



Project	Accounting for Financial Instruments - Hedge Accounting
Topic	Bifurcation-by-risk approaches

Background

1. At the January 19, 2010 joint meeting, the Boards decided that in light of the FASB's goal to publish a comprehensive exposure draft on financial instruments in March 2010 and the IASB's goal to publish an exposure draft on the remaining main phases of the project to replace IAS 39, *Financial Instruments*, in the first quarter of 2010, the Boards will first jointly consider hedge accounting issues relating to financial hedged items. Therefore, this memorandum focuses on bifurcation-by-risk approaches for financial hedged items only.
2. At the February 2, 2010 meeting, the IASB tentatively decided to permit bifurcation-by-risk for financial items. However, at the same meeting, the FASB decided to explore bifurcation-by-risk for financial items and requested the staff to develop possible approaches for consideration at a future meeting. This memorandum responds to the FASB's request.
3. The FASB has decided to require that all financial instruments be recognized on the balance sheet at fair value with the change in fair value recognized in net income ("FV-NI" category) unless the financial instrument qualifies for recognizing certain changes in fair value in other comprehensive income ("FV-OCI" category). If an entity's business strategy is to hold debt instruments with principal amounts for collection or payment(s) of contractual cash flows rather than to sell or settle the financial instruments with a third party, those instruments qualify for FV-OCI. The amount of the change in fair value that is permitted to be recognized in OCI equals the entire change in fair value, excluding current period interest accruals (including amortization/accretion of premium/discount upon acquisition), minus the amount allocated to credit losses. In addition, realized gains or losses from sales or

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The tentative decisions made by the FASB and the IASB at its public meetings are reported in a FASB *Action Alert* and IASB *Update*. Official pronouncements of the FASB and the IASB are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

settlements would be recognized in net income. The FASB also tentatively decided to allow certain types of an entity's own debt that qualify for FV-OCI to be measured at amortized cost.

Purpose of this memorandum

4. This memorandum presents different bifurcation-by-risk approaches to hedge accounting that can accommodate the recognition and measurement requirements for financial instruments developed by the FASB.

Bifurcation-by-risk approaches for hedging financial instruments

5. This memorandum presents the following three approaches for the Board's consideration:
 - (a) Approach A – current bifurcation-by-risk model in Topic 815 of the Accounting Standards CodificationTM (formerly FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*).
 - (b) Approach B – fair value changes for the hedging instrument would be recognized in other comprehensive income, excluding the ineffective portion of those fair value changes
 - (c) Approach C – utilize bifurcation-by-risk guidance to determine if the relationship qualifies for hedge accounting. For fair value hedges, once a relationship qualifies for hedge accounting, the entire fair value change of the hedged item would be recognized in net income. For cash flow hedges, once a relationship qualifies for hedge accounting, the measurement of ineffectiveness would be determined by comparing the change in fair value of the hedging instrument to the change in fair value of a derivative instrument that would hedge all the variability in cash flows of the hedged forecasted transaction. This approach is similar to the approach proposed in the FASB Exposure Draft, *Accounting for Hedging Activities*, issued in June 2008.

6. This memorandum discusses the application of each of these three approaches to hedged items classified as FV-OCI under and hedged items measured at amortized cost under the tentative FASB model.
7. The FASB June 2008 Exposure Draft on hedging activities proposed amending the qualitative assessment criterion needed to qualify for hedge accounting to require that changes in the fair value of the hedging instrument be reasonably effective (rather than highly effective) in offsetting changes in the hedged item's fair value or the variability in the hedged cash flows. The Board decided not to define *reasonably effective* in the Exposure Draft because it believed that the use of judgment should be permitted in determining whether a hedging relationship is reasonably effective. Redeliberations on that Exposure Draft have been included as part of this project.
8. The approaches in this memorandum carry forward the reasonably effective threshold for hedge effectiveness, thereby allowing more hedging relationships to qualify for hedge accounting. The staff plans to address other hedge effectiveness issues at a future joint Board meeting.
9. Agenda paper 4C discussed at the February 2, 2010 joint meeting identified risk components currently eligible for designation in a hedging relationship under both IFRSs and U.S. GAAP. Agenda paper 4C stated that under current IAS 39, for financial items an entity can designate any risk component as long as that component is separately identifiable and measurable (IAS 39.81) and under U.S. GAAP a financial asset or financial liability can be designated for the entirety of its risks or for either one or a combination of the following:
 - (a) benchmark interest rate risk
 - (b) foreign currency risk
 - (c) credit risk of the instrument.

The approaches in this memorandum retain the eligible hedged risks as currently permitted in U.S. GAAP for determining the amount of gain or loss in net income under Approach A or Approach B and for determining if a hedging relationship qualifies for hedge accounting under Approach C.

