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FASB proposal

Hedge accounting improvements

September 26, 2024

FASB proposes updates to improve alignment of hedge accounting guidance with risk management activities.

Source and applicability

- Proposed ASU, Hedge Accounting Improvements
- Any entity that elects to apply hedge accounting

Fast facts, impacts, actions

The proposed ASU is intended to more closely align the financial reporting of hedging activities with the economics of an entity's risk management activities. The amendments are being proposed in response to stakeholder feedback from implementing ASU 2017-12 and the effects of LIBOR cessation. The main proposals are related to cash flow hedging and are as follows.

- **Nonfinancial component hedges:** Permit an entity to designate a variable price component of the forecasted purchase or sale of a nonfinancial asset if the component is clearly and closely related to the nonfinancial asset being purchased or sold.

- **Groups of forecasted transactions – similar risk exposure:** Allow individual forecasted transactions to be hedged in a group if they have a similar risk exposure and explicitly permit interest payments (receipts) based on different interest rate indexes in the same group. Provide guidance for determining whether individual transactions have similar risk exposure.

- **Change in hedged risk for 'choose-your-rate' debt instruments:** Limit the ability to change the hedged risk in a cash flow hedging relationship to hedges of interest payments (receipts) on variable-rate debt instruments with contractual terms that permit the borrower to change the interest rate index and/or tenor ('choose-your-rate' debt instruments). Provide a revised model that allows entities to continue hedge accounting even after the borrower changes to a new interest rate index and/or tenor for choose-your-rate debt instruments and to apply certain simplifying assumptions.

Early adoption would be permitted on any date, so we encourage entities to evaluate the potential benefits of the proposal now. Comments to the FASB on the proposal are due by November 25, 2024.

Background

Hedge accounting is designed to allow an entity that hedges risk inherent in certain transactions by using derivative instruments to provide financial reporting that better reflects those activities. ASU 2017-12, Targeted Improvements to Accounting for Hedging Activities, more closely aligned hedge accounting with an entity's risk management activities and made certain targeted improvements to simplify the application of the hedge accounting guidance. After the issuance of ASU 2017-12, stakeholders asked the FASB to clarify certain aspects of the guidance in the ASU. Additionally, stakeholders requested the FASB address incremental issues arising from the effects of the London Interbank Offered Rate (LIBOR) cessation. The proposed ASU is in response to this feedback.

Nonfinancial component hedges: A clearer approach

For a cash flow hedge of a forecasted transaction that involves a nonfinancial asset or liability, under existing guidance, an entity is permitted to designate either:

- all changes in the purchase or sales price; or
- a contractually specified component of the purchase or sale of a nonfinancial asset or liability.

A contractually specified component is an index or price explicitly referenced in an agreement to purchase or sell a nonfinancial asset. Further, the definition of a contractually specified component is considered to be met if the component is explicitly referenced in agreements that support the price at which a nonfinancial asset will be purchased or sold.

Stakeholders are encountering challenges in interpreting and applying this provision, leading to inconsistent practices and difficulties in determining which nonfinancial components qualify for hedge accounting. To address these concerns, the proposed ASU would revise the nonfinancial component hedging model to be based on the 'clearly and closely related criteria' currently applied when evaluating the normal purchases and normal sales scope exception in Topic 815.

Under the proposed model, an entity may designate the variability in cash flows attributable to changes in a component (or subcomponent) as the hedged risk in a cash flow hedge of the forecasted purchase or sale of a nonfinancial asset as follows.

- If the purchase or sales price is not determined pursuant to a pricing formula in an agreement, the hedged variable component is clearly and closely related to the nonfinancial asset being purchased or sold.
- If the purchase or sales price is determined pursuant to a pricing formula in an agreement, the hedged variable component is either:
  - Explicitly referenced in the agreement's pricing formula and clearly and closely related to the nonfinancial asset being purchased or sold; or
  - A subcomponent of a component that is explicitly referenced in the agreement's pricing formula, if that subcomponent is clearly and closely related to the component.

