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ACCOUNTING FOR FORWARD PLACEMENT AND STANDBY COMMITMENTS AND INTEREST RATE FUTURES CONTRACTS

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INTRODUCTION

1. The use of contracts committing parties to the future delivery of securities collateralized by real estate mortgages (mortgage-backed securities*) in investment and lending activities is an established practice in the financial services industry. More recently, banks, thrift institutions, and other business enterprises sensitive to interest rate movements have used forward placement commitments (forwards) and interest rate futures contracts (futures) to improve profits, protect interest rate spreads (the difference between interest earned on assets and the interest expense of funding such assets), and hedge against adverse fluctuations in interest rates.

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*Significant terms used in this paper are defined in the section on definitions.

2. The applicability of existing accounting literature to forwards and futures transactions is unclear. As a result, the accounting principles set forth in the sections on authoritative and other literature have been inconsistently applied in practice. The diversity in accounting and the recent reports of significant economic losses incurred by several business enterprises have caused concern among the U.S. Congress, financial institutions supervisory agencies, the financial community, and the accounting profession.

3. As a result of the divergence in practice, various organizations are seeking clarification of existing accounting literature to eliminate diversity in financial reporting. This paper discusses the issues involved in accounting for the types of forward commitments and interest rate futures transactions that financial institutions and other business enterprises are entering into.

DEFINITIONS

4. For the purposes of this paper the following terms are defined:

Cash market - The market in which securities are bought and sold under terms agreeable to the buyers and sellers.

Close out (offset) - Entering into a futures contract transaction that is opposite of a currently held futures contract position. For example, a company that is long in a futures position can close out its commitment by selling that position, thus negating any future commitment.

In the forward market, contracts generally may not be closed out since the forward can only be terminated with the consent of the other party to the contract; however, open commitments can be offset (paired off) by entering into an opposite transaction with the same or different parties. In these situations, the previously existing commitment may not be eliminated.

Delayed delivery - A securities transaction in which the settlement date is later than the usual, regular way transaction; that is, the business day following the transaction (trade) date.

Extension - A delay in the settlement of an open forward commitment. Extensions are generally effected only with the consent of the other party to the commitment and are usually accompanied by a payment of consideration. Extensions are not available on futures contracts.

Federal Home Loan Mortgage Corporation (FHLMC) - A corporation chartered by an act of Congress in July, 1970, to assist in developing and maintaining a secondary market in conventional residential mortgages. The Corporation (often referred to as "Freddie Mac") purchases mortgages from financial institutions whose savings accounts are insured by an agency of the U.S. government.

Federal National Mortgage Association (FNMA) - An association (often referred to as "Fannie Mae") organized to provide a secondary market for residential housing mortgages. Financial institutions may sell mortgages to FNMA and invest in FNMA's stock. Business enterprises may invest in FNMA obligations.

Forward contract - See forward placement commitment.

Forward placement commitment (forward) - A cash market transaction in which one party agrees to purchase and another party agrees to sell a security in the future under mutually agreeable terms. A forward placement commitment includes the purchase or sale of a security

on a "delayed delivery" or "when issued" basis. In a forward placement commitment, the buyer (long) agrees to purchase and the seller (short) agrees to deliver a specified security, at a specified price, at a specified future date.

The price quoted in a forward placement commitment may be stated as a fixed price if the terms of the security to be delivered are known or may be stated as a yield if the terms of the security to be delivered are not known.

Unlike futures contracts, forwards are traded over-the-counter and the contract terms are not standardized. Further, forwards generally can be terminated only with the consent of the other party to the commitment. Finally, forwards, as used in this paper, do not include commitments to lend funds in the future at some specified rate (loan commitments).

Futures market - The federally designated commodity exchanges for trading interest rate futures (for example, the Chicago Board of Trade, Chicago Mercantile Exchange, Commodities Exchange (N.Y.C.), and New York Futures Exchange).

Government National Mortgage Association (GNMA) - A wholly-owned corporate instrumentality of the United States government (often referred to as "Ginnie Mae") that buys and sells mortgages insured or guaranteed

by the Federal Housing Administration (FHA) and the Veterans Administration (VA) and that may perform other secondary market functions to support the home mortgage market.

Hedges - The initiation of positions in forward placement commitments or interest rate futures contracts as substitutes for the purchase or sale of actual assets or liabilities, for example, securities, loans, or debt instruments. Gains (losses) on settlement of forward commitments and futures contracts used as hedges will theoretically offset losses (gains) on the purchase and sale of actual assets or liabilities being hedged. The two primary types of hedges covered in this paper are:

Anticipatory hedge - The purchase and sale of forward commitments or futures contracts to protect against adverse changes in interest rates for anticipated transactions, such as the issuance of debt, the resetting of interest rates on variable rate debt instruments, the purchase of securities, or the funding of a fixed-rate loan. An enterprise planning to issue fixed-rate debt, for example, may wish to protect against the risk of rising interest rates before the date of issuance by selling forward commitments or

futures contracts short. If interest rates increase, the gain on the short sale offsets the increased interest expense on the debt issuance. Conversely, if interest rates decline, the reduced interest expense on the debt issuance offsets the loss on the short sale. Also, an enterprise planning to purchase securities may wish to protect against the risk of falling interest rates before the acquisition date by buying forward commitments or futures contracts. If interest rates fall, the gain on the forward commitment or the futures contract offsets the lower yield on the security acquired. Conversely, the higher yield on the security acquired offsets a loss on the forward commitment or the futures contract.

Hedge of existing cash position - The hedge of assets whose market values are sensitive to interest rate movements. In this hedge, forward commitments or futures contracts are used to protect the assets against market price declines caused by rising interest rates. For example, the owner of a long-term U.S. Treasury bond may wish to hedge against falling bond prices by

selling interest rate futures contracts short. If interest rates increase, the gain on the short sale offsets the loss from a decline in the market price of the bond owned. Conversely, if interest rates fall, the loss on the short sale offsets the gain from an increase in the market value of the bond.

Interest rate futures contracts (futures) - Commodity contracts traded on a federally designated commodity exchange regulated by the Commodity Futures Trading Commission. Futures contracts represent commitments to purchase (to take delivery by the "long") or to sell (to make delivery by the "short") a standardized amount of a deliverable grade security at a specified price during a specific month under conditions established by the commodity exchange on which the contracts are traded.

Margin deposit - A specified sum put up by a purchaser (seller) when entering into a futures contract and maintained on deposit with the registered broker until the contract is settled. A deposit is usually cash, U.S. Treasury bills, or a letter of credit. In addition to initial margin deposits, variation margin payments are required after the transaction date. Variation deposits represent, either payments by the holder of the contract to the broker for losses

from market price fluctuations of the futures contract or payments by the broker to the holder for gains from market price fluctuations of the futures contract. Current practice in the futures market is to settle margin accounts daily by cash payments.

