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November 7-10, 2010 | San Antonio

**Derivative Accounting Convergence:  
The path from where we are (US GAAP)  
to where we are headed (IFRS)**

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**HEDGE TRACKERS**

**Google**

# Agenda

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- US GAAP: FAS -> ASC
  - FAS133 et al to ASC 815
  - ASC 815 Proposed Updates
  
  - IAS -> IFRS
  - IAS 39
  - IFRS 9
  
  - ASC -> IFRS Status
-

## FAS133 Background

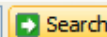
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- FASB began deliberations in 1992
    - Released Exposure Draft 1
    - Released Exposure Draft 2
  - Issued FAS133 in 1998
  - Implemented in 2000
  - Amendments and related Guidance
    - 137, 138, 149, 155, 157, 159...
    - Derivative Implementation Guidance
    - Green Book: Last printing 875 pages (2004)
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## Codification

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- On July 1, 2009 the FASB released the authoritative version of the *FASB Accounting Standards Codification* as the single source of authoritative nongovernmental U.S. GAAP
  - Reorganizes thousands of U.S. GAAP pronouncements into roughly 90 accounting topics
    - All other accounting literature not included in the Codification will be considered nonauthoritative
  - It also includes relevant Securities and Exchange Commission (SEC) guidance



- 10 - Overall
- 15 - Embedded Derivatives
- 20 - Hedging—General
- 25 - Fair Value Hedges
- 30 - Cash Flow Hedges
- 35 - Net Investment Hedges
- 40 - Contracts in Entity's Own Equity
- 45 - Weather Derivatives
- 932 - Extractive Activities—Oil and Gas
- 944 - Financial Services—Insurance
- 954 - Health Care Entities
- 958 - Not-for-Profit Entities

BROWSE

What's New

Cross Reference

CODIFICATION

ex: 740-10-25 GO TO ?

Notice to Constituents

General Principles

Presentation

Assets

Liabilities

Equity

Revenue

Expenses

Broad Transactions

Industry

Master Glossary

OTHER SOURCES

Accounting Standards Updates

Exposure Drafts

About the Codification

The FASB Accounting Standards Codification is a single source of authoritative nongovernmental accounting principles.

- 805 - Business Combinations
- 808 - Collaborative Arrangements
- 810 - Consolidation
- 815 - Derivatives and Hedging
- 820 - Fair Value Measurements and Disclosures
- 825 - Financial Instruments
- 830 - Foreign Currency Matters
- 835 - Interest
- 840 - Leases
- 845 - Nonmonetary Transactions
- 850 - Related Party Disclosures
- 852 - Reorganizations
- 855 - Subsequent Events
- 860 - Transfers and Servicing

Help, and features

Tutorials and help

Helpful tutorials explain how to navigate the site and use its powerful features. [View tutorials...](#)

Join Sections

[Join Sections](#) allows you to select multiple Sections from different Topics and Subtopics and join them into a single document.

Cross Reference

[Cross Reference](#) shows you where current Standards are located in the Codification topical structure.

## Cross Reference Tool

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- Codification prepared US GAAP for convergence with IFRS
- Cross references available between the original standards and the Codification

ODIFICATION

Search box with text 'x: 740-10-25' and 'GO TO ?' button

- Navigation menu items: Notice to Constituents, General Principles, Presentation, Assets, Liabilities, Equity, Revenue, Expenses, Road Transactions, Industry, Master Glossary

OTHER SOURCES

Accounting Standards Updates

ASB logo, 320 icon, and TOP ↑ button

Home > Cross Reference

f Page / Print Functions dropdown menu

Cross Reference

Use this feature to cross reference between the original standards and the Codification. Insert information about a standard to identify the Codification Sections that contain the content. Alternatively, insert information about the Codification to identify the standards that populated that portion of the Codification. Click here for help with or to view a tutorial on the Cross Reference feature. NOTE: The report only includes content contained in published Topics. Click here to view the details of the standard type acronyms.

By Standard ? form with Standard Type and Standard Number dropdowns

or

By Codification ? form with Topic, Subtopic, Section, and Paragraph dropdowns

GENERATE REPORT and START OVER buttons

Sort your results by Standard Type or by Topic.