Approach A

10. Approach A is the current bifurcation-by-risk approach in Topic 815. Paragraph 815-35-20-1 provides guidance on the accounting for subsequent changes in fair value of a derivative instrument designated and qualifying as part of a hedging relationship and the hedged item. For fair value hedges, the gain or loss on a derivative instrument designated and qualifying as a fair value hedging instrument as well as the offsetting loss or gain on the hedged item attributable to the hedged risk is recognized in net income. Under this approach, if an entity designates a financial asset or financial liability (that is measured at amortized cost or at fair value with changes in fair value recognized in OCI) as the hedged item in a fair value hedge, it would be allowed to recognize in net income only the hedged item's offsetting gains and losses for the risk hedged. For cash flow hedges, the effective portion of the gain or loss on a derivative instrument designated and qualifying as a cash flow hedging instrument is recognized in OCI and reclassified into net income as and when the hedged forecasted transaction affects net income. The remaining gain or loss on the derivative instrument (the ineffective portion), if any, is recognized in net income.
11. This approach focuses on reflecting in net income only the impact of discrete risks that management chooses to hedge. This approach would not reflect in the financial statements the effects of risks not hedged by the entity. That is, the arguments for and against bifurcation-by-risk (presented in Agenda paper 4C at the February 2, 2010 joint meeting) apply to this approach.
12. However, this approach would retain current hedge accounting rules; therefore, minimal amendments to current guidance would be required.

Application to hedged items classified as FV-OCI

13. Approach A would not impact the balance sheet as the financial hedged items would be recognized at fair value, but would have the following impact on the performance statement based on the tentative FASB classification and measurement model described in paragraph 3.

Fair value hedges:

	Hedged Item	Hedging Instrument
Recognized in net income:	Current period interest accruals Current period credit losses (if applicable) Unrealized gains and losses attributable to the hedged risk	All gains and losses
Recognized in OCI:	All other remaining unrealized fair value gains and losses	

Cash flow hedges:

	Hedged Forecasted Transaction	Hedging Instrument
Recognized in net income:	Cash flows received/paid	Ineffective portion of gains and losses Gains and losses on cash flows received/paid
Recognized in OCI:		Effective portion of gains and losses <i>Less:</i> gains and losses on cash flows received/paid

Application to hedged items measured at amortized cost

14. Approach A would not impact the balance sheet differently than how the balance sheet is impacted currently under Topic 815 for financial instruments measured at amortized cost. The impact on the performance statement would be similar to the impact on financial instruments in the FV-OCI category illustrated above except that unrealized fair value gains and losses attributable to unhedged risks would not be reflected for hedged items measured at amortized cost in a fair value hedge.

Fair value hedge example

15. For example, an entity holds for collection an 8 percent fixed-rate ABC Company debt security. Under the tentative FASB classification model, this debt security would be classified as FV-OCI. Interest accruals for the debt security are recognized in net income and the debt security is subject to impairment analysis every reporting period with credit impairments recognized in net income.
16. The entity decides to hedge the interest rate risk in the debt security by entering into a pay-fixed, receive-variable interest rate swap with the fixed leg of the swap set at 5 percent and variable leg set at LIBOR. Using Approach A, the accounting result in the financial statements when designating the interest rate swap and the debt security as a fair value hedge of interest rate risk would be the equivalent of a historical cost measurement attribute being applied to the single synthetic instrument created by the combination of the fixed-rate debt security and the interest rate swap (that is, a variable-rate debt security with fixed spread over LIBOR). The net impact on the balance sheet would be zero and the net impact on the performance statement would be the reporting of interest income based on LIBOR (variable piece) plus a fixed amount of 3 percent.

Cash flow hedge example

17. Let us use similar facts as the example above to illustrate Approach A for a cash flow hedge. Assume that an entity holds for collection the same fixed-rate 8 percent ABC Company debt security. However, this time, the entity decides to hedge the credit risk in the debt security by entering into a purchased credit default swap referenced to ABC Company's debt. Using Approach A, the hedge accounting does not impact the balance sheet and its net impact on the performance statement would be the reduction of credit losses reflected on the debt security due to credit protection obtained through the credit default swap. In this example, there may not be significant ineffectiveness because the credit default swap is referenced to the same debt security whose cash flows are hedged.