Market value accounting - Recognizing changes in market prices as they occur and reporting gains and losses on securities transactions on that basis.

Mark-to-market accounting - See market value accounting.

Mortgage-backed securities - Bonds and pass-through certificates collateralized by mortgage loans.

Pair-off - See close out.

Par price cap - A provision in some forward commitments limiting the purchase price to a stipulated percentage of the face amount.

Participation Certificate - A certificate representing an undivided interest in specified residential conventional mortgages that the FHLMC underwrites, owns, and unconditionally guarantees the payment of principal and interest.

Pass-through certificate - A certificate guaranteed by GNMA representing a share in a pool of mortgages insured by the FHA, VA or Farmers Home Administration. An individual pool includes mortgages with the same interest

rate and the same approximate maturity. The payback to investors includes interest and principal, both guaranteed by GNMA. There are minimum trading unit amounts.

Position - A market commitment in securities or interest rate futures contracts.

Rollover - Cancelling an open forward commitment and replacing it with a new commitment with different terms. As with extensions (see definition of extensions), rollovers are generally effected only with the consent of the other party to the commitment and are usually accompanied by payment of consideration. A rollover of an interest rate futures position can be effected by closing out the existing futures position and entering into a new contract for the same security with a different delivery month. Hedging techniques in the futures market often involve rollover transactions dictated by economic conditions and the number of contract months available.

Securities - Instruments covered by forward commitments and interest rate futures narrowly defined for purposes of this paper to include: Debt instruments of the U.S. government (Treasury bills, notes, and bonds); obligations of U.S. government agencies (for example, FHLMC, FNMA and GNMA); obligations of states and political subdivisions; and money market instruments including bankers acceptances,

certificates of deposit, and commercial paper.

Settlement date - The maturity date of a forward commitment or futures contract, that is, the delivery (payment) date.

Standby commitment (put option) - A forward placement commitment with an optional delivery provision. The buyer of a standby commitment pays a fee for the right or option to sell (deliver) to the issuer a specified security, at a specified price (either on a guaranteed or yield basis), at a specified future date.

Trade (transaction) date - The initiation date of a forward commitment or futures contract.

When issued - A short form of "when, as and if issued." The term indicates a conditional transaction in a security authorized for issuance but not issued. All "when issued" transactions are to be settled if and when the security is issued and the appropriate regulatory authority rules that the transactions are to be settled.

SCOPE

5. This paper covers issues in accounting for forward commitments and interest rate futures contracts. It focuses on forward and futures transactions primarily of financial institutions, such as banks, savings and loan associations, broker/dealers, insurance companies, and mortgage bankers; however, it may also apply to similar transactions of other business enterprises. Further, the paper distinguishes and emphasizes the distinction between hedging transactions and speculative trading activities.

6. While this paper addresses accounting issues related to transactions in interest rate futures contracts, it is not intended to cover transactions in futures contracts in commodities such as agricultural products or precious metals. The scope of this paper is limited to interest rate futures contracts because of the similarities between those contracts and forward placement commitments, and the urgent need to clarify the existing accounting literature relating to those types of transactions. Further, this paper does not cover other commodity contracts because use of those contracts in hedging techniques often involves factors such as storage and transportation costs, that do not apply to interest rate futures contracts. Therefore, because of the unique features of interest rate futures contracts and for expediency, only those types of contracts are covered by this paper.

AUTHORITATIVE LITERATURE

7. Accounting principles have not been adopted for all significant types of forward and futures transactions. However, authoritative accounting literature discusses accounting for (a) certain types of delayed delivery contracts other than those involving interest rates, (b) forward commitments involving mortgage bankers' loan inventories, and (c) GNMA futures contracts in the savings and loan industry. The following accounting literature is pertinent to the issues covered in this paper.

8. Financial Accounting Standards Board Statement of Financial Accounting Standards (SFAS) No. 8, Accounting for the Translation of Foreign Currency Transactions and Foreign Currency Financial Statements, addresses accounting for foreign exchange forward contracts and concludes that they may be used to hedge either a foreign currency commitment or an exposed foreign currency net asset or net liability position. The Statement requires, under certain specified conditions, gains and losses on foreign exchange forward contracts used as hedges of commitments to be deferred and included in the measurement basis of the asset or liability subsequently acquired. Further, the discount or premium on a foreign exchange forward contract used to hedge an exposed net asset position or exposed net liability position should be amortized to income over the life of the forward contract. Gains and losses on foreign exchange forward contracts used for speculation should be recognized currently. (The

accounting treatment suggested above is in conformity with the accounting for forward exchange contracts discussed in the proposed FASB statement on Foreign Currency Translation.)

9. American Institute of Certified Public Accountants (AICPA) Statement of Position 74-12, Accounting Practices in the Mortgage Banking Industry, discusses the computation of market value for mortgage loans and GNMA mortgage-backed securities covered by investor commitments, and concludes:

> Market value for loans and GNMA securities covered by investor commitments should be computed based upon commitment prices. These loans must meet the specific terms of the commitments. Where such loans do not meet the requirements of the commitments, or there exists a reasonable doubt as to acceptance, the loans should be considered uncommitted loans for the calculation of market value.

10. The AICPA's Audit and Accounting Guide for Savings and Loan Associations (S & L Guide) concludes that gains and losses on GNMA interest rate futures transactions consummated by S & Ls should be associated with gains and losses from the related cash market transactions. The relevant conclusions from the S & L Guide are:

> . . . if an association hedges to protect itself against sales in the cash market, the gain or loss from the futures contract should be reflected as part of the gain or loss on the loan sold in the cash market.
>
> If an association has entered into a futures contract to hedge against sales of loans in the cash market, write-downs to market of loans held for sale may be

confined to the unhedged portion of the loan inventory.

Gains or losses from futures contracts entered into to hedge against price fluctuations in originating or purchasing loans for investment should be deferred and amortized over the expected life of the related loans.

Contracts should be treated as closed at any time it becomes known that the expected cash transaction will not occur, and the futures contracts should be carried at market thereafter. If a futures contract is not closed at the time the transaction takes place in the cash market, the rollover of the futures contracts should be marked to market and adjusted to market at each financial reporting date. Thereafter, futures contracts that do not represent positions taken as hedges against price fluctuations in originating, purchasing or selling loans should be adjusted to market at each financial reporting date.