Table with columns: Standard Type, Standard Number, Paragraph / Label, Sequence, Topic, Subtopic, Section, Paragraph



## Example of GAAP/ASC Drift

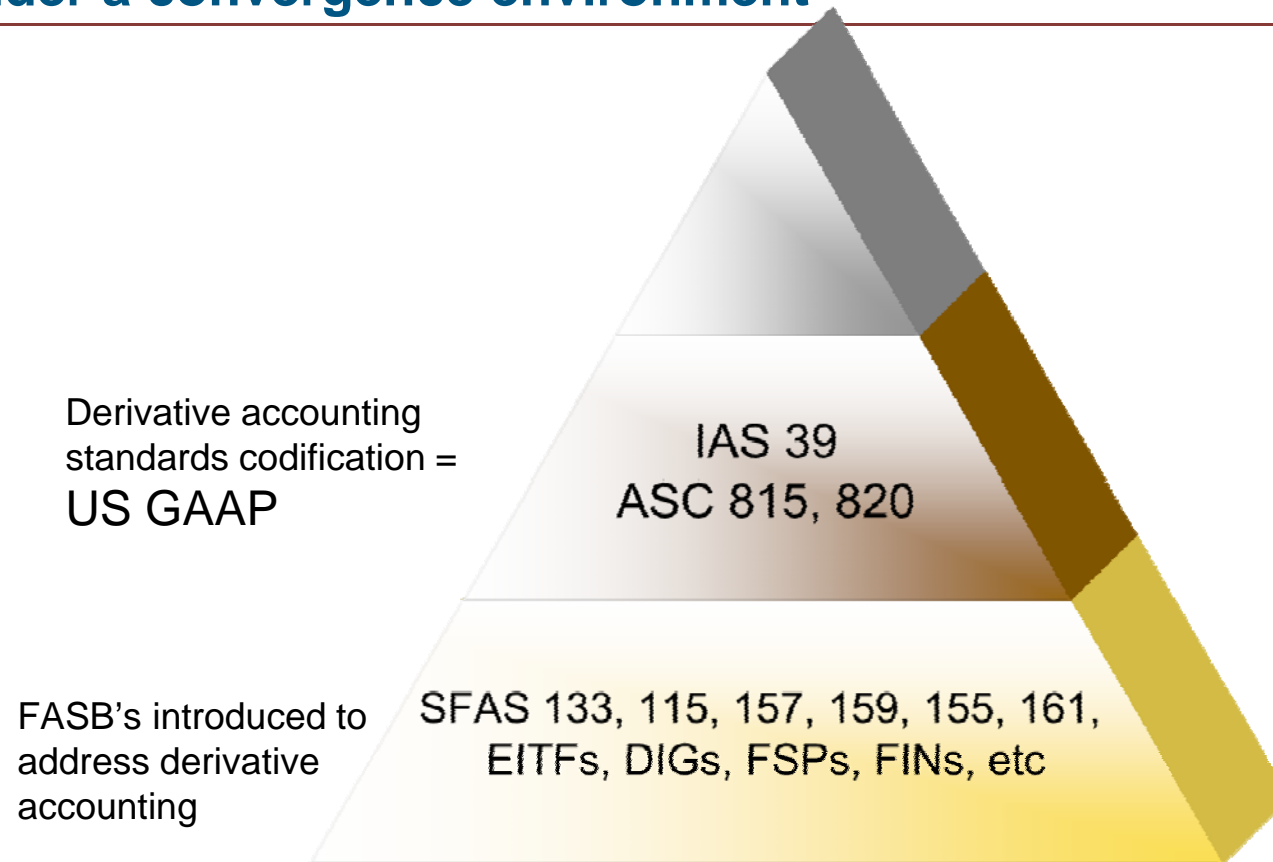
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- FAS 133
- ¶40
- ¶469-471, 474, 475-478, 481-487
- DIG H13
- ASC 815
- ASC 815-20-25-38d
- No equivalent
- ASC 815-30-55-86 to 90



# Evolution of Derivative Accounting

-under a convergence environment



## FASB Process –

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- FASB issued a Proposed Update to *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* on May 26, 2010
  - Red-lined version never issued
  - Comment Letter period expired 9/30/10
  - Over 1,500 Comment Letters
    - Only handful addressing derivatives

## FASB Process – Yet to Come

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- Public roundtable meetings
  - Staff analyzes comment letters, public roundtable discussions, and other information obtained (if applicable)
  - **FASB redeliberates** the proposed provisions
  - **Accounting Standards Update issued**
    - Implementation date(s) and adoption “rules” detailed
-

## Proposed Update (BC 218-220)

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- **Existing Guidance**
  - Emphasis on quarterly effectiveness assessments
  - Hedge accounting applied inconsistently period to period due to “failures”
  - **Proposed Guidance**
  - Effectiveness assessments reserved for corner cases, and updated only under unusual circumstances (117)
  - Consistent application of special hedge accounting (119)
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## Proposed Update (BC 218-220)

