



Foreign Currency Forward Contracts and Cash Flow Hedging

Navigating Accounting and Disclosure Requirements

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Companies use futures contracts (i.e., derivative instruments) to manage exposure to various risks, such as interest rate risk, foreign exchange risk, acquisition of inventory or capital equipment price risk, and credit risk. Because of the great variety of these types of contracts, “instruments” generally refer to any such contracts that trade in markets such as the Chicago Mercantile Exchange as well as agreements developed strictly between companies. For example, one company may

wish to trade a contract payment provision calling for fixed interest payment to another company for a variable interest payment. The instrument achieves the objectives of both: One company locks in a fixed cash flow and the other speculates on interest changes. The accounting literature uses the “derivative” to further describe such contracts.

Hedge accounting generally requires that companies recognize derivatives as assets and liabilities and subsequently measure

them at fair value. A derivative must qualify to be able to use hedge accounting. The alternative is to use nonhedge derivative accounting, which reflects derivative fair value changes in earnings rather than on the balance sheet. Nonhedge accounting is generally unappealing to companies because it creates volatility in earnings. If items initially qualify for hedge accounting but subsequently lose their eligibility, they must revert back to nonhedge accounting and the unrealized gains and losses will be reflected in current earnings.

The breadth and complexity of derivative accounting have created significant challenges for companies that use them. Many companies have failed to account for them properly, resulting in a significant number of restatements. Companies must understand the economics of the transaction from a risk management perspective, and be versed in its accounting complexities. The determination that a transaction qualifies for hedge accounting is subject to interpretation. Different conclusions can be reached as to whether a contract should be accounted for as a derivative instrument. There have been many examples of companies restating their financial statements because their initial judgment that called for derivative accounting subsequently proved to be incorrect.

Background

Derivatives are financial instruments whose value stems from fluctuations of their underlying assets, liabilities, interest rates, foreign currency exchange rates, or indices. Companies must recognize derivatives as assets or liabilities on the balance sheet at fair value and periodically remeasure them. If a derivative qualifies as a hedge instrument, it can decrease the volatility on a company's statement of operations or income. For example, if a derivative qualifies as a cash flow hedge, a company can report the effective portion of the gain or loss on the derivative instrument as a component of other comprehensive income (loss), rather than on the income statement, and reclassify it into earnings in the same period or periods during which the hedged transaction affects earnings.

The accounting rules for derivatives are the most complex ever issued by FASB. The discussion below will examine the accounting and disclosures required when

a company creates a derivative instrument by engaging in a cash flow hedge transaction. Before proceeding, it is necessary to explain some of the technical concepts behind derivatives.

Derivative instruments represent rights or obligations and thus, should be shown as assets or liabilities. Because of the complexity and quick evolution of derivative instruments, they were not required to be reported in financial statements until 1998, when FASB issued SFAS 133, *Accounting for Derivative Instruments and Hedging Activities* (Accounting Standards Codification [ASC] Topic 815).

FASB defines a derivative as a financial instrument or other contract with the following characteristics (ASC 815-10-15-83):

(a) It has (1) one or more underlyings and (2) one or more notional amounts or payment provisions or both. Those terms determine the amount of the settlement or settlements, and, in some cases, whether or not a settlement is required. (b) It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors. (c) Its terms require or permit net settlement, it can readily be settled net by a means outside the contract, or it provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

Generally Accepted Accounting Principles (GAAP) requires that if a hedge transaction meets the criteria that permit the use of hedge accounting, an entity may elect to designate a derivative as one of the following hedges:

■ Fair value—a hedge of the exposure to changes in the fair value of a recognized asset or liability or of an unrecognized firm commitment that are attributable to a particular risk.

■ Cash flow—a hedge of the exposure to variability in the cash flows of a recognized asset or liability, or of a forecasted transaction.

■ Net investment—a hedge of the foreign currency exposure of a net investment in a foreign operation.