11. AICPA Accounting Research Bulletin No. 43, Chapter 4, Inventory Pricing, also discusses the accounting for inventory cost and losses on firm purchase commitments and concludes:

> The primary basis of accounting for inventories is cost. A departure from the cost basis of pricing the inventory is required when the utility of the goods is no longer as great as its cost.
>
> The recognition in a current period of losses arising from the decline in the utility of cost expenditures is equally applicable to similar losses which are expected to arise from firm, uncancellable and unhedged commitments for the future purchase of inventory items. The net loss on such commitments should be measured in the same way as are inventory losses and, if material, should be recognized in the accounts and separately disclosed in the income statement. The utility of such commitments is not impaired, and hence there is no loss, when the amounts to

be realized from the disposition of the future inventory items are adequately protected by firm sales contracts or when there are other circumstances which reasonably assure continuing sales without price decline.

12. ARB 43 can be interpreted to mean that the lower of cost and market (LOCOM) basis for inventory pricing should be followed when cost recovery, after consideration of any hedge, is doubtful. But a writedown to market that is below cost may not be required when forward or futures contracts have been used to offset the decline in market value of the inventory.

13. Certain conclusions may be drawn from the accounting literature discussed in the preceding paragraphs.

1. Gains and losses on forward commitments and futures contracts used to hedge commitments (anticipatory hedges) may be deferred and included in the measurement basis of the asset or liability subsequently acquired.

2. Gains and losses on forward commitments and futures contracts used to hedge assets carried at LOCOM may be included in the LOCOM adjustments.

3. Premiums and discounts on foreign exchange forward contracts (differences between spot and forward or futures rates at the inception of the contract) used to hedge exposed net asset and net liability positions should be amortized to income over the contract lives.

OTHER LITERATURE

14. The Federal Financial Institutions Examination Council (FFIEC) issued a policy statement, effective January, 1980 and revised March, 1980, requiring banks to value periodically (at least once a month) all forward commitments (other than when issued transactions) and all interest rate futures contracts on a market value or LOCOM basis. The choice of a specific method is left to management. However, standby commitments are required to be valued only at LOCOM using end-of-month values of the underlying securities. The policy statement also requires banks to record the securities received on settled contracts using the same valuation basis for carrying the related forward commitment or futures contract.

15. Accounting Opinion No. 2, Accounting for GNMA Mortgage Interest Rate Futures Market Transactions, issued by the Internal Management Committee of the Mortgage Bankers Association, concludes that gains and losses from open futures contracts should be used in LOCOM calculations for mortgage loans held for sale.

16. Interest Rate Futures Contracts - Accounting and Control Techniques for Banks issued September, 1978, Arthur Andersen & Co. (Andersen) states that both realized and unrealized gains and losses on interest rate futures contracts should be recognized in a bank's statement of income during each accounting period, a practice commonly referred to as "mark to market." However,

the publication notes that mark-to-market accounting may sometimes fail to produce symmetry between the treatment of the interest rate futures contract and a related hedged investment or commitment. In those instances, Andersen recognizes that some method other than mark to market may be appropriate.

> . . . exceptions to the general mark -to-market approach are permitted in certain circumstances when the futures contracts can be identified with a specific investment or commitment at the date of execution and the interest rate futures contract utilized has a high positive correlation (prices tend to move in the same direction with similar magnitude) with the specific investment or commitment identified. Accordingly, a gain or loss on a hedge of a specific investment (recorded at cost) may be deferred until the futures contract is closed out or the hedged investment is sold, whichever occurs first. In the case of a hedge of a specific commitment, the gain or loss may be included in the measurement of the dollar basis of the asset acquired or liability incurred.

In articles in the April and May, 1980, issues of the CPA Journal on Interest Rate Futures Trading Accounting and Control, Oppenheim, Appel, Dixon & Co. (Oppenheim) generally concurred with Andersen's conclusions except for futures used to hedge assets carried at cost. Oppenheim believes that gains and losses on futures contracts closed out before an asset is sold should be accounted for as an adjustment to the carrying amount of the hedged asset and, as such, recognized as an adjustment to interest income over the remaining asset life. Andersen believes, however, that in these situations, gains and losses on futures contracts should be recognized when the futures contract is closed out.

DIVERSITY IN PRACTICE

18. Diversity has developed in accounting for interest rate futures contacts and forward placement and standby commitments primarily because of the different accounting practices and conventions used in various industries. For example, both broker-dealers and investment companies generally use the same valuation method (mark-to-market) for forwards and futures, including standby commitments (put options), as for other investment transactions. However, the balance sheet presentation in those two industries differs significantly. Broker-dealers do not report forward and futures transactions in the balance sheet. Whereas investment companies following SEC Release No. IC-1006 and municipal bond funds following the AICPA's Statement of Position 79-1, Accounting for Municipal Bond Funds, record the asset and liability relating to a when issued security and a delayed delivery contract when the priced transaction confirmation is issued.

19. In the mortgage banking industry, gains and losses on forward commitments and futures contracts used to hedge mortgage portfolios are included in the portfolio LOCOM adjustments, although the related assets and liabilities are not reported in the balance sheet.

20. Banks, S & Ls, and credit unions account for forwards, futures, and standbys differently. Although they generally value

contracts used in trading activities at LOCOM or market, they usually value contracts entered into for investment at cost. For example, a security purchased under a forward placement contract is recorded at cost on the settlement date. The forward contract is not reported in the balance sheet and no gain or loss is recognized during the period between the transaction and settlement dates. Similarly, securities received when standby commitments are exercised are recorded at net cost. Futures have not been widely used in the investment activities of banks, S & Ls, and credit unions; consequently, no predominant accounting practice has developed.

21. Financial institutions using futures as anticipatory hedges of investment securities account for gains and losses on the futures transactions under several methods. Some mark the contracts to market. Others recognize all gains and losses when the contract is closed out. Still others include all gains and losses in the cost basis of the securities purchased. Futures contracts used to hedge investment securities are likewise accounted for differently. Some financial institutions defer gains and losses until the contracts are closed out or the hedged securities are sold. Others adjust the cost basis of the investment securities when the futures are closed out before the related securities are sold.

BASIC ISSUES

22. The basic issues discussed in this paper are:

- Should the accounting treatment for forward, futures, and standby transactions be consistent?
- Should the assets and liabilities underlying forward, futures, and standby contracts be recorded in the accounting records before the settlement date?
- If the assets and liabilities underlying forward, futures, and standby contracts are not recorded in the accounting records before settlement date, how should business enterprises account for changes in market price of the contracts between the trade and settlement dates?

Should the accounting treatment for forward, futures, and standy transactions be consistent?

