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TREND ALERT

The Hocus Pocus of Hedge Accounting - Now you see it, will you see it again?

Hedge accounting is governed by a very detailed set of rules and multiple sources of guidance, hence some of the problems faced by companies and their auditors. However, based on some of the reasons for restatement, it appears companies actually failed on some of the simpler aspects of the standard.

Key issues investors should be aware of are:

- Hedge accounting allows companies to reduce earnings volatility through the use of derivative instruments.
- We identified 40 companies (with market caps over $100M) that had hedge accounting restatements in 2005.
- The main reasons for restating were:
    - Incorrect application of the "shortcut" method
    - Hedge accounting requirements not met
    - Improper documentation.

The restatements had differing effects on companies, from a potential earnings decline of over **$10B** in the case of **Fannie Mae**,[1] to a cumulative **$4K** earnings increase in the case of **Glenborough Realty Trust**.

As companies re-examine their hedge accounting, it is possible other restatements may be coming. We therefore urge investors to take a closer look at companies with significant exposure to hedge accounting, before making their investment decisions.

To better understanding the likelihood of a potential restatement and its implications for a company's reported earnings and cash flows, we believe investors should ask management questions such as:

- Is the company using the "shortcut" method of accounting for hedges and if so, have they met all of the criteria for its use? (A response that is limited to saying the auditors consented may be insufficient as the auditors consented to other companies that are now restating).

- How does the company determine if its hedges are highly effective from both a business risk management and accounting perspective? (Our recent Brief Alert on American Airlines and restatements at Fannie Mae highlight concerns that can occur when without notice, investors learn what was supposedly effective turns out to be ineffective. If hedges are not effective for accounting purposes, it is also highly likely they are not effective in mitigating business risk. Furthermore, derivatives that are not effective in mitigating risk, but accounted for as hedges, may result in losses being deferred in the equity section of the balance sheet rather than being recorded in current earnings. Large unrecorded losses in the equity section of the balance sheet in other comprehensive income could potentially be a red flag, as it was at Fannie Mae.)

- What risk management procedures and controls does the company have to (1) ensure derivatives used to manage risk are effective during the duration of the contract and (2) ensure any losses incurred are reported on a timely basis? Has the audit committee reviewed those procedures and controls in the past two years?

[1] Fannie Mae announced its restatement in 2004, but it has not yet been completed. We include Fannie Mae to illustrate the potential effect of a hedge accounting restatement.

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Background

Some companies and their finance executives appear to be incapable of following published accounting rules. In the early to mid 1990's companies took "big bath" restructuring charges including (literally) in some cases the kitchen sink. In the late 1990's companies improperly wrote off large amounts of the price they paid for acquisitions to avoid the future expense associated with acquired intangible assets. In 2004 and 2005, close to 300 companies that failed to follow black and white lease accounting rules that were 30 years old, had to correct the related errors in their financial statements. All of this with the blessing of "independent" auditors.

In the latest rendition of this hocus pocus type accounting we are seeing "hedge" accounting disappear before investors' very eyes. The reason why? Some companies once again with the blessing of their auditors have improperly applied the rules governing accounting for financial instruments and derivatives such as interest rate swaps. As a result, we have seen numerous companies cease using "hedge" accounting they have previously used, and which tends to decrease volatility in reported numbers.

"Hedge accounting" refers to how a company accounts for financial instruments such as interest rate swaps that are used to match and offset the changes in assets or liabilities a company has. For example, a company may owe debt that has variable interest rate payments due. To avoid the potential impact of increasing interest payments and expense in the future, a company may reduce that risk by entering into an interest rate swap that pays the company a variable interest rate and on which the company pays the counter party a fixed rate.

The accounting rules, namely Financial Accounting Standard (FAS) No. 133, *"Accounting for Derivative Instruments and Hedging Activities,"* FAS 138, *"Accounting for Certain Derivative Instruments and Certain Hedging Activities-an amendment of FASB Statement No. 133,"* FAS 149, *"Amendment of FAS 133 on Derivative Instruments and Hedging Activities,"* and the Derivatives Implementation Group's *"Guidance on Statement 133 Implementation Issues"* permit a company to use hedge accounting when:

1. The changes in the value of the derivative match and offset or "hedge" those of the asset, liability or transaction being hedged.

2. The Company determines and demonstrates at the outset of the hedge, that the change in the value of the derivative is "highly effective." That is, the change in value of the derivative is within a range of 80% to 125% of the change in value of the hedged item.

