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Updates on Hedge Accounting for Private Companies

With the era of low, stable interest rates firmly in the rearview mirror, companies may want to reconsider their hedge accounting strategies. Given current economic uncertainties and market volatility, companies may want to revisit previous conclusions about the benefits versus cost and complexity of applying hedge accounting in managing company risks. Over the past several years, FASB has updated its guidance to better align hedge accounting with management's risk strategies and to reduce some of the operational challenges of applying and staying compliant with the rules. This article provides a high-level overview of these updates.

These updates do not affect the private company exception that provides a simplified hedge accounting method for certain variable to fixed rate interest rate swaps.

Background

Hedging is the process of mitigating a company's risk. Under GAAP, derivatives are generally recorded at fair value with changes in fair value reported in earnings. 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 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.

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ASU 2017-12, Targeted Improvements to Accounting for Hedging Activities

Accounting Standards Update (ASU) 2017-12 was issued in 2017 after three exposure drafts and more than 10 years of deliberations. It is now effective for all entities. The ASU expanded the number and types of transactions that qualify for hedge accounting and private companies received significant documentation relief. Industries that benefited the most from these changes include food and agribusiness, oil and gas, insurance, and banking. Significant changes are noted below.

Cash Flow Hedges

Nonfinancial Assets

The ASU expanded hedge accounting for financial and nonfinancial risk components, *e.g.*, purchases of ingredients and materials for production and operations. Previously, only foreign currency risk could be designated as the hedged risk for a nonfinancial item. For a cash flow hedge of a nonfinancial asset, an entity can now designate as the hedged risk the variability in cash flows attributable to changes in a contractually specified component stated in the contract. For forecasted transactions, ASU 2017-12 permits continuation of a hedging relationship if the hedging instrument is a highly effective offset to the revised hedged risk.

Financial Assets

ASU 2017-12 eliminated benchmark interest rates for hedges of variable-rate instruments. For a cash flow hedge of interest rate risk of a variable-rate financial instrument, an entity can now designate as the hedged risk the variability in cash flows attributable to the contractually specified interest rate.

Fair Value Hedges

The ASU significantly expanded derivative strategies eligible for hedge accounting and eliminates the benchmark interest rate concept for hedges of variable-rate financial instruments. Contractually specified interest rates are not limited to market benchmark rates. An entity's own prime rate or a variable rate set through an auction process qualifies as a contractually specified interest rate when it is the rate that is explicitly referenced in the variable-rate financial instrument being hedged. An entity can now use benchmark rate coupon cash flows determined at hedge inception in calculating the fair value change of the hedged item related to interest rate risk.

The ASU created equitable treatment for partial-term fair value hedges and cash flow hedges by allowing an entity to measure the hedged item in a partial-term fair value hedge of interest rate risk by assuming the hedged item has a term that only reflects the designated cash flows being hedged.

Last-of-Layer Method

The ASU created a new method, last-of-layer, allowing an entity to qualify for hedge accounting for a closed portfolio of prepayable assets without having to incorporate the risks and volatility from prepayments, defaults, and

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other factors affecting the timing and amount of cash flows in a hedged item's measurement. Entities need to consider only how changes in the benchmark interest rate affect a decision to settle a debt instrument before its scheduled maturity in calculating the change in fair value of the hedged item attributable to interest rate risk.

Documentation & Timing Relief

Entities were given more time to perform the initial prospective quantitative assessment of hedge effectiveness. Entities can perform that assessment at any time after hedge designation—but no later than the quarterly effectiveness testing date—using data applicable as of the hedge's inception date.

Private companies that are not financial institutions are exempted from providing documentation that discloses any risk management activities. Instead, a "statement of intent to hedge" is required that includes the hedging instrument, hedged item/transaction, the potential risk of the hedged item/transaction, and the method used to review effectiveness. In addition, private companies that are not financial institutions can document the method of assessing hedge effectiveness and perform the initial quantitative effectiveness assessment and all quarterly hedge effectiveness assessments before the date on which the next interim or annual financial statements are available to be issued.

Subsequent Qualitative Assessment

Entities are still required to make an initial quantitative effectiveness assessment at hedge inception, unless a scope exception applies, *i.e.*, shortcut method. However, quantitative reassessment is required only if changes in circumstances suggest that the hedging relationship may no longer be reasonably effective, under an accounting policy election. If elected, an entity is required each quarter to verify and document that the facts and circumstances related to the hedging relationship have not changed such that the entity can assert qualitatively that the hedging relationship was and continues to be highly effective. An entity can still perform quantitative assessments on a hedge-by-hedge basis.

FASB also updated the short-term method to reduce the number of costly restatements when not correctly applied.

A new accounting election is provided for the recognition of excluded components. Entities are allowed to use a systematic and rational method to amortize the initial value of an excluded component into earnings over the life of the hedging instrument. If elected, any difference between the change in fair value of the excluded component and amounts recognized under the systematic and rational method is recognized in OCI. The standard also allows—as an accounting policy election—to apply a mark to market through earnings approach.

