

# Technical Line

FASB – proposed guidance

## A closer look at the FASB's hedge accounting proposal

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### What you need to know

- ▶ The FASB proposed amendments to its hedge accounting guidance that are aimed at enabling entities to more clearly portray the economics of their risk management activities in their financial statements.
- ▶ The proposal would expand the strategies that qualify for hedge accounting, change how many hedging relationships are presented in the financial statements and simplify the application of hedge accounting in certain situations.
- ▶ The proposal would also provide entities with additional flexibility in how they measure the change in the fair value of the hedged item in certain hedging relationships.
- ▶ Certain disclosure requirements would be modified or added.
- ▶ The FASB recently held two public roundtable discussions on the proposal. Redeliberations will begin in 2017.

### Overview

The Financial Accounting Standards Board (FASB or Board) proposed targeted amendments<sup>1</sup> to the hedge accounting model in Accounting Standards Codification (ASC) 815<sup>2</sup> that are aimed at enabling entities to more clearly portray the economics of their risk management activities in their financial statements.

While the proposal would change the guidance on a broad range of hedge accounting topics, the FASB decided against creating an entirely new model. As a result, many aspects of today's guidance would not change, including:

- ▶ The three types of hedge accounting relationships that can be designated under the model (i.e., fair value hedges, cash flow hedges and hedges of net investments in foreign operations)
- ▶ The highly effective threshold to qualify for hedge accounting
- ▶ The requirement for concurrent designation and documentation of hedging relationships
- ▶ The need for entities to consider hedge effectiveness prospectively and retrospectively
- ▶ The ability for entities to voluntarily discontinue hedge accounting

Aspects of ASC 815 that do not relate to hedge accounting also would remain unchanged, including the definition of a derivative, the scope exceptions to derivative accounting, the guidance on bifurcating embedded derivatives and the income statement presentation requirements for derivative instruments not designated in a hedging relationship (e.g., derivatives held for trading purposes or derivatives used as economic hedges).

### **Key provisions of the proposal**

#### ***Alignment of an entity's risk management activities and financial reporting***

This aspect of the proposal addresses risk component hedging, fair value hedges of interest rate risk and recognition and presentation of the effects of hedging instruments.

**Risk component hedging** – For cash flow hedges, the proposal would expand the strategies that qualify for hedge accounting to include hedging the variability in cash flows due to changes in:

- ▶ A contractually specified component in the forecasted purchase or sale of a nonfinancial asset
- ▶ A contractually specified variable interest rate in a variable-rate financial instrument

For hedges of fixed-rate financial instruments, component hedging would continue to be limited to benchmark interest rates, but the Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Rate would be added as an acceptable US benchmark interest rate.

**Fair value hedges of interest rate risk** – Current US GAAP contains limitations on how an entity can measure changes in the fair value of a hedged item attributable to interest rate risk in fair value hedging relationships. The proposal would provide entities with flexibility in how to measure the change in the fair value of the hedged item (i.e., a fixed-rate financial instrument) in order to better reflect the effectiveness of these hedging strategies. These proposed changes include:

- ▶ Determining the change in the fair value of the hedged item by using only the portion of the contractual cash flows related to the benchmark interest rate, not the entire coupon
- ▶ Considering only how changes in the benchmark interest rate affect the decision to prepay the instrument, rather than all factors that would affect this decision (e.g., credit risk)
- ▶ Calculating the change in the fair value of the hedged item in a partial-term hedge by assuming that the hedged item has a term that reflects only the designated cash flows being hedged (i.e., the maturity date of the hedged item would be assumed to be the same as that of the derivative designated as the hedging instrument)

Aspects of ASC 815 that do not relate to hedge accounting would remain unchanged.

**Recognition and presentation of the effects of a hedging instrument** – The proposal would further align the income statement presentation and timing of earnings recognition of the hedging instrument with the hedged item.

To accomplish this, the proposal would (1) eliminate today's US GAAP requirement to separately measure and report hedge ineffectiveness and (2) generally require entities to report the entire effect of the hedging instrument and hedged item in the same income statement line item.

#### ***Simplification of hedge accounting requirements***

The proposal would also simplify certain hedge documentation and assessment requirements. While entities would still need to perform an initial quantitative assessment of effectiveness for many hedging relationships, the proposal would reduce the administrative burden of applying hedge accounting by:

- ▶ Giving entities more time to complete the initial quantitative hedge effectiveness assessment portion of their hedge documentation (i.e., generally until the end of the quarter in which the hedge is designated)
- ▶ Allowing an entity to subsequently assess hedge effectiveness qualitatively unless the facts and circumstances change to an extent that the entity can no longer assert qualitatively that the hedge is highly effective
- ▶ Permitting entities to use the critical terms match method to assess hedge effectiveness of a group of forecasted transactions that occur within the same 31-day period as the hedging derivative's maturity date, without performing a de minimis test
- ▶ Allowing an entity to switch to a quantitative assessment of hedge effectiveness if it inappropriately used the shortcut method, as long as it documented at hedge inception the quantitative methodology to be used if necessary and the hedge is highly effective when this methodology is applied

#### ***Disclosures***

To help users of the financial statements better understand the effects of hedge accounting, the Board proposed requiring the following new or modified disclosures:

- ▶ Revised tabular disclosures that would focus on the effect of hedge accounting by income statement line
- ▶ The cumulative basis adjustment to the hedged item in fair value hedges
- ▶ A description of any quantitative goals of the entity's hedge accounting program and whether they were met

The proposal would also eliminate the current requirement to disclose hedge ineffectiveness because ineffectiveness would no longer be separately measured.

### **How we see it**

Overall, we believe the proposal would significantly improve the US GAAP hedge accounting model. The proposed amendments would increase the number of strategies that qualify for hedge accounting and reduce operational complexities associated with certain existing strategies.

## Background

Statement of Financial Accounting Standards (SFAS) No. 133,<sup>3</sup> issued in 1998, established financial accounting and reporting guidance for derivative instruments and provided special hedge accounting that entities could elect to apply if certain criteria were met. While this guidance has been amended numerous times in order to address various practice issues (primarily based on interpretations by the Derivatives Implementation Group), critics continue to say that the hedge accounting model is overly restrictive and complex.

For example, various common risk management strategies do not qualify for hedge accounting. For other strategies that do qualify, the financial reporting results do not always accurately reflect the economics of the risk management activities undertaken. Some entities also choose to forgo hedge accounting for strategies that would qualify to avoid having to navigate the complex rules.

In an attempt to address these concerns, the Board issued proposals to amend its hedge accounting model in 2008<sup>4</sup> and 2010.<sup>5</sup> The current proposal reflects feedback the FASB received on those proposals, as well as a 2011 discussion paper<sup>6</sup> the Board issued on the hedge accounting model the International Accounting Standards Board (IASB) ultimately issued as part of IFRS 9 *Financial Instruments*.

Although the IASB and FASB were both seeking to better align their hedge accounting models with the risk management activities employed by entities, certain broad principles in the current proposal differ from those in IFRS 9. Refer to the appendix for a summary of key differences.

## Proposed amendments to the overall hedge accounting model

### **Recognition and presentation of the effects of hedging instruments**

While ASC 815 currently requires disclosure of the income statement line item where gains and losses on derivative instruments are reported, it is generally silent on the line item where those gains and losses should be presented. The proposal would generally require the entire change in the fair value of hedging instruments to be presented in the same income statement line where the earnings effect of the hedged item is presented. The only exception would be changes in the hedging instrument's time value excluded from the assessment of hedge effectiveness in a net investment hedge.

The proposal also would eliminate the requirement to separately measure and report hedge ineffectiveness. As a result, the entire change in the fair value of the hedging instrument included in the assessment of effectiveness for cash flow and net investment hedges would be recorded in accumulated other comprehensive income (AOCI) and reclassified into earnings when the hedged item affects earnings (or when it becomes probable that the forecasted transaction being hedged in a cash flow hedge will not occur in the required time period).

The Board believes that further aligning the recognition and presentation of the effects of the hedging instrument and the hedged item in the financial statements would help users better understand the results of an entity's hedge accounting strategies and would make the total cost of hedging more transparent.

### ***Excluded components***

The proposal would continue to permit certain portions of the change in fair value of a hedging instrument related to time value (e.g., the forward points in a forward contract, the premium paid on an option) to be excluded from the assessment of hedge effectiveness and recognized immediately in earnings. The proposal would require the change in excluded time value for cash flow and fair value hedges to be presented in the same income statement line

The proposal would eliminate the requirement to separately measure and report hedge ineffectiveness.

where the earnings effect of the hedged item is presented. For net investment hedges, the proposal would not specify where amounts excluded from the assessment of hedge effectiveness should be presented.

### **Timing of initial prospective quantitative hedge effectiveness assessment**

Like today's guidance, the proposal would require entities to perform an initial prospective assessment of hedge effectiveness at the inception of a hedging relationship. To qualify for hedge accounting, the hedging relationship must be expected to be "highly effective" in achieving offsetting changes in fair value or cash flows attributable to the hedged risk during the period that the hedge is designated.

The proposal would clarify that the initial prospective assessment of hedge effectiveness must be performed on a quantitative basis (e.g., based on a regression analysis) except in the following situations:

- ▶ In a cash flow or fair value hedge, where an entity applies the shortcut method
- ▶ In a cash flow or fair value hedge, where an entity determines that the critical terms of the hedging instrument and hedged item match
- ▶ In a cash flow hedge, where an entity assesses hedge effectiveness based on an option's terminal value
- ▶ In a cash flow hedge, where a private company applies the simplified hedge accounting approach
- ▶ In a cash flow hedge, where an entity assesses hedge effectiveness under the change in variable cash flow method, and all the conditions to assume the hedge is perfectly effective are met
- ▶ In a cash flow hedge, where an entity assesses hedge effectiveness under the hypothetical derivative method, and all of the critical terms of the hypothetical derivative and hedging instrument are the same
- ▶ In a net investment hedge, where an entity assesses hedge effectiveness based on changes in spot exchange rates, and the conditions to assume perfect effectiveness are met
- ▶ In a net investment hedge, where an entity assesses hedge effectiveness based on changes in forward exchange rates, and the conditions to assume perfect effectiveness are met

The proposal also would give entities more time to perform the initial prospective quantitative hedge effectiveness assessment that is part of the concurrent documentation required to be prepared at the inception of the hedging relationship. The proposal indicates that this assessment would be considered to be performed at hedge inception if it is completed by the earliest of the following dates:

- ▶ The first quarterly hedge effectiveness assessment date
- ▶ The date that financial statements are available to be issued
- ▶ The date that the hedging relationship no longer meets the hedge accounting criteria in ASC 815-20-25
- ▶ The date of expiration, sale, termination or exercise of the hedging instrument
- ▶ The date of dedesignation of the hedging relationship

- ▶ For a cash flow hedge of a forecasted transaction, the date that the forecasted transaction occurs

The proposal could provide entities with as much as three additional months to perform their initial quantitative effectiveness tests. However, in performing that assessment, an entity would need to use data as of the date of hedge designation. The following example illustrates when an entity would be required to perform this assessment.