An underlying or a hedged item (ASC 815-10-15-88) is a variable within a derivative instrument that, along with either a

notional amount or a payment provision, determines the settlement amount. A notional amount (ASC 815-10-15-92) is the number of currency units specified in a derivative contract, and it determines the settlement amount under a derivative instrument. In summary, the settlement of a derivative instrument is determined by the interaction of the notional amount and the underlying.

Companies must recognize derivative instruments as assets or liabilities in their statement of financial position at fair value and remeasure their fair values in subsequent periods.

Futures and forwards are contracts to buy or sell a defined amount of a specific underlying asset at a specified price agreed to at origination, with delivery and settlement at a specified future date. Companies use foreign currency forward contracts to hedge against changes in currency exchange rates of an existing asset or liability, a firm commitment, or a forecasted transaction. Cash flow hedges, on the other hand, protect against the risk that variable prices, costs, rates, or terms will make future cash flows uncertain.

A cash flow hedge is a hedge of the variable cash flow of an anticipated or forecasted transaction that will probably occur, but the amount of which has not been fixed at the time of initiation of the hedge transaction. Forecasted transactions must be probable future transactions that do not meet the definition of a firm commitment under GAAP. Forecasted transactions can be contractually established or merely probable because of a company's past or expected business practices. In other words, unlike firm commitment transactions, either some terms of the transaction are variable or the transaction itself is not contractually certain. An example of this type of transaction is illustrated below.

Effectiveness. A transaction must be effective to qualify for hedge accounting under ASC 815. Hedge effectiveness refers to the extent that the changes in the fair value of hedging instrument offset the changes in the fair value of the hedged item (the underlying). Although there is no specific guidance to determine that a hedge is highly effective, FASB staff has stated informally that in order for a hedge to be highly effective, the cumulative change in the value of the derivative instrument

expressed as a ratio of the cumulative change in the fair value of the hedged item (the underlying) must fall within the range of 80% to 120%.

If the hedge is highly effective, then the treatment of the difference in the changes in fair value of the derivative instrument and the hedged item (the underlying) depends upon the type of hedge. For example, for derivative instruments that qualify as cash flow hedges, the effective portion of the gain or loss on the derivative instrument is reported as a component of other comprehensive income (loss) and is reclassified into earnings in the same period or periods during which the hedged forecasted transaction affects earnings. Therefore, an entity can eliminate volatility by using hedge accounting. If, however, the derivative does not qualify as a hedging instrument by being highly ineffective, any difference between the change in the value of the derivative and the hedged item (i.e., the ineffective portion) will be reflected in the income statement.

There are two methods under GAAP to calculate the effectiveness of a cash flow hedge: the spot and forward price methods. Use of the spot price method excludes the time value and will result in more volatile earnings, because changes to the fair value of the hedging instrument that relate to the difference between the spot and forward prices will be recognized in the income statement. Use of the forward method, while more complex, may result in less earnings volatility than the spot price method, because the difference between spot and forward prices are recognized in other comprehensive income.

While GAAP permits entities to exclude all or a part of the hedging instrument's time value from the assessment of hedge effectiveness, no other components of a gain or loss on the designated hedge instru-

ment may be excluded from the effectiveness assessment. When entities exclude the time value for the effectiveness testing purposes, the excluded time value will be reflected in the income statement.

In order to maintain the advantages of hedge accounting treatment, an entity must comply with rigorous GAAP documentation requirements for its hedging transactions. This must be performed at the inception of the hedging relationship and on an ongoing basis (at least quarterly). The assessment must include an evaluation of whether the relationship between the derivative instrument and the hedged item (the underlying) is considered highly effective. In the absence of such documentation, an instrument might not qualify for hedge accounting.

Example

Entity S is the wholly owned subsidiary of Entity A and is primarily engaged in research and development activities. The revenues of Entity S have been consistently equal to 20% of its total expenses—Entity A finances the remaining 80% of S's expenditures. The functional currency of Entity A is its local currency unit (LCU). The functional currency of Entity A is the U.S. dollar (USD).

