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BDO **FLASH** REPORT

FASB

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SUBJECT

FASB ISSUES TARGETED IMPROVEMENTS TO HEDGE ACCOUNTING

SUMMARY

The FASB recently issued ASU 2017-12[1] to improve its hedge accounting guidance. This new standard simplifies and expands the eligible hedging strategies for financial and nonfinancial risks. It also enhances the transparency of how hedging results are presented and disclosed. Further, the new standard provides partial relief on the timing of certain aspects of hedge documentation and eliminates the requirement to recognize hedge ineffectiveness separately in earnings. The ASU is available **here**, and becomes effective for public companies in 2019 and all other entities in 2020. Early adoption is permitted.

DETAILS

Background

Topic 815[2] governs the accounting for derivative instruments and provides an option to elect hedge accounting. Historically, the conditions to apply hedge accounting have been quite stringent.

ASU 2017-12 more closely aligns hedge accounting with a company's risk management activities and simplifies its application through targeted improvements in key practice areas. This includes expanding the list of items eligible to be hedged and amending the methods used to measure the effectiveness of hedging relationships. These changes are intended to allow preparers more flexibility. In addition, the ASU prescribes how hedging results should be presented and requires incremental disclosures.

1 Targeted Improvements to Accounting for Hedging Activities
2 Derivatives and Hedging

Expansion of Risks Eligible to be Hedged

Financial Risk Components

Under current GAAP, a hedge of interest-rate risk is only allowed for specific benchmark interest rates, i.e., LIBOR, US Treasury and the OIS rates. The ASU amends this guidance to allow other interest rates to be hedged:

- For cash flow hedges, the concept of benchmark interest rates was eliminated. Instead, an entity can hedge any contractually specified interest rate. Therefore, variability in cash flows attributable to the prime rate or any other explicitly specified rate can now be hedged.
- For fair value hedges, the concept of benchmark interest rates was retained. However, the Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Rate was added to the list of eligible US benchmark interest rates mentioned above.

Nonfinancial Risk Components

- Similar to the amendments for cash flow hedges of interest-rate risk, the ASU permits an entity to hedge the variability in cash flows attributable to changes in any contractually specified component of a nonfinancial asset. For instance, an entity may hedge just the rubber component of forecasted tire purchases instead of the entire purchase price.

Simplified Application of Interest-Rate Risk in Fair Value Hedges

To simplify and better align fair value hedges of interest-rate risk in a debt instrument with an entity's risk management strategy, the ASU permits an entity to:

- Measure the change in fair value of the hedged item considering only the hedged benchmark interest rate component, instead of the full contractual coupon (including credit spread).
- Measure the hedged item by assuming it has a term that reflects only the designated cash flows being hedged, e.g., the first 3 years of a 7 year note, which was not permitted in the past for fair value hedges.
- Consider how changes in only the hedged benchmark interest rate will affect a decision to settle a prepayable financial instrument before its scheduled maturity, and not credit or other extraneous factors, in calculating the change in fair value of the hedged item.
- Use a "last-of-layer" method in hedging certain portfolios of prepayable financial assets. As such, prepayment risk is not incorporated into the measurement of the hedged item as that bottom layer is not expected to be affected by prepayments.

Elimination of the Separate Measurement and Recording of Hedge Ineffectiveness

The ASU eliminates the concept of hedge ineffectiveness for financial statement recognition purposes. While the hedging relationship still has to be highly effective in order to apply hedge accounting, the ineffective portion of the hedging instrument is no longer required to be recognized currently in earnings or disclosed. As such,

- For cash flow and net investment hedges, all changes in the fair value of the hedging instrument (i.e., both the "effective" and "ineffective" portions) will be deferred in other comprehensive income and recognized in earnings at the same time that the hedged item affects earnings.
- For fair value hedges, the entire fair value change of the hedging instrument is presented in the same income statement line that includes the hedged item's impact on earnings.

Simplifications Related to Effectiveness Assessments and Related Hedge Documentation

The ASU includes other simplifications to hedge effectiveness assessments and the related hedge documentation:

- If certain conditions are met, an entity may elect to perform the subsequent quarterly hedge effectiveness assessments qualitatively even if a quantitative test (e.g., regression) was required to be performed at hedge inception.
- An entity may assume that the hedging derivative's maturity date and the occurrence of the forecasted transactions (e.g., forecasted sales) match if they occur within the same 31-day period or fiscal month.
- The timing of the initial prospective quantitative hedge effectiveness test is extended up to the first quarterly effectiveness assessment date for all entities.
- As additional relief, certain private companies and not-for-profit entities may select the method of assessing hedge effectiveness, and perform both the initial effectiveness test and all subsequent quarterly hedge effectiveness assessments before the date on which the next financial statements are available to be issued. They are required to document only the hedging instrument, the hedged item or transaction, and the nature of the risk being hedged contemporaneously at hedge inception.
- An entity that applies the qualitative shortcut method for assessing hedge effectiveness but later determines this method to be inappropriate is allowed to change to a specified quantitative "long-haul" method (e.g., regression) without dedesignating the hedge, so long as that long-haul method was documented at inception.

Improvements to Presentation and Disclosure

The ASU establishes the following presentation and disclosure requirements:

- Requires presentation of the earnings effect of the hedging instrument in the same income statement line item as the hedged item (e.g., amounts deferred in other comprehensive income for cash flow hedges of interest rate risk will be reclassified to interest expense).
- Requires new tabular disclosures related to the cumulative basis adjustments for fair value hedges; and
- Amends current tabular disclosures related to the effect on the income statement of fair value and cash flow hedges.

EFFECTIVE DATE AND TRANSITION

For public business entities, the ASU is effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. For all other entities, the ASU is effective for fiscal years beginning after December 15, 2019, and interim periods beginning after December 15, 2020.

Early application is permitted in any interim period after issuance of the ASU for existing hedging relationships on the date of adoption. The effect of adoption should be reflected as of the beginning of the fiscal year of adoption (that is, the initial application date).

The transition section of the ASU specifies the following:

- For cash flow and net investment hedges existing at the date of adoption, elimination of the separate measurement and recording of ineffectiveness should be applied through a cumulative-effect adjustment to accumulated other comprehensive income with a corresponding entry to the opening balance of retained earnings.
- The amended presentation and disclosure guidance is required only prospectively.
- Certain beneficial transition elections (e.g., amending hedge documentation to indicate that subsequent hedge effectiveness assessments will be performed qualitatively; documenting the alternative "long-haul" method that will be applied if the shortcut method is determined to be inappropriate; etc.) may be made upon adoption.

ON THE HORIZON

BDO will host a webcast on the key amendments later this fall and details will be provided in advance.