Statement of Financial Accounting Standards No. 104

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FAS104 Summary

Statement of Cash Flows—Net Reporting of Certain Cash Receipts and Cash Payments and Classification of Cash Flows from Hedging Transactions

(an amendment of FASB Statement No. 95)

December 1989

Financial Accounting Standards Board
of the Financial Accounting Foundation
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Statement of Financial Accounting Standards No. 104

Statement of Cash Flows—Net Reporting of Certain Cash Receipts and Cash Payments and Classification of Cash Flows from Hedging Transactions

an amendment of FASB Statement No. 95

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Paragraph Numbers

FAS 104: Statement of Cash Flows—Net Reporting of Certain Cash Receipts and Cash Payments and Classification of Cash Flows from Hedging Transactions

an amendment of FASB Statement No. 95

FAS 104 Summary

This Statement amends FASB Statement No. 95, *Statement of Cash Flows,* to permit banks, savings institutions, and credit unions to report in a statement of cash flows certain net cash receipts and cash payments for (a) deposits placed with other financial institutions and withdrawals of deposits, (b) time deposits accepted and repayments of deposits, and (c) loans made to customers and principal collections of loans.

This Statement also amends Statement 95 to permit cash flows resulting from futures contracts, forward contracts, option contracts, or swap contracts that are accounted for as hedges of identifiable transactions or events to be classified in the same category as the cash flows from the items being hedged provided that accounting policy is disclosed.

This Statement is effective for annual financial statements for fiscal years ending after June 15, 1990, with earlier application permitted. Separate early adoption of either the netting or hedging provisions is permitted. If the provisions of this Statement are elected, restatement or reclassification of comparative amounts in financial statements for earlier periods is required.

INTRODUCTION

Net Reporting of Certain Cash Receipts and Cash Payments

1. In FASB Statement No. 95, *Statement of Cash Flows,* the Board concluded that information about the gross amounts of cash receipts and cash payments during a period generally is more relevant than information about the net amounts of cash receipts and cash payments. However, for certain items, the net amount of cash receipts and cash payments may provide sufficient information. For example, Statement 95 provides that gross cash flows need

not be reported for demand deposits of a bank or for investments, loans receivable, and debt of any enterprise if the original maturity of the asset or liability is three months or less.

2. The Board received several requests to reconsider the requirements of Statement 95 as they relate to banks. Those requests included assertions that the requirements of Statement 95 produce data that are of little or no value and are difficult and costly to accumulate. In particular, because deposit and lending activities generally involve high volumes of transactions, some assert that the cost incurred by the preparer to report gross cash flow information exceeds the benefit to users of the statement of cash flows.

3. This Statement modifies Statement 95 so that banks, savings institutions, and credit unions are not required to report gross amounts of cash receipts and cash payments for (a) deposits placed with other financial institutions and withdrawals of deposits, (b) time deposits accepted and repayments of deposits, and (c) loans made to customers and principal collections of loans. When those enterprises constitute part of a consolidated enterprise, net amounts of cash receipts and cash payments for deposit or lending activities of those enterprises shall be reported separate from gross amounts of cash receipts and cash payments for other investing and financing activities of the consolidated enterprise.

Classification of Cash Flows from Hedging Transactions

4. The Board received requests from various enterprises to reconsider the classification of cash flows from an item that is intended as a hedge of another item. Those requests generally focused on cash flows from a futures contract or forward contract that is accounted for as a hedge of an inventory transaction.

5. Footnote 4 of Statement 95 specified the classification of cash flows from a hedging instrument as follows:

> Each cash receipt or payment is to be classified according to its nature without regard to whether it stems from an item intended as a hedge of another item. For example, the proceeds of a borrowing are a financing cash inflow whether or not the debt is intended as a hedge of an investment, and the purchase or sale of a future s contract is an investing activity without regard to whether the contract is intended as a hedge of a firm commitment to purchase inventory.

