



Management Guide for Preparing Hedging Documentation



BDO Dunwoody LLP
Chartered Accountants
and Advisors

Guide for Preparing Hedging Documentation

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INTRODUCTION

CICA Handbook Section 3855, Financial Instruments: Recognition and Disclosure, and Section 3865, Hedging are very complex accounting standards. This guide is designed to help users of traditional derivative instruments comply with the documentation requirements of Section 3865. It is not designed as a comprehensive reference that will necessarily satisfy the requirements of all entities. If exotic derivatives and/or complicated strategies are employed, consultation with a Financial Instruments expert is strongly recommended. Material discussed in this guide is meant to provide general information and should not be acted upon without first obtaining professional advice appropriately tailored to your individual facts and circumstances.

OVERVIEW OF CICA HANDBOOK SECTIONS 3855 and 3865

Section 3855 makes a dramatic departure from past accounting practice by requiring every derivative contract to be recorded as an asset or liability on the balance sheet at its fair value. Generally, this standard requires gains or losses from derivative instruments to be recorded currently in earnings. However Section 3865 allows special hedge accounting treatment to be applied when certain prerequisite conditions are met. Not all hedges will qualify for this special accounting. For example, some transactions that serve as economic hedges may not meet the pre-qualifying conditions. Moreover, even when transactions do qualify, an entity must specifically elect to use special hedge accounting.

As part of that election, Section 3865 also requires entities to formally document, designate, and assess the effectiveness of relationships that receive hedge accounting treatment.

SPECIAL HEDGE ACCOUNTING

Section 3865 specifies the types of risk that may be hedged and permits three distinct types of hedge accounting: fair value hedges, cash flow hedges, and hedges of net investments in foreign operations.

Fair value hedges are used to hedge exposures associated with changes in the value of an asset, liability, or a firm commitment. In a fair value hedge, the derivative is marked to its fair value currently through earnings. The hedged item is re-valued on the balance sheet, *to reflect the risk being hedged*,¹ and these results flow through current earnings, as well.

A cash flow hedge is used to hedge against the variability in cash flows of an upcoming, forecasted transaction. In a cash flow hedge, the derivative instrument is marked to its fair value. The hedge results, however, must be evaluated to determine how much of the gain or loss is "effective" and how much is "ineffective". The ineffective component of the hedge is recognized currently in earnings. The effective portion initially is recognized in other comprehensive income and then reclassified to earnings in the same periods in which the forecasted cash flows affect earnings. If and when it becomes probable that the forecasted transaction will not occur, the amount deferred in other comprehensive income would be recognized immediately in earnings.

¹ This requirement would be the same as requiring that the hedged item be marked to fair value only if the risk being hedged were the entire price risk of the hedged item. Often, the risk being hedged may reflect only a part of the price change associated with the hedged item, so this requirement is not a mark to fair value approach.

In a hedge associated with the currency exposure of a net investment in a foreign operation, the derivative (or qualifying non-derivative instrument) must be marked to its fair value. The effective hedge results are reported in other comprehensive income. Ineffective hedge results flow through earnings.

DOCUMENTING A HEDGING RELATIONSHIP

To qualify for hedge accounting a derivative instrument must be expected to be highly effective in offsetting changes in fair value or offsetting cash flows for the risk being hedged. Further, a company must designate and document *each* hedging relationship at inception (i.e., contemporaneously). Although the form of the documentation is not specified, a general policy document will not be specific enough to meet this requirement.² In many cases, however, the same type of hedge relationship will be repeated over and over. For instance, the company may use forward contracts to hedge an assortment of prospective purchases from foreign suppliers. Although the specific currencies, sizes of the exposures, and the timing might differ for each hedging relationship, the objectives of the hedges, and the manner of assessing hedge effectiveness would likely be the same for such hedging relationships. Thus, the documentation requirement may be satisfied by completing a standardized form *for each hedge*.

Inadequate or incomplete documentation, *in and of itself*, will disqualify the entity from applying hedge accounting treatment. Companies and their auditors must use judgment to evaluate the sufficiency of the documentation. Documentation would not be considered sufficient unless it included the following information:

- A description of the hedged item (for cash flow hedges, the description should include all relevant details, including the date on or period within which the forecasted transaction is expected to occur, the specific nature of asset or liability involved (if any), and the expected currency amount or quantity of the forecasted transaction);
- A statement designating which type of hedge accounting is being followed (i.e., fair value, cash flow, or net investment in foreign operations);
- A description of the hedging instrument;
- A statement of the intended hedge objective, including a discussion of the nature of the risk being hedged (i.e., source of exposure), and any related hedge strategy or methodology; and
- A discussion explaining how the hedging instrument's effectiveness in offsetting the change in fair value or cash flows associated with the hedged risk will be assessed, both prospectively and retrospectively.

The entity also should document that it has assessed the credit quality of the derivative counterparty to ensure that any change in that counterparty's capacity to perform is reflected in the valuation of the associated derivative. And the documentation should affirm that the hedging relationship is consistent with the entity's hedging policy.

²Section 3865 requires the use of a derivative that is consistent with an entity's established policy for risk management. In addition to contemporaneous documentation for each hedging relationship, we recommend that a company develop an entity-wide policy document covering a range of topics. See Appendix III for further discussion.

If hedging a firm commitment and applying fair value hedge accounting, the documentation also must explain how the change in the firm commitment is measured. Suppose, for example, an entity made a firm commitment to purchase goods from a foreign supplier for €1 million. The change in value of the firm commitment might be measured in a manner consistent with the way accounts payable would be valued – i.e., valued using the spot currency exchange rate. Alternatively, the change in value of the firm commitment might be valued in a way analogous to the treatment of a forward contract – i.e., reflecting the present value of the change in the forward exchange rate associated with the settlement date. In this document, these methods are referred to as the *spot method* and the *forward method*, respectively.

Although not required, we recommend that the documentation include a reasonable method for reclassifying into earnings amounts reported in accumulated other comprehensive income. For example, if a company is hedging the forecasted acquisition of a depreciable asset, the related net gain or loss continues to be reported in other comprehensive income after the acquisition and is reclassified into earnings in the same periods that the company recognizes depreciation expense on the related asset. We believe the method used to reclassify the gain or loss should be consistent with the method the company uses to recognize depreciation expense on the asset. Similarly, if a company is hedging the forecasted purchase of inventory, the company should reclassify amounts from other comprehensive income in a manner consistent with the method it uses to recognize inventory costs (i.e., Average Cost or FIFO). Further, if a company is hedging the forecasted issuance of debt, the amounts would be reclassified into earnings as an adjustment of interest expense.

Assembling hedging documentation is by no means a trivial exercise. Effectiveness testing is an aspect of documentation that is particularly challenging. Procedures must be explicit enough to allow an independent third party to read the documentation and reproduce the results; but perhaps even more critical, the test procedures must be designed properly. Unfortunately, there’s no “one-size-fits-all” solution. That is, while similar hedges may permit common testing procedures, the methodology selected by an entity and articulated in its hedging documentation must be tailored to reflect the hedge objectives stated in the documentation, as well as the particulars of the hedge relationship in question. Ordinarily, an entity should assess effectiveness for similar hedges in a similar manner. An entity should justify the use of different methods for similar hedges.

The following sections provide a more in-depth discussion of the individual items required to be included in an entity’s hedging documentation.

A. Description of the Hedged Item and Accounting Treatment

Appropriate hedge accounting treatment under Section 3865 depends on the nature of the exposure in question. The following tables list the predominate types of exposures that entities face, along with the accounting treatment that would apply to a derivative designated as a hedge of the exposure when all the hedge accounting criteria are met.

Interest Rates	
Source of Exposure	Accounting Treatment
Uncertain interest expense/income	Cash flow hedge
Fixed interest expense/income	Fair value hedge
Forecasted debt issuance	Cash flow hedge
Forecasted purchase of (investment in) fixed income securities	Cash flow hedge
Price risk associated with fixed rate available-for-sale assets	Fair value hedge

Currencies	
Source of Exposure	Accounting Treatment
Forecasted purchases or sales, priced in a currency other than the functional currency, <i>not</i> qualifying as a firm commitment	Cash flow hedge
Forecasted purchases or sales, priced in a currency other than the functional currency, qualifying as a firm commitment	Fair value or cash flow hedge ^a
Assets or liabilities denominated in a currency other than the functional currency	Fair value hedge, cash flow hedge, or neither ^b
Net investments in foreign operations	Hedge of net investments in foreign operations
<p>a. The standard allows the user discretion to use either fair value or cash flow hedge accounting.</p> <p>b. The standard allows the user discretion to use either fair value or cash flow hedge accounting; however, special hedge designation may not be necessary in many cases.</p>	

Commodities and Raw Materials	
Source of Exposure	Accounting Treatment
Forecasted purchases or sales with uncertain cash flows	Cash flow hedge
Firm commitments	Fair value hedge
Price risk associated with inventories	Fair value hedge

For all of the above exposures, the risk is unique to a specific market – i.e., a particular interest rate, a currency, and the price of a commodity or raw material. Sometimes, however, risks may be combined in a single transaction or instrument. For instance, when a company invests or borrows abroad using a fixed rate security denominated in a currency other than the company’s own functional currency, the company is exposed to *two* risks: those associated with (a) the foreign interest rate and (b) the currency exchange rate. The appropriate accounting treatment will vary, depending on whether the hedge is designed to leave the company with a fixed or variable cash flow in the functional currency. The respective accounting treatments are presented in the following table:

Cross-Currency Interest Rate Swaps	
Economic Objective	Accounting Treatment
Swap into fixed interest expense/income of the functional currency	Cash flow hedge
Swap into variable interest expense/income of the functional currency	Fair value hedge or no hedge designation ^a
<p>a. If the hedged item is a variable interest rate instrument denominated in a currency other than the functional currency, no hedge designation is necessary because changes in the value of the hedged item and changes in the value of the hedging derivative would be recorded in earnings currently, independent of any special accounting treatment.</p>	

Identification of Hedged Items

Once the exposure being hedged is determined, the hedged item must be described with sufficient specificity such that its identification can be determined without any ambiguity. For example, it is not sufficient to document that the company is hedging sales of 3,000 units during a particular quarter because it would be impossible to determine whether a particular sale included within a quarter is the hedged transaction. To qualify for hedge accounting, the company could designate the first 3,000 units sold in the quarter or the first 1,000 units sold each month. If the hedging relationship includes the hedge of a group of individual transactions, it should also be sufficiently clear from the documentation that the individual transactions share the same risk of exposure. As reflected in the templates included below, the kind of information that should be assembled would vary, depending on the nature of the hedged item.

Provided below are templates covering documentation of hedged items that could be used as a guide to document some of the more common exposures: interest rate, price risk, or currency risk. Any one of the templates could be adapted to fit a company’s specific facts and circumstances and could be incorporated into a standardized form for hedging relationship documentation.

