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FASB Just Moved a Mountain, Changed Landscape on Hedging

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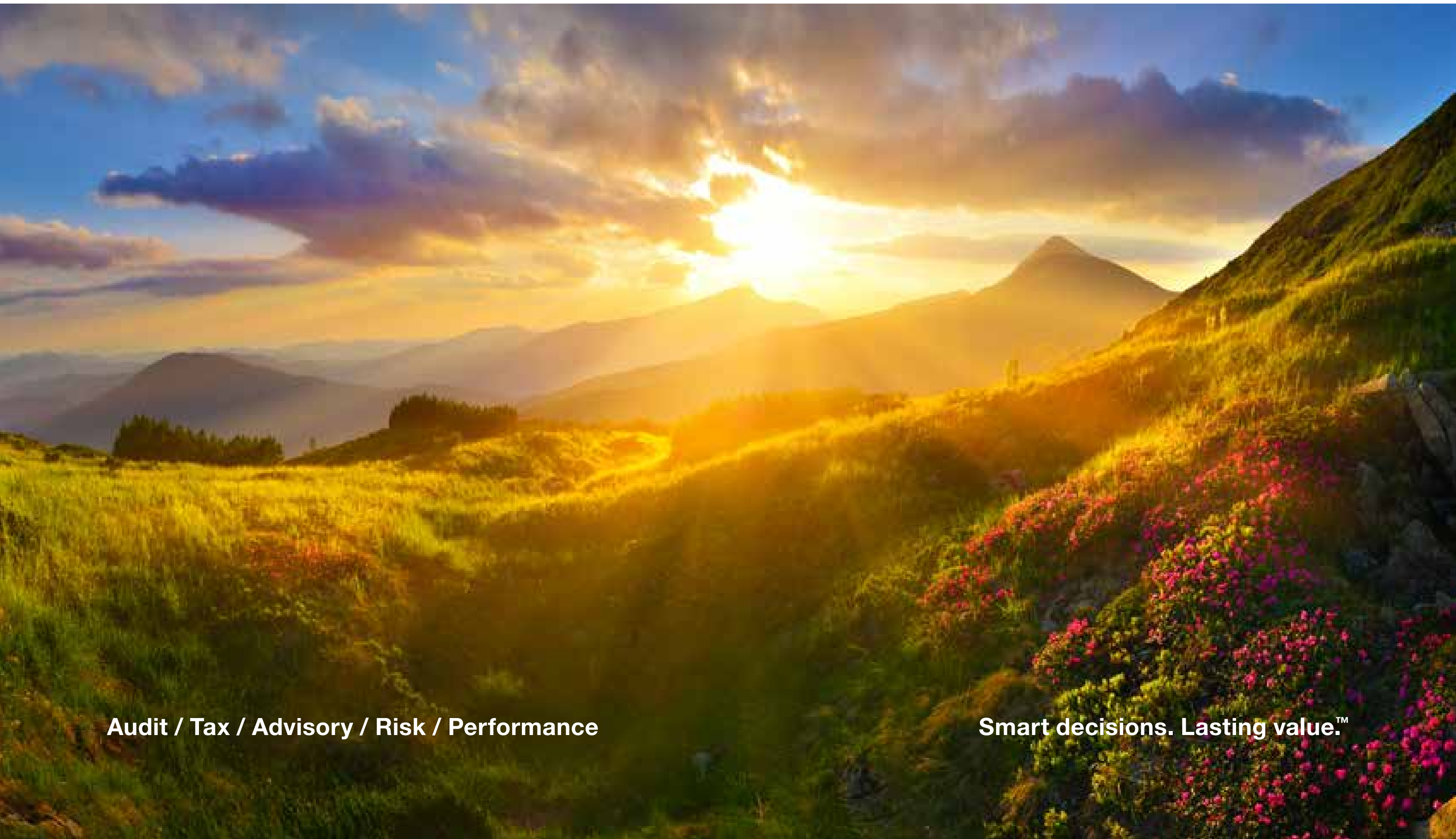

The Financial Accounting Standards Board (FASB) has been on quite a run working to simplify existing standards, and this may be the most impactful update yet – significantly changing the hedging landscape. On Aug. 28, 2017, FASB issued Accounting Standards Update (ASU) No. 2017-12, "Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities." This update, several years in the making, offers simplification, opens the doors to new strategies, and may entice nonhedgers to become hedgers.

