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Drakopoulou, V. (2014). Accounting for Derivative Instruments and Hedging Activities. *Journal of Financial Risk Management, 3*(4). https://doi.org/10.4236/jfrm.2014.34013

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Journal of Financial Risk Management, 2014, 3, 151-165
Published Online December 2014 in SciRes. http://www.scirp.org/journal/jfrm
http://dx.doi.org/10.4236/jfrm.2014.34013

Scientific Research

Accounting for Derivative Instruments and Hedging Activities

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Received 19 September 2014; revised 14 October 2014; accepted 2 November 2014

Academic Editor: Robin H. Luo, ALHOSN University, UAE

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Abstract

The goal of this research was to investigate the reasons behind the plethora of amendments of the FASB Accounting Pronouncements for Financial Instruments from 2002 to 2008. Entities have communicated their apprehensions that the existent disclosure requirements in SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities", do not furnish sufficient input about how derivative and hedging activities influence an entity's financial position, financial performance, and cash flows. Correspondently, in 2008 the FASB issued Statement No. 161, "Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133". The purpose of the study was to investigate the extent to which the thirty companies that comprise the Dow Jones Industrial Average complied with the new qualitative and quantitative disclosure requirements for derivative financial instruments of SFAS No. 161. Following the theoretical framework of corporate risk management, the quarterly financial statements (10Qs) of the thirty companies that comprise the Dow Jones Industrial Average were examined to determine whether companies complied with the qualitative requirements of SFAS No.161 to disclose their objectives for holding or issuing derivative financial instruments and their risk management policy as well as a description of the items being hedged. A surprising finding was that most companies failed with the requirements of SFAS No. 161 to disclose the required information about cash flow hedges, net investments in foreign operations and, fair value hedges. These findings suggest that although the FASB issued SFAS No. 161 to enhance derivative disclosures to enable users of financial statements to evaluate the success and significance of derivative instruments and hedging transactions on an entity's financial statements, companies might need additional time to implement the standard.

Keywords

SFAS 161, SFAS 133, Accounting for Derivative Instruments & Hedging Activities, Fair Value Hedges, Cash Flow Hedges, Risk Management

How to cite this paper: Drakopoulou, V. (2014). Accounting for Derivative Instruments and Hedging Activities. *Journal of Financial Risk Management, 3,* 151-165. http://dx.doi.org/10.4236/jfrm.2014.34013

1. Introduction

The application and complication of derivative instruments and hedging activities have intensified substantially over the past several years. Entities have communicated their apprehensions that the existent disclosure requirements in FASB Statement No. 133, "Accounting for Derivative Instruments and Hedging Activities", do not furnish sufficient input about how derivative and hedging activities influence an entity's financial position, financial performance, and cash flows. Correspondently, the FASB issued Statement No. 161, "Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133". In 1986, the Financial Accounting Standards Board (FASB) added a major project of financial instruments to its agenda. The project was motivated by the emergence of innovative new financial instruments used by companies for risk management and by companies and investors for speculation. The focus is on the FASB for financial instruments accounting pronouncements. Between 1990 and 2008, the FASB issued numerous accounting standards pertaining to financial instruments as shown below:

FASB Statement No. 105, "Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk", (Issue Date 3/90): FASB Statement No. 105, established disclosure information for derivative instruments with "off-balance-sheet risk of accounting loss". This Statement centralized on the credit risk for all derivative instruments representing the first phase on disclosing information about the "extent, nature, and terms of financial instruments with off-balance-sheet credit or market risk". The succeeding disclosure phases of the Board's project contemplated additional disclosure requirement and "recognition and measurement issues" for derivative instruments and off-balance-sheet financing. This Statement prolonged existing disclosure requirements for derivative instruments by compelling the following disclosure information about financial instruments with off-balance-sheet risk of accounting loss: (1) "the face, contract, or notional principal amount", and (2) "the nature and terms of the instruments and a discussion of their credit and market risk, cash requirements, and related accounting policies". Additionally, this Statement required disclosure information about an entity's policy for collateral or other security on derivative instruments since companies could not recognize an accounting loss caused by the failed execution of the terms of the contract of any party to the financial instrument. This Statement was effectual for financial statements released for fiscal years ending after June 15, 1990.

FASB Statement No. 107, "Disclosures about Fair Value of Financial Instruments", (Issue Date 12/91): FASB Statement No. 107 amplified the existent fair value disclosure requirements for derivative instruments by compelling the disclosure of fair value for both derivative assets and derivative liabilities identified and not identified in the statement of financial position, for which the fair value evaluation was achievable. In the contrary, companies required explanatory disclosures apposite to the value of a derivative instrument where the fair value assessing was not feasible. This Statement became effective for financial statements issued for fiscal years ending after December 15, 1992, with the exclusion of companies with less than $150 million in total assets in the current statement of financial position for which effective date was for fiscal years ending after December 15, 1995.

FASB Statement No. 119, "Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments", (Issue Date 10/94): FASB Statement No. 119 remarked disclosures about derivative financial instruments such as futures, forward, swap, and option contracts, and other financial instruments with analogous features by requiring disclosures about the "amounts, nature, and terms of derivative financial instruments held or issued for trading intentions and financial instruments held or issued for purposes other than trading". This Statement required disclosure of the average fair value and of the net trading gains and losses of trading derivative instruments and the purpose of holding or issuing derivative financial instruments other than trading reported in the financial statements. Additionally, companies that hold or issue derivative financial instruments and account for them as hedging transactions, this Statement required disclosure about the predicted agreements, the determination of asset derivatives and liability derivatives used for hedging those transactions, the hedging gains and losses deferred, and the transactions resulted in identification of the deferred gains or losses in earnings. SFAS No. 119 also amended the existing requirements of FASB Statement No. 105, "Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk", and FASB Statement No. 107, "Disclosures about Fair Value of Financial Instruments." This Statement amended Statement 105 to need disaggregation of information by asset-liability class, business activity, risk, and management of derivative financial instruments with off-balance-sheet risk of accounting loss. Additionally, SFAS No. 119 amended Statement 107 to require that fair value information and the related carrying

amounts of derivative assets and derivative liabilities be presented in the financial statements without merging, aggregating, or netting the fair value of derivative financial instruments with the fair value of no derivative financial instruments. SFAS No. 119 became effective for financial statements issued for fiscal years ending after December 15, 1994, except for entities with less than $150 million in total assets for which it became effective for fiscal years ending after December 15, 1995.