Interest Rate Risk	
<i>Fixed rate security/obligation</i>	
Exposure ID: ^a	
Principal amount (if amortizing, attach schedule):	
Counterparty:	
Take-down date:	
Interest rate:	
Payment frequency (daily, monthly, quarterly, etc.):	
Interest convention (A/360; 30/360; A/365; 30/365):	
Maturity date:	
Embedded options (Y/N):	
Describe special features (such as embedded options):	
<p>a. The assignment of an identification number (ID) is not required by the standard. However, it will likely make the identification of specific hedged items easier and more convenient.</p>	

Interest Rate Risk	
<i>Variable rate security/obligation</i>	
Exposure ID: ^a	
Principal amount (if amortizing, attach schedule):	
Counterparty:	
Take-down date:	
Rate index:	
Spread over/under index:	
First reset date:	
Reset frequency:	
Number of periods to be hedged:	
Interest convention (A/360; 30/360; A/365; 30/365):	
Embedded options (Y/N):	
Describe special features (such as embedded options):	
<p>a. The assignment of an identification number (ID) is not required by the standard. However, it will likely make the identification of specific hedged items easier and more convenient.</p>	

Foreign Exchange Risk	
<i>Firm commitment</i> ^a	
Exposure ID: ^b	
Counterparty:	
Purchase (P) or Sale (S):	
Describe goods or services being exchanged:	
Number of units:	
Price per unit (in FX units):	
Non-functional currency:	
Total contract value (in FX units):	
Date the transaction is scheduled to occur:	
Other terms (describe):	
Disincentive (Y/N): ^c	
<p>a. Must be with an unrelated party to qualify as a firm commitment.</p> <p>b. The assignment of an identification number (ID) is not required by the standard. However, it will likely make the identification of specific hedged items easier and more convenient.</p> <p>c. To satisfy the definition of a firm commitment, the contract must include a feature that fosters a “disincentive” or penalizes the company for non-performance.</p>	

Foreign Exchange Risk	
<i>Forecasted cash flow</i>	
Exposure ID: ^a	
Counterparty: ^b	
Purchase (P) or Sale (S):	
Describe goods or services being exchanged:	
Number of units:	
Price per unit (in FX units):	
Non-functional currency:	
Total value of transaction (in FX units):	
Date the transaction is expected to occur: ^c	
Other terms (describe):	
Rationale for the assumption that forecasted transaction is probable: ^d	
<p>a. The assignment of an identification number (ID) is not required by the standard. However, it will likely make the identification of specific hedged items easier and more convenient.</p> <p>b. The forecasted transaction must be with a party external to the reporting entity and present an exposure that could affect reported earnings.</p> <p>c. A reasonable estimate of the timing of the transaction is needed. It is not necessary to be able to specify the exact date at which a hedged forecasted transaction will occur. For instance, it is acceptable to identify transactions that will occur within, say, a three-month window of time.</p> <p>d. To qualify for hedge accounting, occurrence of the forecasted transaction must be probable. An assessment of the likelihood that a forecasted transaction will take place should not be based solely on management's intent. The transaction's probability should be supported by observable facts. Paragraph 3865.44 provides guidance for assessing whether a transaction is probable.</p>	

Foreign Exchange Risk	
<i>Net investment in foreign operations</i>	
Exposure ID: ^a	
Describe the net investment:	
Non-functional currency:	
Total value of the net investment (in the non-functional currency):	
Value of the net investment to be hedged:	
<p>a. The assignment of an identification number (ID) is not required by the standard. However, it will likely make the identification of specific hedged items easier and more convenient.</p>	

Commodity Price Risk ^a	
<i>Forecasted cash flow</i>	
Exposure ID: ^b	
Counterparty:	
Purchase (P) or Sale (S):	
Describe goods being exchanged:	
Number of units:	
Price basis or index per unit:	
Spread over/under index:	
Date the transaction is expected to occur: ^c	
Other terms (describe):	
Rationale for the assumption that forecasted transaction is probable: ^d	
<p>a. This table assumes the relevant commodity is priced in the functional currency.</p> <p>b. The assignment of an identification number (ID) is not required by the standard. However, it will likely make the identification of specific hedged items easier and more convenient.</p> <p>c. A reasonable estimate of the timing of the transaction is needed. It is not necessary to be able to specify the exact date at which a hedged a forecasted transaction will occur. For instance, it is acceptable to identify transactions that will occur within, say, a three-month window of time.</p> <p>d. To qualify for hedge accounting, occurrence of the forecasted transaction must be probable. An assessment of the likelihood that a forecasted transaction will take place should not be based solely on management’s intent. The transaction’s probability should be supported by observable facts. Paragraph 3865.44 provides guidance for assessing whether a transaction is probable.</p>	

B. Description of the Hedging Derivative and Hedge Objectives

As reflected in the tables below, different types of derivatives are used to satisfy different hedging objectives. Note that objectives are stated in two ways. The first reflects that the hedge should be designed to offset some loss or gain associated with the hedged item; the second reflects the economic intent of the hedger. In preparing the hedge documentation, the language used below to describe hedge objectives will likely suffice – either as is, or with minor modifications.

Cash Flow Hedges	
<i>Derivative</i>	<i>Hedge Objective</i>
Swap contracts	To offset a series of uncertain cash flows; or to fix a price associated with a series of uncertain cash flows
Forward contracts	To offset changes of future cash flows associated with the hedged item; or to fix a price associated with a single uncertain cash flow
Futures contracts	To offset changes of future cash flows associated with the hedged item; or to fix a price associated with a single uncertain cash flow
Purchased option contracts ^a (or caps or floors) ^b	To offset prices of future cash flows above (below) the call (put) strike price for an associated hedged item; or to protect against the risk of an adverse price move associated with the exposure beyond a threshold determined as a function of the option's strike price
Collar (or range forward) ^c	To offset prices of future cash flows both above the call strike price and below the put strike price; or to constrain the prospective outcome between upper and lower (i.e., best case/worst case) boundaries
Corridor ^d	To offset prices of future cash flows within a range of possible prices, where the range for which protection is provided is dictated by the strike prices of the component options; or to fix the price of an uncertain cash flow when the underlying price (interest rate) falls within the boundaries of the strike prices of the two component options
<p>a. Written options do not qualify for hedge accounting treatment, except in very limited circumstances (Paragraphs 3865.39 and .40).</p> <p>b. Caps and floors are constructed by grouping together multiple options having staggered expiration dates. For example, a cap on natural gas which gives the holder protection against the risk of the price of natural gas rising above \$3.00 per MMBTU over the next 6 months is “fabricated” by adding six separate options – one call option expiring in one month, a second call option expiring in two months, a third call option expiring in three months, etc. All of these individual options would have the same \$3.00 strike price, however.</p> <p>c. Collars (or range forwards) are constructed by pairing the purchase of a call with the sale of a put, or vice versa. The two component options will have common expiration dates and underlyings. Collars qualify for hedge accounting only if they do not generate a net receipt of cash at inception and if the prospective favorable cash flows are as great as or larger than the prospective unfavorable cash flows.</p> <p>d. Corridors are constructed by pairing the purchase and sale of two calls (or two puts) having the same expiration date but different strike prices. Corridors qualify for hedge accounting only if they do not generate a net receipt of cash at inception and if the prospective favorable cash flows are as great as or larger than the prospective unfavorable cash flows.</p>	

Fair Value Hedges	
<i>Derivative</i>	<i>Hedge Objective</i>
Swap contracts	To offset changes of fair value of the hedged item, due to the risk being hedged; or transform a set of fixed cash flows into a set of variable cash flows
Forward contracts	To offset changes of fair value of the hedged item, due to the risk being hedged; or transform a fixed cash flow into a variable cash flow
Futures contracts	To offset changes of fair value of the hedged item, due to the risk being hedged; or transform a fixed cash flow into a variable cash flow
Purchased option contracts ^a (or caps or floors) ^b	To offset price changes of a hedged item above (below) the call (put) strike price; or to protect against the risk of an adverse price move associated with the exposure beyond a threshold determined as a function of the option's strike price
Collar (or range forward) ^c	To offset price changes of a hedged item both above the call strike price and below the put strike price; or to constrain the value of the hedged item (inclusive of the hedge) between upper and lower (i.e., best case/worst case) boundaries
Corridor ^d	To offset price changes of a hedged item within a range of possible prices, where the range for which protection is provided is dictated by the strike prices of the component options; or to fix the price of a hedged item only when the underlying price (interest rate) falls within the boundaries of the strike prices of the two component options
<p>a. Written options do not qualify for hedge accounting treatment, except in very limited circumstances (Paragraphs 3865.39 and .40).</p> <p>b. Generally, in fair value hedge situations, where the option pertains to a single, discrete price exposure, the terms "call" and "cap" may be used interchangeably. Similarly, "puts" and "floors" are also synonymous.</p> <p>c. Collars or range forwards are constructed by pairing the purchase of a call with the sale of a put, or vice versa. The two component options will have common expiration dates and underlyings. Collars qualify for hedge accounting only if they do not generate a net receipt of cash at inception and if the prospective favorable cash flows are as great as or larger than the prospective unfavorable cash flows.</p> <p>d. Corridors are constructed by pairing the purchase and sale of two calls (or two puts) having the same expiration date but different strike prices. Corridors qualify for hedge accounting only if they do not generate a net receipt of cash at inception and if the prospective favorable cash flows are as great as or larger than the prospective unfavorable cash flows.</p>	

Special Interest Rate Considerations

Interest rate exposures can be thought of as a combination of (a) the risk associated with changes in a benchmark interest rate³ and (b) the risk associated with changes in creditworthiness (i.e., differences between the entire interest rate and benchmark interest rate). With this orientation, the hedger may specify the hedge objective as being designed to offset changes associated with either or both of these potential exposures. *The documentation must be explicit about the company's intentions.* The same benchmark interest rate should be designated for similar hedges of interest rate risk. The use of different benchmark interest rates for similar hedges should be rare and must be justified.

The most frequently used interest rate derivative is the interest rate swap, and when used in its most common application – to swap from variable interest expense/income to fixed, or vice versa – the stated hedge objective in the documentation should likely be to offset the changes in the benchmark interest rate. Sometimes, however, swaps may be used in a different way – particularly in fair value hedging situations. If the hedger intends to offset the effect of a full interest rate change, comprising changes in both the benchmark rate and the credit spread, this intention should be stated in the documentation.⁴

C. Identification of Hedging Derivatives

Just as it is necessary to identify the specific hedged item in a hedging relationship, it is also necessary to identify the hedging instrument. And, as before, different information would be relevant, depending on the nature of the derivative. The following formats are suggested for the more traditional derivatives.

³ The benchmark interest rate is defined as a widely recognized and quoted rate in an active financial market that is broadly indicative of the overall level of interest rates attributable to high-credit quality obligors in that market. In Canada, the Bank of Canada interest rates and the LIBOR swap rate would be considered benchmark interest rates.

⁴ Often, the “hedge ratio” may be indicative of the hedging objective. As a general rule, if the swap has a benchmark interest rate as an underlying (i.e., the LIBOR-based swap rate or a Bank of Canada interest rate) and the notional amount of the swap matches the principal amount of the debt (i.e., the hedge ratio is one-to-one), the hedge objective would most likely be to offset changes in the benchmark rate. On the other hand, when the notional size of the swap differs from that of the hedged item (i.e., the hedge ratio is *not* one-to-one); the full interest rate change may likely be the risk being hedged.

Swap identification	
Derivative ID: ^a	
Counterparty:	
Trade date:	
Notional amount (if amortizing, attach schedule):	
Final settlement date:	
Fixed price (rate):	
Pay (P) or receive (R):	
Interest convention (A/360; 30/360; A/365; 30/365; N/A):	
Variable price (rate):	
Pay (P) or receive (R):	
Interest convention (A/360; 30/360; A/365; 30/365; N/A):	
Start date of first reset period:	
Reset frequency:	
Total number of resets:	
Fair value at inception:	
Embedded options (Y/N):	
Describe special features (such as embedded options):	
a. The assignment of an identification number (ID) is not required by the standard. However, it will likely make the identification of specific hedging derivatives easier and more convenient.	

Forward identification	
Derivative ID: ^a	
Counterparty:	
Trade date:	
Purchase (P) or sale (S):	
Commodity or currency:	
Size (notional amount):	
Forward price:	
Settlement date:	
Fair value at inception:	
Embedded options (Y/N):	
Describe special features (such as embedded options):	
a. The assignment of an identification number (ID) is not required by the standard. However, it will likely make the identification of specific hedging derivatives easier and more convenient.	