The results of operations of Entity A are subject to foreign currency exchange fluctuation due to changes in the exchange value of LCU to USD; Entity A, however, has a natural hedge for 20% of Entity S's expenditures. Therefore, Entity A enters into a two-period forward contract for a cash flow hedge to purchase 20,000 LCU for approximately 83% of S's 24,000 LCU expenditures for two periods (10,000 LCU per period).

The objective of the cash flow hedge is to cover the exposure to variability in the cash flows of a forecasted intercompany

liability (ASC 815-35-55-2). The following table reflects the monthly statement of operations of Entity S:

Revenues	2,000 LCU
Expenditures	<u>12,000</u>
Net loss	10,000 LCU

In this illustration, the hedged item (the underlying) is the exchange rate or the exchange rate index, and the notional amount is the fixed number of currency units (20,000 LCU) which is the payment provision for the settlement of derivative instrument.

According to ASC 830, Foreign Currency Matters, companies should reflect the foreign currency fluctuation on the intercompany accounts that are not hedged or are de-designated (i.e., discontinued as a hedge) (ASC 830-20). Furthermore, they should use average rates or other approximations to reflect the foreign currency translation of revenues and expenses (ASC 830-55-10, 11). This provision affects the de-designated hedges and is reflected in periods 2 and 3 of this example.

Exhibit 1 reflects the conversion rates between USD and LCU for four periods: In period 0, Entity A initiates its hedge documentation for a hedge contract for two 10,000 LCU, representing a two-period forward contract. It must be noted that that initiation of a hedge contract is not reflected in the financial statements but requires footnote disclosures.

For the sake of simplicity, this example ignores the calculation and presentation of present value. Assume also that average rates are the same as spot rates. A discussion of fair value adjustments will follow below. Furthermore, assume that Entity A uses the spot exchange rates to test the hedge effectiveness and therefore excludes the time value. As a result, the foreign exchange (FX) gain and loss due to time value (TV) is reflected in the income statement. Furthermore, the effect of taxes on the financial results is ignored.

Period 1

The following journal entry recognizes change in the fair value of forward contract:

Cash flow hedge asset (des.) ¹	\$400	
FX gain (loss) (excl. TV) ²	\$200	
OCI (loss) ³		\$600

1. $20,000 \text{ LCU} (2 \times 10,000) \times (\$1.12 - \$1.10 \text{ forward rates}) = \400
 2. Foreign exchange is the difference between 1 and 3

EXHIBIT 1
Forward Fair Value Rates

Periods	Spot Rate	Forward Rate	Forward Points	Average Rate
Period 0	\$1.12	\$1.10	\$0.02	\$1.12
Period 1	\$1.15	\$1.12	\$0.03	\$1.15
Period 2	\$1.18	\$1.16	\$0.02	\$1.18
Period 3	\$1.22	\$1.17	\$0.05	—

3. $20,000 \text{ LCU} \times (\$1.15 - \$1.12 \text{ spot rates}) = \600

The following journal entry reflects the end of the period 1 designated hedge transaction:

Expenditures ¹	\$11,200
OCI (loss) ²	\$300
Intercompany liability ³	\$11,500
1. $10,000 \text{ LCU} \times \$1.12 = \$11,200$	
2. $10,000 \text{ LCU} \times (\$1.15 - \$1.12 \text{ spot rates}) = \300	
3. $10,000 \text{ LCU} \times \$1.15 = \$11,500$	

This journal entry reflects that Entity A has been able to eliminate the impact of foreign currency fluctuation through other comprehensive income (loss).

