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Recent 2007 Derivative & Financial Instrument Accounting Developments

April 9, 2007

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Topics

- Update on the SEC's critical terms are the same controversy with suggested workarounds
- New exposure draft on required FAS 133 derivative disclosure will be effective for all 12/31/07 year-end reporting companies
- G19 on swapping CP long-term
- H17 on hedging forecast foreign currency debt
- FAS 157 on how to fair value financial instruments
- FAS 159, the fair value option

New Derivative Disclosure Exposure Draft

- Comments due March 2nd
- Intention to issue a final statement by June 30, 2007
- **Proposed effective date would be for fiscal years and interim periods ending after December 15, 2007**
- Intent to provide an enhanced understanding of an entity's
  - How and why an entity uses derivative instruments
  - How derivative instruments and related hedged items are accounted for under Statement 133 and its related interpretations
  - How derivative instruments affect an entity's financial position, results of operations, and cash flows.

2006 SEC Annual Conference Comments

Thomas Kevits, Professional Accounting Fellow:

- Shortcut method **cannot** be satisfied in spirit
  - All nine criteria must be met **exactly**
- Critical terms match is **not** appropriate when the settlement dates of the forecasted transaction differ from the hedge instrument
  - Ineffectiveness should be measured and recognized
  - **However**, if ineffectiveness is shown (tested) to be clearly *de minimis* (not **immaterial**) under a variety of realistic market scenarios, may be OK
- "Death penalty": Errors subsequently found in the assessment of hedge effectiveness must be calculated **from the inception of the hedge assuming no hedge accounting had occurred**

2007 SEC Comments on Critical Terms

In March, the SEC reconsidered:

- Offered a safe harbor for hedges involving:
  - FX or Commodity risk if exposure and derivative settlement dates were within 30 days
  - CF IRS hedges with different interest payment dates (but not different reset dates)
- **Recommended** that registrants claiming critical terms should validate their assertions that any ineffectiveness is *de minimis*
  - Supplementary tests, not new documentation

Keeping Critical Terms

Hedge **settlements** that occur on **known dates** rather than sales or purchases which can occur any time during a month or quarter:

- Interco royalties that are paid on fixed dates
- Interco trade sales and purchases paid at netting
- External trade payables that are always paid at month-end (a common European practice)
- When sale or purchase is recorded, dedesignate hedge to avoid H15 issue

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Proposed Derivative Disclosure — 1

- Tabular disclosure of year-end o/s derivatives' notional and fair values by primary underlying risk, accounting designation and purpose
  - Location **and amount** of G/L in the P&L
- Disclosure of any derivative contingent terms, fair values of such derivatives and collateral implications
- Disclosure of any leveraged derivatives
- **All** current year realized and unrealized derivative gains and losses
- Disclosure of gains/losses on only **qualifying derivative hedges**

Proposed Derivative Disclosure — 2

- More detailed **qualitative** disclosure of the objectives and strategies for using derivative instruments, the contingent features in such derivative instruments, and counterparty credit risk
- Enhanced interim derivative disclosure requirements
- More detailed assessment of counterparty credit risk, **including groups of counterparties engaging the company in similar transactions**
- No comparative disclosure for periods prior to adoption
- Disclosure need not be applied to immaterial items

G19 — Cash Flow Hedging of CP

Specifically allows CF hedging of fixed rate (zero coupon) debt that will be rolled over (i.e., CP)

- Issue here is how can fixed rate debt be cash flow hedged
- A must read for swappers of CP to long-term

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H17 — Hedging Forecast Foreign Currency Debt

- Companies has used this a way to hedge P&L translation risk, similar to foreign currency AFS
- Short answer: not allowed because the issuance of debt does not directly affect P&L
  - Unlike payment flows, which are hedgeable per G23
  - Unlike forecasted foreign currency sales, which do immediately affect P&L