Option identification	
Derivative ID: ^a	
Counterparty:	
Trade date:	
Notional amount:	
Underlying:	
Expiration:	
Initial net investment:	
For one option	
Call (C) or Put (P):	
Long (L) or Short (S):	
Exercise style (A, E, Other): ^b	
Strike price:	
For second option ^c	
Call (C) or Put (P):	
Long (L) or short (S):	
Exercise style (A, E, Other):	
Strike price:	
a.	The assignment of an identification number (ID) is not required by the standard. However, it will likely make the identification of specific hedging derivatives easier and more convenient.
b.	An American exercise style permits exercise of the option on any business day; a European exercise style only allows exercise on the expiration date.
c.	Information pertaining to a second option would be relevant for derivatives like collars or corridors, which are constructed by combining a purchased option (i.e., a long option) with a sold option (i.e., a short option).

Cap/floor identification	
Derivative ID: ^a	
Counterparty:	
Trade date:	
Notional amount (if amortizing attach schedule):	
Underlying:	
Expiration:	
Initial net investment:	
For first cap or floor	
Cap (C) or Floor (F):	
Long (L) or Short (S):	
Exercise style (A, E, Other): ^b	
Strike price/yield:	
First reset date:	
Reset frequency:	
Number of periods to be hedged:	
For second cap or floor ^c	
Cap (C) or Floor (F):	
Long (L) or Short (S):	
Exercise style (A, E, Other): ^b	
Strike price/yield:	
First reset date:	
Reset frequency:	
Number of periods to be hedged:	
<p>a. The assignment of an identification number (ID) is not required by the standard. However, it will likely make the identification of specific hedged items easier and more convenient.</p> <p>b. An American exercise style permits exercise of the option on any business day; a European exercise style only allows exercise on the expiration date.</p> <p>c. Information pertaining to a second cap or floor would be relevant for derivative instruments like collars or corridors, which are constructed by combining a purchased option (i.e., a long option) with a sold option (i.e., a short option).</p>	

D. Assessing Hedge Effectiveness

One prerequisite for special hedge accounting treatment is that the hedge must be expected to be highly effective in offsetting the changes in fair value, cash flows, or translation adjustments associated with the risk being hedged. Section 3865 requires a company to make this prospective assessment both at the inception of the hedge and on an ongoing basis – at each reporting period, but no less than quarterly. A company also must perform retrospective testing to determine how effective the hedging relationship actually was in achieving offset; and the retrospective test may also serve to satisfy the prospective testing requirement for the next period (i.e., an updated prospective test independent of a just-satisfied retrospective test would not necessarily be required).

In certain cases, the determination that hedges will be effective will be straightforward. Specifically, if the derivative is a swap, a forward contract, or an option and *all* the critical terms of the derivative and the hedged item are the same (i.e., size, reset and payment dates, and market conventions), perfect effectiveness may be assumed. Moreover, when ineffectiveness can

be attributed exclusively to changes in forward price premiums or discounts or changes in options' time values, the exclusion of these effects from the assessment of hedge effectiveness allows entities to assume perfect effectiveness.

In the more general case, the critical terms of the derivative will not match up perfectly with the terms of the hedged item. For instance, the two might have different sizes, (somewhat) different underlyings, different timing for critical dates, or different pricing conventions at work, in which case at least some degree of ineffectiveness must be expected. In these situations, a more formalized analysis is required. In order to qualify for hedge accounting, the company needs to demonstrate rationale for believing that the hedge *will be* effective; and then, at the end of the period (no less frequently than quarterly), it must show that the hedge actually *was* effective. Satisfying the retrospective test allows hedge accounting to be applied and precludes the need to re-run another (updated) prospective test. In any case, in these circumstances, even though the hedge is considered effective, some ineffectiveness may likely be reflected in earnings.

Section 3865 does not specify exactly how the effectiveness test should be constructed, nor does it specify a bright line to distinguish highly effective hedges from those that are less effective. Rather, it allows entities to devise their own tests, requiring only that the methodology be reasonable, that it be documented, and that it be used consistently throughout the hedging period. Given this discretion, in their documentation, companies must define the methods used (threshold requirements to be satisfied in order to qualify for hedge accounting) with enough specificity so that a third party could perform the measurement based on the documentation and come to the same result.

The simplest approach – for both prospective and retrospective tests – is to calculate “dollar offset” ratios. Dollar offset ratios may be calculated either period-by-period or cumulatively. Under the period-by-period approach, gains or losses from the hedging instrument during the period being assessed are compared to the changes in the hedged item's fair value (or hedged transaction's cash flows) attributable to the risk hedged during the same period. Under the cumulative approach, derivative results from inception of the hedge to date are compared to the cumulative change in the hedged item's fair value (or hedged transactions cash flows) attributable to the risk hedged. The high effectiveness criterion usually is satisfied as long as this ratio – whether period-by-period or cumulatively, depending on the specified choice of the company – falls between 80% and 125%.

The primary drawback of a dollar-offset method is that it may prohibit the application of hedge accounting with a much higher frequency than entities might expect. To understand this problem, consider the case where a hedged item and a derivative have a common starting value of \$1 million. Suppose the derivative value changes by \$1, while the hedged item changes by \$2. In this case, the dollar-offset ratio is $\frac{1}{2}$ or 0.5. Thus, under a dollar offset ratio method, this hedge would be deemed to be ineligible for hedge accounting. While this example is presented in the extreme, this problem tends to surface when markets are relatively stable, which may be the case over extended periods of time.

To overcome the shortcomings of the dollar offset calculations, entities may apply other hedge effectiveness testing methodologies such as regression analysis. If regression analysis is used, a consensus view is that an R-Square of 0.8 or higher satisfies this requirement, that the hedged item and hedging item are highly correlated.

Many believe that the slope coefficient of the regression should also be considered in the context of effectiveness testing. This slope coefficient describes the past (and thus, the expected) relationship between the price of the exposure and the price of the derivative. For example, a coefficient of 1.0 would imply that each \$1 change in the underlying price for the derivative has corresponded to (and would be expected to continue to correspond to) a \$1 change in the price of the hedged item. On the other hand, a slope coefficient of, say, 0.5 would suggest that each \$1 change in the underlying price for the derivative has corresponded to a \$0.50 change in the price of the hedged item, such that you would need a derivative position half as big as the exposure being hedged in order to generate the desired offsets. Ultimately, then, a second consideration for those who rely on regression analysis may be that the size of the hedging derivative relative to the size of the exposure should be of a comparable magnitude to the regression's slope coefficient – i.e., within 80% to 125% of the coefficient's value.

A statistical approach to effectiveness testing, such as regression analysis, has another advantage over the offset method. That is, if a regression or other statistical method is used to assess hedge effectiveness, an entity may still be permitted to apply hedge accounting without interruption even if a dollar-offset retrospective analysis suggested that the hedge was not highly effective during that period. For uninterrupted hedge accounting, however, the prospective test must be repeated and satisfied anew.

Application of a regression or other statistical analysis approach to assessing effectiveness is complex. Applying those methodologies require judgment as well as an appropriate interpretation and understanding of the statistical inferences. Assuming a regression test is applied, how should the test be designed? Should the company use monthly data, weekly data, or daily data? Should the data set include 50 observations or 200? Unfortunately, there are no “right” answers to these questions. However, for statistical results to be reliable, 25-30 observations often are considered to be a *bare minimum*. Thus, the frequency of available data might affect the time span used in the regression analysis. For example, with monthly observations, at least 2½-3 years worth of data would be desirable; with daily data, a shorter span might suffice; but as a general rule, more data are preferred to fewer. In general, irrespective of the data frequency, the sample size should be large enough to reflect the range of outcomes that could reasonably occur in the coming period, but not so large that the older data no longer reflect current “reality” – clearly a judgment call. Given this reliance on judgments, entities are advised to discuss these various choices and methods with one who has competent statistical expertise and their auditors before implementing a hedge.

Testing and documenting hedge effectiveness must be performed by the company, keeping in mind that the documentation must be sufficiently specific to allow an independent third party to replicate the test results. This documentation should include such information as the source(s) of the data, the number of observations in the data sets, data frequency (i.e., daily, monthly, quarterly, etc.), and it also should describe how the relevant data sets will be altered when regression updates are performed. For example, the analysis may use a fixed number of periods (i.e., the most recent 60 month observations), or, alternatively, the data set may be expanded as new observations become available, keeping the original starting observation. Either approach is acceptable.

Once adopted, the method detailed in the company’s documentation should be used consistently through the period of the hedge. If an improved method for testing is devised, the existing hedge relationship would have to be discontinued; and for hedge accounting to be applied prospectively, a new relationship would have to be designated, reflecting the new method of testing effectiveness.

Special Considerations Relating to Purchased Option Hedges

When assessing the effectiveness of a hedging relationships involving an option contract the hedger may base the effectiveness test on the “total change in the option’s cash flow” (i.e., inclusive of time value).

E. Measuring Hedge Ineffectiveness

Finally, aside from the issue of effectiveness *testing*, entities also have to measure ineffectiveness. The need to measure ineffectiveness is especially relevant for cash flow hedges and hedges of net investments in foreign entities, as this determination is critical to the allocation of the derivative’s results between other comprehensive income and earnings. But ineffectiveness must be measured for fair value hedges, as well, as the standard requires disclosures of the amount of ineffectiveness.

One frequently used method to measure ineffectiveness for cash flow hedges is to define a *hypothetical derivative* – a derivative that would perfectly match the terms of the hedged items. The results of this hypothetical derivative would then serve as a standard of comparison for the actual derivative results.⁵ For example, if a forecasted purchase of equipment denominated in euros was expected to occur on July 7, 20XX, a forward contract having a July 7, 20XX value date would be a perfect forward contract to use as a hedge; and thus the July 7 contract would be deemed the hypothetical contract. Any other forward contract would almost certainly generate different results. If the cumulative gains or losses of the actual hedging derivative exceed those of the hypothetical derivative, this difference would be the ineffective portion of hedge results, and it would have to be disclosed, as such.

Under the hypothetical derivative approach to measuring effectiveness for cash flow hedges, either of two outcomes are possible: (1) The hedge may be effective – i.e., the cumulative hedge results are equal to or smaller than those of the hypothetical derivative; or (2) The hedge results may have some ineffective component – i.e., the cumulative hedge results are larger than those of the hypothetical derivative. In the first case, gains and losses of the derivative are initially posted to OCI; and the gain or loss specifically relating to the current period is reclassified to earnings. In the second case, ineffectiveness is found by subtracting the cumulative total gain or loss of the hypothetical derivative from the cumulative gain or loss of the actual derivative. This amount is ineffective and thus posted to current earnings. The balance (i.e., the total gain or loss net of the ineffective portion of hedge results) initially is recorded in OCI. In contrast to the first case, the reclassification amount is based on the hypothetical derivative’s gain or loss relating to the current period when the hedge is somewhat ineffective, rather than the actual derivative’s gain or loss.

⁵ Defining the hypothetical derivative may best be accomplished by filling out a derivative identification form along the lines of those presented in Section C (Identification of Hedging Derivatives) of this Documentation Guide.

When measuring effectiveness for variable interest rate exposures hedged with swaps, two other methods of measuring ineffectiveness are available, in addition to the hypothetical instrument method: (a) comparing only the variable cash flows of the derivative to the variable cash flows of the hedged item, or (b) comparing the present value of the cumulative change in expected variable interest flows of the hedged item with the cumulative change in the fair value of the swap.

Shortcut Treatment

In many cases, companies engage in hedging relationships, where the critical terms of the hedging item and the hedged item are the same. In these cases a “shortcut” method may be allowed. The shortcut method is an exception from the periodic effectiveness assessment and measurement requirements of Section 3865. The shortcut method assumes perfect effectiveness. The only requirement to use the shortcut method is that the company must have a basis for concluding that the assumption of perfect effectiveness will continue to hold.

