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To the Point

FASB — proposed guidance

FASB proposes amendments to clarify and improve its hedge accounting guidance

The proposal responds to stakeholders' questions about how to operationalize the guidance that allows changes in the hedged risk in cash flow hedges.

What you need to know

- The FASB proposed amendments to clarify and improve certain aspects of the new hedge accounting guidance provided by ASU 2017-12.
- The proposal would clarify the new guidance on an entity's ability to (1) change the hedged risk in a cash flow hedge and (2) designate contractually specified components in cash flow hedges of nonfinancial forecasted transactions.
- The proposal would also address issues associated with "dual" fair value and net investment hedges and replace the term "prepayable" in the guidance on the shortcut method with the words "early settlement feature."
- Comments are due by 13 January 2020.

Overview

The Financial Accounting Standards Board (FASB or Board) **proposed** amendments to Accounting Standards Codification (ASC) 815[1] to address implementation issues and stakeholder questions related to the hedge accounting guidance it issued in Accounting Standards Update (ASU) 2017-12.[2]

The proposal would clarify or improve the guidance in the following areas:

- Changes in the hedged risk in cash flow hedges, including forecasted transactions hedged in a group

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- Designating contractually specified components in cash flow hedges of nonfinancial forecasted transactions
- Accounting for "dual" fair value and net investment hedges
- Use of the term "prepayable" in the guidance on the shortcut method, which would be replaced with the words "early settlement feature"

The FASB is addressing implementation issues related to the application of the new last-of-layer method for hedging portfolios of prepayable financial assets in a separate project.

Key considerations

Changes in the hedged risk in cash flow hedges

With ASU 2017-12, the FASB amended ASC 815 to make it clear that a change in the hedged risk in a cash flow hedge of a forecasted transaction does not constitute a change in a critical term that requires dedesignation of the hedging relationship. This guidance allows an entity to continue to apply hedge accounting if the hedging instrument is highly effective at offsetting the cash flows attributable to the revised hedged risk.

However, stakeholders raised a number of questions about how to apply this guidance and its interaction with other aspects of ASC 815, including the requirement that the hedged item be documented with sufficient specificity and whether a change in the hedged risk could be deemed to constitute a change in the hedged item.

The proposal would clarify that the forecasted transaction (i.e., hedged item) in a hedging relationship is distinct from the hedged risk, regardless of how these items are documented. As a result, an entity would not consider the hedged risk in determining whether it missed a forecast. The proposal would also clarify that, when hedging interest rate risk, a change in the tenor of an interest rate that results in a change in the number and timing of interest payments would be considered a change in the hedged risk, not a change in the forecasted transaction.

In addition, the proposal would require the forecasted transaction to be documented with sufficient specificity so that it is clear when the transaction occurs whether the transaction is eligible to be identified as the hedged transaction, regardless of the hedged risk.

The proposal would further clarify that an entity would only be required to designate its best estimate of the hedged risk expected to cause variability in the cash flows associated with the forecasted transaction. An entity would not be required to designate other potential hedged risks that do not represent its best estimate but would be required to reevaluate its best estimate of the expected hedged risk at least quarterly.

If an entity's best estimate of its hedged risk changes before the forecasted transaction occurs, the proposal would require the entity to update its hedge documentation for the new hedged risk and perform prospective hedge effectiveness testing using the revised hedged risk beginning on the date the change in hedged risk is identified.

The proposal would also clarify that an entity would not be required to retrospectively test effectiveness with the revised hedged risk for periods before the change in hedged risk was identified. Instead, the entity would use its previously designated hedged risk to retrospectively assess hedge effectiveness for periods before the change in hedged risk was identified. Amounts recorded related to the hedging relationship before the date that the change in hedged risk was identified would not be revised because of the change in hedged risk.

In addition, the proposal would allow entities to use hindsight to identify the hedged transactions. For example, if there is a shortfall in the amount of purchases or sales made based on the entity's best estimate of the hedged risk, the entity may look to transactions that have previously settled in order to determine whether the forecasted transactions have occurred.

How we see it

The proposed amendments to the guidance on changes in the hedged risk, including the proposal that would allow entities to use hindsight to identify hedged transactions, would provide entities with additional flexibility and would likely result in fewer missed forecasts.

