Defining Issues®

September 2016, No. 16-31

Contents

FASB Proposes Targeted Changes to Hedge Accounting

The FASB's proposed Accounting Standards Update (ASU) would provide additional opportunities for an entity to align its hedge accounting with its risk management activities, and has the potential to reduce the cost and effort required to apply hedge accounting.[1]

Key Facts

- The proposed ASU eases the requirements for effectiveness testing, hedge documentation, and application of the shortcut and the critical terms match methods.
- Entities would be permitted to designate contractually specified components as the hedged risk in a cash flow hedge involving the purchase or sale of nonfinancial assets or variable rate financial instruments.
- Entities would no longer separately measure and report hedge ineffectiveness.
- Entities could choose refined measurement techniques to determine the changes in fair value of the hedged item in fair value hedges of benchmark interest rate risk.

Key Impacts

- The proposed ASU would:
  - Expand the types of hedging activities that could qualify for hedge accounting to provide additional opportunities to align hedge accounting with an entity's existing risk management activities; and
  - Reduce the cost and complexity of monitoring the effectiveness of hedge relationships and implementing hedge accounting.

[1] FASB Proposed Accounting Standards Update, Targeted Improvements to Accounting for Hedging Activities, September 8, 2016, available at www.fasb.org.

Contractually Specified Components

The proposed ASU requires certain criteria to be met to designate the variability in cash flows of a contractually specified component as the hedged risk in a cash flow hedge of a nonfinancial asset:

- The purchase or sales contract for the nonfinancial asset must create cash flow variability due to changes in the contractually specified component throughout the life of the hedge;
- All of the stated components of the price must relate to the cost of purchasing or selling the nonfinancial asset in the normal course of business in a particular market; and
- All of the stated components of the price must reflect market conditions at contract inception.

Risk Component Hedging

The proposed ASU would allow an entity to designate the variability in cash flows related to only one of the components of a larger cash payment or receipt as the hedged risk in more circumstances than under current U.S. GAAP.

Cash Flow Hedges of Nonfinancial Hedged Items

Current U.S. GAAP	Proposed ASU
Either the overall variability in cash flows or the foreign currency risk could be designated as the hedged risk. Price risk components, other than foreign currency risk, cannot be hedged.	Entities could designate a contractually specified component of a contract to purchase or sell a nonfinancial item as the hedged risk. For example, an airline could designate the crude oil component of a jet fuel purchase contract as the hedged risk if the changes in the price in the purchase contract vary based on changes in crude oil prices.

KPMG Observations

Under current US GAAP, the ability to apply hedge accounting to one or more discrete risks is limited to hedges of financial instruments and hedges of foreign currency risk. However, for risk management purposes, many entities manage commodity price risk on a component basis rather than on a total price basis. This occurs, in part, because derivative instruments are often available for only the component commodity, not for the overall price of the nonfinancial item being purchased or sold. By permitting an entity to designate a contractually specified component of a forecasted purchase or sale of a nonfinancial item as the hedged risk, the proposed ASU would give entities additional opportunities to apply hedge accounting to existing risk management strategies.

Cash Flow Hedges of Variable Rate Financial Instruments

The proposed ASU would allow an entity to designate variability in a contractually specified non-benchmark variable interest rate as the hedged risk.

Current U.S. GAAP	Proposed ASU
If the variable rate financial instrument is indexed to an interest rate that is not considered a benchmark rate, there is no ability to designate as the hedged risk only the variability in the non-	Entities could designate as the hedged risk any contractually specified variable rate. This ability would eliminate the concept of benchmark interest rates for hedges of variable rate financial instruments.

Current U.S. GAAP	Proposed ASU
benchmark index. Instead, entities would be able to hedge only the overall variability in cash flows.	

Changes to Recognition and Presentation

The proposed ASU would eliminate the requirement to separately measure and report hedge ineffectiveness, and would provide new guidance about income statement classification.

Current U.S. GAAP	Proposed ASU
For cash flow and net investment hedges, changes in the fair value of the hedging instrument are split between the effective portion (recorded in other comprehensive income) and the ineffective portion (recognized in net income).	For cash flow and net investment hedges, the entire change in the fair value of the hedging instrument would be recorded in other comprehensive income.
There is no specific guidance about the income statement classification of amounts reclassified to earnings from other comprehensive income (for cash flow hedges and net investment hedges) or the change in fair value of the hedging instrument (for fair value hedges).	Amounts reclassified to earnings from other comprehensive income and the change in fair value of the hedging instrument would be recorded in the same income statement line item in which the earnings effect of the hedged item is presented.

KPMG Observations

When hedge accounting is applied under current US GAAP, the changes in the fair value of a hedging instrument are split into effective and ineffective portions. The effective portion is recognized in earnings at the time that the hedged item affects earnings. In contrast, the ineffective portion is treated like a separate non-hedging derivative. As a result, the ineffective portion can potentially affect earnings in different reporting periods and in different financial statement line items from the effect of the hedged item.