An entity may assume perfect effectiveness in a hedge of an anticipated purchase of a commodity with a forward contract when the following conditions are met:

- The forward contract is for the same quantity of the same commodity at the same time and location of the hedged transaction;
- At inception of the hedge, the fair value of the swap is zero; and
- Either the change in the discount or premium of the forward is excluded from the assessment of effectiveness, or the change in the expected cash flows on the hedged transactions is on the forward price of the commodity.

Companies often enter into interest rate swap transactions that are perfectly tailored to the exposure that they are intending to hedge. Perfect effectiveness may be assumed when the following conditions are met:

- The notional amount of the swap matches the principal amount of the interest-bearing asset or liability being hedged;
- At inception of the hedging relationship, the fair value of the swap is zero;
- The formula for computing net settlements for the swap is the same for all settlements;
- If the debt is prepayable solely because it has an embedded option, the swap has a mirror image (i.e., comparable) embedded option with matching terms, such that the two embedded options essentially cancel each other in the hedging relationship;
- The index on which the variable leg of the swap is based matches the benchmark interest rate designated as the interest rate risk being hedged;
- There are no other atypical terms in the financial interest or the swap that would invalidate the assumption of no ineffectiveness;
- For fair value hedges
 - The swap’s expiration must match the maturity of the interest bearing asset or liability;
 - No floor or ceilings are applied to the variable leg of the swap; and
 - The frequency of the variable leg re-pricing is generally less than six months;
- For cash flow hedges

- All cash flows from the debt that occur on or before the maturity of the swap are designated as hedged items, but no cash flows following the maturity of the swap may be designated as hedged items;
 - The re-pricing dates of the swap match those of the interest bearing asset or liability; and
 - There is no cap or floor on the variable interest rate of the swap unless the variable-rate asset or liability has a cap or floor that is comparable to the cap or floor on the swap.
- For cross-currency interest rate swaps
 - The formula for computing gross settlement amounts are the same for each settlement;
 - The currency of one of the legs of the swap is the same as the currency of the hedged item and the other leg of the swap is the same as the currency in which the entity measures the hedged item in the financial statements; and
 - When multiple swaps are used the combined effect should be the same as described above.

Companies (and auditors) will want to validate whether the conditions for shortcut treatment are, in fact, satisfied. The following form may be helpful for such purposes.

Shortcut Validation Form

<i>Necessary Condition for All Hedges</i>		<i>Yes</i>	<i>No</i>	<i>NA</i>	
1	Is the notional amount of the swap equal to the principal amount of the interest-bearing asset or liability being hedged?				Yes is required
2	Is the fair value of the swap zero at the inception of the hedging relationship?				Yes is required
3	Is the formula for computing net settlements under the interest rate swap the same for each net settlement (i.e., the fixed rate is the same throughout the term, and the variable rate is based on the same index and includes the same constant adjustment or no adjustment)?				Yes is required
4	Is the variable leg of the swap based on the benchmark interest rate being hedged?				Yes is required
5	Are there any atypical terms that invalidate the assumption of no ineffectiveness?				No is required
6	Is the interest-bearing asset or liability prepayable at a price <i>other than</i> its fair value?				If yes, go to 7; if the answer is No proceed to 8 or 11
7	If the answer to 6 is Yes, does the swap have a mirror image embedded option that cancels out the prepayment option on the debt?				Yes is required if the answer to 6 is Yes. Otherwise, NA is required
<i>Necessary Condition for Fair Value Hedges</i>					
8	Does the swap's expiration match that of the interest-bearing asset or liability?				Yes is required
9	Are any floors or ceilings embedded in the variable leg of the swap?				No is required
10	Is the frequency of the repricing leg six months or less?				Yes is preferred
<i>Necessary Condition for Cash Flow Hedges</i>					
11	Are all of the cash flows of the interest-bearing asset or liability that occur before the swap matures designated as hedged items?				Yes is required
12	Are any of the cash flows of the interest-bearing asset or liability that are scheduled after the maturity of the swap designated as hedged items?				No is required
13	Are the re-pricing dates of the swap the same as the re-pricing dates of the variable rate asset or liability?				Yes is required
14	If there is a cap or floor on the variable interest rate of the swap, is there a comparable cap or floor on the interest-bearing asset or liability?				Yes is required

F. Conclusions

Without question, Section 3865 requires a significant level of documentation in connection with the use of derivatives; and in all likelihood, this attention to detail and the added restrictions pertaining to the applicability of hedge accounting will influence the way companies think – and act – about their risk exposures. Using hedge accounting clearly imposes a “cost” for entities, including the investment in human capital just to achieve an understanding of the Section 3865 requirements and the time required by skilled professionals to satisfy the documentation requirements. Most companies will likely consider ways in which they might be able to reduce, if not eliminate, these costs.

One way is to move to more standardized risk management strategies and tactics. For example, passing the effectiveness requirement is assured by relying on contracts that are tailored to the risks being hedged and therefore qualify for shortcut treatment. Alternatively, for relatively short-term exposures, where the exposure is limited, many entities may be willing to not use hedge accounting. It is very important to note that the decision to enter into hedging relationships to reduce risk exposures and decision to use hedge accounting are two independent decisions.

APPENDIX I

HEDGE RELATIONSHIP DOCUMENTATION: BLANK FORMS

The following pages provide blank forms that may be adapted and used to document specific hedging relationships. The forms are designed to be illustrative of the way in which information may be organized to meet Section 3865 requirements. While all of the major elements of the sample forms *must* be set out, these forms are intended only as a guide. Inevitably, the specifics relating to real-world hedging relationships will likely demand some tweaking of the forms to appropriately capture the idiosyncrasies of the hedges in question. Entities are advised to discuss these various forms and methods with their auditors before implementing a hedge.

Form 1 – Hedging Fixed Rate Debt with an Interest Rate Swap

Form 2 – Hedging Variable Interest Expense with an Interest Rate Swap

Form 3 – Hedging Variable Interest Expense with an Interest Rate Cap

Form 4 – Hedging a Forecasted Transaction with a Currency Forward Contract

Form 5 – Hedging a Firm Commitment with a Currency Forward Contract

Form 6 – Hedging a Net Investment in a Foreign Operation with a Currency Forward Contract

HEDGING SUMMARY FORM 1

*Used for **HEDGING FIXED RATE DEBT WITH AN INTEREST RATE SWAP.**
Complete all shaded areas at the time the derivative instrument is designated as a hedge.*

Hedging relationship ID:

Inception of hedge:

Termination of hedge: _____

Hedged item: Fixed rate debt

Exposure ID:	
Principal amount (if amortizing attach schedule):	
Counterparty:	
Take-down date:	
Interest rate:	
Payment frequency (daily, monthly, quarterly, etc.):	
Interest convention (A/360; 30/360; A/365; 30/365):	
Maturity date:	
Embedded options (Y/N):	
Describe special features (such as embedded options):	

Accounting treatment: Fair value hedge

Nature of risk being hedged (check one):

- _____ (a) Risk of changes in the fair value of debt attributable to changes in benchmark interest rate
(LIBOR-Based Swap Rate _____ Bank of Canada Rate _____ Non-Canadian Rate (describe)_____)
- _____ (b) The risk of changes in fair value attributable to both changes in creditworthiness and changes in the spread over the benchmark interest rate with respect to the hedged item's credit sector at inception of the hedge
- _____ (c) The risk of changes in fair value attributable to changes in total interest rate (i.e., both (a) and (b))

Hedging derivative: Pay floating / receive fixed interest rate swap

Derivative ID:	
Counterparty:	
Trade date:	
Notional amount (if amortizing, attach schedule):	
Final settlement date:	
Fixed rate:	
Pay (P) or receive (R):	R
Interest convention (A/360; 30/360; A/365; 30/365; N/A):	
Variable rate:	
Pay (P) or receive (R):	P
Interest convention (A/360; 30/360; A/365; 30/365; N/A):	
Start date of first reset period:	
Reset frequency:	
Total number of resets:	
Fair value at inception:	
Embedded options (Y/N):	
Describe special features (such as embedded options):	

Hedging Summary Form 1 pg 1 of 2

Risk management strategy and hedge objective (describe):

Method of assessing hedge effectiveness: Shortcut (Y/N)

If yes, complete and attach the Shortcut Validation Form; if no, describe the method used for both the prospective and retrospective tests and attach documentation for each test.

Method of assessing hedge effectiveness prospectively (check one and describe):

dollar offset _____ regression /other statistical method (describe) _____:

Prospective assessment: Highly effective (Y/N) _____ Completed by _____.

Method of assessing hedge effectiveness retrospectively (check one and describe):

dollar offset: period-by-period _____ cumulative _____ regression/statistical method _____

Method of measuring ineffectiveness:

If short-cut treatment is not used, describe how the change in value due to the risk being hedged is determined:

Is the hedge relationship consistent with the company's risk management policy (Y/N)

Prepared by: _____ **Date:** _____ **Approved by:** _____ **Date:** _____

Hedging Summary Form 1 pg 2 of 2

HEDGING SUMMARY FORM 2

*Used for **HEDGING VARIABLE INTEREST EXPENSE WITH AN INTEREST RATE SWAP.***

Complete all shaded areas at the time the derivative instrument is designated as a hedge.

Hedging relationship ID:

Inception of hedge: **Termination of hedge:** _____

Hedged item: Variable interest expense

Exposure ID:	
Principal amount (if amortizing, attach schedule):	
Counterparty:	
Take-down date:	
Rate index:	
Spread over/under index:	
First reset date:	
Reset frequency:	
Number of periods to be hedged:	
Interest convention (A/360; 30/360; A/365; 30/365):	
Embedded options (Y/N):	
Describe special features (such as embedded options):	

Accounting treatment: Cash flow hedge

Reclassification of OCI (describe process):

Nature of risk being hedged (check one):

- _____ (a) Risk of changes in cash flows attributable to changes in benchmark interest rate
(LIBOR_____ Bank of Canada Rate_____ Non-Canadian
Rate(describe)_____)
- _____ (b) Risk of changes in cash flows attributable to both changes in creditworthiness and changes in the spread over the benchmark interest rate with respect to the hedged item's credit sector at inception of the hedge
- _____ (c) Risk of changes in cash flows attributable to changes in total interest rate (i.e., both (a) and (b))

Hedging derivative: Pay fixed / receive floating interest rate swap

Derivative ID:	
Counterparty:	
Trade date:	
Notional amount (if amortizing, attach schedule):	
Final settlement date:	
Fixed price (rate):	
Pay (P) or receive (R):	P
Interest convention (A/360; 30/360; A/365; 30/365; N/A):	
Variable price (rate):	
Pay (P) or receive (R):	R
Interest convention (A/360; 30/360; A/365; 30/365; N/A):	
Start date of first reset period:	
Reset frequency:	
Total number of resets:	
Fair value at inception:	
Embedded options (Y/N):	
Describe special features (such as embedded options):	

Risk management strategy and hedge objective (describe):

Method of assessing hedge effectiveness: Shortcut (Y/N)

If yes, complete and attach the Shortcut Validation Form; if no, describe the method used for both the prospective and retrospective tests and attach documentation for each test:

Method of assessing hedge effectiveness prospectively (check one and describe)
dollar offset _____ regression/other statistical method _____:

Prospective assessment: Highly effective (Y/N) _____ Completed by _____

Method of assessing hedge effectiveness retrospectively (check one and describe):
dollar offset: period-by-period _____ cumulative _____ regression/statistical method _____

Method of measuring ineffectiveness: (If shortcut method does not apply, check one):

Change in variable cash flows _____ Hypothetical derivative _____ Change in fair value _____

Is the hedge relationship consistent with the company's risk management policy (Y/N)

