Notice for Recipients
of This Proposed Statement 133 Implementation Issue

This proposed Implementation Issue would amend the accounting and reporting requirements of paragraph 68 of Statement 133 (the shortcut method) to address certain practice issues. The objective is to improve financial reporting related to the shortcut method to increase comparability in financial statements.

The Board invites individuals and organizations to send written comments on all matters in this proposed Implementation Issue. Comments are requested from those who agree with the provisions of this proposed Implementation Issue as well as from those who do not. Comments are most helpful if they identify the issues to which they relate and clearly explain the issue or question. Those who disagree with the provisions are asked to describe their suggested alternatives, supported by specific reasoning.

Responses from interested parties wishing to comment must be received in writing by Friday, September 21, 2007. Interested parties should submit their comments by email to "director@fasb.org, File Reference: Proposed Issue E23." Those without email may send their comments to "Russell G. Golden, Director of Technical Application & Implementation Activities, FASB, 401 Merritt 7, PO Box 5116, Norwalk, CT 06856-5116, File Reference: Proposed Issue E23." Responses should not be sent by fax.

All comments received by the FASB are considered public information. Those comments will be posted to the FASB's website and will be included as part of the public record with other project materials.

Title:	Hedging—General: Issues Involving the Application of the *Shortcut Method* under Paragraph 68
Paragraph references:	63, 68–70, 114, 132
Date released:	July 23, 2007
Comment deadline:	September 21, 2007

INTRODUCTION

This proposed Implementation Issue addresses a limited number of issues that have caused implementation difficulties in the application of paragraph 68 of Statement 133 (the shortcut method). This proposed Implementation Issue would amend 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(a):

2. 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(b):

3. 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 primary market (or most advantageous market, as applicable) under FASB Statement No. 157, *Fair Value Measurements*.

Paragraph 68(e):

4. 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.
5. 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.
6. A fair value hedging relationship that begins subsequent to initial recognition of the hedged item would not meet paragraph 68(e).
7. 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.

AMENDMENTS TO STATEMENT 133

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~~.]

Paragraph 68:

> 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, ~~A~~an entity may assume no 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 date to issue or purchase an interest-bearing asset or liability provided that 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) 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) ~~if all of the applicable conditions in the following list are met~~.

Conditions applicable to both fair value hedges and cash flow hedges

a. The notional amount of the swap matches the principal amount of the interest-bearing asset or liability being hedged and 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. This requirement also is met if the notional amount of the swap and principal amount of the asset or liability match for each hedged interest payment for a cash flow hedge or match over the entire term of the interest-bearing asset or liability for a fair value hedge, even if the hedged item amortizes or otherwise adjusts subsequent to hedge inception. However, a swap contract whose notional amount for each interest payment is based on the estimated rate of unscheduled prepayments (but does not exactly match the outstanding principal on the debt security) does **not** meet the requirement in this paragraph.

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 ~~is~~ 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).

e. Any other terms in the interest-bearing financial instruments or interest rate swaps are both typical of those instruments and do not invalidate the assumption of no ineffectiveness. That is, the terms of the interest rate swap and the interest-bearing financial instrument must both:

    1. Be typical for those instruments; **and**
    2. Not invalidate the assumption of no ineffectiveness.

For example, in a fair value hedging relationship the fair value of the hedged item must equal its par value at inception of the hedging relationship because the amortization of the initial difference (a discount or premium) would create ineffectiveness. However, an exception to this principle exists, as follows: A difference between fair value and par value of the hedged item would not invalidate the assumption of no ineffectiveness if the difference is a discount or premium attributable solely to the market convention of rounding the coupon rate of the hedged item at issuance.

[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 No. Statement 157, *Fair Value Measurements*) with no embedded financing within the terms of the swap.

[Note: Because Subparagraphs (c), (d), (dd), and (f–k) are not amended by this Implementation Issue, they have been omitted.]

