

Paved with Good Intentions

The Road to Better Accounting for Hedges

By Ira G. Kawaller

With 10 years of experience under the current regime of accounting for derivative contracts and hedging transactions, the FASB has determined that it's time to make some adjustments. Accountants should be wary of the changes. Besides affecting the accounting procedure relating to these instruments and activities, the proposed changes may also seriously impact the manner in which certain derivative hedges are structured—particularly in connection with interest rate risk management activities.

Accounting rules for derivatives and hedging transactions were put forth by the FASB in SFAS 133, *Accounting for Derivative Instruments and Hedging Activities*. This standard was initially issued in June 1998. It has been amended twice since then, with relatively minor adjustments, but in 2008 the FASB issued a more substantive exposure draft with significant proposed changes. Although the comment period on this exposure draft is over, the project appears to be in limbo. Proposed changes have neither been accepted nor rejected. Further adjustments are likely to be made as the FASB moves to harmonize U.S. accounting guidance with International Financial Reporting Standards (IFRS). When attention turns to derivatives, this latest exposure draft could very likely serve as a starting point.

The prospective decisions about the accounting treatment for these derivatives could have a profound impact on the structure and composition of derivatives transactions.

The Current Standard

SFAS 133 has long been recognized as one of the most complicated

viding different answers for different situations. The “normal” treatment simply requires gains and losses recognized in earnings. This treatment, however, is often problematic for companies that use derivatives for hedging purposes. For such entities, the preferred treatment would recognize gains or losses of derivatives concurrently with the earnings impacts of the items being hedged. The normal accounting treatment generally won't yield this desired result, but the alternative “hedge accounting” will.

For purposes of this discussion, attention is restricted to the two primary hedge accounting types: cash flow and fair value. For cash flow hedges, the exposure being hedged (i.e., the hedged item) must be an uncertain cash flow, forecasted to occur in a later time period. In these cases, effective gains or losses on derivatives are originally recorded in other comprehensive income (OCI) and later reclassified from OCI to earnings when the hedged item generates its earnings impact. Ineffective results

are recorded directly in earnings. In essence, this accounting treatment serves to defer the derivatives' gains or losses—but only for the portion of the derivatives' results that are deemed to be effective—thus pairing the earnings recognition for the derivative and the hedged item in a later accounting period.

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accounting standards the FASB has ever issued. A core principle of this standard is that derivative instruments must be recognized on the balance sheet as assets or liabilities at their fair market value. The critical issue, then, is the question of how to handle gains or losses. Should they be reported in current income or elsewhere? Ultimately, SFAS 133 ended up pro-

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For fair value hedges, the hedged item must be a recognized asset or liability or firm commitment subject to price risk. For fair value hedges, derivatives' gains or losses are recorded in current income (both effective and ineffective), but so too are the changes in value of the associated hedged items (i.e., gains or losses that accrue to the hedged item, due to the risks being hedged). Thus, fair value hedging accelerates the earnings impact of the

face of it, it has suggested changes that would lower the bar to qualify for such treatment. Under the current rules, a prospective hedger must perform a prospective effectiveness assessment at or before the start of the hedging relationship. These assessments must validate that the proposed hedge is expected to be "highly effective" in offsetting changes in fair values or cash flows of the designated hedged item, as a prerequisite to qualify for hedge accounting. Then, on an ongo-

tive assessment can demonstrate that a hedge will work sufficiently well. Reliance on a qualitative assessment seems likely to be too amorphous to be of much practical value. The uncertainty as to what works and what doesn't could be eradicated by requiring a quantitative prospective effectiveness test that demonstrates a reasonably high correlation between the prices underlying the derivative and those underlying the exposure. In fact, this correlation proposition was stated in paragraph 75 of the original standard, but in practice, auditing firms have looked for additional—or even alternative—statistical criteria to be satisfied. Perhaps worth noting, the proposed amendment would delete paragraph 75 from the standard, but the same principle appears to be preserved in a revised paragraph 94.

The second problem may be semantic, but these standards are read literally and the words have to be right. Specifically, the proposed wording related to the prospective effectiveness test states that "changes in fair value of the hedging instrument would be reasonably effective in offsetting changes in the hedged item's fair value," for fair value hedges, and "changes in fair value of the hedging instrument would be reasonably effective in offsetting the variability in the hedged cash flows," for cash flow hedges.

The difficulty with this language is that it ignores derivative settlements altogether. That is, derivative results consist of realized results, which take the form of settlements paid or received, and unrealized results. (Think of swaps, as opposed to forward contracts.) Focusing only on changes in present values ignores the former. Does this guidance really mean that the effects of periodic cash settlements can be ignored? This author thinks not, but that's what the proposed changes seem to say. This problem could be easily remedied by substituting "the hedging instrument's gains or losses (inclusive of fair value changes and any settlements)" for "changes in fair value of the hedging instrument." Without this change, there would surely be considerable confusion, with many reporting entities incorporating flawed effectiveness measures.