6. This Statement modifies Statement 95 to permit cash flows resulting from futures contracts, forward contracts, option contracts, or swap contracts that are accounted for as hedges of identifiable transactions or events (for example, a cash payment from a futures contract that hedges a purchase or sale of inventory), including anticipatory hedges, to be classified in the same category as the cash flows from the items being hedged provided that accounting policy is disclosed. If for any reason hedge accounting for an instrument that hedges an identifiable transaction or event is discontinued, then any cash flows subsequent to the date of

discontinuance shall be classified consistent with the nature of the instrument.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Amendments to Statement 95

7. Statement 95 is amended as follows:

a. The following paragraph is added after paragraph 13:

> Banks, savings institutions, and credit unions are not required to report gross amounts of cash receipts and cash payments for (a) deposits placed with other financial institutions and withdrawals of deposits, (b) time deposits accepted and repayments of deposits, and (c) loans made to customers and principal collections of loans. When those enterprises constitute part of a consolidated enterprise, net amounts of cash receipts and cash payments for deposit or lending activities of those enterprises shall be reported separate from gross amounts of cash receipts and cash payments for other investing and financing activities of the consolidated enterprise, including those of a subsidiary of a bank, savings institution, or credit union that is not itself a bank, savings institution, or credit union.

b. Footnote 4 is superseded by the following:

> Generally, each cash receipt or payment is to be classified according to its nature without regard to whether it stems from an item intended as a hedge of another item. For example, the proceeds of a borrowing are a financing cash inflow even though the debt is intended as a hedge of an investment, and the purchase or sale of a futures contract is an investing activity even though the contract is intended as a hedge of a firm commitment to purchase inventory. However, cash flows from futures contracts, forward contracts, option contracts, or swap contracts that are accounted for as hedges of identifiable transactions or events (for example, a cash payment from a futures contract that hedges a purchase or sale of inventory), including anticipatory hedges, may be classified in the same category as the cash flows from the items being hedged provided that accounting policy is disclosed. If for any reason hedge accounting for an instrument that hedges an identifiable transaction or event is discontinued, then any cash flows subsequent to the date of discontinuance shall be classified consistent with the nature of the instrument.

Effective Date and Transition

8. The provisions of this Statement are effective for annual financial statements for fiscal years ending after June 15, 1990, with earlier application permitted. Separate early adoption of either paragraph 7(a) or paragraph 7(b) is permitted. If the provisions of this Statement are elected, restatement or reclassification of comparative amounts in financial statements for earlier periods is required.

This Statement was adopted by the affirmative votes of five members of the Financial Accounting Standards Board. Messrs. Lauver and Swieringa dissented.

Messrs. Lauver and Swieringa dissent from the provision of this Statement that permits banks, savings institutions, and credit unions to report net cash receipts and cash payments for certain deposit and lending activities (paragraph 7(a) of this Statement). They continue to support the conclusion in paragraph 11 of Statement 95 that "generally, information about the gross amounts of cash receipts and cash payments during a period is more relevant than information about the net amounts of cash receipts and payments." Statement 95's permitted use of the indirect method is inconsistent with that conclusion because major classes of gross operating cash flows are not required to be reported separately. That permitted exception is now used to justify reporting net cash flows for certain investing and financing activities.

It is asserted that gross cash flow amounts for certain deposit and lending activities may be no more relevant than net cash flow amounts. Messrs. Lauver and Swieringa do not believe that that assertion is supportable. Consider, for example, one bank that adopted Statement 95 in 1988 and reported gross cash payments for loans originated or acquired of $14.9 billion, $10.8 billion, and $8.8 billion for 1988, 1987, and 1986, respectively. That bank also reported gross cash receipts for principal collected on loans of $14.3 billion, $10.4 billion, and $8.1 billion, respectively. Those gross cash flow amounts indicate a compound annual growth in those loan activities of over 30 percent over the 2-year period. Reporting gross amounts for lending activities provides information about events that occurred during a period that is not provided by reporting net cash flows for those activities and is not provided elsewhere in the financial statements.

