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FASB Proposes Updates to Hedge Accounting

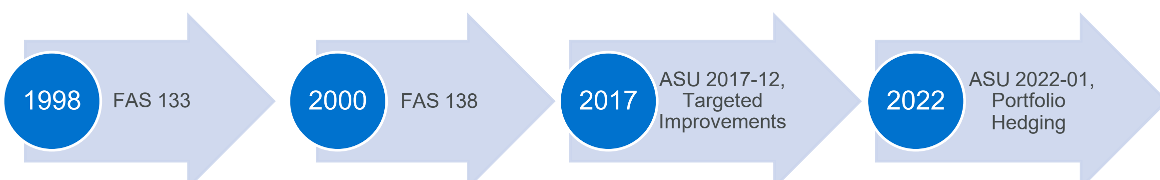
On September 25, 2024, FASB issued a proposal that would make five targeted changes to hedge accounting to better align hedge accounting with the economics of management's risk mitigation strategies. Comments are requested by November 25, 2024.

Background

Hedging is the process of mitigating a company's risk. Hedge accounting is optional and prevents earnings volatility. Without hedge accounting, a change in a derivative's fair value may be recorded in a different period than the earnings effect of a forecasted transaction, or the change in a derivative's fair value may be recorded in earnings, but the hedged asset or liability may be recorded at amortized cost or at fair value through other comprehensive income (OCI).

To qualify for hedge accounting, a company must complete documentation requirements and prove a highly effective offset between the hedging instrument and the related hedged item through quantitative testing. For qualifying hedges, GAAP provides special hedge accounting either for the hedging instrument (cash flow hedges) or the hedged item (fair value hedges) to minimize earnings volatility. Hedge accounting then allows the recognition of gains/losses from both items in the same period.

FASB overhauled hedge accounting guidance with the issuance of Accounting Standards Update (ASU) 2017-12, which was intended to better match hedge accounting economics with management's risk management strategies and reduce some operational challenges of applying and staying compliant with the accounting rules. ASU 2017-12 created a last-of-layer method to make it easier to hedge payable financial instruments. Stakeholders lobbied to allow multiple layers of a single closed portfolio to be hedged, and in 2022, FASB issued ASU 2022-01.



Stakeholders requested clarification on certain issues and were concerned that the 2017 guidance increased the prevalence of missed forecasted transactions for otherwise highly effective hedging relationships. FASB issued a proposal in 2019 to address these items, but feedback indicated the amendments would be too operationally challenging to implement. FASB believes the new proposal's more targeted changes will be more cost-effective to implement and easier to audit.

Issues Covered

1. Similar Risk Assessment for Cash Flow Hedges

Accounting Standards Codification (ASC) 815 allows an entity to designate cash flow hedges of groups of forecasted transactions using a single derivative as the hedging instrument. To qualify, the group's individual forecasted transactions must share the same risk exposure. Since the sunset of the London Interbank Offered Rate (LIBOR), a variety of new rates have emerged. An existing example in ASC 815 was interpreted to restrict hedges of interest receipts to only those based on the same index. Financial institutions have noted more granular groups are needed to comply with the shared risk exposure requirement to apply cash flow hedge accounting. These smaller, more granular groups have increased the risk of missed forecasted transactions.

Proposal

Consistent with the 2019 exposure draft, the new proposal would remove the single index example. The new amendments also would update several instances of “share the same” to “have a similar” to reinforce that the same index is not required to comply with the shared risk exposure requirement. An entity would need to formally document (at hedge inception) the method that will be used to determine whether a group of individual forecasted transactions have a similar risk exposure.

2. Hedging Forecasted Interest Payments on Choose-Your-Rate Debt

A choose-your-rate debt instrument has contractual terms that permit the borrower to change the interest rate index and interest rate tenor (reset frequency) upon which interest is accrued. The proposal would change the hedge risk guidance to allow these transactions to be hedged. This was the intention of the 2019 proposal, but the amendments were considered too broad and would be challenging to implement and audit.

Proposal

The new amendments are more prescriptive and limited, focusing on this one pervasive hedging strategy and adding an illustrative example. This model should not be applied by analogy to other hedging relationships, including relationships in which forecasted transactions are identified in accordance with the first-payments-received technique.

3. Cash Flow Hedges of Nonfinancial Forecasted Transactions

After the issuance of ASU 2017-12, stakeholders asked for clarification on several issues related to the contractually specified component hedge model. The 2019 amendments failed to adequately address users’ concerns.

