

Title:	Hedging—General: Issues Involving the Application of the Shortcut Method under Paragraph 68
Paragraph references:	63, 68–70, 114, 132
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INTRODUCTION

This Implementation Issue addresses two issues that have caused implementation difficulties in the application of paragraph 68 of Statement 133 (the shortcut method). This Implementation Issue amends the accounting and reporting standards of Statement 133, paragraph 68, as indicated below.

STATEMENT 133 IMPLEMENTATION ISSUE GUIDANCE

Paragraph 68 (Introductory Paragraph)

1. The shortcut method may be applied to a qualifying fair value hedge when the relationship is designated on the trade date of both the swap and the hedged item (for example, debt), even though the hedged item is not recognized for accounting purposes until the transaction settles (that is, until its settlement date), provided that the period of time between the trade date and the settlement date of the hedged item is within established conventions for that marketplace.

Paragraph 68(b)

2. Paragraph 68(b) is met for an interest rate swap that has a non-zero fair value at the inception of the hedging relationship provided that the swap was entered into at the hedge's inception for a transaction price of zero and the non-zero fair value is due solely to the existence of a bid-ask spread in the entity's principal market (or most advantageous market, as applicable) under FASB Statement No. 157, *Fair Value Measurements*. The interest rate swap would be reported at its fair value as determined under Statement 157.

AMENDMENTS TO STATEMENT 133

Paragraph 68 of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, is amended as follows: [Added text is underlined and deleted text is ~~struck-out~~.]

An assumption of no ineffectiveness is especially important in a hedging relationship involving an interest-bearing financial instrument and an interest rate swap because it significantly simplifies the computations necessary to make the accounting entries. If all of the applicable conditions in the following subparagraphs are met, ~~An~~ entity may assume no

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ineffectiveness in a hedging relationship of interest rate risk involving a recognized interest-bearing asset or liability (or a firm commitment arising on the trade [pricing] date to purchase or issue an interest-bearing asset or liability) and an interest rate swap (or a compound hedging instrument composed of an interest rate swap and a mirror-image call or put option as discussed in paragraph 68(d) below) provided that, in the case of a firm commitment, the trade date of the asset or liability differs from its settlement date due to generally established conventions in the marketplace in which the transaction is executed. ~~if all of the applicable conditions in the following list are met:~~

Conditions applicable to both fair value hedges and cash flow hedges

- b. If the hedging instrument is solely an interest rate swap, the fair value of that swap at the inception of the hedging relationship must be zero, with one exception. The fair value of the swap may be other than zero at the inception of the hedging relationship only if the swap was entered into at the relationship's inception, the transaction price of the swap was zero in the entity's principal market (or most advantageous market), and the difference between transaction price and fair value is attributable solely to differing prices within the bid-ask spread between the entry transaction and a hypothetical exit transaction.^{18b1} If the hedging instrument is a compound derivative composed of an interest rate swap and mirror-image call or put option as discussed in paragraph 68(d), the premium for the mirror-image call or put option must be paid or received in the same manner as the premium on the call or put option embedded in the hedged item. That is, the reporting entity must determine whether the implicit premium for the purchased call or written put option embedded in the hedged item was principally paid at inception-acquisition (through an original issue discount or premium) or is being paid over the life of the hedged item (through an adjustment of the interest rate). If the implicit premium for the call or put option embedded in the hedged item was principally paid at inception-acquisition, the fair value of the hedging instrument at the inception of the hedging relationship must be equal to the fair value of the mirror-image call or put option. In contrast, if the implicit premium for the call or put option embedded in the hedged item is principally being paid over the life of the hedged item, fair value of the hedging instrument at the inception of the hedging relationship must be zero (except as discussed previously regarding differing prices due to the existence of a bid-ask spread).

^{18b1} This guidance is applicable only to transactions considered "at market" (that is, transaction price is zero exclusive of commissions and other transaction costs, as discussed in paragraph 9 of FASB Statement No. 157, *Fair Value Measurements*).

[Note: Because subparagraphs (a), (c), (d), (dd), and (e-k) are not amended by this Implementation Issue, they have been omitted.]

EFFECTIVE DATE AND TRANSITION

The implementation guidance in this Issue is effective for hedging relationships designated on or after January 1, 2008.

At adoption, an entity shall assess preexisting hedging relationships to determine whether they met the requirements of this Implementation Issue as of the inception of the hedging relationship. An entity that had designated a qualifying hedging relationship utilizing the shortcut method that does not qualify for the shortcut method based on this amendment must dedesignate that hedging relationship prospectively (that is, the hedging relationship must be dedesignated at the effective date). If the hedging relationship had been a fair value hedge, the recognition in earnings due to adjustment of the carrying amount of the hedged asset or liability for the period prior to the effective date shall not be reversed. If the hedging relationship had been a cash flow hedge, the derivative's gain or loss for the period prior to the effective date shall remain in accumulated other comprehensive income and be reclassified into earnings when the hedged transaction affects earnings in accordance with paragraph 33 of Statement 133.