23. Some believe the characteristics of the forward and futures markets are too dissimilar to require consistent accounting treatment. Periodic cash payments are made for gains and losses in the futures market. In the forward market, however, other than commitment fees, cash has not traditionally been paid until settlement date. In addition, futures contracts are generally closed out before the specified delivery month, but forward contracts are generally held open until the underlying security is delivered. Finally,

organized exchanges, providing daily quoted market prices, exist in the futures market; however, no organized exchanges exist for the forward market. Instead, prices are determined on an over-the-counter basis, making it difficult to obtain meaningful price quotations for longer term forward placement and standby contracts.

24. Others believe forward and futures transactions are the same in substance and should be accounted for in the same manner. They hold that both forwards and futures are agreements or commitments to deliver or accept delivery of an underlying security at a future date under certain predetermined conditions. Like foreign exchange forward and futures contracts, they are merely alternative transactions.

25. Others agree that forwards and futures are the same in substance; however, they believe standby commitments are different and should be accounted for differently. They hold that a seller of a standby commitment is an issuer of a "put" option, receiving a fee for assuming all the market risks of ownership but sharing in none of the rewards. In other words, settlement of the standby commitment depends on market price movements and results in delivery only if the contract price exceeds the market price of the underlying security on settlement date. Those holding this view argue that sales of standby commitments are made for speculation, since they provide only downside risk. Therefore, sales of standbys should be accounted for as a trading activity. Yet, purchases of standby commitments limit downside

market risk without impairing the upside market potential. This group believes purchases of standby commitments are the same as purchases of forward placement contracts except for the premium paid and, therefore, should be accounted for as forward placement contracts.

Should the assets and liabilities underlying forward, futures, and standby contracts be recorded in the accounting records before settlement date?

26. Some believe assets and liabilities underlying forward, futures, and standby contracts should be recorded in the accounting records on the trade (transaction) date. If the security price is not known on the trade date (as in the case of municipal securities purchased on a "when issued" basis and forward and standby commitments priced on a yield basis), this group believes the underlying assets and liabilities should be recorded when the priced transaction confirmation is issued. They argue that this position is consistent with "trade date accounting" for securities transactions required, they believe, under generally accepted accounting principles. Proponents of this view also believe that recording security transactions on the settlement date is not in accordance with generally accepted accounting principles but has been accepted in practice only because it is practical and usually does not produce results materially different from trade date accounting. Proponents argue that once the price of the forward or futures contract is confirmed, that is, the purchase or sale price is known, delay in recording the

underlying asset and liability is unreasonable. Therefore, all material transactions should be recorded. Further, this group contends that recording assets and liabilities on the trade date makes the accounting issues involving recognition of gains and losses noncontroversial, since accounting for assets and liabilities is covered in accounting literature. For example, securities purchased by banks and thrift institutions for investment are accounted for on an amortized cost basis, whereas, securities purchased for trading are accounted for on a market value or LOCOM basis.

27. Conversely, others believe the underlying assets and liabilities should not be recorded in the accounting records on the trade date because the balance sheet would be inflated with noninterest-bearing assets and liabilities. Further, these transactions are usually settled on a net basis or are liquidated before settlement; therefore, trade date accounting would not represent the anticipated settled results. Proponents of this view also believe nonrecognition of the underlying assets and liabilities before the settlement date is consistent with current accounting treatment for commodity transactions and foreign exchange forward contracts. In support of their position, they refer to many similar types of commitments not currently presented in the balance sheet, for example, letters of credit, commitments to make or purchase loans, and commitments to purchase fixed assets.

If the assets and liabilities underlying forward, futures, and standby contracts are not recorded before settlement date, how should business enterprises account for changes in the market price of the contracts between trade date and settlement dates?

28. The primary recognition methods are:

a. Market value

b. Deferral

c. Hybrid

29. Market value method. Some believe market value accounting (also referred to as mark-to-market accounting) should be used for all forward and futures transactions because they are speculative activities. They believe hedging can be done only in the broadest sense, that is, matching interest-sensitive assets with interest-sensitive liabilities. Therefore, the use of forwards and futures as hedges must be directed to net interest rate exposure. Since the effect of a mismatch in interest-sensitive assets and interest-sensitive liabilities is recognized currently as an increase or decrease in the net interest spread, gains and losses on forward and futures transactions should also be recognized currently to associate them with the income statement effect of the net interest rate exposure.

30. The proponents of market value accounting also believe hedging an asset carried at cost is not sensible, since the presumption is that an asset carried at cost is being held long term or to maturity. To hedge such an asset indicates a near-term

intent to sell; consequently, the hedged asset should be carried at market or at LOCOM.

31. Those advocating market value accounting believe anticipatory hedges are purely speculative, since they are entered into only to benefit from a movement in interest rates for anticipated transactions. Therefore, a business enterprise is speculating that interest rates will move in the anticipated direction. Those supporting this view argue that these speculative transactions are trading activities; therefore, gains or losses on the transaction should be recognized currently.

32. Proponents of market value accounting believe deferral accounting for hedges would require the development of arbitrary criteria to distinguish speculative and hedge positions. In contrast, market value accounting is practicable, easy to implement, and eliminates the potential for accounting abuses.

33. Deferral method. Although they agree with the advocates of market value accounting for speculative forward and futures transactions, proponents of deferral accounting believe deferral of gains and losses on hedge transactions is appropriate in certain circumstances. This group contends that accounting for trading securities differs from accounting for investment securities for the banking and thrift industries; therefore, accounting for speculative forward and futures transactions should differ from

accounting for nonspeculative (hedging) activities. Proponents of the deferral method argue that existing authoritative accounting literature clearly acknowledges the use of hedging techniques and prescribes accounting for hedge transactions. The proponents point to SFAS No. 8, which provides specialized accounting treatment for foreign exchange forward contracts used to hedge either commitments or exposed net asset and net liability positions. Under SFAS No. 8, foreign exchange forward contracts should not be carried only at market but are accounted for on a basis reflecting the intent of the transaction, i.e., hedge or non-hedge. In certain specified circumstances, the revised AICPA Audit and Accounting Guide for Savings and Loan Associations also endorses deferral accounting for GNMA interest rate futures contracts used as hedges.

34. Regarding hedges of assets, the proponents of deferral accounting believe the net interest rate exposure argument for market value accounting is not an accounting argument but a strategy for using forward and futures contracts to hedge. They believe accounting principles should be developed for specific transactions and that the accounting for an asset being hedged should be the same regardless of the financing method.

