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Changes to hedge accounting

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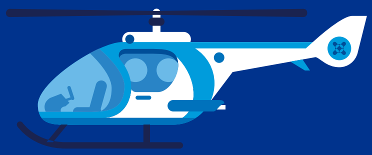


KPMG reports on ASU 2017-12[1], which simplifies and expands the application of hedge accounting.

Applicability

Companies that elect to apply hedge accounting.

Facts and impacts

The ASU changes the recognition and presentation requirements of hedge accounting including:

- eliminating the requirement to separately measure and report hedge ineffectiveness; and
- presenting all items that affect earnings in the same income statement line as the hedged item.

The ASU also provides new alternatives for:

- applying hedge accounting to additional hedging strategies;
- measuring the hedged item in fair value hedges of interest rate risk;
- reducing the cost and complexity of applying hedge accounting by easing the requirements for effectiveness testing, hedge documentation and application of the critical terms match method; and
- reducing the risk of material error corrections if a company applies the shortcut method inappropriately.

Recognition and presentation

The ASU requires that when a hedge is deemed 'highly effective', hedge accounting must be applied to the entire change in the fair value of the hedging instrument. When hedge accounting is applied, the changes in the fair value of the hedging instrument and the hedged items may not exactly offset each other even though the relationship is highly effective.

Under current US GAAP, the change in fair value of the hedging instrument is divided between amounts that offset the hedged item ('effective portion') and amounts that do not offset the hedged item ('ineffective portion'). The ineffective portion was sometimes reported in an income statement line item that was different from the line item used to report the earnings effect of the hedged item.

For cash flow and net investment hedges, the timing of earnings recognition differed between the ineffective and effective portions. The ineffective portion of the hedge relationship was recognized immediately in earnings, while the effective portion was initially recognized in other comprehensive income and later reclassified to earnings when the hedged transaction affected earnings.

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

The ASU eliminates the notion of ineffective portions of hedge relationships. This change will be most significant for cash flow and net investment hedges because it will change the timing of earnings recognition. Now the entire change in the fair value of the hedging instrument will be recorded in other comprehensive income, and the ineffective portion will no longer be separately recognized in earnings.

For all hedges, the entire change in the fair value of the hedging instrument will be recorded in the same income statement line item as the hedged item. A company will no longer be able to apply judgment in determining the income statement classification of ineffective amounts. This could lead to additional volatility in line items such as revenue, interest income or interest expense.

Both current US GAAP and the ASU permit, in some circumstances, excluding amounts from the assessment of hedge effectiveness (e.g. premiums on options used as a hedging instrument). This creates an excluded portion of a hedge relationship. Changes in the fair value of the excluded component are recognized immediately in earnings or, under a new alternative provided by the ASU, deferred in other comprehensive income and subsequently recognized in earnings. The ASU requires the excluded portion to be recorded in the same income statement line item as the earnings effect of the hedged item.

New hedging strategies

The ASU permits hedging risk components of nonfinancial assets and allows more flexibility for hedging interest rate risk in cash flow hedges.

Hedging components of nonfinancial hedged items

The ASU allows a company to designate a contractually specified component of a contract to purchase or sell a nonfinancial item as the hedged risk in a cash flow hedge. This allows a company to designate the variability in cash flows related to only one of the components of a cash payment or receipt as the hedged risk.

The ability to hedge contractually specified components also extends to not-yet-existing contracts if the company expects them to include a contractually specified component.

Example: A bakery has a purchase contract to buy flour for the price of wheat (using a specified index) plus $1 (per unit of measure). The company designates the wheat index component as the hedged risk in its cash flow hedge.

KPMG observation

Under current US GAAP, the ability to apply hedge accounting to one or more discrete risks is limited to hedges of financial instruments and foreign currency risk. However, for risk management purposes, many companies that purchase or sell nonfinancial assets hedge a commodity exposure that is only one component of the total price. This occurs, in part, because derivative instruments are often only available for the component commodity, not for the overall price of the nonfinancial item being purchased or sold.

By permitting a company to designate a contractually specified component of a forecasted purchase or sale of a nonfinancial item as the hedged risk, the ASU gives companies additional opportunities to apply hedge accounting.

Hedging variable interest rate financial instruments

The ASU allows a company to designate any contractually specified variable interest rate as the hedged risk. This eliminates the current US GAAP requirement that the hedged risk in a cash flow hedge of interest rate risk must be a specified benchmark rate. The most significant effect of this change will be the ability to designate prime lending rates as the hedged risk for prime-based variable rate loans.

Example: A debt contract specifies the rate as a specified Bank's prime lending rate plus 100 basis points. Although the specified Bank's prime lending rate is not a benchmark interest rate, it can be the hedged risk because it is contractually specified.

New accounting alternatives for fair value hedges of interest rate risk

The ASU creates new accounting alternatives for measuring the change in the fair value of the hedged item in fair value hedges of interest rate risk. The FASB intends that these changes will better align hedge accounting with the risk management strategies that companies use to manage interest rate risk. The most significant changes are hedging:

- only the benchmark component;
- only a portion of the remaining term; and
- prepayable financial assets using a 'last-of-layer' method.

Hedging only the benchmark component

The ASU provides a new alternative to measure the change in fair value of the hedged item based solely on the benchmark rate component of the contractual coupon cash flows – not based on the cash flows from the entire contractual coupon.

This change is intended to permit companies to design hedges that better offset and therefore reduce income statement volatility when they hedge interest rate risk with common hedging instruments such as swaps based on LIBOR.

Example: A 5-year debt instrument with a fixed rate coupon of 3 percent is hedged with a 5-year interest rate swap that pays LIBOR and receives a fixed 2 percent. Under current US GAAP, the change in the fair value of the hedged item would be determined based on the entire 3 percent coupon.