Under this transition, a hedging relationship that does not qualify for the shortcut method based on this Implementation Issue could be redesignated without application of the shortcut method in paragraph 68 if that hedging relationship meets the applicable requirements of Statement 133.

The above response has been unanimously approved by the Board by written ballot.

BASIS FOR CONCLUSIONS

At the February 15, 2006 Board meeting, the Board agreed to add a project to its agenda that would provide clarifying language to Statement 133 in response to inquiries received involving the application of the shortcut method. The objective of this Implementation Issue is to improve financial reporting by addressing uncertainty in practice about when an entity qualifies for the shortcut method.

Settlement of Hedged Item Occurs Subsequent to Swap Trade Date

It is customary for a debtor or investor to enter into an at-market interest rate swap at the date the issuance or purchase of an interest-bearing asset or liability is firmly committed to and priced (referred to herein as the trade date), because at that date the debtor or investor begins to be exposed to changes in interest rates. The debt obligation often is not recognized for financial reporting purposes until it is issued several days later (on the settlement date). Consequently, if a hedging relationship is designated on the trade date, the hedged item may not yet be a recognized asset or liability. Given that the practice described above is common, concern has arisen as to whether the fair value hedging relationship meets the requirement in paragraph 68 (that the hedged item must be a recognized asset or liability). The Board decided that such market realities should not disqualify the use of the shortcut method provided that the difference between the trade date and the settlement date are in accordance with normal market terms and conventions.

Application of Paragraph 68(b) When the Transaction Price of Interest Rate Swap Is Zero

Paragraph 68(b) of Statement 133 requires the fair value of an interest rate swap at the inception of the hedging relationship to be zero to meet that requirement for the shortcut method. Prior to the issuance of Statement 157, the fair value of a derivative that was entered into in the reporting entity's principal market was generally considered to be the transaction price (which is an entry price). Upon adoption of Statement 157, the fair value of an interest rate swap at initial recognition would be based on an exit price, as discussed in paragraph 31 of Statement 157, which might be other than zero due to the existence of a bid-ask spread. As a result, an entity might not pay or receive an amount at inception of the interest rate swap, but due to differences in the bid-ask spread in its principal market, the fair value at inception of the hedging relationship may be other than zero. The Board decided in this Implementation Issue that when a company enters into an interest rate swap with a transaction price of zero in its principal (or most advantageous) market, a difference between transaction price and fair value that is attributable solely to differing prices within the bid-ask spread between the entry transaction and a hypothetical exit transaction would not preclude the application of the shortcut method.

Board Redeliberations on the Exposure Draft to E23

The exposure draft (that is, the Proposed Implementation Issue) for Implementation Issue E23 included the following proposed guidance on other issues in addition to the issues discussed above:

Paragraph 68(a)

1. Paragraph 68(a) is met if (a) the notional amount of the swap and the principal amount of the hedged item match for each hedged interest payment for a cash flow hedge or match over the entire term of the hedged item for a fair value hedge, and (b) the notional amount of the fixed leg of the swap matches the notional amount of the variable leg of the swap throughout the life of the hedging relationship.

Paragraph 68(e)

1. Paragraph 68(e) is met if the terms of the interest rate swap and the interest-bearing financial instrument **both** are typical for those instruments **and** do not invalidate the assumption of no ineffectiveness.
2. The par value of the hedged item is not required to equal its fair value at inception of the hedging relationship provided that the difference (a discount or premium) is attributable solely to the market convention of rounding the coupon rate.
3. A fair value hedging relationship that begins subsequent to initial recognition of the hedged item would not meet paragraph 68(e).
4. A hedge of a zero-coupon financial instrument fails paragraph 68(e) because the interest rate swap contains a financing element (fixed payments on the fixed leg of the swap are being financed); it also fails paragraph 68(a) because the notional amount of the fixed leg of the swap does not match the notional amount of the variable leg of the swap throughout the life of the hedging relationship.

The Board decided to provide guidance in this Implementation Issue about (a) the circumstance in which the settlement of the hedged item occurs subsequent to the swap's trade date and (b) the application of paragraph 68(b) when the transaction price of interest rate swap is zero. However, the Board decided not to address the other issues that had been included in the Proposed Implementation Issue because the Board believes those issues to be less pressing and because the Board is actively considering, in another project, an approach to simplify hedge accounting that would involve eliminating all use of the shortcut method described in paragraph 68 of Statement 133.