35. The following paragraphs summarize the views of proponents of the deferral method of accounting for forwards and futures contracts entered into for specific hedging purposes:

a. Hedging assets carried at cost does not indicate an intent to sell, since the use of forwards and

futures to protect against losses in the marketplace provides no assurance that the asset will be sold. The use of futures and forward contracts to protect assets carried at cost should be viewed as a "liquidity" hedge. For example, investment account securities of banks and thrift institutions can be viewed principally as secondary reserve funds for liquidity purposes. In periods of rising interest rates, these reserve funds may be needed because of heavy loan demands and the effects of disintermediation. However, security prices will be falling and sales of investment securities will probably result in losses. Prudent management of investment portfolios often requires lengthening or shortening maturity structures in periods of fluctuating interest rates. This type of portfolio management does not necessitate the use of market value accounting for the investment portfolio, just as hedging techniques should not necessitate market value accounting for forwards and futures.

b. In specific investment situations, forwards and futures may be coupled with the acquisition of securities to produce a higher yield than the yield on an alternative investment. For example, a business enterprise could purchase either a one-year Treasury note yielding 10% or a twenty-year Treasury bond and sell Treasury bond futures contracts to deliver a Treasury bond in one year producing a

composite yield higher than 10%. In these circumstances, separating the futures transaction from the cash market transaction would result in an income statement presentation not reflecting the economic substance of the combined events.

c. Hedge transactions to protect against adverse price movements for anticipated transactions are not speculative. Some proponents of this view argue that the risks of not hedging are greater than hedging. Further, this group believes anticipatory hedges are similar to hedges of foreign exchange commitments covered in SFAS No. 8. That Statement concludes that the dollar basis of a hedged foreign currency commitment should be established at the transaction date and any gain or loss on the forward or futures contract should be included in the dollar basis of the commitment when honored.

d. Accounting principles should not be based solely on practical considerations. Therefore, market value accounting should not be adopted merely because it is easy to implement. Marking to market all foreign exchange forward contracts is easy but not permitted by SFAS No. 8, which requires the matching of contracts with hedged assets or liabilities. In other words, forward contracts should be accounted for according to their use, not the practical limitations of the method.

36. Hybrid Method. Proponents of the hybrid method generally agree with those supporting market value accounting for forward and futures transactions. However, proponents of this method also believe gains and losses on the hedged assets should be recognized during the hedge period to provide the accounting symmetry advocated by proponents of the deferral method. They argue that the market value method of accounting for forward and futures contracts used to hedge assets carried at cost (such as, investment securities and loans) does not provide accounting symmetry because gains (losses) on the forwards and futures are recognized but losses (gains) on the hedged asset positions are not. Therefore, they believe changes in the market price of hedged assets starting with the inception of the hedged should be recognized currently and should be matched with the recognition of the gain or loss on the forward or futures contract used to hedge the asset. This method, they believe, overcomes many of the problems of the market value and deferral methods.

37. Opponents of the hybrid method of accounting argue that it is not in conformity with generally accepted accounting principles, which require assets to be carried at either historical unamortized cost or market value, not at a hybrid amount equal to historical cost plus or minus an amount representing some, but not all, changes in market value since the date of asset acquisition. Opponents also object to the practical problems associated with this method. For example, the record keeping would be complex and difficult to implement when market values of the hedges assets, such as loans, are not readily available.

OTHER ISSUES

38. Other issues that may affect accounting for forward and futures contracts under the deferral method include:

- Are criteria needed for ascertaining whether forward and futures contracts are entered into as hedges?
- If the cash transaction does not occur when an anticipatory hedge is closed out, when should gains and losses on the forward and futures positions be recognized?
- If an anticipatory hedge is extended or rolled over, should gains and losses be recognized currently or deferred to maturity of the extension or rollover?
- When should an enterprise recognize gains and losses on forward and futures contracts used to hedge assets?
- If hedged securities are deliverable under the terms of forward and futures contracts, should "locked in" gains and losses be amortized over a period ending with the maturity of the contracts?
- If a series of futures contracts (referred to as a strip) is entered into for successive delivery

months, how should gains and losses relating to each component of the strip be accounted for?

- What financial statement disclosures should be made for open forward and futures positions?

Are Criteria Needed for Ascertaining that Forward and Futures Contracts are Entered into as Hedges?

39. Some believe criteria are needed to determine when a forward or futures contract is a hedge transaction. Others believe no criteria are needed. Those who believe no criteria are needed argue that the accounting should be based solely on the intent of the transaction, citing SFAS No. 8, which gives no criteria for determining when forward contracts are hedges of net exposed assets or net exposed liabilities. They argue that the presence of exposure with an offsetting forward or futures contract is sufficient evidence that a hedge exists.

40. Those who believe criteria should be established to relate specific hedged assets, liabilities, or commitments directly with forward and futures positions argue that the criteria are needed to determine when gains and losses on forward and futures transactions should be recognized. Proponents of this view argue that SFAS No. 8 established criteria for the use of foreign exchange forward contracts to hedge foreign exchange commitments and that similar criteria are needed for forward and

futures contracts for securities. In their opinion, transactions that do not conform to the criteria should be accounted for as a trading activity. They believe the following criteria should be established for determining whether a hedge has been established:

- At the time the forward commitment or futures contract is entered into, its purpose should be specifically identified and documented as part of the accounting records. The dollar amount and description of the asset or liability for which the hedge is intended should be specified.
- The prices of the forward commitments or futures contracts and the hedged assets or liabilities should possess a high degree of positive correlation, that is, the tendency to move in the same direction with similar magnitude.
- For an anticipatory hedge, the anticipated transaction must reasonably be expected to be fulfilled in the ordinary course of business.

41. Proponents of this view believe that only when the preceding criteria are met should forward and futures contracts be accounted for using the deferral method.

If the Cash Transaction Does Not Occur When an Anticipatory Hedge Is Closed Out, When Should Gains and Losses on the Forward and Futures Position Be Recognized?

42. Some believe gains and losses should be recognized immediately. Others believe gains and losses should be deferred and included in the measurement of the dollar basis of the anticipated transaction when consummated or recognized when the enterprise knows that the transaction will not occur.

If an Anticipatory Hedge is Extended or Rolled Over Should Gains and Losses Be Recognized Currently or Deferred to Maturity of the Extension or Rollover?

43. Some believe gains and losses on the old contracts (closed out contracts) should be recognized currently. They argue that extensions and rollovers represent separate economic transactions that must be accounted for independently of the accounting treatment given the original contract. Opponents of this view argue that extensions and rollovers merely represent continuations of the original contracts and do not constitute separate economic events for accounting purposes. Therefore, gains and losses should continue to be deferred to maturity of the extension or rollover.

When Should an Enterprise Recognize Gains and Losses on Forward and Futures Contracts Used to Hedge Assets?

44. Some believe deferred gains and losses should be recognized on the earlier of the date the forward and futures contracts are closed out or the hedged assets are sold. Others believe gains and losses should continue to be deferred until the assets are sold, if the forward or futures positions are closed out before the sale of the hedged assets. Still others believe deferred gains and losses should be recorded as adjustments to the cost basis of the hedged assets and, therefore, amortized to interest income over the remaining lives of the assets.