Moreover, Messrs. Lauver and Swieringa believe that reporting gross cash flow amounts is no less useful for banks, savings institutions, and credit unions than for finance companies, insurance companies, and other financial intermediaries. Paragraph 7(a) permits different cash flow reporting for enterprises that engage in essentially identical lending activities. Paragraph 7(a) also permits a consolidated enterprise to report net cash flows for the lending activities of its bank and savings institution subsidiaries even though it is required to report gross cash flows for the essentially identical lending activities of its finance, leasing, and insurance subsidiaries. Because paragraph 7(a) distinguishes among enterprises that engage in essentially identical lending transactions, Messrs. Lauver and Swieringa believe that exemption is inconsistent with the Board's stated mission to develop "neutral standards that result in accounting for similar transactions and circumstances similarly."

The Board's justification for the exemption provided to banks, savings institutions, and credit unions is that the costs of accumulating and reporting gross cash flow amounts are perceived to be larger for those enterprises than for finance companies, insurance companies, and other financial intermediaries that already voluntarily incur many of those costs as part of their reporting systems. The observation that "little incremental cost is required to develop gross cash flow information" by finance companies does not take into consideration the costs that those companies have already incurred to implement data-gathering systems that can be used to accumulate gross cash flow amounts. Messrs. Lauver and Swieringa believe that if cost-benefit judgments are to be used to justify an exemption, it is important to measure and consider all costs that are attributable to meeting a reporting requirement assuming equivalent data-gathering systems have been installed. Otherwise, individual enterprises or industries that have already installed those systems will be subjected to a reporting requirement, and enterprises or industries that have not already installed those systems will be exempted.

Mr. Lauver dissents from the provision of this Statement that permits classification of cash flows from certain hedging instruments in the same category as the cash flows from the items being hedged (paragraph 7(b) of this Statement). He believes that alternative does not enhance the objective of a statement of cash flows but has the objective of establishing net cash flow from operating activities as an alternative performance indicator, an objective that he believes is undesirable. Hedge accounting is an accounting technique whose objective is the reporting of entity performance. It is an optional accounting technique that associates two separate economic transactions, which in the aggregate are expected to mitigate the risk to the entity of either one alone, for the purpose of permitting the results of the two transactions to be reported in the statement of operations of a single fiscal period. In that way any gain on one transaction will counteract an anticipated loss on the other and vice versa.

Statement 95 states that the primary purpose of a statement of cash flows is to provide relevant information about cash receipts and cash payments of an enterprise during a period. Mr. Lauver finds it difficult to see how this purpose is enhanced, for example, by permitting cash flows from a futures contract for gold, an optional transaction, to be classified in the same category as the cash flows from the operation of a gold mine when hedge accounting is optionally elected. He believes that the ongoing activity of operating a mine and the optional, occasional entry of a position in a futures market based on anticipated future prices are not integral; that conclusion is especially clear because they are only regarded as being related when an accounting election is made. He believes that the objective of reporting cash flows should not be confused with the objective of reporting entity performance and that hedge accounting should not be used as a basis for establishing standards for providing a statement of cash flows whatever its merits for use in the statement of operations.

Further, Mr. Lauver believes, independent of the foregoing, that interest rate swap contracts should not be included in paragraph 7(b). He believes that when the objective of those contracts is to hedge net interest rate spreads, they do not hedge an identifiable transaction or event, and when the objective is that expressed in the last sentence of paragraph 40, the conclusion therein is inconsistent with paragraph 7(b) because that conclusion is not conditioned on the existence of a hedge.

Members of the Financial Accounting Standards Board:

Dennis R. Beresford, *Chairman*
Victor H. Brown
Raymond C. Lauver
James J. Leisenring
C. Arthur Northrop
A. Clarence Sampson
Robert J. Swieringa

Appendix

BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

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Appendix: BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

Introduction

9. This appendix summarizes considerations that were deemed significant by members of the Board in reaching the conclusions in this Statement. It includes reasons for accepting certain views and rejecting others. Individual Board members gave greater weight to some factors than to others.

