# Appendix A Derivatives

AACSB assurance of learning standards in accounting and business education require documentation of outcomes assessment. Although schools, departments, and faculty may approach assessment and its documentation differently, one approach is to provide specific questions on exams that become the basis for assessment. To aid faculty in this endeavor, we have labeled each question, exercise, and problem in *Intermediate Accounting, 9e,* with the following AACSB learning skills:

|  |  |
| --- | --- |
| **Questions** | **AACSB Tags** |
| A-1 | Reflective thinking |
| A-2 | Reflective thinking |
| A-3 | Analytic |
| A-4 | Reflective thinking |
| A-5 | Reflective thinking |
| A-6 | Reflective thinking |
| A-7 | Reflective thinking |
| **Exercises** |  |
| A-1 | Reflective thinking |
| A-2 | Analytic |
| A-3 | Analytic |
| A-4 | Analytic |
| A-5 | Analytic |
| A-6 | Analytic |
| **Problems** |  |
| A-1 | Reflective thinking , Analytic |
| A-2 | Reflective thinking, Analytic |
| A-3 | Reflective thinking , Analytic |

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# Questions for Review of Key Topics

Question A–1

These instruments “derive” their values or contractually required cash flows from some other security or index.

Question A–2

The FASB has taken the position that the income effects of the hedge instrument and the income effects of the item being hedged should be recognized at the same time.

Question A–3

If interest rates change, the change in the debt’s fair value will be less than the change in the swap’s fair value. The gain or loss on the $500,000 notional difference will not be offset by a corresponding loss or gain on debt. Any increase or decrease in income resulting from a hedging arrangement would be a result of hedge ineffectiveness such as this.

Question A–4

A futures contract is an agreement between a seller and a buyer that calls for the seller to deliver a certain commodity (such as wheat, silver, or Treasury bond) at a specific future date, at a *predetermined* price. Such contracts are actively traded on regulated futures exchanges. If the “commodity” is a *financial instrument*, such as a Treasury bill, commercial paper, or a CD, the contract is called a financial futures agreement.

Question A–5

An interest rate swap exchanges fixed interest payments for floating rate payments, or vice versa, without exchanging the underlying notional amount.

*Answers to Questions (continued)*

Question A–6

All derivatives, without exception, are reported on the balance sheet as either assets or liabilities at fair (or market) value. The rationale is that (a) derivatives create either rights or obligations that meet the FASB’s definition of assets or liabilities and (b) fair value is the most meaningful measurement.

Question A–7

A gain or loss from a cash flow hedge is deferred as other comprehensive income until it can be recognized in earnings along with the earnings effect of the item being hedged.

# Exercises

Exercise A–1

Indicate (by abbreviation) the type of hedge each activity described below would represent.

**Hedge Type**

FV Fair value hedge

CF Cash flow hedge

FC Foreign currency hedge

N Would not qualify as a hedge

**Activity**

FV 1. An options contract to hedge possible future price changes of inventory.

CF 2. A futures contract to hedge exposure to interest rate changes prior to replacing bank notes when they mature.

CF 3. An interest rate swap to synthetically convert floating rate debt into fixed rate debt.

FV 4. An interest rate swap to synthetically convert fixed rate debt into floating rate debt.

FV 5. A futures contract to hedge possible future price changes of timber covered by a firm commitment to sell.

CF 6. A futures contract to hedge possible future price changes of a forecasted sale of tin.

FC 7. ExxonMobil’s net investment in a Kuwait oil field.

CF 8. An interest rate swap to synthetically convert floating rate interest on a stock investment into fixed rate interest.

N 9. An interest rate swap to synthetically convert fixed rate interest on a held-to-maturity debt investment into floating rate interest.

CF 10. An interest rate swap to synthetically convert floating rate interest on a held-to-maturity debt investment into fixed rate interest.

FV 11. An interest rate swap to synthetically convert fixed rate interest on a stock investment into floating rate interest.

