The new guidance reduces some of the complexity of applying hedge accounting and makes the results easier for investors to understand.
Key considerations

Recognition and presentation of the effects of hedging instruments

The new guidance eliminates the requirement to separately measure and report hedge ineffectiveness. For qualifying cash flow and net investment hedges, this means that the entire change in the fair value of the hedging instrument included in the assessment of hedge effectiveness will be recorded in other comprehensive income (OCI), and amounts deferred in OCI will be reclassified to earnings in the same income statement line item that is used to present the earnings effect of the hedged item when the hedged item affects earnings.

For qualifying fair value hedges, the change in the fair value of the hedged item attributable to the hedged risk and the change in the fair value of the hedging instrument that is included in the assessment of hedge effectiveness will be recognized in earnings and presented in the same income statement line item.

Excluded components

The new guidance allows entities to exclude the portion of the change in fair value of the hedging instrument attributable to a cross-currency basis spread from the assessment of hedge effectiveness; they currently can exclude only the change in fair value of the hedging instrument related to time value. The initial value of any excluded components will be amortized into earnings using a systematic and rational method, and any difference between the change in fair value of the excluded component and the amount amortized into earnings during the period will be recognized in OCI (even for fair value hedges). However, an entity may make an accounting policy election to recognize in earnings all changes in the fair value of excluded components at each measurement date (consistent with the requirement in current US GAAP).

For fair value and cash flow hedges, any amounts excluded from the assessment of hedge effectiveness are required to be presented in the same income statement line item as the earnings effect of the hedged item, regardless of whether these amounts are amortized or immediately recognized in earnings. Consistent with current US GAAP, the amendments do not provide guidance on the income statement presentation for amounts excluded from the assessment of hedge effectiveness for net investment hedges.

How we see it

When the hedging instrument is held to its maturity, the change in the fair value of any excluded components recorded in OCI should ultimately net to zero. However, if a hedge relationship is discontinued, it is likely that the balance in OCI will include an amount related to the change in the fair value of the excluded component.

The new guidance makes it clear that such amounts should be recognized in earnings when other aspects of the hedge affect earnings. This would be when the hedged item in a cash flow hedge affects earnings (assuming the forecasted transaction is still probable) or when the basis adjustments to the hedged item in a fair value hedge are recognized in earnings.

Risk component hedging

For cash flow hedges, the amendments expand the types of permissible hedging strategies to include hedging the variability in cash flows due to changes in:

- A contractually specified component in the forecasted purchase or sale of a nonfinancial asset
- A contractually specified variable interest rate in a variable-rate financial instrument
For hedges of fixed-rate financial instruments, component hedging will continue to be limited to benchmark interest rates. However, the Securities Industry and Financial Markets Association or SIFMA municipal swap rate has been added to the list of permitted US benchmark interest rates.

**How we see it**

Under current guidance, companies generally have been required to designate the total price risk of forecasted purchases or sales of nonfinancial items (such as commodities) as the hedged item in cash flow hedges. This often has resulted in the recognition of ineffectiveness or the failure to qualify for hedge accounting because most entities use liquid derivatives with underlyings based on a commodity price index to hedge, rather than the price at the location where the commodity will be bought or sold. The new guidance should increase the number of nonfinancial hedging strategies that qualify for hedge accounting as the derivative’s underlying will be more closely aligned with the risk being hedged.

**Fair value hedges of interest rate risk**

The guidance makes the application of the long-haul method for fair value hedges of benchmark interest rate risk less complex by allowing:

- Entities to determine the changes in the fair value of the hedged item by using only the portion of the contractual cash flows related to the benchmark interest rate, not the entire coupon
- Entities that hedge prepayable instruments to consider only how changes in the benchmark interest rate affect the decision to prepay the instrument, rather than all factors that would affect this decision (e.g., credit risk)
- Entities to calculate the change in the fair value of the hedged item in a partial-term hedge of a fixed-rate financial instrument by assuming that its maturity date is the same as the derivative designated as the hedging instrument

The guidance also provides a new approach, referred to as the “last-of-layer” method, for hedging prepayable assets in a closed portfolio or beneficial interests secured by prepayable financial instruments. Using this approach, together with the new guidance allowing partial-term hedges of benchmark cash flows, an entity can designate as the hedged item a stated amount of the asset(s) that it does not expect to be affected by prepayments or defaults (i.e., the last layer). Any prepayments or defaults that occur will be applied first to the portion of the closed portfolio or beneficial interest that is not part of the hedged item.

**How we see it**

To use this approach, an entity will need to complete and document at hedge inception and at each subsequent effectiveness assessment date an analysis to support its expectation that the hedged portion of the assets will be outstanding for the life of the hedge relationship. When this is the case, the approach allows the entity to ignore prepayment risk in measuring the change in fair value of the hedged item.

**Hedge documentation and effectiveness assessment**

While entities will still need to perform an initial quantitative assessment of effectiveness for many hedge relationships, the new guidance makes the application of hedge accounting less complex by allowing:

- An entity to perform the initial quantitative hedge assessment up until the end of the quarter in which the hedge was designated, with additional relief provided for certain private companies and not-for-profit entities
An entity to subsequently assess hedge effectiveness qualitatively, unless the facts and circumstances of the hedge relationship change to an extent that the entity can no longer assert qualitatively that the hedge is highly effective.

An entity to use the critical terms match method for assessing hedge effectiveness of a group of forecasted transactions that occur within the same 31-day period or fiscal month of the hedging derivative’s maturity, without performing a de minimis test.

An entity to switch to the long-haul method if it inappropriately used the shortcut method, as long as it documented at the inception of the hedge the long-haul methodology to be used if needed and the hedge is highly effective when this methodology is applied.

Disclosures

To help users of the financial statements better understand the effects of hedge accounting, the guidance requires revised tabular disclosures that focus on the effect of hedge accounting by income statement line and the disclosure of the cumulative basis adjustments to the hedged assets and liabilities in fair value hedges. Certain additional disclosures are also required for hedge relationships designated under the last-of-layer method. Today’s requirement to disclose hedge ineffectiveness is eliminated because this amount is no longer separately measured.

Transition and effective date

Entities will apply the amendments to cash flow and net investment hedge relationships that exist on the date of adoption using a modified retrospective approach (i.e., with a cumulative effect adjustment recorded to the opening balance of retained earnings as of the initial application date).

The guidance also provides transition relief to make it easier for entities to apply certain amendments to existing hedges (including fair value hedges) where the hedge documentation needs to be modified.

The presentation and disclosure requirements apply prospectively.

The guidance is effective for public business entities for fiscal years beginning after 15 December 2018, including interim periods within those years. For all other entities, the guidance is effective in fiscal years beginning after 15 December 2019, and interim periods within fiscal years beginning a year later. Early adoption is permitted in any interim period or fiscal year before the effective date. If the guidance is early adopted in an interim period, any adjustments would be reflected as of the beginning of the fiscal year that includes that interim period.

Endnotes:

1 Accounting Standards Update 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities.

2 ASC 815, Derivatives and Hedging.