#### **Illustration 1 – Timing of initial quantitative prospective effectiveness assessment**

Assume that Company A has determined that it is probable it will purchase 100 bushels of corn on 16 December 20X1 at the spot price in location Y on that day. To lock in the base corn price associated with this forecasted purchase, Company A purchases a two-month corn futures contract on the Chicago Mercantile Exchange on 16 October 20X1. This futures contract will net settle on 16 December 20X1.

Company A designates the futures contract as the hedging instrument in a cash flow hedge of the variability in the total price of its forecasted purchase of corn at location Y. On 16 December 20X1, the forecasted purchase occurs.

While Company A would need to concurrently document its hedging relationship on 16 October 20X1 (the hedge inception date), it would have until 16 December 20X1 to perform its initial prospective quantitative assessment to validate that the hedge was expected to be highly effective. The data used for this assessment would be as of 16 October 20X1.

The reason Company A would have to complete its initial prospective quantitative assessment of hedge effectiveness before the end of the quarter is because the forecasted transaction occurred during the same quarter that the hedging relationship was initiated.

### **How we see it**

Giving entities more time to perform their initial prospective quantitative assessment could provide relief to entities that do not have significant hedging activities or lack the resources to complete this quantitative analysis on the date the hedge is executed. However, the FASB would still require entities to concurrently complete all the other hedge documentation requirements so they would not have the benefit of hindsight when determining whether to designate a derivative instrument as part of a hedging relationship. For example, as of the hedge inception date, they would still need to document their risk management strategy, identify the hedging instrument and hedged item and define the methodology that will be used to initially assess hedge effectiveness.

We also note that even if the initial prospective quantitative assessment of hedge effectiveness is performed at the end of the quarter in which the hedging relationship is designated, this assessment cannot be used to conclude that the hedging relationship was effective during the quarter (i.e., as a retrospective assessment at quarter end) or is expected to be effective in future periods (i.e., as a prospective assessment at quarter end).

### **Subsequent hedge effectiveness assessments**

The proposal would retain the current requirement to assess hedge effectiveness on an ongoing basis (i.e., whenever financial statements or earnings are reported, and at least every quarter). Each assessment must consider whether the hedge has been highly effective (i.e., a retrospective assessment) and is expected to continue to be highly effective (i.e., a prospective assessment).

ASC 815 currently requires entities to perform ongoing assessments quantitatively, unless the hedging relationship meets the criteria to be considered perfectly effective (e.g., under the shortcut or critical terms match methods). The proposal would permit entities to assess ongoing hedge effectiveness qualitatively, even for hedging relationships that are not assumed to be perfectly effective, if (1) an initial quantitative assessment is performed and demonstrates that the relationship is expected to be highly effective and (2) at inception, the entity can reasonably support an expectation of high effectiveness on a qualitative basis in subsequent periods. However, if the facts and circumstances change and the entity can no longer assert qualitatively that the hedging relationship was and continues to be highly effective, the entity would be required to perform subsequent effectiveness assessments on a quantitative basis.

At the inception of a hedging relationship, an entity would need to document its election to subsequently assess hedge effectiveness qualitatively. This documentation would need to include how the entity intends to perform the qualitative assessment and what quantitative method would be used if a qualitative assessment is no longer appropriate. The proposal would also require an entity to document that it will perform the same quantitative assessment for both initial and subsequent prospective assessments.

The proposal also would require an entity to apply its election to qualitatively assess hedging relationships consistently for similar hedges.

Ongoing hedge effectiveness assessments could be performed qualitatively for hedging relationships that are not assumed to be perfect.

### How we see it

The proposal would provide a one-time transition election that would allow entities to change their documentation for existing hedges and switch to a qualitative subsequent assessment without dedesignating the hedging relationships.

It is unclear to us whether the FASB intended to preclude an entity that did not make this election from using a qualitative method to subsequently assess hedge effectiveness for similar new hedges after adoption. The proposal seems to suggest this by stating that the requirement to assess effectiveness for similar hedges in a similar manner applies to an entity's selection of hedging relationships for which qualitative assessments are elected. The FASB also states in paragraph BC168 of the proposal that the one-time transition election "would ensure that similar hedging relationships are assessed for effectiveness in accordance with paragraph 815-20-25-81."

In our view, entities should be permitted to assess hedge effectiveness qualitatively for hedging relationships entered into after adoption, even if they elect not to change their approach for similar existing hedging relationships.

### *Initial quantitative test of hedge effectiveness*

The proposal would permit entities to assess ongoing hedge effectiveness qualitatively for hedging relationships that are not assumed to be perfectly effective. However, as noted above, one of the requirements to use this approach is that the entity initially performed a prospective assessment of hedge effectiveness on a quantitative basis. This is different from those hedging relationships whose effectiveness can be assessed qualitatively under the current guidance, including hedging relationships assessed under the critical terms match method, because no initial prospective quantitative assessment is required for hedging relationships that are assumed to be perfectly effective.

Accordingly, the proposed guidance in paragraphs ASC 815-20-35-2A through 35-2E and 815-20-55-79G through 55-79U of the proposal would not apply to hedging relationships where an initial prospective assessment of hedge effectiveness is not performed quantitatively.

The complete list of situations where an initial prospective quantitative assessment of hedge effectiveness is not required is shown above in the “Timing of initial prospective quantitative hedge effectiveness assessment” section of this publication.

This is an important distinction as it could have an effect on whether subsequent assessments can continue to be performed on a qualitative basis. In paragraph BC139 of the proposal, the Board states that the criteria for continuing to apply the critical terms match method are more “stringent” than the proposed criteria for continuing to perform a subsequent qualitative assessment. That is, any change in the critical terms of the hedging relationship would preclude subsequent assessments under the critical terms match method. In contrast, an entity would not be precluded from continuing to perform a qualitative assessment unless the facts and circumstances change such that the entity can no longer assert qualitatively that the relationship is highly effective.

The Board believes this difference is reasonable because, under the critical terms match method, effectiveness of the hedging relationship is assumed to be perfect if the critical terms of the hedging instrument and the hedged item match at the inception and on an ongoing basis. In contrast, an entity that would apply the proposed guidance on using a qualitative method to subsequently assess effectiveness is required to establish the effectiveness of that hedging relationship on a quantitative basis at hedge inception.

### How we see it

Allowing entities to subsequently assess hedge effectiveness qualitatively would not eliminate the need for them to perform ongoing “math” related to the hedged item. For fair value hedging relationships, entities would still need to measure the change in the hedged item attributable to the hedged risk in order to appropriately adjust the carrying value of the hedged item.

Because this aspect of the proposal relates to hedging relationships that are not assumed to be perfect, it would be inappropriate to assume that the change in the fair value of the hedged item is equal to the change in the fair value of the hedging instrument. However, the proposed amendments related to measuring the change in fair value of the hedged item in a fair value hedge of interest rate risk would likely reduce the earnings mismatch recognized in these hedging relationships.

#### ***Expectation of high effectiveness on a qualitative basis***

The proposal would provide implementation guidance<sup>7</sup> on determining whether an entity can reasonably support performing assessments of effectiveness on a qualitative basis after hedge inception. While acknowledging that this determination would require judgment, the proposal indicates that an entity should carefully consider the following factors:

- ▶ Results of the quantitative assessment performed at hedge inception
- ▶ Alignment of the critical terms of the hedging relationship

For example, the proposal says an entity should consider whether changes in market conditions could cause the fair value of the hedging instrument and hedged item to diverge, due to differences in their critical terms. If the underlyings of the hedging instrument and hedged item differ, the proposal states that an entity should consider the extent and consistency of correlation between changes in the different underlyings, as this could inform the entity about how expected changes in market conditions could affect the effectiveness of the hedging relationship prospectively.

The proposal also provides a number of examples<sup>8</sup> that indicate that an entity could not reasonably support subsequently assessing hedge effectiveness on a qualitative basis unless the initial quantitative assessment indicates that the hedging relationship is not close to failing, and changes in the underlyings of the hedged item and the hedging instrument have been consistently highly correlated.

#### ***Changes in facts and circumstances***

At every assessment date, the proposal would require an entity to verify and document that the facts and circumstances have not changed to an extent that it can no longer assert qualitatively that the relationship was and is expected to continue to be highly effective. While this assessment may be relatively straightforward in certain cases, it may require significant judgment in others. The proposal provides the following indicators that may, individually or in the aggregate, support an entity's assertion that a qualitative assessment continues to be appropriate:

- ▶ The factors assessed at hedge inception that enabled the entity to reasonably support an expectation of high effectiveness on a qualitative basis have not changed to an extent that the entity no longer can assert qualitatively that the hedging relationship was and continues to be highly effective
- ▶ There have been no adverse developments regarding the risk of counterparty default
- ▶ In a cash flow hedge of a variable-rate financial instrument with an interest rate cap or interest rate floor that is not mirrored in the hedging instrument, the variable rate does not approach or move above or below the rate associated with the cap or floor
- ▶ In a cash flow hedge of the variability in cash flows attributable to the changes in a contractually specified component of a forecasted purchase or sale of a nonfinancial asset with a cap or floor that is not mirrored in the hedging instrument, the price associated with the contractually specified component does not approach or move above or below the price associated with the cap or floor

The proposal provides two examples of facts and circumstances changing to an extent that an entity could no longer assert qualitatively that a relationship was and would continue to be highly effective. In one example,<sup>9</sup> an entity designates a euro-denominated forward contract as a foreign currency cash flow hedge of its forecasted sales denominated in a currency that is pegged to the euro. When the currency became unpegged to the euro during the relationship, the entity concluded that a qualitative assessment was no longer appropriate.

In the other example,<sup>10</sup> an entity concludes that subsequent assessment of hedge effectiveness on a qualitative basis is no longer appropriate for its fair value hedge of fixed-rate debt when the counterparty to its hedging instrument experiences significant credit deterioration.

#### **How we see it**

In some cases, determining whether a change in facts and circumstances is significant enough to necessitate switching from a qualitative to a quantitative assessment would require significant judgment. However, we would expect that this determination could, in part, depend on the methodology the entity used to perform its initial quantitative assessment.