Prepared by: _____ **Date:** _____ **Approved by:** _____ **Date:** _____

HEDGING SUMMARY FORM 3

*Used for **HEDGING VARIABLE INTEREST EXPENSE WITH AN INTEREST RATE CAP.**
Complete all shaded areas at the time the derivative instrument is designated as a hedge.*

Hedging relationship ID:

Inception of hedge:

Termination of hedge: _____

Hedged item: Variable interest expense

Exposure ID:	
Principal amount (if amortizing, attach schedule):	
Counterparty:	
Take-down date:	
Rate index:	
Spread over/under index:	
First reset date:	
Reset frequency:	
Number of periods to be hedged:	
Interest convention (A/360; 30/360; A/365; 30/365):	
Embedded options (Y/N):	
Describe special features (such as embedded options):	

Accounting treatment: Cash flow hedge

Reclassification of OCI (describe process):

Nature of risk being hedged (check one):

- _____ (a) Risk of changes in cash flows attributable to changes in benchmark interest rate
(LIBOR_____ Bank of Canada Rate_____ Non-Canadian Rate
(describe)_____)
- _____ (b) Risk of changes in cash flows attributable to both changes in creditworthiness and changes in the spread over the benchmark interest rate with respect to the hedged item’s credit sector at inception of the hedge
- _____ (c) Risk of changes in cash flows attributable to changes in total interest rate (i.e., both (a) and (b))

Hedging derivative: Interest rate cap

Derivative ID:	
Counterparty:	
Trade date:	
Notional amount (if amortizing attach schedule):	
Underlying:	
Expiration:	
Initial net investment:	
For first cap or floor	
Cap (C) or Floor (F):	
Long (L) or Short (S):	
Exercise style (A, E, Other):	
Strike price/yield:	
First reset date:	
Reset frequency:	
Number of periods to be hedged	
For second cap or floor	
Cap (C) or Floor (F):	
Long (L) or Short (S):	
Exercise style (A, E, Other):	
Strike price/yield:	
First reset date:	
Reset frequency:	
Number of periods to be hedged:	

Risk management strategy and hedge objective (describe):

Hedging Summary Form 3 pg 2 of 3

Method of assessing hedge effectiveness:

Items excluded from effectiveness assessment (describe): _____

If time value is excluded from effectiveness, how is intrinsic value calculated (check one)?

spot price versus the strike price

forward price versus the strike price, discounted

forward price versus the strike price, undiscounted

Method of assessing hedge effectiveness prospectively (check one):
dollar offset _____ regression /other statistical method (describe) _____:

Prospective assessment: Highly effective (Y/N) _____ Completed by _____

Method of assessing hedge effectiveness retrospectively (check one and describe):
dollar offset: period-by-period _____ cumulative _____ regression/statistical method _____

Method of measuring ineffectiveness (check one):

change in variable cash flows _____ hypothetical derivative _____ change in fair value _____

Is the hedge relationship consistent with the company's risk management policy (Y/N)

Prepared by: _____ **Date:** _____ **Approved by:** _____ **Date:** _____

Hedging Summary Form 3 pg 3 of 3

HEDGING SUMMARY FORM 4

*Used for **HEDGING A FORECASTED TRANSACTION WITH A CURRENCY FORWARD CONTRACT.**
Complete all shaded areas at the time the derivative instrument is designated as a hedge.*

Hedging relationship ID:

--

Inception of hedge:

--

Termination of hedge: _____

Hedged item: Forecasted purchase or sale, denominated in a non-functional currency

Exposure ID:	
Counterparty:	
Underlying good:	
Price per unit (in FX units):	
Non-functional currency:	
Total value of transaction (in FX units):	
Date the transaction is expected to occur:	
Rationale for the assumption that forecasted transaction is probable:	

Accounting treatment: Cash flow hedge

Reclassification of OCI (describe process):

--

Nature of risk being hedged: The variability of cash flows in the functional currency, due to changes in currency exchange rates.

Hedging derivative: Currency forward contract

Derivative ID:	
Counterparty:	
Trade date:	
Purchase (P) or sale (S):	
Currency:	
Size (notional amount):	
Forward price:	
Settlement date:	
Fair value at inception:	
Embedded options (Y/N):	
Describe special features (such as embedded options):	

Hedging Summary Form 4 pg 1 of 2



Risk management strategy and hedge objective (describe):

Method of assessing hedge effectiveness:

Items excluded from effectiveness testing (describe): _____

Method of assessing hedge effectiveness prospectively (check one):

dollar offset _____ regression /other statistical method (describe) _____:

Prospective assessment: Highly effective: _____ Completed by _____

Method of assessing hedge effectiveness retrospectively (check one and describe):

dollar offset: period-by-period _____ cumulative _____ regression/statistical method _____

Method of measuring ineffectiveness (describe):

Is the hedge relationship consistent with the company's risk management policy (Y/N)

Prepared by: _____ **Date:** _____ **Approved by:** _____ **Date:** _____

Hedging Summary Form 4 pg 2 of 2

Risk management strategy and hedge objective (describe):

Method of assessing hedge effectiveness:

Items excluded from effectiveness testing (describe): _____

Method of assessing hedge effectiveness prospectively (check one):

dollar offset _____ regression /other statistical method (describe) _____:

Prospective assessment: Highly effective (Y/N) _____ Completed by _____.

Method of assessing hedge effectiveness retrospectively (check one and describe):

dollar offset: period-by-period _____ cumulative _____ regression/statistical method _____

Method of measuring ineffectiveness (describe):

Is the hedge relationship consistent with the company's risk management policy (Y/N)

Prepared by: _____ **Date:** _____ **Approved by:** _____ **Date:** _____

Hedging Summary Form 5 pg 2 of 2

HEDGING SUMMARY FORM 6

*Used for **HEDGING A NET INVESTMENT IN A FOREIGN OPERATION WITH A CURRENCY FORWARD CONTRACT.***

Complete all shaded areas at the time the derivative instrument is designated as a hedge.

Hedging relationship ID:

Inception of hedge:

Termination of hedge: _____

Hedged item: Net investment in foreign subsidiary

Exposure ID:	
Describe the net investment:	
Non-functional currency:	
Total value of the net investment (in the non-functional currency):	
Value of the net investment to be hedged:	

Accounting Treatment: Hedge of net investment in foreign operations

Nature of risk being hedged: The change in the value of the net investment in the functional currency, due to changes in currency exchange rates.

Hedging Derivative: Currency forward contract

Derivative ID:	
Counterparty:	
Trade date:	
Purchase (P) or sale (S):	
Currency:	
Size (notional amount):	
Forward price:	
Settlement date (expiration):	
Embedded options (Y/N):	
Describe special features (such as embedded options):	

Risk management strategy and hedge objective (describe):

Method of assessing hedge effectiveness:

Items excluded from effectiveness testing (describe): _____
Method of assessing hedge effectiveness prospectively (check one): dollar offset _____ regression /other statistical method (describe) _____:
Prospective assessment: Highly effective (Y/N) _____ Completed by _____
Method of assessing hedge effectiveness retrospectively (check one and describe): dollar offset: period-by-period _____ cumulative _____ regression/statistical method _____

Method of measuring ineffectiveness (describe):

--

Is the hedge relationship consistent with the company's risk management policy (Y/N)

Prepared by: _____ **Date:** _____ **Approved by:** _____ **Date:** _____

Hedging Summary Form 6 pg 2 of 2

APPENDIX II

HEDGE RELATIONSHIP DOCUMENTATION: ILLUSTRATIVE EXAMPLES

The following examples are designed to illustrate the way in which documentation forms might be adapted and completed to meet Section 3865 requirements. Once again, companies are advised to discuss various choices and methods with their auditors before implementing a hedge.

- | | |
|----------------|---|
| Example 1 | Hedge of Fixed Rate Debt with an Interest Rate Swap |
| Example 2 | Hedge of Variable Interest Expense with an Interest Rate Swap |
| Example 3 | Hedge of Variable Interest Expense with an Interest Rate Cap (Time Value Excluded From Hedge Effectiveness Assessments) |
| Examples 4 & 5 | Hedge of the Purchase from a Foreign Supplier with a Foreign Currency Forward Contract (Anticipated Cash Flow on a Specific Date) |
| Example 6 | Hedge of the Purchase from a Foreign Supplier with a Foreign Currency Forward Contract (Anticipated Cash Flow during a Prescribed Time Interval Date) |
| Example 7 | Hedge of a Net Investment in a Foreign Operation with a Foreign Currency Forward Contract |
| Example 8 | Hedge of the Purchase of a Commodity with a Futures Contract (Anticipated Cash Flow during a Prescribed Time Interval) |

Example 1 – Hedge of Fixed Rate Debt with an Interest Rate Swap

Company XYZ coordinated the issuance of fixed-rate, non-amortizing debt with the establishment of an at-market receive fixed / pay floating interest rate swap. The transactions were tailored in such a way as to ensure the application of shortcut method.

Tips, Traps, and Suggestions:

- Section 3865 ***limits*** the use of the shortcut method to hedging relationships that meet each and every applicable condition in paragraph 31, which essentially stipulates that the swap must be designed in such a way that the economic objective of swapping from fixed-to-floating (or vice versa), will be satisfied, *perfectly*. When a company intends to use the shortcut method, all of the qualifying criteria that validate this expectation should be documented at the inception of the hedge. Further, the company should have a basis for concluding that on an ongoing basis the counterparty will comply with the contractual terms of the hedging derivative. **Those intending to use the shortcut method should proceed with caution.**
- The common parlance is that the “critical terms of the swap have to match the critical terms of the hedged item” in order to qualify for the shortcut treatment. This notion of matching, however, does not apply to the two, respective fixed rates. That is, the fixed rate on the debt and the fixed rate on the swap do *not* have to be the same to qualify for the shortcut. Such differences would influence the resulting *spread* over or under the underlying variable interest rate on the swap, but the basic result of swapping from fixed-to-floating would be left intact.
- To qualify for shortcut, the debt must be a recognized asset or liability when the swap is initially transacted. The shortcut method cannot be elected for fair value hedges in cases where the fixed-rate debt has not yet been issued.
- To qualify for the shortcut method, a company must prepare formal contemporaneous documentation at inception of the hedging relationship. Under the shortcut method, there is no requirement to assess effectiveness on an on-going basis if all the shortcut criteria are met. We believe it is a best practice, for a company to validate, no less frequently than quarterly, the fact that the qualifying criteria are satisfied.

HEDGING FIXED RATE DEBT WITH AN INTEREST RATE SWAP

Hedging relationship ID:

Hedge 1

Inception of hedge:

5/16/2006

Termination of hedge: _____

Hedged item: Fixed rate debt

Debt identification number/counterparty	Bond 1
Balance outstanding	\$50 mil
Issue date	5/16/2006
Maturity date	5/16/2013
Fixed rate of interest	8.0%
Coupon frequency (daily, monthly, quarterly, etc.)	Semi-annual
Interest convention (A/360; 30/360; A/365; 30/365)	30/360
Accrual periods	Six-month intervals that commence on 5/16 and 11/16, subject to normal business day conventions.
Portion of debt to be hedged	100 percent

Accounting treatment: Fair value hedge

Nature of risk being hedged: The risk associated with changes in the value of the debt due to changes in the LIBOR-based swap rate (i.e., the benchmark interest rate).

Hedging derivative: Pay floating / receive fixed interest rate swap

Derivative ID	Swap 1
Counterparty	XYZ Bank
Trade date	5/16/2006
Notional amount	\$50 mil
Fixed rate (receiving)	7.8%
Interest convention (A/360; 30/360; A/365; 30/365; N/A):	30/360
Accrual periods (fixed side)	Six-month intervals that commence on 5/16 and 11/16, subject to normal business day conventions.
Start date	5/16/2006
End date	5/16/2013
Fair value at inception	\$0
Floating rate index (receiving)	6-month LIBOR
Reset frequency:	Semi-annually
Interest convention (A/360; 30/360; A/365; 30/365; N/A):	30/360

Risk management strategy and hedge objective:

The objective is to convert fixed rate financing to floating, for the life of the loan.