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hedged item relative to when it would otherwise be recognized. Without hedge accounting, this hedged item would generally be carried at historical cost, such that no market effects would be recognized in current income.

Hedge accounting isn't simply an election. Companies must qualify for this treatment by satisfying specific conditions and properly documenting these hedge relationships. Meeting these requirements has proved to be an arduous task. SFAS 133's guidance on whether hedge accounting can be applied is subject to interpretation, and not all auditors agree. In many cases, auditors have imposed their own guidelines, with requirements that may not have been explicitly stated by the standard.

Prospective Effectiveness Testing

It appears that the FASB agrees that reporting entities are having too hard a time qualifying for hedge accounting; on the

ing basis—but no less frequently than quarterly—the hedge would have to be assessed retrospectively, to validate its effectiveness.

Under the proposed amendment, these requirements would be eased. The new rule would require reporting entities to offer a "qualitative assessment" which demonstrates that 1) an economic relationship exists between the derivative and the hedged item, and that 2) changes in the derivative's fair value would be *reasonably effective* in offsetting fair values or cash flows of the designated hedge item. Additionally, the issues would only be reconsidered if a material change in the hedge relationship were to occur, calling into question whether the hedge will continue to perform sufficiently well. This language reflects a clear easing with regard to prospective effectiveness testing.

Despite the obvious intent, the proposed language is problematic on two points: First, it's not at all clear how a qualita-

Hedging the Benchmark Interest Rate

In all likelihood, the issue in the proposed amendment that will get the most attention—and criticism—is the one that would sharply curtail the designation of changes in the benchmark interest rate as the risk being hedged. Under the current guidance, hedgers may designate changes in 1) LIBOR, 2) the LIBOR-based swap rate, or 3) U.S. Treasury interest rates as the risks that they intend to hedge. Using a derivative tied to any of these benchmarks makes it easy to assert a hedge's effectiveness in offsetting the risk due to benchmark rate changes. Using such derivatives to hedge risks other than the benchmark interest rate changes, on the other hand (i.e., a risk consisting of both the benchmark rate change and the change due to variability of the issuer's credit worthiness), is another matter. Derivatives that are based solely on benchmark interest rates aren't designed to offset changes in entity-specific credit spreads, but when this component of a hedged item's rate change is dominant, the benchmark derivative might appear ineffective.

This issue is pervasive. For example, most variable rate lending determines the interest payments based on LIBOR plus (or minus) a spread, where spreads are adjusted either periodically or in response to changing credit considerations. Because the benchmark-based derivative doesn't compensate for this spread adjustment, a nontrivial change in this spread—or even a trivial change, when benchmark rates remain unchanged—could jeopardize the ability to apply hedge accounting.

Economists have long thought of interest rates as being composed of a risk-free rate and a credit differential. Thinking about interest rates as being composed of a benchmark rate and a residual is little more than a technical refinement. Either way, interest rate risk has historically been thought of as being composed of the risk associated with a generic base rate and an entity-specific consideration. The derivatives marketplace offers its most ubiquitous tools for managing only the first of these components, making the application of hedge accounting tenuous for interest rate hedgers seeking to use plain vanilla

derivative instruments in textbook risk management applications.

The problem is even more severe for entities with fixed-rate exposures (i.e., fair value hedgers). In this case, there's a clear disconnect between what swaps are designed to do versus what the FASB requires as a prerequisite to qualify for hedge accounting. In order to qualify for fair value hedge accounting, an entity must stipulate that the swap's results can be expected to offset changes in the debt's fair value. In fact, swaps don't do that.

Consider the case of a company that 1) issues fixed-rate debt for 10 years, and simultaneously 2) enters into a 10-year pay-floating/receive-fixed swap. Assuming the notional amount of the swap matches the principal on the debt and the swap's accrual periods are aligned with the debt's accrual periods, it's clear that this

life of the swap. That will depend upon the course of interest rates throughout the hedge, but the prospect of this gain or loss being equal to the change in the fair value of the debt is virtually zero.

This conceptual (and practical) difficulty seems to be lost on the FASB. It happens that fair value hedge accounting will only reflect the economics of the hedge (i.e., the objective of converting prospective fixed-interest payments into variable-interest payments) if the shortcut treatment is applied. The shortcut treatment is a special provision of SFAS 133 that applies to those cases where an interest rate swap is tailored to match the critical terms of the designated hedged item. When these conditions are satisfied and the shortcut treatment is elected, all concerns about effectiveness are obviated. The shortcut simply allows the car-

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swap will perfectly replace fixed-interest payments with variable payments based on the variable index of the swap. Will the swap serve to offset the change in the fair value of the debt? No.