Period 2

Entity A de-designates (or simply discontinues) the 10,000 LCU derivative at the end of period 1 and settles the derivative in period 3. The following journal entry recognizes change in the fair value of the de-designated portion of the forward contract:

Cash flow hedge asset (de-designated) ^{1(R)}	\$400
Other income (exp.) ^{1(R)}	\$400
1. $10,000 \text{ LCU} \times (\$1.16 - \$1.12 \text{ forward rates}) = \400	

(R) Will be reversed at time of settlement

The following journal entry reflects the impact of ASC 830, Foreign Currency Matters, on the 10,000 LCU de-designated hedge at the end of period 2:

Other income (exp.) ^{1(R)}	\$300
Intercompany liability ^{1(R)}	\$300

1. $10,000 \text{ LCU} \times (\$1.18 - \$1.15) = \300
(R) Will be reversed at time of settlement

The following journal entry recognizes change in the fair value of the designated portion of the forward contract:

Cash flow hedge asset (des.) ¹	\$400
FX gain or loss (excluded TV) ²	\$100
OCI (loss) ³	\$300
1. $10,000 \text{ LCU} \times (\$1.16 - \$1.12 \text{ forward rates}) = \400	
2. Difference between 1 and 3	
3. $10,000 \text{ LCU} \times (\$1.18 - \$1.15 \text{ spot rates}) = \300	

The following journal entry reflects the end of period 2 designated hedge transaction:

Expenditures ¹	\$11,200
OCI (loss) ²	\$600
Intercompany liability ³	\$11,800
1. $10,000 \text{ LCU} \times \$1.12 = \$11,200$	
2. $10,000 \text{ LCU} \times (\$1.18 - \$1.12) = \600	
3. $10,000 \text{ LCU} \times \$1.18 = \$11,800$	

Period 3

The following two sets of entries will be reversed upon the hedge settlement.

First, Entity A de-designates an additional 10,000 LCU derivative at the end of period 2 and settles the total amount of the derivative in period 3. The following journal entry recognizes the change in the fair value of the de-designated forward contract:

Cash flow hedge asset (de-designated) ^{1(R)}	\$200
Other income (expense) ^{1(R)}	\$200
1. $20,000 \text{ LCU} \times (\$1.17 - \$1.16 \text{ forward rates}) = \200	

(R) Will be reversed at time of settlement

Second, the following entry reflects the impact of ASC 830, Foreign Currency Matters, on the 20,000 LCU de-designated hedge at the end of period 3:

Other income (exp.) ^{1(R)}	\$800
Intercompany liability ^{1(R)}	\$800
1. $20,000 \text{ LCU} \times (\$1.18 - \$1.22) = \800	

(R) Will be reversed at time of settlement

Exhibit 2 reflects a partial presentation of Entity A's income statement subsequent to its engagement in hedging activities and prior to settlement for its intercompany balance during each period.

As shown in Exhibit 2, Entity A has been able to accomplish the following:

- It has stabilized its expenses and its gross loss.
- It has been able to project and achieve its cash flow objectives.

Clearly, A is better off financially as a result of the derivative transaction, but that was not the objective. The goal was to provide visibility on the projection of cash and expenses, and Entity A was able to achieve this goal.

Entity A has not been able to achieve the following:

- The FX loss (excluded time value) did not get reflected in other comprehensive income and expenses because Entity A chose to exclude the time value from the assessment of hedge effectiveness. As discussed above, such an election results in more earnings volatility.
- There was a gap between the time of the hedge settlement and the date of occurrence of transaction, and as a result, Entity A has not been able to achieve the following:

- The intercompany balance is adjusted in every period for foreign currency translation under ASC 830, and the amount is reflected in the income statement.

- The cash flow hedge assets, which were created during the hedge period, are adjusted for fluctuations in forward rates, and the amount is reflected in the statement of operations.

As a result of the two factors above, the amount of net loss has fluctuated from one period to the next; nevertheless, all of these adjustments are reversed when the hedge transaction is settled.

