For certain fair value hedging relationships, the current model allows an entity to adjust the carrying amount of the hedged item for changes in fair value due only to the changes in the risk being hedged. For example, if an entity has an interest bearing asset with a fixed rate, it could hedge the benchmark interest rate risk of that asset and would only have to consider changes in fair value due to changes in the benchmark interest rate.

Likewise, for certain cash flow hedging relationships, the current model allows an entity to compute the change in hedged cash flows due only to the changes in the risk being hedged. For example, if an entity is planning to issue floating rate debt, it could hedge the variability in cash flows of the future interest payments due to the changes in the benchmark interest rate. Such a hedge relationship would allow an entity to ignore other causes of changes in cash flows.

The full fair value and cash flow hedge accounting models proposed in the ED generally disallow hedging a specific risk (with limited exceptions) that exists in a hedged item and, thus, require that all changes in fair value or cash flows be considered in hedging relationships.

**FICG Observation:** Some companies, such as financial institutions, will likely be disappointed with the restriction on the risks that can be designated, especially those that employ hedging strategies to hedge exposure to changes in the benchmark interest rate on loan portfolios. A requirement to hedge total changes in fair value of loans could prove challenging. Volatility in the credit spread and a lack of derivatives available to cost-effectively manage this risk contribute to the challenge.

Other companies, such as certain industrial companies, may not be troubled by this proposed change. Their hedging strategies may center on hedging the price risk on the purchase or sale of nonfinancial assets for which a bifurcated risk approach is not permitted.

The proposed standard continues to permit the designation of foreign exchange risk for hedging relationships.

Using the full fair value and cash flow models will cause more volatility in income than the current accounting model as changes in value of hedged items caused by risks that are not being hedged must be included in income. The potential volatility of non-hedged risks was one of the reasons that companies did not make broader use of the fair value option within FAS 159 to reduce reliance on hedge accounting.

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In addition, significant changes in value due to risks that are not being hedged could cause a hedge relationship to be deemed ineffective even when a derivative instrument is effectively managing the specific risk that is intended to be hedged.

### Fair Value Hedge

Under the proposed guidance, the hedged risk in a fair value hedge relationship must be either the risk of changes in the overall fair value of the entire hedged item or the risk of changes in fair value attributable to changes in foreign currency exchange rates. The only exception is when an entity designates its own issued debt or other borrowings (or a specific portion thereof) as the hedged item at inception of the debt. In this case, the entity is permitted to designate just the benchmark interest rate risk, foreign exchange risk, or a combination of these two risks.

The Board's proposed guidance states that the change in overall fair value (except for the aforementioned exceptions) of the entire hedged item for fair value hedges shall adjust the carrying amount of the hedged item and be recognized in earnings during the hedge period. Gain or loss on the hedged item cannot be based on the gain or loss on the hedging instrument, which was the manner in which the gain or loss of the hedged item was often computed when using the shortcut or critical terms match methods.

### Cash Flow Hedge

For cash flow hedges, the hedged risk must be either the risk of overall changes in the hedged cash flows or the risk of changes in functional-currency-equivalent cash flows attributable to changes in the foreign currency exchange rates. The only exception is when an entity designates interest payments as the hedged transaction on its own issued debt or other borrowings at the inception of the debt. In this case, the entity would be permitted to designate just the benchmark interest rate risk, foreign exchange risk, or a combination of these two risks.

The ED specifies that hedging relationships that are entered into and designated within a "reasonably short period of time" after recognition of the debt may be considered entered into at inception. The term "reasonably short period of time" is not defined in the proposed amendment.

**FICG Observation:** The proposed standard continues to permit the designation of foreign exchange risk and benchmark interest rate risk on a company's own debt, provided the company designates the hedging relationship at the time of borrowing.

Many companies may be disappointed that they are further limited in managing these specific risks over the duration of their borrowing portfolio, as "late hedge" to these bifurcated exposures will no longer be permitted.

The ED also may result in an entity hedging the total variability in the anticipated future cash flows of a forecasted debt issuance prior to the debt being issued, and then the variability due to the changes in the benchmark interest rate once the debt is issued.

### Shortcut and Critical Terms Match Methods

The ED eliminates the shortcut and critical terms match methods of hedge accounting. Under the current hedge accounting model, the shortcut and critical terms match methods are used to qualitatively assess the effectiveness of hedge relationships and generally resulted in the assumption of no ineffectiveness being recorded.

