AFP Thought Leadership Series:
Hedging Vesting
NQDC Plan Liabilities

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The AFP Thought Leadership Series addresses a variety of financial, tax, accounting, plan design and rabbi trust funding issues related to nonqualified deferred compensation plans (NQDC plans). Prior white papers covering a variety of subject matter may be found at: http://atlasfinancialpartners.com/publications.html and include the following:

1. **Hedging Nonqualified Deferred Compensation Plans** – This acts as a primer on the use of dynamically-reweighted total return swaps (TRS Hedge™) to hedge P&L volatility related to NQDC plans. It makes a solid case that this strategy substantially improves on older approaches, such as the use of mutual funds, ETFs or corporate-owned life insurance to hedge NQDC plans – from the perspectives of financial (NPV) results, tax, accounting, flexibility and ease of use.

2. **The Swap Overlay Strategy** – This white paper addresses the use of the TRS Hedge™ as an overlay strategy for companies that currently hold Corporate-Owned Life Insurance (COLI), mutual funds or other physical assets in rabbi trusts. It shows that the combination of the TRS Hedge™ with the existing strategies still provides plan sponsors with all of the benefits addressed in our introductory paper – although plan sponsors will still experience NPV costs due to the holding of physical assets on their balance sheets.

3. **Hedging vs. Funding NQDC Plan Liabilities** – We have found that benefits consultants, COLI brokers and other advisors in the NQDC space often confuse informal funding of NQDC plans with hedging. In this white paper, we show that informal funding is an option that most plan sponsors may wish to avoid – because of high NPV costs and lack of value for plan participants. A detailed analysis shows the TRS Hedge™ provides a superior hedge for NQDC plan liabilities over the use of physical assets such as COLI or mutual funds.

4. **Accounting Memo** – This document may be shared with accountants to help illustrate the accounting treatment for most NQDC plans and the related TRS Hedge™ strategy.

The subject matter in the following white paper focuses on the unique accounting requirements for NQDC plans subject to vesting.
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I. **Summary**

Many companies offer NQDC plans that provide benefits that vest over several years. For plans with vesting features, the full economic exposure of the plan liabilities is borne by the company upfront, while for accounting purposes the liability is accrued over the vesting period. Companies would generally like to hedge their economic exposure, but doing so with physical investments such as corporate-owned life insurance (COLI) or mutual funds creates a mismatched accounting result and hedging the accounting exposure results in a permanent, under-hedged exposure.

As a result, we have seen companies elect to fully accrue the unvested liability in order to have the economic hedge match the accounting result.

Financial Accounting Standards Board Statement No. 133, Accounting for Derivative Instruments and Hedging Activities, provides an alternative: the “Cash flow hedge” election. Combined with the use of a total return swap to hedge the NQDC plan, a cash flow hedge election allows the company to hedge the full economic exposure and defer a portion of the gain/loss on the hedge until it recognizes the loss/gain on the NQDC plan.

The result: a company can hedge its economic exposure without creating year-to-year mismatches in its accounting results.

II. **Background**

NQDC plans are generally offered to senior employees as a tax-advantaged retirement savings plan and for retention purposes. Deferrals into the plans may be elective or involuntary contributions. Generally, the plans are exempt from ERISA provisions; formal funding of the plan liabilities is not allowed.

Typically, the plans offer a diversified, broad menu of investment deferral options similar to a company’s qualified 401(k) plan. The NQDC plan liability is marked-to-market with the change expensed through the income statement as “Compensation Expense”.

Traditionally, plan sponsors have managed these liabilities in one of three ways:

- Leave liability exposure unhedged and accept the resulting income statement (“Compensation Expense”) volatility
- Buy matching mutual funds or corporate-owned life insurance (COLI)

Gain and losses from holding mutual funds or COLI are generally recorded in “Other” or “Investment” income, not in Compensation Expense.
Further complicating this is the fact that many companies’ NQDC plans provide benefits that vest over several years (e.g. broker commissions, portfolio manager incentives, company stock awards, and company matching programs). For these plans, the full economic exposure of the plan liabilities is borne by the company upfront, while for accounting purposes the liability is accrued over the vesting period. Companies would like to hedge their economic exposure, but doing so with physical investments such as COLI or mutual funds creates a mismatched accounting result (see below). And, hedging the accounting exposure results in a permanent, under-hedged net exposure.