It should also be noted that if the hedge had failed the effectiveness test, then the

EXHIBIT 2
Effect of Hedging on the Income Statement

Description ¹	Period 1	Period 2	Period 3
Revenues	\$ 2,300	\$ 2,360	\$ 0
Expenses not hedged	\$ 2,300	\$ 2,360	\$ 0
Expenses hedged	\$11,200	\$11,200	\$ 0
Gross loss	\$11,200	\$11,200	\$ 0
FX gain (loss) (excluding time value)	(\$ 200)	\$ 100	\$ 0
Other income (expense)	–	\$ 400	\$ 200
Other expense, ASC 830	–	(\$ 300)	(\$ 800)
Net loss	\$11,400	\$11,000	\$ 600

1. Average LCU rates for the conversion of revenues and expenses for period 1 and period 2 are \$1.15 and \$1.18, respectively. The intercompany debt would be settled at \$1.17 in period 3.

amount in other comprehensive income would have been reclassified into the income statement.

The following journal entry reflects the settlement of the derivative:

Intercompany liability	\$23,300	
Other income (exp.) ¹	\$	500
Cash flow hedge assets (des.) ²	\$	800
Cash ¹	\$22,000	

1. $20,000 \times (\$0.02 \text{ forward points at period } 0 + \$100 \text{ [excluding TV FX loss]})$
2. $\$400 \text{ in period } 1 + \$400 \text{ in period } 2$
3. $20,000 \text{ LCU} \times \$1.10 = \$22,000$

Exhibit 3 shows the balance of the hedge-related accounts at the end of each period presented.

Despite some volatility during the interim periods, Entity A achieved its objective of recording its expenses at the spot rate of \$1.12 and its obligations at the forward rate of \$1.10 (the prevailing rates at the initiation of the hedge transaction). The difference between the two rates (the forward points) is reflected in the income statement.

Fair Value Measurement

FASB's objective is for companies to estimate the fair value of derivatives separately from the fair value of the non-derivative portions of the contract. Generally, the fair value of derivative instruments in a loss position should not be offset against the fair value of derivative instruments in a gain position (ASC 815-10-45-4).

FASB allows a company to measure the fair value of its financial assets and liabilities based on one or more of the following valuation techniques:

- Market approach, which uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities (ASC 820-10-35-29);

- Cost approach, which is the amount required to replace the service capacity of an asset (i.e., replacement cost) (ASC 820-10-35-34); or

- Income approach, in which future amounts are converted into a single present amount based on market expectations, including present value techniques, option pricing, and excess earnings models (ASC 820-10-35-32).

Furthermore, FASB has established a three-tier fair value hierarchy that prioritizes the inputs used in measuring fair value as follows:

- Level 1, observable inputs such as quoted prices in active markets (ASC 820-10-35-40);

- Level 2, inputs other than quoted prices in active markets, observable either directly or indirectly (ASC 820-10-35-47); and

- Level 3, unobservable inputs for which there are little or no market data that require the reporting entity to develop its own assumptions (ASC 820-10-35-52).

In practice, most companies use the "income approach" and Level 2 inputs to value their derivatives. GAAP defines the

income approach as one that uses valuation techniques to convert future amounts (e.g., cash flows or earnings) to a single present amount (discounted). Those valuation techniques include the following: present value techniques; option-pricing models (which incorporate present value techniques), such as the Black-Scholes-Merton formula (a closed-form model) and a binomial model (a lattice model); and the multiperiod excess earnings method, which is used to measure the fair value of certain intangible assets.

GAAP requires that the fair market value of the financial assets be reflected in the financial statements. If the fair market values of the cash flow hedge assets were \$410 and \$1,230 at the end of period 1 and period 2, respectively, Entity A would record the following journal entries:

Period 1

Cash flow hedge asset	\$10	
OCI (designated)		\$5
Other income (de-designated)		\$5
<i>\$410 fair market value, less \$400 book value</i>		

Period 2

Cash flow hedge asset	\$20	
Other income (de-designated)		\$20
<i>\$1,230 fair market value, less \$1,200 book value and \$10 period 1 fair market value</i>		

