

Potential Counterparty Default and Other Accounting Considerations Related to the Credit-Market Turmoil

Financial Reporting Alert 08-14

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Introduction

This Alert addresses the impact that recent market events, such as the bankruptcy of Lehman Brothers Holdings Inc. and the credit-standing deterioration of other financial institutions, may have on an entity's financial statements. This alert focuses on the following:

- The impact of possible counterparty default on an entity's derivative contracts that are (1) designated as hedging instruments in cash flow or fair value hedging relationships and/or (2) accounted for under the normal purchases and normal sales exception criteria defined in Statement 133,¹ as amended.
- Other accounting considerations associated with counterparty default (or potential default), highlighted in [Appendix A](#) below.
- Other accounting considerations arising from the current turmoil in the credit markets, highlighted in [Appendix B](#) below.

Although this Alert highlights a number of items preparers and auditors should consider, it is neither a comprehensive checklist nor a complete analysis. Organizations should consider their own facts and circumstances and monitor ongoing developments to determine the impact of market conditions on their financial statements. Consultation with independent accountants also may be advisable in certain circumstances.

Hedge Accounting

Hedge Effectiveness Assessment — For a relationship to qualify for hedge accounting, the hedging derivative must be highly effective in offsetting changes in the fair value or cash flows of the hedged item. The effectiveness of the hedging relationship must be established at hedge inception, and after inception an entity must assess hedge effectiveness both retrospectively and prospectively whenever financial statements or

earnings are reported, and at least quarterly.² Implementation Issue E7³ clarifies that the assessment “can be based upon regression or other statistical analysis of past changes in fair values or cash flows *as well as on other relevant information*” (emphasis added).

Implementation Issue G10⁴ indicates that an entity must consider the possible impact of counterparty default, i.e., noncompliance with the contractual terms of the contract, when assessing whether a hedging relationship continues to be highly effective. The Issue notes that in making this assessment, “the entity should also consider the impact of any related collateralization or financial guarantees.” In addition, in its assessment of the effectiveness of a hedging relationship, if an entity concludes that “the likelihood that the counterparty [to the hedging derivative instrument] will not default ceases to be probable,” the hedging relationship no longer would qualify for hedge accounting. The entity must treat the identified risk of counterparty default as “other relevant information” that cannot be ignored when it makes the effectiveness assessment. This qualitative evidence would outweigh any quantitative assessment that may still indicate that the hedging relationship is still highly effective (e.g., a regression analysis based on historical data).

In such circumstances, it would not be appropriate for the entity to apply hedge accounting for any period after the date as of which the hedging relationship was last assessed as being highly effective. Typically, this would be the end of the preceding reporting period (i.e., the end of the last quarter) unless the entity can identify the “event or change in circumstances that caused the hedging relationship to fail the effectiveness criterion” pursuant to Statement 133. If the specific triggering event that caused the hedge to become ineffective can be identified, **and** if the entity performed an effectiveness assessment as of the date before the trigger date that indicates that the hedging relationship was highly effective through that date, hedge accounting may be applied up to the date **immediately before the trigger date**. Application of hedge accounting at or beyond the trigger date would not be appropriate.

Upon cessation of the hedging relationship, the entity would continue to record the former hedging derivative at fair value, with any subsequent changes in fair value recorded in earnings. For hedging relationships that previously qualified as fair value hedges, previous hedge adjustments made to the carrying amount of the hedged item would be accounted for in the same manner as other components of the hedged item’s carrying amount. For example, an adjustment of the carrying amount of a hedged asset held for sale (such as inventory) would remain part of the hedged item’s carrying amount until it is sold and recognized as part of the cost of sales, whereas adjustments to the carrying amount of a hedged interest-bearing asset would be amortized to earnings. For previous cash flow hedges, the amount recorded in accumulated other comprehensive income (AOCI) would remain there and not be reclassified into earnings until the forecasted transaction affects earnings unless it becomes probable that the forecasted transaction or cash flow will no longer occur by the end of the originally specified period (or within an additional two months after the specified period).

Even if an entity concludes that it still is probable that the counterparty to the hedging derivative will not default, the entity still must separately assess the impact of a change in the counterparty’s creditworthiness on hedge effectiveness. See [Financial Reporting Alert 08-8, Consideration of Credit Risk in Fair Value Hedge Effectiveness Assessments](#).