FASB Statement No. 133, "Accounting for Derivative Instruments and Hedging Activities", (Issue Date 6/98): SFAS No. 133 became effective for all fiscal quarters of fiscal years beginning after June 15, 1999 substantiating accounting and reporting standards for derivative instruments, embedded derivatives and hedging activities. Those standards include the identification in the statement of financial position of all derivatives as either assets or liabilities accounted for at fair value. According to SFAS No. 133 if specific conditions are met, a derivative could particularly designated as (a) "a fair value hedge, a hedge of the exposure to changes in the fair value of a recognized asset or liability or an unrecognized firm commitment", (b) "a cash flow hedge, a hedge of the exposure to variable cash flows of a forecasted transaction", or (c) "a hedge of the foreign currency exposure of a net investment in a foreign operation, an unrecognized firm commitment, an available-for-sale security, or a foreign-currency-denominated forecasted transaction". Under SFAS No. 133, a company-practicing hedge accounting is needed to demonstrate at the initiation of the hedge the approach it will exercise for valuing the effectiveness of the hedging derivative and the measurement approach for deciding the ineffective aspect of the hedge. Those approaches must be uniform with the entity's approach to managing risk. The accounting for the gains and losses resulting from variations in the fair value of a derivative pivots on the considered purpose of the derivative and the resulting designation. Initially, Fair value hedge accounting portrays in income the degree to which the hedge is not effective in attaining balancing out changes in fair value by identifying the gain or loss from fair value hedges in income in the time of change in conjunction with the counterbalancing loss or gain on the hedged item assignable to the risk being hedged. Succeeding, cash flow hedge accounting represents initial reporting of the effective portion of the derivative's gain or loss as a component of other comprehensive income and afterwards reclassified into income when the forecasted transaction affects earnings while the ineffective portion of the gain or loss is reported in earnings directly. Subsequently, for a derivative designated as hedging the foreign currency exposure of a net investment in a foreign operation, the gain or loss is stated in other comprehensive income as part of the accumulative conversion change. The accounting for fair value hedging addresses derivatives designated as a hedge of the foreign currency exposure of an unrecognized firm commitment or an available-for-sale security. Likewise, the accounting for a cash flow hedge applies to a derivative designated as a hedge of the foreign currency exposure of a foreign-currency-denominated forecasted transaction. Lastly, derivatives not designated as a hedging instrument, the gain or loss is recognized in earnings in the period of change.

FASB Statement No. 137, "Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133—an amendment of FASB Statement No. 133", (Issue Date 6/99): FASB Statement No. 137 delayed the effective date of SFAS No. 133 for all fiscal quarters of all fiscal years beginning after June 15, 2000 under the requests of entities and their auditors wishing more time to study, understand, and implement the provisions of Statement 133 and complete information system modifications. Additionally, Statement 137 replaced paragraph 50 of SFAS No. 133 by requiring entities at the date of initial application to choose to either (a) "recognize as an asset or liability in the statement of financial position all embedded derivative instruments that are required to be separated from their host contracts" or (b) "select either January 1, 1998 or January 1, 1999 as a transition date for embedded derivatives". This Statement was taken by adoption by the assenting votes of five members of the Financial Accounting Standards Board. The two Board members who dissented Mr. Cope and Mr. Foster were apprehensive that users of financial statements would recommence as to be disadvantaged from essential information to investment decision-making process supporting that the advantages of procrastinating implementation of SFAS No. 133 does not compensate for the benefits of actuate implementation.

FASB Statement No. 155, "Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140", (Issue Date 02/06): This Statement became effective for all financial instruments acquired or issued after September 15, 2006 requiring that the fair value appointment may be implemented upon adopting this Statement for hybrid financial instruments that had been bifurcated prior to the adoption of this Statement. This Statement resolved the concerns referred in Statement 133 Implementation Issue No. D1 concerning the implementation of the bifurcation requirements of beneficial interests in securitized financial assets.

Statement 155 resolved the bifurcation requirements by (a) allowing fair value re-measurement for any hybrid financial instrument that comprises an embedded derivative that would need bifurcation to be re-measured at fair value, and (b) substantiated essentials to value interests in securitized financial assets to distinguish interests that are freestanding derivatives or that are hybrid financial instruments that comprise an embedded derivative requiring bifurcation. Statement No. 155 provisions applied to derivative instruments held by an entity at the date of adoption on an "instrument-by-instrument basis" with the difference between the total carrying value of the existent bifurcated hybrid financial instrument and the fair value of the combined hybrid financial instrument acknowledged to beginning retained earnings as a cumulative-effect adjustment separating aggregate gain positions from loss positions determined on an instrument-by-instrument basis. This Statement ameliorated financial reporting by excluding application of Statement 133 to interests in securitized financial assets enforcing similar instruments to be accounted for alike regardless of the form of the instruments and by permitting companies to designate the fair value measurement at purchase, issuance, or when a previously recognized financial instrument was subject to re-measurement, on an instrument-by-instrument basis, in cases in which a derivative would otherwise have to be bifurcated. Providing a fair value measurement appointment additionally culminated in more financial instruments being calculated at what the Board valued as the most pertinent attribute for financial instruments, fair value.

FASB Statement No. 161, "Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133", (I*ssue Date* 03/08): This Statement changes the disclosure requirements for derivative instruments and hedging activities. Entities are required to provide enhanced disclosures about (a) "how and why an entity uses derivative instruments", (b) "how derivative instruments and related hedged items are accounted for under Statement 133 and its related interpretations", and (c) "how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows". This Statement is deliberated to ameliorate financial reporting by improving the current disclosure framework presented in Statement 133. SFAS No. 161 requires disclosing the objectives for using derivative instruments kindred to underlying risk and accounting designation to convey the objectives of derivative use in terms of the risks that the entity is aspiring to control. Consequently, SFAS No. 161 requires in a tabular format the disclosure of the gains or losses resulting from changes in fair value of derivative instruments furnishing users of financial statements a more complete picture of the derivative assets and liabilities and the effect of using those derivatives during the reporting period. Additionally, an entity should disclose information about credit-risk-related contingent features to provide users of financial statements with information on the potential effect on an entity's liquidity from using derivatives. Finally, this Statement requires cross-referencing within the footnotes, which should help users of financial statements locate important information about derivative instruments.