FAS 159 Fair Value Option

- Allows entities to irrevocably elect to fair value specific financial assets and liabilities that would otherwise be accounted for at historic cost
- This includes contractual firm commitments that would otherwise not be booked
- Does exclude consolidated investments, pension obligations, lease contracts, and other items
- Changes in fair value of designated liabilities reflecting changes in entity's credit worthiness would be reflected in P&L
- In a Phase 2, the fair value option would be applied to non-financial assets and liabilities, such assets and liabilities to be specified

FAS 157 — Fair Valuing Financial Instruments

- Issued in September 2006
- “FV is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.” [FAS 157.05]
- General fair value principles:
  - Exit price notion based upon highest value “in use” or “stand alone”
  - Excludes transaction costs
  - Assumes orderly markets
  - No large block discount
  - Mid-points OK
  - Allows present valuing of point estimates or of probability weighted estimates

FAS 157 — Fair Valuing Financial Instruments

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  - Allows present valuing of either:
    - Point estimates or
    - Probability weighted estimates

FAS 157 — 3 Levels of Reliability

- Level 1
  - Quoted market prices
- Level 2
  - Pricing models using objective market data inputs
- Level 3
  - Subjective assumptions used to model prices

Disclosure Requirements

General principle: disclose enough information on the pricing techniques used to allow the reader to form his own judgement (157.32). Specific requirements:

- The fair value measurements at reporting date
- Separating out the fair value measurements by the Level 1/Level 2/Level 3 hierarchy
- Significant detail about Level 3 valuations and their impact on P&L
- In annual financials, disclosure on valuation techniques used and any changes in techniques over the year

FAS 157 — Implications

- Increased market data and systems requirements
- Need to include credit of issuer of the financial instrument, especially if issuer has a different credit rating than the pricing model's assumption
- Additional documentation required to prove reliability of the estimate
- More time and money with the auditor
- Auditors prefer external valuation services
- If using in-house models, have to show controls over inputs and outputs are adequate

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- **The benefit of 157 is that it allows imperfect hedging without the complications of FAS 133 hedge accounting**

About Greenwich Treasury — 1

Since 1992, Greenwich Treasury Advisors has been delivering integrated treasury solutions for over 300 global businesses:

- Risk
  - FX/IR/commodity risk assessment and policies
  - FAS 133/IAS 39 hedging and documentation
  - Performance measurement
  - Best practices
- Cash
  - Global liquidity management
  - Cross-border cash consolidation
  - Bank reviews and RFP development

About Greenwich Treasury — 2

- Structures
  - Diagnostic treasury reviews
  - Implementing spin-offs and merger treasuries
  - In-house banking and outsourcing
- Technology
  - Treasury system RFP's, review and selection
  - Treasury intranet and web application design
- For more info, visit www.greenwichtreasury.com
  - Free articles on risk management, FAS 133, treasury systems and treasury maxims at /articles.cfm

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NZ Dairy Board
Procter & Gamble
Saint-Gobain
Siemens

Jeff Wallace

- Founded Greenwich Treasury Advisors in 1992, and author of:
  - *The Group of 31 Report: Core Principles for Managing MNC FX Risk* (AFP, 1999)
  - *A Risk Metric Approach to Hedging* (GTA, 2002)
  - FAS 133 chapter of *The Handbook of International Finance & Accounting* (John Wiley, 2004)
- Formerly VP-International Treasury at American Express, AT at Seagram and at D&B; CPA at PW
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GTA Senior Directors

- Hugh Brocklesby
  - Former SVP & Treasurer of a commodities trading company and Lloyds banker
- George Caravanos
  - Former AT at Compaq
- James Hodge
  - Former AT at IBM and AT&T
  - UofC Ph.D. economist

Why Clients Choose Greenwich Treasury

- Corporate treasury expertise
  - Each consultant brings over 25 years of **corporate** treasury experience
- Proven methodologies
  - Data gathering and analysis
- Collaborative approach
  - We work as part of your team
- Independent with no conflicts of interest
- 100% guarantee of your satisfaction
  - Or we will return 100% of your fee