EFFECTIVE DATE AND TRANSITION

The effective date of the implementation guidance in this Issue for each reporting entity is the first day of its first fiscal quarter beginning after the date that the Board-approved guidance is posted to the FASB website.

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.

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 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 is not yet 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). Additional concerns also have arisen about applying the shortcut method, because when the hedged item is recognized (on the settlement date), the asset or liability would likely have a par value that differs from its fair value and the interest rate swap would likely not have a zero fair value. The Board decided that these narrow 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.

Hedged Item Is Subject to Principal Pay-Downs Prior to Maturity

If the swap's notional amount and the asset or liability's principal amount on which the interest is based match for each interest payment during the hedging relationship for a cash flow hedge or over the term of the interest-bearing asset or liability for a fair value hedge, the condition in paragraph 68(a) is met. A swap contract that merely estimates the rate of unscheduled prepayments (but does not exactly match the outstanding principal on the security, even though it is close) does **not** meet the condition in paragraph 68(a) because it would be invalid to assume no ineffectiveness.

Although paragraph 68(a) refers to the swap's notional amount in the singular, it does not require that the notional amount of the swap remain unchanged over the period of the hedging relationship. Because of this, a swap with a notional amount that changes at each settlement to match the principal of the interest-bearing asset or liability on which the calculation of interest is based complies with paragraph 68(a). That guidance applies regardless of whether the changes in notional amounts are triggered by unscheduled prepayments or contractually scheduled principal amortization. Thus, the variable notional amount does not invalidate the assumption of no ineffectiveness, provided the swap's notional amount and the outstanding principal amount of the debt on which interest payments are based are the same amount for each settlement.

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

Paragraph 68(b) of Statement 133 previously required 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 likely would 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 their primary market, the fair value at inception 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 application of the shortcut method.

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 Statement 157) with no embedded financing within the terms of the swap.

Terms of Swap and Hedged Item Must both Be Typical and Not Invalidate the Assumption of No Ineffectiveness (Paragraph 68(e))

Questions have arisen in practice as to the intended meaning of paragraph 68(e). The Board decided to clarify that both conditions must be met and that significant discounts and premiums are an example of a term of a hedged item that would invalidate the assumption of no ineffectiveness. An entity should take into account **both** of the following when applying paragraph 68(e):

1. The entity should consider all of the terms in the interest-bearing financial instrument and the interest rate swap, including terms that are explicitly considered under paragraphs 68(a)–68(dd) and paragraphs 68(f)–68(k). If any terms are not typical of those instruments, then paragraph 68(e) is not met (even if those terms do not invalidate the assumption of no ineffectiveness).
2. If **any** of the terms of the interest-bearing financial instrument invalidate the assumption of no ineffectiveness (regardless of whether the terms of the interest-bearing financial instrument and the interest rate swap are considered typical of those instruments), then paragraph 68(e) is not met.

Inception at Recognition of Hedged Item—Effect of the Normal Market Convention of Rounding the Coupon Rate

Some have interpreted paragraph 68(e) as requiring that the par value of the hedged item be equal to its fair value at the inception of the hedging relationship in order to qualify for the shortcut method for fair value hedges. This is because the amortization of an initial difference between fair value and par value (a premium or discount) would create ineffectiveness that would violate paragraph 68(e). However, due to certain market realities (such as the effect of the normal market convention of rounding the coupon rate), par value rarely, if ever, equals fair value at the inception of the hedging relationship involving a debt instrument.

A common reason for a debtor to issue its debt at a discount or premium is due to the market convention of rounding the interest rate to be paid on the debt (mainly rounding down) when pricing the debt. For example, on July 1, assume Company A issues 3-year debt. When pricing the issue, Company A looks to the 3-year Treasury yield (4.958 percent) and applies its credit spread (50 basis points) to determine a yield of 5.458 percent on its bonds. In accordance with normal market convention, Company A rounds the coupon rate down to 5.45 percent, or even 5.40 percent, in order to provide investors with an instrument with a simple yield. Given that the actual yield is 5.458 percent, Company A issues the debt at a slight discount due to this market convention of rounding the coupon rate. Thus, the fair value of the debt does not equal its par value if it was designated as the hedged item in a fair value hedge upon the debt's initial recognition.