The ED no longer allows an entity to assume a hedge relationship is perfectly effective. While the shortcut and critical terms match methods will be eliminated under the proposed guidance, companies may consider the criteria in these methods in developing their assertion that a hedge relationship may be perfectly effective. However, entities will be required to fair value both the hedged item and hedging instrument for all changes in fair value, which may result in the recognition of ineffectiveness in the income statement.

### Changes to Hedge Effectiveness Assessments

The proposed guidance eliminates the requirement to perform a quantitative assessment of hedge effectiveness at inception and on an ongoing basis. The guidance requires an assessment of a hedging relationship's effectiveness to be performed at inception of the hedging relationship to demonstrate that:

- 1) An economic relationship exists between the hedging instrument and the hedged item or hedged forecasted transaction; and
- 2) Changes in fair value of the hedging instrument would be **reasonably effective** in offsetting changes in the hedged item's fair value or the variability in the hedged cash flows attributable to changes in the hedged risk.

The ED permits this assessment to be performed qualitatively. A quantitative effectiveness assessment may be required if an entity deems it necessary to prove that an economic relationship exists between the hedged item and hedging instrument, and that the hedge relationship will be reasonably effective.

**FICG Observation:** Many companies will wonder if and when to perform a quantitative analysis of hedge effectiveness. Despite this uncertainty, in most instances, companies will be able to avoid performing extensive quantitative analyses for hedges that obviously qualify for hedge accounting.

The term "reasonably effective" is not defined by the proposed guidance. The Board stated that it did not define the term because of the need for judgment when determining whether something is reasonably effective. The Board feels that such judgment would include a

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holistic consideration of all the facts and circumstances for why an entity entered into a hedging relationship.

**FICG Observation:** The Board's decision to not define "reasonably effective" is consistent with a more principles-based standard. Reasonably effective refers to a level that is somewhere below the current level of highly effective, but it is unclear as to how much lower. Whether a relationship can be deemed reasonably effective will require judgment and will likely depend on the nature of the hedging relationship as well as specific attributes of the hedged item and hedging instrument.

Quarterly reassessment of the effectiveness of a hedging relationship, whether qualitatively or quantitatively, would no longer be required under the proposed amendment. Reassessment would only be required if circumstances suggest that the hedging relationship may no longer be effective.

**FICG Observation:** Many companies will be relieved by the elimination of the requirement to prepare ongoing quantitative analyses of hedge effectiveness, but they should stay alert for circumstances that indicate that their hedging relationships are no longer reasonably effective. It will be necessary to monitor changes in market conditions and ongoing hedge relationship results for unexpected changes or significant deviations from expected outcomes.

Similar to the Board's decision not to define "reasonably effective", the ED does not specify when reassessment will be required. To the extent that companies move away from performing quarterly quantitative analysis, these procedures will likely have to be replaced with other controls designed to identify if there have been changes to the environment that would suggest that the hedge relationship is no longer "reasonably effective".

The ED also notes that an entity may assess effectiveness using a method that would include a derivative that settles within a reasonable period of time of the cash flows related to the hedged transactions. This method may be beneficial for cash flow hedge relationships in which the hedged item relates to a group of designated forecasted transactions within a specific time period. The ED indicates that the time period is reasonable if the difference is minimal between the forward rate on the derivative and the forward rate on the derivative or derivatives that would exactly offset the changes in cash flows of the forecasted transactions. See below for a discussion of this matter as it relates to measurement of ineffectiveness.

### *Changes to Ineffectiveness Measurement*

Under the proposed guidance, ineffectiveness of cash flow hedge relationships can be measured using the hypothetical derivative method, or Method 2, within DIG Issue G7. This method is one of the most common methods that entities currently use to measure the ineffectiveness of cash flow hedge relationships. The hypothetical derivative method allows an entity to construct a derivative that mirrors the terms of the hedged item (for the hedged risk) and use it as a proxy for the actual hedged item when measuring ineffectiveness. The

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change in fair value of the perfect derivative is regarded as a proxy for the present value of the cumulative change in expected future cash flows of the hedged transaction.