Period 3

OCI		\$ 5
Other income		\$25
Cash flow hedge asset		\$30

EXHIBIT 3
Hedge-Related Accounts

Description	Period 1	Period 2	Period 3	After Settlement
Cash flow hedge asset (designated)	\$ 400	\$ 800	\$ 800*	\$ 0
Cash flow hedge asset (de-designated)	—	\$ 400	\$ 600*	\$ 0
FX gain (loss) (excluding time value)	(\$ 200)	\$ 100	(\$ 100)	(\$ 100)
Other comprehensive income	\$ 300	\$ 0	\$ 0	\$ 0
Intercompany liability	\$11,500	\$23,300	\$ 23,300*	\$ 0
Expenditures	\$11,200	\$22,400	\$ 22,400	\$22,400
Other income	—	\$ 400	\$ 600*	\$ 500
Other expense, ASC 830	—	(\$ 300)	(\$ 1,100)*	\$ 0
Intercompany liability, ASC 830	—	\$ 300	\$ 1,100*	\$ 0
Cash	—	—	—	(\$22,000)

* Reversed at the time of hedge settlement

Reversal of entries in period 1 and period 2 upon settlement of the hedge

Best Practices

Preparing and gathering information to properly execute a hedge contract is a significant undertaking and requires extensive coordination among the accounting, finance, treasury, risk management, legal, and information technology departments. Many companies have elected to outsource the function or use the assistance of expert third parties to design and implement hedge operations.

Hedge accounting requires extensive documentation at inception. A derivative instrument absent such documentation will not qualify for hedge accounting. Additionally, a hedge may also lose its privilege for hedge accounting if it is not fully utilized by the end of the program. There is usually a grace period of up to 60 days for companies to cure the deficiency; otherwise, the transaction loses eligibility for hedge accounting treatment. Companies usually hedge between 75% and 80% of their forecasted amount to cover possible underutilization due to any unforeseen economic circumstances.

Most companies that engage in foreign currency forward contracts choose to ignore time value for the measurement of effectiveness (as illustrated in the example above). The exclusion of time value may create some volatility in earnings—as it did during the recent financial crisis—but the impact on earnings is only temporary and corrects itself by the end. Nevertheless, this approach remains popular among companies that engage in foreign currency forward contracts, because it makes achievement of the effectiveness threshold more feasible.

From an administrative perspective, companies usually use the end-of-last-period spot rate as the average for the current-period exchange rate, because an actual calculation of an average exchange rate is problematic and cannot be determined until the period is complete. Furthermore, many companies have a policy of reversing the prior-period journal entries and creating a fresh inception-to-date journal entry each period. The advantage of this approach is that any bookkeeping errors are flushed out as part of the reversal. This is unlike this example above, whereby the

journal entries for each period reflected only the change in the economics of that particular period.

Disclosures

In March 2008, FASB issued SFAS 161, *Disclosures About Derivative Instruments and Hedging Activities* (ASC 815). This pronouncement expanded the disclosure requirements for derivatives and amended SFAS 133 (ASC 815). The required additional disclosures became effective for interim periods beginning after November 15, 2008. The following is a summary, taken from “Derivatives: New Disclosures Required,” by Barbara Apostolou and Nicholas G. Apostolou, *The CPA Journal*, November 2008, of the disclosure provisions related to foreign currency forward contracts:

- Fundamental disclosures, such as the reason a company uses foreign currency forward contracts and how it accounts for it;
- Qualitative disclosures, such as objectives of the hedge program, type of hedge (e.g., cash flow), and volume of transaction;
- Volumetric disclosures, such as the aggregate U.S. dollar notional amount of foreign currency forward contracts held by the company as of a specific date;
- Quantitative disclosures, such as the balance sheet tables, reflecting location and fair value of derivatives on gross basis, as well as statement of operations or income tables, reflecting net gains and losses of derivatives and segregation of derivatives designated or not designated as hedging instruments. ASC 815 requires the following information to be presented in tabular format in quarterly and annual reports:
 - Designated derivative assets and liabilities for the current period and end of last year;
 - Nondesignated derivative assets and liabilities for the current period and end of last year;
 - Gains (losses) recognized in other comprehensive income (loss) for the effective portion of derivative instruments designated and qualified as cash flow hedges for the current and prior periods;
 - Gains (losses) reclassified from other comprehensive income (loss) to earnings to offset the actual amounts of revenues and expenditures for the current and prior periods;

