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

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Agenda

- 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

- 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
Codification

• 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
FAS133 -> ASC 815
Cross Reference Tool

• Codification prepared US GAAP for convergence with IFRS

• Cross references available between the original standards and the Codification
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?

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Generate Report  Start Over

Sort your results by Standard Type or by Topic.
Example of GAAP/ASC Drift

- 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

Derivative accounting standards codification = US GAAP

IAS 39
ASC 815, 820

FASB’s introduced to address derivative accounting

SFAS 133, 115, 157, 159, 155, 161, EITFs, DIsGs, FSPs, FINs, etc
FASB Process –

• 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

- 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)

- **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)
Proposed Update (BC 218-220)

- **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)

- **Existing Guidance**
  - Document effectiveness test so that 3rd 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)

- **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)

- **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 low 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
Proposed Update (BC 116-118)

- **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)

- Existing Guidance
  - Voluntary dedesignation of relationships allowed

- Proposed Guidance
  - No voluntary deesignations, instrument must be terminated, sold, etc. or underlying must no longer qualify
  - Must document compensating trades as such to terminate hedge relationship
IFRS Convergence
Evolution of Derivative Accounting
-under a convergence environment

- FASB’s introduced to address derivative accounting
- IAS 39
- IFRS 9, 7
- Derivative accounting standards codification = US GAAP
- SFAS 133, 115, 157, 159, 155, 161, EITFs, DIFs, FSPs, FINs, etc
International Financial Reporting Standard

• **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

• 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

- 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
IFRS Convergence With IAS

• Project exists to replace IAS 39 with IFRS 9 by Q2/2011
  – 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

• 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
IFRS: Fair Value Considerations

- 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

- 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

- 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?

- 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

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
IFRS: Hedge Relationships Defined

- 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 hypothesis 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

• 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

- 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

• 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 3rd 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

- Discontinuance of special hedge accounting:
- If forecast transaction no longer expect to occur gains and losses deferred reclassified to P&L
  - Hurtle 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

- 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

- 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

• 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

- IASB (www.iasb.org)
- FASB (www.fasb.org)
- AICPA IFRS resources site (www.ifrs.com/)
- Securities and Exchange Commission (www.sec.gov)
  - SEC Roadmap to IFRS (www.sec.gov/spotlight/ifrsroadmap.htm)
- PricewaterhouseCoopers (http://www.pwc.com/gx/en/ifrs-reporting/index.jhtml)
FAS 133/ASC 815
IAS39/IFRS9
Derivative Accounting

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