The ASU makes hedge accounting more closely reflect a company's risk management activities and provides financial statement users with more decision-useful information about the effect of hedging activities. The update provides targeted improvements to simplify certain aspects of hedge documentation, effectiveness assessments, and accounting and disclosures; in addition, it expands permissible hedge strategies and permits early adoption – not just a few changes, but many. So read on, and prepare for mountainous revisions.

Cash Flow Hedges

- By removing the concept of benchmark interest rates, companies now will be permitted to designate the hedged risk based on any contractually specified interest rate within the hedged transaction.* Under existing literature, companies can hedge overall changes in cash flows or changes due to a benchmark interest rate (for example, Libor , U.S. Treasury, or the Federal Funds Effective rate). Prior to this update, nonbenchmark interest rates, such as prime rate (even if contractually specified), required companies to identify the hedged risk as overall changes in cash flows, which was operationally difficult.
- Hedging a forecasted purchase or sale of a nonfinancial asset now will permit the designated hedged risk to be a contractually specified component within the hedged transaction.* Prior to this update, companies were required to hedge the overall change in cash flows. For example, copper is a component of brass. If the settlement of a purchase or sale contract for brass was contractually tied to copper, the company now would be able to specify the copper component as the hedged risk. Companies that use commodities may want to evaluate existing contracts and consider modifying the settlement provision to improve the ability to hedge the contract.
- As a result of this update, if the hedge is considered effective, the entire change in fair value of the hedging derivative is reported in other comprehensive income (or in the currency translation adjustment section of other comprehensive income) even if ineffectiveness is present. Current standards require separate recognition of ineffectiveness for cash flow hedges. This change will greatly simplify the accounting operations for cash flow hedges that are not fully effective, and it might result in a company pursuing risk management strategies that currently would not be desirable due to accounting complexity.

Fair Value Hedges

- Unlike with cash flow hedges, for fair value hedges, FASB retained the concept of benchmark interest rates but expanded the concept to include the Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Rate for hedges of fixed-rate tax-exempt financial instruments.**
- The update will now permit companies to use the change in fair value of the hedged item using either the entire coupon or the portion of the contractual cash flows related to the benchmark interest rate. When assessing effectiveness and measuring ineffectiveness under current standards, a company must consider the entire coupon of the hedged item, even when the designated risk being hedged is the benchmark interest rate. Using the entire coupon in the change in fair value analysis creates a source of ineffectiveness, which at times can be significant. As a result of this change, fair value hedges will be more effective using the alternative approach. Companies with fair value hedges will want to consider applying this change to existing hedges to simplify quarterly hedge effectiveness assessments.*
- The update permits partial-term fair value hedges by allowing a company to assume the hedged item has a term that reflects only the designated cash flows being hedged. For example, a 10-year fixed-rate instrument can now be hedged using a two-year interest-rate swap without the difference in duration causing ineffectiveness.** Under current standards, the duration of the hedging derivative not matching the duration of the hedged instrument causes ineffectiveness, often to the extent hedge accounting was not permitted.
- Building on partial-term hedges and computing changes in value using benchmark rate cash flows, FASB also added a mechanism where hedging pools of fixed-rate financial assets will be less complex. Using a new technique known as the last-of-layer method, a company now can designate the hedged item as a closed portfolio of prepayable fixed-rate financial assets (or securities backed by a portfolio of prepayable financial instruments) up to an amount that is not expected to be affected by prepayments, defaults, or other events affecting timing of cash flows. Prepayment risk is not incorporated into the measurement of the hedged item. Instead, the company will document at inception and each quarter thereafter its expectation that the hedged portion of the assets will be outstanding for the life of the hedge relationship. Hedging pools of fixed-rate financial assets under existing literature is very difficult, if not impossible. This change is a significant simplification and might become a common method for balance sheet hedging.**
- Ineffectiveness is no longer measured under the update. If the hedge is considered effective, companies will now simply record the entire change in fair value of the hedging derivative in the same income statement line that is used to present the earnings effect of the hedged item.