If Hedged Securities Are Deliverable Under the Terms of Forward and Futures Contracts Should the "Locked In" Gains and Losses Be Amortized Over the Periods Ending with the Maturities of the Forward and Futures Contracts?

45. The ultimate gain or loss, if delivery is made can be determined for hedges of securities in which the hedged securities are "deliverable" (meet the contract specifications) under a forward or futures contract. Some believe this quantifiable gain or loss should be amortized over the life of the forward or futures contract. Others believe the gain or loss should not be recognized until the forward or futures contract is closed out or the hedged asset is sold, but losses should be amortized.

If a Series of Futures Contracts (referred to as a strip) Is Entered into for Successive Delivery Months, How Should the Gains and Losses Relating to Each Component of the Strip Be Accounted for?

46. A futures strip is the purchase of a series of futures contracts with successive delivery months. For example, on January 1, an enterprise may purchase a $1 million U.S. Treasury bill having a maturity of March 19, and then may purchase a series of 90-day U.S. Treasury bill futures contracts maturing at the end of three successive months (for example, March, June, and September) with the intent of taking delivery of the securities under each contract. The funds to pay for the securities delivered under the contracts to be settled in March, June, and September would be provided by the maturity of the U.S. Treasury bill previously purchased.

47. Some believe the futures strip should be viewed as a single transaction bearing a composite yield for all securities purchased under the contracts. They believe the composite yield should be recognized ratably over the life of the strip with no recognition of gain or loss on the separate futures transactions.

48. Others believe each contract should be viewed as a separate transaction; therefore, gains and losses should be included in the cost of the securities received under each contract.

What Financial Statement Disclosure Should Be Made for Open Forward and Futures Positions?

49. The issue of financial statement disclosure for open forward and futures positions arises when assets and liabilities underlying forward or futures contracts are not recorded on the trade date. Some believe open forward and futures positions can be closed out or paired off at any time; therefore, disclosure of open positions is not meaningful. There is no assurance, they argue, that the commitments will be held open to settlement. In addition, generally accepted accounting principles do not require disclosure of foreign exchange forward contracts and other similar commitments. Others believe forward and futures positions represent significant market exposure requiring disclosure of, at a minimum, gross long and short positions. In any event, disclosure of material amount of deferred gains and losses related to open positions may be appropriate.

ADVISORY CONCLUSIONS

50. The following are the advisory conclusions on the basic issues.

a. The accounting treatment for financial futures and forward placement transactions should be consistent. They are alternative transactions similar to foreign exchange futures and forward transactions. However, in forward transactions under which a standby commitment is sold, the transaction should be accounted for as a "put" option. The premium received (standby commitment fee) on the sale of the option should be recorded as a liability representing the market value of the standby commitment on the trade date. Thereafter, the liability should be accounted for on a market value basis. The writer (seller) of the option should report the option in the liability section of the balance sheet and subsequently adjust it to its current market value (payment required to close out the open standby commitment). Unrealized gains or losses should be credited or charged to current income. For example, if the current market value of the option exceeds the premium received, the excess is a loss; if the premium exceeds the current market value of the option, the excess (limited to the amount of the premium received) is a gain. The higher of cost and market valuation for standby commitments should be followed rather than the mark-to-market method when an entity uses the lower of cost and market

method for similar types of short term or other trading positions. Obtaining the market value of a standby commitment may sometimes be difficult thereby necessitating a fair value determination. Among the many factors to be considered in determining the fair value of a standby commitment are the price of the underlying security, the liquidity of the market, and the time remaining to the settlement date.

In contrast, the purchase of a standby commitment is a transaction similar to a purchase of a forward placement contract (except for the premium paid), and the buyer should account for the transaction as a forward placement contract. Standby commitments not purchased for hedging should be accounted for on a market value basis (see paragraph (c) below). Premiums paid on standby commitments purchased as a hedge of an asset should be deferred and included in the determination of the gain or loss on the standby commitment (see paragraph 53 (d)).

b. Assets and liabilities underlying a forward and futures contract should not be recorded in the balance sheet on a trade date basis, except as prescribed for investment companies and municipal bond funds. The accounting treatment recommended in this paper is consistent with the accounting treatment for other types of commitments, including foreign exchange forward commitments.

c. Changes in market values of forward and futures contracts should generally be recognized currently in the income statement. This basis of accounting (commonly referred to as "mark-to-market") should be used when (1) the forward and futures contracts are entered into for speculation, (2) forward and futures contracts represent hedges of asset positions, contemplated asset purchases or short positions, all of which are, or will be, carried at market value, or (3) the criteria for hedge accounting for specific hedging transactions discussed in paragraph 53(a) are not met. However the aggregate lower of cost and market valuation for forward and futures contracts should be followed rather than the mark-to-market method when an entity uses the lower of cost and market method for similar types of short term or other trading positions.

51. An entity should use hedge accounting rather than the mark-to-market approach for forward and futures contracts that meet the criteria for hedges discussed in paragraph 53(a). Hedge accounting is based on the concept of symmetry between the accounting for the forward or futures contract and that of the asset or liability being hedged.

52. Following are the accounting principles that should be followed in various specific hedging situations:

a. Anticipatory hedge of an asset or liability to be carried at cost. Gains and losses on forward and futures contracts should be deferred and included in

measurement of the dollar basis of the asset acquired or the liability incurred for which the hedge was intended. The gains and losses would then be amortized to income over the asset or liability holding period as an adjustment to interest income or interest expense.

b. Hedge of an asset carried at cost. Gains and losses on forward and futures contracts sold to hedge against market declines for existing assets carried at cost should be deferred and recognized in income when the hedged asset is sold or recorded as an adjustment to the carrying value of the asset if the futures or forward contract is closed out before the hedged asset is sold (see paragraphs 53(d) and (e)).

c. Hedge of assets carried at lower of cost and market or hedge of liabilities carried at higher of cost and market. Gains and losses on forward and futures contracts bought or sold to hedge against market declines in existing assets positions carried at the lower of cost and market or short positions carried at the higher of cost and market should be deferred and considered in determining the lower of cost and market or higher of cost and market adjustment at the end of each reporting period. Deferred gains and losses from those hedges should be recognized in income when the hedged commitment or position is honored or sold. If a hedged asset continues to be held after the forward or future contract is closed out, the deferred gain or loss should be

included in the carrying amount of the asset being hedged; the asset (at its adjusted cost) will be subject to the lower of cost and market test at each subsequent reporting date.

