Private Company Reporting: Simplified Hedge Accounting for Certain Interest Rate Swaps
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Executive Summary

U.S. generally accepted accounting principles (GAAP) now includes alternatives for private companies. Accounting Standards Update (ASU) 2014-03, Derivatives and Hedging (Topic 815): Accounting for Certain Receive-Variable Pay-Fixed Interest Rate Swaps – Simplified Hedge Accounting Approach, issued in January 2014, provides private companies a practical expedient to qualify for cash flow hedge accounting under Topic 815. The accounting alternative is available to private companies wanting to apply hedge accounting to variable-rate debt that is economically converted to a fixed-rate borrowing using a receive-variable, pay-fixed interest rate swap, provided certain conditions are met.

The update assumes there is no ineffectiveness in the cash-flow hedging relationship, eliminating the burden of assessing hedge effectiveness. In addition, it expands the time frame to complete documentation requirements, introduces a new measurement approach (settlement value) and exempts the private company from certain fair market value disclosure requirements.

The simplified hedge accounting approach is available to all entities, except public business entities (as defined in ASU 2013-12, Definition of a Public Business Entity), not-for-profit entities, employee benefit plans within the scope of Topic 960-965 and financial institutions. A private company can elect to apply this approach to any swap, on a swap-by-swap basis, whether existing at the date of adoption or entered into after that date, provided it meets all the requirements for applying this approach.

The guidance is effective for annual periods beginning after December 15, 2014, and interim periods within annual periods beginning after December 15, 2015, with early adoption permitted. Private companies can apply either the modified retrospective approach or the full retrospective approach upon adoption.

Background

In 2012, FASB’s Board of Trustees approved the establishment of the Private Company Council (PCC), a new body to improve the process of setting accounting standards for private companies. The PCC and FASB, working jointly, mutually agreed on criteria to decide if and when alternatives within U.S. GAAP are warranted for private companies. Based on those criteria, the PCC will review and propose alternatives within U.S. GAAP to address the needs of private company financial statement users.

The Private Company Decision-Making Framework provides considerations for the PCC and FASB in making user-relevance and cost-benefit evaluations for private companies under the existing conceptual framework. The framework is a tool to help the board and the PCC identify the difference between information needs of users of public company financial statements and users of private company financial statements, as well as to identify opportunities to reduce the relatively greater cost and complexity of preparing financial statements for private companies in accordance with U.S. GAAP.

Private companies find it particularly difficult to obtain fixed-rate debt for commercial loans. To compensate, entities hedge the risk of unfavorable changes in interest rates—and increases in cash outflows—on their variable-rate debt by entering into a swap agreement. The combination of variable-rate borrowing and the swap creates a fixed-rate borrowing between the lender and the borrower, and the periodic interest expense charge approximates the amount if the private company had entered into fixed-rate instead of variable-rate borrowing.

Arrangements where an entity hedges the interest-rate risk of variable-rate debt with a receive-variable, pay-fixed interest rate swap are among the most common and noncomplex hedge arrangements (called “plain vanilla” swaps in the industry). Hedge accounting avoids reporting the volatility of interest expense as charges to the current period income statement; instead, entities recognize changes in the swap’s market value through stockholder’s equity as an annual component of other comprehensive income (OCI).
Many private companies lack the expertise or resources to comply with hedge accounting requirements and fear the effect on their financial statements of disallowance for noncompliance. Other entities simply choose not to incur the cost of compliance. As a result, entities often opt not to elect hedge accounting and are subject to periodic income statement volatility.

Scope

Understanding the definition of a public business entity is critical, as it will be used to determine which entities are eligible to apply the accounting and reporting alternatives approved by FASB and the PCC.

An entity meeting any of the following criteria is considered a public business entity and, therefore, is not eligible to apply the swap accounting alternative available to private companies:

- It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC, including other entities for which financial statements or financial information are required to be or are included in a filing. For example, a company would be considered public if its historical, standalone financial statements are required to be included in an SEC filing, such as under Regulation S-X Rule 3-05, Financial Statements of Businesses Acquired or to Be Acquired.
- It is required by the Securities Exchange Act of 1934, as amended, or rules or regulations promulgated under the act to file or furnish financial statements with a regulatory agency other than the SEC, e.g., the Office of the Comptroller of the Currency.
- It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of, or for purposes of issuing, securities not subject to contractual restrictions on transfer.
- It has issued, or is a conduit bond obligor for, securities that are traded, listed or quoted on an exchange or over-the-counter market.
- It has one or more securities not subject to contractual restrictions on transfer, and it is required by law, contract or regulation to prepare U.S. GAAP financial statements (including footnotes) and make them publicly available on a periodic basis, e.g., interim or annual periods. Note: An entity must meet both of these conditions to meet this criterion.