2. Accounting for Derivatives and Hedging Activities

The main issue in accounting for derivatives is the treatment of the gains and losses resulting from the change of the derivative's carrying value to fair value since all derivatives are reported on the balance sheet at fair value and fair value can change from period to period. Furthermore, since the main objective of hedging is to secure the income statement from the impact of opposed changes in prices, interest rates, or currency exchange rates, companies exercising derivatives for hedging would like to use an accounting approach that causes the gain or loss from the derivative to impact earnings in the equivalent period as the gain or loss resulting from the risk being hedged. This accounting approach is referred to as hedge accounting. Hedge accounting is allowed only if several conditions are met. The three most important of these conditions relate to (1) "the nature of the hedged risk", (2) "the hedge effectiveness", and (3) "documentation". If any of these conditions is not met, hedge accounting is not allowed, and any change in the carrying value of the derivative must be recognized immediately in earnings.

2.1. Proposed Amendment of SFAS 133: Hedge Effectiveness

Hedged risks that allow a derivative to qualify for hedge accounting include (1) interest rate risks, (2) price risks, (3) foreign currency exchange rate risks, and (4) credit risks. Derivatives used to hedge these risks can be designed as hedges of three types of risk exposures: (1) fair value exposure, (2) cash flow exposure, and (3) exposure to changes in the value of a net investment in a foreign operation. For a derivative designated as hedging the exposure to changes in the fair value of a recognized asset or liability or a firm commitment (referred to as a

fair value hedge), the gain or loss is recognized in earnings in the period of change together with the offsetting loss or gain on the hedged item attributable to the risk being hedged. The effect of that accounting is to reflect in earnings the extent to which the hedge is not effective in achieving offsetting changes in fair value. For a derivative designed as hedging the exposure to variable cash flows of a forecasted transaction referred to as a cash flow hedge, "the effective portion of the derivative's gain or loss is initially reported as a component of other comprehensive income (outside earnings) and subsequently reclassified into earnings when the forecasted transaction affects earnings. The ineffective portion of the gain or loss is reported in earnings immediately. For a derivative designated as hedging the foreign currency exposure of a net investment in a foreign operation, the gain or loss is reported in other comprehensive income (outside earnings) as part of the cumulative translation adjustment" (FASB No. 133, p. 5).

Hedge effectiveness relates to the capability of the derivative instrument to originate gains and losses that counteract losses and gains on the hedged item. For hedge accounting to be used, a company must anticipate that the hedge will be highly effective in offsetting for changes in the value of the hedged item or changes in cash flows connected to the hedged item. After the hedge is in place, it must practically be highly effective to continue the use of hedge accounting. Effectiveness tests can be based on changes in the value of the complete hedged instrument or can omit changes in the value related to course of time. For example, futures and forward prices can be viewed as the total of the current spot price plus a forward discount or premium. The change in forward discount or premium is unrelated to any changes in an item where futures are used to hedge, so a valid approach is to exclude the changes in discount or premium from the measurement of hedge effectiveness. In this case, hedge effectiveness would be evaluated by comparing changes in the spot rate component of futures prices to changes in the value of the hedged item. Accordingly, the company must select a method to measure the portion of the change in the value of the derivative intended to offset changes in the hedged exposure and to evaluate hedge effectiveness (1) at the inception of the hedge and (2) on an ongoing basis while the hedge is in place (Trombley, 2003: p. 35).

The Financial Accounting Standards Board issued on November 6, 2008 an exposure draft of the proposed amendment of FASB Statement No. 133. This proposed Statement would amend the hedge effectiveness guidance in Statement 133 to no longer require (a) that a hedging relationship be highly effective, (b) a quantitative assessment of the effectiveness of a hedging relationship, or (c) ongoing effectiveness testing. This proposed Statement would require that a hedging relationship be "reasonably effective" and not "highly effective". The Board decided to amend the hedge effectiveness specifications in Statement 133 to diminish the complication of qualifying for hedge accounting, make it simpler for entities to regularly execute hedge accounting, and furnish comparability and uniformity in financial statement results. It would also require a qualitative assessment of the hedging relationship's effectiveness at inception of the hedging relationship and only in specific conditions, would require a quantitative assessment to illustrate that changes in fair value of the hedging instrument are anticipated to be reasonably effective in offsetting changes in fair value of the hedged item or variability in cash flows of the hedged transaction. Finally, entities after inception of the hedging relationship would need to qualitatively or quantitatively reevaluate effectiveness only if incidents evoke that the hedging relationship may no longer be reasonably effective (FASB Exposure Draft amendment of SFAS No. 133, 2008).

2.2. Methods of Testing Hedge Effectiveness

As Trombley (2003) states, the hedge must be expected to be highly effective in achieving gains and losses that offset gains and losses on the hedged risk at the inception of the hedge. The two acceptable approaches for assessing expected effectiveness are "critical terms analysis" and "statistical analysis". Critical term analysis assesses the critical terms including the nature of the underlying, the notional amount of the derivative, and the actual amount of the hedged item, the delivery date, and the settlement date. If the critical terms of the hedged item and the hedging instrument match, effective hedging can reasonably be assumed. If critical terms analysis fails because the critical terms of the hedged item and the hedging instrument do not match, the alternative is statistical analysis. There are three primary methods of testing the hedging effectiveness of forwards, futures, and swaps when the critical terms of the hedging derivative and the hedged item are not identical: (1) "the dollar-offset method", and (2) the "regression method" (Finnerty, & Grant, n.d.).