Approach B

18. Approach B would amend the current guidance for fair value hedges only. Guidance for cash flow hedges would remain unchanged. For fair value hedges, the ineffective portion of the gain or loss on a derivative instrument designated and qualifying as a fair value hedging instrument would be recognized in net income. The remaining gain or loss on the derivative instrument (the effective portion) would be recognized in OCI. This model would require reclassifications into net income for amounts necessary to offset gains and losses recognized in net income on the hedged item. The amounts reclassified would differ depending on the type of hedging relationship entered into by the entity. For example, for an interest rate risk hedge, the amounts that would need to be reclassified from OCI into net income on the derivative instrument would be the amounts necessary to achieve the variable rate created by the combination of the hedged item and the derivative instrument. The measurement and recognition of fair value changes of the hedged item would not be affected under this approach.
19. This approach, similar to Approach A, focuses on reflecting in net income only the impact of discrete risks that management chooses to hedge. This approach would not reflect in the financial statements the effects of risks not hedged by the entity. That is, the arguments for and against bifurcation-by-risk (presented in Agenda paper 4C at the February 2, 2010 joint meeting) also apply to this approach.
20. The staff believes this approach is more complex than Approach A and entities would require additional guidance to determine the amounts for reclassifications from OCI to net income for the hedging instrument. In addition, this approach would require a decision to be made by the Board for hedged items measured at amortized cost. The Board would need to decide whether fair value changes attributable to the hedged risk for those hedged items should be recognized in OCI. If the Board decides to retain amortized cost measurement for those hedged items, volatility would be increased in OCI. However, if the Board decides to require fair value changes attributable to the hedged risk for those hedged items to be recognized in OCI, volatility would be reduced because the fair value changes for the hedged item would offset (to a certain extent) the fair value changes for the hedging instrument recognized in OCI under this approach.

21. Comprehensive income under both Approach A and B would be the same; it is just a matter of where the change in fair value associated with future cash flows would be reflected for both the FV-OCI hedged item and the derivative.
22. This approach would be a departure from the tentative FASB classification and measurement model because it would require certain fair value changes for a derivative to be recognized in OCI. Currently, the FASB tentative model requires all derivative fair value changes to be recognized in net income. In addition, this approach would increase the use of OCI.

Application to hedged items classified as FV-OCI

23. Approach B would not impact the balance sheet as all financial instruments are recognized at fair value under the tentative model, but would have the following impact on the performance statement based on the tentative FASB classification and measurement model described in paragraph 3.

Fair value hedges only (guidance for cash flow hedges unchanged from Approach A):

	Hedged Item	Hedging Instrument
Recognized in net income:	Current period interest accruals Current period credit losses	Ineffective portion of gains and losses Offsetting gains and losses related to hedged item
Recognized in OCI:	Unrealized fair value gains and losses	Effective portion of fair value gains and losses <i>Less:</i> offsetting gains and losses related to hedged item

24. Effectively, this approach would keep in OCI the fair value changes associated with the risk hedged that are not realized in the current period for both the hedged item and the hedging instrument.

Application to hedged items measured at amortized cost

25. Approach B would not impact the balance sheet differently than how the balance sheet is impacted currently under Topic 815 for financial instruments measured at amortized cost if

the hedged item is adjusted for changes attributable to the hedged risk. The impact on the performance statement would be similar to the impact on financial instruments in the FV-OCI category illustrated above except that unrealized fair value gains and losses would not be reflected for hedged items measured at amortized cost in a fair value hedge. This approach would increase the use of OCI. Most current period effects for financial instruments measured at amortized cost are recognized in net income and recognizing certain fair value changes on the hedging instrument in OCI would be inconsistent with where the current period effects of the hedged item are recognized.

Example (fair value hedge only)

26. For example, an entity holds for collection an 8 percent fixed-rate ABC Company debt security. Under the tentative FASB classification model, this debt security is classified as FV-OCI. Interest accruals for the debt security are recognized in net income and the debt security is subject to impairment analysis every reporting period with credit impairments recognized in net income.
27. The entity decides to hedge the interest rate risk in the debt security by entering into a pay-fixed/receive-variable interest rate swap with the fixed leg of the swap set at 5 percent and variable leg set at LIBOR. Using Approach B, hedge accounting does not impact the balance sheet for FV-OCI hedged items and its net impact on the performance statement would be the reporting of interest income based on LIBOR (variable piece) plus a fixed amount of 3 percent due to the requirement to reclassify offsetting gains or losses from OCI into net income for the interest rate swap. Under the FASB tentative model, fair value changes that are not related to the interest rate risk (the hedged risk) would be reflected in OCI for both the debt security and the interest rate swap. Fair value changes related to interest rate risk would be reflected in OCI for the debt security but only the effective portion (less amounts reclassified to net income) would be reflected in OCI for the interest rate swap. If the hedged item was measured at amortized cost, the effective portion of the fair value change of the interest rate swap would be reflected in OCI and the ineffective portion of the fair value change of the interest rate swap would be reflected in net income.