It is important to note an entity may meet the definition of a public business entity solely because its financial statements or financial information must be included in a filing with the SEC, such as under Regulation S-X, Rule 3-09, Separate Financial Statements of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons, or Regulation S-X, Rule 3-05, Financial Statements of Businesses Acquired or to Be Acquired, and Regulation S-X, Rule 4-08(g), Summarized Financial Information. The board decided that in those situations, those financial statements must be prepared using the same accounting principles as a public business entity, meaning the private company’s financial statements would need to be retrospectively adjusted to unwind any previously elected private company alternatives. In that case, the entity is only a public business entity for purposes of financial statements filed or furnished with the SEC. The entity would not be considered a public business entity for purposes of its standalone financial statements not filed or furnished with the SEC.

Criteria to Elect the Simplified Hedge Accounting Approach

Private companies, other than financial institutions, will qualify for the practical expedient and may elect to use the simplified hedge accounting approach to certain derivative instruments (receive-variable, pay-fixed interest rate swaps) meeting the following criteria:

- The variable rate on both the swap and the borrowing is based on the same index and reset period, e.g., one-month LIBOR
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- The terms of the swap are typical—the swap is what is generally considered a plain vanilla interest rate swap—and there is no floor or cap on the variable interest rate of the swap unless the borrowing has a comparable floor or cap
- The repricing and settlement dates for the swap and borrowing match or are within a few days
- The swap’s fair value at inception—at the time of application of the simplified hedge accounting approach—is at or near zero
- The notional amount of the swap matches the principal amount of the borrowing being hedged
- All interest payments on the debt during the term of the swap are designated as hedged during the term of the swap, whether in total or in proportion to the hedged principal amount of the debt

If the above conditions are met, the company may assume no ineffectiveness and may recognize the changes in fair value (or settlement value) of the swap in accumulated other comprehensive income (AOCI).

The practical expedient is allowed on a forward-starting swap, as long as the swap meets the listed requirements and the private company deems the occurrence of forecasted interest payments to be swapped as probable.

When a private company determines a hedge criterion is no longer met, the company must cease applying the simplified hedge accounting approach as of the date the hedge no longer qualifies and apply the general guidance in Topic 815 on a prospective basis. This includes recognizing gains and losses deferred in AOCI and measuring the swap at fair value on the date of change and subsequent changes in fair value in current earnings.

Practical Considerations

Below are some practical considerations for a few of the above criteria to apply the simplified hedge accounting.

**Plain Vanilla Interest Rate Swap**

FASB has not defined a plain vanilla swap. Using the generally accepted definition, however, plain vanilla interest rate swaps are the exchange of a variable-rate financial instrument, i.e., a commercial loan, for a fixed-rate financial instrument, i.e., interest rate swap derivative, often with the same counterparty.

The plain vanilla swap criterion may be met when the interest rate terms on the debt differ from the interest rate terms on the swap, or when the stated or nominal interest rate floor (or cap) on the debt differs from the stated interest rate floor (or cap) on the swap. In these situations, the comparability criterion may be met when the allowed fluctuation, or the difference between the stated interest rate and the stated floor/cap, is comparable for both the debt and swap. The existing shortcut method requires that the repricing dates of the hedged item and hedging instrument match exactly. Private companies will need to use judgment in defining “a few days,” being cautious when implementing policy since swaps qualify for the simplified hedge accounting approach on a swap-by-swap basis.

**Fair Value “At or Near Zero”**

Private companies must determine that the swap’s fair value at the time the simplified hedge accounting approach is applied is at or near zero. Due to its retrospective application, companies will qualify as long as the swap’s fair value was at or near zero at the time the swap was entered into. In other words, the entity does not need to consider the fair value at the time of application of the simplified approach.
Recognition & Measurement

The existent requirements under Topic 815 require companies to value swaps at fair value through earnings each period when hedge accounting is not used. The argument against this approach is that reporting valuation adjustments through earnings does not reflect the economic substance of an actual transaction and only exposes the entity to income statement volatility. When hedge accounting is used, companies recognize changes in fair value (or settlement value) through stockholder’s equity as a component of OCI.

The board has a long-standing view that an entity should recognize derivative instruments separately in the financial statements and not net them with related hedged debt. With separate financial statement presentation, the instruments’ economic profile and value are transparent to the financial statement user. The update does not change this foundational premise but does introduce a new measurement objective: “settlement value.”