Amounts Excluded From Hedge Effectiveness Assessment

The update allows additional flexibility involving the accounting of components excluded from the assessment of effectiveness. Excluding components is a narrow application of the existing standard involving option premiums or certain applications of forward rates versus spot rates and is now expanded to include certain hedges involving cross-currency swaps. Companies currently are required to record the change in value of excluded components directly in earnings. Under the ASU, companies can choose to follow existing literature or can record these amounts through other comprehensive income. Using a new method known as the amortization approach, companies can record the initial value of the excluded components through earnings using a systematic and rational method over the life of the hedge. The difference between the change in value of the excluded component and the amount recognized in earnings is reported in other comprehensive income (or, for net investment hedges, in the cumulative translation adjustment section of other comprehensive income). The amortization method approach has the opportunity to reduce income statement volatility otherwise caused by excluded components.*

Hedge Documentation

- The update in certain circumstances will allow a significant reduction in the effort required for quarterly effectiveness assessments for long-haul method hedges. A company now can elect to perform subsequent quarterly assessments using qualitative methods alone if at inception it can "reasonably support an expectation of high effectiveness on a qualitative basis for subsequent periods," and it will be required to perform quantitative assessments only if the facts and circumstances change. For example, hedges requiring quarterly regression analysis may now only require qualitative assessments.*
- The update also will allow additional time for the initial quantitative hedge analysis (for example, regression analysis). Initial qualitative documentation is still required at inception of the hedge.
- The update allows a company using the critical terms match method for a group of forecasted transactions to assume the derivative maturity date and forecasted transaction dates are the same (that is, terms match) if they occur within the same 31-day period or fiscal month. Currently, companies would need to perform a de minimus test as part of a hedge designation to make this assertion.
- The ASU also simplifies the shortcut method. When using the shortcut method, companies now may specify in the hedge designation a long-haul method to be applied if it is later determined that the shortcut method should not have been applied or is no longer appropriate. Existing standards are very limiting in that a failed shortcut method hedge is evaluated as if hedge accounting was never applied and often results in restatements. This change in the update is significant in that a shortcut method hedge will now have the opportunity to continue on using a long-haul method, if that method was specified in the original hedge designation and the hedge would have been considered highly effective using that method.*

Disclosures

The update removes the ineffectiveness disclosure from the tabular footnote presentation because it is no longer separately recorded. Additional tabular disclosure requirements related to cumulative-basis adjustments for fair value hedges also have been added. The basis adjustment disclosure was expanded in part due to the addition of the last-of-layer method.

Effective Dates and Transition

For public business entities, the amendments are effective for fiscal years beginning after Dec. 15, 2018, and interim periods within those fiscal years. For all other companies, the amendments are effective for fiscal years beginning after Dec. 15, 2019, and interim periods within fiscal years beginning after Dec. 15, 2020. Transition requirements and elections are to be applied to hedging relationships existing on the date of adoption. **Early adoption is permitted in any interim period after issuance of the update for financial statements that have not been issued or have not yet been made publicly available.** If a company early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period.

The amendments in this ASU are applied using the modified retrospective method with a cumulative-effect adjustment related to eliminating the separate measurement of ineffectiveness to accumulated other comprehensive income and a corresponding adjustment to opening retained earnings as of the fiscal year a company adopts this update. Amended disclosure guidance is required only prospectively.

Bonus: The update provides for a reclassification of certain debt securities from held-to-maturity to available-for-sale only if the debt security is eligible to be hedged using the last-of-layer method. Any unrealized gain or loss existing at the time of transfer is recorded in accumulated other comprehensive income. As a permitted activity, the reclassification of securities will not taint future held-to-maturity classification so long as the securities transferred are eligible to be hedged under the last-of-layer method in accordance with Accounting Standards Codification 815-20-25-12A.

Upon adoption, companies also may elect to incorporate many of these amendments into existing hedge designations without the changes being considered a dedesignation/redesignation event. Separate transition guidance is provided for the various elections in Section 815-20-65-3 and for the timing of these elections, which can be made at the adoption or no later than specified in the update.

Because of the simplification aspects of the amendments contained in the update, many companies might prefer early adoption. However, the ability to take advantage of the varying elections occurs only within the transition guidance and requires careful modification of existing documentation. **Additional elections cannot be made after the dates specified, and a cautious approach to early adoption will help a company take full advantage of all the available simplifications.**

New Opportunities

While hedge accounting is still complex and continues to require precise documentation, ASU 2017-12 offers many simplifications and potential new strategies. Will companies that never hedged now venture into the world of hedge accounting? Will the shortcut method make a comeback? Will companies choose transactions that are less than 100 percent effective knowing ineffectiveness will no longer need to be measured and recorded and regression can be limited to inception only? How will the last-of-layer method change the landscape of hedging?

There are so many new opportunities to consider, because FASB just moved a mountain.

Learn More

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* Companies may elect to apply to existing hedges without a dedesignation, which will result in a corresponding adjustment to opening retained earnings.

** Applicable to new hedges only. Applying to an existing hedge results in a hedge dedesignation/redesignation event.

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