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The new FASB exposure draft—a long-awaited solution

Toward Improved Accounting for Derivatives and Hedging Activities

By ***Corliss J. Montesi*** *and* ***Timothy S. Lucas***

The FASB has issued an exposure draft that would require derivatives to be measured at fair value. The accounting for resultant gain or loss would be based on various factors described in the proposed statement. The authors discuss the problems that gave rise to the proposed statement, some of the board's fundamental decisions, and how the proposed accounting works, while providing answers to some frequently asked questions. An article in the accounting department presents a comprehensive example of how the proposed accounting would be applied.

In June 1996, the FASB issued an exposure draft (ED) of a proposed statement, *Accounting for Derivative and Similar Financial Instruments and for Hedging Activities*. The proposed approach to accounting for derivative financial instruments and hedging activities in that ED would significantly improve current accounting, provide uniform accounting guidance for all derivative financial instruments and hedging activities, and provide criteria for hedge accounting.

Derivative financial instruments are not new, but the extent of use and complexity have grown rapidly in recent years. Changes in global financial markets and related financial innovations have led to the development and use of new derivative financial instruments to manage or hedge exposures to risk, including interest rate risk, foreign exchange risk, and price risk. Accounting standards have not kept pace with those changes. Derivatives are powerful and useful risk management tools, and the inadequacy of financial reporting may discourage their legitimate use by contributing to an atmosphere of uncertainty. Concerns about inadequate financial reporting have been heightened by the publicity surrounding recent large derivative losses at a few companies. The SEC and others have urged the board to deal expeditiously with problems in this area.

What Problems Does the Proposed Statement Seek to Address?

One of the board's objectives in issuing the proposed statement is to resolve several problems with the accounting and reporting practices for derivatives and hedging activities. The proposed statement addresses the following problems:

The accounting guidance for derivatives and hedging is incomplete. Only a few types of derivatives used today are specifically addressed in accounting standards. SFAS No. 52, *Foreign Currency Translation*, addresses forward foreign exchange contracts, and SFAS No. 80, *Accounting for Futures Contracts*, addresses exchange-traded futures contracts. Similarly, those two standards are the only ones that specifically provide for hedge accounting. The Emerging Issues Task Force (EITF) has addressed the accounting for some derivatives and for some hedging activities not covered in Statements 52 or 80; however, that effort has been on an ad hoc basis. Large gaps remain in the authoritative accounting guidance. Accounting practice has filled some of those gaps on issues such as "synthetic instrument accounting" without any commonly understood limitations on their appropriate use. The result of this accounting hodgepodge is that a) many derivative instruments are carried "off balance sheet" regardless of whether they are part of a hedging strategy, b) practices are inconsistent among entities and for similar instruments held by the same entity, as noted below, and c) users of financial reports are confused or even misled.

> The result of this accounting hodgepodge is that many derivative instruments are carried "off balance sheet."

The accounting guidance for derivatives and hedging is inconsistent. Under the existing accounting guidance (FASB standards and EITF consensuses), the required accounting treatment may differ depending on the type of instrument used in hedging and the type of risk being hedged. For example, an anticipated transaction may qualify as a hedged item only if the hedging instrument is a nonforeign currency futures contract or a nonforeign currency purchased option. Additionally, derivatives are measured differently under the exist-

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ing accounting standards—futures contracts are reported at fair value, foreign currency forward contracts are reported at amounts that reflect changes in foreign exchange rates but not other value changes, and other derivatives may be unrecognized or reported at nominal amounts that are a small fraction of the value of their potential cash flows. Other hedge accounting inconsistencies relate to level of risk assessment (transaction-based versus entitywide) and measurement of hedge effectiveness.

The accounting guidance for derivatives and hedging is complex. The lack of a single, comprehensive approach to accounting for derivatives and hedging makes the existing accounting guidance very complex. The incompleteness of the FASB statements on derivatives and hedging forces entities to look to a variety of different sources, including the numerous EITF issues and nonauthoritative literature, to determine how to account for specific instruments or transactions. Because there is often nothing directly on point, entities are forced to analogize to existing guidance. Because different sources of analogy often conflict, a wide range of answers can often be supported, and no answer is safe from later challenge.

The effects of derivatives are not transparent. Under the current varied practices, derivatives may or may not be recognized in the financial statements. If recognized in the financial statements, realized and unrealized gains and losses on derivatives may be deferred from earnings recognition and reported as part of the carrying amount (or basis) of a related item or as if they are freestanding assets or liabilities. As a result, users of financial statements find it difficult to determine what an entity has or has not done with derivatives and what the related effects are. The FASB has already taken steps to improve financial statement disclosures about derivatives, including those held for hedging. However, it is still difficult to understand how financial statements can purport to present financial position without reporting the material benefits and obligations associated with derivative instruments.