Assume that there is a total $100 deferral, vesting over 5 years, allocated to an equity investment option that appreciates 10% per year, and no haircut related to participants expected to leave before vesting.

### Table 1

<table>
<thead>
<tr>
<th>Year</th>
<th>0</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>Cumulative</th>
</tr>
</thead>
<tbody>
<tr>
<td>Economic Exposure</td>
<td>$100.00</td>
<td>$110.00</td>
<td>$121.00</td>
<td>$133.10</td>
<td>$146.41</td>
<td>$161.05</td>
<td></td>
</tr>
<tr>
<td>Accounting Liability</td>
<td>$20.00</td>
<td>$22.00</td>
<td>$48.40</td>
<td>$79.86</td>
<td>$117.13</td>
<td>$161.05</td>
<td></td>
</tr>
<tr>
<td>Gain / (Loss) on TRS Hedge</td>
<td>$10.00</td>
<td>$11.00</td>
<td>$12.10</td>
<td>$13.31</td>
<td>$14.64</td>
<td>$61.05</td>
<td></td>
</tr>
<tr>
<td>(Inc) / Dec in Comp Expense related to mark to market of NQDC plan liability</td>
<td>-2.00</td>
<td>-6.40</td>
<td>-11.46</td>
<td>-17.27</td>
<td>-23.92</td>
<td>-61.05</td>
<td></td>
</tr>
<tr>
<td>Net P&amp;L from Economic Hedge (&quot;Tracking Error&quot;)</td>
<td>$8.00</td>
<td>$4.60</td>
<td>$0.64</td>
<td>-$3.96</td>
<td>-$9.28</td>
<td>$0.00</td>
<td></td>
</tr>
</tbody>
</table>

As you can see from the Table 1, if the company hedges the full economic exposure over the 5-year period, on a cumulative basis, the gains on the hedge equal the expense of the NQDC plan. However, because the plan liability is not fully accrued until year 5, the accounting results are skewed and there is tracking error (i.e. the difference between the gain/loss on the hedge and the loss/gain from the plan) in each year.

### Table 2

<table>
<thead>
<tr>
<th>Year</th>
<th>0</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>Cumulative</th>
</tr>
</thead>
<tbody>
<tr>
<td>Economic Exposure</td>
<td>$100.00</td>
<td>$110.00</td>
<td>$121.00</td>
<td>$133.10</td>
<td>$146.41</td>
<td>$161.05</td>
<td></td>
</tr>
<tr>
<td>Accounting Liability</td>
<td>$0.00</td>
<td>$22.00</td>
<td>$48.40</td>
<td>$79.86</td>
<td>$117.13</td>
<td>$161.05</td>
<td></td>
</tr>
<tr>
<td>Gain / (Loss) on TRS Hedge</td>
<td>$0.00</td>
<td>$2.20</td>
<td>$4.84</td>
<td>$7.99</td>
<td>$11.71</td>
<td>$26.74</td>
<td></td>
</tr>
<tr>
<td>(Inc) / Dec in Comp Expense related to mark to market of NQDC plan liability</td>
<td>-2.00</td>
<td>-6.40</td>
<td>-11.46</td>
<td>-17.27</td>
<td>-23.92</td>
<td>-61.05</td>
<td></td>
</tr>
<tr>
<td>Net P&amp;L from Accounting Hedge (&quot;Tracking Error&quot;)</td>
<td>-2.00</td>
<td>-$4.20</td>
<td>-$6.62</td>
<td>-$9.28</td>
<td>-$12.21</td>
<td>-$34.31</td>
<td></td>
</tr>
</tbody>
</table>

Conversely, if the company elects to hedge the accounting exposure, they are effectively under-hedged and there is tracking error in each year AND a cumulative $34.31 loss.
Under FASB #133, a company utilizing the TRS Hedge™ may hedge the full economic exposure and take a “Cash flow Hedging” election. In this case, the company can then defer a portion of the gain/loss on the hedge until it recognizes the loss/gain on the plan.