3. The company engages in an appropriate business and risk management process of actually documenting the derivative to be considered a hedge at the outset and throughout the life of the derivative contract.

The FASB accounting rule is based on the simple principle that derivatives should be marked to market with the change in value being recorded in earnings. However, it does permit the more complex hedge accounting whereby the changes in value (gains or losses) of a derivative are recorded either in earnings or as a component of other comprehensive income, depending on the type of hedge (*See Appendix A*). But to prevent abuses, hedge accounting, which is considered an exception to the basic principle of FAS 133, is only permitted if strict criteria are met and fully complied with. As noted above, one of the criteria is, the company must determine the hedge is effective in offsetting the risk to the company. (Intra company risk, for example, contracts between subsidiaries that do not create a risk to the consolidated company do not qualify for hedge accounting).

The effectiveness of hedges in general, must be determined on a contract by contract basis. However, the FASB provided yet another exception to the fundamental principle and permits a "shortcut" method to determining effectiveness when using an interest rate swap to hedge, if certain specific criteria are met. These criteria in paragraph 68 of FAS 133 are:

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Conditions applicable to both fair value hedges and cash flow hedges

1. The notional amount of the swap matches the principal amount of the interest-bearing asset or liability being hedged.

2. If the hedging instrument is solely an interest rate swap, the fair value of the swap at its inception is zero. There are other applicable conditions if the instrument is a compound derivative composed of an interest rate swap and an option.

3. The formula for computing net settlements under the interest rate swap is the same for each net settlement. (That is, the fixed rate is the same throughout the term, and the variable rate is based on the same index and includes the same constant adjustment or no adjustment.)

4. The interest-bearing asset or liability is not prepayable, unless the asset or liability is prepayable solely due to an embedded option and the hedging instrument is a compound derivative composed of an interest rate swap and an option.

5. The index on which the variable rate is based matches the benchmark interest rate designated as the interest rate risk being hedged for that hedging relationship.

6. Any other terms in the interest-bearing financial instruments or interest rate swaps are typical of those instruments and do not invalidate the assumption of no ineffectiveness.

Conditions applicable to fair value hedges only

1. The expiration date of the swap matches the maturity date of the interest-bearing asset or liability.

2. There is no floor or cap on the variable interest rate of the swap.

3. The interval between repricings of the variable interest rate in the swap is frequent enough to justify an assumption that the variable payment or receipt is at a market rate (generally three to six months or less).

Conditions applicable to cash flow hedges only

1. All interest receipts or payments on the variable-rate asset or liability during the term of the swap are designated as hedged, and no interest payments beyond the term of the swap are designated as hedged.

2. There is no floor or cap on the variable interest rate of the swap unless the variable-rate asset or liability has a floor or cap. In that case, the swap must have a floor or cap on the variable interest rate that is comparable to the floor or cap on the variable-rate asset or liability. (For this purpose, comparable does not necessarily mean equal. For example, if a swap's variable rate is LIBOR and an asset's variable rate is LIBOR plus 2 percent, a 10 percent cap on the swap would be comparable to a 12 percent cap on the asset.)

3. The repricing dates match those of the variable-rate asset or liability.

One of the criteria requires that the value of an interest rate swap be zero at its inception. Accordingly, it is clear in black and white in the published rule that when a premium is paid for a swap, it does not qualify for the shortcut method. Yet as noted later in this report, numerous companies have flaunted this rule, too often with the blessing of their auditors. We understand regulators have become aware of this abuse, and are properly focusing on it and getting it corrected.

We note that when FAS 133 first became effective in 2000, the SEC staff cautioned companies to correctly apply the new standard. In fact companies were given extra time to apply the new standard to ensure an effective

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implementation. Notwithstanding that, beginning in early 2001 and perhaps culminating with Fannie Mae, the SEC staff required companies to restate their financial statements when they failed to demonstrate and document the derivatives were in fact being used as effective hedges.

Current concerns regarding the use of hedge accounting

We question whether some companies have deliberately disregarded accounting rules in order to apply hedge accounting and reduce earnings volatility. Recently a number of companies have announced restatements due to improper hedge accounting. It is possible other companies may have similar problems that have not yet been discovered or reported.

Many companies use some form of derivative instrument to protect their assets against market forces such as interest rate and commodity price changes. Companies also use derivatives to protect against liabilities, such as the risk of increasing interest payments on floating interest rate debt. Certain companies tend to have a higher proportion of assets and liabilities for which they need to protect against market risks. These include financial institutions, companies in the energy and mining sectors, and companies that deal in commodities. Investors should monitor companies that make significant use of hedge accounting as improper application could materially impact earnings.