Compared to existing US GAAP, the model based on clearly-and-closely-related criteria is expected to expand the availability of hedge accounting for forecasted purchases and sales of nonfinancial assets because it would allow hedging components that are not explicitly referenced in an agreement's pricing formula.

Example

On December 31, 20X0, Entity ABC forecasts that it will purchase at least 20,000 pounds of chocolate in the spot market in June 20X1. On January 1, 20X1, ABC enters into a forward contract on cocoa. ABC designates the forward contract as the hedging instrument in a cash flow hedge of the variability in cash flows attributable to the cocoa component related to its forecasted purchase of chocolate in the spot market. ABC determines the cocoa component is clearly and closely related to the forecasted purchase of the chocolate in the spot market.

Groups of forecasted transactions: Similar risk exposure

Under existing guidance, for a group of individual transactions to be designated as the hedged transaction in a cash flow hedge, the transactions must share the same risk exposure for which they are being hedged. In its limited discussion on how to make this assessment, existing guidance includes an illustration stating that interest payments in the group shall vary with the same index to qualify for hedging with a single derivative instrument. Stakeholders have found the concept of sharing risk exposure challenging to apply in practice.

To address these concerns, the proposed ASU would transition from the requirement to 'share the same' risk exposure to a requirement to 'have a similar' risk exposure. It would also include an illustration permitting interest rate payments (receipts) that have different interest rate indexes to be included in the same group. These changes would expand the pool of individual forecasted transactions that are permitted to be hedged in a single cash flow hedging relationship, thereby broadening portfolios of forecasted transactions, providing greater flexibility, and more closely aligning hedge accounting with an entity's actual risk management strategies.

In addition, the proposed ASU would allow an entity to determine whether individual forecasted transactions have similar risk exposure through one of the two methods listed below. An entity would generally apply the selected method consistently to similar hedges. In addition, it would assess similarity with the same frequency as it assesses effectiveness and use the same threshold for determining whether a hedging relationship is highly effective.

- The hedging instrument is highly effective in achieving offsetting changes in cash flows attributable to each hedged risk in the group.
- Each hedged risk related to the forecasted transaction is similar to every other hedged risk in the group.

In allowing an entity to assess similarity by determining whether the designated hedging instrument is highly effective against each hedged risk (i.e. the first method above), the proposed ASU would permit an entity to use the same evaluation to support its assessment of similarity of individual forecasted items in the group and of whether the hedge is highly effective. This dual-purpose testing of effectiveness and similarity would provide efficiencies for entities, particularly for those with more complex hedging strategies.

Change in hedged risk: Forecasted interest payments (receipts) on choose-your-rate debt

ASU 2017-12 permitted entities to continue applying hedge accounting in a cash flow hedge if the designated hedged risk changes during the life of the hedging relationship and the hedging instrument is highly effective. However, stakeholder feedback was that for the change in hedged risk model to be operable and aligned with the existing cash flow hedging framework, it would need to be significantly revised.

Accordingly, this proposed ASU would limit the ability to change the hedged risk in a cash flow hedging relationship to hedges of interest payments (receipts) on specified variable-rate debt instruments known as 'choose-your-rate' debt. That type of debt instrument permits the borrower to change the interest rate index and/or tenor. Further, the proposed ASU would provide a new approach for hedging interest payments (receipts) on those instruments because that ability to change the interest rate index and/or tenor has resulted in hedge accounting being limited in practice under the existing guidance.

Under the proposed ASU, the hedged risk for choose-your-rate debt instruments would be the initially selected interest rate index (and the tenor of that rate, if applicable). If the borrower selects a different contractual rate in the future during the hedge period, the hedged risk changes to reflect the newly selected contractually specified interest rate index or tenor in that subsequent period without an automatic dedesignation. Hedge effectiveness testing would be performed using the selected rate; however, when the interest rate selection changes, the entity would retrospectively test effectiveness using the previously selected interest rate and prospectively using the new interest rate.

Next Steps

The FASB will determine the effective date after stakeholder feedback is considered.

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