Easier Hedge Accounting Rules Now Available

On August 28, 2017, the Financial Accounting Standards Board (FASB) released Accounting Standards Update (ASU) 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*. The amendments better align hedge accounting with management's risk activities, make targeted changes to reduce the cost and complexity of applying hedge accounting and enhance financial statement understandability through new disclosure and presentation changes. Although the changes do not go as far as some had hoped, there are considerable benefits for all entities and significant documentation relief is offered to private companies. Industries that can benefit the most from these changes include food and agribusinesses, oil and gas, insurance and banking. For public business entities (PBE), the rules are effective in 2019 and all other entities have an additional year. Early adoption is permitted upon issuance for all entities at the start of any fiscal period.

This alert summarizes the new ASU's key benefits. Additional **BKD Thoughtware**® is forthcoming, including a comprehensive white paper and narrowly focused articles on considerations for early adoption and private company benefits.

Risk Component Hedging

Current rules limit which risks can be hedged. The ASU significantly expands hedge accounting for financial and nonfinancial risk components, notably:

- For a cash flow hedge of a nonfinancial asset, an entity could designate as the hedged risk the variability in cash flows attributable to changes in a contractually specified component stated in the contract. Currently, only foreign currency risk can be designated as the hedged risk for a nonfinancial item. This change would allow entities to benefit from hedge accounting for derivatives to offset risk from price changes in ingredients or inventory items, *e.g.*, a tire company's hedging against changes in rubber prices.
- For a cash flow hedge of interest rate risk of a variable-rate financial instrument, an entity could designate as the hedged risk the variability in cash flows attributable to the contractually specified interest rate. This would eliminate current guidance on "benchmark" interest rates for hedges of variable-rate instruments. Currently, only variability in cash flows related to one of three defined benchmark interest rates are permitted to be the hedged risk.
- For fair value hedges of interest rate risk, the ASU adds the Securities Industry and Financial Markets Association Municipal Swap Rate as an eligible benchmark interest rate in addition to those already permitted—the U.S. Treasury Rate, the London Interbank Offered Rate Swap Rate and the Fed Funds Effective Swap Rate. This would benefit tax-exempt issuers and investors.

Fair Value Hedges of Interest Rate Risk

Current guidance limits how an entity measures changes in fair value of the hedged item attributable to interest rate risk in certain fair value hedging relationships. The new standard:

- Allows partial-term fair value hedge of interest rate risk. Under the new rules, there will be an assumption that only the hedged cash flows are the hedged item
- Permits an entity to measure the change in fair value of the hedged item on the basis of the benchmark rate component of the contractual coupon cash flows determined at hedge inception, rather than on the full contractual coupon cash flows as currently required
- Addresses hedging prepayable instruments. In assessing hedge effectiveness due to prepayment risk, entities will only need to consider changes in the benchmark interest rate, not other noninterest rate prepayment provisions

Hedge Effectiveness

Hedge effectiveness is the extent to which changes in the fair value or cash flows of the hedging instrument offset changes in the fair value or cash flows of the hedged item for the hedged risk. Today's guidance contains specific requirements for initial and ongoing quantitative hedge effectiveness testing as well as strict requirements related to the specialized accounting methods—"shortcut" or "critical terms match" method—that allow an entity to skip ongoing quantitative assessments. Under the ASU, hedgers would be allowed to use less burdensome qualitative testing when certain criteria are met. A change in the facts and circumstances of the hedging relationship would require a return to quantitative testing; however, a company could subsequently return to qualitative testing if performing a quantitative test confirms a high degree of effectiveness was maintained and is expected in the future. Other changes include:

- Time to Perform Initial Effectiveness Assessment Extended – If a quantitative assessment of effectiveness is required, *e.g.*, the hedge relationship does not qualify for shortcut or critical terms match, the test can be deferred to the quarter end reporting date—or for private companies, when statements are available to be issued—but must use data applicable as of the hedge inception date
- Critical Terms Match Method – The criteria has been updated to allow for the hedging of a group of forecasted exposures by assuming a match in maturity dates if exposure and hedge mature within the same 31-day period or fiscal month. This will primarily benefit foreign exchange or commodity hedges.
- If the shortcut method is no longer appropriate, an entity could apply a quantitative method for assessing hedge effectiveness as long as the hedge is highly effective and the entity documents at inception which methodology it would use. A failed use of the shortcut method would not necessarily disqualify a company from the benefits of hedge accounting, as it would under current rules, making it easier to avoid restatements
- Cross-currency basis spreads can be excluded from the hedge effectiveness assessment, in addition to option premiums and forward points. A new accounting policy election would permit the changes in fair value of excluded components in either other comprehensive income or current earnings

Effective Date

The amendments will be effective for PBEs for fiscal years beginning after December 15, 2018, and interim periods therein. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020.

Entities may early adopt in any interim period after the standard's issuance date using a modified retrospective approach. Entities would apply the guidance to all hedging relationships existing on the adoption date, with a cumulative effective adjustment to the opening balance of retained earnings.

BKD will continue to monitor updates. For more information, contact your BKD advisor.

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