10. In response to requests that additional net reporting of cash receipts and cash payments be permitted under FASB Statement No. 95, *Statement of Cash Flows,* the Exposure Draft leading to FASB Statement No. 102, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale,* invited interested parties to submit information about the circumstances in which additional net reporting might be appropriate. Requests for additional net reporting of cash flows focused generally on the banking industry and specifically on (a) deposits placed with banks, (b) deposits taken, (c) loans to customers, and (d) investment securities. There also were requests that the Board reexamine the classification requirement for cash flows resulting from an instrument that is intended as a hedge of another item. This Statement responds to those requests.

11. An FASB Exposure Draft, *Statement of Cash Flows—Net Reporting of Certain Cash Receipts and Cash Payments and Classification of Cash Flows from Hedging Transactions,* was issued for public comment on July 25, 1989. The Board received 112 letters of comment in response to the Exposure Draft. The Board concluded that it could reach an informed decision on the basis of existing information without a public hearing.

Net Reporting of Certain Cash Receipts and Cash Payments

12. In Statement 95, the Board concluded that information about gross amounts of cash receipts and cash payments during a period generally is more relevant than information about net amounts of cash receipts and cash payments. However, paragraph 76 of Statement 95 acknowledges that in certain circumstances, information about both cash receipts and cash payments may be no more relevant than information about only the net change.

13. Specifically, Statement 95 permits the reporting of net cash flows for (a) cash equivalents, (b) operating activities when the indirect method is used to report cash flows, (c) items in which the enterprise is substantively holding or disbursing cash on behalf of its customers, such as demand deposits of a bank and customer accounts payable of a broker-dealer, and (d) items for

which the turnover is quick, the amounts are large, and the maturities are short. However, (d) above is limited to investments (other than cash equivalents), loans receivable, and debt providing that the original maturity of the asset or liability is three months or less.

14. The Exposure Draft proposed to amend Statement 95 to permit banks, savings institutions, and credit unions to report net cash flows for certain deposit and lending activities. Most respondents agreed with that proposal and contended that the requirements of Statement 95 for reporting cash flows for deposit and lending activities are costly for those enterprises to apply and that information about the gross cash flows for those activities is not useful. Representatives of the banking industry asserted that banks have had to spend an inappropriate amount of time and money to comply with the requirements for reporting cash flow information and that the additional costs include not only start-up costs or costs of modifying systems to adopt the standard but also ongoing costs of periodic reporting.

15. The Board concluded that for a bank, savings institution, or credit union information about gross cash flows for certain activities may be more difficult and costly to provide than for other enterprises, and the usefulness of this information may be questionable. The Board noted that major banking activities, such as deposit taking and lending, are required to be reported as investing or financing activities, while major activities of other enterprises, such as purchasing and selling goods and services, are reported as operating activities. Enterprises that report cash flows from operating activities using the indirect method are not required to report gross amounts of cash flows from those transactions. As noted in paragraph 109 of Statement 95, preparers of financial statements said that it would be costly for their enterprises to report gross operating cash receipts and cash payments and that they do not presently collect information in a manner that would allow them to determine amounts such as cash received from customers or cash paid to suppliers directly from their accounting systems. The Board gave particular consideration to that factor in deciding whether to permit use of the indirect method.

16. In addition, gross amounts of cash flows for certain banking activities may be difficult and costly to accumulate because of numerous noncash transactions. To report cash receipts and cash payments in a statement of cash flows, transactions that do not involve either a cash receipt or a cash payment must be eliminated from any totals. For example, when a loan is renewed or its terms are otherwise modified, the accounting records may indicate that the loan is repaid and a new loan is made. However, that transaction does not involve a cash flow and should not be reported in the statement of cash flows. The amount of effort currently required to separate cash transactions from noncash transactions is compounded by the high volume of transactions.