Over the life of the debt, the change in the fair value will typically be known with certainty from day one. It will be the difference between the redemption value and the issue value. If the debt is issued at par and redeemed at par, this change in fair value will be zero. The gain or loss on the swap, however, will be the sum of the cash flows paid or received over the

rying value of the hedged item (i.e., the fixed-rate security) to be adjusted in such a way as to foster the all-in interest expenses or revenues to conform to the economic objectives of the hedge. Without this shortcut, companies have tied themselves in knots trying to demonstrate something to be true that isn't—that the swap's result could be expected to offset the fair value change of the debt due to the risk being hedged.

The proposed amendment perpetuates an unworkable situation by disallowing the shortcut treatment altogether. Thus, with-

out this shortcut, reporting entities seeking hedge accounting are forced to claim that they expect what shouldn't be expected.

There is an easy fix for this problem. In the classical application of interest rate swaps, when entities use swaps to convert fixed-rate debt to floating-rate debt, their objective is related to prospective cash flows. They care nothing about offsetting fair values. As a consequence, the problem would be solved if the FASB permitted all interest rate hedges that relate to future cash flows—whether fixed or floating—to be accounted for as cash flow hedges, with effective gains or losses being recognized in OCI and later reclassified to earnings. At present, this course of action is not allowed because a prerequisite for cash flow hedging is that the forecasted cash flow designated as the hedged item must be uncertain. Thus, a set of fixed cash flows may not be designated as the hedged item in a cash flow hedge.

That requirement, however, could be—and should be—eliminated. If the economic objective of the hedge is to alter future cash flows, entities should be able to say so and apply an accounting treatment consistent with this view. That would be cash flow hedging. Fair value hedging should be limited to those applications when the economic objective is to compensate for changes in the fair value of the hedged item. With the requirement to apply fair value hedges to all circumstances when fixed-rate instruments serve as the hedged item, the FASB has forced a round peg into a square hole.

Software and Programming Implications

One other significant change under the amendment has to do with the process of determining whether cash flow hedges are effective. Recall that effective results are initially recorded in OCI and later reclassified to earnings, while ineffective results are directly recorded in current earnings.

This issue could be conveniently addressed by reference to a hypothetical derivative (i.e., a derivative that delivers exactly the gain or loss required to offset the risk being hedged). Currently, the process for discriminating between effective

and ineffective results is asymmetric. That is, ineffective results impact earnings only if the derivative's actual gain or loss is larger than its hypothetical gain or loss. Under the proposed approach, ineffectiveness will impact earnings in both directions. Put another way, the OCI allocation will be determined solely on the basis of the hypothetical result, and the earnings impact will reflect any difference between actual results and hypothetical results, regardless of which is larger.

Whether this adjustment is an improvement or not is subject to debate. Either way, a change will necessitate reprogramming spreadsheets or SFAS 133 accounting software.

Amendment Falls Short

On balance, the proposed amendment would do more harm than good. The one positive aspect is the seeming effort to make hedge accounting more accessible. This result could be effected, however, with greater specificity: A prerequisite condition for hedge accounting should simply be to demonstrate reasonable correlation between prices underlying the derivative and prices associated with the hedged item. When such prices aren't readily available, reporting entities would be permitted—and expected—to rely on proxy variables. Instead, the proposal offers an alternative that will likely still leave reporting entities and their auditors wondering when a quantitative assessment is required and how it can be satisfied. The FASB should make it crystal clear that reasonable correlation, in and of itself, is sufficient to allow hedge accounting to be applied.

The changes related to benchmark interest rates are, in the author's judgment, ill-considered. It seems evident that the overriding sentiment at the FASB is to disallow benchmark hedging, but rather than close the door altogether, the FASB is proposing something of a safe harbor for hedgers who implement hedges on their own debt at the time of issue. Unfortunately, this safe harbor has a booby trap. More likely than not, the prospect of foregoing benchmark hedging will inhibit firms from managing their hedges responsibly—adjusting their hedge coverage up and down as conditions or appetites for risk

vary. Benchmark hedging should be left where it is. Interest rate derivatives are so widely used because, for the most part, they are designed to offset the impact of changes in benchmark interest rates, and they perform as advertised. When pursuing this objective, the accounting should be simple and straightforward. Allowing the changes in the benchmark interest rate to be the designated risk being hedged would preserve this simplicity.

The third change addressed above—the proposed symmetric treatment of imperfect hedge results—is another change better left undone. Reporting entities have accommodated the current procedures, albeit not without some effort. The suggested change will keep consultants and IT professionals busy accommodating the new rules, but it will do little to aid the users of financial statements.