Financial statements should provide investors with adequate disclosures to properly assess a company's financial position. However, in many instances companies' present disclosures of derivatives in a manner that makes it difficult, if not impossible, for investors to analyze material risks to the company. We urge investors to discuss hedge accounting disclosures with management, as this is one area which usually presents challenges in analyzing a company's financial position.

Companies (with market caps over $100M) that recently announced restatements related to hedge accounting are shown in the table below. These restatements have been noted in Glass Lewis brief alerts. As the table shows, the impact on a company's earnings can be quite significant (Fannie Mae) or immaterial (Glenborough Realty Trust). The table also shows increased earnings for some companies, and decreases for others. This speaks to the volatile nature of financial instruments, and their potential impact on a company's earnings.

Hedge accounting restatements 2005

Ticker		Derivative	Reasons for restating	Effect/Potential effect on earnings
TAYC	Taylor Capital Group	Interest rate swaps	Improper application of short-cut method	Decrease of $1M
CLFC	Center Financial Corporation	Interest rate swaps	Improper application of short-cut method	Increase of $0.2M
TSFG	South Financial Group	Interest rate swaps	Improper application of short-cut method	Decrease of $15M
PBKS	Provident Bankshares	Interest rate swaps	Improper application of short-cut method	Decrease by $0.7M
PULB	Pulaski Financial Corp	Interest rate swaps	Improper application of short-cut method	Decrease by $0.5M
MBI	MBIA	Interest rate swaps	Improper application of short-cut method	Increase by $6.8M
CIT	CIT Group	Cross-currency interest rate swaps	Improper application of short-cut method	Increase by $37.5M

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Hedge accounting restatements 2005 (cont'd)

Ticker	Company	Derivative	Reasons for restating	Effect/Potential effect on earnings
GE	General Electric	Interest rate and currency swaps	Improper application of shortcut method	Increase by $538M
KRC	Kilroy Realty Corporation	Interest rate swaps and caps	Requirements for hedge accounting not met	Increase by $4.2M
PETDE	Petroleum Development Corporation	Futures and options contracts	Requirements for hedge accounting not met	Decrease by $2M
SBCF	Seacoast Banking Corporation of Florida	Interest rate swaps	Requirements for hedge accounting not met	Decrease by $0.2M
FNM	Fannie Mae	Interest rate swaps Swaptions Interest rate caps Forward contracts Currency swaps	Requirements for hedge accounting not met	Decrease of $11B
CEN	Ceridian Corporation	Interest rate and fuel price contracts	Requirements for hedge accounting not met	Increase by $38M
LCC	U.S. Airways/America West Airlines	Fuel price contracts	Requirements for hedge accounting not met	No impact
NU	Northeast Utilities	Futures and swaps	Requirements for hedge accounting not met	Decrease by $46M
ABBC	Abington Community Bancorp	Interest rate swaps and caps	Requirements for hedge accounting not met	Decrease by $0.4M
CTCI	CT Communications	Interest rate swaps	Requirements for hedge accounting not met	Decrease by $0.1M
SPP	Sappi Ltd	Not disclosed	Requirements for hedge accounting not met	Decrease by $1M
AIG	American International Group	Interest rate swaps Cross currency swaps Forward contracts	Improper documentation	Increase of $500M
AMTD	Ameritrade	Embedded collars in forward contracts	Improper documentation	Decrease by $10M

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Hedge accounting restatements 2005 (cont'd)