The guidance in the proposed ASU takes the approach that the entire change in the fair value of the hedging instrument should be considered to be a cost (or benefit) of hedging. Thus, the entire change would be displayed in the same period, and in the same line item, as the earnings effect of the hedged item.

Ineffectiveness Eliminated

The concept of *ineffectiveness* would be removed from U.S. GAAP because the proposed ASU would no longer require entities to separately measure and record the effective and ineffective portions of hedging instruments.

However, the Board decided to retain the *highly effective* threshold as one of the criteria to qualify for hedge accounting.

Reduced Cost and Complexity for Preparers

The proposed ASU includes several simplifications that would reduce cost and complexity including these changes.

Fair Value Hedges of Interest Rate Risk

Current U.S. GAAP	Proposed ASU
The change in fair value of the hedged item for the hedged risk is based on the item's stated maturity date. It can be very difficult to achieve hedge accounting if there is a mismatch in the maturities of the hedged item and the hedging derivative.	Partial-term hedges would be permitted. Entities may calculate the change in fair value of the hedged item for the hedged risk by assuming that the hedged item has the same term as the hedging derivative.

More Time to Perform Initial Effectiveness Testing

Current U.S. GAAP	Proposed ASU
Initial prospective quantitative effectiveness testing should be performed contemporaneously with hedge designation.	Initial prospective quantitative effectiveness testing may be performed after hedge designation. The proposed ASU includes a number of different dates that would need to be considered when determining when the initial testing would need to be completed, but in all cases it would be required on or before the next quarterly hedge effectiveness assessment date.

Subsequent Effectiveness Testing Can Be Qualitative

Current U.S. GAAP	Proposed ASU
If subsequent effectiveness testing is required, it must be quantitative.	Subsequent effectiveness testing may be performed based on either quantitative or qualitative considerations. Subsequent qualitative testing must be elected at the inception of the hedge, at which time the entity must be able to reasonably support an expectation

Current U.S. GAAP	Proposed ASU
	of high effectiveness in subsequent periods. Qualitative testing must be performed and documented at least every three months. If changes in facts and circumstances no longer enable an entity to assert qualitatively that a hedging relationship was, and continues to be, highly effective, the entity would be required to perform quantitative testing from that point forward.

Qualifying Criteria for the Critical Terms Match Method

Current U.S. GAAP	Proposed ASU
The criteria to be met to apply the critical terms match method for a group of forecasted transactions include that the hedged forecasted transactions should take place at the same time and location as the hedging derivative.	Entities may assume that the hedging derivative matures at the same time as the hedged forecasted transactions if the derivative's maturity ***and*** the forecasted transactions take place within a 31-day period. Entities may ignore location differences in determining whether the critical terms match when designating contractually specified components of nonfinancial assets.

Error Corrections Resulting from Misapplication of the Shortcut Method

Current U.S. GAAP	Proposed ASU
An entity that determines that it inappropriately used the shortcut method loses hedge accounting in all periods in which it had been previously applied.	An entity that determines that it inappropriately used the shortcut method may apply hedge accounting to previous periods if the: • Hedge is found to have been highly effective from inception of the hedging relationship when assessed using a quantitative method; and

Comments on the proposed ASU are due November 22.

Two public roundtable meetings are tentatively planned for December 2.

Current U.S. GAAP	Proposed ASU
	• Entity documented at the inception of the hedging relationship which quantitative method it would use if the shortcut method was found to be inappropriate.

KPMG Observations

By permitting an entity to retroactively apply a quantitative method of assessing hedge effectiveness when specified criteria are met, the proposed ASU would, compared with current U.S. GAAP, reduce the amount of the error when the shortcut method had been applied inappropriately. This change would reduce the likelihood that the error would be considered to be material and lead to a restatement of previously issued financial statements.

The Board made this change based on its belief that when a hedge is highly effective, applying hedge accounting in prior periods provides financial statement users with better information than restating results to completely remove hedge accounting. However, the Board decided that hedge accounting would continue to be removed if the entity failed to document at the inception of the hedging relationship which quantitative method it would use if the shortcut method was found to be inappropriate, regardless of whether the relationship would have been highly effective if a quantitative method had been chosen.

Proposed Transition and Effective Date

Entities would initially apply the proposed ASU using a modified-retrospective approach with a cumulative effect adjustment to accumulated other comprehensive income and opening retained earnings as of the most recent period presented on the date of adoption. The proposed ASU provides specific transition guidance for fair value hedges of interest rate risk and risk component hedging, as well as one-time transition elections related to hedge documentation.

The proposed ASU would allow early adoption at the beginning of any fiscal year before the effective date. The Board will determine the effective date after it receives stakeholder feedback.

Contact us: This is a publication of KPMG's Department of Professional Practice 212-909-5600

Contributing authors: Mark Northan, Mahesh Narayanasami, and Casey C. Miles

Earlier editions are available at: kpmg.com/us/frn