53. The following are the advisory conclusions on the other issues.

a. Criteria should be established to distinguish hedge from non-hedge situations. The following are the recommended criteria:

- o At the time the forward commitment or futures contract is entered into, its purpose should be specifically identified and documented as part of the accounting records. The dollar amount and description of the asset or liability for which the hedge is intended should be specified.
- o The price of the forward commitment or futures contract and the hedged assets or liabilities should have a high degree of positive correlation, that is, the tendency to move in the same direction with similar magnitude .
- o For an anticipatory hedge, the anticipated transaction should reasonably be expected to be fulfilled in the ordinary course of business.

If these criteria are met, a specific hedge is entered into and hedge accounting should be

followed.[1]

b. A forward or futures contract entered into as an anticipatory hedge should extend at least to the anticipated transaction date. The intended use of successive futures contracts satisfies this condition if the futures market precludes a single contract covering the entire period. However, if a forward or futures contract previously considered as a hedge of an anticipatory transaction is closed out, paired off, or otherwise terminated before the cash transaction date, the deferred gain or loss, if any, should continue to be deferred and included in the measurement of the dollar basis of the asset acquired or the liability incurred. If it becomes known that the anticipated cash market transaction will not occur, the deferred gain or loss on the forward or futures contract should be recognized immediately in income.

c. If an anticipatory hedge is extended or rolled over and such extension or rollover was not previously

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[1] The establishment of criteria to identify specific hedging situations in which hedge accounting is to be applied is based on the presumption that in the absence of evidence to the contrary, the intended cash transaction will occur and will conform to the timing originally contemplated and documented as part of the accounting records. Failures to complete transactions as originally intended may indicate that the activity is a trading activity. For example, if an enterprise repeatedly closes out anticipatory hedges and recognizes gains, stating that the original intended cash market transactions will not occur, then market value accounting should be followed for subsequent futures and forward transactions.

contemplated in the original anticipatory hedge transaction (see paragraph 53(b)), the extension or rollover should be accounted for as a completed transaction. The deferred gain or loss, if any, should be recognized immediately in income. For example, if a forward commitment to purchase securities is entered into as an anticipatory hedge with the anticipated transaction date being the maturity of the forward commitment and it is extended or rolled over, any unrealized gain or loss on the forward commitment should be recognized in income on the extension or rollover date.

d. The deferred gain or loss on a forward or future contract hedging an asset accounted for on a cost basis should be recognized when the hedged asset is sold. However, if the short forward or futures position is closed out before the hedged asset is sold, the carrying amount of the asset should be adjusted for deferred gains or losses. The carrying amount of the asset, however, should not be adjusted to an amount in excess of the fair market value of the asset at the date the hedge position is closed out. A premium or discount resulting from the adjustment to the carrying amount should be amortized over the remaining life of the asset as interest income.

e. If a hedged security is deliverable under a forward or futures contract used as a hedge, and if a loss is attributable to the hedge, the loss should be amortized to income

over the life of the forward or futures contract; a gain attributable to the hedge should not be recognized until the forward or future contract is closed out or the hedged asset is sold. (Paragraphs 52(b) and 53(d))

f. A futures strip should be viewed as one security transaction bearing a composite yield to be recognized ratably over the life of the strip.

g. In specific hedging situations meeting the criteria set forth in paragraph 53(a), the amount of long and short forward and futures positions as well as the nature of the hedging activity should be disclosed in an enterprise's financial statements. Further, gains and losses deferred under hedge accounting for open positions should also be disclosed. (It should be noted that disclosure requirements for interest rate futures contracts and forward and standby contracts is the subject of an exposure draft proposed by the Financial Accounting Standards Board.)

APPENDIX A

EXAMPLES OF HEDGE ACCOUNTING

Assumptions Used in Examples:

- Margin requirement on futures contract is $1,000 per contract
- Daily settlement in cash with broker for all interest rate futures gains and losses
- Commissions and fees ignored
- Premium amortization and discount accretion ignored
- All accounting journal entries made on a pre-tax basis; i.e., income tax effects of transactions ignored

Short Hedge of Investment Security Accounted for on a Cost Basis

Summary of Hedge Transaction:

On October 12, 1979, an institution purchased $10 million 8-3/4% U.S. Treasury bonds due August, 1994, at a price of 89.30 or a cost of $8,993,750. Having funded the investment with short-term deposits and fearing an increase in interest rates, management decides to hedge this investment by selling short 100 December '80 U.S. Treasury bond futures contracts on the XYZ Exchange at a price of 83.16.

The hedge is maintained until March 31, 1980, when the U.S. Treasury bonds are sold at a price of 74.10, and the futures position is closed out by buying 100 December '80 U.S. Treasury bond futures contracts on the XYZ Exchange at a price of 67.27.

Accounting Journal Entries:

October 12, 1979 -

Investment in U.S. Treasury bonds	$8,993,750	
Cash		$8,993,750

(To record purchase of $10 million 8-3/4% U.S. Treasury bonds due August, 1994, @ 89.30)

Margin Deposit with Broker	$100,000	
Cash		$100,000

(To record margin deposit for short sale of 100 December '80 U.S. Treasury bond futures contracts @ 83.16)

October 13 - 31, 1979 -

Cash	$312,500	
Deferred Gain/Loss on Short Hedge of Investment Security		$312,500

(To record cash settlements with broker for gain on futures position - futures price is 80.12 on October 31, 1979 -- $31.25 (83-16/32 - 80-12/32) X 100 = $312,500)

Month ended November 30, 1979 -

Deferred Gain/Loss on Short Hedge of Investment Security	$265,625	
Cash		$265,625

(To record cash settlements with broker for loss on futures position - futures price is 83.01 on November 30, 1979 -- $31.25 (83-01/32 - 80-12/32) X 100 = $265,625)

Month ended December 31, 1979 -

Deferred Gain/Loss on Short Hedge of Investment Security	$62,500	
Cash		$62,500

(To record cash settlements with broker for loss on futures position - futures price is 83.21 on December 31, 1979 -- $31.25 (83-21/32 - 83-01/32) X 100 = $62,500)

Three months ended March 31, 1980 -

Cash	$1,581,250	
Deferred Gain/Loss on Short Hedge of Investment Security		$1,581,250

(To record cash settlements with broker for gains on futures position - futures price is 67.27 on March 31, 1980 -- $31.25 (83-21/32 - 67-27/32) X 100 = $1,581,250)

Cash	$100,000	
Margin Deposit with Broker		$100,000

(To record return of margin deposit from broker upon closing out of short futures position by buying 100 December '80 U.S. Treasury bond futures contracts @ 67.27)

Deferred Gain/Loss on Short Hedge of Investment Security	$1,565,625	
Gain on Sale of Investment Securities		$1,565,625

