The Fundamental Concepts

The FASB considered various approaches to reconcile and extend the previous hedge accounting guidelines in Statements 52 and 80. However, the FASB decided that such an approach was not practical and instead decided to pursue a new approach to applying hedge accounting that would coexist with the primary goal of making the effects of derivatives more transparent in the financial statements. The four basic underlying premises of the new approach are:

- Derivative instruments represent rights or obligations that meet the definitions of assets (expected future cash inflows due from another party) or liabilities (expected future cash outflows owed to another party) and should be reported in the financial statements.
- Fair value is the most relevant measure for financial instruments and the only relevant measure for derivative instruments.
- Only items that are assets or liabilities should be reported as such in the financial statements. (The FASB believes gains and losses from hedging activities are not assets or liabilities and, therefore, should not be deferred.)
- Special accounting for items designated as being hedged should be provided only for qualifying transactions, and one aspect of qualification should be an assessment of the expectation of the effectiveness of the hedge (i.e., offsetting changes in fair values or cash flows during the term of the hedge for the risk being hedged).

The FASB has announced that Statement 133 is simply an interim step on the road to accomplish its “vision” of having all financial instruments measured at fair value on the balance sheet.

The key changes Statement 133 introduces are:

- All derivatives are carried at fair value.
- The definition of a “derivative” is now broader.
- Hedge accounting continues, but the accounting varies based on the type of hedge relationship: fair value, cash flow, or net investment in a foreign operation.
- Because all derivatives are now on the balance sheet, the mechanics of the new hedge accounting impacts other accounts on the balance sheet in order to preserve the hedging effect in the income statement.
- Specific criteria to be able to use hedge accounting are established.
- The ineffective portion of a hedge is recognized in income and not deferred, thus creating potential volatility in income.
- Gains or losses that qualify as cash flow hedges are recognized in other comprehensive income, thus creating potential volatility in equity.
- Hedging certain foreign currency transactions is easier under the new rules.
- New disclosures are required.

The remainder of this chapter presents a brief summary of the major provisions of Statement 133.