Exercise A–2

**Requirement 1**

**January 1 March 31 June 30**

Fair value of interest rate swap 0 $6,472 $11,394

Fair value of note payable $200,000 $206,472 $211,394

Fixed rate 10% 10% 10%

Floating rate 10% 8% 6%

Fixed interest receipts $5,000 $5,000

Floating payments 4,000 3,000

Net interest receipts (payments) $1,000 $2,000

***Exercise A–2 (concluded)***

**Requirement 2**

**January 1**

Cash 200,000

Notes payable 200,000

*To record the issuance of the note*

**March 31**

Interest expense ([10% x ¼] x $200,000) 5,000

Cash 5,000

*To record interest*

Cash ($5,000 – ([8% x ¼] x $200,000)) 1,000

Interest expense 1,000

*To record the net cash settlement*

Interest rate swap [asset] ($6,472 – 0) 6,472

Holding gain—interest rate swap 6,472

*To record change in fair value of the derivative*

Holding loss—hedged note 6,472

Note payable ($206,472 – 200,000) 6,472

*To record change in fair value of the note*

**June 30**

Interest expense ([10% x ¼] x $200,000) 5,000

Cash 5,000

*To record interest*

Cash ($5,000 – ([6% x ¼] x $200,000)) 2,000

Interest expense 2,000

*To record the net cash settlement*

Interest rate swap [asset] ($11,394 – 6,472) 4,922

Holding gain—interest rate swap 4,922

*To record change in fair value of the derivative*

Holding loss—hedged note 4,922

Note payable ($211,394 – 206,472) 4,922

*To record change in fair value of the note*

Exercise A–3

**Requirement 1**

**January 1 March 31 June 30**

Fair value of interest rate swap 0 $6,472 $11,394

Fair value of investment $200,000 $206,472 $211,394

Fixed rate 10% 10% 10%

Floating rate 10% 8% 6%

Fixed interest payments $5,000 $5,000

Floating interest receipts (4,000) (3,000)

Net interest payments $1,000 $2,000

***Exercise A–3 (concluded)***

**Requirement 2**

**January 1**

Investment in notes 200,000

Cash 200,000

*To record the investment of the note*

**March 31**

Cash 5,000

Interest revenue ([10% x ¼] x 200,000) 5,000

*To record interest*

Interest revenue 1,000

Cash ($5,000 – ([8% x ¼] x $200,000)) 1,000

*To record the net cash settlement*

Holding loss—interest rate swap 6,472

Interest rate swap [liability] ($6,472 – 0) 6,472

*To record change in fair value of the derivative*

Investment in notes ($206,472 – 200,000) 6,472

Holding gain—hedged investment 6,472

*To record change in fair value of the investment*

**June 30**

Cash 5,000

Interest revenue ([10% x ¼] x $200,000) 5,000

*To record interest*

Interest revenue 2,000

Cash ($5,000 – ([6% x ¼] x $200,000)) 2,000

*To record the net cash settlement*

Holding loss—interest rate swap 4,922

Interest rate swap [liability] ($11,394 – 6,472) 4,922

*To record change in fair value of the derivative*

Investment in notes ($211,394 – 206,472) 4,922

Holding gain—hedged investment 4,922

*To record change in fair value of the investment*

Exercise A–4

**Requirement 1**

**June 30**

Fair value of interest rate swap $11,394

Fair value of note payable $220,000

Fixed rate 10%

Floating rate 6%

Fixed receipts $5,000 ([10% x ¼] x $200,000)

Floating payments (3,000) ([6% x ¼] x $200,000)

Net interest receipts (payments) $2,000

***Exercise A–4 (concluded)***

**Requirement 2**

Your entries would be the same whether there was or was not an additional rise in the fair value of the note (higher than that of the swap) on June 30 due to investors’ perceptions that the creditworthiness of LLB was improving. When a note’s fair value changes by an amount different from that of a designated hedge instrument for reasons unrelated to interest rates, we ignore those changes. We recognize only the fair value changes in the hedged item that we can attribute to the risk being hedged (interest rate risk in this case). The entries would be:

**June 30**

Interest expense ([10% x ¼] x $200,000) 5,000

Cash 5,000

*To record interest*

Cash ($5,000 – ([6% x ¼] x $200,000) 2,000

Interest expense 2,000

*To record the net cash settlement*

Interest rate swap [asset] ($11,394 – 6,472) 4,922

Holding gain—interest rate swap 4,922

*To record change in fair value of the derivative*

Holding loss—hedged note 4,922

Note payable ($211,394 – 206,472) 4,922

*To record change in fair value of the note due to interest*

Exercise A–5

**January 1**

Cash 200,000

Notes payable 200,000

*To record the issuance of the note*

**March 31**

Interest expense ([10% x ¼] x $200,000) 5,000

Cash 5,000

*To record interest*

Cash ($5,000 – ([8% x ¼] x $200,000)) 1,000

Interest rate swap ($6,472 - 0) 6,472

Interest revenue ([10% x ¼] x $0) 0

Holding gain—interest rate swap (to balance) 7,472

*To record the net cash settlement, accrued interest on the*

*swap, and change in fair value of the derivative*

Holding loss—hedged note 6,472

Notes payable ($206,472 – 200,000) 6,472

*To record change in fair value of the note due to interest*

**June 30**

Interest expense ([8% x ¼] x $206,472) 4,129

Notes payable (difference) 871

Cash ([10% x ¼] x $200,000) 5,000

*To record interest*

Cash ($5,000 – ([6% x ¼] x $200,000)) 2,000

Interest rate swap ($11,394 – 6,472) 4,922

Interest revenue ([8% x ¼] x $6,472) 129

Holding gain—interest rate swap (to balance) 6,793

*To record the net cash settlement, accrued interest on the*

*swap, and change in fair value of the derivative*

Holding loss—hedged note 5,793

Notes payable ($211,394 – 206,472 + 871) 5,793

*To record change in fair value of the note due to interest*

Exercise A–6

**Requirement 1**

**June 30**

Fair value of interest rate swap $11,394

Fair value of note payable $220,000

Fixed rate 10%

Floating rate 6%

Fixed receipts $5,000 ([10% x ¼] x $200,000)

Floating payments (3,000) ([6% x ¼] x $200,000)

Net interest receipts (payments) $2,000

***Exercise A–6 (concluded)***

**Requirement 2**

Your entries would be the same whether there was or was not an additional rise in the fair value of the note (higher than that of the swap) on June 30 due to investors’ perceptions that the creditworthiness of LLB was improving. When a note’s fair value changes by an amount different from that of a designated hedge instrument for reasons unrelated to interest rates, we ignore those changes. We recognize only the fair value changes in the hedged item that we can attribute to the risk being hedged (interest rate risk in this case). The entries would be:

**June 30**

Interest expense ([8% x ¼] x $206,472) 4,129

Notes payable (difference) 871

Cash ([10% x ¼] x $200,000) 5,000

*To record interest*

Cash ($5,000 – ([6% x ¼] x $200,000)) 2,000

Interest rate swap ($11,394 – 6,472) 4,922

Interest revenue ([8% x ¼] x $6,472) 129

Holding gain—interest rate swap (to balance) 6,793

*To record the net cash settlement, accrued interest on the*

*swap, and change in fair value of the derivative*

Holding loss—hedged note 5,793

Notes payable ($211,394 – 206,472 + 871) 5,793

*To record change in fair value of the note due to interest*

# Problems

Problem A–1

**Requirement 1**

**January 1 December 31**

**2018 2018 2019 2020**

Fixed rate 8% 8% 8% 8%

Floating rate 8% 9% 7% 7%

Fixed receipts $ 8,000 $8,000 $8,000

Floating payments 9,000 7,000 7,000

Net interest receipts (payments) $(1,000) $1,000 $1,000

**Requirement 2**

**January 1, 2018**

Cash 100,000

Notes payable 100,000

*To record the issuance of the note*

**December 31, 2018**

Interest expense (8% x $100,000) 8,000

Cash 8,000

*To record interest*

Interest expense 1,000

Cash ($8,000 – [9% x $100,000]) 1,000

*To record the net cash settlement*

Holding loss—interest rate swap (to balance) 1,759

Interest rate swap (0 – $1,759) 1,759

*To record the change in fair value of the derivative*

Notes payable ($98,241 – 100,000) 1,759

Holding gain—hedged note 1,759

*To record change in fair value of the note*

*Problem A–1 (continued)*

**Requirement 3**

**December 31, 2019**

Interest expense (8% x $100,000) 8,000

Cash 8,000

*To record interest*

Cash ($8,000 – [7% x $100,000]) 1,000

Interest expense 1,000

*To record the net cash settlement*

Interest rate swap ($935 – [–1,759]) 2,694

Holding gain—interest rate swap (to balance) 2,694

*To record the change in fair value of the derivative*

Holding loss—hedged note ($100,935 – 98,241) 2,694

Notes payable (to balance) 2,694

*To record change in fair value of the note due to interest*

*Problem A–1 (continued)*

**Requirement 4**

**December 31, 2020**

Interest expense (8% x $100,000) 8,000

Cash 8,000

*To record interest*

Cash ($8,000 – [7% x $100,000]) 1,000

Interest expense 1,000

*To record the net cash settlement*

Holding loss—interest rate swap (to balance) 935

Interest rate swap (0 – $935) 935  
*To record the change in fair value of the derivative*

Notes payable ($100,000 – 100,935) 935

Holding gain—hedged note 935

*To record change in fair value of the note due to interest*

Note payable 100,000

Cash 100,000

*To repay the loan*

*Problem A–1 (continued)*

**Requirement 5**

**Swap Note**

*Jan. 1, 2018* 100,000

*Dec. 31, 2018* 1,759 1,759

*Balance*  1,759 98,241

*Dec. 31, 2019* 2,694

2,694

*Balance* 935 100,935

*Dec. 31, 2020* 935 935

100,000

*Balance* 0 0

*Problem A–1 (continued)*

**Requirement 6**

**Income Statement + (−)**

***2018*** (8,000) Interest expense

(1,000) Interest expense

(1,759) Holding loss—interest rate swap

1,759 Holding gain—hedged note

(9,000) Net effect—same as floating interest payment on swap

***2019*** (8,000) Interest expense

1,000 Interest expense

2,694 Holding gain—interest rate swap

(2,694) Holding loss—hedged note

(7,000) Net effect—same as floating interest payment on swap

***2020*** (8,000) Interest expense

1,000 Interest expense

(935) Holding loss—interest rate swap

935 Holding gain—hedged note

(7,000) Net effect—same as floating interest payment on swap

*Problem A–1 (concluded)*

**Requirement 7**

Your entries would not be affected. When a note’s fair value changes by an amount different from that of a designated hedge instrument for reasons unrelated to interest rates, we ignore those changes. We recognize only the fair value changes in the hedged item that we can attribute to the risk being hedged (interest rate risk in this case). The entries still would be:

Interest expense (8% x $100,000) 8,000

Cash 8,000

*To record interest*

Interest expense 1,000

Cash ($8,000 – [9% x $100,000]) 1,000

*To record the net cash settlement*

Holding loss—interest rate swap (to balance) 1,759

Interest rate swap (0 – $1,759) 1,759

*To record the change in fair value of the derivative*

Notes payable ($98,241 – 100,000) 1,759

Holding gain—hedged note 1,759

*To record change in fair value of the note*

**Problem A–2**

**Requirement 1**

CMOS has an unrealized gain due to the increase in the value of the derivative (not necessarily the same amount). Because interest rates declined, the swap will enable CMOS to pay the lower floating rate (receive cash on the net settlement of interest). The value of the swap (an asset) represents the present value of expected future net cash receipts. That amount has increased, as has the swap’s fair value, creating the unrealized gain. There is an offsetting loss on the bonds (a liability) because the fair value of the company’s debt has increased. Because the loss on the bonds exactly offsets the gain on the swap, earnings will neither increase nor decrease due to the hedging arrangement.

**Requirement 2**

CMOS would have an unrealized *loss* due to the decrease in the value of the derivative. Because interest rates increased, the swap will cause CMOS to pay the higher floating rate (pay cash on the net settlement of interest). The value of the swap (an asset) represents the present value of expected future net cash receipts. That amount has decreased, as has the swap’s fair value, creating the unrealized loss. There is an offsetting gain on the bonds (a liability) because the fair value of the company’s debt has decreased. Because the gain on the bonds exactly offsets the loss on the swap, earnings will neither increase nor decrease due to the hedging arrangement.