For example, the determination may require less judgment if the entity's initial quantitative assessment included scenario or stress testing that indicated the extent to which facts and circumstances (including market factors) could change without calling into question the effectiveness of the hedge. Such an approach may be especially helpful in situations where a high level of correlation has existed between the hedging instrument and the hedged item under relatively stable market conditions.

If an entity determines that a qualitative effectiveness assessment is no longer appropriate, the proposal indicates that it should begin performing quantitative effectiveness assessments (using the method documented at hedge inception) as of the period in which the facts and circumstances changed. If the entity cannot determine when the facts and circumstances changed, it would need to quantitatively assess all periods that were previously assessed qualitatively since inception of the hedging relationship.

If there are any periods in which the hedging relationship is not highly effective based on a quantitative test, the entity would apply the guidance in ASC 250<sup>11</sup> on error corrections to the difference between the recorded results of applying hedge accounting and the results without applying hedge accounting.

If a subsequent quantitative assessment is required, the proposal would prohibit the entity from reverting back to assessing hedge effectiveness qualitatively without dedesignating and redesignating the hedging relationship. However, the proposal notes that an entity could perform occasional quantitative assessments to prove to a third party (presumably a regulator or an independent auditor) that the hedging relationship is highly effective, without losing the ability to subsequently assess hedge effectiveness qualitatively, as long as the results of the quantitative test show that the hedge was and continues to be highly effective.

The likelihood that misapplying the shortcut method will result in a restatement would be significantly reduced under the proposal.

#### **Misapplication of the shortcut method**

The proposal would retain the shortcut method of assessing hedge effectiveness.

However, the proposal addresses a practice issue that has resulted in numerous restatements. Under current practice, if an entity determines that its use of the shortcut method was not appropriate, the entity is required to apply the guidance on error corrections in ASC 250 to the difference between the results recorded when applying the shortcut method and the results of not applying hedge accounting. That is, an entity may not currently assess the need for restatement by considering whether the hedging relationship would have qualified for hedge accounting under a quantitative assessment methodology.

The proposal would allow entities that misapplied the shortcut method to use a quantitative method to assess hedge effectiveness and measure hedge results without dedesignating the hedging relationship only if both of the following conditions are met:

- ▶ The entity documented at hedge inception the quantitative method it would use to assess effectiveness and measure hedge results if necessary
- ▶ Based on that quantitative method, the hedging relationship was highly effective on a prospective and retrospective basis for the periods in which the shortcut criteria were not met

If both of these conditions are met, an entity would apply the guidance on error corrections in ASC 250 to the difference, if any, between its financial results reflecting the use of the shortcut method and the financial results when the hedging relationship is assessed under the quantitative method previously documented.

This approach would not only reduce the likelihood of a restatement but could also enable entities to continue hedge accounting without having to dedesignate and redesignate hedging relationships. This would mean that the ongoing assessment of hedge effectiveness would not be impacted by a hedging instrument having a fair value other than zero at hedge inception, which would typically be the case if the entity dedesignated and redesignated the hedging relationship.

If the entity does not document a quantitative method to be used if it misapplies the shortcut method (i.e., the first condition is not met), the hedging relationship would be invalid in the period in which the shortcut criteria were not met and in all subsequent periods. If the entity does document such a quantitative method (i.e., the first condition is met), the hedging relationship would be considered invalid in all periods in which (1) the shortcut criteria were not met and (2) the quantitative assessment indicates that the hedging relationship was not highly effective on a prospective and retrospective basis. In both cases, the entity would apply the guidance on error corrections in ASC 250 to the difference between the results recorded from applying the shortcut method and the results of not applying hedge accounting in the periods in which the hedging relationship was considered invalid.

If the entity could not determine when the shortcut criteria were no longer met, it would have to assess effectiveness beginning at hedge inception. This would also be the case if the entity determines that the hedging relationship never qualified for use of the shortcut method.

### How we see it

This aspect of the proposal would be a welcome change to current practice, which often results in restatements when the shortcut method is inappropriately applied to hedging relationships that are clearly highly effective.

Historically, the Securities and Exchange Commission (SEC) staff has emphasized that there is no "spirit" to the shortcut method because it represents a specific, rules-based exception to the general hedging guidance in ASC 815. As a result, the SEC staff has indicated that this rule should be strictly applied and an entity should quantify the error resulting from misapplication as if it had never qualified for hedge accounting, even if the hedging relationship would have been highly effective under the long-haul method.

## Proposed amendments to fair value hedges

### Recognition and presentation of the effects of hedging instruments

The proposal would not change the timing of when the change in fair value of the hedging instrument is recognized in earnings for fair value hedges. That is, gains and losses on the hedging instrument and on the hedged item (attributable to the hedged risk) would continue to be recognized in earnings every period. As a result, consistent with today's guidance, there would be an immediate earnings effect in the income statement if there is a mismatch between the change in the fair value of the hedged item attributable to the hedged risk and the change in fair value of the hedging instrument.

However, the proposal would require all changes in the fair value of a hedging instrument in a fair value hedge to be presented in the same income statement line item as the earnings effect of the hedged item. This would include changes in the hedging instrument's time value that is excluded from the assessment of hedge effectiveness.

Current guidance does not specify an income statement line in which the gains and losses of derivatives designated in fair value hedging relationships should be presented. However, the SEC staff<sup>12</sup> expects registrants to present the effective portion of an effective hedging relationship in the income statement line associated with the hedged item. We understand there is diversity in practice regarding where the ineffective portion of the hedge, as well as any amounts excluded from the assessment of hedge effectiveness, are presented but note that for fair value hedges of interest rate risk, many financial institutions currently report these amounts in other income/expense.

## How we see it

The Board's view that all changes in the fair value of the hedging instrument should be recognized in the same income statement line as the earnings effect of the hedged item would have different consequences in a fair value hedge than in a cash flow hedge.

Some constituents believe that, for fair value hedges, recognizing the entire change in fair value of the hedging instrument in the same income statement line where changes in the value of the hedged item are presented would reduce transparency of reporting about certain key income statement line items such as interest expense.

Consider a hedge of fixed-rate debt with an interest rate swap that is not fully collateralized. Under the proposal, valuation adjustments made to the overall fair value of the hedging instrument related to credit risk would be reported in current-period interest expense. While the effect of presenting these adjustments in interest expense would ultimately net out over the life of the hedging relationship (assuming there is no default on the hedging instrument), the proposal would result in increased volatility in interest expense reported in each period.

The following chart compares the recognition and presentation requirements for the various components of the change in a hedging instrument's fair value under today's guidance and under the proposal:

Hedging instrument's change in fair value	Fair value hedges			
	Current guidance		Proposed guidance	
	Recognition	Income statement presentation	Recognition	Income statement presentation
Ineffective portion*	Immediately in earnings	No guidance	Immediately in earnings	Same line item as hedged item effect
Effective portion*	Immediately in earnings	Same line item as hedged item effect	Immediately in earnings	Same line item as hedged item effect
Excluded component (e.g., time value of an option)	Immediately in earnings	No guidance	Immediately in earnings	Same line item as hedged item effect

\* These amounts are included in the assessment of hedge effectiveness.

### Benchmark interest rates

ASC 815 permits entities to designate interest rate risk as the hedged risk in fair value hedges of fixed-rate financial instruments but requires the designated risk to be defined as the changes in fair value attributed to one of the following benchmark interest rates:

- ▶ Direct Treasury obligations of the US government
- ▶ The London Interbank Offered Rate (LIBOR) Swap Rate
- ▶ The Fed Funds Effective Swap Rate (also referred to as the Overnight Index Swap Rate or OIS)

The proposal would add the SIFMA Municipal Swap Rate to the list of permissible benchmark rates. The SIFMA rate represents the rate at which municipalities with the highest credit quality can obtain short-term financing and is widely recognized and quoted in the US. For these reasons, the Board believes that it should be considered a benchmark rate.

### **Total coupon or benchmark rate coupon cash flows**

In a fair value hedge of interest rate risk that does not qualify for the shortcut method, the change in the fair value of the hedged item (i.e., a fixed-rate debt instrument) attributable to changes in the benchmark interest rate must be determined quantitatively.

Current guidance includes various methodologies to measure the change in fair value of a fixed-rate debt instrument attributable to changes in the benchmark interest rate, but all require that the entire contractual cash flows of the hedged item, including the portion of the coupon payment in excess of the benchmark interest rate (i.e., credit spread), be used in the calculation performed. Because these excess cash flows are generally not present in the hedging instrument, a mismatch between the change in the fair value of the hedging instrument and the change in the fair value of the hedged item is created, and that difference is recognized immediately in earnings.

Over the years, the Board received feedback from many constituents who said that measuring changes in the fair value of the hedged item using the total coupon cash flows misrepresents the true effectiveness of these hedging relationships. They emphasized that these hedging relationships are not meant to manage credit risk, and that using the total contractual cash flows to determine the change in the fair value of the hedged item attributable to the change in the benchmark interest rate creates an earnings mismatch that reflects the portion of the financial instrument that the entity does not intend to hedge.

The proposal would address this concern by allowing entities to use either (1) the full contractual coupon cash flows or (2) the benchmark component (determined at hedge inception) of the contractual coupon cash flows to calculate the change in the fair value of the hedged item in a fair value hedge of interest rate risk.

The proposal would add the SIFMA Municipal Swap Rate to the list of permissible benchmark interest rates.

### **How we see it**

This aspect of the proposal would result in fair value hedges of interest rate risk being more effective, but certain mismatches would likely continue to exist and cause earning volatility.

The proposal includes examples of how to determine the hedged item's change in fair value attributable to changes in the benchmark interest rate under two different methodologies.<sup>13</sup> While both examples conclude that the hedges are perfectly effective, we note that this likely would not be the case absent the assumptions that the FASB used to simplify these examples (e.g., a flat yield curve, no changes in the counterparty's creditworthiness). For example, if a hedging derivative is not fully collateralized, the credit risk associated with the derivative would continue to result in an earnings mismatch, even when benchmark cash flows are used to determine the change in the fair value of the hedged item. If the hedging derivative is fully collateralized, an earnings mismatch could still occur if different discount rates are used to measure the collateralized derivative (i.e., OIS discount rate) and the hedged item (i.e., LIBOR discount rate, assuming the benchmark interest rate being hedged is LIBOR).

We also note that the examples in the proposal illustrate calculations for only the first assessment period following hedge inception. We do not believe that both methodologies described in the examples would result in a perfect offset in subsequent assessment periods. Instead, we would expect the adjustment to the hedged item due to changes in interest rates to differ between the two methodologies, while the change in the fair value of the hedging derivative would be the same under both.