Dollar-Offset Method: Finnerty et al. (n.d.) determines that the dollar-offset method evaluates the fair value or cash flow changes of the hedged item and the derivative. The change in the value of the derivative closely counteracts the change in the value of the hedged item under a highly effective hedge. Consequently, in a highly ef-

fective hedge the ratio of the lump sum of the intermittent changes in the value of the derivative and the hedged item would equal one "after multiplying the ratio by negative one to adjust for the two sums having opposite signs in a hedging relationship". In a speech at the "SEC's 1995 Annual Accounting Conference, a member of the SEC's Office of the Chief Accountant articulated an 80/125 standard for hedge effectiveness as measured by the dollar-offset method". Trombley (2003) explains that the cumulative dollar-offset method has emerged as a standard practice and it calculates the delta ratio on a quarterly basis using cumulative changes in the value of the derivative and the value of the hedged item. Although there is no authoritative standard for a minimum or maximum delta ratio, common practice is to use the "80/125 standard", that is, if the delta ratio falls outside the range of 0.80 and 1.25, hedge accounting should be discontinued. In conformity to SFAS No. 133 entities should use either a "period-by-period" approach or a "cumulative" approach retrospectively every quarter to assess the effectiveness of a fair value hedge or a cash flow hedge to achieve offsetting changes in fair values or cash flows under the dollar-offset approach. The "period-by-period" approach requires contrasting the changes arise throughout the assessed period of the hedging instrument's fair values or cash flows to the changes in the hedged item's fair value or hedged transaction's cash flows attributable to the hedged risk that have occurred during the same period. The "cumulative" approach entails comparing the cumulative changes in the hedging instrument's fair values or cash flows to the cumulative changes in the hedged item's fair value or hedged transaction's cash flows attributable to the risk hedged from the inception of the hedge until today. According to paragraphs 20(a) and 28(a) of SFAS No. 133, entities may select at the inception of the hedge either approach depending on the nature of the hedge documented to designate how effectiveness will be assessed (Derivatives Implementation Group, DIG Issue No. E8, 2000).

Regression Method: Regression analysis is a statistical method that grants quantitative information about the relationship between two or more variables. In the context of SFAS 133, the necessity to prove that a derivative will be highly effective transcribes to display that the price or interest rate or currency exchange rate connected with the hedged item sustains closeness to the price corresponding with the hedging derivative. Simple regression furnishes a summary statistic, the correlation coefficient, which quantifies the proximity of the relationship. Correlation coefficients may range in value from −1.0 to +1.0, where 1.0 is expressive of a perfect correlation between the two respective variables. A related statistic to the correlation coefficient is the coefficient of determination, or the R-Squared. The R-Squared is found simply by squaring the correlation coefficient, so the possible range of the R-Squared statistic is from zero to one. While SFAS 133 does not define how to determine highly effective hedges from those that are less effective, the staff of the Securities and Exchange Commission (SEC) has supported informally that a correlation of 0.90 or a R-Square of 0.80 is a satisfactory shortcut to substantiate assumptions of hedge effectiveness (Kawaller, 2002).

Hedge Documentation: According to the Derivatives Implementation Group (DIG) Issue No. J3 (1999), the designation and documentation of hedging relationships must be concurrent with the initial adoption date of SFAS No. 133. At the inception of a fair value or cash flow hedge entities must provide formal documentation of the "hedging relationship, the entity's risk management objectives and strategies for undertaking the hedge, including identification of the hedging instrument, the hedged item, the nature of the risk being hedged, and the method of assessing the hedging instrument's effectiveness" in reference to designating hedging relationships.

The Board requires concurrent designation and documentation of a hedge to prevent management's intent to attain a preferred hedge accounting result by prohibiting reviewing transactions with "hindsight" and making retroactive decisions after hedge results are acknowledged. Specifically, at the inception of a cash flow or a fair value hedge, Statement 133 requires entities to provide documentation to indicate the period they anticipate the forecasted transaction to transpire. After the date of initial application the designation and formal documentation of a hedging relationship accomplish hedge accounting only prospectively with any gain or loss on the derivative recognized currently in earnings prospectively from the date of initial application (Derivatives Implementation Group (DIG) Issue No. J3, 1999).

2.3. Problems with the Application of SFAS 133

*S*FAS 133 made substantial progress in clearing up a great deal of confusion over the accounting for derivatives project. Nonetheless, it left some problems unresolved and generated some lingering concerns. SFAS 133 does not prescribe what constitutes effective hedging. Thus, there is some fear that restatements of earnings will be required if later it is determined that the effectiveness test used by a firm is not acceptable. SFAS 133 also re-

quire that some embedded derivatives be stripped out and valued. This can be extremely complex and is subject to a wide margin of error. SFAS 133 does not permit hedge accounting for bonds designed to held- to- maturity. It reflects the all-too-common and naïve view that as long as a bond is to be held to maturity, any losses in value are ultimately recouped. This ruling overlooks the opportunity cost of holding a bond in an environment of higher interest rates. It reflects, not surprisingly, an accounting view of a transaction rather an economic view.

Under SFAS 133, valuation of derivative instruments and the corresponding hedged instrument is critical. SFAS 133 do not permit macro hedges. In a macro hedge, a firm takes all of its positions into account and hedges the net exposure. For example, a firm could have exposures to a variety of asset classes. Due to correlations among those asset classes, there may be considerable risk reduction. The firm may then choose to hedge only the remaining risk. Yet, such hedges will now no longer qualify for hedge accounting. Hedges must be transaction specific. The conclusion is that if SFAS 133 forces firms to pay more attention to the market values of their derivatives and their hedged instruments, it probably will serve a good purpose (Chance & Brooks, 2007).

3. SFAS 161 Disclosure Requirements for Derivatives & Hedging Activities Evince from the DOW 30

In March 2008, the FASB issued Statement of Financial Accounting Standards No. 161, "*Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No.* 133." FASB Statement No. 161 provides disclosure requirements for derivative instruments and hedging activities and applies to all derivative instruments, including bifurcated derivative instruments and related hedged items accounted for under FASB Statement No. 133. It amends and expands the previous disclosure requirements of FASB Statement No. 133 and is effective for interim periods beginning after November 15, 2008 and fiscal year that include those interim periods. This study examines the quarterly financial statements (10Qs) as of September 30, 2008 of the thirty companies that comprise the Dow Jones Industrial Average to determine the extent to which these companies complied with the qualitative and quantitative disclosure requirements of SFAS No. 133 as amended by SFAS No. 161 for derivative financial instruments. A surprising finding was that most companies failed with the requirements of SFAS No. 133 to disclose the required information about cash flow hedges, net investments in foreign operations and, fair value hedges.