Settlement Value

To provide relief from the cost and complexity of calculating the fair value of swaps, when the simplified hedge accounting approach is used, companies may value the hedged instrument at “settlement value” in place of fair value. Settlement value, however, is not a standard measurement and is not defined in U.S. GAAP. FASB and the PCC have provided some guidance:

“The primary difference between settlement value (that is, the amount to be paid to or received from the swap counterparty to terminate the swap) and fair value is that generally the nonperformance risk of the swap counterparties is not considered in the settlement value.”

Nonperformance risk relates to the credit risk of both the reporting entity and the counterparty to the swap. The update does not specify how the settlement value should be calculated; however, it does state that it is acceptable to perform a present-value calculation of the swap’s remaining estimated flows using a valuation technique not adjusted for the risk of nonperformance.

Documentation

The update also broadens the window to complete the election documentation requirements for a period up until the date on which the annual financial statements are available to be issued. Under Topic 815, without adoption of the simplified hedge accounting approach, companies are required to complete the documentation requirements concurrently with entering into the swap agreement.

This is a welcome change for private companies, the majority of which either have inadequate resources to meet hedge documentation requirements at inception of a hedging relationship or are not knowledgeable of the requirements until the auditor requests documentation for entities using an interest rate swap for the first time.

Private companies will be required to document that the hedging arrangement has met the requirements for the simplified hedge accounting approach. They will need to determine the nature and extent of the initial assessment showing qualification for the practical expedient. This will include documentation that the entity’s intent with the
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A swap arrangement is to economically convert variable-rate debt into fixed-rate debt using a plain vanilla swap contract meeting all practical expedient conditions.

Analysis of the swap’s ability to economically convert variable-rate borrowing to fixed-rate borrowing includes evaluating the credit or default risk of the counterparty, e.g., a financial institution. Private companies will need to determine whether to document an ongoing assessment in subsequent years to identify any adverse developments regarding the counterparty’s (and its own) ability to perform under the contract, as well as the effect, if any, of the swap arrangement in economically converting variable rate borrowing to fixed rate.

Disclosures

The disclosure requirements in Topics 815 and 820 apply to swaps accounted for under the alternative approach. Under the simplified hedge accounting approach, the settlement value of the interest rate swap is the basis for the hedging instrument measurement and reporting in the statement of financial position, as well as for footnote disclosures. In other words, the disclosure requirements under Topics 815 and 820 apply to swaps accounted for under the simplified hedge accounting approach measured at settlement value. In providing those disclosures, however, an entity would substitute fair value with settlement value wherever applicable, disclosing hedging instruments measured at settlement value separately from amounts reported at fair value.

The ASU also addresses the fair value disclosures required by Topic 825 (previously Statement of Financial Accounting Standards No. 107 disclosures). Topic 825 requires fair value disclosures if the entity has any instruments accounted for as a derivative. Under the ASU, a swap recorded under the simplified hedge accounting approach is not considered a derivative instrument; therefore, the fair value disclosures of Topic 825 would not be required unless one of the other conditions is met. Topic 825 has been amended so that if fair value disclosures are required, the swaps accounted for under the simplified method need not be included in those disclosures.

Transition

Entities within the scope of the update can opt to apply the amendments in the update using either of the following:

- A modified retrospective approach in which the entity adjusts the opening balances of the current period to reflect application of the proposed amendments
- A full retrospective approach in which the entity adjusts the financial statements for each prior period presented and the opening balances of the earliest period presented to reflect the period-specific effects of applying the proposed amendments

Because Topic 815 permits election of hedge accounting on a swap-by-swap basis, a private company can elect to apply this approach to any swap, whether existing at the date of adoption or entered into on or after that date, provided it meets all the requirements for applying the simplified hedge accounting approach. In the period of adoption, the private company would apply the guidance in applicable sections of GAAP for accounting changes.

Conclusion

An era is beginning where GAAP permits public and private companies to apply different accounting for the same economic transactions, under the premise that user needs are substantially different to justify separate recognition, measurement and disclosure principles. FASB has endorsed alternative accounting treatments designed to reduce complexity and costs for private companies.

With change comes new policies and procedures. Entities will need to develop and document their own criteria and processes for election of hedge accounting under Topic 815 on a swap-by-swap basis, including consideration of qualitative assessments supporting use of the simplified hedge accounting approach.
Entities anticipating going public generally should proceed with extra caution. These companies may need to unwind their application of the accounting alternative when it is no longer in the scope of the guidance. All private companies should speak to their vested stakeholders and lenders before formally adopting the simplified hedge accounting approach to ensure the new approach satisfies lending covenants and other financial statement requirements.

Contact your BKD advisor for more information.

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