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- **Existing Guidance**
- Effectiveness focused on sophisticated quantitative statistical modeling and testing
- “Highly Effective” litmus test (80-125% offset)
- **Proposed Guidance**
- Effectiveness to focus on qualitative support for economic relationship between derivative and hedged item
- Use “Reasonably Effective” (***judgment not numbers*** BC220) -- holistic consideration of what lead to hedge relationship
  - IR swap can avoid hedging entire inventory

## Proposed Update (116)

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- **Existing Guidance**

- Document effectiveness test so that 3<sup>rd</sup> party can re-perform the test and achieve similar results
  - Algorithms
  - Data points
  - Data sources
- Partial compensation in derivative could trigger automatic de/redesignation

- **Proposed Guidance**

- Document sources of volatility in the cash flows of the forecasted transaction(116)
- Document factors supporting conclusion of reasonably effective
- Modification of derivative requires “update” in documentation

## Proposed Update (BC 218-220)

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- **Existing Guidance**
- Matched terms: FX & Commodity assumption that hedge is perfectly effective
- Short-cut: IR assumption that hedge is perfectly effective
- **Proposed Guidance**
- No longer have ability to assume hedge relationship is 100% effective, *measurement of ineffectiveness is required on all designated hedges (114)*



## Proposed Update (BC 224-229)

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- **Existing Guidance**
  - Over-performance of derivative the only source of ineffectiveness in cash flow hedges
  - Inconsistent practice on credit effect on derivative & hedged item
  - **Proposed Guidance**
  - Over **and** underperformance of derivative are sources of ineffectiveness in cash flow hedges (123)
    - Hedged item recorded in income at hypothetical rate
  - Credit risk on derivative instrument fair value must be considered(114)
    - Impact hedged item with derivative credit
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## Proposed Update (BC 116-118)

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- **Existing Guidance**
- Option premium can be accounted for with the underlying hedged item, DIG G20
- **Proposed Guidance**
- Option premium must be amortized over life of option
  - (offset is OCI)

## Proposed Update (BC 116-118)

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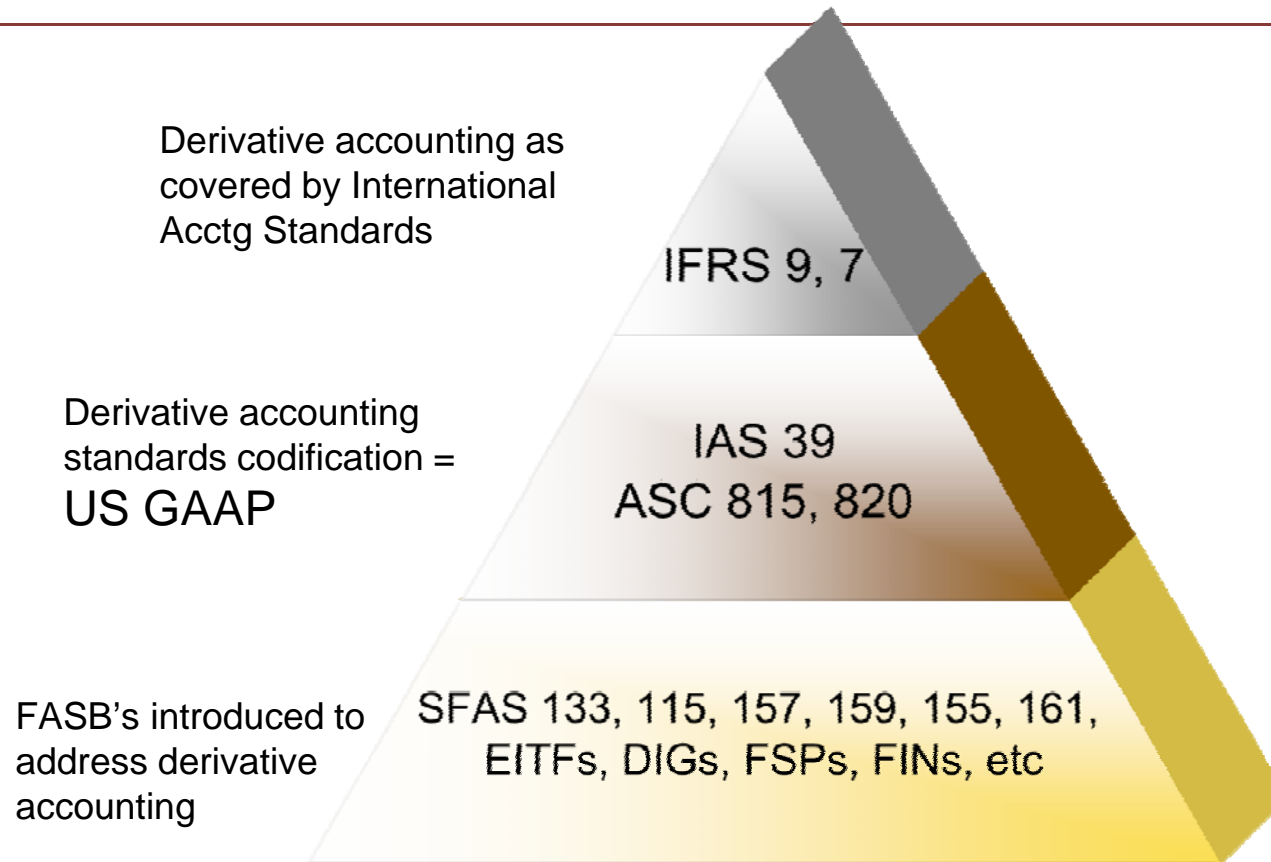
- **Existing Guidance**
  - Voluntary dedesignation of relationships allowed
  - **Proposed Guidance**
  - No voluntary dedesignations, instrument must be terminated, sold, etc. or underlying must no longer qualify
  - Must document compensating trades as such to terminate hedge relationship
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# IFRS Convergence