Forecasted Transactions — Implementation Issue G10 also states that when an entity evaluates its cash flow hedging relationships, it must also consider the creditworthiness of the counterparty to the hedged forecasted transaction when assessing whether the

occurrence of that forecasted transaction is probable. This is especially important when the hedged transaction involves the counterparty's obligation to make contractual payments. A forecasted transaction whose occurrence is not probable cannot be designated as the hedged item in a cash flow hedge.

Normal Purchases and Normal Sales Scope Exception

Statement 133 states that "forward contracts that contain net settlement provisions . . . are not eligible for the normal purchases and normal sales exception unless it is probable at inception and throughout the term of the individual contract that the contract will not settle net and will result in physical delivery." In assessing whether continued application of the normal purchases and normal sales (NPNS) scope exception is appropriate, an entity must consider whether facts and circumstances suggest that the counterparty to the contract may net settle the contract, negotiate an early settlement to the contract, or otherwise reach an outcome that indicates that it no longer is probable that the contract will result in physical delivery.

A contract that no longer qualifies for the NPNS exception that still meets the definition of a derivative would need to be recorded at fair value in the entity's financial statements, with an offsetting entry to current period earnings, unless the entity has legally been relieved of its rights and obligations under the contract. As with other derivatives, subsequent changes in the fair value of the contract would be recognized in earnings.

If the contract is later assigned to another creditworthy party and physical delivery becomes probable, it may be possible for the entity to redesignate the contract as a NPNS contract. In such a case, the carrying value of the contract would no longer be adjusted for changes in its fair value. Implementation Issue A18⁵ clarifies that "the carrying amount of that contract becomes its cost basis and the entity should apply other generally accepted accounting principles that are applicable to that contract prospectively from the date that the contract ceased to be a derivative." Typically, the carrying amount of the derivative would become an adjustment to the cost basis of the asset purchased under the contract or an adjustment to the cost of sales of an asset sold under the contract.

Disclosure Requirements

An entity should provide disclosures that clearly indicate the current and future financial statement effects of the event(s) that caused hedging relationships to fail the effectiveness criterion. Specific disclosure should be provided for any material gain or loss that is recognized because of the discontinuance of hedge accounting. In addition, paragraphs 44 and 45 of Statement 133 require additional disclosures for fair value and cash flow hedging relationships that may be relevant in these situations, including:

- For fair value hedges, the "amount of net gain or loss recognized in earnings when a hedged firm commitment no longer qualifies as a fair value hedge."
- For cash flow hedges:
 - "A description of the transactions or other events that will result in the reclassification into earnings of gains and losses that are reported in accumulated other comprehensive income, and the estimated net amount of the existing gains or losses at the reporting date that is expected to be reclassified into earnings within the next 12 months."
 - "The amount of gains and losses reclassified into earnings as a result of the

discontinuance of cash flow hedges because it is probable that the original forecasted transactions will not occur by the end of the originally specified time period or within [an additional two months].”

An entity also should ensure that it provides appropriate MD&A disclosure in its financial statement filings.

Example

Facts

On January 2, 2008, GasCo entered into a forward contract with TraderCo to sell gas at a fixed price in one year. The contract meets the definition of a derivative and is designated in a fair value hedging relationship as a hedge of GasCo’s gas inventory. Every quarter, GasCo assesses the effectiveness of this hedging relationship on the basis of regression analysis (both prospectively and retrospectively). The forward contracts with TraderCo are typically net settled (GasCo does not deliver the gas). As of June 30, 2008, the derivative was in a \$1 million gain position for GasCo, and GasCo appropriately recorded the derivative at its fair value. On September 15, 2008, because of the sudden deterioration in the credit rating of TraderCo, GasCo does not believe it will be able to fully collect under the derivative (and because of the credit concerns, the fair value of the derivative decreases to \$250 thousand).

Question

If the regression analysis performed as of September 30, 2008, indicates that the hedge has been highly effective, may hedge accounting be applied in the quarter ended September 30, 2008, and prospectively?