The ASU allows the change in the fair value of the debt instrument to be measured based on the portion of the 3 percent coupon that relates to LIBOR. In this case, the change in the fair value of the hedged item (debt instrument) caused by the benchmark rate (LIBOR) will offset the change in the fair value of the LIBOR swap so the income statement volatility is minimized.

Hedging only a portion of the remaining term

The ASU allows a company to designate a portion of the remaining term of a loan or debt security as the hedged item in a fair value hedge of interest rate risk.

Example: A 10-year debt instrument with a fixed rate coupon of 5 percent is hedged with a 5-year interest rate swap that pays LIBOR and receives a fixed 2 percent. The ASU allows the change in the fair value of the hedged item (debt instrument) to be measured based on the cash flows associated with only the first 5 years of the 10-year debt instrument, with an assumption that the outstanding principal will be paid at the end of 5 years.

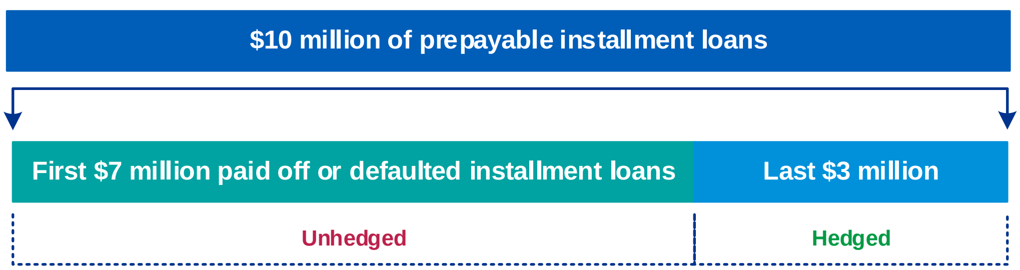
Hedging prepayable financial assets using a last-of-layer method

A company hedging a portfolio of prepayable assets may designate an amount that is not expected to be affected by prepayments (or other events that would affect the timing and amounts of cash flows) as the hedged item (last-of-layer method). Using this method, the fair value of the hedged item is measured as if it were not prepayable.

This alternative may alleviate the need for a company to match the prepayment risk of the hedged item with a similar feature in the hedging instrument to qualify for hedge accounting and/or reduce volatility in the income statement.

Example: A company has a portfolio of $10 million of prepayable 15-year installment loans. The company wants to hedge the interest rate risk associated with $3 million of the loans for 12 years because it expects that amount will not be affected by prepayments or other events.

The ASU allows a company to designate a $3 million layer of the portfolio as the hedged item, and measure the change in fair value for that layer as if it was not prepayable. The hedging instrument could then be a plain-vanilla, non-prepayable interest rate swap without subjecting the company to income statement volatility related to a mismatch between prepayable loans and a non-prepayable interest rate swap.



Reduced cost and complexity to apply hedge accounting

Current US GAAP	ASU
Subsequent effectiveness testing may be qualitative	
If subsequent effectiveness testing is required, it must be quantitative.	— Subsequent effectiveness testing may be performed qualitatively as long as a company can reasonably support an expectation that the hedge is highly effective now and in subsequent periods. — A company must periodically verify and document that facts and circumstances have not changed.

Current US GAAP	ASU
Qualifying criteria for the critical terms match method	
The criteria to be met to apply the critical terms match method for a group of forecasted transactions include that the hedged forecasted transaction should take place at the same time as the hedging derivative.	— A company may apply the critical terms match method if the forecasted transaction is expected to occur, and the hedging derivative matures, within the same 31-day period or fiscal month.
More time for initial effectiveness testing	
Initial prospective effectiveness testing should be performed contemporaneously with hedge designation.	— Initial prospective hedge effectiveness testing may be performed after hedge designation. — The ASU specifies several considerations for determining the date effectiveness testing should be performed. However, in all cases it would be required within three months of hedge designation, and before financial statements are available to be issued. Additional relief is provided for private companies that are not financial institutions.
Error corrections resulting from misapplication of the shortcut method	
A company that determines that it inappropriately used the shortcut method loses hedge accounting in all previous periods in which it had been previously applied.	A company that inappropriately applied the shortcut method may continue to apply hedge accounting to previous periods if it: — documented at the inception of the hedge which quantitative method it would use to assess hedge effectiveness if the shortcut method was inappropriate; and — determines that, when the quantitative method identified in its hedge documentation was applied, the hedge was highly effective for the periods in which the shortcut method criteria were not met.

KPMG observation

By permitting a company to retroactively apply a quantitative method of assessing hedge effectiveness when specified criteria are met, the ASU reduces the amount of error when the shortcut method had been applied inappropriately. This change reduces the likelihood that the error is material and will require a restatement of previously issued financial statements.

Effective dates and transition

	Public business entities	Other entities
Effective date	For annual and interim periods in fiscal years beginning after December 15, 2018.	For annual periods in fiscal years beginning after December 15, 2019, and interim periods in fiscal years beginning after December 15, 2020.
Early adoption allowed?	Yes, any time after the issuance of the ASU including in an interim period. If adopted at other than the beginning of a fiscal year, cumulative effect adjustments are reflected as of the beginning of the fiscal year.	
Transition	— Generally achieved through cumulative effect adjustment to accumulated other comprehensive income with a corresponding adjustment to opening retained earnings as of the beginning of the fiscal year of adoption. — Changes to income statement classification and financial statement disclosures are applied prospectively from the date of adoption. — Specific transition guidance provided for fair value hedges of interest rate risk and risk component hedging. — One-time transition elections are available to modify existing hedge documentation.	

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KPMG's Financial Reporting View
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