# Evolution of Derivative Accounting

-under a convergence environment



# International Financial Reporting Standard

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- **IAS** were issued between 1973 and 2001 by the Board of the International Accounting Standards Committee.
- In 2001, the new IASB took over the responsibility for setting International Accounting Standards and adopted existing IAS
  - Subsequent standards issued by IASB are called **IFRS**.
  - 110 countries have either adopted or in the process of adopting IFRS

## ASC (US GAAP) -> IFRS Status

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- February 2010: SEC approved new IFRS timeline shifting earliest possible adoption date to 2015
  - No early adoption
- June 2011: Scheduled completion date for convergence projects with FASB and IASB
- 2011: *SEC to vote* on mandate for US companies to use IFRS



# Derivative Accounting Under IAS

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- IAS 39
    - Treatment for all Financial Instruments
      - Principles for recognizing/measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items.
  - Derivative accounting is subset
    - Cash Flow
    - Fair Value
    - Net Investment Hedging
    - Virtual and Embedded Derivatives
  - Disclosure separately handled under IFRS 7
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## IFRS Convergence With IAS

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- Project exists to replace IAS 39 with IFRS 9 by Q2/2011
  - Phase 1 IASB issued IFRS 9 Financial Instruments in 11/2009: Classification and Measurement of Financial Assets
  - Phase 2 Exposure draft of Amortized Cost and Impairment was issued
  - Phase 3 to simplify and improve hedge accounting expected to be issued by Q3/2010\* for completion by Q2/2011

\*This timing has been slipping (originally indicated Q2/2010)

## *Similarities* Between US GAAP and IFRS

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- Three types of hedge relationships:
  - Cash Flow
  - Fair Value
  - Net Investment
- Documentation and effectiveness assessment requirements
- Most risks allowed to be hedged and hedging instruments

***Caveat: There are some differences to look out for***

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## IFRS: Fair Value Considerations

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- Hierarchy of valuation input reporting
- No distinction between recurring and non-recurring fair value measurement
- Company must ***elect and disclose use of trade-date or settlement-date*** accounting by category of financial asset
- Bid price for assets and ask price for liabilities
  - ***Mid-market pricing only for offsetting positions***

## IFRS: Virtual Derivatives

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- No documentation requirements surrounding normal purchase/normal sale, called “Own Use” contracts (¶5)
  - Takes delivery
  - No history of settling net in cash
  - No history of selling within a short period after delivery
- Climatic/geological contracts must be treated as either insurance or derivatives

## IFRS: Available For Sale Securities

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- Changes in value attributable to changes in exchange rates are reflected in P&L
  - Replaces need for FV hedges of foreign currency denominated AFS securities
  - Calculation not specified

## IFRS: Credit Effect Liabilities?

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- Credit Risk in Liability Measurement Discussed at October 2009 IASB Meeting
- At that meeting the Board decided to **stop work on credit risk in liability** measurement as separate project and not to reach a general conclusion on credit risk at this time. Instead, the issues will be incorporated into the Conceptual Framework Measurement project