Table 3

<table>
<thead>
<tr>
<th>Year</th>
<th>0</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>Cumulative</th>
</tr>
</thead>
<tbody>
<tr>
<td>Economic Exposure</td>
<td>$100.00</td>
<td>$110.00</td>
<td>$121.00</td>
<td>$133.10</td>
<td>$146.41</td>
<td>$161.05</td>
<td></td>
</tr>
<tr>
<td>Accounting Liability</td>
<td>$20.00</td>
<td>$22.00</td>
<td>$48.40</td>
<td>$79.86</td>
<td>$117.13</td>
<td>$161.05</td>
<td></td>
</tr>
<tr>
<td>Gain / (Loss) on TRS Hedge</td>
<td>$10.00</td>
<td>$11.00</td>
<td>$12.10</td>
<td>$13.31</td>
<td>$14.64</td>
<td>$61.05</td>
<td></td>
</tr>
<tr>
<td>Portion Recognized in P&amp;L</td>
<td>$2.00</td>
<td>$6.40</td>
<td>$11.46</td>
<td>$17.27</td>
<td>$23.92</td>
<td>$61.05</td>
<td></td>
</tr>
<tr>
<td>Portion recorded in Other Comprehensive Income (Equity)</td>
<td>$8.00</td>
<td>$4.60</td>
<td>$0.64</td>
<td>-$3.96</td>
<td>-$9.28</td>
<td>$0.00</td>
<td></td>
</tr>
<tr>
<td>(Inc) / Dec in Comp Expense related to mark to market of NQDC plan liability</td>
<td>-$2.00</td>
<td>-$6.40</td>
<td>-$11.46</td>
<td>-$17.27</td>
<td>-$23.92</td>
<td>-$61.05</td>
<td></td>
</tr>
</tbody>
</table>

Net P&L from Economic Hedge (“Tracking Error”) | $0.00 | $0.00 | $0.00 | $0.00 | $0.00 | $0.00 |

Under FASB #133, with a cash flow hedge election a portion of the hedging gains/losses is recorded in Other Comprehensive Income (in the Equity section of the balance sheet) until the losses/gains related to the plan are recognized.

Result: The company can hedge its economic exposure without creating year-to-year mismatches in its accounting results.

III. THE NQDC TOTAL RETURN SWAP HEDGE

As noted above, much material on the hedging of NQDC plan liabilities is available on our website (see Hedging Nonqualified Deferred Compensation Plans at http://atlasfinancialpartners.com/publications.html). Below is a summary of the opportunity and benefits of using total return swaps to hedge these liabilities.

- Nonqualified deferred compensation plans create frequently-reweighted mark-to-market “short” positions on corporate balance sheets. These exposures trigger highly-visible unbudgeted executive compensation expense
- NQDC plans are complex, customized and require knowledge of tax, accounting, actuarial, corporate finance, regulations, legislative change, plan design, administrative systems, and participant education
- Analect Benefit Finance (ABF) has created an efficient solution with supporting systems and controls to hedge this exposure in a tax- and accounting-advantaged manner. The total return swap strategies (TRS Hedge™) we use require knowledge and systems to respond to changing investment menus, perform ongoing correlation analyses, measure
P&L exposures, manage dynamic reweighting and perform tax and accounting recordkeeping and reporting

- We have developed systems, controls, intellectual resources and IP to support the implementation and ongoing administration of the TRS Hedge™ strategy

The TRS Hedge™ of NQDC plan liabilities is equivalent to:

- A bank swap counterparty/provider borrowing money on the company’s behalf
- Investing that cash in assets of the company’s choosing (typically indices, ETFs and/or company stock)
- Holding those assets on the bank’s balance sheet
- Settling the TRS monthly, cash payments and mark-to-market, which is highly correlated to the return of the NQDC plan
- Liquidating the assets when directed by the company
- The company receiving any gain (paying any loss) on the assets

The benefits of utilizing the TRS Hedge™ are:

- It creates economic value and reduces the cost of the NQDC plan by freeing up cash that can be reinvested in the company’s business
- It mitigates market-based risk and income statement volatility by hedging the NQDC liability exposure in a highly correlated manner
- It eliminates highly visible swings in compensation expense because, under FASB #133, the gains/losses on the TRS Hedge™ are recorded in the same income statement line item as the NQDC plan expenses, compensation expense
- It enhances tax efficiency because a company can take a tax hedge election under Section 1221(b) of the Internal Revenue Code and defer taxes on the TRS Hedge™ gains, losses and expenses until distribution payments are made from the plan (and deducted)
- It offers maximum flexibility of investment options offered to participants, since any publicly available investment can generally be hedged with the TRS Hedge™
- It eases administration for the company as the support for the TRS Hedge™ is completely outsourced (see Section V below) and there is no impact on the company’s existing plan recordkeeper or the employee interface
IV. “CASH FLOW HEDGING” ELECTION

Financial Accounting Standards Board Statement No. 133, Accounting for Derivative Instruments and Hedging Activities, establishing the accounting guidelines related to derivative hedges (see relevant excerpts in the Appendix). It allows, for instance, for the gains on the TRS Hedge™ to be recorded in the same income statement line item as the expenses related to the NQDC plan (i.e. executive compensation expense).

FASB No. 133 also anticipates situations where a derivative may be used to hedge an anticipated transaction, a transaction that is highly likely to occur but has not yet been reflected in the financial statements. The future vesting of a company’s NQDC plan liabilities is an example of such a transaction.

As a result, if a company hedges a vesting NQDC plan and elects to treat the TRS Hedge™ as a “cash flow hedge”, it can defer the recognition of the gains and losses on the TRS Hedge™ until the NQDC plan vests and the related expense is recognized. Prior to recognition in the income statement, the TRS Hedge™ gains are recorded in Other Comprehensive Income (in the Equity section of the balance sheet).

V. REPORTING AND ADMINISTRATION

Analect Benefit Finance has developed a suite of services for clients who elect to utilize the TRS Hedge™ to hedge their NQDC plan liabilities, such as:

- Development, maintenance, and running of TRS Swap Hedge algorithms
- Incorporate proxy hedges
- Execute market-based TRS hedges of the plan liabilities
- Prepare and distribute TRS hedge re-weighting requests
- Ensure accurate swap execution by confirming re-weighting results with swap provider
- Confirm notional swap balances outstanding with swap provider
- Confirm floating amount and equity amount calculations
- Quarterly swap settlement audits and confirmations, including dividends, units, pricing, transactions, LIBOR rates, spreads, dates and day counts, and fees (if applicable)
- Integrate TRS hedge into overall risk reporting
- Comprehensive P&L attribution model
- Track cumulative gain/loss, equity amount, and floating amount by participant
- Coordinate communication between plan sponsor, plan record keeper, and swap provider
- Respond to ad hoc plan sponsor inquiries
- Maintain all agreed-upon records on behalf of plan sponsor
- Provide the following reporting package: Swap Order Requests, Net Monthly Exposure, Accounting Report, Tax Report, Financing and Equity Leg Calculations, Fee Calculation Report, Tracking Error Attribution Analysis

We have found that auditors require specialized detailed reporting in order to sign off on the cash flow hedge election under FAS 133. As a result, we have developed customized reports to meet these requirements for our clients that use the TRS Hedge™ to hedge liabilities subject to vesting. These reports include:

- The tracking of earnings and expenses down to the vested vs. unvested level, allowing for accurate tracking of the “cash flow hedge” for purposes of deferring recognition.
- Projected Other Comprehensive Income (OCI) for each vesting schedule, forecasting future P&L impacts.
- Earnings that transfer from OCI to vested based on scheduled adjustments and forfeitures.
- Recommended journal entries to separate the booking of OCI and compensation expense of the Total Return Swap receivables/payables.
- Recommended journal entries for reclassification of the equity leg due to vesting schedule or forfeiture adjustments.
- Tax entries analysis of deferred tax asset (DTA) based on corporate tax rate relative to journal entries.

VI. CONCLUSIONS

Many companies offer nonqualified deferred compensation plans (NQDC plans) that provide benefits that vest over several years. For plans with vesting features, the full economic exposure of the plan liabilities is borne by the company upfront, while for accounting purposes the liability is accrued over the vesting period. Companies would generally like to hedge their economic exposure, but doing so with physical investments such as corporate-owned life insurance (COLI) or mutual funds creates a mismatched accounting result and hedging the accounting exposure results in a permanent, under-hedged exposure.