Finally, the amendment can be faulted for what it doesn't do: It fails to address what may be the most pernicious shortcoming of the present standard. That is, when interest rate swaps are used in the traditional manner to swap from fixed to floating cash flows, swap gains or losses simply do not offset—nor should they be expected to offset—the fair values of the fixed-rate securities that generate the original fixed-rate payments (receipts). Yet, any entity seeking to apply fair value hedge accounting has to make exactly this attestation. The remedy is drastic yet simple: Apply cash flow hedge accounting to all interest hedges that address future cash flows—irrespective of whether those original cash flows happen to be fixed or floating. In other words, eliminate the requirement that hedged items in cash flow hedges must be uncertain forecasted cash flows—just being a forecasted cash flow should be sufficient.

The FASB deserves to be commended on the effort to simplify and improve on this accounting standard, but the proposal on the table falls short of those worthwhile goals. □

Ira G. Kawaller is president of Kawaller & Company, LLC, and managing director of the Kawaller Fund. He can be contacted at kawaller@kawaller.com.

Turning Payroll Pains into Payroll Gains

By Julie Lubetkin

How many accountants practicing today—who were practicing 20 years ago—could have ever imagined the evolution and variety of technology being used in practice today? Back then, secretaries took dictation, photocopiers reproduced documents at the speed of four pages per minute, and a pay phone was the best option for staying connected to clients and the office from a remote location. Fast-forward to today. Fax machines have come and gone; professional practices are going paperless; it is common practice to carry a BlackBerry, Treo, or iPhone; and the Internet has made it possible for practically everyone to share files across the country or around the world with the click of a button.

Today, having to wait 30 minutes for a file from a client can feel like having to wait 29 minutes too long. Accountants are using the Internet to virtually work from anywhere, which is amazing progress for an industry that historically has been so deeply rooted in the physical exchange and retention of paper.

Few of us would want to go back to the days of strictly paper-based practices. But how much progress have we really made? Have we taken advantage of the online technologies that allow access to client files and work anytime and from anywhere? Services like online payroll have become so highly automated that, after the initial setup, either the accountant or client can run a payroll online in under five minutes. To better appreciate how easy online payroll services are to master, look more closely at how automated the entire payroll process has become.

Changing the Way Payroll Is Processed

The advancements made in the engineering of online payroll services technology have opened doors for accounting professionals. Accountants can rely on guaranteed calculations, secure electronic funds transfer and file sharing, and the opportunity to share the payroll workload with each client being served. There are addi-

tional time-saving features such as the ability to work from virtually anywhere, and the means to manage clients across the country. Consider these benefits as a positive change for payroll services that will be necessary and can also become more profitable.

Running a payroll has been reduced from a multihour task to one that can be done in minutes. After logging into the online payroll website, the employee hours are entered, resulting in paychecks being calculated. After a quick on-screen review of the paycheck details, any necessary edits can be made (vacation, over-

aged. Accountants can log in and manage tasks from anywhere. This accessibility has removed the challenges formerly associated with payroll services.

Because online payroll service is Internet-based, accounting professionals are able to market to and serve payroll clients nationally. Free practice-branded marketing materials can help promote online payroll services and stimulate interest among existing clientele and future prospects. Having professionally crafted marketing tools presents a positive impression of the quality and reliability of the services offered.

The automation and engineering advancements allow professionals to remain as involved in the payroll process as they choose to be.

time, sick time, and bonus pay) before the checks are printed.

Select online payroll service providers have engineered their technology to electronically manage W-2s, 940s, 941s, 1099s, and the electronic processing of tax payments. Forms that used to be paper-based only are now available electronically. Some online payroll service providers have engineered their technology to automatically populate a form. Vendors have also incorporated a variety of technologies for importing and exporting information from the software.

With some online payroll service technologies, a majority of the workload can be handled by the client. The accounting professional operates more as an advisor and can offer the service with little or no investment in staff. The client benefits by keeping payroll service costs lower by managing varying levels of the workload.

Work Anytime, Anywhere

Online payroll services have changed how and where payroll services are man-

Marketing to businesses with multistate locations becomes easier when the online payroll service technology enables accountants to offer payroll to clients located all over the country. Payroll service technologies can scale up, for example, allowing accountants with local or regional clients to expand their services to national or affiliated offices.

Online payroll technology allows accounting professionals with little to no payroll experience the opportunity to begin offering this service. The automation and engineering advancements allow professionals to remain as involved in the payroll process as they choose to be and generate a revenue stream that requires little time to manage. In tough economic times, accountants and their clients will appreciate how online payroll services have turned payroll pains into payroll gains. □

Julie Lubetkin is the marketing director for the Accounting Professional Program with PayCycle, Inc.