

FAS 161 – Expanded Derivatives Disclosure – A Hedge Fund Perspective

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In March 2008, the Financial Accounting Standards Board (FASB or the Board) issued Statement of Financial Accounting Standards No. 161, *Disclosures about Derivative Instruments and Hedging Activities* (FAS 161). FAS 161 requires (i) enhanced disclosures regarding the objectives and strategies for using derivatives; (ii) quantitative data about the fair value of gains and losses on derivative contracts; and (iii) details concerning the credit-risk related contingent features of the reported hedged positions. FAS 161 is effective for fiscal years and interim periods beginning after November 15, 2008.

Concerning the scope of this statement, “[t]he Board... specifically acknowledged that the scope of this project should result in disclosures that provide information on (i) why entities enter into derivative instruments; (ii) how those instruments modify the risks that the entity is facing; and (iii) where in the financial statements those risk management effects are reported. The Board concluded that to address those issues, the project’s scope should encompass all derivative instruments accounted for under Statement 133 [*Accounting for Derivative Instruments and Hedging Activities*] and the related hedged items.” While FAS 133 deals with accounting for derivatives, with some guidance as to disclosure, FAS 161 speaks to the disclosure of the accounting activity for derivatives.

FAS 161, like FAS 133, makes no specific distinction between derivatives held for trading purposes and those held for purposes other than trading; a distinction that previously was made under FAS 119. Prior to FAS 133, this was a particularly useful distinction for a hedge fund, where the primary purpose of using derivatives is trading. Unfortunately, hedge funds only represent a fraction of the accounting world to which the accounting standards apply. Such a distinction was less meaningful for large corporations where the primary purpose of holding derivatives was to hedge against certain risks, be it cash flow, foreign exchange rates, inventory in physical commodities, etc.

The distinction made under FAS 133 was between derivatives designated as one of three types of hedges (fair value, cash flow or foreign currency) and derivatives not designated as a hedging instrument. Under FAS 161, the focus is on what risk(s) are each of the three types of hedges trying to mitigate? To address this concern, the FASB looked to answer three questions:

- How and why does an entity use derivatives?;
- How are derivatives, and any related hedged item(s), accounted for under FAS 133?; and
- How do derivatives, and any related hedged item(s), affect the entity’s financial position, financial performance and cash flows?

Disclosure Requirements Under FAS 161, as it Applies to Hedge Funds

FAS 161 amends paragraph 44 of FAS 133, which details the requirements for disclosure. Highlights of the disclosure requirements are listed below and consist of qualitative disclosures (how and why derivatives are used), disclosures related to derivatives presented in the balance sheet (the terms “balance sheet” and “income statement” are used generically throughout) (the effect on financial position), and disclosures related to derivative activity presented in the income statement (the effect on financial performance). Hedge funds would generally need to focus on the requirements of items 1 through 3 and 4.b., below.

1. The objectives for holding the derivative, with a distinction made between those derivatives used for risk management purposes and those used for “other” purposes (e.g. trading);
2. Information that would make it clear to readers the volume of derivative activity, including, but not limited to, qualitative disclosures regarding the entity’s objectives and strategies for using such derivatives;
3. The location and fair value of the derivatives reported in the balance sheet, using the following criteria:

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- a. Fair value should be presented on a gross basis, even if the derivatives qualify for net presentation on the balance sheet (in accordance with FASB Interpretation No. 39);
 - b. Cash collateral amounts (typical in a commodities futures account) should not be included;
 - c. Presentation, separately of asset and liability amounts, segregated between those derivatives that qualify as hedging derivatives under the statement and those that do not (“those that do not” would generally be derivative contracts entered into for trading purposes and would generally be the bulk of the disclosure for a hedge fund);
 - d. The asset and liability amounts would further be segregated by meaningful type, including, but not limited to, interest rate contracts, foreign exchange contracts, commodities contracts, etc.;
 - e. For each item presented, the balance sheet line item in which the fair value amount disclosed is contained on the balance sheet;
4. The location and amount of gains and/or losses of the derivatives reported in the income statement using the following criteria:
- a. Separate presentation for this disclosure is expected for fair value hedges and cash flow hedges further segregated by where the income is presented in the body of the financials (i.e. income statement or statement of other comprehensive income);
 - b. Separate presentation for derivative instruments not designated as hedging instruments (included in this type would be derivatives used for trading purposes).

FAS 161 goes on to state that derivatives that fit into the description of item 4.b. above, where it is the entity’s policy to include such derivatives in its trading activities (i.e. hedge funds), may provide alternative disclosure that consists of:

- Gains and/or losses of the derivatives reported in the income statement separated by major type including, but not limited to, interest rate, foreign exchange, commodities, etc.;

- The line item on the income statement where the gains/losses are included; and
- A description of the nature of its trading activities and related risks and how the entity manages those risks.