Response

No. If the likelihood that an entity will not default ceases to be probable, the hedging relationship ceases to qualify for hedge accounting prospectively, and the carrying amount of the hedged item shall not be adjusted as of the last time compliance with the effectiveness criterion was established (generally the last assessment date, which is June 30, 2008, in this example). However, if GasCo can identify the date of the event or change in circumstances that caused the likelihood of TraderCo’s not defaulting to cease being probable (the “trigger date”), and if GasCo performed an assessment of effectiveness as of the date before the trigger date that indicates that the hedging relationship was highly effective through that date, hedge accounting may be applied (i.e., the hedged item may be adjusted for changes in its fair value because of changes in the risk being hedged) up to the date immediately before the trigger date.

Appendix A — Other Considerations Associated With the Risk of Counterparty Default on a Contractual Arrangement

The table below notes other areas of accounting that could be affected when there is a risk that a counterparty to a contractual arrangement could default. Fundamental to any analysis of possible accounting ramifications is an entity’s assessment and inventory of its exposures to counterparties at risk. Such exposures may be direct (e.g., an investment in a security issued by an entity in financial distress) or indirect (e.g., an investment in a mutual fund that is heavily invested in securities issued by an entity in financial distress).

Topic	Considerations
Applying Hedge Accounting to Forecasted Debt Issuances	The level of liquidity in the credit markets may call into question an entity's ability to assert that occurrence of its forecasted debt issuance is probable.
Fair Value Measurements/Hierarchy Classification	<p>For transactions with entities or affiliates in financial distress, it is important to understand the legal status of the specific counterparty to the entity's contracts. For example, is the counterparty bankrupt? Does the bankruptcy of an affiliate of the counterparty trigger the default provisions of the contractual arrangement?</p> <p>An entity also should assess whether:</p> <ul style="list-style-type: none"> • Potential counterparty default would affect the entity's master netting or collateral agreements and the valuation of its derivatives. That is, would the provisions of those agreements be triggered by the bankruptcy or default of the counterparty or its affiliates? What are the accounting implications of those provisions? • The pricing inputs used to measure fair value of the contract represent inputs in an active or inactive market. • Transactions with a defaulted counterparty represent forced or distressed transactions. • The creditworthiness or legal status of the counterparty trigger transfers between categories in the Statement 157 fair value hierarchy (e.g., transfer between Level 2 and Level 3). <p>An entity also should consider the recent guidance released by the SEC staff and the FASB, which was discussed in proposed FASB Staff Position (FSP) No. FAS 157-d, "Determining the Fair Value of a Financial Asset in a Market That Is Not Active," and in Deloitte's Financial Reporting Alerts 08-11, SEC and FASB Release Fair Value Clarifications, and 08-12 (Revised), FASB Votes to Issue Proposed Staff Position Clarifying Fair Value Measurement Guidance.</p>
Transfers and Servicing of Financial Assets and Extinguishments of Liabilities	<p>If an entity in financial distress is the counterparty to a repurchase or dollar roll arrangement:</p> <ul style="list-style-type: none"> • For open contracts, what are the accounting implications of the settlement terms embedded in the default provisions of the contractual arrangements? • What is the impact of possible default on recognition and valuation of collateral posted for these arrangements? • Has it been determined whether the transferor in these transactions has given up effective control?

Appendix B — Other Considerations Related to the Current Economic Environment

The table below notes some important accounting issues that preparers should also consider in light of the current economic environment.

Topic	Considerations
Goodwill and Intangible Assets	A decline in the price of an entity's equity securities may indicate an