Fundamental Decisions Underlying The Proposed Statement

In considering the problems with the existing accounting guidance and how to account for derivatives and hedging, the board made four fundamental decisions that have become the cornerstones of the proposed statement. Those fundamental decisions are as follows:

Derivatives are assets or liabilities and should be reported in the financial statements. Derivatives are assets or liabilities because they are rights or obligations. Many can be settled for cash simply by making a phone call. The ability to settle a derivative in a gain position by receiving cash is evidence of the right to a future economic benefit and indicates the instrument is an asset. Similarly, the fact that a cash payment is required to settle a derivative in a loss position is evidence of the duty to sacrifice assets in the

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EXHIBIT
CRITERIA TO QUALIFY FOR HEDGE ACCOUNTING

Basic Criteria

- At the inception of the hedge, there is formal documentation of the hedging instrument and the specifically identified hedged item or transaction, including the nature of the risk being hedged.
- The use of the derivative is consistent with the entity's established policy for risk management.
- The hedging derivative is not a net written option.
- The hedged item or transaction presents an exposure to changes in price that, if prices change, could affect reported earnings.

Additional qualifying criteria for hedges of cash flow exposures

- Depending on the characteristics of the forecasted transaction, documentation includes the expected date of the forecasted transaction, the type of commodity, asset, or liability involved, and the expected dollar amount or quantity of the forecasted transaction.
- Both at inception and on an ongoing basis, the derivative is expected to have cumulative net cash flows that will offset substantially all of the changes in cash flows of the hedged transaction that are attributable to the risk being hedged (or, for a purchased option, substantially all of the cash flow losses).
- The contractual maturity or repricing date of the derivative is on or about the projected date of the hedged forecasted transaction.
- The forecasted transaction is probable, is part of an established business activity, and presents an exposure to price changes that would produce variations in cash flows.
- The exposure is a transaction, that is, an external event involving an exchange with a party that is not part of the reporting entity.
- The forecasted transaction is not the acquisition of an asset or incurrence of a liability that will be measured at fair value subsequent to acquisition or incurrence with changes in fair value reported in earnings.
- At the inception of the hedge, the variable cash flows of the forecasted transaction do not relate to an asset or liability that is being hedged as a fair value hedge.

Additional qualifying criteria for hedges of fair value exposures

- The hedged item is specifically identified as either all or a proportion (expressed as a percentage) of an asset or liability.
- The hedged item is a single asset or liability (or proportion thereof) or is a portfolio of similar items, such as similar assets or similar liabilities (or proportion thereof).
- The hedged item has a reliably measurable fair value, and changes in the fair value of the derivative are expected, both at inception and on an ongoing basis, to offset substantially all of the changes in the fair value of the hedged item that are attributable to the risk being hedged (or, for a purchased option, substantially all of the losses).
- The hedged item is not (1) a debt security that is classified as held to maturity, (2) oil or gas in the ground, unmined mineral ore, an agricultural product in process, or similar item, (3) an intangible asset, (4) an investment accounted for by the equity method, (5) mortgage servicing rights that have not been recognized as assets, (6) a lease, or (7) a liability for insurance contracts written, except for written financial guarantees. However, certain forecasted transactions related to those items may qualify for hedge accounting.
- The entity is able to allocate to the hedged item any "general reserves" (valuation accounts), deferred fees and costs, or purchase premiums or discounts established for a group of items of which the hedged item is a part.
- At the inception of the hedge, any variable cash flows related to the hedged item are not being hedged as a cash flow hedge of a forecasted transaction.

future and indicates the instrument is a liability. Recognizing those assets and liabilities will make the financial statements more complete and more informative.

Fair value is the most relevant measure for financial instruments and the only relevant measure for derivatives. Derivatives should be measured at fair value and adjustments to the carrying amounts of hedged items should reflect offsetting changes in their fair values (that is, gains and losses) arising while the hedge is in effect. Fair value information on financial instruments is useful to present and potential investors, creditors, and other users of financial statements in making rational investment, credit, and other decisions. Fair values also are more understandable than historical cost or cost-based measures for many financial instruments. Concerns about how to measure the fair values of certain financial assets and liabilities make it inappropriate to require that all financial instruments be measured at fair value at this time. However, because of the ways that derivative values can change and because historical cost of derivatives is often zero, fair value is the only relevant measure for derivatives.

Only items that are assets or liabilities should be reported as such in the financial statements. A derivative loss should not be reported as an asset because it has no future economic benefit associated with it. The loss cannot be

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exchanged for cash, used to produce something of value, or used to settle liabilities. Similarly, a derivative gain should not be reported as a liability because it does not involve an obligation to sacrifice assets in the future.