### ***Sub-benchmark issue***

The proposal would prohibit the use of benchmark cash flows to determine the change in the fair value of the hedged item in a fair value hedge of interest rate risk if the current market yield of the hedged item is less than the benchmark interest rate, at the inception of the hedging relationship. This situation is commonly referred to as the “sub-benchmark issue” and could occur when a high credit-quality borrower obtains financing at a fixed rate that is less than the current benchmark rate (i.e., the instrument has a “negative credit spread”).

The proposal would require a comparison, at the inception of the hedging relationship, of the market yield of the hedged item with the benchmark interest rate being hedged, not the benchmark interest rate and the contractual coupon rate. This distinction is important for hedging relationships designated after the issuance of the fixed-rate financial instrument, which are known as “late hedges.” By comparing the benchmark interest rate to the market yield of the hedged item at hedge inception, an entity would not be precluded from using benchmark cash flows to measure the change in fair value of the hedged item in a “late hedge” simply because benchmark interest rates have increased from the time the fixed-rate financial instrument was issued.

### **How we see it**

This proposed limitation seems inconsistent with the treatment of negative credit spreads in cash flow hedges of interest rate risk. That is, a comparable limitation does not exist for an entity seeking to hedge interest rate risk in a variable-rate financial instrument whose coupon payments are based on a contractually specified variable interest rate (e.g., LIBOR) less a fixed credit spread.

In addition, as noted in paragraph BC126 of the proposal, many stakeholders believe that “treasurers view risk management as managing cash flows (such as managing the fixed/floating cash flow profile) rather than managing instruments.” With this view in mind, we find it difficult to understand why the treatment of a negative credit spread should differ when an entity hedges benchmark interest rate risk in a fair value hedge and a cash flow hedge if, in both instances, the entity is trying to manage its fixed/floating cash flow profile.

### **Prepayment features**

A prepayment option that allows a hedged financial instrument to be settled before its scheduled maturity can also complicate a fair value hedge of interest rate risk. ASC 815-20-25-6 states that the effect of an embedded prepayment option should be “considered” when designating a hedge of interest rate risk. Many have interpreted this guidance to require the consideration of all factors that could cause the hedged item to be prepaid, including changes in interest rates and credit spreads, among other factors.

As a result, when hedging benchmark interest rate risk, a mismatch between the change in fair value of the hedging instrument and the hedged item will occur even when the hedging instrument includes a similar prepayment feature. This is because the factors, other than changes in interest rates, that could cause the hedged item to be prepaid would affect the prepayment feature in the hedging instrument differently, if at all. Some stakeholders have indicated that this mismatch, which is recognized in earnings immediately, can be so significant that the hedge would not be highly effective.

Under the proposal, when measuring the change in the fair value of a prepayable financial instrument that is the hedged item in a fair value hedge, an entity would be able to consider only how changes in the benchmark interest rate affect the decision to settle the hedged item

prior to its scheduled maturity. The Board believes that this proposed amendment would more accurately reflect the change in fair value of the hedged item attributable solely to interest rate risk.

#### **Illustration 2 – Fair value hedge of callable debt**

Assume that Entity ABC issued \$100,000,000 of fixed-rate debt that is due in 10 years. The debt is issued at par and pays 5% interest due quarterly. The debt contains a call option that permits Entity ABC to prepay the debt at par plus accrued interest after five years. Entity ABC hedges the change in fair value of the debt due to changes in LIBOR by entering into a cancelable interest rate swap under which Entity ABC receives a fixed rate of 4% and pays the three-month LIBOR rate. The floating leg resets on a quarterly basis, and net settlements occur once each quarter.

Entity ABC accounts for the swap and debt as part of a fair value hedging relationship under ASC 815 and elects to compute the change in the fair value of the hedged item due to changes in LIBOR using the benchmark coupon payments.

Under current guidance, Entity ABC would consider how changes in its credit spread would affect its decision to exercise the call option when estimating the change in the debt's fair value due to changes in the benchmark interest rate. Under the proposal, Entity ABC would be able to ignore changes in its credit spread and consider only how changes in the benchmark interest rate would affect its decision to call the debt.

#### **How we see it**

Because the proposed guidance on measuring the effect of prepayment features when hedging changes in the benchmark interest rate of a fixed-rate financial instrument is written very broadly, there could be differing views on how to apply it.

For instance, some prepayment features in financial instruments are not exercisable unless a specified event occurs (e.g., there is a change in control). Since the proposal does not specifically address how contingently exercisable prepayment features in a hedged item would be assessed, it is unclear how entities would consider contingencies that are unrelated to interest rate risk. One approach could be to ignore the prepayment feature until the contingent event occurs. Another would be to determine the fair value of the prepayment feature based solely on changes in the benchmark interest rate and then multiply this value by the probability of the non-interest related contingent event occurring.

The Board may provide additional clarity on this issue in redeliberations.

#### **Partial-term hedges**

ASC 815 currently permits designating one or more contractual cash flows in a financial instrument (e.g., the first three years of interest rate payments on a five-year fixed-rate debt instrument) as the hedged item in a fair value hedge. However, it includes an example<sup>14</sup> that indicates that it would likely be difficult to find a derivative instrument that will be highly effective as a fair value hedge of selected fixed cash flows of a financial instrument. This lack of effectiveness would result from the fact that the hedging instrument (e.g., a three-year receive fixed, pay floating interest rate swap) and the hedged item (e.g., five-year fixed-rate debt) would react differently to changes in interest rates because the principal repayment of the debt occurs on a different date than the swap's maturity.

Stakeholders have identified the inability to hedge selected fixed interest rate payments in a fair value hedge as one of the weaknesses of the current hedge accounting model. They note that many entities view the purpose of their risk management activities as managing cash

flows (i.e., managing fixed versus variable cash flows) rather than managing instruments. They also note that the guidance on cash flow hedges allows entities to convert variable cash flows into fixed cash flows for a portion of the hedged item.

The proposal would address this inconsistency by allowing entities to measure the change in the fair value of the hedged item attributable to interest rate risk using an assumed term that begins with the first hedged cash flow and ends with the last hedged cash flow. That is, when measuring the change in the fair value of the hedged item attributable to the change in interest rate risk, entities could assume that the maturity of the hedged item, and thus principal repayment, occurs on the date when the last hedged cash flow is due and payable. As a result, partial-term fair value hedges could be highly effective when the assumed terms of the hedged item match those of the hedging instrument.

The following example, which is based on an example provided in the proposal,<sup>15</sup> illustrates this concept.

### Illustration 3 – Fair value hedge of fixed-rate debt using the partial-term approach

On 1 January 20X1, Entity S issues a non-callable, five-year, \$100,000,000 debt instrument with a 3% semiannual interest coupon. On the same date, the issuer also enters into a two-year interest rate swap with a notional amount of \$100,000,000. Entity S designates the swap as a fair value hedge of the fixed-rate debt attributable to benchmark interest rate risk for the first two years of its term. The swap pays LIBOR and receives a fixed rate of 2% (annual rate), with payments made semiannually. The swap has a fair value of zero at inception. The designated benchmark interest rate is the LIBOR swap rate.

To simplify the example, the yield curve is assumed to be flat at the level of the current benchmark interest rate, and there are assumed to be no changes in creditworthiness that would change the effectiveness of the relationship.

Entity S elected to calculate fair value changes in the hedged item attributable to benchmark interest rate risk based on the benchmark component of the contractual coupon cash flows of the hedged item determined at hedge inception.

At 30 June 20X1, the LIBOR swap rate increased by 50 basis points to 2.5% (annual rate). The change in fair value of the interest rate swap for the period 1 January 20X1 to 30 June 20X1 is a decline of \$731,633, calculated as follows:

- ▶ Receive fixed leg = semiannual fixed rate of 1% x \$100,000,000 notional = \$1,000,000 each period. Present value of fixed leg =  $[(1,000,000/(1.0125)^1) + (1,000,000/(1.0125)^2) + (1,000,000/(1.0125)^3)] = \$2,926,534$
- ▶ Pay floating leg (based on flat yield curve) = semiannual floating rate of 1.25% x (\$100,000,000) notional = (\$1,250,000) each period. Present value of floating leg =  $[(1,250,000/(1.0125)^1) + (1,250,000/(1.0125)^2) + (1,250,000/(1.0125)^3)] = (\$3,658,167)$

In calculating the change in fair value of the debt attributable to changes in the benchmark interest rate, Entity S assumes the debt has the same maturity as the hedging instrument (i.e., two years). The change in fair value of the debt attributable to changes in the benchmark interest rate for the period 1 January 20X1 to 30 June 20X1 is a gain of \$731,633, calculated as follows:

- ▶ Beginning balance (discounted using semiannual rate of 1% on 1 January 20X1) =  $(1,000,000/(1.01)^1) + (1,000,000/(1.01)^2) + (1,000,000/(1.01)^3) + (101,000,000/(1.01)^4) = \$100,000,000$

▸ Ending balance (discounted using semiannual rate of 1.25% on 30 June 20X1) =  $(1,000,000/(1.0125)^1) + (1,000,000/(1.0125)^2) + (101,000,000/(1.0125)^3) = \$99,268,367$

By assuming the maturity of the debt is the same as the maturity of the hedging instrument and using the benchmark coupon rate to compute the change in fair value of the hedged item due to changes in the benchmark interest rate, Entity S determines that the change in fair value of the hedged item perfectly offsets the change in fair value of the hedging instrument.

While this example relates to a hedge of the first two years of interest payments associated with an existing financial instrument, the proposal would permit an entity to hedge any consecutive interest payments associated with an existing financial instrument.

The proposal also clarifies how permitting partial-term fair value hedging would interact with the guidance on portfolio hedges and the requirements for using the shortcut method.

#### **Portfolio hedges**

ASC 815-20-25-12(b)(1) requires that if similar assets or similar liabilities are aggregated and hedged as a portfolio, the individual assets or individual liabilities must share the risk exposure for which they are designated as being hedged. The change in fair value attributable to the hedged risk for each individual item in a hedged portfolio is expected to respond in a generally proportionate manner to the overall change in fair value of the aggregate portfolio attributable to the hedged risk.

In a partial-term hedge of interest rate risk, the proposal would allow entities to determine whether a group of fixed-rate financial instruments meets this requirement by considering the assumed maturity of the instruments in the portfolio (i.e., the term of the cash flows designated as being hedged) rather than the contractual maturity of these instruments. For example, assuming all other requirements were met, an entity could hedge only the first four years of interest coupons in a portfolio of fixed-rate loans with various scheduled maturity dates that exceeded four years.

#### **Shortcut method**

The proposal would allow entities to apply the shortcut method to partial-term fair value hedges of interest rate risk even though the expiration date of the interest rate swap used as the hedging instrument does not match the actual maturity date of the interest-bearing asset or liability being hedged. As long as all other criteria to apply the shortcut method are satisfied, an entity could apply the shortcut method as the assumed maturity date of the hedged item would be deemed to match the expiration date of the hedging instrument.

