GIANT Steps

Good news on the derivatives accounting front

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KEY HIGHLIGHTS:

- Under the proposed changes, hedgers would be allowed up to three months from the derivatives' transaction dates to define and satisfy effectiveness tests.
- Under the revised approach for cash flow hedges, the distinction between effective versus ineffective earnings would be ignored—at least as far as journal entries are concerned.
- The only downside to the proposed changes is that FASB still seems committed to relying on the concept of "offsets" in considering hedge effectiveness.

After years of benign neglect, it appears that the Financial Accounting Standards Board (FASB) is ready to reconsider the accounting treatment for derivative contracts. In June, the FASB made a variety of tentative decisions, which, unless modified, will critically impact a sizable portion of commercial enterprises that use derivatives for hedging purposes. The prospective changes will simplify accounting processes and generally serve to improve the alignment of the accounting with the economics underlying derivatives transactions.

The critical adjustments relate to hedge accounting—the allowable treatment for qualifying transactions whereby derivatives' gains or losses are reported in the same accounting period as the earnings impacts of the associated hedged items. By pairing these results in a common accounting period, this treatment reflects the economic intent of the hedge.

While hedge accounting is an elective treatment, it requires satisfying a variety of prerequisite conditions. Among the current prerequisites is the requirement to document the hedging relationship in a very specific way, including the specification of prospective and retrospective hedge effectiveness testing methodologies. This documentation must be correct and complete as of the derivative transaction date if hedge accounting is to be applied from the start. Under the proposed changes, hedgers would be allowed up to three months from the derivatives' transactions dates to define and satisfy these tests. Clearly for first-time hedgers, this adjustment will make the application of hedge accounting a lot easier.

Cash flow hedges

Presuming hedge accounting is authorized, one of the most significant changes will apply to cash flow hedges,which are hedges that relate to risks associated with uncertain, forecasted transactions. Under the current procedures, before any journal entries can be made, hedge results must be evaluated to determine the portion of gains or losses deemed to be effective versus ineffective. Effective results are initially reported in other comprehensive income (OCI) and later reclassified to earnings, concurrently with the recognition of the earnings effects of the item(s) being hedged. Ineffective results are not deferred but instead are posted directly to earnings.

The effective/ineffective assessment requires an evaluation of the cumulative hedge performance, and it is also asymmetric. That is, cumulative ineffective earnings arise only in the situation when the hedge gains or losses are too large relative to the gains or losses that a perfect hedge would have yielded. Thus, if hedges "underperform," ineffective earnings are deemed to be zero.

With the proposed changes, the FASB will be taking a dramatic leap. Under the revised approach, as long as the entity qualifies for cash flow hedge accounting, the distinction between effective versus ineffective earnings would be ignored—at least as far as journal entries are concerned. All hedge results would be posted to OCI and subsequently reclassified to earnings, again timed to coincide with the earnings recognition for the hedged item. Thus, to the extent that any ineffectiveness arises, it will show up in earning only when the reclassification occurs and not throughout the hedging horizon as is the case under current guidance. This adjustment should foster some lesser income volatility during the hedge period than we have experienced under the current regime.

A further advantage to this revision is that it eliminates the prospects of two entities using the same derivative and posting different earnings outcomes as a consequence of employing different methodologies for how they each measure ineffectiveness. Under the proposed rules, both entities will post identical earnings impacts when they hold the same derivative position(s).

At this point, although it would seem that we no longer need to worry about ineffective versus effective hedge results as far as journal entries are concerned, the measurement of these effects will still be necessary in order to satisfy disclosure requirements. Although it might be reasonable to expect ineffective results to be immaterial in the vast majority of cases, auditors would presumably expect this immateriality to be demonstrated. Thus, while we won't have to measure effective and ineffective results for journal entries, we'd still have to perform that analysis to comply with disclosure requirements.