Financial Accounting Standards Board Statement No. 133, Accounting for Derivative Instruments and Hedging Activities, provides an alternative: the “Cash flow hedge” election. Combined with the use of a total return swap to hedge the NQDC plan, a cash flow hedge election allows the company to hedge the full economic exposure and defer a portion of the gain/loss on the hedge until it recognizes the loss/gain on the NQDC plan.

The result: a company can hedge its economic exposure without creating year-to-year mismatches in its accounting results.
VII. Appendix – FASB 133

The information below contains relevant excerpts from FASB Statement No. 133.

**STATEMENT NO. 133**
**ACCOUNTING FOR DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES (ISSUED 6/98)**

Summary

This Statement establishes accounting and reporting standards for derivative instruments and for hedging activities. It requires that an entity recognize all derivatives as either assets or liabilities in the balance sheet and measure those instruments at fair value. **If certain conditions are met, a derivative may be specifically designated as** (a) a hedge of the exposure to changes in the fair value of a recognized asset or liability or an unrecognized firm commitment, (b) a **hedge of the exposure to variable cash flows of a forecasted transaction**.

The accounting for changes in the fair value of a derivative (that is, gains and losses) depends on the intended use of the derivative and the resulting designation. For a derivative designated as hedging the exposure to changes in the fair value of a recognized asset or liability or a firm commitment (referred to as a fair value hedge), the gain or loss is recognized in earnings in the period of change together with the offsetting loss or gain on the hedged item attributable to the risk being hedged. The effect of that accounting is to reflect in earnings the extent to which the hedge is not effective in achieving offsetting changes in fair value.

For a derivative designated as hedging the exposure to variable cash flows of a forecasted transaction (referred to as a cash flow hedge), the effective portion of the derivative's gain or loss is initially reported as a component of other comprehensive income (outside earnings) and subsequently reclassified into earnings when the forecasted transaction affects earnings. The ineffective portion of the gain or loss is reported in earnings immediately.

Under this Statement, an entity that elects to apply hedge accounting is required to establish at the inception of the hedge the method it will use for assessing the effectiveness of the hedging derivative and the measurement approach for determining the ineffective aspect of the hedge. Those methods must be consistent with the entity's approach to managing risk. This Statement precludes designating a non-derivative financial instrument as a hedge of an asset.

In summary: This Statement generally provides for matching the timing of gain or loss recognition on the hedging instrument with the recognition of (a) the changes in the fair value of the hedged asset or liability that are attributable to the hedged risk or (b) the earnings effect of the hedged forecasted transaction.

Further, from paragraph 18: The accounting for changes in the fair value (that is, gains or losses) of a derivative depends on whether it has been designated and qualifies as part of a hedging relationship and, if so, on the reason for holding it. Either all or a proportion of a derivative may be designated as the hedging instrument. Gains and losses on derivative instruments are accounted for as follows:
a. *No hedging designation.* The gain or loss on a derivative instrument not designated as a hedging instrument shall be recognized currently in earnings.

b. *Fair value hedge.* The gain or loss on a derivative instrument designated and qualifying as a fair value hedging instrument as well as the offsetting loss or gain on the hedged item attributable to the hedged risk shall be recognized currently in earnings in the same accounting period, as provided in paragraphs 22 and 23.

c. *Cash flow hedge.* The effective portion of the gain or loss on a derivative instrument designated and qualifying as a cash flow hedging instrument shall be reported as a component of other comprehensive income (outside earnings) and reclassified into earnings in the same period or periods during which the hedged forecasted transaction affects earnings, as provided in paragraphs 30 and 31. The remaining gain or loss on the derivative instrument, if any, shall be recognized currently in earnings, as provided in paragraph 30.