Hedge accounting should be provided for only qualifying transactions, and one aspect of qualification should be an assessment of offsetting changes in fair values or cash flows. Some believe hedge accounting would be an unnecessary and undesirable complication in a world where all assets and liabilities were measured at fair value. Given the current financial reporting model, however, special accounting is necessary to achieve a reasonable presentation of financial position and results of operations. But, special accounting for hedging activities should not be provided in all cases in which an entity asserts a relationship between items or transactions; it should be limited to transactions that meet reasonable criteria. Because a primary purpose of hedging is to link items or transactions whose changes in fair values or cash flows are expected to offset, one of the criteria for qualification for hedge accounting should focus on the extent offset is expected and achieved.

How Would the Proposed Accounting Work?

Under the proposed statement, all derivatives would be reported on the balance sheet as assets or liabilities and measured at fair value. That implements the first two fundamental decisions. The accounting for gains and losses that result from changes in fair value would depend on the reason for holding the instrument and whether it qualifies for designation as a hedge of a fair value exposure, a cash flow exposure, or a net investment in a foreign entity. The criteria to qualify for hedge accounting are listed in the *Exhibit.*

Hedges of Fair Value Exposures

Most assets, liabilities, and firm commitments expose an entity to the risk of a change in fair value. If a derivative is designated as a hedge of that risk, the change in the fair value of the derivative would effectively adjust the basis of the hedged asset or liability to the extent there is an offsetting change in the fair value of that hedged item. If the hedged item is a firm commitment, the "basis adjustment" would be to a separate asset or liability, reflecting the fair value of the commitment.

The approach can be described as reporting in earnings both the full gain or loss on the derivative and the loss or gain on the hedged item, up to the amount that provides offset. Alternatively, it can be described as deferring the derivative gain or loss as an adjustment of the basis of the hedged item, to the extent there is an offsetting loss or gain on the hedged item. The effect on assets, liabilities, and earnings is the same either way.

> There would be no earnings impact for perfect hedges because gains and losses would net to zero.

The effect of this accounting treatment is that overhedges (an excess derivative gain or loss over the offsetting loss or gain on the hedged item) would be reflected in earnings. There would be no earnings impact for perfect hedges (the gains and losses exactly offset), because gains and losses would net to zero, or for underhedges (the gain or loss on the derivative is less than the offsetting loss or gain on the hedged item), because excess hedged item losses or gains are not recognized.

If the derivative gain or loss exceeds the offsetting loss or gain on the hedged item (an overhedge), previously unrecognized gains and losses on the hedged item that have occurred during the hedge period, are available to provide additional earnings offset in the current period on a net basis.

Identification of Hedged Item. The proposed statement would require that an entity specifically identify the proportion (percentage) of the asset or liability being hedged, and only the gain or loss related to that proportion would be reported in earnings. For example, if 60% of an item is designated as being hedged, the amount of gain or loss recognized would be the lesser of 60% of the full change in fair value of the asset or liability or the amount of loss or gain on the derivative. Proportional designation would not permit an entity to identify a particular risk or component instrument of a compound instrument as the item being hedged.

Hedged firm commitments may be separated into a financial instrument aspect (such as the obligation to pay a foreign currency) and a nonfinancial asset or liability aspect (such as the right to receive a fixed asset) for hedge accounting purposes. Those aspects would then be analyzed and measured separately, and a derivative could be designated as a fair value hedge of the financial instrument, the nonfinancial asset or liability, or the entire firm commitment.

Preexisting Gains or Losses on Hedged Items. At the inception of a hedge, the fair value of a hedged item may differ from its carrying amount, resulting in a "preexisting" unrecognized gain or loss. That gain or loss would not be included in subsequent hedge accounting computations and would be prohibited from early earnings recognition. A preexisting gain or loss would be recognized in earnings based on applicable accounting principles; that recognition would not be changed by the proposed statement.

Exceptions for Some Foreign Currency Hedge Transactions. To accommodate the extensive practice that exists for foreign currency hedging, the proposed statement makes two exceptions that retain provisions of SFAS No. 52. Those exceptions are not consistent with

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other hedge accounting provisions. An entity would be permitted to designate a nonderivative financial instrument (such as a cash security) denominated in a foreign currency as a fair value hedge of a firm commitment. An entity also would be permitted to designate a foreign currency financial instrument (derivative or nonderivative) as a fair value hedge of the foreign currency exposure of a net foreign investment and to report changes in fair value due to changes in foreign exchange rates in other comprehensive income as a translation adjustment.