The Board decided to address some of the issues regarding how to create the perfect hypothetical derivative, including:

- How to create the perfect hypothetical derivative when a group of forecasted transactions is hedged by one hedging instrument;
- What credit spread to use when discounting cash flows of a perfect hypothetical derivative; and
- What the perfect hypothetical derivative would be when an option is used in a cash flow hedge and how to account for the option's upfront cost.

### *Hypothetical Derivative for a Group of Forecasted Transactions*

Under the proposed guidance, an entity is permitted to create a hypothetical derivative with a single maturity date when hedging a group of forecasted transactions in a cash flow hedge if the transactions settle within a reasonable time period of the maturity date of the hypothetical derivative. The time period is reasonable if the difference is minimal between the forward rate on the derivative and the forward rate on the derivative or derivatives that would exactly offset the changes in cash flows of the forecasted transactions.

***FICG Observation:*** The issue of using a single derivative to hedge a group of forecasted cash flows that occur on differing dates was the subject of a speech by the SEC Staff and a number of discussions with the SEC. The initial language the Board was planning to include in the ED stipulated that a group of forecasted transactions being hedged by one hedging instrument must settle within a "month" of the hypothetical derivative's maturity date. The Board decided it did not want to include a "bright line" in the standard and, therefore, decided to remove this language from the ED.

This is an area of simplification that many companies may find helpful. Companies often hedge forecasted purchases and sales that occur ratably over the month by entering into a derivative with a notional amount equal to the total of the hedge transactions and a settlement date at a particular point in time during the month. This proposed provision would relieve companies of the burden to look at the perfect hypothetical derivative that would have a notional amount and settlement date that corresponds to each day in which the forecasted transactions occur. Companies, however, will need to analyze their hedging strategies to determine the "reasonable period" within which a derivative could settle and qualify for this provision.

The Board defines a "reasonable" time period as one where the forward rates of the derivative or derivatives that would perfectly hedge the group of transactions is minimally different from the forward rate of the hypothetical derivative. For companies that use options as the hedging instrument, the premiums of those options should be considered. Because

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option premiums factor in volatility for which forward rates do not, the current criteria outlined by the Board may be more difficult to apply for option hedging strategies.

### *Credit Spread to be used when Discounting the Hypothetical Derivative*

The proposed guidance addresses questions that have arisen about what credit spread to use when measuring changes in fair value of a hypothetical derivative. The Board concluded that an entity should use the same credit risk adjustment to value its hypothetical derivative as it uses on the actual derivative.

***FICG Observation:*** The Board's decision to require an entity to use the same credit risk adjustment on the hypothetical derivative that is used on the actual derivative alleviates the concern that many people had that the inclusion of credit risk in the derivative valuation could render a relationship ineffective.

However, because the impact of own credit on derivative valuations will be included in the measurement of a cash flow hedge, and, thus, potentially included in other comprehensive income as opposed to earnings, companies will still be required to allocate credit adjustments to individual cash flow hedge relationships.

In addition, the ability to apply the same credit risk adjustment to the hypothetical derivative as the actual derivative does not eliminate the requirement to monitor the likelihood of derivative counterparty performance for hedge effectiveness.

### *Hypothetical Derivative when using a Purchased Option as the Hedge Instrument*

The ED provides that if a purchased option contract is designated as the hedging instrument to provide only one-sided offset against the hedged risk, the determination of ineffectiveness to be reported in earnings can include total changes in the option's cash flows. Ineffectiveness may be measured by comparing the change in fair value of the actual derivative to the change in fair value of a hypothetical derivative.

The Board's decision to permit entities to defer the changes in fair value of a purchased option associated with the time value component of the option, when used in a cash flow hedge, carries forward the guidance in DIG Issue G20.

***FICG Observation:*** Under the ED, if an entity wishes to hedge an exposure using options under the total change in cashflows approach described in DIG Issue G20, the cost of the option must be amortized from OCI to earnings on a rational basis, which adjusts earnings for the cost of the option contract.

Under current guidance, for certain hedge relationships (such as foreign currency hedges of forecasted sales), no amounts would have been reclassified from OCI into income prior to the occurrence of the forecasted sale.

## "Underhedging" in Cash Flow Hedge Relationships

Under current guidance, in cash flow hedge relationships where the hypothetical derivative method is utilized, the change in fair value of a derivative hedging instrument is recorded as an asset or liability on the balance sheet and accumulated OCI is adjusted to a balance that reflects the lesser of the cumulative change in fair value of the actual derivative or the cumulative change in fair value of the hypothetical derivative.