Recognition & Presentation

Entities now report the entire effect of the hedging instrument in the same income statement line item where the earnings effect of the hedged item is reported.

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ASU 2022-01, Portfolio Method for Hedge Accounting

Stakeholder feedback indicated that while the last-of-layer method was useful, hedge accounting could better reflect risk management activities if the scope were expanded to allow multiple layers of a single closed portfolio to be hedged, and on March 28, 2022, FASB issued ASU 2022-01, *Fair Value Hedging—Portfolio Layer Method*.

The ASU allows multiple hedged layers to be designated for a single closed portfolio of financial assets or one or more beneficial interests secured by a portfolio of financial instruments. An entity can now achieve hedge accounting for hedges of a greater proportion of the interest rate risk for assets in a closed portfolio. To reflect this expansion, the last-of-layer method was renamed the portfolio layer method. ASU 2022-01 includes other refinements and clarifications to ASU 2017-12:

- Allows nonprepayable assets in the closed portfolio; however, financial liabilities are still excluded from scope
- Specifies eligible hedging instruments in a single-layer hedge
- Provides additional guidance on the accounting for and disclosure of hedge basis adjustments under the portfolio layer method
- Specifies the assessment of hedge basis adjustments when determining credit losses for the closed portfolio's assets

Multiple Hedged Layers of a Single Closed Portfolio

In applying hedge accounting to multiple hedged layers, an entity has the flexibility to achieve hedge accounting using different types of derivatives and layering techniques that best align with their individual circumstances. An entity is not restricted from using any particular types of derivatives to achieve its risk management objectives. For example, an entity may use multiple spot-starting constant-notional swaps with different term lengths, a combination of spot-starting and forward-starting constant-notional swaps, multiple spot-starting or forward-starting amortizing-notional swaps, or any combination of those derivatives to hedge different amounts of the closed portfolio and qualify for hedge accounting. The ASU also specifies that an entity hedging multiple amounts in a closed portfolio with a single amortizing-notional swap is executing a single-layer hedge, not hedges of multiple layers.

If multiple hedged layers are designated, an entity must perform an analysis to support its expectation that the aggregate amount of the hedged layers is anticipated to be outstanding for the designated hedge periods. The analysis should incorporate the entity's current expectations of prepayments, defaults, and other factors affecting the timing and amount of cash flows associated with the closed portfolio.

As prepayments, defaults, and other factors occur that affect the timing or amount of cash flows, those events should be applied first to the portion of the closed portfolio that is not hedged.

Example

If an entity designates two spot-starting swaps, one in a hedging relationship with a hedged layer of $20 million and another in a hedging relationship with a hedged layer of $10 million that overlap during Years One to Three, the entity should support its expectation that the aggregate amount of at least $30 million is anticipated to be outstanding for the period during which the two hedges overlap.

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While only closed portfolios may be hedged under the portfolio layer method, an entity is permitted to designate new hedging relationships and dedesignate existing hedging relationships associated with the closed portfolio any time after the closed portfolio is established and designated in a portfolio layer method hedge. This allows the accounting to better reflect changes in an entity's risk management activities in a dynamic interest rate environment.

Breaches

If a breach is **anticipated**—meaning the aggregate amount of the hedged layers is no longer anticipated to be outstanding in future hedged periods—an entity must partially or fully dedesignate a hedged layer or layers until a breach is no longer anticipated. If a hedging relationship is fully or partially discontinued because of an anticipated breach, the outstanding basis adjustment associated with the dedesignated amount as of the discontinuation date should be allocated to the remaining individual assets in the closed portfolio that supported the dedesignated hedged layer using a systematic and rational method. An entity should amortize those amounts over a period that is consistent with the amortization of other discounts or premiums associated with the respective assets in accordance with other accounting guidance, *e.g.*, Accounting Standards Codification (ASC) 310-20, *Receivables—Nonrefundable Fees and Other Costs*.

If a breach has **occurred**—meaning the aggregate amount of the hedged layers exceeds the closed portfolio amount—an entity is required to partially or fully dedesignate a hedged layer or layers until the aggregate amount of the hedged layers no longer exceeds the closed portfolio. As of the discontinuation date, an entity would determine the portion of the basis adjustment associated with the amount of the hedged layer that exceeds the closed portfolio using a systematic and rational method and immediately recognize that amount in interest income. An entity is required to disclose the amount of the hedge basis adjustment in current-period interest income from the breach and the circumstances that led to the breach.

If there are multiple hedged layers in an actual or anticipated breach, an entity should determine which hedges to dedesignate or partially dedesignate in accordance with an accounting policy election that specifies a systematic and rational approach to determining which hedge or hedges to dedesignate (or partially dedesignate). An accounting policy should be established no later than when an entity first anticipates a breach or when a breach has occurred (whichever comes first). That policy should be applied consistently to all portfolio method breaches (anticipated or occurred).