Hedges of Cash Flow Exposures

Forecasted transactions expose an entity to the risk of a change in expected cash flows—for example, an increase or decrease in expected cash flows associated with future sales, future purchases, or future interest receipts or payments on a variable-rate financial instrument. The board recognizes that hedging is often a rational economic activity used to cope with uncertainty about the future and that the risks associated with forecasted transactions in many cases look similar to those associated with assets, liabilities, and firm commitments. The lack of associated assets or liabilities, however, makes it debatable whether a forecasted transaction exposes an entity to the possibility of loss or whether it exposes an entity only to the possibility of losing all or part of a future opportunity. Furthermore, there are difficulties associated with providing hedge accounting for cash flow hedges of forecasted transactions. From a conceptual perspective, it is difficult to justify deferring a derivative gain or loss when the gain or loss is not a liability or an asset and is not associated with an existing liability or asset. From a practical perspective, it is difficult to assess the effectiveness of a cash flow hedge of a forecasted transaction because it involves expectations, not rights and obligations.

The board decided to accommodate some forecasted transaction hedging because of the extensive practice that currently exists. An example of forecasted transaction hedging is the purchase of futures in the commodities markets to control the market rate risk of inventory pur-

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chases. It decided that the best way to provide hedge accounting would be to defer derivative gains and losses as part of other comprehensive income, rather than as liabilities or assets, and report those gains and losses in earnings on the projected date of the forecasted transaction. Hedge accounting for forecasted transactions would be limited to the life of the derivative because the contractual maturity or repricing date of the derivative must be on or about the projected date of the hedged forecasted transaction. The proposed accounting is intended to 1) avoid the conceptual difficulty of deferring gains and losses on the derivative hedging instrument as liabilities and assets, 2) assist financial statement users by making the deferred gains and losses visible, 3) reflect the effectiveness of cash flow hedges, and 4) put some limitations on hedge accounting for forecasted transactions.

Frequent Questions

The following provides answers to two frequently asked questions on the proposed statement to accounting for derivatives and hedging.

What financial instruments would be considered derivatives under the proposed statement? Under the proposed statement, the term derivative would include those financial instruments generally considered to be derivatives, such as forwards, futures, options, swaps, and similar instruments. The scope would include commodity-based contracts that permit settlement by delivery of a commodity but that can be settled for cash, which were excluded from the scope of earlier statements on financial instruments. The scope also would include financial instruments with embedded derivatives when the embedded derivative causes the financial instrument to have characteristics similar to derivatives, such as structured notes.

Would futures contracts qualify for hedge accounting? Futures contracts are derivative financial instruments traded on organized exchanges. Generally, they "settle daily," requiring a deposit of cash or collateral if the value goes down and allowing a withdrawal if the value goes up. Futures contracts would qualify as hedging instruments provided they meet the criteria that would be applied to all derivatives designated as hedges. For hedges of fair value exposures, derivatives must meet an offset criterion—changes in the fair value of the derivative must be expected to substantially offset changes in fair value of the hedged item.

For hedges of cash flow exposures, derivatives must meet an offset criterion and a maturity criterion. The offset criterion would require an expectation that cumulative cash flows on the derivative will offset substantially all of the changes in cash flows on the hedged forecasted transaction. The maturity criterion would require that the contractual maturity or repricing date of the derivative be on or about the projected date of the forecasted transaction. The criteria have been developed so that the daily cash settlement on futures contracts will not interfere with qualification for hedge accounting. However, the criteria would preclude the use of a series of short-term futures contracts that hedge a longer-term forecasted transaction from qualifying for hedge accounting. To the extent practicable, the board would like to have the accounting requirements be neutral and not encourage or discourage the use of particular types of contracts. That desire for neutrality must be balanced with the need to reflect substantive economic differences between different instruments.

The Board's Expectations

The board believes that the proposed hedge accounting approach would accommodate a wide variety of risk management activities. Some have suggested that the financial statement results of applying the proposed statement on accounting for derivatives and hedging will not reflect the "economics" of certain hedging and risk management activities. The board believes that because entities have different and often conflicting views of risk and manage risk differently, no single approach to hedge accounting could ever accommodate all hedging and risk management activities. The board believes that providing hedge accounting to the whole range of activities undertaken by some under the title "risk management" would be inconsistent with the usefulness and understandability of financial reporting.

The board also believes that the proposed statement would make significant improvements in financial reporting. The requirements of the proposed statement would increase the visibility, comparability, and understandability of the risks associated with derivatives by requiring that all derivatives be reported as assets and liabilities and measured at fair value. It would remove the inconsistencies and gaps in current accounting by providing comprehensive guidance for derivatives and hedging activities. It also would accommodate a reasonable range of hedge accounting practice by 1) permitting hedge accounting for most derivative instruments, 2) permitting hedge accounting for hedges of forecasted transactions regardless of the type of risk, and 3) eliminating the requirement that an entity demonstrate risk reduction on a net entity-wide basis.

Key Dates

The proposed statement would be effective for fiscal years beginning after December 15, 1997. The ED is available for public comment through October 11, 1996. A public hearing on the ED is scheduled for mid-November in conjunction with an ED on reporting comprehensive income. After the public hearing and a review of the comment letters, the board will redeliberate the decisions in the ED before issuing a final statement. ❑

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