Method of assessing hedge effectiveness:

Based on our analysis, we believe it is highly probable that XYZ will comply with the terms of the derivative. Thus we have chosen to apply the shortcut method. Application of the shortcut method obviates the need to assess hedge effectiveness – other than documenting that the qualifying criteria are satisfied, as shown below:

Necessary Condition for All Hedges		Yes	No	NA	
1	Is the notional amount of the swap equal to the principal amount of the interest-bearing asset or liability being hedged?	X			Yes is required
2	Is the fair value of the swap zero at the inception of the hedging relationship?	X			Yes is required
3	Is the formula for computing net settlements under the interest rate swap the same for each net settlement (i.e., the fixed rate is the same throughout the term, and the variable rate is based on the same index and includes the same constant adjustment or no adjustment)?	X			Yes is required
4	Is the variable leg of the swap based on the benchmark interest rate being hedged?	X			Yes is required
5	Are there any atypical terms that invalidate the assumption of no ineffectiveness				No is required
6	Is the interest-bearing asset or liability prepayable at a price <i>other than</i> its fair value?		X		If yes, go to 7; if the answer is No proceed to 8 or 11t
7	If the answer to 5 is No, proceed to 7 or 10 If the answer to 5 is Yes, does the swap have a mirror image embedded option that cancels out the prepayment option on the debt?				Yes is required if the answer to 6 is Yes. Otherwise, NA is required
Necessary Condition for Fair Value Hedges					
8	Does the swap’s expiration match that of the interest-bearing asset or liability?	X			Yes is required
9	Are any floors or ceilings embedded in the variable leg of the swap?		X		No is required
10	Is the frequency of the repricing leg six months or less?	X			Yes is preferred
Necessary Condition for Cash Flow Hedges					
11	Are all of the cash flows of the interest-bearing asset or liability that occur before the swap matures designated as hedged items?			X	Yes is required
12	Are any of cash flows of the interest-bearing asset or liability that are scheduled after the termination of the swap designated as hedged items?			X	No is required
13	Are the re-pricing dates of the swap the same as the re-pricing dates of the variable rate asset or liability?			X	Yes is required

Example 1 - Fixed Rate Debt with an Interest Rate Swap

14	If there is a cap or floor on the variable interest rate of the swap, is there a comparable cap or floor on the interest-bearing asset or liability?			X	Yes is required
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Shortcut qualifications (re)validated on the following dates:

Date	By	Date	By
5/16/06	<u>RBS</u>		

Method of measuring ineffectiveness: The hedge meets the criteria for the shortcut method and is assumed to be perfectly effective.

Is the hedge relationship consistent with the company’s risk management policy?) Y

Prepared by: RBS Date: 5/16/06

Approved by: COS Date: 5/16/06

Example 2 -- Hedge of Variable Interest Expense with an Interest Rate Swap

Company XYZ entered into a non-amortizing variable rate loan agreement with ABC bank, with interest rate resets based on three-month LIBOR plus a spread. Subsequent to taking down the loan, the Company decided to hedge the remaining variable interest rate exposure and entered into a “receive floating / pay fixed” interest rate swap. The reset dates and accrual intervals are not the same for the swap and the loan, thereby ruling out the application of the shortcut method.

Tips, Traps, and Suggestions:

- The hedged forecasted transaction should be described with sufficient specificity so that when a transaction occurs, it is clear whether that transaction is or is not the hedged transaction. By describing the hedged item as a series of forecasted cash flows *not* tied to any specific debt or counterparty, the company will protect itself from having to accelerate any accumulated OCI if it refinances or restructures its debt.
- The occurrence of the forecasted transaction must be probable. Probability should be supported by observable facts and circumstances.
- The hedging horizon can be set for any length for which qualifying variable cash flows are probable, irrespective of the maturity of the debt associated with the most immediately scheduled cash flows.
- The specified future cash flows may represent only a portion of variable interest payments on the debt.
- Cash flows designated as the hedged item must be subject to a common risk – i.e., one-month LIBOR, or three-month LIBOR.
- As long as the variable rate is a benchmark rate – even if a (constant or non-constant) spread is applied – the specified risk being hedged should likely be the risk associated with changes in the benchmark rate. If the variable interest rate is other than a benchmark rate (i.e., Prime), the risk being hedged would have to be the risk associated with changes in the entire cash flow.
- Total results of the swap include two components: (1) changes in the fair value of the swap over the accounting period and (2) settlements realized during the period. Both are relevant when assessing retrospective effectiveness and/or measuring ineffectiveness.

HEDGING VARIABLE INTEREST EXPENSE WITH AN INTEREST RATE SWAP

Hedging relationship ID:

Hedge 2

Inception of hedge:

10/15/05

Termination of hedge: _____

Hedged item: LIBOR-based cash flows reflecting the following:

Principal amount	\$75 million
Variable rate index	3-month LIBOR
Frequency of cash flows	Quarterly
Designated cash flows	The hedged item consists of 20 discrete quarterly cash flows. Each such cash flow is the first cash flow in the quarter based on 3-month LIBOR. Thus, the first cash flow being hedged will occur on or subsequent to the first business day in February 2006. The remaining 19 cash flows will fall on a quarterly cycle begins on the first business day of February, May, August, and November, in like manner.
Rationale for the assumption that forecasted transaction is probable	Outstanding variable rate debt far exceeds the notional amount associated with the designated hedged items, and the company believes that it is probably that it will have outstanding at least \$75 million of debt with interest tied to 3-month LIBOR throughout the five-year term of the swap.

Hedging derivative: Pay fixed / receive floating interest rate swap

Derivative ID	Swap 2
Counterparty	ABC Bank
Trade date	10/15/05
Notional amount	\$75 mil
Start date	11/15/05
End date	11/15/10
Fair value at inception	\$0
Fixed rate (pay)	7.8%
Interest convention	30/360
Accrual period length	Quarterly
Floating rate (receive)	3-month LIBOR
Interest convention	30/360
Accrual period length	Quarterly

Accounting treatment: Cash flow hedge

Nature of risk being hedged: Risk of changes in the cash flows attributable to changes in 3-month LIBOR (i.e., the benchmark interest rate)

Risk management strategy and hedge objective: The Company's hedging objective is to eliminate the variability of its interest expense that arises because of changes in 3-month LIBOR, for the designated interest payments.

Method of assessing hedge effectiveness*:

Prospective testing – The Company relies on regression analysis for validating the expectation that the hedge will be highly effective. The Y variable in the regression will reflect the variable rate associated with the hedged item and the X variable will reflect the variable rate associated with the hedging derivative. In this case both indices relate to 3-month LIBOR, so the two series will differ only in the situation where the interest resetting dates are expected to differ in which case alignment of the two series will be adjusted to reflect this expected difference.

The analysis will rely on daily interest rate observations, starting on January 2, 2003, with new data being added to the data set as they become available. Satisfying the prospective test requires that the R-square statistic in the regression be no lower than 0.8.

Beyond the R-Square consideration, it is expected that the hedge will be implemented in a manner that is consistent with the slope coefficient of the regression. For instance, a coefficient of 1.0 is consistent with arranging a hedge where the notional size of the swap is equivalent to the notional size of the exposure; a coefficient of 0.95 would be consistent with the notional size of the hedge being set equal to 95% of the notional size of the debt. We deem the hedge to be acceptably constructed if the ratio of the notional size of the swap relative to the size of the debt falls between 80% and 125% of the value of the regression's slope coefficient.

Retrospective testing – The retrospective test relies on the period-by-period dollar offset ratio calculation. The test compares the total result of the actual derivative (i.e., changes in its present value plus/minus any settlements realized during the period with the total result of a hypothetical derivative that perfectly matches the terms of existing debt. Whenever the schedule of expected settlement days changes for the hedged item, a new hypothetical derivative will have to be devised – one having a fixed rate that makes the present value of the hypothetical derivative equal to zero at this starting point. Thus, if the change occurs within the accounting period, the result on the old hypothetical derivative would apply up to the date of the change, and the result on the new hypothetical would apply going forward.

If, at the inception of the hedging relationship and thereafter, (a) the resets dates of the hedged item and the hedging derivative are the same and (b) the schedule of the respective variable cash flows are the same, the hypothetical derivative would be identical to the actual derivative, and thus the dollar offset ratios would be 1.0.

To pass the retrospective test, the dollar offset ratio for the current period would have to fall within the range of 0.8 to 1.25, inclusive. Coming within this range would validate the prospective expectation and no updating of the prospective regression test would be required. Failing the dollar offset test, on the other hand, would require updating the data set and re-running the prospective regression test.

* See attached memo for initial assessment.

Method of measuring ineffectiveness: Ineffectiveness is measured using the cumulative dollar offset method which reflects a comparison of the results of the actual derivative to those of the hypothetical derivative(s). The company compares the total derivative result to the total result of the hypothetical derivative(s), on a cumulative basis.

Date	Prospective R-Square	Test Slope Coefficient	Cumulative Results (Actual derivative)	Cumulative Results (Hypothetical derivative)	Dollar Offset Ratio

Reclassification of OCI (describe process): Amounts will be reclassified into earnings in the same periods in during which the hedged forecasted cash flows affect earning. At the end of the process, the resulting AOCI should be equal to the effective hedge results that pertain only to future periods.

Is the hedge relationship consistent with the company’s risk management policy Y

Prepared by: JBS **Date:** 10/15/05

Approved by: COS **Date:** 10/15/05

Memo

From: COS
To: Files
Subject: Discussion of regression analysis used to test effectiveness for Swap 2
Initially prepared: October 15, 2005

The Company will assess effectiveness based on a correlation analysis that compares the interest rate associated with the hedged item to the interest rate associated with the derivative. A threshold of 0.8 for the R-Square (or higher) and a slope coefficient between 80 and 125% are required to apply hedge accounting. We will use the regression program in Excel to perform these assessments.

The interest rate on the debt is 3-month LIBOR + 50 basis points. The original rate-setting date was November 1, with quarterly resets. The original rate setting date on the swap is the 15th of November, also with quarterly resets.

The hedge objective is to offset the effect of changes in LIBOR over the coming 20 quarters (i.e., the spread is irrelevant for hedge effectiveness testing purposes). Given the mismatch in the reset dates, this hedge fails to qualify for shortcut treatment, even though the notional amount of the swap corresponds to the notional amount of the hedged item, and thus a hedge effectiveness test is required. We elected to use a regression analysis for prospective hedge effectiveness testing.

The data used in the analysis are daily observations of 3-month LIBOR, starting with a January 2, 2003 observation. The sample size expands to include the latest possible full month of data prior to the date of the analysis. For example, the original prospective test was performed on 10/15/05 with a sample that ran from January 2, 2003 through October 15, 2005. For the prospective test that would be completed after the end of the next quarter the sample would run from January 2, 2003 through February 28, 2006.

These data are published by the British Bankers Association. The regression analysis compares the original data set of LIBOR to that same data, lagged an appropriate number of observations to reflect the timing difference between the rate setting date on the loan and the rate setting date on the swap – a 14 day difference in this case.

The fact that LIBOR data are only provided on weekdays complicates this adjustment. Given that there are typically about 254 trading days per year, the average month has about 21 trading days. We assumed that the difference between the 1st of the month and the 15th of the month is normally about 11 business days. For that reason, the regression compared the 3-month LIBOR with 3-month LIBOR lagged by 11 business days.