17. In determining the relevance of reporting gross cash flows, the Board considered comments from various users of banks' financial statements. Those users included financial analysts and individuals involved in mergers and acquisitions of financial institutions. While some users noted that a statement of cash flows for a bank may be important, particularly when determining whether an acquisition is economically sound, they generally agreed that the value of certain historical gross cash flow information is limited. Information about gross cash flows

may provide a starting point or reference, but other information would be more relevant for analyzing liquidity or estimating future cash flows.

18. The high volume of transactions common to banks results in reporting gross amounts of cash flows that are large in relation to other cash flows. For example, gross cash flows pertaining to time deposits reported in the statement of cash flows of one major bank totaled more than 600 times the year-end balance of cash and cash equivalents. Banks generally have asserted that reporting gross cash flows of that magnitude tends to obscure more relevant data that may be included in the statement of cash flows. The Board generally believes that the size of a gross cash flow amount does not affect its relevance provided that amount is fairly reported.

19. Comparability of certain gross cash flow amounts among banks may be limited. Although Statement 95 permits the reporting of net cash flows when the original maturity of an asset or liability is three months or less, for practical reasons some enterprises have chosen to report gross cash flows for all such items rather than to separate them into those that qualify for net reporting and those that do not. In effect, gross cash flows and net cash flows may be reported differently, resulting in a lack of comparability.

20. Comparability also may be affected by internal accounting procedures because banks, savings institutions, and credit unions have the ability to create a reported cash flow through a debit or credit to a customer's demand deposit account. For example, if a customer rolls over a certificate of deposit upon maturity, a bank can record that transaction with or without making an entry to the customer's demand deposit account (that is, the bank may or may not debit and credit the demand deposit account), yet by definition one procedure results in a reported cash flow and the other does not. Thus, a bank that debits and credits a customer's demand deposit account when a loan or a certificate of deposit is renewed would report higher gross cash flow amounts relative to a bank that does not.

21. This Statement restricts the net reporting of lending activities to loans made to customers and to principal collections of loans. The Board believes that permitting net reporting of cash flows for all lending activities of banks would result in the loss of certain relevant gross cash flow information. For example, information about cash payments for purchases of loan portfolios or cash receipts from sales of loan portfolios provides relevant information about a bank's activities.[1] Furthermore, the Board believes that reporting gross cash flows for purchases or sales of loan portfolios should not be as difficult or costly as reporting gross cash flows for loans made or principal collections of loans. Purchases and sales of loan portfolios generally occur less frequently and are more centrally controlled. As a result, the Board concluded that net reporting of cash flows for lending activities of banks should be limited to cash payments for loans made to customers and principal collections of loans.

22. Some respondents stated that the Exposure Draft was not clear about whether a bank would be permitted to report net cash flows for principal collections attributable to purchased loans or for loans made to customers if those loans are subsequently sold. The amendment to

Statement 95 in paragraph 7(a) of this Statement has been revised to clarify that net reporting of inflows of principal collections from purchased and originated loans and outflows for loan originations to customers irrespective of whether those loans are subsequently sold is permitted. (Refer to footnote 1.)

23. Statement 95 precludes reporting net cash flows for purchases and sales or maturities of investment securities. Some respondents to the Exposure Draft requested that the Board allow banks to classify cash flows from investment securities as operating activities or otherwise allow net reporting of those cash flows. However, investing in securities is not an activity that is unique to banks; similar activities occur in many other enterprises. These activities have been defined by Statement 95 as investing activities. The Board concluded that the cost and difficulty of reporting gross cash flow information for investment security transactions are less than for deposit and lending activities. Generally, investment activities are more centralized within the enterprise, the volume of transactions is smaller, and noncash transactions are less prevalent. Gross cash flow amounts may be useful because those amounts may enable users to assess investment portfolio turnover or to observe changes in an enterprise's investment strategies. The Board concluded that the benefit from reporting those amounts generally would exceed the cost.

