July 7, 2015

Update on FASB Deliberations Related to Hedge Accounting

At its June 29, 2015 board meeting, the Financial Accounting Standards Board (the "FASB") moved towards simplifying hedge accounting and making it easier for certain types of interest rate and commodity hedges to qualify for hedge accounting treatment.

The FASB tentatively made the following decisions with regard to amending ASC 815, *Derivatives and Hedging*:

General Effectiveness Related Issues

- Will retain the current highly effective threshold (80 to 125% offset) for all hedge relationships.

- Will continue to require quantitative effectiveness testing at inception of a hedge, for hedges that do not meet the requirements for the shortcut or critical terms match methods.

- Will no longer require on-going quantitative effectiveness testing, unless facts and circumstances change which may impact the effectiveness of the hedge.

  Currently, on-going quantitative effectiveness testing is required at least every quarter for hedges that do not meet the requirements for the shortcut or critical terms match method.

  Impact: This change will lessen some of the administrative burden of using hedge accounting.

Hedge Ineffectiveness and Financial Statement Presentation

- Eliminated the requirement to measure hedge ineffectiveness each period.

  For cash flow hedges that meet the highly effective threshold, the entire change in the fair value of the derivative would be recorded in OCI and reclassified to the same income statement line as the hedged item when the hedged item affects earnings. For fair value hedges that meet the highly effective threshold, the entire change in the fair value of the derivative would be recorded in the same income statement line as the hedged item.

  Currently, the ineffective portion of the change in fair value of a derivative designated as a cash flow hedge is recorded in earnings while the effective portion of the change in its fair value is recorded in OCI. For fair value hedges, the entire change in the fair value of the derivative is recorded in earnings. ASC 815 does not specify where in the income statement to record derivative gains and losses but does require that the location be disclosed.

Impact: This change will reduce quarterly earnings volatility for cash flow hedges that use a long haul effectiveness method.

Component Hedging of Nonfinancial Items

- Will allow component hedging for non-financial items such as commodities provided the components / ingredients are contractually specified and are linked to an index or rate stated in the contract.

  Currently, entities are limited to hedging either the entire price risk or the foreign exchange risk of non-financial items.

  Impact: Allowing component hedging will make it easier for some commodity hedges to meet the effectiveness threshold and qualify for hedge accounting treatment.

  For example, consider a manufacturing company that purchases copper coil, the price of which is contractually determined based on the COMEX copper price index plus a variable amount to cover fabrication and delivery costs as well as the supplier's profit. If the manufacturer were to hedge its forecasted purchases of copper coil using a derivative that settles based on the COMEX copper price index, it would currently need to assess hedge effectiveness based on all changes in the price of the copper coil. Since changes in the cost of fabrication and delivery are not offset by the derivative, there could be significant ineffectiveness and the hedge may not qualify for hedge accounting. Under the proposed guidance, effectiveness could be assessed based only on changes in the copper component (COMEX price index) of the copper coil price.

Hedging Interest Rate Risk

- Will retain the shortcut method for hedges of interest rate risk and also lessen the impact of misapplying the shortcut method.

  Under the proposed guidance, hedge accounting would not be automatically disallowed for a misapplication of the shortcut method provided: (i) that an alternative long haul effectiveness assessment method has been documented at inception of the hedge and (ii) that the use of the alternative method confirms that the hedge has been highly effective from its inception.

  Currently, if it was subsequently determined that not all of the shortcut criteria were met, hedge accounting would be disallowed retroactively and may result in a restatement if there are material changes in financial results.

Impact: Will encourage more companies to use the shortcut method.

- Eliminated the concept of benchmark interest rate for variable-rate financial instruments.

  Under the proposed guidance, an entity may designate the contractually specified index rate of a variable-rate financial instrument in a cash flow hedge of interest rate risk. For example, an entity could designate a Prime linked interest rate swap as a hedge of the interest rate risk of a Prime-based loan.

  Currently in a hedge of interest rate risk, an entity can only hedge a benchmark interest rate (in the U.S., either the LIBOR swap rate, the OIS rate, or the Treasury rate). If hedging an interest rate index that is not a benchmark rate, all changes in cash flows would need to be considered in the effectiveness assessment including the non-hedged credit component of those cash flows.

  Impact: Will make it easier for hedges of variable-rate financial instruments that are not indexed to a benchmark interest rate to meet the effectiveness threshold.

- Retained the concept of benchmark interest rates for hedges of fixed-rate financial instruments and added the Financial Markets Association Municipal Swap Index (SIFMA) to the list of benchmark interest rates.

  Impact: This change will improve the effectiveness of fair value hedges of tax exempt bonds by excluding the credit component from the effectiveness assessment.

- In a fair value hedge of interest rate risk, will be able to designate the benchmark component of the total coupon cash flows attributable to the benchmark interest rate as the hedged risk.

  Currently, for fair value hedges of fixed-rate debt that do not qualify for the shortcut method, all cash flows to include the credit spread component of interest rate coupon payments are included in the effectiveness assessment.

  Impact: This change will improve the effectiveness of fair value hedges of fixed-rate debt that do not qualify for the shortcut method.

- Will allow partial-term hedging of a fixed-rate financial instrument.

  An entity will be able to designate a portion of the term of a fixed-rate financial instrument as the hedged risk. The change in the fair value of the hedged item can be calculated assuming the same term as the derivative designated as the hedging instrument.

Currently it is difficult for partial term fair value hedges to qualify for hedge accounting because the non-hedged contractual cash flows cannot be excluded when assessing effectiveness.

Impact: Partial term hedges are more likely to meet the effectiveness threshold and qualify for hedge accounting.

- In a fair value hedge of callable debt, an entity may consider the effect of a prepayment option only as it relates to the risk designated as being hedged; e.g., interest rate risk.

Hedge Documentation

- No changes to the requirement that hedge documentation be in place before hedge accounting can be applied with one exception - the initial quantitative effectiveness testing can be completed by the end of the quarter in which the hedge is designated.

  Currently, the prospective effectiveness assessment should be completed no later than on the hedge designation date.

  Impact: This change will give companies more time to complete the initial prospective effectiveness assessment.

Miscellaneous

- Expand or amend hedge accounting disclosures to address: (i) the cumulative basis adjustments for fair value hedges, (ii) the impact of hedge accounting on income statement line items, and (iii) quantitative goals that an entity may have established to achieve hedge accounting objectives.

- Will continue to allow entities to voluntarily de-designate hedges.

Next Steps

Look for the FASB staff to issue a draft of a proposed Accounting Standards Update to amend Topic 815 by Q4 of this year.