One of the criteria to qualify for the shortcut method is that the interest-bearing asset or liability being hedged can generally not be prepayable.<sup>16</sup> However, under the proposal, the shortcut method could be applied to partial-term hedges of fixed-rate financial instruments that are prepayable, as long as the instrument cannot be prepaid before its assumed maturity date (and all other criteria to qualify for the shortcut method are satisfied).

For example, assume Company X issued a 10-year fixed-rate instrument with an embedded call option that was exercisable only after year seven. The proposal would permit Company X to designate a fair value hedge of interest rate risk for a term ending any time prior to the date the call option becomes exercisable in year seven and qualify for the shortcut method, assuming all other conditions for that method are met.

The proposal would allow entities to apply the shortcut method to partial-term fair value hedges of interest rate risk.

## Proposed amendments to cash flow hedges

### Recognition and presentation of the effects of hedging instruments

Under today's guidance, the change in the fair value of the hedging instrument included in the effectiveness assessment of a cash flow hedge is split into two components: (1) the effective portion and (2) the ineffective portion. The ineffective portion is the amount by which the cumulative change in the fair value of the hedging instrument exceeds the cumulative change in expected cash flows on the hedged transaction from the inception of the hedging relationship. ASC 815 provides various ways to calculate the cumulative change in expected cash flows of the hedged transaction. For example, ASC 815-30-35 provides the following approaches for hedges involving interest rate swaps: (1) the change-in-variable-cash-flows method, (2) the hypothetical-derivative method and (3) the change-in-fair-value method.

Currently, an entity is required to measure and immediately recognize in earnings any ineffectiveness related to a cash flow hedge, although ASC 815 does not specify the income statement line where ineffectiveness should be presented. The effective portion of the change in the fair value of the hedging instrument is deferred in AOCI until the hedged transaction affects earnings, and it is then reclassified from AOCI to the same income statement line as the earnings effect of the hedged item.

The proposal would eliminate the requirement to separately measure and report ineffectiveness. Instead, the entire change in the fair value of the hedging instrument included in the assessment of hedge effectiveness would be deferred in AOCI until the hedged transaction affects earnings. At that time, this amount would be reclassified from AOCI to the same income statement line as the earnings effect of the hedged item.

### **How we see it**

While the proposal would eliminate the current requirement to separately measure and report ineffectiveness, the extent to which a hedging instrument does or does not offset changes in the fair value or cash flows of the hedged item would still be important for cash flow hedges.

To initially qualify for hedge accounting, an entity must expect the hedging instrument to be highly effective at offsetting changes in the fair value or cash flows attributable to the hedged risk during the period that the hedge is designated. To maintain hedge accounting, an ongoing assessment of hedge effectiveness indicating that the hedging instrument has been, and is expected to continue to be, highly effective at offsetting these changes is required. Although the FASB didn't define the term "highly effective" in the proposal, practice has consistently interpreted the term to mean an offset of 80% to 125%.

Even for hedging relationships determined to be highly effective, the income statement line where the hedged item is reported will ultimately be affected if the hedging instrument is not perfectly effective at offsetting changes in the fair value or cash flows attributable to the hedged risk. Any mismatch will be reported in this line item when the hedged transaction affects earnings.

### ***Excluded components***

As previously noted, under ASC 815, an entity may elect to exclude the time value associated with option and forward contracts used as hedging instruments from the assessment of hedge effectiveness. Changes in these excluded components are recognized in earnings immediately. While current guidance does not specify the income statement line in which these amounts should be presented, many companies present them in other income or expense.

The proposal would require changes in these excluded components to be presented in the same income statement line item as the earnings effect of the hedged item as illustrated in the following example.

#### **Illustration 4 – Presentation of excluded component**

Entity A manufactures gold watches and forecasts the purchase of 1,000 troy ounces of gold in the next six months. To hedge against a price increase above \$1,300/troy ounce in the next six months, Entity A purchases an option that provides it with the right, but not the obligation, to purchase 1,000 troy ounces of gold at a fixed price of \$1,300/troy ounce. If the market price does not exceed that strike price, the option will expire unexercised. The purchase price of the option is \$1 million, which represents the time value of the option at inception.

Assume that Entity A designates the purchased option in a cash flow hedging relationship and elects to assess hedge effectiveness based solely on the option's intrinsic value, pursuant to ASC 815-20-25-82 and 815-30-35-3. While changes in the option's intrinsic value would be deferred in AOCI and reclassified to cost of goods sold when the gold watches are ultimately sold, changes in the option's time value would be recognized immediately in cost of goods sold. As result, the decay of the option's time value could affect Entity A's reported cost of goods sold over multiple periods before the watches are sold.

Although some may consider these excluded amounts to be outside of the hedging relationship since they are not considered when assessing hedge effectiveness, the Board believes these amounts, along with the effective and ineffective portions of the hedging relationship, represent the total cost of hedging. As such, the proposal would require the entire change in the fair value of the hedging instrument in a cash flow hedge to be presented in the same income statement line item as the earnings effect of the hedged item.

#### **How we see it**

The proposal would require entities to present changes in any excluded components in the income statement line where the effect of the hedged item is reported, but does not amend the existing requirement in US GAAP that these changes be recognized in earnings immediately. This could create volatility in these line items that stems not only from the proposed presentation requirement but also from the mismatch in the timing of when the excluded amount is recognized in earnings and when the hedged item and the rest of the changes in the fair value of the hedging derivative are recognized in earnings.

One potential fix the FASB could consider to address concerns about volatility distorting key income statement line items would be to allow the change in excluded time value of the hedging instrument to be deferred and recognized in earnings at the same time the hedged item affects earnings. Such an approach would be consistent with the treatment of these amounts under IFRS 9 and the treatment of an option's time value under US GAAP when hedge effectiveness is based on an option's terminal value. Alternatively, the FASB could consider allowing the time value of the hedging instrument to be recognized in earnings on a systematic and rational basis over the life of the hedge, if this amount is excluded from the assessment of hedge effectiveness.

The following chart compares the recognition and presentation requirements for the various components of the change in a hedging instrument's fair value under today's guidance and under the proposal:

Hedging instrument's change in fair value	Cash flow hedges			
	Current guidance		Proposed guidance	
	Recognition	Income statement presentation	Recognition	Income statement presentation
Ineffective portion*	Immediately in earnings	No guidance	AOCI until hedged item affects earnings	Same line item as hedged item effect
Effective portion*	AOCI until hedged item affects earnings	Same line item as hedged item effect	AOCI until hedged item affects earnings	Same line item as hedged item effect
Excluded component (e.g., time value of an option)	Immediately in earnings	No guidance	Immediately in earnings	Same line item as hedged item effect

\* These amounts are included in the assessment of hedge effectiveness.

Amounts reclassified from AOCI due to a missed forecasted transaction would be presented where the hedged item would have affected earnings.

#### ***Missed forecasted transactions***

When it becomes probable that a forecasted transaction will not occur within the originally specified time period (as documented at the inception of the hedging relationship) or two months thereafter (as provided for in ASC 815-30-40-4), the hedging relationship must be dedesignated, and any deferred gains and losses on the derivative instrument that have been recorded in AOCI must be reclassified into earnings. ASC 815 does not currently specify the income statement line where this amount should be presented.

The proposal would require that the amount reclassified from AOCI in these situations be presented in the same income statement line as the effect of the hedged item had the transaction occurred within the required time period. This presentation is consistent with the Board's view that the entire change in the fair value of the hedging instrument should be considered part of the cost of hedging and, therefore, presented in the same income statement line as the effect of hedged item. The Board notes in paragraph BC64 of the proposal that it believes that changes in the fair value of the hedging derivative represent a cost of hedging, regardless of whether the forecasted transaction occurs.

#### **Component hedging**

US GAAP currently contains limitations on how an entity can designate the hedged risk in certain cash flow hedging relationships. The proposal would expand the types of permissible hedging strategies to include hedging the variability in cash flows due to changes in:

- ▶ A contractually specified component in the forecasted purchase or sale of a nonfinancial asset
- ▶ A contractually specified variable interest rate in a variable-rate financial instrument

The Board believes that expanding the ability for entities to hedge specific risk components would result in financial reporting that more accurately reflects an entity's risk management activities. In addition, the Board believes that designating the variability in cash flows attributable to changes in a contractually specified component or interest rate as the hedged risk is objective and would be relatively straightforward to apply.

### ***Nonfinancial items***

Except for foreign exchange risk, ASC 815 does not currently allow entities to hedge risk components related to the forecasted purchase or sale of a nonfinancial asset such as a commodity. For example, if an entity wants to hedge the price risk related to the forecasted purchase or sale of a commodity, it is required to designate changes in the total price of the commodity as the hedged risk. The total price to purchase or sell a commodity at a specific location typically comprises a base price or market index (e.g., New York Mercantile Exchange or NYMEX price of natural gas at Henry Hub in Louisiana) and a basis differential related to the location and/or the grade of the commodity involved (e.g., transportation costs, quality, supply and demand).

However, many entities employ hedging strategies that focus on hedging a particular component of the total price. As a result, the current requirement that the hedged risk be designated as the variability in total price leads to the recognition of ineffectiveness or, in some cases, the failure to qualify for hedge accounting. This is the case even though the variability that creates the ineffectiveness, or the inability to apply hedge accounting, typically results from a factor (e.g., basis risk) that the entity never intended to hedge.

By allowing entities to hedge nonfinancial risk components, the proposal would resolve for components that are contractually specified, what many have long believed to be a fundamental weakness in the existing hedge accounting model.

### ***Contractually specified components***

The proposal would define a contractually specified component as an index or price explicitly referenced in an agreement to purchase or sell a nonfinancial asset other than an index or price calculated or measured solely by reference to an entity's own operations. An example of this would be a contract for the sale of natural gas that is contractually linked to the Henry Hub (Louisiana) NYMEX price (i.e., Henry Hub, plus or minus a basis differential).

### **How we see it**

While the proposed definition of a contractually specified component refers to an index or price explicitly referenced in an agreement, the proposal does not define what constitutes an agreement.

As such, it is not clear whether the counterparties would be required to have a legally binding obligation to provide a payment or product (e.g., a commodity) before the transaction is executed. For example, it is not clear whether an entity could designate a contractually specified component as the hedged risk in the forecasted purchase or sale of a commodity in the spot market if it receives an invoice or receipt at the time of purchase or sale that specifies how the spot price was determined (i.e., the spot price is decomposed).

