

FASB In Focus

Accounting Standards Update No. 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*

On August 28, 2017, the Financial Accounting Standards Board (FASB) issued an Accounting Standards Update (ASU) intended to improve accounting for hedging activities.

The objective of the ASU is to better align hedge accounting with an organization's risk management activities in the financial statements. In addition, the ASU simplifies the application of hedge accounting guidance in areas where practice issues exist.

Why Did the FASB Embark on a Project to Improve Accounting for Hedging Activities?

Current Generally Accepted Accounting Principles (GAAP) provides special accounting for hedging activities to address differences in accounting for hedging instruments and hedged items or transactions as established in *FASB Accounting Standards Codification*® Topic 815, *Derivatives and Hedging*.

Since the original issuance of the guidance in 1998, the FASB has been asked to address numerous practice issues that have developed over time. As a result, the FASB proposed broad-based changes to the hedge accounting model in two Exposure Drafts issued in 2008 and 2010. However, after the comment period ended for the 2010 Exposure Draft, the project to improve the hedge accounting guidance was put on hold to allow the FASB to pursue other financial instrument initiatives. In the current project, the FASB decided not to overhaul the hedge accounting guidance but instead to

focus on targeted improvements to expeditiously address key practice issues that have been identified by stakeholders.

What Kind of Outreach Did the FASB Undertake When Developing the ASU?

When the hedging project was reactivated in 2014, the FASB conducted extensive outreach activities and received significant input from a wide variety of stakeholders. The outreach activities undertaken by the FASB to develop the ASU are depicted below:

How Will the Changes Improve Accounting for Hedging Activities?

Through its outreach activities, the FASB observed two primary concerns. First, financial statement preparers have expressed concerns over the difficulties associated with applying hedge accounting and its limitations for hedging both nonfinancial and financial risks. Second, users of financial statements have expressed concerns over the manner in which hedging activities are reported in the financial statements.

Outreach with Stakeholders

Meetings with
33 investors
and other users on the
2016 Exposure Draft



**2 public
round tables**

with a total of 18 participants
including preparers, regulators,
and auditors



Meetings with
advisory groups



60 comment letters
on the 2016 Exposure Draft



70 meetings

on the 2016 Exposure Draft

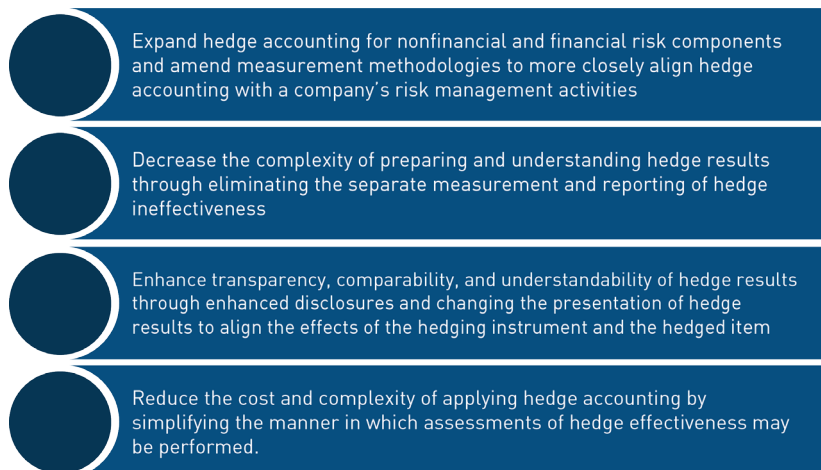


81 meetings

with preparers, practitioners,
regulators, users, and others between
reactivation of the project in 2014
and the issuance of the 2016
Exposure Draft.



The amendments are intended to address these concerns through changes to the hedge accounting guidance that will accomplish the following:

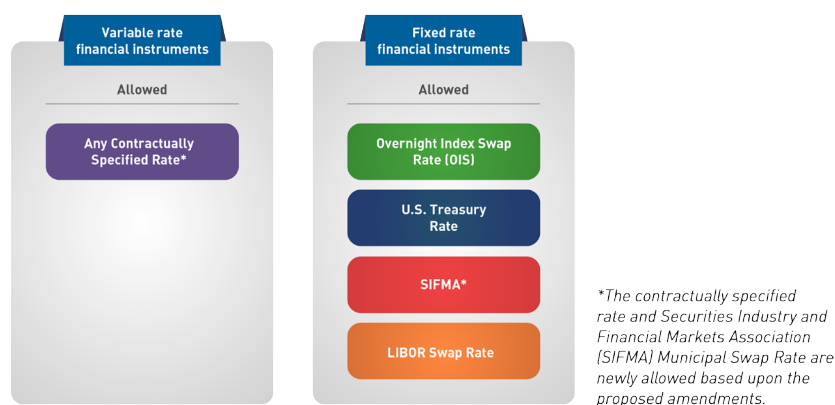


What Will the Changes Accomplish?