The significant modification to existing derivative disclosures is the addition of the “balance sheet” and “income statement” disclosures, both of which are required to be presented in a tabular format. Most of FAS 161’s other required disclosures are qualitative and commonly disclosed by hedge funds under existing generally accepted accounting principles, usually in the footnotes to the financial statements that address trading activities and related risks. Realizing that some of the required disclosures may already exist within financial statements, or may make more sense, from a reader’s perspective, to be placed in various sections of the financial statements, FAS 161 also requires that any disclosure within the notes be cross-referenced to other relevant disclosures of the derivative activity of the entity.

Following are examples of the tabular disclosures from FAS 161, adjusted to illustrate possible disclosures of a generic hedge fund or commodity pool. As stated in FAS 161, these examples are not all-inclusive and are not necessarily the only way in which the information can be presented. Additionally, for the ease of the reader, only one year is presented. If the entity’s financial statements require dual or multi-year presentation, this disclosure should be presented for each period presented.

(Note though that FAS 161 is not retroactive. Accordingly, this information does not need to be presented for periods that began before November 15, 2008.)

At first glance, (Figure 1 on page 16), this disclosure might appear to duplicate information already required to be disclosed under Statement of Position 03-4. However, FAS 161 requires disclosure based on whether the positions are assets (have unrealized gains) or liabilities (have unrealized losses) at the balance sheet date. Condensed schedule of investment disclosures for derivatives are usually based on whether the positions are long or short.

As Figure 2 on page 16 shows, both “totals” would agree to one another. Also notice that the second portion of the income statement disclosure looks very similar

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1 FIGURE THE "BALANCE SHEET" DISCLOSURE

Asset Derivatives December 31, 2009		Liability Derivatives December 31, 2009		Net	
Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value		
Derivatives not designated as hedging instruments under Statement 133⁽¹⁾					
Foreign exchange contracts	Deposits with broker	\$XXX	Deposits with broker	\$XXX	\$XXX
Equity contracts	Deposits with broker	\$XXX	Deposits with broker	\$XXX	\$XXX
Commodity contracts	Deposits with broker	\$XXX	Deposits with broker	\$XXX	\$XXX
Other contracts	Deposits with broker	\$XXX	Deposits with broker	\$XXX	\$XXX
Total derivatives not designated as hedging instruments under Statement 133					
		<u>\$XXX</u>	<u>\$XXX</u>	<u>\$XXX</u>	

⁽¹⁾ See footnote [insert footnote cross reference] for additional information on [The Entity's] purpose for entering into derivatives not designated as hedging instruments and its overall risk management strategies.

to what is already presented on the face of the income statement. If realized and change in unrealized income/loss are solely the result of derivatives activity, it is possible that a footnote disclosure might make more sense here, avoiding redundancy. This tabular disclosure would be of particular value in the event of derivatives activity included in "other income/loss."

Lastly, FAS 161 appears to be another step towards the convergence of accounting principles generally accepted in the United States of America with International Financial Reporting Standards (IFRS), specifically IFRS 7, *Financial Instruments Disclosures*. While FAS 161 concerns itself only with derivatives – in an effort not to delay the reporting transparency desired with respect to derivatives – the FASB is considering a long term project to address all financial instruments.

MFA's *Sound Practices for Hedge Fund Managers* recommends periodic disclosure of relevant performance data and related information to hedge fund investors. This recommendation is generally consistent with the prescriptive disclosure requirements of FAS 161.

A copy of FAS 161 can be found at the FASB's Web site at www.fasb.org. ©

2 FIGURE THE "INCOME STATEMENT" DISCLOSURE

Type of Instrument	Trading Revenue For the Year Ended December 31, 2009
Foreign exchange	\$XXX
Equity	\$XXX
Commodity	\$XXX
Other	\$XXX
Total	<u>\$XXX</u>

Line Item in Income Statement	Trading Revenue For the Year Ended December 31, 2009
Realized	\$XXX
Change in unrealized	\$XXX
Other	\$XXX
Total	<u>\$XXX</u>

Arthur Bell Certified Public Accountants is a public accounting firm providing a full range of accounting, audit, tax and consulting services to the hedge fund and managed funds industry. Arthur Bell was recently honored as the Employer of the Year by the Career Center at the University of Baltimore. The award was presented on September 24, 2008 at the President's Reception and recognizes Arthur Bell's continuous support of the accounting faculty, students and Career Center at the University of Baltimore.

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