(To recognize deferred gain on short hedge at time it is closed out)

Cash	$7,431,250	
Loss on Sale of Investment Securities	1,562,500	
Investment in U.S. Treasury Bonds		$8,993,750

(To record loss on sale of $10 million 8-3/4% U.S. Treasury bonds due August 1994 @ 74.10)

Anticipatory Hedge of Purchase of "GNMA Pass-Through Certificates"

Summary of Hedge Transaction:

On January 1, 1980, an institution, currently funding its home mortgage loan portfolio with fixed rate, long-term deposits, anticipates reinvesting its expected mortgage repayments of $900,000 over the next six months in GNMA pass-through certificates. Fearing interest rates will fall before such a reinvestment can take place, management decides to protect the institution against the risk of falling interest rates by entering into a forward placement contract to purchase a $1 million 9 1/2% GNMA's pass-through certificate for delivery on June 1, 1980, at a price of 88. The institution and the seller (brokerage firm) agree that "good delivery" of 9 1/2% GNMA's will be within 2 1/2% (±) of the $1 million principal balance.

Accounting Journal Entries:

January 1, 1980 through May 30, 1980 -

No entries are necessary as forward placement contract required no margin deposit or daily cash settlements for market value fluctuations over the holding period.

June 1, 1980 -

Investment in GNMA - 9 1/2%, pool No. XXXXX	$874,654	
Cash		$874,654

(To record purchase of 9 1/2% GNMA, pool No. XXXXX delivered with a current face amount of $993,975, within the 2 1/2% range for "good delivery")

Anticipatory (Long) Hedge of Purchase of Investment Security to be Accounted For on a Cost Basis

Summary of Hedge Transaction:

A company owns $5,000,000 of securities maturing on May 1, 1980. On October 1, 1979, management decides to hold these securities to maturity and then reinvest the proceeds upon maturity in four-year U.S. Treasury notes. Having funded the existing securities with long-term, fixed-rate liabilities and fearing a decrease in interest rates, management decides to hedge this anticipated transaction by buying 50 May '80, four-year U.S. Treasury note futures contracts on the ABC Exchange at a price of 92.18.

The anticipatory hedge is maintained until April 30, 1980, when it is closed out by selling 50 May '80, four-year U.S. Treasury note futures contracts on the ABC Exchange at a price of 89.50.

On May 2, 1980, the company buys $5,000,000 9 1/2% U.S. Treasury notes due May, 1984, at a price of 98.17.

Accounting Journal Entries:

October 1, 1979 -

Margin Deposit with Broker	$50,000	
Cash		$50,000

(To record margin deposit for purchase of 50 May '80 U.S. Treasury note futures contracts @ 92.18)

Three months ended December 31, 1979 -

Deferred Gain/Loss on Long Hedge of Investment Security	$182,754	
Cash		$182,754

(To record cash settlements with broker for loss on futures position - futures price is 88.40 on December 31, 1979 -- $15.62 (92 18/64 - 88 40/64) X 50 = $182,754)

Three months ended March 31, 1980 -

Deferred Gain/Loss on Long Hedge of Investment Security	$402,996	
Cash		$402,996

(To record cash settlements with broker for loss on futures position - futures price is 80.36 on March 31, 1980 -- $15.62 (88 40/64 - 80 36/64) X 50 = $402,996)

Month ended April 30, 1980 -

Cash	$460,790	
Deferred Gain/Loss on Long Hedge of Investment Security		$460,790
(To record cash settlement with broker for gain on futures position - futures price is 89.50 on April 30, 1980 -- $15.62 (89 50/64 - 80 36/64) X 50 = $460,790)		
Cash	$50,000	
Margin Deposit with Broker		$50,000
(To record return of margin deposit from broker upon closing out of long futures futures position by selling 50 May '80 U.S. Treasury note futures contracts @ 89.50)		

May 2, 1980 -

Investment in U.S. Treasury Notes	$5,051,522	
Deferred Gain/Loss on Long Hedge of Investment Security		$ 124,960
Cash		4,926,562
(To record purchase of $5,000,000 9 1/2 U.S. Treasury notes due May, 1984, @ 98.17, and to include deferred loss on anticipatory hedge in the measurement of the dollar basis of the Treasury notes purchased)		

Anticipatory Hedge of Debt Issuance

Summary of Hedge Transaction:

On January 15, 1980, a company finalizes its plans to issue $25 million, 10-year notes in late March, 1980. On that date management decides to hedge against the risk of rising interest rates, between January 15 and the date the debt is to be issued, by selling short 350 June '80 U.S. Treasury bond futures contracts on the XYZ Exchange at a price of 80.16.

As feared by management, interest rates increase; however, on March 14, 1980, management believes that interest rates have stabilized and may begin to fall. Therefore, on March 14, management decides to close out the short futures hedge position by buying 350 June '80 U.S. Treasury bond futures contracts on the XYZ Exchange at a price of 69.08.

The $25 million, 10-year notes are issued on March 28, 1980.

Accounting Journal Entries:

January 15, 1980 -

Margin deposit with Broker	$350,000	
Cash		$350,000

(To record margin deposit for short sale of 350 June '80 U.S. Treasury bond futures contracts @ 80.16)

January 16 - 31, 1980 -

Cash	$1,881,250	
Deferred Gain/Loss on Hedge of Debt Issuance		$1,881,250

(To record cash settlements with broker for gain on futures position - futures price is 75.04 on January 31, 1980 -- $31.25 (80 16/32 - 75 4/32) X 350 = $1,881,250)

Month ended February 29, 1980 -

Cash	$2,143,750	
Deferred Gain/Loss on Hedge of Debt Issuance		$2,143,750

(To record cash settlements with broker for gain on futures position - futures price is 69.00 on February 29, 1980 -- $31.25 (75 4/32 - 69) X 350 = $2,143,750)

March 1 - 14, 1980 -

Deferred Gain/Loss on Hedge of Debt Issuance	$87,500	
Cash		$87,500

(To record cash settlements with broker for loss on futures position - futures price is 69.08 on March 14, 1980 -- $31.25 (69 8/32 - 69) X 350 = $87,500

Cash	$350,000	
Margin Deposit with Broker		$350,000

(To record return of margin from broker upon closing out of short futures position by buying 350 June '80 U.S. Treasury bond futures contracts @ 69.08)

March 28, 1980 -

Cash	$25,000,000	
Deferred Gain/Loss on Hedge of Debt Issuance	3,937,500	
Notes Payable-Principal		$25,000,000
Notes Payable-Unamortized Hedge Gain		3,937,500

(To record issuance of debt and establish an unamortized gain account to be amortized over the life of the debt)