Voluntary Dedesignations

An entity may elect to fully or partially discontinue hedge accounting prospectively for all or a portion of the hedged layer for one or more hedging relationships related to a closed portfolio at any time, even if a breach has not occurred or is not anticipated. If multiple hedged layers are associated with the closed portfolio, the entity may voluntarily elect to fully or partially dedesignate any hedges associated with that closed portfolio.

If a hedging relationship is voluntarily fully or partially discontinued, the outstanding basis adjustment associated with the dedesignated amount as of the discontinuation date should be allocated to the closed portfolio's remaining individual assets that supported the dedesignated hedged layer using a systematic and rational method. An entity shall amortize those amounts over a period that is consistent with the amortization of other discounts or premiums associated with the respective assets in accordance with other accounting guidance.

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Transfers & Sales

For the transfer of a participating interest or the sale of an entire financial asset or group of financial assets included in a closed portfolio hedged in an existing portfolio layer method hedge, an entity should follow guidance in ASC 860-20-40; however, an entity shall not include any portion of the hedge basis adjustment that is maintained on the closed portfolio.

Presentation

For an existing portfolio layer method hedge, if the closed portfolio's assets are presented in different line items in the balance sheet, an entity shall allocate the portfolio layer method basis adjustment to the assets' associated line items in the statement of financial position using a systematic and rational method.

If a hedged item is measured at fair value with changes in fair value reported in OCI, *e.g.*, an available-for-sale (AFS) debt security, the adjustment of the hedged item's carrying amount should be recognized in earnings rather than in OCI to offset the gain or loss on the hedging instrument. If the hedged item is a hedged layer designated in a portfolio layer method hedge on a closed portfolio and that portfolio includes only AFS debt securities, the entire gain or loss on the change in fair value on the hedged item attributable to the hedged risk shall be recognized in earnings rather than in OCI to offset the gain or loss on the hedging instrument. If a closed portfolio includes both AFS debt securities and non-AFS debt securities, an entity should determine the portion of the change in fair value related to the AFS debt securities using a systematic and rational method. That amount would be recognized in earnings rather than in OCI. However, an entity should not adjust the carrying amount of the individual AFS debt securities included in the closed portfolio.

Fair Value Hedge Basis Adjustments

ASU 2017-12 provided guidance on breaches and anticipated breaches for last-of-layer hedges; however, it did not provide guidance on the accounting treatment for the portion of the basis adjustment related to the breached amount. To promote consistent reporting of hedge basis adjustments for both single and multiple hedged layers, ASU 2022-01 includes the following clarifications:

- An entity must maintain basis adjustments in an existing hedge on a closed portfolio basis—no allocation to individual assets is permitted. Any change in basis adjustment should be recognized currently in earnings. An entity may not apply this guidance by analogy to other components of the recorded investment.
- An entity is required to immediately recognize and present the basis adjustment associated with the amount of the dedesignated layer that was breached in interest income and is required to disclose that amount and the circumstances that led to the breach.
- An entity must disclose the total amount of the basis adjustments in existing hedges as a reconciling amount if other areas of GAAP require the disaggregated disclosure of the amortized cost basis of assets in the closed portfolio.
- An entity is prohibited from considering basis adjustments in an existing hedge when determining credit losses.

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Effective Date & Transition

The ASU is already effective for public business entities. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2023 and interim periods within those fiscal years.

Upon adoption, any entity may designate multiple hedged layers of a single closed portfolio solely on a prospective basis. All entities are required to apply the amendments related to hedge basis adjustments under the portfolio layer method—except for those related to disclosures—on a modified retrospective basis by means of a cumulative-effect adjustment to the opening balance of retained earnings on the initial application date. The disclosure changes can be reflected on a prospective basis from the initial application date or on a retrospective basis to each prior period presented after the date of adoption of ASU 2017-12.

An entity may reclassify debt securities classified in the held-to-maturity category at the date of adoption to the AFS category only if the entity applies portfolio layer method hedging to one or more closed portfolios that include those debt securities. Reclassification must be made within 30 days of adoption, and the securities must be included in one or more closed portfolios that are designated in a portfolio layer method hedge within that 30-day period.

Transition Disclosures

The following transition disclosures are required in each interim financial statement and the annual financial statement for the fiscal year of adoption:

- The nature of and reason for the change in accounting principle related to accounting for hedge basis adjustments
- The effect of adoption on any line item in the statement of financial position, if material, as of the beginning of the first period for which the ASU is applied. Presentation of the effect on financial statement subtotals is not required
- The cumulative effect of the change on retained earnings or other equity components in the statement of financial position as of the beginning of the first period for which the ASU is applied

Conclusion

Company management should carefully review all the facts and circumstances before choosing a course of action. Forvis Mazars can help private companies prepare for the new standard by identifying key changes that may have the most effect on existing hedges, assessing potential new hedging strategies, and evaluating transition election and timing. For more information, visit forvismazars.us.

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