Date of initial analysis: 10/15/05
R-Square: 0.971
Performed by: _____ COS _____
Highly effective (Y/N) _____ Y _____

SUMMARY OUTPUT

<i>Regression Statistics</i>	
Multiple R	0.985384
R Square	0.970983
Adjusted R Square	0.970944
Standard Error	0.230428
Observations	753

ANOVA

	<i>df</i>	<i>SS</i>	<i>MS</i>	<i>F</i>	<i>Significance F</i>
Regression	1	1334.335	1334.335	25130.02	0
Residual	751	39.87603	0.053097		
Total	752	1374.211			

	<i>Coef.</i>	<i>Std. Err.</i>	<i>t Stat</i>	<i>P-value</i>
Intercept	-0.210808	0.034298	-6.14638	1.29E-09
X Variable 1	-1.032307	0.006512	-158.5245	0

Memo

From: COS
To: Files
Subject: Method of Measuring Ineffectiveness
Initially prepared: October 15, 2005

As discussed in our documentation for Hedge 2, we use the “hypothetical derivative” method for measuring the portion of the hedge results deemed to be effective and ineffective. This procedure requires the identification of a hypothetical, perfect swap – the swap that would have qualified for the shortcut treatment. In this case, the hypothetical swap is a forward-starting swap. That is, the hypothetical swap is transacted on 10/15/05, but the first reset period begins on 11/1/05. The hypothetical swap has the following characteristics:

Derivative ID:	HypotheticalSwap2
Counterparty:	NA
Trade date:	10/15/05
Notional amount (if amortizing attach schedule):	\$75 mil
Final settlement date:	11/1/10
Fixed rate:	7.9%
Pay (P) or receive (R):	P
Variable rate:	3 month LIBOR
Pay (P) or receive (R):	R
Interest convention (A/360; 30/360; A/365; 30/365; NA):	A/360
First reset date:	11/1/05
Reset frequency:	Quarterly
Number of periods to be hedged:	20 quarters
Fair value at inception:	\$0
Embedded options (Y/N):	N
Describe special features (such as embedded options):	None

The specific fixed rate of the hypothetical swap is the coupon rate that makes the present value of the expected cash flows of this hypothetical instrument equal to zero. In this case, that rate turns out to be 7.9%.⁶

Under the hypothetical derivative method, accumulated OCI will be the lesser of either the cumulative gains or losses of the actual swap or the cumulative gains or losses of the “perfect” hypothetical swap. The amount recorded in earnings will be equal to the excess of the cumulative gains or losses of the swap over the cumulative gains or losses of the perfect hypothetical swap.

When hedge results are effective (i.e., when the cumulative hedge results are equal to or smaller than those of the hypothetical derivative), all gains and losses of the derivative are initially posted to OCI; and the gain or loss specifically relating to the current period is reclassified to earnings. Alternatively, when hedge results have some ineffective component (i.e., the cumulative hedge results are larger than those of the hypothetical derivative), ineffectiveness is found by subtracting the cumulative total gain or loss of the hypothetical derivative from the cumulative gain or loss of the actual. The gain or loss of the hypothetical derivative would be deemed effective and thus would be initially recorded in OCI. In this case, the current period’s reclassification from OCI to

⁶ Although this interest rate should be determined rigorously, 7.9% is an assumed result, used for illustrative purposes.

Example 2 - Variable Interest Expense with an Interest Rate Swap

earnings is equal to the portion of the hypothetical derivative's gain or loss that specifically relates to the current period's interest expense.

Example 3 – Hedge of Variable Interest Expense with an Interest Rate Cap (Time Value Excluded from Hedge Effectiveness Assessments)

Company XYZ entered into a non-amortizing variable rate loan agreement with ABC bank, with interest rate resets based on three-month LIBOR plus a spread. Subsequent to taking down the loan, the Company decided to hedge the remaining variable interest rate exposure and entered into an interest rate cap. The company expects to evaluate hedge effectiveness by comparing the changes of the intrinsic value of the hedging derivative to changes in the risk being hedged associated with the hedged item.

Tips, Traps, and Suggestions:

See Tips, Traps, and Suggestions, for Examples 2. All of the same concerns pertaining to the hedged item are equally applicable in this example. In addition –

- Caps are actually combinations of individual options, commonly called, “caplets,” where each caplet is intended as the hedging instrument for a specific, discrete interest rate exposure. For instance, a five-year cap, covering quarterly interest rate resets, is really 20 individual caplets, bundled in a single contract.
- The reporting entity will need to track intrinsic value changes for each caplet.
- The initial caplet value is essential information for the determination of reclassification journal entries.
- When using caps (or floors), documentation should reflect the fact that the payoff of this hedging instrument is asymmetrical. That is, the intended offsets occur *only* when the interest rates rise above (or fall below, for floors) the strike yields specified in the cap (or floor) contract.
- The intrinsic value of a cap is found by summing the intrinsic values of the component caplets.

HEDGING VARIABLE INTEREST EXPENSE WITH AN INTEREST RATE CAP

Hedging relationship ID: Hedge 3

Inception of hedge: 10/15/05

Termination of hedge:

Hedged item: LIBOR-based cash flows reflecting the following:

Principal amount	\$75 million
Variable rate index	3-mo. LIBOR
Frequency of cash flows	Quarterly
Designated cash flows	The hedged item consists of 20 discrete cash flows. Each such cash flow is the first cash flow in the quarter based the designated variable rate index and the designated frequency. Thus, the first cash flow being hedged will occur on or subsequent to the first business day in November 2005. The remaining 19 cash flows will fall on a quarterly cycle begins on the first business day of February, May, August, and November, in like manner.
Rationale for the assumption that forecasted transaction is probable	Outstanding variable rate debt far exceeds the notional amount associated with the designated hedged items, and the company does not foresee the likelihood of reducing this outstanding debt materially over the horizon of the hedge.

Hedging derivative: Interest rate cap

Derivative ID	CAP1
Counterparty	ABC Bank
Trade date	10/15/05
Notional amount	\$75 mil
Start date	11/1/05
End date	11/1/10
Initial cap premium	\$1.0 mil
Variable rate benchmark	3-mo. LIBOR
Strike yield	5.0%
Exercise style	European
Reset frequency	Quarterly
Number of caplets	20

Accounting treatment: Cash flow hedge

Nature of risk being hedged: Risk of changes in the cash flows attributable to changes in 3-month LIBOR (i.e., the benchmark interest rate), when LIBOR rises above the strike yield specified by the cap.

Method of assessing hedge effectiveness:

Prospective testing – The Company relies on regression analysis for validating the expectation that the hedge will be highly effective. The Y variable in the regression will reflect the variable rate associated with the

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Reclassification of OCI: The cap price is separated into prices of individual caplets for hedging interest expenses over 20 successive quarters. The cumulative change of each caplet's intrinsic value is reclassified from OCI to income coincidentally with the recognition of the interest expense for the associated period. (Time value changes for all caplets are recorded in earnings in each period and thus are not subject to reclassification.)

Is the hedge relationship consistent with the company's risk management policy Y

Prepared by: RBS Date: 10/15/05

Approved by: CBS Date: 10/15/05

Examples 4 & 5 -- Hedge of the Purchase from a Foreign Supplier with a FX Forward Contract (Anticipated Cash Flow on a Specific Date)

Company XYZ's functional currency is the Canadian dollar. XYZ anticipates that it will make a purchase from a foreign supplier, with payment to be made in that supplier's (non-dollar) currency. Payment is expected to be made coincidentally with the purchase date. Put another way, the Company will *not* record an accounts payable liability when the purchase is recorded; but instead, the Company will make a simultaneous settlement. The Company decides to hedge this risk by entering into a forward contract to buy the non-dollar currency units. The value date on the forward contract is set to coincide with the expected purchase and settlement date.

Tips, Traps, and Suggestions:

- The anticipated purchase may or may not be a firm commitment. If it is a firm commitment, the hedger has the choice of applying either fair value hedge accounting (where the firm commitment is the designated hedged item) or cash flow hedge accounting (where the anticipated payment is the designated hedged item). On the other hand, if the exposure does not qualify as a firm commitment, the only kind of hedge accounting that would be permissible is cash flow hedge accounting.
- Example 4 illustrates the documentation for a cash flow hedge; Example 5 illustrates the documentation for a fair value hedge.

HEDGING A FORECASTED TRANSACTION WITH A CURRENCY FORWARD CONTRACT

Hedging relationship ID:

Hedge 4

Inception of hedge:

8/14/05

Termination of hedge: _____

Hedged item: Payment for a forecasted purchase, denominated in a non-functional currency

Exposure ID	Widget1
Counterparty	Widget Co.
Underlying good	The first 5,000 widgets purchased on 5/15/06
Price per unit (in FX units)	€1,000
Non-functional currency	Euros
Total value of transaction (in FX units)	€ million
Expected purchase date	5/15/06
Expected settlement date	5/15/06
Rationale for the assumption that forecasted transaction is probable	We have a history of buying widgets from foreign suppliers in quantities consistent with this purchase.

Hedging derivative: Currency forward contract

Derivative ID	Forward 1
Counterparty	FX Bank
Trade date	8/14/05
Amount of currency to purchase	€ million
Forward price	\$1.2456 per €
Settlement date	5/15/06

Accounting treatment: Cash flow hedge

Nature of risk being hedged: The variability of cash flows in dollars (the functional currency) due to changes in the spot €/\$ exchange rate.

Risk management strategy and hedge objective: To lock in a dollar cash outflow for widgets by fixing the €/\$ exchange rate at \$1.2456 per € with the forward purchase of euros.

Method of assessing hedge effectiveness: Because the notional size of the currency of the hedged item equals that of the hedging derivative, and because the forward dates relevant to the hedged item and the hedging derivative are identical, this hedge can be deemed to be perfectly effective unless there are changes in the timing or amounts of the hedged item and/or changes in the creditworthiness of the counterparty. Each quarter we will revalidate this conclusion and ascertain that there have been no adverse changes in the creditworthiness of FX Bank.

Effectiveness qualifications (re)validated on the following dates:

8/14/05	<i>AE</i>				

Method of measuring ineffectiveness: We will use the hypothetical derivative method to measure ineffectiveness. With the all-in-one criteria satisfied, the hypothetical derivative is identical to the actual contract and the hedge results will be perfectly effective.

Reclassification of OCI: OCI reclassification will occur coincident with the sale of the resulting finished goods on a FIFO basis – approximately 60 days after the widget purchase.

Is the hedge relationship consistent with the company’s risk management policy Y

Prepared by: AE Date: 8/14/05

Approved by: CBS Date: 8/14/05

HEDGING A FIRM COMMITMENT WITH A CURRENCY FORWARD CONTRACT

Hedging relationship ID:

Hedge 5

Inception of hedge:

8/14/05

Termination of hedge: _____

Hedged item: A firm commitment denominated in a non-functional currency

Exposure ID	Widget1
Counterparty	Widget Co.
Underlying good	The first 5,000 widgets purchased on 5/15/06
Price per unit (in FX units)	€1,000
Non-functional currency	Euros
Total value of transaction (in FX units)	€5 million
Expected purchase date	5/15/06
Expected settlement date	5/15/06
Disincentive (Y/N):	Y

Hedging derivative: Currency forward contract

Derivative ID	Forward 1
Counterparty	FX Bank
Trade date	8/14/05
Amount of currency to purchase	€5 million
Forward price	\$1.2456 per €
Settlement date	5/15/06

Accounting treatment: Fair value hedge

Nature of risk being hedged: Currency exchange rate risk – i.e., changes in the dollar value of the firm commitment, due to changes in forward €/\$ exchange rate, relating to a 5/15/06 value date.

Risk management strategy and hedge objective: To lock in a dollar cost of widgets by fixing the €/\$ exchange rate at \$1.2456 per € with the forward purchase of euros.

Method of valuing firm commitment: We will measure the change in value of the firm commitment in a manner similar to the treatment of the forward contract (i.e., to reflect the present value of the change in the forward exchange rate associated with the settlement date). Because all of the critical terms match, changes in the value of the firm commitment will be precisely equal to the changes in value of the hedging derivative.