Proposal

These revised changes would expand hedge accounting for forecasted purchases and sales of nonfinancial assets. FASB has developed a principle-based model for cash flow hedges on nonfinancial price components with eligibility based on the clearly and closely related criteria in ASC 815’s normal purchase and normal sales scope exception. Components that may be designated are not only the contract’s explicitly referenced variable components, but also variable subcomponents that are clearly and closely related to an explicitly referenced component. Entities also would be able to designate the variability of multiple nonfinancial hedged components as the hedged risks in a cash flow hedge if the forecasted transactions have a similar risk exposure. FASB observed that more hedges may qualify for the critical terms match method of assessing hedge effectiveness with the expanded ability to designate a component or subcomponent as the hedged risk in a nonfinancial purchase or sale transaction. Two examples have been added to illustrate these concepts.

4. New Written Options as Hedging Instruments

Many lending institutions enter into interest rate swaps with mirror-image options to mitigate their exposure to interest rate risk from lending activity, which requires application of the net written option test to determine if the compound derivative (the swap and the written cap or floor) is eligible for hedge accounting. The net written option test was developed more than 25 years ago when LIBOR was the predominant reference rate, and both the variable leg of the interest rate swap and the variable loans were tied to the same LIBOR tenor. After LIBOR cessation, it became common for the variable leg of the interest rate swap to be tied to Daily Secured Overnight Financing Rate (SOFR), which often does not match the rate on the variable-rate loans (which may be tied to Term SOFR or Daily SOFR with a different compounding convention).

Proposal

The guidance for applying the net written option test when the designated hedging instrument in a cash flow hedge is a compound derivative made up of a written option and a non-option derivative would be amended to allow entities to assume that certain terms of the compound derivative and the hedged item are matched for purposes of applying the test.[1] The interest rate of the hedged transaction and hedging instrument would be considered to match if it is a derivation of the same index, and the timing of occurrence of the hedged transaction and the settlement of the hedging instrument (as well as reset dates) would be considered to match if they are within the same 31-day period or fiscal month.

5. Dual Hedges

ASU 2017-12 eliminated the separate measurement and recognition of ineffectiveness for net investment hedges and required that amounts included in the assessment of effectiveness be recorded in accumulated other comprehensive income (AOCI) until the foreign entity is substantially liquidated. This meant that for dual hedges (foreign-currency-denominated debt instruments that are designated as the hedging instrument in a net investment hedge and designated as the hedged item in a fair value hedge of interest rate risk), the gain or loss on the remeasurement of the fair value hedge basis adjustment at the spot exchange rate must be deferred in AOCI. Before ASU 2017-12, foreign exchange (FX) remeasurement was recognized in current-period earnings after offsetting with the FX remeasurement of the hedging instrument. FASB had not intended to change the previous practice.

Proposal

Consistent with the 2019 proposal, these amendments would exclude the fair value hedge basis adjustment from the assessment of the effectiveness of the net investment hedge when the debt instrument also is designated as

[1] "Topic 815 – Hedge Accounting Improvements," fasb.org, June 14, 2024.

the hedge item in a fair value hedge of interest rate risk. The notional amount of the debt instrument would match the notional amount of the investment in a foreign subsidiary that is designated in the net investment hedge. Because the debt instrument's fair value hedge basis adjustment would be excluded from the assessment of effectiveness of the net investment hedge, the remeasurement for changes in the spot rates on the fair value hedge basis adjustment would be recognized in earnings in accordance with ASC 830-20, *Foreign Currency Matters—Foreign Currency Transactions*.

Effective Date & Transition

An effective date will be determined after a review of the comment letter feedback. Early adoption will be permitted for all entities on any date. Adoption would be on a prospective basis, and special transition provisions are included for each of the five changes.

Conclusion

The assurance team at Forvis Mazars delivers extensive experience and skilled professionals to help align with your objectives. Our proactive approach includes candid and open communication to help address your financial reporting needs. At the end of the day, we know how important it is for you to be able to trust the numbers; our commitment to independence and objectivity helps provide the security and confidence you desire.

Whether you are publicly traded or privately held, Forvis Mazars can provide an independent and objective view into your financial reporting. We leverage some of the latest technologies and process automation tools to provide companies assurance on their financial statements to help meet stakeholders' needs.

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