The Board accepted this practical reality of markets and decided to clarify that a discount or premium attributed solely to coupon rounding would not disqualify a debt instrument from being the hedged item under the shortcut method.

Hedge Relationship Begins After Hedged Item Is Recognized

The Board decided that a fair value hedging relationship that begins subsequent to initial recognition would not meet the requirement in paragraph 68(e). The non-par fair value of the debt means that, even considering the effect of the credit spread differential that paragraph 70 of Statement 133 contemplates, there is a higher or lower yield on the debt than on par debt. The value of this coupon differential, which is not merely compensating for credit risk, is, like any other cash flows to be received in the future, subject to changes in value as benchmark rates change. Those changes, which would not be expected to be offset by changes in a zero-fair-value swap, will create ineffectiveness, causing the relationship to fail the requirements in paragraph 68(e). Therefore, in the above example, no ineffectiveness cannot be assumed.

The Board believes that this guidance also is consistent with Statement 133 Implementation Issue No. E15, "Continuing the Shortcut Method after a Purchase Business Combination," which

provides an example of a hedging relationship that met the requirements of paragraph 68 but, due to a business combination, a redesignation event occurred. Implementation Issue E15 emphasizes that the post-acquisition hedging relationship is a new relationship that has a new inception date. Even in the unlikely circumstance that the new hedging relationship qualifies for the shortcut method, there would be no continuation of the shortcut method of accounting that had been applied by the acquired entity.

When the Hedged Item Is a Zero-Coupon Financial Instrument

Questions arose in practice about whether a zero-coupon financial instrument could qualify as the hedged item under the shortcut method. The Board believes that a hedge of a zero-coupon financial instrument is not eligible for the shortcut method because the interest rate swap contains a financing element (fixed payments on the fixed leg of the swap are being financed) and thus fails paragraph 68(e)(1) since it invalidates the assumption of no ineffectiveness. A hedge of a zero-coupon financial instrument also fails paragraph 68(a) because the notional amount of the fixed leg of the swap typically does not match the notional amount of the variable leg of the swap throughout the life of the hedging relationship.

Consider the following example: Company G issues a $100,000 par amount 5-year zero-coupon bond. The proceeds on the bond issuance equal $78,350 (providing an implicit 5 percent compounded semiannual rate). Company G enters into a receive-fixed,pay-variable interest rate swap that has an initial notional amount equal to the proceeds of $78,350. The variable leg of the swap resets and settles on a quarterly basis. The fixed leg of the swap involves 1 final receipt of $21,650 at the end of the 5 years. The swap has essentially converted the 1-time compounded interest payment of $21,650 required to be paid by the issuer at the end of year 5 ($78,350 + $21,650 = $100,000 face amount) to a variable-rate quarterly interest payment on $78,350.

The zero-coupon debt hedge described above does not meet the condition in 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. In the example above, the notional amount of the variable leg of the swap is fixed at $78,350, while the notional amount of the fixed leg starts at $78,350, but the interest implicitly continues to increase by 5 percent every year until the notional amount equals $100,000. The requirement in paragraph 68(a) implicitly includes a requirement that the notional amount of both legs of the swap also agree. The Board decided to make this explicit.

Paragraph 68(e) also would not be met because the interest rate swap contains a financing element (fixed payments on the fixed leg of the swap are being financed). While the above example may result in a highly effective hedging relationship (as might, say, a hedge using an accreting interest rate swap where the notional on both legs accrete), it fails paragraph 68(e)(1), since it invalidates the assumption of no ineffectiveness.