If the FASB clarifies that a component needs to be specified in a legally binding agreement, this could limit an entity's ability to hedge contractually specified components in certain situations.

The following illustration, which is based on an example in the proposal,<sup>17</sup> shows how a contractually specified risk component can be defined and assessed for hedge effectiveness.

**Illustration 5 – Cash flow hedge of a contractually specified component in a forecasted purchase of a nonfinancial asset**

An entity manufactures keys for door locks. On 1 January 20X1, the entity enters into an agreement with a supplier to purchase 100,000 key plates on 1 July 20X1. The contract specifies a per-unit purchase price comprising the spot price of COMEX copper, the spot price of COMEX zinc, the current cost of refining copper and zinc into key plates and the current cost of transporting the key plates to the entity as of the delivery date. The key plates will require 10,000 pounds of copper for the manufacturing process.

The entity would like to hedge the variability in the cost of the key plates attributable only to the change in the price of copper. Therefore, on 1 January 20X1, the entity enters into a forward contract to purchase 10,000 pounds of COMEX copper on 1 July 20X1 at a fixed price and designates it in a cash flow hedge of the forward purchase of key plates for the variability in the purchase price attributable to changes in the COMEX copper price index.

As long as all of the critical terms of the hedging relationship match (i.e., notional, index and settlement date), the hedging relationship would be perfectly effective. However, the entity's assessment of effectiveness would need to incorporate the effect of a change in timing if the hedging instrument's maturity date and the date on which the price of the copper component is expected to be fixed no longer match.

The proposal would permit an entity to designate the variability in cash flows attributable to changes in a contractually specified component as the hedged risk in the forecasted purchase or sale of a nonfinancial asset for a period longer than the contractual term of the agreement or for a not-yet-existing contract to purchase or sell a nonfinancial asset. However, all the conditions required to hedge a nonfinancial component (including the additional criteria discussed below) would need to be met in the future contract, as well as all the other requirements for cash flow hedge accounting.

The following example, which is based on an example in the proposal,<sup>18</sup> illustrates the designation of a contractually specified component in a contract that doesn't exist yet.

**Illustration 6 – Hedge of a contractually specified component in a contract that doesn't exist yet**

Entity A's objective is to hedge the variability in cash flows attributable to changes in a contractually specified component to purchase soybeans in six months, on 30 June 20X1.

Entity A only purchases soybeans from Supplier Z, and Entity A only has executed contracts to purchase soybeans from Supplier Z from 1 January 20X1 through 31 March 20X1. All of Entity A's contracts to purchase soybeans from Supplier Z are based on the ABC soybean index price, plus a basis differential for transportation costs that varies. Entity A expects that the forecasted transaction to purchase soybeans from Supplier Z on 30 June 20X1 will be based on the ABC soybean index price, plus a basis differential.

On 1 January 20X1, Entity A designates the variability in cash flows attributable to changes in the contractually specified ABC soybean index in the contract it expects to enter into as the hedged risk in a cash flow hedging relationship. (Although Entity A designates this hedging relationship on 1 January 20X1, it could enter into a derivative and designate it as the hedging instrument in a hedging relationship at any time before it enters into the contract on 31 March 20X1.)

On 31 March 20X1, Entity A enters into a contract with Supplier Z to purchase soybeans on 30 June 20X1. If the contract references a different contractually specified component than the designated ABC soybean index or the contract is a fixed-price contract, Entity A would discontinue hedge accounting in accordance with the guidance in ASC 815-30-40-1 through 40-6 because the designated hedged risk is not present in the executed contract. If it is still probable that the hedged forecasted cash flows will occur, the net gain or loss on the hedging instrument in AOCI would not be reclassified into earnings immediately. Instead, Entity A would reclassify amounts from AOCI to earnings when the hedged forecasted transaction affects earnings in accordance with ASC 815-30-35-38 through 35-41 and present those amounts in the same income statement line item as the earnings effect of the hedged item.

Immediate reclassification would be required only if it becomes probable that the hedged forecasted transaction (that is, the purchase of soybeans on 30 June 20X1) will not occur. As discussed in ASC 815-30-40-5, if an entity has a pattern of determining that it is not probable that hedged forecasted transactions will occur, that would call into question both the entity's ability to accurately predict forecasted transactions and the propriety of applying cash flow hedge accounting for similar forecasted transactions in the future.

As noted in the example above, if the contract that is executed references a contractually specified component that differs from the contractually specified component that was designated at hedge inception or is a fixed-price contract, the entity would discontinue the hedging relationship because the designated hedged risk would not be present in the executed contract. However, unless it becomes probable that the hedged forecasted transaction (i.e., the purchase of soybeans) will not occur on 30 June 20X1, or within two months thereafter, the gain or loss on the hedging instrument previously deferred will remain in AOCI until the hedged forecasted transaction affects earnings.

### How we see it

Although the proposed guidance on hedging nonfinancial risk components would benefit many companies, some entities would likely continue to be required to designate the total price risk as the hedged risk related to the forecasted purchase or sale of nonfinancial assets.

This would be the case if the component the entity wishes to hedge is not contractually specified. For example, many airlines hedge forecasted purchases of jet fuel with crude oil derivatives. Because a purchase contract for jet fuel generally does not specify the crude oil price as a component of the total price, an airline would not be permitted to designate only changes in the crude oil price as the hedged risk, even though the price of crude oil and the price of jet fuel may be highly correlated. The airline would be required to designate the hedged risk as the total purchase price of the jet fuel.

Another example would be entities that purchase commodities using fixed-price contracts. In many instances, because a fixed-price contract can only be entered into one to two months prior to delivery of the product, entities will hedge the variability in the commodity price they are exposed to prior to entering the fixed-price contract (i.e., the variability in price from the date the forecasted purchase is deemed probable, which may be six months in advance of delivery, to the date when the fixed-price contract is entered into, which may be one month prior to delivery). In these situations, the example in the proposal would suggest that an entity would be required to continue to hedge the variability in the total price risk (including basis risk) during this period.

It should be noted that if the hedging relationship is highly effective, the effect of a cash flow hedge on the entity's financial statements would be virtually identical, regardless of whether the designated risk is the total price risk or a component of the total price risk. This is because under the proposal, the entire change in fair value of the derivative included in the assessment of a highly effective cash flow hedge would be deferred in AOCI and recognized in the income statement line affected by the hedged item only when that hedged item affects earnings.

However, hedges of total price risk have a greater likelihood of losing hedge accounting (e.g., due to volatility in the basis) and could require additional effort to assess hedge effectiveness.

In addition to requiring the index or price to be contractually specified, the proposal would require the following conditions to be met for an entity to designate a nonfinancial component as the hedged risk in a cash flow hedge:

- ▶ The purchase or sale contract for the nonfinancial asset creates an exposure related to the variability in cash flows attributable to the contractually specified component throughout the life of the hedging relationship.
- ▶ The stated components of the price of the nonfinancial contract all relate to the cost of purchasing or selling the nonfinancial asset in the normal course of business in a particular market (e.g., transportation costs, labor costs, local supply and demand factors).
- ▶ All of the stated components of the price of the nonfinancial contract reflect market conditions at contract inception (e.g., transportation costs reflect market conditions for the distance between the supplier and the customer).

It's important to note that the first condition listed above would not prevent an entity from hedging a contractually specified component that is limited by a cap or floor, even when the hedging instrument does not contain a similar cap or floor. However, in these instances, the effect of the price cap or floor in the hedged item must be considered when establishing whether the hedging relationship will be highly effective in accordance with the guidance in ASC 815-20-25-75, 25-79(a) and 25-100. This is consistent with the requirements for other hedging relationships where the hedged exposure is limited and the hedging instrument is not (e.g., debt with an embedded floor at 0% hedged with a plain vanilla interest rate swap).

The second and third conditions are intended to address the Board's concerns that an entity could (1) inappropriately elect hedge accounting by fabricating a contractually specified component to which the entity does not have price exposure and then enter into a derivative to hedge that component or (2) specify a component in a contract that it may not have price exposure to if other terms of the contract are written in a way that the exposure to the component is mitigated or eliminated.

#### ***Financial items***

Under today's guidance, entities are limited to hedging benchmark interest rates in cash flow hedges of variable-rate financial instruments. Accordingly, if a variable-rate financial instrument is indexed to a nonbenchmark interest rate, entities are required to designate the overall variability in cash flows as the hedged risk. The proposal would allow an entity to designate any contractually specified interest rate in a variable-rate financial instrument as the hedged risk in a cash flow hedge. For example, an entity could hedge the variability in cash flows of a variable-rate financial instrument due to changes in the prime rate, as long as this rate is contractually specified in the instrument. This guidance would apply to cash flow hedges of existing variable-rate financial instruments, as well the forecasted issuance or purchase of a variable-rate financial instrument.

Component hedging for variable-rate financial instruments would be expanded beyond benchmark interest rates.

The proposal would also provide guidance on designating a hedge of interest rate risk associated with a forecasted issuance or purchase of a debt instrument if the entity does not know at the designation date whether the debt will have fixed or variable interest rate payments. In this case, the interest rate designated as the hedged risk would be required to qualify both as a benchmark interest rate (for the purchase or sale of fixed-rate debt) and as a contractually specified interest rate (for the purchase or sale of variable-rate debt). Therefore, any benchmark rate specified in ASC 815 (e.g., LIBOR) would meet this requirement as long as it is contractually specified when a variable-rate debt instrument is issued or purchased.

### **Critical terms match method of assessment**

Under today's guidance, certain cash flow hedging relationships are assessed qualitatively by comparing the critical terms of the hedging instrument with those of the hedged item every period. If the critical terms match, an entity may assume that the hedging relationship is perfectly effective and, therefore, highly effective retrospectively and prospectively.

While the SEC staff historically interpreted "match" to mean "match exactly," the staff's comments at an Emerging Issues Task Force meeting in 2007 led to the development in practice of what is known as the "de minimis" test. Under this approach, the critical terms match method can be applied when the terms of the hedging instrument do not exactly match those of the hedged item if a quantitative analysis is performed at hedge inception to support an assertion that any ineffectiveness would not exceed a de minimis amount. This approach is often applied to a cash flow hedge of a group of forecasted transactions using a single hedging instrument (e.g., hedging variability in monthly sales denominated in a foreign currency due to changes in foreign exchange rates with a single foreign exchange forward contract).

The proposal would allow an entity to apply the critical terms match method to a group of forecasted transactions without performing a de minimis test if the forecasted transactions occur within the same 31-day period as the maturity of the hedging derivative.