Under this guidance, ineffectiveness is not recorded when an entity is "underhedged" (i.e., when the actual derivative changes in value less than the hypothetical derivative). The proposed guidance in the ED requires that ineffectiveness be recorded in cash flow hedge relationships when an entity is "overhedged" or "underhedged". Any difference between the change in fair value of the actual hedging instrument and the hypothetical derivative instrument is recorded in current earnings. The ED provides an example illustrating journal entries for a cash flow hedge relationship in which an entity is underhedged.

**FICG Observation:** The reporting of ineffectiveness on underhedges and the amortization of the cost of an option are significant changes from current GAAP. The Board noted that any ineffectiveness on a cash flow hedge that results from a company entering into a derivative that does not mature on the date of the forecasted transaction and that provides cash flows that do not exactly offset the hedged cash flows should be reported in earnings.

The Board also noted that the time value component in a purchased option represents ineffectiveness that should be reported in earnings and that, consistent with foreign currency hedges, should be recognized in earnings on a rational basis. These changes would appear to move closer to synthetic instrument accounting, because the difference between the actual price of the forecasted transaction and what would have been the locked-in price if the derivative was perfect would be reflected in earnings.

## Dedesignation of Hedging Relationships

For both fair value and cash flow hedges, the proposed guidance provides that an entity shall not have the option to remove the designation of the hedging relationship after it has been established unless the derivative is terminated, the hedged item is gone, or the relationship is disqualified from hedge accounting. A hedging derivative may be terminated by entering into an offsetting derivative instrument.

**FICG Observation:** The Board does not believe that a company should be able to use dedesignation of a hedge as a tool for changing measurement attributes and/or managing the classification of certain items reported in earnings. In their view, if the economics of the hedging relationship has not changed since the hedge accounting election, then a simple election with no economic impact should not discontinue that accounting. However, companies would be able to achieve the same result as dedesignation by terminating the hedging instrument and subsequently entering into a similar new derivative, albeit by incurring additional transaction costs.

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“Delta” hedging where a derivative instrument is dedesignated and redesignated to a different hedged item (or different percentage of a hedged item) will be prohibited.

Another area where companies may dedesignate hedge relationships without terminating or settling the derivative is in instances where entities are applying DIG Issue H15 in hedging a forecasted transaction through the liquidation of the associated receivable or payable. Many entities dedesignate the derivative transaction once a receivable is recognized to comply with the central treasury function requirements of the Standard or because hedge accounting is no longer critical due to natural offset from the revaluation of the receivable or payable under FAS 52 "Foreign Currency Translation." Under the proposed guidance, companies that hedge through the settlement date will no longer be able to dedesignate at the recognition date of the receivable or payable without terminating the derivative or entering into an offsetting derivative.

This also may impact net investment hedge relationships where derivatives may be dedesignated and redesignated to compensate for changes in net investment balances.

Fair value hedge accounting shall be discontinued if any criterion in paragraphs 20 and 21 (requirements to achieve hedge accounting) of Statement 133 is no longer met. Cash flow hedge accounting shall be discontinued if any criterion in paragraphs 28 and 29 (requirements to achieve hedge accounting) of Statement 133 is no longer met.

### **Hedging Intercompany Transactions**

The ED indicates that a forecasted transaction must present exposure to variations of cash flows that could affect reported earnings at the financial statement "consolidation level" in which hedge accounting is sought. Therefore, forecasted intercompany transactions may no longer be an eligible hedged item at the consolidated level.

For example, assume a USD functional currency parent has a EURO functional currency subsidiary that makes EURO denominated intercompany royalty payments to its parent and those royalty payments have no relationship to a transaction with a party external to the consolidated entity. Since the revenue and expense associated with these payments (including the impact of foreign exchange rates) are eliminated in the preparation of the parent company's consolidated financial statements, the royalty payment may not qualify as a hedged item in the consolidated financial statements.

***FICG Observation:*** Many companies utilize hedging strategies in which they hedge the foreign exchange risk of forecasted intercompany expenses, royalties, and revenues. Careful analysis is required as to whether those hedging strategies will continue to qualify for hedge accounting in the consolidated financial statements.