*Problem A-2 (continued)*

**Requirement 3**

The unrealized gain on the swap and loss on the bonds would not be affected. When a hedged debt’s fair value changes by an amount different from that of a designated hedge instrument for reasons unrelated to interest rates, we ignore those changes. We recognize only the fair value changes in the hedged item that we can attribute to the risk being hedged (due to interest rate risk in this case). Because the loss on the bonds exactly offsets the gain on the swap, earnings will neither increase nor decrease due to the hedging arrangement.

**Requirement 4**

There would be an unrealized gain due to the increase in the value of the derivative. There is an unrealized loss on the bonds (a liability). However, the gain on the derivative would be $20,000 more than the loss on the bonds. Because the loss on the bonds is less than the gain on the swap, earnings will increase by $20,000 (ignoring taxes) due to the hedging arrangement, an effect resulting from hedge ineffectiveness. This is an intended effect of hedge accounting. To the extent that a hedge is effective, the earnings effect of a derivative cancels out the earnings effect of the item being hedged. All ineffectiveness of a hedge is recognized currently in earnings.

*Problem A–2 (concluded)*

**Requirement 5**

There would be an unrealized loss due to a decrease in the value of the derivative, a liability to BIOS. Because interest rates declined, the swap would cause BIOS to receive the lower floating rate (pay cash on the net settlement of interest). The value of the swap represents the present value of expected future net cash payments. That amount has increased, as has the swap’s fair value, creating the unrealized loss. There would be an offsetting gain, though, on the bond investment because the fair value of the company’s investment has increased. Because the gain on the bonds exactly offsets the loss on the swap (a liability), earnings will neither increase nor decrease due to the hedging arrangement.