Paragraph 20. An entity may designate a derivative instrument as hedging the exposure to changes in the fair value of an asset or a liability or an identified portion thereof ("hedged item") that is attributable to a particular risk. Designated hedging instruments and hedged items qualify for fair value hedge accounting if all of the following criteria and those in paragraph 21 are met:

a. **At inception of the hedge,** there is formal documentation of the hedging relationship and the entity’s risk management objective and strategy for undertaking the hedge, including identification of the hedging instrument, the hedged item, the nature of the risk being hedged, and how the hedging instrument’s effectiveness in offsetting the exposure to changes in the hedged item’s fair value attributable to the hedged risk will be assessed. There must be a reasonable basis for how the entity plans to assess the hedging instrument’s effectiveness.

(1) For a fair value hedge of a firm commitment, the entity’s formal documentation at the inception of the hedge must include a reasonable method for recognizing in earnings the asset or liability representing the gain or loss on the hedged firm commitment.

(2) An entity’s defined risk management strategy for a particular hedging relationship may exclude certain components of a specific hedging derivative’s change in fair value, such as time value, from the assessment of hedge effectiveness, as discussed in paragraph 63 in Section 2 of Appendix A.

b. **Both at inception of the hedge and on an ongoing basis,** the hedging relationship is expected to be highly effective in achieving offsetting changes in fair value attributable to the hedged risk during the period that the hedge is designated. An assessment of effectiveness is required whenever financial statements or earnings are reported, and at least every three months. All assessments of effectiveness shall be consistent with the risk management strategy documented for that particular hedging relationship (in accordance with paragraph 20(a) above).

Paragraph 21. An asset or a liability is eligible for designation as a hedged item in a fair value hedge if all of the following criteria are met:

a. The hedged item is specifically identified as either all or a specific portion of a recognized asset or liability or of an unrecognized firm commitment. The hedged item is a single asset or liability (or a specific portion thereof) or is a portfolio of similar assets or a portfolio of similar liabilities (or a specific portion thereof).

b. The hedged item presents an exposure to changes in fair value attributable to the hedged risk that could affect reported earnings.

c. The hedged item is not an asset or liability that is remeasured with the changes in fair value attributable to the hedged risk reported currently in earnings.
Paragraph 22. Gains and losses on a qualifying fair value hedge shall be accounted for as follows:

a. The gain or loss on the hedging instrument shall be recognized currently in earnings.

b. The gain or loss (that is, the change in fair value) on the hedged item attributable to the hedged risk shall adjust the carrying amount of the hedged item and be recognized currently in earnings.

If the fair value hedge is fully effective, the gain or loss on the hedging instrument, adjusted for the component, if any, of that gain or loss that is excluded from the assessment of effectiveness under the entity’s defined risk management strategy for that particular hedging relationship (as discussed in paragraph 63 in Section 2 of Appendix A), would exactly offset the loss or gain on the hedged item attributable to the hedged risk. Any difference that does arise would be the effect of hedge ineffectiveness, which consequently is recognized currently in earnings. The measurement of hedge ineffectiveness for a particular hedging relationship shall be consistent with the entity’s risk management strategy and the method of assessing hedge effectiveness that was documented at the inception of the hedging relationship, as discussed in paragraph 20(a). Nevertheless, the amount of hedge ineffectiveness recognized in earnings is based on the extent to which exact offset is not achieved. Although a hedging relationship must comply with an entity’s established policy range of what is considered “highly effective” pursuant to paragraph 20(b) in order for that relationship to qualify for hedge accounting, that compliance does not assure zero ineffectiveness.

Cash Flow Hedges

Paragraph 28. An entity may designate a derivative instrument as hedging the exposure to variability in expected future cash flows that is attributable to a particular risk. That exposure may be associated with an existing recognized asset or liability (such as all or certain future interest payments on variable-rate debt) or a forecasted transaction (such as a forecasted purchase or sale). Designated hedging instruments and hedged items or transactions qualify for cash flow hedge accounting if all of the following criteria and those in paragraph 29 are met:

a. At inception of the hedge, there is formal documentation of the hedging relationship and the entity’s risk management objective and strategy for undertaking the hedge, including identification of the hedging instrument, the hedged transaction, the nature of the risk being hedged, and how the hedging instrument’s effectiveness in hedging the exposure to the hedged transaction’s variability in cash flows attributable to the hedged risk will be assessed. There must be a reasonable basis for how the entity plans to assess the hedging instrument’s effectiveness.