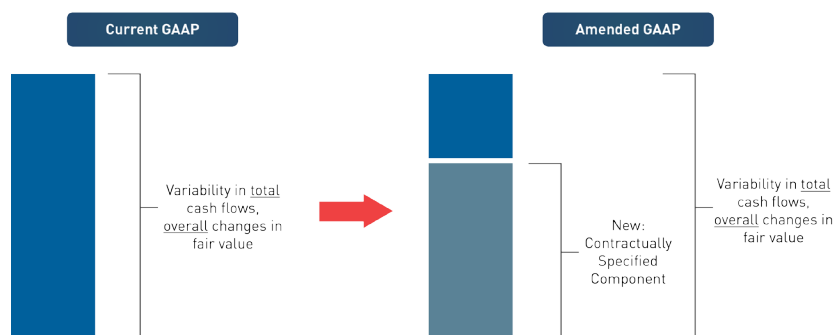
Alignment of Hedge Accounting with Risk Management Activities

The amendments will expand hedge accounting for both financial and nonfinancial risk components to better align hedge accounting with a company's risk management activities. Specifically, the amendments permit more flexibility in hedging interest rate risk for both variable rate and fixed rate financial instruments, and introduce the ability to hedge risk components for nonfinancial hedges. The following indexes are eligible to be designated when hedging interest rate risk and the following risks are eligible to be designated when hedging a nonfinancial item:

Indexes Eligible to Be Designated in a Hedge of Interest Rate Risk



Eligible Hedged Risks for Nonfinancial Items



Current GAAP contains limitations on how a company can measure changes in fair value of the hedged item attributable to interest rate risk in certain fair value hedging relationships. Stakeholders emphasized that this did not reflect the economics of the hedging relationship. Therefore, the following refinements were made to the measurement of the hedged item:

- a. Measure the hedged item in a partial-term fair value hedge of interest rate risk by assuming the hedged item has a term that reflects only the designated cash flows being hedged
- b. Consider only how changes in the benchmark interest rate affect a decision to settle a prepayable instrument before its scheduled maturity when calculating the fair value of the hedged item
- c. Measure the fair value of the hedged item using the benchmark rate component of the contractual coupon cash flows determined at hedge inception.

The amendments also expand fair value hedges of interest rate risk for closed portfolios of prepayable financial assets or one or more beneficial interests secured by a portfolio of prepayable financial instruments. Under the amendments, a company may designate an amount that is not expected to be affected by prepayments, defaults, and other events affecting the timing and amount of cash flows (the “last-of-layer” method). Under this designation, prepayment risk is not incorporated into the measurement of the hedged item.

For fair value, cash flow, and net investment hedges, the reporting of amounts excluded from the assessment of hedge effectiveness

will change to allow companies to use an amortization approach or to continue mark-to-market accounting consistent with current GAAP.

Elimination of the Separate Measurement and Recording of Hedge Ineffectiveness

To simplify the reporting of hedge results for financial statement preparers and decrease the complexity of understanding hedge results for investors, the FASB has eliminated the separate measurement and reporting of hedge ineffectiveness. Mismatches between changes in value of the hedged item and hedging instrument may still occur but they will no longer be separately reported. For cash flow and net investment hedges, all changes in value of the hedging instrument included in the assessment of effectiveness will be deferred in other comprehensive income and recognized in earnings at the same time that the hedged item affects earnings.

Improvements to Presentation and Disclosure

The amendments will enhance the presentation of hedge results in the financial statements and disclosures about hedging activities by:

- a. Requiring changes in the value of the hedging instrument be presented in the same income statement line item as the earnings effect of the hedged item
- b. Amending the current tabular disclosure of hedging activities to focus on the effect of hedge accounting on individual income statement line items
- c. Requiring a new disclosure that will provide investors with more information about basis adjustments in fair value hedges.

Simplifications Related to Effectiveness Assessments

The ASU also includes targeted improvements to simplify assessments of hedge effectiveness. Those simplifications will:

- a. Allow a company to perform subsequent assessments of hedge effectiveness qualitatively if certain conditions are met
- b. Allow companies more time to perform the initial quantitative hedge effectiveness assessment
- c. Allow a company to apply the “long-haul” method for assessing hedge effectiveness when use of the shortcut method was not or no longer is appropriate if certain conditions are met
- d. Clarify that a company may apply the “critical terms match” method for a group of forecasted transactions if the transactions occur and the derivative matures within the same 31-day period or fiscal month, and the other requirements for applying the critical terms match method are satisfied.

Private Company Considerations

The FASB also considered the constraints that private companies that are not financial institutions and certain not-for-profit organizations face in completing hedge documentation in a timely manner. The Board decided to provide relief by aligning the timing of performance and documentation of initial and subsequent effectiveness testing with the timing of the issuance of interim (if applicable) or annual financial statements. These amendments do not affect and are in addition to the special guidance applicable to private companies that are not financial

institutions under the simplified hedge accounting approach.

Who Will Be Affected by the New Guidance?

The standard will apply broadly to any company that elects to apply hedge accounting in accordance with current GAAP (Topic 815).

How Does the FASB's ASU Compare with International Financial Reporting Standards (IFRS)?

Although the language used to describe the hedge accounting guidance in the ASU and in IFRS 9, *Financial Instruments*, differs, there are several areas of alignment between the two standards, and it is expected that many common hedge accounting strategies will have similar outcomes related to hedging components of financial instruments and nonfinancial items and in the measurement of hedged items in fair value hedges of interest rate risk. However, differences still remain between the two standards in the criteria for qualifying for hedge accounting. Additionally, IFRS 9 retained the separate measurement

and reporting of hedge ineffectiveness and does not have broad guidance on presentation.

When Will the ASU Be Effective?

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

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

What about Transition?

The transition section of the ASU specifies the following:

- For cash flow and net investment hedges existing at the date of adoption, a company must apply a cumulative-effect

adjustment related to the separate measurement of ineffectiveness to accumulated other comprehensive income with a corresponding adjustment to the opening balance of retained earnings as of the beginning of the fiscal year that a company adopts the amendments.

- The amended presentation and disclosure guidance is required only prospectively.
- Also, certain elections may be made by a company upon adoption to allow for existing hedging relationships to transition to the newly allowable alternatives within the ASU.

For more information about the project, please visit the FASB's website at www.fasb.org.