ALTERNATIVE VIEWS

Three Board members dissented to the issuance of this proposed *Implementation* Issue. Those Board members generally support the conclusions reached in this proposed *Implementation* Issue but disagree with the conclusion that a condition of the shortcut method is that the fair value of the hedged item has to equal its principal amount (which disqualifies hedge transactions that are entered into after the initial issuance or purchase of the debt instrument). Those Board members believe that Statement 133 does not currently include this requirement, and they do not support amending Statement 133 to add such a requirement.

Paragraph 68 enumerates the requirements for the shortcut method. Paragraph 68(a) states: "The notional amount of the swap matches the principal amount of the interest-bearing asset or liability being hedged." Paragraph 68(b) imposes an additional requirement for the swap—its fair value must equal zero at inception. No other condition states that the fair value of the hedged item must equal its principal amount.

Paragraph 114 sets forth the computational steps in the shortcut method for a fair value hedge. Subparagraph (c) states:

> Compute and recognize interest expense using that combined rate and the fixed-rate liability's principal amount. (Amortization of any purchase premium or discount on the liability also must be considered, although that complication is not incorporated in this example.)

The table following that guidance also states that the trade date of the swap and the borrowing date of the debt "need not match for the assumption of no ineffectiveness to be appropriate." Those Board members believe this guidance explicitly permits the hedged item to have a purchase premium or discount and still qualify for the shortcut method. Therefore, those Board members reject the suggestion that paragraph 68(e) implicitly requires that the fair value of the hedged item equal its principal amount.

Those Board members also observe that Statement 133 Implementation Issue No. E10, "Application of the Shortcut Method to Hedges of a Portion of an Interest-Bearing Asset or Liability (or Its Related Interest) or a Portfolio of Similar Interest-Bearing Assets or Liabilities," refers to either the principal amount or the notional amount of the hedged item. It does not mention the fair value of the hedged item. Likewise, Implementation Issue E15, concludes the shortcut method would generally not be permitted because the fair value of the swap is unlikely to be zero at the date of the acquisition. The guidance does not mention that the fair value of the hedged items would not likely equal their principal or notional amounts.

Those Board members would not amend Statement 133 to impose this new requirement. They believe that changes in the fair value of a debt instrument prior to the hedge transaction do not distort the effectiveness of the hedging relationship going forward, provided that the terms of the swap match the remaining terms of the debt. In that case, it is still reasonable to assume that changes in the fair value of the swap will be highly effective in offsetting subsequent changes in the fair value of the debt attributable solely to subsequent changes in the benchmark interest rate. Other accounting standards would govern the recognition in earnings of any premium or discount on the hedged item prior to the inception of the hedge. That element does not represent ineffectiveness in the current hedging transaction. Those Board members observe that the same economic phenomenon exists in the issues involving differences between the fair value of the hedged item and the principal amount due to differences in the trade date of the derivative and settlement date of the debt, or due to a rounding down of the coupon at issuance (that is, the fair value of the hedged item might be different from its principal amount). The Board appropriately decided to permit the shortcut method in those cases albeit primarily on the basis of the expected insignificance of the premiums and discounts and also because of prevalent market conventions relating to the hedged items.

Questions have been raised about whether the Board should retain the shortcut method (or even hedge accounting) at all. Those Board members observe that there is still a mixed-measurement attribute model under which derivatives are required to be carried at fair value and most other financial instruments are not. The shortcut method was designed to significantly simplify the bookkeeping requirements for a narrow set of highly effective, extremely common transactions that are viewed by most market participants as "swapping the coupon" on a debt instrument (not as a hedge of the fair value of the debt). Those Board members would consider replacing the shortcut method with a principle that would apply more broadly to highly effective hedge transactions where the critical terms match as a different form of simplification. The shortcut method will be considered as part of a separate FASB project. Those Board members support the Board's goal of someday measuring all financial instruments at fair value but do not believe that significantly limiting hedge accounting is appropriate in the current mixed-attribute scheme. In the meantime, the Board has issued an Exposure Draft to improve the disclosures related to derivatives and hedging activities. That proposed standard would enhance the transparency of derivatives, including why they are held, how they are being accounted for, and their quantitative effects in the financial statements.