3.1. SFAS 161 Disclosure Guidance

In an effort to assist financial statement users in better understanding the nature of an entity's derivatives and hedging transactions in the context of an entity's risk exposures, the Financial Accounting Standards Board issued FASB Statement No. 161 to enhance derivative disclosures to enable users of financial statements to evaluate the success and significance of derivative instruments and hedging transactions on an entity's financial statements.

Amendments to FASB Statement No. 133: FASB Statement No. 161 contains extensive qualitative and quantitative disclosure requirements by requiring entities to provide transparency about: (1) "how and why an entity uses derivative instruments", (2) "how derivative instruments and related hedged items are justified under Statement 133", (3) "how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows" .To meet those objectives, FASB Statement No. 161 requires: (a) "qualitative disclosures about objectives and strategies for holding or issuing derivative instruments, the context needed to understand those objectives, and the strategies for achieving those objectives", (b) "the information about derivative instruments should be disclosed by each instrument's primary underlying risk exposure such as interest rate risks, credit risks, foreign currency exchange rate risk, commodity price risk, equity price risk or overall price risk", (c) "derivative instruments should be distinguished between those used for risk management purposes including those designated as hedging instruments and those used for other purposes". Under SFAS No. 161, derivatives designated as hedging instruments should be classified as fair value hedging instruments, cash flow hedging instruments, and foreign currency exposure hedging instruments, (d) information about the volume of derivative activity (SFAS No. 161, p. 2).

Fair Value amounts of Derivative Instruments: Financial Accounting Standards Board Statement No. 133 as amended by SFAS No. 161 requires all entities to recognize all of its derivative instruments as either assets or liabilities in the statement of financial position at fair value. The accounting for changes in the fair value of a de-

rivative instrument depends on whether it has been "designated and qualifying" as a hedging instrument or not and fair value amounts should be presented separately by type of derivative contracts such as interest rate contracts, foreign exchange contracts, commodity contracts, credit contracts and other contracts. Also gains and losses should be presented separately for derivative instruments "designated and qualifying" as hedging instruments in (a) "fair value hedges", (b) "cash flow hedges", and (c) derivative instruments not "designated or qualifying" as hedging instruments under this Statement (SFAS No. 161, pp. 4-5)

Fair Value Hedges: The Board acknowledged that for users of financial statements to deduce the full effects of a "designated and qualifying" hedging transaction, information should be furnished about the location and amount of gains and losses on hedged items that are reported in the statement of financial performance. The net gain or loss identified in earnings in the reporting period should denote (a) "the amount of the hedges' ineffectiveness and (b) "the component of the derivative instrument's gain or loss, if any, excluded from the assessment of hedge effectiveness" (SFAS No. 161, paragraph 45, p. 7).

Cash Flow Hedges: The effective allocation of the gain or loss on a derivative instrument that is "designated and qualify" as a cash flow hedge should have stated as a constituent of other comprehensive income and reclassified into earnings in the same line item accompanying the forecasted transaction and in the same period or periods in which the hedged transaction influences earnings. The unexpended gain or loss on the derivative instrument remaining from the aggregate variations of the present value of future cash flows of the hedged item, if any, or hedge components proscribed from the appraised effectiveness, should have recognized in the statement of financial performance during the current period (SFAS No. 161, p. 8).

3.2. Research Questions

The research study addressed in the application component was adopted by the original research of Bhamornsiri and Schroeder (2004), "The Disclosure of information on derivatives under SFAS No. 133, Evidence from the Dow 30." The research questions were redesigned to analyze the quarterly financial statements (10-Qs) filed with the Securities and Exchange Commission (SEC) as of September 30, 2008 of the thirty companies that comprise the Dow Jones Industrial Average, to determine whether the sample companies complied with the qualitative and quantitative disclosure requirements of SFAS No. 133 as amended by SFAS No. 161. Specifically, the research questions include:

1. *How many entities considered adopting SFAS No.* 161?
2. *Do the companies use*:
   a. Fair value hedges?
   b. Cash flow hedges?
   c. Foreign currency hedges to reduce market risk?
3. *Do the companies comply with the qualitative requirements to disclose*?
   a. The fair value amounts of derivative instruments as separate asset and liability values segregated between derivatives that are "designated and qualifying" as hedging instruments and those that are not?
   b. The line item(s) in the statement of financial position in which the fair value amounts of derivative instruments are included?
4. *Do entities that account for derivative instruments and related hedged items under SFAS No.* 133 *disclose?*
   a. Quantitative and qualitative disclosures about market risk?
   b. The entity's objectives for holding or issuing derivative instruments?
   c. The information about derivative instruments by each instrument's primary underlying risk exposure?
5. *Do companies comply with SFAS No.* 161 *requirements for fair value hedges to disclose*?
   a. The location of gain or loss recognized in income on derivative?
   b. The amount of gain of loss recognized in income on derivative?
   c. The ineffective amount of a fair value hedge?
6. *Do companies comply with SFAS No.* 161 *requirements for cash flow hedges to disclose*?
   a. The amount of gain or loss recognized in OCI on derivative (effective portion)?
   b. The location of gain or loss recognized in OCI on derivative (effective portion)?
   c. The amount of gain or loss reclassified from accumulated OCI into income (effective portion)?
   d. The amount and location of gain or loss recognized in income on derivative (ineffective portion and amount excluded from effectiveness testing)?

3.3. Results

For Research Questions 1 and 2, it can be observed from **Table 1**, that all the 30 companies comprising the Dow Jones Industrial Average (30 Dow) reported using derivatives as part of their risk management strategy. Within the 30 Dow companies a total of twenty-seven companies disclosed using fair value hedges, all thirty disclosed using cash flow hedges and twenty disclosed the use of foreign exchange hedges. In addition, a total of seventeen of the 30 Dow companies disclosed adoption of SFAS No. 161 on January 1, 2009; ten companies did not disclose implementation of SFAS No. 161, and only, three companies of the Dow 30 disclosed early implementation of SFAS No. 161 on November 15, 2008 including Citigroup, Inc., E.I. du Pont and Verizon.

From **Table 2**, we can detect a variation between the Dow 30 companies in compliance with the qualitative requirements of SFAS No. 133 to disclose the fair value amounts of derivative financial instruments as separate

Table 1. Use of derivatives.