24. Based on the factors discussed in paragraphs 14-20, the Board concluded that the cost for a bank, savings institution, or credit union to report gross amounts of cash receipts and cash payments for certain deposit and lending activities generally would exceed the benefit to users of the statement of cash flows. In response to comments, the Board also considered whether to permit finance companies, insurance companies, and other financial intermediaries to report net cash flows for their lending activities. A significant difference between those enterprises and banks, savings institutions, and credit unions is that generally finance companies, insurance companies, and other financial intermediaries cannot create reported cash flows by debiting and crediting customers' demand deposit accounts as discussed in paragraph 20. In addition, most finance companies presently accumulate loan origination or loan volume statistics for operating or other internal purposes. Accordingly, little incremental cost is required to develop gross cash flow information for external reporting. Because insurance companies generally do not engage in lending activities to the extent of banks, savings institutions, and credit unions, reporting gross cash flows for their lending activities should not be as costly. Thus, the Board concluded that for enterprises other than banks, savings institutions, and credit unions, the cost of reporting gross cash flows for lending activities generally would not exceed the benefit.

25. Some respondents requested that the Board define the transactions for which reporting net cash flows might be appropriate and allow that reporting for all enterprises that have those transactions. The Board concluded that while similar transactions generally should be accorded similar accounting treatment, in this circumstance cost-benefit considerations support different reporting based on the type of entity confronted with the transaction.

26. Consolidated enterprises frequently are engaged in various businesses in different industries. For example, a consolidated enterprise may include an industrial company, a finance

company, a savings institution, and a leasing company. The Exposure Draft proposed that net cash flows may be reported for the specified activities of only a bank, savings institution, or credit union and not for those activities elsewhere within the consolidated enterprise. For example, net cash flow reporting of loans made to customers and principal collections of loans would not be permitted for a finance company or leasing subsidiary of a bank, savings institution, or credit union. Furthermore, net cash flow amounts for deposit or lending activities of a subsidiary that is a bank or a savings institution should be reported separate from gross cash flow amounts for other investing and financing activities of the consolidated enterprise.

27. Some respondents to the Exposure Draft requested that the Board extend the net reporting of cash flows for deposit or lending activities to all similar activities within a consolidated reporting entity. In particular, they suggested that subsidiaries engaged in bank-related activities should be allowed to report on a basis consistent with that of a bank parent; otherwise, the financial statements would be inconsistent and confusing to users. However, bank-related subsidiaries often apply generally accepted accounting principles that differ from those of a bank subsidiary included in a consolidated group. For example, a bank may carry its investment securities at amortized cost, a broker-dealer subsidiary may carry its investment securities at market, and a venture capital subsidiary may carry its investment securities at fair value as determined by its board of directors. The Board noted that subsidiaries of a consolidated group often apply different, yet appropriate, accounting principles for similar transactions.

28. In response to requests by some respondents, the Board also considered whether the criteria for classifying cash flows should be modified to require that certain deposit and lending activities now classified as investing or financing activities be classified as operating activities. Although deposit and lending activities may be a bank's principal activities, they are not operating activities as described in Statement 95. Cash flows from operating activities include cash receipts and cash payments for purchases and sales of goods and services (inventory transactions), returns on investments, and all other cash receipts and payments not specifically defined as investing or financing activities.

29. The Board believes that a bank's deposit and lending activities are not analogous to inventory transactions in other business enterprises but are more analogous to the issuance of bonds by those enterprises to finance the construction of a new plant or the acquisition of a business. Similarly, gathering deposits is a financing activity. Cash received from customers is fungible and is commingled with the bank's other funds. Those deposits are available for a variety of purposes—to purchase trading or investment securities, to make loans, to pay operating expenses, or to redeem debt. Although deposit and lending activities may be a bank's principal activities, the Board believes that they are appropriately classified as financing or investing activities.

