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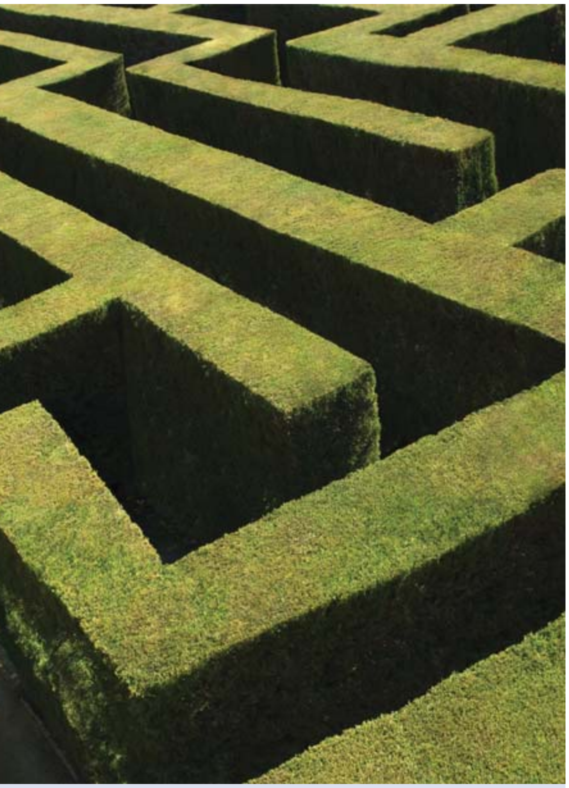

Alert

Proposed Guidance on Applying the "Shortcut Method" of Hedge Accounting

Companies will be required to evaluate previous and new hedges of interest rate risk, and fewer of them will qualify to use the simplified "shortcut method" of hedge accounting under Statement 133's requirements, if newly proposed guidance is adopted without change.[1] More companies may therefore need additional systems to track the data and the evaluations for far more demanding hedge accounting.

The proposed guidance is intended to clarify the requirements to apply the shortcut method. In the past, some companies have misapplied the shortcut method, resulting in restatements. The proposed remedy is to amend the requirements in paragraph 68 of Statement 133, the paragraph that presents the criteria for the shortcut method. A hedging relationship that does not meet the shortcut method criteria is disqualified from hedge accounting from the inception of the relationship. Hedging relationships that no longer qualify for the shortcut method under the proposed guidance would be subject to its transition provisions.

The proposed guidance would not preclude any hedging relationship from qualifying for hedge accounting. It would affect only whether the qualification may be achieved through the provisions of paragraph 68.

The Shortcut Method

The shortcut method refers to the simplified method of measuring and assessing hedge effectiveness permitted for those relationships that qualify under the criteria in paragraph 68 of Statement 133. The criteria may be applied only to hedging relationships of interest rate risk that involve an interest rate swap and a recognized interest-bearing financial asset or liability.

If the shortcut method cannot be applied, companies must document, at the inception of a hedging relationship and periodically thereafter, why they expect the relationship to be highly effective in offsetting changes in fair value or cash flows from the risk being hedged and

[1] FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities, June 1998, as amended, and related interpretations, and Proposed Statement 133 Implementation Issue No. E23, Issues Involving the Application of the Shortcut Method under Paragraph 68, July 23, 2007, all available at www.fasb.org.

how effectiveness will be assessed and measured. However, a company that meets the requirements for the shortcut method may assume no ineffectiveness. Thus, under the shortcut method, initial and ongoing effectiveness assessments are not necessary, and there is no measurement of ineffectiveness (which would otherwise be recorded in earnings).

The FASB included the shortcut method in Statement 133 as an exception in response to preparers and others who claimed that the requirements were overly burdensome for 'straightforward' hedges of interest rate risk. Its application was intended to be limited.

Terms of Swap and Asset or Liability

Statement 133's paragraph 68 sets as a criterion for the shortcut method that "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." Some have viewed this criterion as not having been met only when the terms were both "not typical" *and* "invalidated the assumption of no ineffectiveness." The proposed guidance would clarify that this criterion means the relationship does not qualify if such terms are "not typical" *or* "invalidate the assumption of no ineffectiveness" or both. The proposed clarification would likely reduce significantly the number of previous and new hedging relationships that qualify for application of the shortcut method.