Method of assessing hedge effectiveness: Because the notional size of the currency of the hedged item equals that of the hedging derivative, and because the forward dates relevant to the hedged item and the hedging derivative are identical, this hedge can be deemed to be perfectly effective unless there are changes in the timing or amounts of the hedged item and/or changes in the creditworthiness of the counterparty. Each quarter we will revalidate this conclusion and ascertain that there have been no adverse changes in the creditworthiness of FX Bank.

Qualifications (re)validated on the following dates:

8/14/05 AE				

Method of measuring ineffectiveness: We will use the hypothetical derivative method to measure ineffectiveness. With the all-in-one criteria satisfied, the hypothetical derivative is identical to the actual contract and the hedge results will be perfectly.

Is the hedge relationship consistent with the company’s risk management policy Y

Prepared by: AE Date: 8/15/05

Approved by: CBS Date 8/15/05

Example 6 – Hedge of Purchases from a Foreign Supplier with a Foreign Currency Forward Contract (Anticipated Cash Flow during a Prescribed Time Interval)

Company XYZ anticipates that it will make multiple purchases from a foreign supplier, with payment to be made in that supplier’s (non-dollar) currency. The purchases are expected to occur within some finite time horizon, but not on a single day. Accounts payable will be recorded when the purchases are recorded, and the settlement of these associated accounts payable will be made at a later date. The company decided to hedge this risk by entering into a forward contract to buy the non-dollar currency units with a value date on the forward contract set to coincide with the expected settlement date.

HEDGE OF FORECASTED PURCHASES FROM A FOREIGN SUPPLIER WITH A CURRENCY FORWARD CONTRACT (SETTLEMENT FOLLOWING THE PURCHASE DATE)

Hedging relationship ID:

Hedge 6

Inception of hedge:

8/14/05

Termination of hedge: _____

Hedged item: The combination of forecasted purchases denominated in a foreign (non-functional) currency, followed by the recording of a foreign-currency-denominated accounts payable.

Exposure ID	Widget1
Counterparty	Widget Co.
Underlying good	The first 5,000 widgets purchases in April 2006
Price per unit (in FX units)	€1,000
Non-functional currency	Euros
Total value of transaction (in FX units)	€5 million
Expected purchase interval	Month of April 2006
Expected settlement date	9/15/06
Rationale for the assumption that forecasted transaction is probable	We have a history of buying widgets from foreign suppliers in amounts consistent with this purchase.

Hedging derivative: Currency forward contract

Derivative ID	Forward 1
Counterparty	FX Bank
Trade date	8/14/05
Amount of currency to purchase	€5 million
Forward price	\$1.2711 per €
Settlement date	9/15/06

Accounting treatment: Cash Flow Hedge

Nature of risk being hedged: This is designated as a dual purpose hedge to hedge the foreign currency exposure of our anticipated purchase of widgets in May and after the purchase to hedge the settlement of the related accounts payable on September 15.

Risk management strategy and hedge objective: To offset the effect of changes in the spot €/ \$ exchange rate.

Examples 6 – Hedge of the Purchase from a Foreign Supplier with a Foreign Currency Forward Contract (Anticipated Cash Flow During a Prescribed Time Interval)

Method of assessing hedge effectiveness: The Company has assumed perfect effectiveness as the anticipated purchase in a foreign currency results in the recognition of an accounts payable, and the value-date on the forward contract designated as a hedge is set to match the expected settlement date of the payable. Each quarter we will revalidate the continued probability of the amount and timing of the transactions and the counterparty's ability to perform under the contract.

Method of measuring ineffectiveness: We will use the hypothetical derivative method to measure ineffectiveness. As long as the forecasted purchase and settlement of the payable remain the same, the hypothetical derivative and the real derivative will be identical.

Reclassification of OCI: The hedge gains or losses will be reclassified separately for results related to (a) the forecasted purchase, and (b) results related to the payable, respectively. The former amount arises from two sources: (1) spot price changes that occur prior to the purchase date and (2) the share of the forward points attributable to the purchase. This amount is reclassified coincidentally with the sale of the resulting finished goods on a FIFO basis – approximately 60 days after the widget purchase. The remaining portion of the hedge gains or losses will be reclassified concurrently with the recognition of the transaction gains or losses attributable to the payable.

Is the hedge relationship consistent with the company's risk management policy Y

Prepared by: AE **Date:** 8/14/05

Approved by: CBS **Date:** 8/14/05

Example 7 – Hedge of a Net Investment in a Foreign Operation with a Foreign Currency Forward Contract

Company QXR is a wholly owned subsidiary of Company XYZ. Company QXR is located in Germany, and its functional currency is the euro. Company XYZ, on the other hand is domiciled in the Canada, and its functional currency is the dollar. Company XYZ decides to sell euros forward to hedge the currency exposure associated with a portion of its investment exposure.

Tips, Traps, and Suggestions:

- When forward contracts are used to hedge, the presence of forward points will lead to a mismatch between the measured gains or losses of the designated hedged item and the losses or gains on the forwards. This mismatch is unavoidable, but the assessment of effectiveness can exclude these forward points, or not. In either case hedge accounting can be applied.
- Electing to exclude forward points from effectiveness consideration forces the gains or losses from forward point changes to be recorded in earnings; not making this election allows this effect to be recorded in other comprehensive income.

HEDGING A NET INVESTMENT IN A FOREIGN OPERATION WITH A CURRENCY FORWARD CONTRACT

Hedging relationship ID:

Hedge 7

Inception of hedge:

7/7/05

Termination of hedge: _____

Hedged item: Net investment in a foreign operation

Exposure ID:	Net INV1
Describe the net investment:	QXR subsidiary
Non-functional currency:	Euros
Total value of the net investment (in the non-functional currency):	€50 million
Value of the net investment to be hedged:	€10 million

Accounting treatment: Net Investment in Foreign Operations

Nature of risk being hedged: The change in the fair value of the net investment, measured in dollars, due to changes in the spot €/\$ exchange rate.

Hedging derivative: Currency forward contract

Derivative ID	Forward 2
Counterparty	FX Bank
Trade date	7/7/05
Amount of currency to sell	€10 million
Forward price	\$1.3784 per €
Settlement date	12/31/06

Risk management strategy and hedge objective (describe): Offset the changes in the value of a portion of the net investment that is recognized in the translation account.

Method of assessing hedge effectiveness: We will assess effectiveness based on the overall changes in the value of the forward contract. So long as the critical terms of the forward contract and the net investment match there will be no ineffectiveness. We will revalidate this every quarter and monitor the credit risk of the counterparty.

Method of measuring ineffectiveness: We will use the hypothetical derivative methods to measure ineffectiveness. Because the actual derivative is identical to the hypothetical derivative there should be no ineffectiveness.

Is the hedge relationship consistent with the company's risk management policy Y

Prepared by: AE **Date:** 7/7/05

Approved by: CBS **Date:** 7/7/05

Example 8 – Hedge of the Purchase of a Commodity with a Futures Contract (Anticipated Cash Flow during a Prescribed Time Interval)

Company XYZ anticipates that it will buy natural gas each month over several coming months. The gas is priced at an industry benchmark price, with a spread (or basis) that changes over time. The Company decides to enter into a hedge using a strip of natural gas futures contracts, traded at the NYMEX – i.e., a series of contracts with sequential expiration dates, with each expiration being associated with purchases in successive months. Each respective contract will be liquidated when the prices are determined for the designated hedged items.

Tips, Traps, and Suggestions:

- Given the standardized nature of futures contracts, entities will likely elect to exclude forward points (i.e., the futures basis) from the assessment of hedge effectiveness. In doing so, it is important to distinguish between the spot price underlying the futures contract and the entity-specific spot price. The former pertains to the precise underlying commodity relevant to the futures contract, per se, while the latter reflects the entity's all-in purchase or sales price.
- If excluding the forward points from the hedge effectiveness assessment, measurement of the forward point effects requires coincident observations of the spot and futures prices. Daily settlement prices may serve as a good, objective reference for these values.
- In the designation of the hedged item, the documentation must be sufficiently specific as to *precisely* identify which sales or purchases pertain to the hedging relationship. This determination must be clear as of the date that the hedging relationship begins. It cannot be “figured out” as of the close of the accounting period.

HEDGING A FORECASTED COMMODITY TRANSACTION WITH A FUTURES CONTRACT

Hedging relationship ID: Hedge 8

Inception of hedge: 8/15/05

Termination of hedge: _____

Hedged item: The first 50,000 mmbtus of natural gas that the Company purchases in each of the nine months starting in January of 2006.

Exposure ID	NatGas1
Commodity	Natural Gas
Monthly volume	50,000 mmbtus
Price basis or index per unit	Chicago City Gate
Spread over/under index	Variable
Date the transaction is expected to occur	Each month, Jan – Sep, 2006
Purchase price as of the inception of the hedge	2.294
Rationale for the assumption that forecasted transaction is probable	The size of the hedge represents half of normal expected usage

Hedging derivative: Futures contracts

Type of futures contract	Natural gas		
Contract size	10,000 mmbtus		
Exchange	NYMEX		
Broker	Ace Futures Brokers, Inc.		
Trade date	8/15/05		
Front-month contract price on trade date	2.194		
Expiration / futures price / quantity	Jan	2.220	5 (long)
	Feb	2.279	5
	Mar	2.355	5
	Apr	2.420	5
	May	2.490	5
	Jun	2.505	5
	Jul	2.543	5
	Aug	2.570	5
	Sep	2.750	5

Accounting treatment: Cash flow hedge

Nature of risk being hedged: Risk of changes in the cash flows attributable to changes in the company's purchase price for natural gas purchased at Chicago City Gate.

Reclassification of OCI (describe process): Reclassification associated with each month's purchases is performed 60 days after the purchase date, reflecting the normal production cycle between gas purchases and the sale of finished goods. The amount reclassified related to each futures contract reflects only the changes in the front-month futures price over the life of the relevant futures contract, as the remaining portion of the hedge results (i.e., those relating to futures' forward points) were excluded from hedge effectiveness and recorded directly in earnings as they accrued.

Is the hedge relationship consistent with the company's risk management policy Y

Prepared by: AE Date: 8/15/05

Approved by: CBS Date: 8/15/05

APPENDIX III

RISK MANAGEMENT POLICY DOCUMENTATION

One of the prerequisites for applying hedge accounting is that hedging activities should be consistent with the company's risk management policy. We recommend that this policy be presented formally to the company's board for its approval.

Such a policy document should provide broad, conceptual guidance and authorization relating to the types of exposures for which hedging is permitted; the types of derivatives that the company deems to be acceptable; the hedging strategies and objectives that may be pursued; and the ways in which hedge effectiveness may be measured and assessed. In addition, the policy document should also detail specific procedures designed to insure that hedging activities will be handled in a manner that is consistent with the objectives of the management.

In this latter regard, the following issues should be addressed:

- (a) personnel authorized to engage in hedging transactions;
- (b) approved counterparties and/or brokers, and associated position limits;
- (c) identification of the GAAP and required regulatory basis of accounting;
- (d) procedures relating to who bears the responsibility for deciding how much of any allowable exposure to hedge and how frequently and by whom this assessment should be re-visited; and
- (e) procedures for overseeing this responsibility, including establishment of a review and reporting process performed by independent professionals.

The policy document should reflect the need for control, on one hand, and the benefits that come from providing enough latitude for the company to be able to react and respond to changing market conditions, on the other. That is, an overly detailed policy document may limit the company's capacity to adjust hedge positions in a way that may be reasonable and prudent. But at the same time, a policy that is too general and imprecise may open the door for trading activity that might be inconsistent with the company's risk appetite. Ideally, a risk policy document should be sensitive to the need for balance.