DOW30 Companies	Early Adoption of SFAs 161	Fair Value Hedge	Cash Flow Hedge	Foreign Currency Hedge
3M Co.	NO	YES	YES	NO
Alcoa Inc.	NO	YES	YES	NO
American Express Co.	YES	YES	YES	YES
AIG, Inc.	1/1/2009	YES	YES	YES
AT&T, Inc.	No	YES	YES	NO
Bank of America, Co.	No	YES	YES	NO
Boeing, Co.	No	YES	YES	NO
Caterpillar, Inc.	1/1/2009	YES	YES	YES
Chevron, Corp.	1/1/2009	YES	YES	YES
Citigroup, Inc.	11/15/2008	YES	YES	YES
E.I. du Pont	11/15/2008	YES	YES	YES
Exxon Mobile Corp.	YES	YES	YES	YES
GE Co.	YES	YES	YES	YES
General Motors, Corp.	1/1//2009	YES	YES	YES
Hewlett-Packard Co.	YEs	YES	YES	YES
Intel Corp.	1/1/2009	YES	YES	YES
IBM	1/1/2009	YES	YES	YES
Johnson & Johnson	NO	NO	YES	NO
JP Morgan & Chase & Co.	Yes	YES	YES	YES
McDolalds Corp.	NO	YES	YES	NO
Merck & Co., Inc.	1/1/2009	YES	YES	YES
Microsoft Corp.	1/1/2009	YES	YES	YES
Pfizer, Inc.	NO	YES	YES	NO
Coca-Cola Co.	NO	YES	YES	NO
Home Depot, Inc.	NO	NO	YES	NO
Procter & Gamble, Co.	1/1/2009	YES	YES	YES
United Technologies, Corp.	1/1/2009	YES	YES	YES
Verizon	11/15/2009	YES	YES	YES
Wal-Mart Stores, Inc.	1/1/2009	No	YES	YES
Walt Disney	1/1/2009	YES	YES	YES

Table 2. Disclosures.

DOW30 Companies	Asset/Liability Derivatives designated as Hedging Instruments under SFAS 133			
	Objectives and Risk Management Policy	Description of Items been hedged?	Balance Sheet Location	Fair Value of Derivative Assets
3M Co.	YES	YES	FOOTNOTES	IMMATERIAL
Alcoa Inc.	YES	YES	FOOTNOTES	UNDISCLOSED AMOUNT
American Express Co.	YES	YES	FOOTNOTES	YES
AIG, Inc.	YES	YES	FOOTNOTES	YES
AT&T, Inc.	YES	YES	FOOTNOTES	UNDISCLOSED AMOUNT
Bank of America, Co.	YES	YES	FOOTNOTES	IMMATERIAL
Boeing, Co.	YES	YES	FOOTNOTES	IMMATERIAL
Caterpillar, Inc.	YES	YES	FOOTNOTES	YES
Chevron, Corp.	YES	YES	FOOTNOTES	YES
Citigroup, Inc.	YES	YES	FOOTNOTES	YES
E.I. du Pont	YES	YES	FOOTNOTES	YES
Exxon Mobile Corp.	YES	YES	FOOTNOTES	YES
GE Co.	YES	YES	FOOTNOTES	YES
General Motors, Corp.	YES	YES	FOOTNOTES	YES
Hewlett-Packard Co.	YES	YES	FOOTNOTES	YES
Intel Corp.	YES	YES	FOOTNOTES	YES
IBM	YES	YES	BALANCE SHEET	985
Johnson & Johnson	YES	YES	FOOTNOTES	UNDISCLOSED AMOUNT
JP Morgan & Chase & CO.	YES	YES	FOOTNOTES	YES
McDonalds' Corp.	YES	YES	BALANCE SHEET	(4.0)
Merck & Co., Inc.	YES	YES	FOOTNOTES	YES
Microsoft Corp.	YES	YES	FOOTNOTES	YES
Pfizer, Inc.	YES	YES	BALANCE SHEET	7152
Coca-Cola Co.	YES	YES	BALANCE SHEET	201
Home Depot, Inc.	YES	YES	BALANCE SHEET	315
Procter & Gamble, Co.	YES	YES	FOOTNOTES	UNDISCLOSED AMOUNT
United Technologies, Corp.	YES	YES	FOOTNOTES	YES
Verizon	YES	YES	FOOTNOTES	YES
Wal-Mart Stores, Inc.	YES	YES	BALANCE SHEET	72
Walt Disney	YES	YES	BALANCE SHEET	(9)

asset and liability values. Seven companies from the Dow 30 provided the fair value amounts of derivative assets and liabilities as a separate line item in the statement of financial position. Sixteen companies disclosed their derivative financial instruments as a component of other assets and liabilities with supplemental footnote disclosures while four companies indicated that the value of their derivative financial instruments was incorporated as an undisclosed amount of other assets and liabilities and the remaining three companies disclosed the fair value of their derivative financial instruments as immaterial in the footnotes of their financial statements. As shown in **Table 2**, all 30 Dow companies were found to comply with the qualitative requirements to disclose their objectives for holding or issuing derivative financial instruments and risk management policy as well as a description of the items being hedged. However, again there is a lack of consistency in the amount of disclosed information since only several companies disclosed this information more clearly and extensively than others. The following disclosures from two of the 30 Dow companies were quoted from their September 30, 2008 Quarterly Financial Statements (10Qs) to illustrate this point:

> "Market risk is the risk to earnings or value resulting from movements in market prices. The Company's market risk consists primarily of interest rate risk in the card, insurance and certificate businesses and foreign exchange risk in international operations. As described in the Company's Annual Report on Form 10-K for the year ended December 31, 2007 (see "Item 7A. Quantitative and Qualitative Disclosures About Market Risk"), the detrimental effect on the Company's pretax earnings of a hypothetical 100 basis point increase in interest rates would be approximately $227 million, and of a 10 percent strengthening of the U.S. dollar related to anticipated overseas operating results for the next 12 months would hypothetically be approximately $115 million, based on year-end positions. These sensitivities are based on the hypothetical assumption that all relevant maturities and types of interest rates and foreign exchange rates that affect the Company's results would increase instantaneously and simultaneously and to the same degree. There were no material changes in these market risks since December 31, 2007. The actual impact of interest rate and foreign exchange rate changes will depend on, among other factors, the timing of rate changes, the extent to which different rates do not move in the same direction or in the same direction to the same degree, and changes in the volume and mix of the Company's businesses" (American Express, 2008-10Q).
>
> "At June 30, 2008, we had interest rate swaps with a notional value of $6000 and a fair value of $24. In the second quarter we entered into an additional interest rate swaps with a notional amount of $2750. We have fixed-to-fixed cross-currency swaps on foreign-currency-denominated debt instruments with a U.S. dollar notional value of $4774 to hedge our exposure to changes in foreign currency exchange rates. The increase in 2008 relates to our April 2008 entry into additional fixed-to-fixed cross-currency swaps on our Euro-denominated global notes with a U.S. dollar notional value of $1975 to hedge our exposure to changes in foreign currency exchange rates. This hedge also includes interest rate swaps of a fixed foreign-denominated rate to a fixed U.S.-denominated interest rate, which results in a U.S.-denominated semi-annual rate of 5.78% on our Euro-denominated notes. These derivatives have been designated at inception and qualify as cash flow hedges with a net fair value of $112 at June 30, 2008" (AT & T, Inc., 2008-10Q).

From **Table 3**, it can be seen that the Dow 30 companies complied more consistently with the qualitative disclosure requirements of SFAS No. 133 in comparison to their erratic compliance with the SFAS No. 133 quantitative disclosure requirements. Only twelve companies of the Dow 30 that indicated the use of fair value hedges recognized in income the amount of gain/loss on the derivative while sixteen companies did not disclose any gain or loss in income by designated the fair value hedge as not significant or immaterial. Another problem noticed was numerous companies did not specifically indicate the type of hedges been disclosed. However, since SFAS No. 133 requires the effect of fair value hedges to be included in current earnings, these disclosures were apparently related to the fair value hedges. In addition, only twelve companies of the Dow 30 disclosed the location of gain/loss recognized in income on derivative and only four companies disclosed the ineffective amount of fair value hedges.

From **Table 4**, it can be seen that nineteen companies of the Dow 30 that indicated the use of cash flow hedges recognized in other comprehensive income the amount of gain/loss on derivative, only seven companies reclassified from accumulated other comprehensive income into income the effective portion of the amount of gain or loss on the derivative and three companies recognized in income the gain or loss on derivative of the ineffective portion and amount excluded from the effectiveness testing.

Table 3. Derivatives in SFAS No. 133 fair value hedging relationships.

	Location of Gain/Loss Recognized in Income on Derivative	Amount of Gain/Loss Recognized in Income on Derivative (in millions)	Ineffective Amount
3M Co.	Not disclosed	Not disclosed	Not disclosed
Alcoa Inc.	Footnotes	(61)	Not disclosed
American Express Co.	Footnotes	(12)	Not disclosed
AIG, Inc.	Not disclosed	Not disclosed	Not disclosed
AT&T, Inc.	Footnotes	1.3	Not disclosed
Bank of America, Co.	Footnotes	(59)	Not disclosed
Boeing, Co.	Footnotes	(21)	(44)
Caterpillar, Inc.	Footnotes	(24)	100% Effective
Chevron, Corp.	Not disclosed	Not disclosed	Not disclosed
Citigroup, Inc.	Footnotes	85	168
E.I. du Pont	Not disclosed	Not disclosed	Not disclosed
Exxon Mobile Corp.	Not disclosed	Not disclosed	Not disclosed
GE Co.	Not disclosed	Not disclosed	Not disclosed
General Motors, Corp.	Not disclosed	Not disclosed	Not disclosed
Hewlett-Packard Co.	Footnotes	(99)	(218)
Intel Corp.	Footnotes	(25)	Not material
IBM	Not disclosed	Not disclosed	Not disclosed
Johnson & Johnson	Not disclosed	Not disclosed	Not disclosed
JP Morgan & Chase & Co.	Footnotes	604	(386)
McDolalds Corp.	Not disclosed	Not disclosed	Not disclosed
Merck & Co., Inc.	Not disclosed	Not disclosed	Not disclosed
Microsoft Corp.	Footnotes	(165)	Not disclosed
Pfizer, Inc.	Not disclosed	Not disclosed	Not disclosed
Coca-Cola Co.	Footnotes	125	Not material
Home Depot, Inc.	Not applicable	Not applicable	Not applicable
Procter & Gamble, Co.	Not applicable	Not applicable	Not applicable
United Technologies, Corp.	Not disclosed	Not disclosed	Not disclosed
Verizon	Not disclosed	Not disclosed	Not disclosed
Wal-Mart Stores, Inc.	Not disclosed	Not disclosed	Not disclosed
Walt Disney	Not disclosed	Not disclosed	Not disclosed

Table 4. Cash flow hedges.

	Amount of Gain/Loss Recognized in OCI on Derivative	Location/Amount of Gain/Loss Reclassified from Accumulated OCI into Income (Effective Portion)	Location/Amount of Gain/Loss Recognized in Income on Derivative (Ineffective portion and Amount Excluded from Effectiveness Testing)
3M Co.	Not disclosed	Not disclosed	Not disclosed
Alcoa Inc.	Not disclosed	Not disclosed	Not disclosed
American Express Co.	Not disclosed	Not disclosed	Not disclosed
AIG, Inc.	144	Not disclosed	Not disclosed
AT&T, Inc.	(21)	5	Not disclosed
Bank of America, Co.	Footnotes	(14)	(59)
Boeing, Co.	97	Not disclosed	Not disclosed
Caterpillar, Inc.	31	(35)	Not disclosed
Chevron, Corp.	Not disclosed	Not disclosed	Not disclosed
Citigroup, Inc.	(760)	Not disclosed	Not disclosed
E.I. du Pont	(124)	(81)	18
Exxon Mobile Corp.	Not disclosed	Not disclosed	Not disclosed
GE Co.	(202)	(32)	Not disclosed
General Motors, Corp.	93	116	Not disclosed
Hewlett-Packard Co.	11	Not disclosed	3
Intel Corp.	54	Not disclosed	Not disclosed
IBM	596	Not disclosed	Not disclosed
Johnson & Johnson	64	105	Not disclosed
JP Morgan & Chase & Co.	433	Not disclosed	Not disclosed
McDolalds Corp.	231	Not disclosed	Not disclosed
Merck & Co., Inc.	Not disclosed	Not disclosed	Not disclosed
Microsoft Corp.	293	Not disclosed	Not disclosed
Pfizer, Inc.	Not disclosed	Not disclosed	Not disclosed
Coca-Cola Co.	Not disclosed	Not disclosed	Not disclosed
Home Depot, Inc.	8	Not disclosed	Not disclosed
Procter & Gamble, Co.	Not applicable	Not applicable	Not disclosed
United Technologies, Corp.	Not disclosed	Not disclosed	Not disclosed
Verizon	(8)	Not disclosed	Not material
Wal-Mart Stores, Inc.	Not disclosed	Not disclosed	Not disclosed
Walt Disney	(59)	Not disclosed	Not disclosed

