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Heads Up

In This Issue:

FASB Invites Comments on IASB's Hedge Accounting Proposals

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The FASB recently issued a discussion paper (DP)[1] that seeks constituents' feedback on the proposals in the IASB's exposure draft (ED)[2] on revising the hedge accounting requirements in IAS 39.[3] The DP is part of the FASB's ongoing project to improve and simplify the accounting requirements for financial instruments, including hedging activities, and its efforts to work toward convergence of global accounting standards. The FASB intends to consider constituents' views on the IASB's proposals during its redeliberations of the hedge accounting provisions in its proposed Accounting Standards Update (ASU) on financial instruments.[4] The FASB also will participate in the IASB's discussions and redeliberations of the ED.

See the appendix of this *Heads Up* for a comparison between the hedging model in the FASB's proposed ASU and that in the IASB's ED.

Editor's Note: For more information about the FASB's proposed ASU and the IASB's ED on hedge accounting, see Deloitte's May 28, 2010, and December 22, 2010, *Heads Up* newsletters.

The FASB's DP incorporates the ED and includes additional questions for respondents that focus on provisions of the ED that differ significantly from U.S. GAAP. The DP also requests feedback on whether certain provisions of the ED are operational. The comment deadline is April 25, 2011, for the FASB's DP and March 9, 2011, for the IASB's ED. Constituents are encouraged to comment on both documents.

Highlights of the IASB's Proposal

- The ED proposes a new hedge accounting model that relies on the risk management objectives of an entity as the basis for hedge accounting.
- The proposed rules regarding what items can qualify for hedge accounting, what instruments can be designated in hedging relationships, and the effectiveness requirement are generally more relaxed.
- The assessment of hedge effectiveness would be limited to a forward-looking test without a bright-line threshold (i.e., no 80–125 percent offset requirement and no retrospective hedge effectiveness test). In many cases, this assessment would be qualitative; however, a quantitative measurement could be necessary in some circumstances.
- Voluntary dedesignation of a hedging relationship would not be permitted; a hedge could be discontinued only when it no longer meets the qualifying criteria.

1 FASB Discussion Paper, *Selected Issues About Hedge Accounting.*
2 IASB Exposure Draft, *Hedge Accounting.*
3 IAS 39, *Financial Instruments: Recognition and Measurement.*
4 FASB Proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities.*

Appendix — Hedge Accounting

The following table summarizes similarities and differences between the FASB's hedging model under the proposed ASU and the IASB's ED on hedge accounting:

Subject	FASB's Proposed ASU	IASB's ED on Hedge Accounting
Hedged Items		
Ability to designate as the hedged item an exposure that contains a freestanding derivative	Not permitted.	A combination of an exposure (e.g., a recognized nonderivative asset or liability) and a derivative could be designated jointly as a hedged item.
Risk components	The proposed ASU retains the provision under current U.S. GAAP (ASC 815[5]) that allows an entity to designate hedges of **financial** items for certain risks (e.g., benchmark interest rate risk, foreign currency risk, credit risk). Component hedging of **nonfinancial** items not permitted (except for foreign currency risk in a cash flow hedge).	ED aligns the requirements for eligible risk components for both financial and nonfinancial items. Risk components of any item would be eligible for hedge accounting provided that the risk component is (1) separately identifiable and (2) reliably measurable.
Groups and net positions	Hedges of net positions not permitted.	Permits groups of individually eligible hedged items to be hedged collectively as a group, provided that the group of items is managed together for risk management purposes. Such groups may be net positions (certain conditions apply to cash flow hedges).
Hedging Instruments		
Time value of financial options	No changes to ASC 815. If intrinsic value of the option is designated as a hedge, the time value is recognized in earnings. If option time value is included in the hedge, an entity can defer time value in OCI when certain conditions are met.	Proposes a two-step approach to accounting for time value of options: *Step 1* — Defer in OCI an amount of fair value change of the time-value component (on the basis of a hypothetical option that has matched terms to the hedged item). *Step 2* — Reclassify amounts from OCI to profit or loss or to the basis of the hedged item, depending on whether the hedged item is transaction-related or period-related.
Nonderivative financial instruments	Not permitted except for certain foreign currency hedges.	Permits nonderivative financial instruments classified as FVTPL as qualifying hedging instruments (except for certain written options).
Effectiveness Assessment		
Effectiveness threshold	Reasonably effective.	Hedging relationship must achieve "other-than-accidental offset" and meet the objective of hedge effectiveness assessment (i.e., minimize expected hedge ineffectiveness).
Means of assessing effectiveness (quantitative versus qualitative)	Typically, only a qualitative assessment is required; however, a quantitative assessment may be necessary if the qualitative assessment is not conclusive.	No specific requirement for a quantitative assessment; qualitative assessment may be sufficient in some cases.
Frequency of hedge effectiveness assessments	Inception only, unless reassessment is warranted because of a change in circumstances.	An entity would need to determine that a hedging relationship meets the hedge effectiveness requirements at inception and then on an ongoing basis (at a minimum, each reporting period or upon a significant change in circumstances).
Ineffectiveness Measurement		
Determination of amounts recorded in AOCI for cash flow hedges	Eliminates the "lower of test" in ASC 815. Recorded at the amount necessary to offset the present value of the cumulative change in expected future cash flows on the hedged transaction since hedge inception, less any amounts previously reclassified.	Retains the "lower of test" in IAS 39.

[5] FASB Accounting Standards Codification Topic 815, *Derivatives and Hedging.*

Subject	FASB's Proposed ASU	IASB's ED on Hedge Accounting
Cash Flow Hedge — Mechanics		
Basis adjustment	No changes to ASC 815 requirements. Amount is reclassified from OCI to earnings when the hedged transaction affects earnings.	Eliminates the option in IAS 39, which permits an entity to either adjust the basis of the hedged nonfinancial item (when the forecasted transaction is recognized) or reclassify amounts from AOCI to profit or loss, when the hedged items affect earnings. The ED requires an entity to apply a basis adjustment when the forecasted transaction is recognized.
Fair Value Hedge — Mechanics		
Changes in fair value of hedged item — balance sheet impact	No changes to ASC 815. Changes in fair value of the hedged item are recorded as an adjustment to the carrying value of the hedged item.	Changes in fair value of the hedged item are reported in a separate line item on the balance sheet. Carrying value of the hedged item is not adjusted.
Changes in fair value of hedged item and hedging instrument — income statement impact	No changes to ASC 815. Changes in fair value of the hedged item and the hedging instrument are recorded in the income statement.	Changes in fair value of the hedged item and the hedging instrument are recorded in OCI, with any hedge ineffectiveness recognized in profit or loss.
Dedesignation		
Voluntary dedesignation of a hedging relationship	An entity cannot voluntarily remove hedge designation after it has been established; however, the entity may enter into an offsetting derivative to effectively terminate the hedge.	An entity cannot voluntarily remove hedge designation after it has been established; however, partial dedesignation and rebalancing may be required.

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