Problem A–3

**Requirement 1**

**January 1 December 31**

**2018 2018 2019 2020**

Fixed rate 8% 8% 8% 8%

Floating rate 8% 9% 7% 7%

Fixed payments $ 8,000 $8,000 $8,000

Floating payments 9,000 7,000 7,000

Net interest receipts (payments) $(1,000) $1,000 $1,000

**Requirement 2**

**January 1, 2018**

Cash 100,000

Notes payable 100,000

*To record the issuance of the note*

**December 31, 2018**

Interest expense (8% x $100,000) 8,000

Cash 8,000

*To record interest*

Interest expense (8% x $0) 0

Holding loss—interest rate swap (to balance) 2,759

Interest rate swap (0 – $1,759) 1,759

Cash ($8,000 – [9% x $100,000]) 1,000

*To record the net cash settlement, accrued interest on the*

*swap, and change in fair value of the derivative*

Notes payable ($98,241 – 100,000) 1,759

Holding gain—hedged note 1,759

*To record change in fair value of the note due to interest*

*Problem A–3 (continued)*

**Requirement 3**

**December 31, 2019**

Interest expense (9% x $98,241) 8,842

Notes payable (difference) 842

Cash (8% x $100,000) 8,000

*To record interest*

Cash ($8,000 – [7% x $100,000]) 1,000

Interest rate swap ($935 – [– 1,759]) 2,694

Interest expense (9% x $1,759) 158

Holding gain—interest rate swap (to balance) 3,852

*To record the net cash settlement, accrued interest on the*

*swap, and change in fair value of the derivative*

Holding loss—hedged note ($100,935 – 98,241 – 842) 1,852

Notes payable (to balance) 1,852

*To record change in fair value of the note due to interest*

*Problem A–3 (continued)*

**Requirement 4**

**December 31, 2020**

Interest expense (7% x $100,935) 7,065

Notes payable (difference) 935

Cash (8% x $100,000) 8,000

*To record interest*

Cash ($8,000 – [7% x $100,000]) 1,000

Holding loss—interest rate swap (to balance) 0

Interest rate swap (0 – $935) 935  
Interest revenue (7% x $935) 65

*To record the net cash settlement, accrued interest on the swap,*

*and change in fair value of the derivative*

Notes payable ($100,000 – 100,935 + 935) 0

Holding gain—hedged note 0

*To record change in fair value of the note due to interest*

Note payable 100,000

Cash 100,000

*To repay the loan*

*Problem A–3 (continued)*

**Requirement 5**

**Swap Note**

*Jan. 1, 2018* 100,000

*Dec. 31, 2018* 1,759 1,759

*Balance*  1,759 98,241

*Dec. 31, 2019* 2,694 842

1,852

*Balance* 935 100,935

*Dec. 31, 2020* 935 935

100,000

*Balance* 0 0

*Problem A-3 (continued)*

**Requirement 6**

**Income Statement + (−)**

***2018*** (8,000) Interest expense

(2,759) Holding loss—interest rate swap

1,759 Holding gain—hedged note

(9,000) Net effect—same as floating interest payment on swap

***2019*** (8,842) Interest expense

(158) Interest expense

3,852 Holding gain—interest rate swap

(1,852) Holding loss—hedged note

(7,000) Net effect—same as floating interest payment on swap

***2020*** (7,065) Interest expense

65 Interest revenue

(0) Holding loss—interest rate swap

0 Holding gain—hedged note

(7,000) Net effect—same as floating interest payment on swap

*Problem A–3 (concluded)*

**Requirement 7**

Your entries would not be affected. When a note’s fair value changes by an amount different from that of a designated hedge instrument for reasons unrelated to interest rates, we ignore those changes. We recognize only the fair value changes in the hedged item that we can attribute to the risk being hedged (interest rate risk in this case). The entries still would be:

Interest expense (8% x $100,000) 8,000

Cash 8,000

*To record interest*

Interest expense (8% x $0) 0

Holding loss—interest rate swap (to balance) 2,759

Interest rate swap (0 – $1,759) 1,759

Cash ($8,000 – [9% x $100,000]) 1,000

*To record the net cash settlement, accrued interest on the*

*swap, and change in fair value of the derivative*

Notes payable ($98,241 – 100,000) 1,759

Holding gain—hedged note 1,759

*To record change in fair value of the note due to interest*

# Cases

#### Real World Case A–1

**Requirement 1**

When Johnson & Johnson indicates that it expects that substantially all of the balance of deferred net losses on derivatives will be reclassified into earnings over the next 12 months as a result of transactions that are expected to occur over that period, it is saying that these as-yet-unrecognized net losses will be included in net income. A gain or loss from certain hedges is deferred as other comprehensive income until it can be recognized in earnings along with the earnings effect of the item being hedged.

**Requirement 2**

A gain or loss from a “fair value” hedge is recognized immediately in earnings along with the loss or gain from the item being hedged. On the other hand, a gain or loss from a “cash flow” hedge is deferred in the manner described by Johnson & Johnson until it can be recognized in earnings along with the earnings effect of the item being hedged. The hedging transactions referred to by Johnson & Johnson might be related to foreign currency hedges used to hedge foreign currency exposure to a forecasted transaction. They are treated as a cash flow hedge.

**Communication Case A–2**

Depending on the assumptions made, different views can be convincingly defended. The process of developing and synthesizing the arguments likely will be more beneficial than any single solution. Each student should benefit from participating in the process, interacting first with his or her partner, then with the class as a whole. It is important that each student actively participate in the process. Domination by one or two individuals should be discouraged.

Hedging means taking an action that is expected to produce exposure to a particular type of risk that’s precisely the *opposite* of an actual risk to which the company already is exposed. Under existing hedge accounting, if the contract meets specified hedging criteria, the income effects of the hedge instrument and the income effects of the item being hedged should be recognized at the same time.

Arguments raised may focus on a variety of issues including:

**•** Which hedges should qualify for special accounting? Hedges of risk of loss? Hedges that reduce the variability of outcomes?

**•** Should treatment be different for fair value hedges and cash flow hedges?

**•** Should only risk exposures arising from existing assets or liabilities qualify for special accounting? Should anticipated transactions be included also?

**•** To what extent, if any, must there be correlation between the gains and losses on the hedge instrument and the item being hedged?