Approach C

28. Approach C utilizes the bifurcation-by-risk notion to determine if a hedging relationship qualifies for hedge accounting but requires both the hedged item and the hedging instrument to be measured at fair value with fair value changes recognized in net income. If the entity determines that the hedged item and hedging instrument qualify as part of a hedging relationship, all fair value changes for the derivative instrument and the hedged item would be recognized in net income. This approach would include an exception for designation of an entity's own debt or interest payments on own debt as the hedged item/forecasted transaction at inception similar to the exception proposed in the FASB June 2008 Exposure Draft on hedging activities. Under this approach, if an entity designates its own debt (that is measured at amortized cost) as the hedged item in a fair value hedge, it would be allowed to recognize in net income only the hedged item's offsetting gains and losses for the risk hedged. For a cash flow hedge that designates interest payments on own debt as the hedged forecasted transaction, an entity would be allowed to reflect ineffectiveness only on the risk hedged in net income.
29. This approach is similar to the fair value approach because it focuses on individually measuring the change in fair value of the derivative and the change in fair value of the hedged item. This approach would reflect in the financial statements the effects of both risks hedged and risks not hedged by the entity. This approach does not focus on reflecting in net income only the impact of discrete risks management chooses to hedge. However, this approach would allow more hedging relationships to qualify for hedge accounting because all changes in the fair value of the derivative must not be expected to reasonably offset all of the changes in fair value (or, the overall changes in cash flows) of a recognized debt instrument (or a forecasted purchase or issuance of a debt instrument) for the relationship to qualify for hedge accounting.
30. The exception for own debt (that is measured at amortized cost) would address concerns around incorporating the effects of an entity's own credit risk in (a) the measurement of the hedged item in a fair value hedge and (b) the measurement and reporting of ineffectiveness in a cash flow hedge.

31. Even though this approach would require retaining hedge effectiveness and eligible hedge risks guidance for entities to determine if they qualify for hedge accounting, the FASB staff believes that this approach would simplify hedge accounting and increase comparability. In addition, this approach would eliminate classification and measurement differences between the FASB tentative model and the IFRS 9 model for financial instruments designated and qualifying for hedge accounting.
32. This approach could be viewed as being similar to electing the fair value option or electing the default fair value measurement attribute under the tentative FASB model. However, the fair value option and the default fair value measurement attribute are only available to entities at initial recognition and once elected can not be subsequently changed. Approach C would allow for late hedges and provide flexibility for dedesignation and redesignation of hedging relationships.

Application to hedged items classified as FV-OCI

33. Approach C would not impact the balance sheet. It would also not impact comprehensive income on the performance statement. However, it would require all fair value changes for the hedged item to be reflected in net income rather than OCI, thereby presumably increasing the volatility in net income. The additional fair value change that would be reflected in net income under Approach C would be the remainder fair value change on the hedge item mainly relating to liquidity risk.

Application to hedged items measured at amortized cost

34. Approach C would impact the balance sheet because it would require a hedged item previously measured at amortized cost to be measured at fair value if it qualifies for hedge accounting. This change would impact the performance statement by requiring fair value changes for the period on the hedged item to be recognized in net income.

Staff Recommendation

35. **The FASB staff recommends Approach A if the FASB retains the tentative classification and measurement model for financial instruments. If the FASB increases**

the amortized cost category to allow more financial instruments to be measured at amortized cost, the FASB staff recommends Approach C.

36. The FASB staff believes that entities should reflect all risks (hedged or unhedged) in the financial statements. The FASB staff recommends Approach A because the staff believes that the tentative FASB classification and measurement model requiring all financial instruments to be measured at fair value (apart from the very narrow amortized cost option) achieves that objective. The staff recognizes that all risks (hedged or unhedged) would not be reflected in the financial statements under Approach A for an entity's own debt instruments that qualify for the narrow amortized cost exception. However, given the concerns around incorporating the effects of an entity's own credit risk in (a) the measurement of the hedged item in a fair value hedge and (b) the measurement and reporting of ineffectiveness in a cash flow hedge, the staff believes this outcome is reasonable.
37. However, if the FASB increases the amortized cost category, thereby allowing more financial instruments to be measured at amortized cost, the FASB staff believes that Approach C would achieve the objective of reflecting all risks (hedged or unhedged) in the financial statements. Approach C also addresses the concerns around incorporating the effects of an entity's own credit risk by providing an exception for own debt. In addition, since Approach C retains the bifurcation-by-risk criteria, it addresses concerns expressed by constituents regarding the inability to qualify for hedge accounting under a full fair value approach. Approach C accommodates late hedges and provides flexibility for dedesignation and redesignation of hedging relationships.
38. The FASB staff believes that Approach B is complex and is not an improvement to hedge accounting.

Question for the Board – bifurcation-by-risk approaches

Does the Board believe bifurcation-by-risk should be permitted?

If yes, which of the three approaches presented above does the Board prefer?