## Additional Disclosures

Fair value hedges would require a tabular disclosure for assets and liabilities reported within a single line item in the statement of financial position for which the carrying value includes fair value adjustments related to FAS 133 fair value hedging. Disclosures would include:

- a. The carrying value of the assets or liabilities included within the line item;
- b. The cumulative fair value adjustments related to FAS 133 fair value hedging;
- c. The cumulative fair value adjustments other than those related to FAS 133 fair value hedging; and
- d. The carrying value of the assets or liabilities excluding any fair value adjustments.

For synthetically created variable or fixed-rate debt that is created through the use of interest rate swaps, entities would be required to disclose as part of their debt disclosure:

- a. That the entity uses derivative contracts to convert a portion of its fixed rate debt to variable rate debt and variable rate debt to fixed rate debt;
- b. How the maturity structure of the derivatives correspond to the maturity structure of the debt being hedged; and
- 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

The Board's goal is to issue a final standard by December 31, 2008. The proposed guidance would require application of the amended hedging requirements for financial statements issued for fiscal years beginning after June 15, 2009, and interim periods within those fiscal years. Early adoption would not be permitted.

***FICG Observation:*** A January 1, 2010 effective date for a calendar year-end may sound deceptively far away. However, it is important to consider that cash flow hedging strategies are often entered into more than a year in advance of the forecasted transaction. Therefore, companies may wish to consider any possible effects of the proposed standard on their current hedging strategies before they enter into new hedging relationships. Furthermore, companies may want to begin evaluating whether any changes will be needed to their systems, processes, and internal control policies and procedures as a result of the requirements of the proposed new standard.

The Board has provided that at the date of initial application, hedging relationships would be required to be dedesignated and designated anew using the qualifying criteria of Statement 133 as amended except in hedging relationships in which the designated risk(s) being hedged are the same under both the current and proposed guidance (such as foreign exchange risk, overall fair value risk of a hedged item, and benchmark interest rate risk of an entity's own debt hedged at its inception).

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For hedges of benchmark interest rate risk of an entity's own debt initiated prior to transition, the hedging relationship need not begin at inception of the debt.

Prospective application would be required for fair value hedges and limited retrospective application would be required for cash flow hedges.

**FICG Observation:** While the designated risk being hedged may be the same under both the current and proposed guidance, the method to assess effectiveness may no longer be eligible under the proposed guidance (e.g., shortcut method and critical terms match method). Therefore, while the designated risk does not change, companies will need to dedesignate and redesignate the hedge relationship using an eligible method under the proposed guidance. For these particular effectiveness methods, while there may not be an effect to the financial statements upon dedesignation and redesignation, the documentation of the new hedge relationship will need to be performed.

The retrospective requirements for cash flow hedges would require a reconciliation of what is currently in OCI to what would be in OCI if ineffectiveness had been measured under the new guidance. The difference between the amounts recorded under the current guidance and amounts that would have been recorded under the new guidance will be recorded as an adjustment to opening retained earnings. If an entity currently has many cash flow hedge relationships, this reconciliation could take a considerable amount of time and effort.

The ED provides that any held-to-maturity securities may be transferred into the available-for-sale category ("AFS") or trading category at the date of initial application. An entity will be able to designate a security transferred into the AFS category as the hedged item in a fair value hedge of the exposure to changes in its overall fair value or designate its variable interest payments as the hedged transactions in a cash flow hedge of overall changes in hedged cash flows.

Finally, the proposed guidance would permit a one-time fair value option election under FASB Statement No. 156 for servicing assets and servicing liabilities designated as a hedged item on the date immediately preceding initial application, and under Statement No. 159 for eligible financial instruments designated as a hedged item on the date immediately preceding initial application.

### **Implementation Considerations**

The Board's proposed amendment to FAS 133 would result in the following additional costs:

- a. Costs to implement changes in systems and processes used to comply with the proposed hedge accounting guidance;
- b. Costs to initially develop methods to calculate overall changes in fair value of hedged items in fair value hedging relationships; and
- c. Costs to initially develop methods for constructing perfect derivatives for use in measuring ineffectiveness in cash flow hedging relationships.

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***FICG Observation:*** The proposed guidance reduces the administrative burden of applying hedge accounting by lowering the threshold to qualify for hedge accounting from "highly effective" to "reasonably effective," eliminating the requirements to perform quantitative analysis at inception and on an on-going basis, and reducing the documentation requirements.

## **Questions**

Questions regarding this Advisory, financial instruments or credit in general may be directed to:

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