The proposed guidance would clarify that hedges of foreign exchange risk and credit risk are excluded from the scope of the guidance on changes in hedged risk.

Hedging contractually specified components of nonfinancial items

ASU 2017-12 provided guidance that allows entities to hedge the risk of variability in cash flows attributable to changes in a "contractually specified" component of a forecasted purchase or sale of a nonfinancial asset.

The proposal would clarify that a risk component may be specified outside of the purchase or sales contract itself and that an entity may base its expectation that a contractually specified component would be explicitly referenced based on its prior experience with similar transactions.

The proposal would clarify how a contractually specified component may be evidenced.

The proposal would also provide examples of where a component may be specified, including:

- Supply arrangements
- Ancillary or side agreements
- Purchase or sale agreements accounted for as derivatives
- Receipts from spot transactions

The proposal would further clarify that a contractually specified component would be evidenced by documentation that supports the price at which the nonfinancial asset is purchased or sold, regardless of whether the documentation existed before or after the transaction is consummated. The proposal would clarify that for non-spot-market transactions, the pricing formula that includes the contractually specified component would have to determine the price of the nonfinancial asset. To hedge a contractually specified component in a spot-market transaction, the proposal would require the pricing formula that includes the contractually specified component to be based on how the price of the nonfinancial asset is determined in the spot market.

How we see it

We believe that, under the proposal, entities would be able to hedge a contractually specified component in spot-market transactions for certain commodities but not others. This is because the component an entity would like to hedge may be explicitly referenced and market-based for certain commodities (e.g., a Chicago Board of Trade futures contract in a spot-market purchase of corn) but not others (e.g., a crude oil index for a spot-market purchase of jet fuel).

The proposal would also amend the guidance in ASC 815 that requires an entity to apply the normal purchases and normal sales (NPNS) scope exception to a contract that would otherwise be accounted for as a derivative under ASC 815 in order to hedge a contractually specified component of such a contract. The proposal would clarify that such contracts would

be eligible for component hedging if physical settlement of the contract is probable and the forecasted transaction is not the acquisition of a nonfinancial asset that would subsequently be remeasured with changes in fair value attributable to the hedged risk reported in earnings.

The proposal would also indicate that in order to determine whether it can hedge a contractually specified component in a forecasted transaction that is otherwise eligible to be hedged, an entity would need to apply the portion of the NPNS scoping guidance requiring that all pricing components in the agreement be based on underlyings that are clearly and closely related to the asset being sold or purchased.

Dual fair value and net investment hedges

The proposal would eliminate the unintended recognition and presentation mismatch for dual hedges that resulted from guidance in ASU 2017-12. Under this strategy, a foreign-currency-denominated debt instrument is designated as both the hedging instrument in a net investment hedge and the hedged item in a fair value hedge of interest rate risk. The proposal would require an entity to exclude the foreign-currency-denominated debt instrument's fair value hedge basis adjustment from the assessment of hedge effectiveness in the net investment hedge and recognize the remeasurement of this basis adjustment (based on changes in the spot exchange rate) immediately in earnings.

Use of the term 'prepayable'

The proposal would replace the term "prepayable" in the guidance on applying the shortcut method with the term "early settlement feature." The FASB is proposing this change to make it clear that the meaning in this context can differ from its use of prepayable elsewhere in ASC 815 (e.g., financial assets considered prepayable for the purposes of applying the last-of layer method may be different from the financial assets considered prepayable for the purposes of applying the shortcut method).

Effective date and transition

The proposal would be effective for all entities for fiscal years beginning after 15 December 2020. For public business entities, it would be effective for interim periods in the year of adoption. For all other entities, it would be effective for interim periods in fiscal years beginning after 15 December 2021. Early adoption would be permitted for any entity that has adopted ASU 2017-12.

Entities that adopt the proposed amendments on the same date they adopt ASU 2017-12 would apply the transition method in ASU 2017-12. Entities that have already adopted ASU 2017-12 would be permitted to apply the proposal prospectively or retrospectively to the date they adopted ASU 2017-12, except for the proposed amendments on dual hedges, which would have to be applied retrospectively.

Endnotes:

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[1] ASC 815, *Derivatives and Hedging.*

[2] ASU 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities.*

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