■ Gains (losses) reflected in earnings due to their exclusion from assessment of hedge effectiveness (e.g., the time value exclusion above), for the current and prior periods;

■ Gains (losses) reclassified into earnings for the ineffective portion of the hedge or as a result of discontinuation of hedge program (de-designation) for the current and prior periods.

In the “Qualitative and Quantitative Disclosures About Market Risk” section of quarterly and annual reports, companies must disclose the hedge program and the economics of a transaction from a risk management perspective. The table included in this section should reflect the notional amount in foreign currency and its equivalent in U.S. dollars as well as the average rate of the committed amount for the hedge program during the period.

Companies must also disclose the fair value of derivative instruments and the method of arriving at such a fair value measurement in a “Fair Value Measurement” note in quarterly and annual reports.

A “Commitment and Contingencies” note should reflect the maximum length of time over which a company is hedging its exposures. It should also state that the company has arrived at such amounts based on the forecast of operating expenditures and revenues. Companies must disclose the amount of gains and losses related to derivative instruments in a “Other Comprehensive Income or Loss” note, net of tax effects. Companies should also disclose whether these transactions are speculative in nature.

ASC 815 requires that when a company discloses information on derivative instruments in more than a single note, it should cross-reference those sources of information.

Recent Developments

FASB and the International Accounting Standards Board (IASB) are jointly reconsidering the accounting for all financial instruments, including hedge accounting. The objective of this joint project is to improve the usefulness of financial statements and simplify the accounting for financial instruments. Despite starting a joint project, the two boards have been pulled in different directions by political forces, and as a result have reached different conclusions.

FASB released its highly anticipated proposed update on the accounting for financial instruments on May 26, 2010. Among the proposed changes are requirements to measure more financial instruments at fair value and simplification of hedge accounting. Comments on the exposure draft were due by September 30, 2010; no effective date has been proposed.

FASB is proposing the following changes to modify ASC 815 hedge accounting, based largely on changes that it proposed in 2008:

- Replacing the notion of highly effective with “reasonably effective.”
- Eliminating the “short-cut method” (which was not discussed above),
- Requiring that both “overhedges” as well as “underhedges” result in ineffectiveness,
- Reassessing hedges for reasonable effectiveness qualitatively rather than quarterly,
- Prohibiting discretionary de-designation of a hedge prior to its maturity.

In contrast, the IASB published its approach on November 12, 2009, with the release of International Financial Reporting Standard (IFRS) 9, *Financial Instruments*. IFRS 9, which reached fundamentally different conclusions than FASB’s exposure draft, may be adopted early but is not effective until January 1, 2013. The IASB is conducting its project in three separate phases: classification and measurement, impairment, and hedge accounting. The IASB recently issued guidance which requires that most financial instruments be measured either at amortized cost or at fair value, with changes in fair value recognized in the income statement. The European Commission, however, has refused to endorse this standard pending further analysis.

As indicated, the accounting pronouncements surrounding the derivatives are the most complex ever issued by FASB. FASB has acknowledged this fact and has embarked on several projects to simplify the account-

ing for derivatives. The IASB has likewise undertaken similar projects; however, it appears that the two standards setters are heading in different directions rather than toward a single, converged standard, with FASB generally emphasizing more fair value accounting than the IASB.

The discussion above is meant to cover some basic principles and lay the groundwork for the accounting and disclosures required for cash flow hedges and foreign currency forward contracts. The rules and principles of accounting for derivative instruments remain very complex and require careful application of professional judgment. □

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