3.4. Discussion

This study studied the disclosure of information on the use of derivative financial instruments by Dow 30 companies under the provisions of SFAS No. 133 as amended by SFAS No. 161. According to the original research of Bhamornsiri and Schroeder (2004), they deduced that the demonstrated companies consented with the qualit-

ative disclosure requirements of SFAS No. 133. Consequently, financial statement users could value these companies' policies for utilizing derivative financial instruments. However, the authors established that Dow 30 had differences in encountering the quantitative requirements of SFAS No. 133 resulting in the inability of financial statement users to assess the results of the companies' strategies for using derivative financial instrument. Supplemental, the authors' study of the quarterly financial statements of the Dow 30 compelled diversity among the disclosure information of companies concerning the quantity of information disclosed, the place in the footnotes of the information disclosed, and the presentation used to disclose the information about derivative financial instruments. The authors concluded that (a) "the lack of a clear understanding of the provisions of SFAS No. 133", (b) "the belief that some of the information was immaterial" and (c) "the desire to conceal potentially unfavorable information" were the practicable clarifications of their findings. In agreement to my analysis of the quarterly financial statements of the Dow 30 as of September 30, 2008, I concluded that the majority of companies misappropriated the specifications of SFAS No. 133 to disclose the required information about cash flow hedges, net investments in foreign operations and, fair value hedges. Under Statement 133 the effective portion of a cash flow hedge and a hedge of a net investment in a foreign operation should have deferred in OCI until the hedged transaction influenced income, and the pertinent derivative value should reclassified from OCI into earnings to edict the timing effect of the hedged item or hedged forecasted transaction. I concluded that most companies failed to comply with the requirements of SFAS No. 133 to individually disclose the beginning and ending accumulated derivative gain or loss in accumulated other comprehensive income, the corresponding net changes of the current hedging transactions, and the net amount of any reclassification into earnings. The firms mainly trapped by incredulity where those employed cash flow hedges with interest rate swaps efficient for the "shortcut method" and those utilizing the "all-in-one" cash flow approach for commodity purchase and sale contracts that met the definition of a derivative. Moreover, I comprehended by my analysis of the Dow 30 10-Q's that numerous companies that employed derivative instruments that were "designated and qualified" to hedge the exposure to changes in the fair value of an asset or a liability, failed to disclose the gain or loss on the derivative instrument in the same line item corresponding with the hedged item in current earnings. As it is stated in Ernst & Young's (2008) "Financial Reporting Developments for FASB Statement No. 161", one of the great challenges companies visages on reporting derivative financial instruments on their financial statements sequels from the Statement 133's "micro" focus on individual transactions and individual hedged items. Statement 133 does not impose well-informed guidance to help management theorize its general organizational risk disclosures. Most entities concentrate on risk disclosures from a macro-viewpoint while Statement 133 does not allow a macro, enterprise-extensive perspective for the use of derivative financial instruments. Hence, entities practice, gather, and appoint a micro epitome of derivatives to accomplish the overall macro risk objectives. Also the unavailability of a recommended format of the disclosure requirements adds an additional constraint to companies' visage of the implementation of SFAS No. 133. Although, Statement 161 gives qualitative and quantitative samples to exemplify the application of the disclosure requirements entities have the versatility to present their disclosures differently since these instances are not at a recommended format. SFAS No. 161 incorporates two different "tabular formats" for quantitative disclosure requirements, one "balance sheet-centric" and one "income statement-centric". These two tabular formats about disclosing the location and fair values of derivative instruments and their corresponding gains and losses should grant a more complete representation and best convey a discernment of the impact of an entity's use of derivatives on results of financial performance and cash flows throughout the reporting period and on the financial position at period ends. Supplemental, Statement 161 requires the fair value amounts on a gross basis to be displayed as separate assets and liability values separated among "designated & qualifying" instruments and those who are not, and by the type of contract to facilitate readers of financial statements to better comprehend how the various risks are being administered.

3.5. Conclusion

SFAS No. 133 is famously criticized as being excessively difficult, very lengthy, and rules-based. SFAS No. 133 pertains to numerous pages of implementation instructions referring to the scope exceptions and interpretive guidance on the definition of net settlement. The proposed Statement should restate the underlying principles of derivative and hedging accounting and substantially decrease the length and difficulty of the standard. It is believed that the proposed Statement does not denote amelioration in financial reporting. While it is reputed that the proposed modifications applying to simplifying the assessment of effectiveness utilizing principally qualitative factors is an enhancement in financial reporting, conversely the proposed changes to hedge accounting for fi-

nancial instruments which condemn the bifurcation-by-risk approach to qualifying for hedge accounting and to estimating and recognizing ineffectiveness would intensify financial reporting for derivative financial instruments (FASB Exposure Draft amendment of SFAS No. 133, 2008). In conclusion, as determined in the proposed Statement (2008), "changes in the fair value of the derivative expected to reasonably offset all of the changes in fair value or cash flows of a recognized derivative financial instrument for the relationship to qualify for hedge accounting". The proposed Statement may preclude some of the simple effective hedging strategies presently used since derivatives are designed to manage only distinct risks such as interest rates and not all risks. Even if the derivative was estimated to grant "reasonable offset", the entity would have to recognize changes in the value of the hedged item or forecasted transaction relating to unhedged risks, which would not have been recognized if hedge accounting had not been designated. This change mostly influences hedges of interest-earning assets and interest-bearing liabilities that are hedged after inception and forecasted transactions involving debt instruments.

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