	<p>impairment of the entity’s goodwill and indefinite-lived intangible assets. Statement 142⁶ states that goodwill of a reporting unit should “be tested for impairment between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount.” A decline in the quoted market price of an entity’s equity securities, and thus its market capitalization, could be viewed as an indicator of possible impairment that would require the entity to test goodwill for impairment at a date other than the annual testing date.</p> <p>Statement 142 provides similar guidance for impairment tests of indefinite-lived intangible assets. Deteriorating market conditions could give rise to indicators of impairment that would require the entity to perform an impairment test before its annual testing date.</p>
Other-Than-Temporary-Impairment	The current economic environment continues to require entities to focus on whether impairment of certain investments is other than temporary.
Consolidation Considerations (FIN 46(R) and Reconsideration Events)	<p>The filing of bankruptcy or default of an enterprise with an interest in a previously determined variable interest entity (VIE) could cause other interest holders in the VIE to reassess whether they are the primary beneficiary of the VIE under paragraph 15 of Interpretation 46(R).⁷ The primary beneficiary of a VIE consolidates the VIE.</p> <p>Interpretation 46(R) requires an enterprise with an interest in a VIE to reconsider whether it is the primary beneficiary of the VIE if, for example, the following events occur:</p> <ul style="list-style-type: none"> • A change in “the entity's governing documents or contractual arrangements . . . in a manner that reallocates between the existing primary beneficiary and other unrelated parties (a) the obligation to absorb the expected losses of the [VIE] or (b) the right to receive the expected residual returns of the [VIE].” • The acquisition by the enterprise of additional variable interests in the VIE.
Cash Flow Hedges of Choose-Your-Rate Debt	In applying cash flow hedge accounting to choose-your-rate debt, an entity may have designated the risk of changes in its cash flows attributable to changes in the designated benchmark interest rate as its hedged risk and ignored the rate optionality of the debt when assessing and measuring hedge effectiveness. In such cases, the accounting treatment was based on an assertion that the entity would always select a single benchmark interest rate at each interest reset date. Current market conditions may prompt an entity to select a different rate, which would make application of hedge accounting inappropriate for the reporting period in which the different rate was selected for this hedge and other similar hedges of choose-your-rate debt.
Going Concern/Liquidity	<p>Continued deterioration in the credit markets may present liquidity concerns for entities, such as the following:</p> <ul style="list-style-type: none"> • Credit rating/downgrades and market illiquidity may affect an entity’s ability to raise capital when needed. • The availability of lines/letters of credit may be affected if the lending institution is in financial distress. • Access to the commercial paper markets may be limited because of lack of demand.

	<ul style="list-style-type: none"> Declines in the value of investments offered as collateral may require posting of additional collateral.
Income Taxes	<p>Changes in recorded amounts of assets and liabilities without a corresponding change to the tax basis generally result in the recognition of a deferred tax liability or deferred tax asset. Entities should keep in mind that Statement 109⁸ requires deferred tax assets to be reduced by a <i>valuation allowance</i> "if, based on the weight of available evidence, it is <i>more likely than not</i> (a likelihood of more than 50 percent) that some portion or all of the deferred tax assets will not be realized. The valuation allowance should be sufficient to reduce the deferred tax asset to the amount that is more likely than not to be realized."</p> <p>An entity should carefully consider whether a valuation allowance is required. Future realization of the tax benefit of a tax asset ultimately depends on the existence of sufficient taxable income of the appropriate character (e.g., ordinary income or capital gain) within the appropriate period available under the tax law.</p>
Disclosures	<p>The credit crisis underscores the importance of providing comprehensive disclosures about (1) the effects of the current credit environment on an entity's financial position, results of operations, cash flows, and liquidity and (2) the potential exposures associated with this environment. Entities should consider information included in the following Deloitte Alerts:</p> <ul style="list-style-type: none"> Financial Reporting Alert 08-4, Turmoil in the Credit Markets: The Importance of Comprehensive and Informative Disclosures. Financial Reporting Alert 08-7, SEC Advises Registrants to Further Explain Fair Value in MD&A. Financial Reporting Alert 08-10, SEC Advises Registrants to Further Explain Fair Value in MD&A — An Addendum to the March 2008 SEC Letter.
Bailout Legislation	<p>The recently signed bailout law may raise additional accounting questions in a number of areas, including:</p> <ul style="list-style-type: none"> Income taxes. Loan impairments. Debt and equity securities. Derivatives and hedge accounting. Transfers and servicing of financial assets. Fair value measurements. <p>Entities should review the provisions of the law for possible accounting ramifications and watch for additional guidance.</p>

¹ FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

² See paragraphs 20(b) (fair value hedges) and 28(b) (cash flow hedges) of Statement 133; see Implementation Issue E7.

[3](#) Statement 133 Implementation Issue No. E7, "Hedging — General: Methodologies to Assess Effectiveness of Fair Value and Cash Flow Hedges."

[4](#) Statement 133 Implementation Issue No. G10, "Cash Flow Hedges: Need to Consider Possibility of Default by the Counterparty to the Hedging Derivative."

[5](#) Statement 133 Implementation Issue No. A18, "Definition of a Derivative: Application of Market Mechanism and Readily Convertible to Cash Subsequent to the Inception or Acquisition of a Contract."

[6](#) FASB Statement No. 142, *Goodwill and Other Intangible Assets*.

[7](#) FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities*.

[8](#) FASB Statement No. 109, *Accounting for Income Taxes*.

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