The Board views this proposed amendment as a reasonable accommodation for hedges of groups of forecasted transactions that occur within a narrow time frame that otherwise would meet all of the criteria to apply the critical terms match method. This is based on the Board's belief that when a single derivative is designated and is highly effective as a hedge of a group of exposures in which the settlement of individual transactions and the derivative instrument occur within the same 31-day period but on different days, any mismatches between the change in the fair value of the hedging instrument and the individual hedged forecasted transactions would be minimal.

The following illustration highlights how this approach would be applied.

#### **Illustration 7 – Proposed 31-day rule for applying critical terms match**

Company A, whose functional currency is US dollars, expects to have euro-denominated sales throughout the year. To limit its exposure to the dollar/euro exchange rate over the next year, Company A designates a series of forward contracts to buy US dollars and sell euros as the hedging instruments in cash flow hedges of its forecasted monthly euro sales in each of the next 12 months. Each forward contract hedges the first 1 million euros in sales each month. The forward contracts mature at the end of each month in which the forecasted sales occur.

Because the hedged forecasted monthly sales occur within the same 31-day period as the forward contracts' maturities, Company A could elect to assess hedge effectiveness using the critical terms match method without performing a quantitative analysis to support that any ineffectiveness would not exceed a de minimis amount.

## How we see it

This accommodation would apply only to a group of forecasted transactions, not to hedges of individual forecasted transactions. That is, the proposal would not provide a 31-day “window” for individual forecasted transactions to qualify for use of the critical terms match method or to continue to use this method if any of the critical terms have changed.

For example, an entity that initially assesses the effectiveness of a cash flow hedge of a single forecasted transaction using the critical terms match method (because its best estimate of the timing matches the terms of the hedging instrument) would be required to perform subsequent quantitative assessments of hedge effectiveness if the expected timing of the forecasted transaction changes (even if the expected change in timing is less than 31 days).

## Foreign currency hedges

The proposal would continue to permit the following hedges of foreign currency exposure:

- ▶ A fair value hedge of an unrecognized firm commitment or a recognized asset or liability (including an available-for-sale security)
- ▶ A cash flow hedge of any of the following:
  - ▶ A forecasted transaction
  - ▶ An unrecognized firm commitment
  - ▶ The forecasted functional-currency-equivalent cash flows associated with a recognized asset or liability
  - ▶ A forecasted intra-entity transaction
- ▶ A hedge of a net investment in a foreign operation

The proposed amendments to the guidance on cash flow and fair value hedges discussed in the previous sections of this publication would also apply to cash flow and fair value hedges of foreign currency exposures. While the same is generally true for net investment hedges, certain aspects of the proposal differ.

### Recognition and presentation of the effects of hedging instruments

The entire change in the fair value of a hedging instrument included in the assessment of hedge effectiveness in a net investment hedge would be recorded in the cumulative translation adjustment (CTA) section of AOCI. That amount would remain in the CTA section of AOCI until the period in which the hedged item affects earnings (e.g., the foreign subsidiary is sold). At that time, the amount in the CTA section of AOCI would be reclassified to the same income statement line where the earnings effect of the hedged item is presented

Today’s guidance on net investment hedges requires measuring and recognizing immediately in earnings any ineffectiveness, regardless of whether the relationship is underhedged or overhedged. Therefore, the proposal to eliminate the requirement to separately measure and report ineffectiveness could be viewed as having a greater effect on net investment hedges than on cash flow hedges for which ineffectiveness is currently recognized only for overhedges. In addition, because amounts accumulated in the CTA section of AOCI are not released until a sale or liquidation of the hedged investment in a foreign entity, “ineffectiveness” under the proposal that would be deferred in the CTA section of AOCI may never be recognized in earnings.

**Excluded components**

The proposal would not require the change in time value excluded from the assessment of a net investment hedge to be presented in the same income statement line as the earnings effect of the hedged item. Like today's guidance, the proposal would not specify the income statement line in which excluded components in net investment hedges should be presented.

The Board noted in paragraph BC77 of the proposal that requiring the excluded component in a net investment hedge to be presented in the same income statement line as the earnings effect of the hedged item could result in the presentation in a line item called "gain or loss on the sale of subsidiary," when a sale did not occur in the current period and may not occur within a reasonable time period, if at all. The Board did not believe that mandating this presentation would be an improvement to financial reporting.

The following chart compares the recognition and presentation requirements for the various components of the change in a hedging instrument's fair value under today's guidance and under the proposal:

Hedging instrument's change in fair value	Net investment hedges			
	Current guidance		Proposed guidance	
	Recognition	Income statement presentation	Recognition	Income statement presentation
Ineffective portion*	Immediately in earnings	No guidance	CTA until hedged item affects earnings	Same line item as hedged item effect
Effective portion*	CTA until hedged item affects earnings	Same line item as hedged item effect	CTA until hedged item affects earnings	Same line item as hedged item effect
Excluded component (e.g., time value of an option)	Immediately in earnings	No guidance	Immediately in earnings	No guidance

\* These amounts are included in the assessment of hedge effectiveness.

**Disclosures**

The proposal would modify the disclosure requirements for both interim and annual reporting periods. The Board believes the proposed changes would enhance disclosures of an entity's hedging activities and the effect those activities have on the financial statements. The proposed disclosures include:

- ▶ A revised tabular disclosure that shows the effect of hedge accounting by income statement line
- ▶ The cumulative basis adjustment to the hedged item in fair value hedges
- ▶ A description of any quantitative goals of the entity's hedging program and whether they were met

The proposal would not specify the income statement line where excluded components in net investment hedges should be presented.

***Tabular disclosures that show the effect of hedge accounting by income statement line***

The proposal would amend the tabular disclosure requirements regarding the effect of hedge accounting on the income statement as follows:

- ▶ For fair value, cash flow and net investment hedges, the current requirement to disclose the ineffective portion of gains and losses on hedging instruments and related hedged items would be eliminated because this amount would no longer be separately measured and reported.
- ▶ For fair valued hedges, entities would be required to include in the tabular disclosures the amount of periodic gains and losses on hedged items, as well as the amount of gains and losses on hedging instruments excluded from the assessment of effectiveness.
- ▶ For fair value and cash flow hedges, entities would be required to disclose the total amount of each income and expense line in the income statement in which hedge accounting adjustments have been recorded, as well as the amount of gains and losses from both hedging instruments and hedged items that are included in these line items, so that users would have all relevant information in one location.

The FASB believes these proposed changes would not require entities to generate any new information and would better reflect the results of its proposed cost of hedging model where the full change in the fair value of the designated hedging instrument would be presented in the same income statement line item as the earnings effect of the hedged item.

***The cumulative basis adjustment to the hedged item in fair value hedges***

Under today's guidance, an entity is required to disclose the periodic basis adjustments to the hedged item in a fair value hedge, either in a tabular or non-tabular format. The proposal would require the following additional information to be disclosed regarding the hedged item in a fair value hedge:

- ▶ The carrying value of the hedged item recognized in the statement of financial position
- ▶ The cumulative amount of fair value hedging adjustments to the hedged item included in the carrying amount of the hedged item recognized in the statement of financial position
- ▶ The specific line in the statement of financial position that includes the hedged item
- ▶ The cumulative amount of fair value hedging adjustments remaining for any hedged items for which hedge accounting has been discontinued

The Board believes the additional disclosures would assist users in evaluating the amount, timing and uncertainty of prospective cash flows associated with hedged assets or liabilities.

***A description of the quantitative goals of the entity's hedging program***

US GAAP currently requires an entity that holds or issues derivative instruments (or nonderivative instruments that are designated as hedging instruments) to disclose the following:

- ▶ Its objectives for holding or issuing those instruments
- ▶ The context needed to understand those objectives
- ▶ Its strategies for achieving those objectives

To help users better understand an entity's objectives and success in hedging its risk exposures, the proposal would require an entity to disclose its quantitative goals, if any, that it sets when developing its hedging objectives and strategies and whether it met those goals. The proposal provides an example of an entity disclosing that its goal is to apply hedge accounting to 80% of forecasted commodity purchases in 20X3, 20X2 and 20X1, and that this goal was met.

This disclosure requirement would relate only to hedge accounting activities that have occurred in the current and prior financial reporting periods.

### How we see it

It is not clear to us whether requiring entities to disclose their quantitative hedge accounting goals, if any, and whether those goals were met would result in decision useful information for financial statement users. Because this disclosure would focus solely on an entity's hedge accounting objectives and would not include information about the entity's broader risk management strategies, the information would potentially be incomplete and its usefulness would seem to be limited. For instance, many financial institutions manage their exposure to interest rate risk through a variety of techniques that might include offsetting interest-bearing asset and liability positions, entering into economic hedges, and electing the fair value option as a means to reduce earnings volatility resulting from accounting mismatches, in addition to entering into strategies that qualify for hedge accounting.

Even when only strategies to which hedge accounting is applied are used, the proposed disclosures may not include all relevant information. Consider a USD functional reporting entity that has forecasted future monthly revenues and expenses in euros (e.g., forecasted revenue of 1,000 euros and forecasted expenses of 700 euros). Economically, this entity would like to hedge its net margin in euros (i.e., 300 euro). However, because ASC 815 prohibits hedging offsetting exposures on a net basis, from an accounting perspective the entity would need to document that it was hedging an amount of either its forecasted gross euro-denominated revenues or euro-denominated expenses (e.g., hedging the first 300 of monthly euro revenue). Requiring this entity to disclose that its quantitative goal was to hedge 30% of its monthly euro denominated revenue would not provide useful information about its actual risk management strategy.

### Transition

Entities would apply the proposal on a modified retrospective basis to hedging relationships that exist at the date of adoption. Existing relationships would be those in which the hedging instrument has not expired, been sold, terminated or exercised or relationships that the entity has not dedesignated.

The proposal would not apply to amounts in AOCI as of the adoption date that relate to hedging relationships that no longer exist (e.g., amounts associated with a cash flow hedge of interest rate risk related to the forecasted issuance of fixed-rate debt where the hedging relationship was terminated years earlier when the debt was issued).

For existing cash flow and net investment hedges, an entity would record the cumulative effect of applying the proposal as an adjustment to the opening balance of retained earnings as of the most recent period presented at the date of adoption with an offsetting adjustment to AOCI.

## How we see it

We believe this approach is superior to either a prospective or full retrospective transition approach when considered from a cost/benefit perspective. Transition on a prospective basis could result in entities needing to apply two different hedge accounting models until their existing hedges expire. Full retrospective transition would also be costly and complex because it would require entities to apply the guidance to hedging relationships that no longer exist as of the date of adoption.