An example in the proposal would introduce a requirement in fair value hedging relationships that the fair value of the interest-bearing asset or liability must equal its par value at the inception of the hedging relationship because amortizing that type of difference (a discount or premium) would create ineffectiveness. The example and the proposed guidance would disqualify from the shortcut method hedging relationships that begin subsequent to the initial recognition of an interest-bearing asset or liability or involve a zero-coupon asset or liability. However, a difference between the fair value and par value of the asset or liability would not invalidate the assumption of no ineffectiveness if the difference is a discount or premium attributable solely to the normal market convention of rounding the coupon rate of the asset or liability at issuance.

Hedging Interest Rate Risk on an Unsettled Interest-Bearing Asset or Liability

The proposal would allow companies to apply the shortcut method to a hedging relationship that is designated on the trade date of both the interest rate swap and the interest-bearing asset or liability even though the asset or liability is not recognized for accounting purposes until the transaction is settled. Debtors and investors often enter into at-market interest rate swaps on the date an interest-bearing asset or liability that is firmly committed to and priced is issued or purchased (i.e., the trade date), because that is the date the investor or debtor begins to be exposed to changes in interest rates. However, to qualify for application of the shortcut method, the interest-bearing asset or liability must be recognized for accounting purposes (which does not occur until the settlement date) at the inception of the relationship. The requirement for the interest-bearing asset or liability to be recognized for accounting purposes is inconsistent with the criterion that requires the fair value of the swap at the inception of the hedging relationship to be zero, and the proposed requirement for the fair value of the interest-bearing asset or liability to be equal to its par value (discussed above), both of which would not be met if the relationship could not be designated until the settlement date of the asset or liability. To address this situation, the proposed guidance states that a difference in the fair value of the asset or liability between its trade and settlement date would not disqualify the use of the shortcut method if the difference is in accordance with normal market terms and conventions.

Principal Pay-downs Prior to Maturity

Under Statement 133, in order to qualify for the shortcut method, the notional amount of the swap must match the principal amount of the interest-bearing asset or liability. Under the proposal, a hedging relationship that includes a principal amortizing interest-bearing asset or liability and a swap with a notional amount that amortizes to match the outstanding principal of the asset or liability would comply with the shortcut method criterion.

Interest Rate Swap with a Non-zero Fair value at Inception

Before Statement 157, the fair value of an interest rate swap that was entered into in an entity's principal market was generally considered the transaction price (which is an entry price).[2] Under Statement 157, the fair value of a swap at initial recognition is based on an exit price that likely would be other than zero because of a bid-ask spread. Statement 133's criteria for the shortcut method require the fair value of the swap at

[2] FASB Statement No. 157, Fair Value Measurement, September 2006, available at www.fasb.org.

inception to be zero. The proposed changes would allow a company to apply the shortcut method to a non-zero fair value on the swap at the inception of a hedging relationship if the swap was entered into at the inception of the relationship, the transaction price of the swap was zero in the company's principal market (i.e., most advantageous market), and the difference between the transaction price and fair value is attributable solely to differing prices within the bid-ask spread between the entry transaction and the hypothetical exit transaction. This guidance applies only to transactions considered at market (i.e., where the transaction price is zero exclusive of commissions and other transaction costs) with no embedded financing within the terms of the swap.

Effective Date and Transition

The proposed guidance would be effective on the first day of the first fiscal quarter beginning after the date the FASB-approved guidance is posted on the FASB website.

The proposal would require companies that adopt the guidance to assess previous hedging relationships to determine whether they met the new requirements as of the inception of the hedging relationship. Some companies would likely have to obtain information that was not previously required and is not readily available.

Companies with hedging relationships that previously qualified for applying the shortcut method but do not qualify under the proposed new guidance at the inception of the relationship would have to dedesignate the hedging relationship prospectively at the effective date of the new guidance as follows:

- For fair value hedging relationships, the recognition in earnings due to adjustments of the carrying amount of the interest-bearing asset or liability for the periods prior to the effective date would not be reversed.
- For cash flow hedging relationships, the swap gains or losses for the periods prior to the effective date would remain in accumulated other comprehensive income and be reclassified into earnings when the hedged transaction affects earnings in accordance with Statement 133.

Hedging relationships that do not qualify for the shortcut method based on the proposed guidance may be redesignated.

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The proposal's deadline for comments is September 21, 2007.

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