Classification of Cash Flows from Hedging Transactions

30. Prior to the issuance of Statement 95, the Board addressed the classification of cash flows

resulting from an instrument that is intended as a hedge of another item. The Board concluded that the cash flows from a hedging instrument should always be classified according to the nature of that instrument rather than in the same category as the cash flows of the item being hedged. The Board believed that the purchase or sale of a hedging instrument, such as a futures contract or a forward contract, is an investing activity. The Board also believed that implementation of an approach that classified the cash flows from a hedging instrument in the same category as the cash flows of the item being hedged would be more difficult and would require enterprises to maintain additional records.

31. After Statement 95 was issued, the Board received several inquiries about that classification requirement. Enterprises were particularly concerned about classifying cash flows from futures contracts or forward contracts that are accounted for as hedges of inventory transactions in a manner different from the cash flows from the purchase or sale of inventory. They indicated that the hedging transaction is integral to the inventory transaction and that the decision to purchase or sell futures contracts with the sole objective of reducing exposure to inventory price increases, establishing a profit floor, or locking in a gross margin is an operating decision by the enterprise to reduce the risks associated with its normal commercial operations of buying and selling goods. They urged the Board to allow cash flows from those types of hedges to be classified as operating cash flows and not as investing cash flows. They view that activity as being substantially different from an enterprise's typical investing activities. Some asserted that less effort would be required to classify the cash flows in the same category as the hedged item.

32. The Board readdressed the classification of cash flows from hedging instruments and reviewed examples from enterprises that engage in extensive hedging activities, primarily purchases or sales of futures contracts, related to their inventory transactions. The Board also considered foreign currency forward contracts related to a commitment to purchase or sell inventory or to a borrowing denominated in a foreign currency.

33. The Exposure Draft for this Statement proposed that cash flows from a futures contract, forward contract, or option contract that is accounted for as a hedge of an identifiable transaction or event be classified in the same category as the cash flows from the item being hedged.

34. The majority of the respondents to the Exposure Draft agreed that the cash flows of a hedging instrument that is accounted for as a hedge of an identifiable transaction or event should be classified in the same category as the cash flows from the item being hedged. They stated that a contract designed to lock in the future cost of a commodity is substantially different from an investment transaction. The objective of the hedging contract is to reduce the risk of price fluctuations and not to realize a profit. They asserted that the hedging contract is an integral part of the transaction and that reporting the cash flows of the hedge in the same category as the item being hedged would result in a more meaningful and understandable presentation.

35. However, some respondents opposed classifying cash flows from hedging instruments in

the same category as the cash flows from the items being hedged. They cited increased cost in linking the two transactions together and commented that the hedging of a transaction is not a single economic event but two indirectly related transactions.

36. The Board believes that while generally each cash receipt or payment should be classified consistent with its nature, in some circumstances it may be appropriate to classify the cash flows from a hedging instrument in the same category as the cash flows from the item being hedged. For example, an enterprise may purchase a futures contract for the sole purpose of reducing exposure to increases in the price of a planned inventory purchase. The purchase of the hedging instrument may be considered integral to the subsequent purchase of the inventory. For this and similar instances when the hedging instrument is considered integral to the underlying transaction and is accounted for as a hedge, the Board believes that it may be appropriate to link the cash flows. The Board concluded that cash flows from certain contracts that are accounted for as hedges of identifiable transactions or events should be permitted to be classified in the same category as the cash flows from the items being hedged provided that accounting policy is disclosed. Changes in that policy are accounting changes to be reported in accordance with APB Opinion No. 20, *Accounting Changes.*

37. Hedge accounting reports gains or losses on the hedging instrument in the same period as the offsetting gains or losses of the item hedged. However, the cash flows from the hedging instrument may occur in a period different from the cash flows of the item hedged regardless of the amount of gain or loss that is hedged in a given year. In addition, a hedging instrument may be accounted for as a hedge for only a portion of the time that it is outstanding. Requiring the cash flows of an instrument designated as a hedge for a specified period to be linked with the item being hedged could entail significant costs. The Board is concerned that a requirement to classify the cash flows from a hedging instrument in the same category as the item being hedged may be difficult and costly.