However, it's worth noting that applying the modified retrospective approach could result in previously recognized hedge ineffectiveness for cash flow hedges being reported through earnings more than once. Consider an existing hedge of a single cash flow with ineffectiveness of \$100 that has been recognized in earnings prior to adoption. Under the proposal, this amount would be recorded in AOCI upon adoption with an offset to beginning retained earnings. When the hedged item affects earnings, this amount could once again be recorded in earnings as part of the reclassification of amounts in AOCI to earnings.

The proposed disclosure requirements would be required only prospectively. As such, an entity would continue to provide disclosures in accordance with the current guidance for comparative periods before the date of adoption. However, in accordance with the requirements of ASC 250, an entity would need to disclose the following information in each interim and annual financial statement period in the fiscal year of adoption:

- The nature of and reason for the change in accounting principle
- The cumulative effect of the change on the opening balance of each affected component of equity or net assets in the statement of financial position as of the date of adoption

The Board will set an effective date after it considers feedback on the proposal. However, the proposal indicates that early adoption would be permitted at the beginning of any fiscal period before the effective date.

### **One-time elections**

The proposal would provide three one-time elections an entity could use to apply aspects of the proposal to existing hedging relationships.

#### ***Subsequent qualitative assessments***

During the first fiscal year after adoption, an entity would be able to elect to modify its hedge documentation of an existing hedging relationship to specify that subsequent prospective and retrospective effectiveness assessments will be performed qualitatively rather than quantitatively.

#### ***Misapplication of shortcut method***

During the first fiscal year after adoption, an entity would be able to elect to modify its hedge documentation for existing hedging relationships assessed under the shortcut method to specify a quantitative assessment methodology to be used if it determines that it inappropriately applied the shortcut method.

#### ***Hedging contractually specified components in a cash flow hedge***

Before its first quarterly assessment of effectiveness after adoption, an entity would be able to elect to amend its hedge documentation for existing cash flow hedging relationships to specify the hedged risk as a contractually specified component (for nonfinancial items) or a contractually specified interest rate (for variable-rate financial instruments).

Early adoption of the proposal would be permitted at the beginning of any fiscal period before the effective date.

However, the Board noted that changing the hedged risk would trigger a dedesignation of the existing hedging relationship, and that redesignating the same hedging instrument would likely result in the ongoing hedging relationship being less effective. This is because when the hedge is redesignated, the actual hedging instrument would likely have a fair value that isn't zero, while the hypothetical derivative used to assess hedge effectiveness would have a fair value of zero because its terms are required to be set at market rates as of the hedge inception date.

To allow entities to more accurately reflect their risk management activities immediately upon adoption, the proposal would permit entities to set the market terms of the hypothetical derivative to those that existed on the original hedge inception date rather than the market terms on the date the hedging relationship is redesignated.

### **Transition considerations for fair value hedges of interest rate risk**

The proposal would provide transition guidance for entities that want to incorporate certain of the proposed amendments to their existing fair value hedges of interest rate risk. This could include modifying existing hedging relationships to:

- ▶ Calculate the change in fair value of the hedged item using only the benchmark cash flows
- ▶ Calculate the change in fair value of a prepayable hedged item considering only how changes in the benchmark interest rate affect the decision to exercise an embedded prepayment feature
- ▶ Change the hedged risk from total price risk to interest rate risk related to the SIFMA rate

To make any of these changes to existing fair value hedges of interest rate risk, an entity would be required to dedesignate and redesignate the hedging relationship. However, the proposal provides different guidance with respect to how the effect of these changes would be subsequently accounted for.

For the first two types of changes, the cumulative basis adjustment to the hedged item related to the dedesignated hedging relationship would be carried forward to the hedged item in the redesignated hedging relationship at an amount that would have been recorded if the revised measurement methodology had been used throughout the hedging relationship's life. The change in the basis adjustment of the hedged item would be recorded with a corresponding adjustment to the opening balance of retained earnings on the date of adoption as illustrated below.

#### **Illustration 8 – Election to use only benchmark cash flows upon adoption**

Assume that, upon adoption, an entity elects to incorporate the proposed amendment permitting the change in fair value of the hedged item in a fair value hedge of interest rate risk to be calculated using only benchmark cash flows. As of the adoption date, the entity has one existing fair value hedging relationship of interest rate risk. The hedged item's carrying amount is \$105, which comprises the hedged item's par amount of \$100 and a \$5 basis adjustment that was determined by applying the existing guidance. That is, the change in fair value was calculated using the hedged item's full contractual coupon. The entity has not begun amortizing the basis adjustment pursuant to ASC 815-25-35-9.

Using only the benchmark cash flows, the entity determines that there has been a \$7 change in fair value of the hedged item attributable to the benchmark interest rate from hedge inception to the adoption date. Therefore, upon adoption, the entity would increase the carrying amount of the hedged item by \$2, with an offset to the opening balance of retained earnings.

In contrast, if an entity elects to use the SIFMA Municipal Swap Rate, the cumulative basis adjustment of the hedged item from the dedesignated hedging relationship would be amortized to earnings over the remaining life of the hedged item on a "level-yield" basis. The Board indicated that because the hedged risk has changed, it would not be appropriate for an entity to carry forward the dedesignated hedged item's cumulative basis adjustment to the redesignated hedging relationship.

### Endnotes:

- <sup>1</sup> Proposed Accounting Standards Update, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*.
- <sup>2</sup> ASC 815, *Derivatives and Hedging*.
- <sup>3</sup> Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities* (SFAS 133).
- <sup>4</sup> Proposed Statement of Financial Accounting Standards, *Accounting for Hedging Activities, an amendment of FASB Statement No. 133*.
- <sup>5</sup> Proposed Accounting Standards Update, *Financial Instruments (Topic 825) and Derivatives and Hedging (Topic 815): Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*.
- <sup>6</sup> FASB Discussion Paper, "Selected Issues about Hedge Accounting (Including IASB Exposure Draft, *Hedge Accounting*)."
- <sup>7</sup> Proposed ASC 815-20-55-79G.
- <sup>8</sup> Proposed ASC 815-20-55-79H through 55-79N.
- <sup>9</sup> Proposed ASC 815-20-55-79P through 55-79R.
- <sup>10</sup> Proposed ASC 815-20-55-79S through 55-79U.
- <sup>11</sup> ASC 250, *Accounting Changes and Error Corrections*.
- <sup>12</sup> See remarks by E. Michael Pierce at the 2000 AICPA National Conference on Current SEC Developments.
- <sup>13</sup> Proposed ASC 815-25-55-61A through 55-61C, Example 9: Fair Value Hedge of the LIBOR Swap Rate in a \$100,000 BBB-Quality 5-Year Fixed-Rate Noncallable Note, and proposed ASC 815-25-55-106 through 55-108, Example 16: Fair Value Hedge of the LIBOR Swap Rate in a \$100 Million A1-Quality 5-Year Fixed-Rate Noncallable Debt.
- <sup>14</sup> ASC 815-20-55-5 through 55-8 (formerly part of Statement 133 Implementation Issue F2).
- <sup>15</sup> Proposed ASC 815-25-55-94 through 55-99, Example 15: Fair Value Hedge of Interest Rate Risk using the Partial-Term Approach.
- <sup>16</sup> ASC 815-20-25-104(e).
- <sup>17</sup> Proposed ASC 815-30-55-134 through 55-142, Example 22: Assessing Effectiveness of a Cash Flow Hedge of a Forecasted Purchase of Inventory with a Forward Contract (Contractually Specified Component).
- <sup>18</sup> Proposed ASC 815-20-55-26A through 55-26C.

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## Appendix: Comparison with IFRS 9

The following table highlights certain key differences between the proposal and IFRS 9.

Issue	FASB proposal	IFRS 9
<b>Hedging nonfinancial risk components</b>	Only contractually specified components can be identified and designated as the hedged risk.	Contractually specified or non-contractually specified components (if separately identifiable and reliably measurable) can be identified and designated as the hedged risk.
<b>Hedging financial risk components</b>	For cash flow hedges, only contractually specified components can be identified and designated as the hedged risk.  For fair value hedges, only benchmark interest rates can be separately identified and designated as the hedged risk.	Contractually specified or non-contractually specified components (if separately identifiable and reliably measurable) can be identified and designated as the hedged risk.
<b>Recognition of "ineffectiveness" for cash flow and net investment hedges</b>	"Ineffectiveness" is recorded in AOCI and reclassified to earnings when the hedged item affects earnings (or when it becomes probable that the forecasted transaction being hedged in a cash flow hedge will not occur in the required time period).	Ineffectiveness is recognized through earnings each reporting period. For cash flow hedges the ineffectiveness recorded is limited to overhedges.
<b>Presentation of changes in the fair value of hedging instruments included in the effectiveness assessment</b>	The entire change in fair value of the hedging instruments included in the assessment of hedge effectiveness is presented in the same income statement line item as the earnings effect of the hedged item.	No guidance specifying where the change in fair value of the hedging instrument included in the assessment of hedge effectiveness should be presented.
<b>Recognition and presentation of changes in the fair value of hedging instruments excluded from the effectiveness assessment</b>	For fair value and cash flow hedges, the change in time value excluded from the assessment of hedge effectiveness is recognized in earnings immediately and presented in the same income statement line item as the earnings effect of the hedged item.  For net investment hedges, the change in time value excluded from the assessment of hedge effectiveness is recognized in earnings immediately, but no presentation guidance is provided.  Foreign currency basis spreads are not addressed in the proposal.	The change in time value or the value of foreign currency basis spreads excluded from the assessment of hedge effectiveness is deferred in AOCI and reclassified to earnings based on the nature of the hedged item. For transaction-related hedged items, this amount is reclassified to earnings when the hedged item impacts earnings or reclassified to the carrying amount of the nonfinancial item being hedged when the nonfinancial item is recognized. For time-period related hedged items, the deferred amount is reclassified to earnings on a systematic and rational basis.  No guidance specifying where the change in time value excluded from the assessment of hedge effectiveness should be presented.

Issue	FASB proposal	IFRS 9
Assessment of hedge effectiveness and effectiveness threshold	<p>Prospective and retrospective assessment of hedge effectiveness is required on an ongoing basis.</p> <p>Hedging relationships must be highly effective to qualify for hedge accounting.</p>	<p>Only prospective assessment of hedge effectiveness is required.</p> <p>To qualify for hedge accounting, there must be an economic relationship between the hedging instrument and hedged item, the value changes that result from that economic relationship may not be dominated by the effect of credit risk and the designation cannot reflect an imbalance between the weightings of the hedged item and hedging instrument that would create hedge ineffectiveness.</p>
Voluntary dedesignation	Permitted at any point during the hedging relationship.	Prohibited unless the designated risk objective changes. Rebalancing is required in certain circumstances.
Disclosure of ineffectiveness	No requirement to separately measure and disclose	Required to separately measure and disclose.