Commodity hedging concerns

Of particular concern to commodity hedgers is the requirement that stipulates (currently) that the hedged item must be defined as the full price effect of any commodity exposure. This requirement is likely to be liberalized. Specifically, if the full price being hedged expressly references some component price, that component price may be deemed to be the risk being hedged. A large portion of commodity purchases and sales are structured in this way, where the price references an industry standard price (or a benchmark price), plus or minus a basis.

Under the proposed rules that benchmark price can be defined to be the hedged item. This adjustment could be profoundly important in that it will likely expand the capacity to apply hedge accounting to many enterprises that have had difficulty passing effectiveness test (or simply declined to try) due to the volatility associated with basis conditions. This change has been long-awaited and will likely be widely appreciated.

An analogous liberalization appears to be in store for interest rate hedges. In this sector, hedgers have always enjoyed the capacity to hedge benchmark rate exposures (as opposed to the full interest rate exposures) for most interest rate situations, but benchmark rates have been limited to LIBORs, LIBOR-based swap rates, Treasury rates, or Fed Funds rates. The new rules would expand allowable benchmark rates to include SIFMA (Securities Industry and Financial Markets Association Municipal Swap Index). They would also allow the ability to designate any contractual index (e.g., Prime—not just benchmark rates) as the risk being hedged.

Two other changes affecting fair value hedges of interest rate exposures—i.e., hedges of fixed rate exposures—are also worth noting, in connection with:

- For fair value interest rate hedges, derivative results are recorded in earnings coincidently with changes in the value of the hedged item due to the risk being hedged. The FASB now appears ready to allow entities to value the adjustment to the carrying value of the hedged item using the same discount factors as those used to value the hedging derivative. With this change, the long haul method yields an identical adjustment to the carrying value of the hedged item as does the shortcut method, thereby obviating the need for shortcut, altogether. This change assures an accounting outcome for an interest swap hedge that is consistent with the intended economic objective of swapping from fixed-to-floating interest rates.
- Partial-term hedging would be permitted for fair value hedges, whereby entities could qualify for hedge accounting when swapping from fixed-to-floating over a shorter span than the full maturity off the instrument being hedged. Allowing hedge accounting in this situation is an improvement in that it permits the harmonization of the economics and the accounting for this strategy, where otherwise, the two were at odds.

What's Not in the Proposal?

Besides covering what the proposed changes would do, it may be useful to explore what they've failed to do. In fact, the only substantive reservation I have with respect to the proposed adjustments is the FASB still seems committed to relying on the concept of **"offsets"** in considering hedge effectiveness.

Both practitioners and academics have long believed this concept to be seriously flawed. In the vast majority of situations, high correlation between the price levels associated with the exposure and those underlying the derivative should serve a sufficient basis for expecting hedges to perform well over the long run or over repetitive applications. This statement, however, is not the same as asserting that such situations will reliably result in dollar offset calculations that fall between the traditional 80 percent to 125 percent bounds. In fact, numerous studies have demonstrated that even with data samples with very highly correlated price levels, the 80 percent to 125 percent boundary conditions are often violated with a seemingly high frequency (often approaching 50 percent of the periods in the sample).

Dollar offset ratios often blow up in periods of low volatility when nothing much is happening. With highly correlated price level, you can reasonably assume that dollar offsets to fall within the prescribed 80 percent to 125 percent range with sustained price moves, but all bets are off if you artificially constrain time periods to too limited horizons or periods in which price changes revert to zero. This current offset orientation ends up denying hedge accounting for too many entities that are pursuing reasonable and responsible hedging strategies.

Dramatic improvement

The proposed rules are a dramatic improvement over the current guidance. They will make it easier to qualify for and apply hedge accounting, and they'll also simplify the required processing procedures.

Don't expect these changes to be effective anytime real soon, but it looks like they're on their way. At this point, a formal process is required before any changes in the current guidance will apply. The FASB staff needs to prepare an Accounting Standards Update to amend Topic 815, with a proposed transition plan; the public will have an opportunity to comment; and then the FASB will ultimately accept, reject, or modify the guidance. My own experience suggests that the proposed changes will be warmly received by those who attend to these kinds of issues, and it seems likely that virtually all of the substantive adjustments thus far suggested will be adopted.