

To the Point

FASB – discussion paper

Hedge accounting – FASB seeks reaction to IASB's proposed model

The FASB's request for input from constituents is the first step toward a possible converged model with the IASB.

What you need to know

- ▶ The FASB is seeking comment on the IASB proposal that would significantly change the hedge accounting model in IFRS.
- ▶ The FASB's questions suggest that it may be contemplating how to incorporate some of the IASB ideas into its hedging framework.
- ▶ The FASB, which proposed its own hedge accounting model in May 2010, has been waiting for the IASB to complete its version.
- ▶ The deadline for comments to the FASB is 25 April 2011. Comments to the IASB are due by 9 March 2011.

Overview

The Financial Standards Accounting Board (FASB) and the International Accounting Standards Board (IASB) (collectively, the Boards) have been debating hedge accounting separately, but their goal has always been to achieve a converged solution.

Both Boards want to make hedge accounting more accessible to constituents. They also want to address long-standing criticisms that both of their models are overly complex. In the US, there were major practice issues that led to disqualification from hedge accounting and restatements over the past decade.

In a change that many companies have pushed for, the IASB has proposed expanding qualification for hedge accounting to more hedge relationships when they align with a company's actual risk management strategies and objectives. The FASB took a less ambitious approach.

The FASB's discussion paper¹ seeks feedback on constituents' views on the IASB model. While the request reflects the FASB's goal of convergence, the nature and tone of the questions indicate that the FASB wants to avoid creating new practice problems.

The IASB hedging model

The IASB's December 2010 exposure draft² seeks to better link qualification for hedge accounting to a company's risk management strategy. If a strategy is designed to achieve an unbiased offset to the hedged risk and minimize hedge ineffectiveness, there would be no requirement that the hedge be tested afterward and be proven to be effective.

Instead, a hedge design would be required to be monitored for the emergence of bias over time, and a hedger would be required to rebalance the hedge to remove the bias. Such rebalancing would not be deemed to constitute a new hedge, but rather a continuation of the originally designated and documented relationship. Hedge accounting would have to cease if a company's risk management strategy changes.

Two elements of the IASB model could have great appeal if permitted in the US. The model would allow companies to design hedges that focus on only a component of non-financial risk (such as the crude oil component of refined fuel), thereby reducing what constitutes hedge ineffectiveness in the income statement. Also, companies could use a single derivative to hedge a "net" exposure to a common risk, such as foreign-currency-denominated sales less cost of sales or LIBOR-based assets net of related LIBOR-based liabilities.

The FASB alternative

The FASB's May 2010 exposure draft³ preserved the fundamental accounting structure of the US GAAP hedging model, including what constitutes an eligible hedge strategy. Proposed changes to US GAAP (ASC 815) include:

- ▶ Replacing the notion of a "highly effective" hedge relationship with one that is "reasonably effective," lowering the bar on what constitutes a qualifying hedge
- ▶ Eliminating the shortcut method for interest rate swaps and the "critical terms match" concept for other derivatives, while acknowledging that qualitative assessments of what constitutes "reasonably effective" are acceptable in most instances
- ▶ Replacing requirements that hedges be reassessed every quarter with requirements that hedges be reassessed qualitatively (or quantitatively, if necessary) only if circumstances suggest that the hedging relationship may no longer be reasonably effective

Concerns about the clarity, operability and auditability of the IASB's proposal appear to underpin the questions posed by the FASB.

Key considerations

The FASB's discussion paper seeks feedback on a number of the significant changes proposed by the IASB to determine whether the IASB's proposals are a better starting point for any changes to the US GAAP hedging model. The primary areas for which the FASB seeks US constituent feedback focus on differences from US GAAP and include:

- ▶ Risk management objective – Linking qualification for hedge accounting to whether a hedge is consistent with a company's risk management activities and whether such a criterion is understandable and auditable
- ▶ Hedging instruments – Expanding the population of permissible hedging instruments to include certain non-derivative financial instruments
- ▶ Risk components of hedged items – Allowing a risk component of financial or non-financial items to be hedged if it is "separately identifiable and reliably measurable"
- ▶ Layer components of hedged items – Expanding the layer components that may be hedged to include the "last units" (e.g., the last 10,000 units sold in June)
- ▶ Groups of hedged items – Allowing certain aggregated groups and net positions to be hedged and removing the requirement for items within the group to behave in an approximately proportionate manner
- ▶ Initial qualification – Changing the basis of initial qualification for hedge accounting (i.e., the "highly effective" threshold in current US GAAP) to whether the relationship (1) "will produce an unbiased result and minimize expected hedge ineffectiveness" and (2) is expected to achieve "other than accidental offsetting"
- ▶ Ongoing qualification – Permitting or requiring an entity to "rebalance" a hedge relationship if the relationship is no longer unbiased, but requiring an entity to discontinue hedge accounting if there is a change in the risk management strategy
- ▶ Option premiums – Requiring an entity to capitalize the time value of an option as a basis adjustment of the hedged item, if the hedged item will subsequently result in recognition of a non-financial asset or liability
- ▶ Presentation and disclosure – Separately presenting as an asset or liability the change in the fair value of the hedged item attributable to the hedged risk for fair value hedges, and significantly increasing required disclosures of risk management activities overall

How we see it

There are a number of details in the IASB's proposed model that need to be further clarified before that proposal can be fully evaluated. Nevertheless, several elements strike us as deserving serious consideration by the FASB.

We support allowing hedgers to designate components of non-financial risk as the hedged risk in a hedge relationship. We also believe that the concept of treating a rebalanced hedge as a continuation of the originally documented relationship, rather than mandating a fresh start to the hedge accounting, would be helpful to US constituents.

In applying the IASB's proposed model to a number of relatively common hedging scenarios, we believe it is sometimes unclear how the model should be applied.

For example, assume that a company enters into a 3-month LIBOR-based forward-starting interest rate swap intended to hedge the variability in cash flows related to variable rate debt it plans to issue later in the year. Also assume that the debt winds up being indexed to 1-month LIBOR instead of 3-month LIBOR.

It is unclear whether the decision to issue 1-month LIBOR-based debt would be viewed as (1) a new "risk management strategy," thereby causing the existing hedge to terminate; (2) a change in the hedge ratio requiring "rebalancing" under the proposed model; or (3) a change that introduces no new bias in either direction and therefore requires no action at all, other than to measure the new hedge ineffectiveness.

We believe the third view is the appropriate response, but given the number of potential ways in which the model can be read to apply to such a scenario, further clarification is necessary to ensure consistent application and reduce the risk of future practice issues.

Next steps

- ▶ Companies should evaluate how the IASB proposal would affect their hedging activities and participate in the comment process, particularly if there are aspects of the IASB model that they believe should be incorporated into the US model. In commenting to the FASB, companies should consider showing how incorporating parts of the IASB model into the US model would improve financial reporting and help users understand the company's risk management activities.
- ▶ To facilitate your evaluation, we will publish a comprehensive analysis of the IASB's proposed hedging model and a separate Technical Line that will discuss the key differences between the IASB's and the FASB's proposed hedging models.
- ▶ Feedback should be provided by 25 April 2011.

Endnotes:

¹ FASB Discussion Paper, *Invitation to Comment – Selected Issues about Hedge Accounting*

² IASB Exposure Draft 2010-13, *Hedge Accounting*

³ FASB Proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedge Accounting*

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