   (1) An entity’s defined risk management strategy for a particular hedging relationship may exclude certain components of a specific hedging derivative’s change in fair value from the assessment of hedge effectiveness, as discussed in paragraph 63 in Section 2 of Appendix A.

   (2) Documentation shall 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) The phrase expected currency amount refers to hedges of foreign currency exchange risk and requires specification of the exact amount of foreign currency being hedged.

   (b) The phrase expected . . . quantity refers to hedges of other risks and requires specification of the physical quantity (that is, the number of items or units of measure) encompassed by the hedged forecasted transaction. If a forecasted sale or purchase is being hedged for price risk, the hedged transaction cannot be specified solely in terms of expected currency amounts, nor can it be specified as a percentage of sales or purchases during a
period. The current price of a forecasted transaction also should be identified to satisfy the criterion in paragraph 28(b) for offsetting cash flows.

The hedged forecasted transaction shall be described with sufficient specificity so that when a transaction occurs, it is clear whether that transaction is or is not the hedged transaction. Thus, the forecasted transaction could be identified as the sale of either the first 15,000 units of a specific product sold during a specified 3-month period or the first 5,000 units of a specific product sold in each of 3 specific months, but it could not be identified as the sale of the last 15,000 units of that product sold during a 3-month period (because the last 15,000 units cannot be identified when they occur, but only when the period has ended).

b. **Both at inception of the hedge and on an ongoing basis,** the hedging relationship is expected to be highly effective in achieving offsetting cash flows attributable to the hedged risk during the term of the hedge, except as indicated in paragraph 28(d) below. An assessment of effectiveness is required whenever financial statements or earnings are reported, and at least every three months. All assessments of effectiveness shall be consistent with the originally documented risk management strategy for that particular hedging relationship.

Paragraph 29. A forecasted transaction is eligible for designation as a hedged transaction in a cash flow hedge if all of the following additional criteria are met:

a. The forecasted transaction is specifically identified as a single transaction or a group of individual transactions. If the hedged transaction is a group of individual transactions, those individual transactions must share the same risk exposure for which they are designated as being hedged. Thus, a forecasted purchase and a forecasted sale cannot both be included in the same group of individual transactions that constitute the hedged transaction.

b. The occurrence of the forecasted transaction is probable.

c. The forecasted transaction is a transaction with a party external to the reporting entity (except as permitted by paragraph 40) and presents an exposure to variations in cash flows for the hedged risk that could affect reported earnings.

d. The forecasted transaction is not the acquisition of an asset or incurrence of a liability that will subsequently be remeasured with changes in fair value attributable to the hedged risk reported currently in earnings. If the forecasted transaction relates to a recognized asset or liability, the asset or liability is not remeasured with changes in fair value attributable to the hedged risk reported currently in earnings.

Paragraph 30. The effective portion of the gain or loss on a derivative designated as a cash flow hedge is reported in other comprehensive income, and the ineffective portion is reported in earnings.

Paragraph 31. Amounts in accumulated other comprehensive income shall be reclassified into earnings in the same period or periods during which the hedged forecasted transaction affects earnings (for example, when a forecasted sale actually occurs). If the hedged transaction results in the acquisition of an asset or the incurrence of a liability, the gains and losses in accumulated other comprehensive income shall be reclassified into earnings in the same period or periods during which the asset acquired or liability incurred affects earnings (such as in the periods that depreciation expense, interest expense, or cost of sales is recognized). However, if an entity expects at any time that continued reporting of a loss in accumulated other comprehensive income would lead to
recognizing a net loss on the combination of the hedging instrument and the hedged transaction (and related asset acquired or liability incurred) in one or more future periods, a loss shall be reclassified immediately into earnings for the amount that is not expected to be recovered.

VIII. APPENDIX – ACKNOWLEDGEMENTS

ABOUT THE AUTHORS

Clifford R. Eisler and David J. Marshall are the co-founders of Analect Benefit Finance LLC and its parent company, Atlas Financial Partners LLC, which advise companies on the design, implementation, administration, hedging and funding of employee benefit plans. ABF is an advisory and technology firm focused on helping financial institutions and corporations improve the efficiency of their multiple nonqualified benefit programs and related funding and hedging strategies. ABF has offices in New York, Orlando and Boston.

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