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To the Point

FASB — final guidance

FASB clarifies and enhances its hedge accounting guidance

The guidance is intended to make it easier for entities to achieve and maintain hedge accounting for a greater number of highly effective economic hedges.

What you need to know

- The FASB amended certain aspects of its hedge accounting guidance to better reflect an entity's risk management activities in the financial statements.
- The guidance expands the hedged risks permitted to be aggregated in a group of individual forecasted transactions and increases the variable price components eligible to be designated as the hedged risk in the forecasted purchase or sale of nonfinancial assets. It also eliminates the requirement to apply the net written option test when certain compound derivatives are used in interest rate hedges.
- In addition, the guidance simplifies the application of hedge accounting for entities hedging forecasted interest payments on choose-your-rate debt instruments and addresses application issues related to "dual hedges," where a foreign-currency-denominated debt instrument is designated as a hedging instrument and a hedged item.
- The amendments are effective for public business entities for fiscal years beginning after 15 December 2026, and interim periods within those fiscal years. For all other entities, they are effective one year later. Early adoption is permitted.

Overview

The Financial Accounting Standards Board (FASB or Board) issued a final **Accounting Standards Update** (ASU) amending Accounting Standards Codification (ASC) 815, *Derivatives and Hedging*, to address implementation issues related to the hedge accounting guidance in ASU 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*, and certain hedge accounting issues arising from reference rate reform.

The amendments respond to feedback the Board received from stakeholders on its November 2019 proposal to clarify certain aspects of the guidance in ASU 2017-12, as well as its 2021 Agenda Consultation. They are intended to enhance or clarify the guidance under ASC 815 in the following areas:

- Aggregating similar hedge risks in a group of forecasted transactions
- Hedging forecasted interest payments on choose-your-rate debt instruments
- Hedging variable price components of nonfinancial forecasted transactions
- Using certain compound derivatives to hedge interest rate risk
- Accounting for dual hedge strategies

The guidance is intended to more closely align hedge accounting with the economics of an entity's risk management activities and limit the occurrence of unintuitive dedesignation events and missed forecasted transactions for certain highly effective economic hedges. The Board believes this will provide financial statement users with more decision-useful information about an entity's risk management strategies.

Key considerations

Similar risk assessment for cash flow hedges of a group of forecasted transactions

The guidance expands the hedged risks that are permitted to be aggregated in a group of individual forecasted transactions in a cash flow hedge by allowing transactions that have a similar risk exposure, rather than a shared risk exposure, to be grouped together. A group of individual forecasted transactions is considered to have a similar risk exposure if either of the following applies:

- The designated hedging instrument is highly effective in achieving offsetting changes in cash flows attributable to each hedged risk in the group (assessed individually).
- Each discrete hedged risk in the group is similar to every other hedge risk in the group (determined using the same threshold that is applied to determine whether a hedging relationship is highly effective).

Entities are required to assess the similarity of hedged risks included in a group at hedge inception and on an ongoing basis. An entity is required to dedesignate the hedging relationship if it determines as part of its ongoing similar risk assessment that one or more hedged risks related to the group of individual forecasted transactions are no longer similar.

Hedging forecasted interest payments on choose-your-rate debt instruments

The amendments facilitate the application of cash flow hedge accounting to forecasted interest payments on variable-rate debt instruments with contractual terms that permit the borrower to change the debt's interest rate index or tenor (referred to as "choose-your-rate" or "you-pick-'em" debt).

An entity can elect to apply a simplified model when hedging these instruments that allows it to subsequently select an alternative interest rate index or tenor without automatically dedesignating the hedging relationship when certain criteria are met. In addition, hedge accounting may continue uninterrupted when the choose-your-rate debt is replaced if certain conditions are met.

Entities may elect to apply the simplified model to hedges of existing choose-your-rate debt, as well as forecasted issuances of choose-your-rate debt. However, the application of the model and criteria that need to be met differ somewhat for these strategies (e.g., the guidance provides different criteria regarding what interest rates are eligible to be designated at the inception of the hedge).

How we see it

While the amendments provide a model to simplify the application of hedge accounting to choose-your-rate debt instruments and address the diversity in practice that exists for this pervasive hedge strategy, they eliminate the broader change in hedge risk guidance in paragraphs 815-30-35-37A and 815-20-55-56 that was introduced in ASU 2017-12. In deciding to narrow the change in hedged risk guidance, the Board noted that other amendments in the new guidance address the risk of missed forecasts for certain types of hedges, thereby minimizing the need for a broader solution.

Cash flow hedges of nonfinancial forecasted transactions

The ASU expands the components eligible to be hedged for forecasted purchases and sales of nonfinancial assets.

The guidance expands the variable price components eligible to be designated as the hedged risk in the forecasted purchase or sale of nonfinancial assets by permitting entities to designate components that meet the criteria of being clearly and closely related in the normal purchases and normal sales (NPNS) scope exception. If the criteria are met, entities may hedge components of forecasted spot purchases and sales, as well as subcomponents of explicitly referenced components in an agreement's pricing formula. Currently, entities are limited to hedging risk components that are contractually specified in the purchase or sale transaction.

The ASU also clarifies that entities may hedge a variable price component in a forecasted transaction relating to the purchase or sale of a nonfinancial item under a contract accounted for as a derivative if this transaction is otherwise eligible to be hedged. Currently, an entity is required to apply the NPNS scope exception to a contract meeting the definition of a derivative to hedge any contractually specified component in the contract.

Net written options as hedging instruments

The guidance eliminates the requirement to apply the net written option test to hedging relationships where the hedging instrument is a combination of a written option and a non-option derivative instrument (e.g., an interest rate swap where the variable pay leg is floored) if all of the following are met:

- The derivative is designated as the hedging instrument in a cash flow hedge or fair value hedge of interest rate risk (including the interest rate risk portion of a hedge of both interest rate risk and foreign exchange risk).
- The hedging instrument is a combination of a written option and a swap.
- The notional amount of the written option matches the notional amount of the swap.

A compound derivative that meets the above criteria is not considered to be a written option.

This clarification is intended to address stakeholder concerns that highly effective hedging strategies would fail the net written option test due to differences in rates and minor differences in forecasted payment or reset dates associated with those rates that have become more prevalent as a result of reference rate reform.

Dual hedge strategy

The amendments address the recognition and presentation mismatch for dual hedges resulting from the guidance in ASU 2017-12 that eliminated the separate measurement and recognition of hedge ineffectiveness. Under a dual hedge 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 ASU requires 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. As a result, the remeasurement of this basis adjustment (based on changes in the spot exchange rate) will be immediately recognized in earnings, where it offsets the foreign exchange remeasurement of the derivative designated as the hedging instrument in the fair value hedge of interest rate risk. This is consistent with the outcome before the adoption of ASU 2017-12.

Effective date and transition

The guidance is effective for public business entities for fiscal years beginning after 15 December 2026, and interim periods within those fiscal years. For all other entities, it is effective for fiscal years beginning after 15 December 2027, and interim periods within those fiscal years. Early adoption is permitted.

Entities are required to apply the guidance prospectively. In addition, the transition guidance allows entities to modify certain aspects of existing hedging relationships without dedesignating the hedge to enable the application of the amendments to those hedges.

Entities are required to disclose the nature of and reason for the accounting principle change, as well as the method of applying the change, in both the interim and annual reporting periods of adoption.