**•** How should any deferred gain or loss be classified prior to recognition?

**Real World Case A–3**

The following is a copy of the U.S. Treasury Bond Futures: Settlement Prices as of July 7, 2016:

| **Month** | **Open** | **High** | **Low** | **Last** | **Change** | **Settle** | **Estimated Volume** | **Prior Day Open Interest** |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **Month** | **Open** | **High** | **Low** | **Last** | **Change** | **Settle** | **Estimated Volume** | **Prior Day Open Interest** |
|  | | | | | | | | |
| SEP 16 | 176'08 | 176'22 | 175'09 | 176'10 | +'12 | 176'08 | 243,967 | 568,609 |
| DEC 16 | 174'16 | 175'04B | 173'28A | 174'27B | +'12 | 174'25 | 9 | 142 |
| MAR 17 | - | - | - | - | +'12 | 173'21 | 0 | 0 |
| Total |  |  |  |  |  |  |  |  |

# U.S. Treasury Bond Futures Settlements

Bottom of Form

#### Research Case A–4

**[Note: This case requires the student to reference a journal article. Authoritative accounting literature references are to pre-Codification standards.]**

**Requirement 1**

**According to the authors, the primary problems or issues the FASB was attempting to address with the standard are the following:**

* **Previous accounting guidance for derivatives and hedging was incomplete.** Only a few types of derivatives used today were specifically addressed in accounting standards. SFAS No. 52, “Foreign Currency Translation,” addresses forward foreign exchange contracts, and SFAS No. 80, “Accounting for Futures Contracts,” addresses exchange-traded futures contracts. Similarly, those two standards were the only ones that specifically provided for hedge accounting. The Emerging Issues Task Force (EITF) addressed the accounting for some derivatives and for some hedging activities not covered in Statements 52 or 80; however, that effort was on an ad hoc basis. Large gaps remained in the authoritative accounting guidance. Accounting practice had filled some of those gaps on issues such as “synthetic instrument accounting” without any commonly understood limitations on their appropriate use. The result of this accounting hodgepodge was that (a) many derivative instruments were carried “off balance sheet” regardless of whether they are part of a hedging strategy, (b) practices were inconsistent among entities and for similar instruments held by the same entity, and (c) users of financial reports were confused or even misled.
* **Previous accounting guidance for derivatives and hedging was inconsistent.** Under the previous accounting guidance (FASB standards and EITF consensuses), the required accounting treatment may have differed depending on the type of instrument used in hedging and the type of risk being hedged. For example, an anticipated transaction could qualify as a hedged item only if the hedging instrument was a nonforeign currency futures contract or a nonforeign currency purchased option. Additionally, derivatives were measured differently under the previous accounting standards—futures contracts were reported at fair value, foreign currency forward contracts at amounts that reflect changes in foreign exchange rates but not other value changes, and other derivatives unrecognized or reported at nominal amounts that were a small fraction of the value of their potential cash flows. Other hedge accounting inconsistencies related to level of risk assessment (transaction-based versus entity-wide) and measurement of hedge effectiveness.

*Case A–4 (concluded)*

* **Previous accounting guidance for derivatives and hedging was complex.** The lack of a single, comprehensive approach to accounting for derivatives and hedging made the accounting guidance very complex. The incompleteness of the FASB statements on derivatives and hedging forced entities to look to a variety of different sources, including the numerous EITF issues and nonauthoritative literature, to determine how to account for specific instruments or transactions. Because there was often nothing directly on point, entities were forced to analogize to existing guidance. Because different sources of analogy often conflict, a wide range of answers could often be supported, and no answer was safe from later challenge.
* **Effects of derivatives were not apparent.** Under the previous varied practices, derivatives may or may not have been recognized in the financial statements. If recognized in the financial statements, realized and unrealized gains and losses on derivatives may have been deferred from earnings recognition and reported as part of the book value (or basis) of a related item or as if they are freestanding assets or liabilities. As a result, users of financial statements found it difficult to determine what an entity has or has not done with derivatives and what the related effects were. It was difficult to understand how financial statements could purport to present financial position without reporting the material benefits and obligations associated with derivative instruments.

**Requirement 2**

**In considering the issues, the FASB made four fundamental decisions that became the cornerstones of the proposed statement. According to the article, those fundamental decisions were:**

* Derivatives are assets or liabilities and should be reported in the financial statements.
* Fair value is the most relevant measure for financial instruments and the only relevant measure for derivatives.
* Only items that are assets or liabilities should be reported as such in the financial statements. A derivative loss should not be reported as an asset because it has no future economic benefit associated with it.
* Hedge accounting should be provided for only qualifying transactions, and one aspect of qualification should be an assessment of offsetting changes in fair values or cash flows.