Ticker	Company	Derivative	Reasons for restating	Effect/Potential effect on earnings
UMH	United Mobile Home	Interest rate swaps	Improper documentation	Decrease by $0.3M
OMG	OM Group	Not disclosed	Improper documentation	Increase by $0.1M
MHL	MortgageIT Holdings	Interest rate swaps, caps and forward sales commitments	Improper documentation	Decrease by $0.1M
IPX	Interpool	Interest rate swaps	Improper documentation	Increase by $0.1M
IMH	Impac Mortgage Holdings	Forward contracts	Improper documentation	Decrease by $85M
ADG	Allied Defense Group	Foreign currency exchange contracts	Improper documentation	Decrease by $23M
IPR	International Power	Interest rate swaps	Improper documentation	Increase by $11M
GLB	Glenborough Realty Trust	Interest rate cap	Improper documentation and recording of derivative fair value	Increase of $4K
ECR	ECC Capital Corporation	Interest rate swaps	Incorrect valuation	Increase by $6M to $8M
CFNL	Cardinal Financial	Not disclosed	Incorrect valuation	Not disclosed
SWS	SWS Group	Embedded option in subordinated debt	Incorrect valuation	Increase by $3M
CELG	Celgene Corporation	Warrants	Derivative instrument not accounted for as derivative	Increase by $22M
BVC	Bay View Capital	Interest rate caps	Derivative instrument not accounted for as derivative	Increase by $0.4M
WGR	Western Gas Resources	Gas storage and transportation contracts	Instruments do not meet definition for derivative classification	Decrease by $20M
SEO	Stora Ensa	Not disclosed	Recorded fair value of derivative instead of change in fair value	Decrease by $178M
LBTYA	Liberty Media	Embedded derivatives in Convertible Debt	Embedded derivative not separately accounted for	Increase by $14M
SCO	Scor	Forward exchange contract	Mark-to-market adjustment recorded twice	Decrease by $29M

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Hedge accounting restatements 2005 (cont'd)

Ticker	Company	Derivative	Reasons for restating	Effect/Potential effect on earnings
GGY	General Geophysics	Embedded option in convertible debt	Option not marked-to-mark	Decrease by $30M
AMCR	Amcor Ltd	Not disclosed	Error in calculating the effective hedge of a net investment	Increase by $0.5M
HT	Hersha Hospitality	Interest rate swaps	Instrument not timely designated as hedge	Decrease by $0.1M
NTR	New York Mortgage Trust	Not disclosed	Not disclosed	Increase by $0.1M

Note: Apart from Fannie Mae, this list includes companies that restated in 2005. It does not include companies that announced a restatement in 2005 but have not yet filed their restated financial statements.
Note: Fannie Mae announced its restatement in 2004, but it has not yet been completed. We include Fannie Mae to illustrate the potential effect of a hedge accounting restatement
Note: Companies are grouped according to the reason for restatement
Note: AIG's restatement included other accounting errors which negatively impacted earnings.

The proper use of hedge accounting can reduce volatility in a company's earnings. Changes in fair value of the derivative and the hedged asset offset each other. If a derivative is ineffective in offsetting changes in the hedged asset or anticipated transaction, companies are required to record the ineffectiveness in income, which increases earnings volatility. If a derivative does not qualify for hedge accounting, earnings volatility may be substantially increased. Investors do not usually regard earnings volatility favorably, and this may have led some companies to use hedge accounting without the instruments meeting the appropriate criteria.

Recent publicized restatements related to hedge accounting include Fannie Mae and American International Group (AIG). Fannie Mae developed its own methodology for determining whether hedge accounting was appropriate, which was contrary to FAS 133. In AIG's case the derivatives were not properly matched with the underlying asset and the required documentation as to the effectiveness of this matching was improper. Both companies mainly used interest rate swaps as their hedge instrument. An interest rate swaps is one of the most widely used derivatives and FAS 133 provides extensive guidelines regarding its use as a hedge instrument. We believe companies of the size and resources of Fannie Mae and AIG should have been able to properly apply these guidelines.

The companies identified mainly restated due to improper use of the "short-cut" method, non-qualification of the transaction for hedge accounting and inadequate documentation. Use of the "short-cut" method allows a company to assume no hedge ineffectiveness in a hedging transaction and therefore no impact on earnings. Under the alternative "long-haul" method a company must account for hedge ineffectiveness in earnings, which may increase earnings volatility.

As noted earlier, companies must meet very specific criteria in order to use the "shortcut" method. The most frequent violation of the shortcut method is the requirement that the interest rate swap has a zero fair value at inception. At the recently concluded SEC and PCAOB conference, an SEC staff noted there have been instances where companies have applied the short-cut method without meeting all of the criteria listed in paragraph 68 of FAS 133. He referred to the guidance in Derivative Implementation Issue E-4 which requires all short-cut conditions to be met before the method maybe applied. Simply complying with the "spirit" or "principle" of the short-cut method is not acceptable.[1]

[1] Speech by Mark A. Northan, Professional Accounting Fellow, Office of the Chief Accountant, AICPA SEC and PCAOB Conference, December 5-7, 2005.

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We believe there may be other companies using the "short-cut" method which have not met all the criteria. Companies will be required by independent auditors or regulators to restate their financial statements if there is a material impact on earnings. It is important for investors to note companies may not apply hedge accounting during the period in which they improperly used the "short-cut" method. The "long-haul" method cannot be applied retroactively, even if the transaction qualified for its use.