38. For some hedging transactions, the cash flows cannot clearly be classified in the same category as the cash flows from the item being hedged. For example, an enterprise may hedge a net investment in a foreign operation with a borrowing that is denominated in the same currency as the net investment being hedged. Accounting for the borrowing as a hedge does not change the basic nature of the transaction; that is, it is still a borrowing. Furthermore, the cash flows from that foreign operation may include some cash flows that are properly classified as operating activities, some as investing activities, and some as financing activities. Accordingly, the cash receipts and payments from that borrowing cannot be identified with any specific cash flows from that operation and should be classified as financing activities.

39. Several respondents to the Exposure Draft suggested that the amendment to Statement 95 should encompass cash flows from hedging instruments other than futures contracts, forward contracts, and option contracts. Some requested that the amendment include cash flows from any instrument that would be considered a hedge of another transaction or event, while others specified that only cash flows from those instruments that qualify as hedges under current

generally accepted accounting principles should be included. A few commented that the amendment should include cash flows from hedging instruments that may evolve in the future, and others requested that the Board clarify whether cash flows from swap contracts would be included.

40. The Board concluded that cash flows from swap contracts should be included within the scope of this Statement. Paragraph 17 of FASB Statement No. 52, *Foreign Currency Translation,* indicates that currency swaps are, in substance, essentially the same as forward contracts and should be accounted for the same as forward contracts. The Board also concluded that cash flows from an interest rate swap intended to effectively convert the interest rate of an asset or liability from variable to fixed or fixed to variable may be classified as operating cash flows consistent with the interest cash flows relating to the underlying asset or liability.

41. The Board believes the scope of this Statement should not be extended beyond the instruments named and conditions specified in paragraph 7(b). Otherwise, some may infer that the Board would endorse hedge accounting for any instrument that could be considered to reduce exposure to price or interest rate risk. This Statement does not address hedge accounting in the statement of financial position or the statement of operations. The Board is addressing the broader issues of hedge accounting as part of its project on financial instruments and off-balance-sheet financing.

Effective Date and Transition

42. The Exposure Draft would have been effective for annual financial statements for fiscal years ending after December 15, 1989, and would have required comparative amounts in financial statements for earlier periods to be reclassified. Because this Statement permits additional net reporting of certain cash flows, most of those responding to the Exposure Draft encouraged the Board to adopt the early effective date and commented that it would reduce cost and effort necessary to provide the information required to prepare the statement of cash flows. However, some requested that the Board delay the effective date to provide preparers of financial statements additional time to accumulate necessary information to modify the classification of cash flows from certain hedging transactions. The Board concluded, primarily because this Statement is being issued late in the year, to delay the effective date, while allowing early adoption of either or both of the major provisions.

43. Some respondents suggested that reclassification of cash flows from hedging transactions for earlier periods should not be required. They indicated that the cost of reclassifying could exceed the benefits of additional comparability and that some enterprises may not have systems in place to accumulate the necessary information. Many of the concerns regarding requiring reclassification were in the context of an early implementation date and a requirement to modify the classification of cash flows from certain hedging transactions. Many of the respondents who agreed with the proposal to require consistent classification of cash flows from hedging transactions said that it would not be costly to report in that manner because their accounting

records already link those transactions together.

44. Because modification of the classification of cash flows from certain hedging transactions is permitted and not required, the Board believes that when the option is elected, hedging cash flows for earlier periods should be reclassified to improve comparability. Also, hedging instruments and the items being hedged are linked for accounting purposes, and enterprises would have had to track them together for statement of financial position and statement of operations purposes. In addition, the Board believes that banks, savings institutions, and credit unions can restate without difficulty cash flows for the deposit and lending activities that this Statement allows to be reported net.

Footnotes

FAS104, Appendix, Footnote 1--Statement 102, paragraph 9, specifies the reporting in a statement of cash flows for those loans acquired specifically for resale and carried at market value or at the lower of cost or market value.