# IFRS: Documentation Requirements

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- Mostly the same with some exceptions (¶88) :
    - How entity will assess effectiveness
      - **No Short-cut or Matched Terms**
      - Expected to be highly effective in achieving offsetting changes in fair value of cash flows
      - **Effectiveness must be reliably measured**
      - Prospective and retrospective testing required at inception and each reporting date
        - **Results not detailed as 80% - 125%**
    - Hedge period “a reasonably specific and *narrow* range of time”
      - ~~No two month rule or DIG G16 accommodations~~
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## IFRS: Hedge Relationships Defined

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- Impact of credit captured in effectiveness assessment
  - the fair value of the derivative (asset) includes credit risk in the effectiveness assessment and measurement tests but the hypo does not
- Non-derivative financial asset/liability can be designated as hedge of foreign currency risk
  - **CF**, FV and NI
- May designate proportions or combinations of derivatives
- Limitations on partial-term (of the derivative) hedging

## IFRS: Hedged Item

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- A non-financial item for FX risk or changes in entire item
- No non-functional transaction requirement for party to hedge instrument
- FX risk on ***firm commitment to acquire a business*** in business combination

## IFRS: Option Treatment

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- Purchased options can be designated in hedges of financial and non-financial risk
- May designate risk above or below a price or rate
  - **Time value must be excluded from forecast transaction**
    - May include or exclude TV from ineffectiveness
  - **Written options only when offset purchased option**

## IFRS: No Internal Netting

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- Hedge of an overall net position (outside of FV hedge of interest portfolio) does not qualify for hedge accounting.
  - Exposures may not be netted, then hedged with 3<sup>rd</sup> parties
- Hedge accounting only to the effect that external derivative is designated as an offset of cash inflows OR cash outflows

## IFRS: Cash Flow Hedges

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- Discontinuance of special hedge accounting:
- If forecast transaction **no longer expect to occur** gains and losses deferred reclassified to P&L
  - Hurdle is much lower than probable not to occur
- If forecasted transaction is still expected to occur amounts accumulated in OCI remain until hedged item occurs
  - **2 month grace period removed**

# Fair Value Exposure for Portfolio of IR risk

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- Define portfolio (can include assets & liabilities)
- Stratify portfolio based on expected (not contractual) repricing
- Designate % of assets/liabilities per time period
  - Assets/liabilities should be able to qualify as FV exposures independently, fair value must change in response to risk hedged, time periods (stratified) sufficiently tight
- Designate portion of risk hedged (index)
- Designate instrument per stratification



## Fair Value Accounting for Portfolio of IR risk

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- Gain or loss on hedged item may be presented as adjustment of carrying amount of hedged item
- Gain or loss on hedged item may be presented as separate line item in balance sheet adjacent to related asset(s)/liability(ies)

# Additional Resources-GAAP Reference Paragraphs

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- ASC Proposed Update: Derivative & Hedging Guidance buried throughout the update:
  - Questions from FASB on hedging
    - Questions 56-58 and 61-64
  - Proposed guidance: 110-128
  - Implementation guide: IG172-180
  - Background/conclusions: BC216-235

## Additional resources-websites

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- IASB ([www.iasb.org](http://www.iasb.org))
  - FASB ([www.fasb.org](http://www.fasb.org))
  - AICPA IFRS resources site ([www.ifrs.com/](http://www.ifrs.com/))
  - Securities and Exchange Commission ([www.sec.gov](http://www.sec.gov))
    - SEC Roadmap to IFRS ([www.sec.gov/spotlight/ifrsroadmap.htm](http://www.sec.gov/spotlight/ifrsroadmap.htm))
  - PricewaterhouseCoopers (<http://www.pwc.com/gx/en/ifrs-reporting/index.jhtml>)
  - EY (<http://www.ey.com/GL/en/Issues/IFRS/IFRS>)
  - KPMG (<http://kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/IFRS-briefing-sheets/Pages/default.aspx>)
  - Deloitte ([http://www.deloitte.com/view/en\\_US/us/Services/additionalservices/IFRS/8f2bbf2733101210VgnVCM100000ba42f00aRCRD.htm](http://www.deloitte.com/view/en_US/us/Services/additionalservices/IFRS/8f2bbf2733101210VgnVCM100000ba42f00aRCRD.htm))
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# FAS 133/ASC 815 IAS39/IFRS9 Derivative Accounting

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