While certain aspects of FAS 133 are complex, we believe the proper application of the shortcut criteria should not be that difficult for accountants with appropriate expertise. Paragraphs 20, 21, 28 and 29 of FAS 133 provide general guidelines regarding the requirements for hedge accounting and proper documentation (See Appendix B). Guidance related to specific financial instruments is further provided in the standard.

We believe other companies may be re-examining their hedge accounting in light of recent publicity surrounding the issue. We also understand accounting firms may have accepted this erroneous accounting and are now subject to increased regulatory scrutiny for doing so. There may be a pattern similar to the recent lease accounting restatements among retailers, as more companies discover they have not properly applied hedge accounting. Investors should take a closer look at companies with significant exposures to hedge accounting.

Investors should also monitor derivative disclosures claiming: "The ineffective portion of cash flow and fair value hedges were not material," as this may indicate the improper use of hedge accounting. Investors should further question companies with significant hedging activities and significant losses included in other comprehensive income. This is an indication of increased risk if a company has not formally documented and appropriately calculated the effectiveness of their respective derivatives. Given the number of errors in accounting for derivatives reported to date, we believe an increasing number of companies making these claims may need to restate their financial statements in the future.

Hedge accounting is governed by a very detailed set of rules and multiple sources of guidance, hence some of the problems faced by companies and their auditors. However, based on some of the reasons for restatement, it appears companies actually failed on some of the simpler aspects of the standard.

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Appendix A - Types of hedges and accounting for them

Hedge accounting refers to how a company accounts for derivatives used to offset changes in a company's assets or liabilities. Companies must account for derivatives as either assets or liabilities and measure them at fair value, with fair value changes recorded in earnings unless certain criteria are met. A derivative may be designated as:

1. A fair value hedge - a hedge of the exposure to changes in the fair value of an asset or liability.

2. A cash flow hedge - a hedge of the exposure to variable cash flows of a forecasted transaction, or,

3. A hedge of the foreign currency exposure of an investment in a foreign operation, an available-for-sale security, or a foreign-currency-denominated forecasted transaction. A hedge of an available-for-sale security is accounted for as a fair value hedge. A hedge of a foreign-currency-denominated transaction is accounted for as a cash flow hedge.

The accounting for changes in the fair value of a derivative (that is, gains and losses) depends on the intended use of the derivative and the resulting designation.

- For a fair value hedge, the gain or loss is recorded in earnings together with the offsetting loss or gain on the hedged item. Any gain or loss not offset by a loss or gain on the hedged item will therefore impact earnings.

- For a cash flow hedge, the effective portion of the derivative's gain or loss is initially reported as a component of other comprehensive income (does not impact earnings) and subsequently reclassified into earnings when the transaction is completed. The ineffective portion of the gain or loss is reported in earnings immediately.

- For a derivative designated as hedging the foreign currency exposure of an investment in a foreign operation, the effective portion of the derivative gain or loss is reported in other comprehensive income (does not impact earnings). The ineffective portion of the gain or loss is reported in earnings immediately.

Appendix B - Summary of criteria for hedge classification of derivatives

For Fair Value and Cash Flow Hedges

A derivative may be designated as a fair value or cash flow hedge if the following criteria are met:

1. At inception of the hedge, there must be formal documentation of the hedging relationship and the Company's risk management objective and strategy for undertaking the hedge. The Company must have a reasonable basis for assessing the derivative's effectiveness.

2. Both at inception of the hedge and on an ongoing basis the hedge is expected to be highly effective in offsetting changes in the hedged item. Hedge effectiveness must be assessed whenever financial statements or earnings are reported, and at least every three months. The effectiveness assessment must be consistent with the risk management strategy for the particular hedging relationship.

3. If a written option is designated as hedging an asset or liability, there must be at least as much potential for gain as there is for losses resulting from changes in the combined fair values of the hedged item and the written option.

In addition, for a cash flow hedge: If a derivative is used to exchange variable interest receipts or payments for other variable receipts or payments, the derivative must be a link between an existing designated asset (or group of similar assets) with variable cash flows and an existing designated liability (or group of similar liabilities) with variable cash flows and be highly effective at achieving offsetting cash flows.

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Source: Company 8-K (Section 4.02 filed in 2005), 10-K and 10-Q filings. Financial Accounting Standards133, 138, 149, and Derivatives Implementation Group's "Guidance on Statement 133 Implementation Issues."

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