September 8, 2016

FASB In Focus

Proposed Accounting Standards Update

Targeted Improvements to Accounting for Hedging Activities

On September 8, 2016, the Financial Accounting Standards Board (FASB) issued a proposed Accounting Standards Update (ASU) intended to improve accounting for hedging activities.

The objective of the proposed ASU is to better portray the economic results of an organization's hedging activities in the financial statements. In addition, the proposed ASU would simplify the application of hedge accounting guidance in areas where practice issues exist.

Why Did the FASB Embark on a Project To Improve Accounting for Hedging Activities?

Current GAAP provides special accounting for hedging activities to address differences in accounting for hedging instruments and hedged items or transactions as established in *FASB Accounting Standards Codification*® Topic 815, Derivatives and Hedging.

Given that the original guidance was issued in 1998, the FASB has been asked to address numerous practice issues that have developed over time. As a result, the FASB proposed broad-based changes to the hedge accounting model in two Exposure Drafts issued in 2008 and 2010. However, after the comment period ended for the 2010 Exposure Draft, the project to improve the hedge accounting guidance was suspended to allow the FASB to pursue other financial instrument initiatives. In the current project, the FASB decided not to overhaul the hedge accounting guidance but instead to focus on targeted improvements to expeditiously address key practice issues that have been identified by stakeholders.

What Kind of Outreach Did the FASB Undertake When Developing the Proposed ASU?

When the hedging project was reactivated in 2014, the FASB participated in extensive outreach activities, received significant input from a wide variety of stakeholders, and considered the feedback received from the 2008 and 2010 Exposure Drafts. The outreach activities undertaken by the FASB to develop the proposed ASU are depicted below:

How Will the Proposed Changes Improve Accounting for Hedging Activities?

Through the outreach that has been performed to date, the FASB has observed two primary concerns. First, financial statement preparers have expressed concerns over the difficulties associated with applying hedge accounting and its limitations for hedging both nonfinancial and financial risks. Second, users of financial statements have expressed concerns over the manner in which hedge activities are reported in the financial statements.

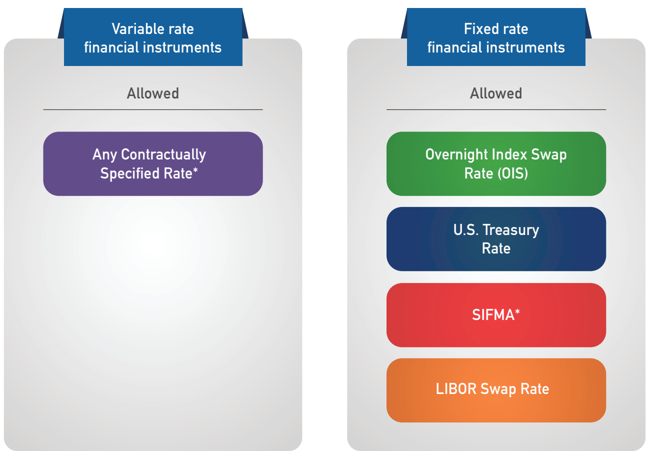
The proposed amendments are intended to address these concerns through changes to the hedge accounting guidance that will accomplish the following:

- Expand hedge accounting for nonfinancial and financial risk components to allow institutions to achieve hedge accounting for more of their risk management activities
- Decrease the complexity of preparing and understanding hedge results through eliminating the separate measurement and reporting of hedge ineffectiveness
- Enhance transparency, comparability, and understandability of hedge results through enhanced disclosures and changing the presentation of hedge results to align the effects of the hedging instrument and the hedged item
- Reduce the cost and complexity of applying hedge accounting by simplifying the manner in which assessments of hedge effectiveness may be performed.

What Would the Proposed Changes Accomplish?

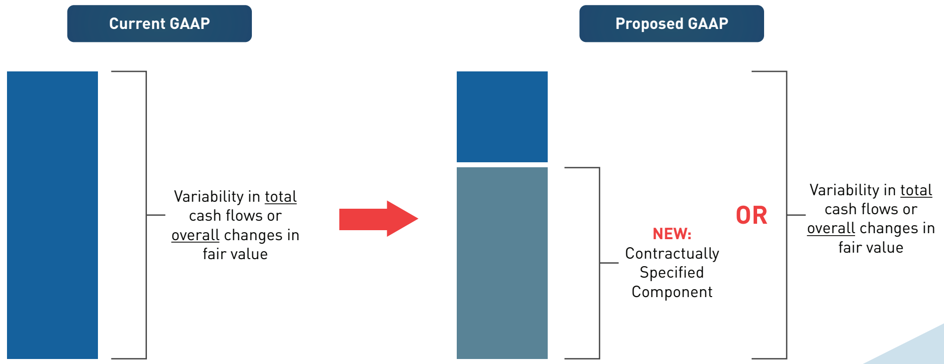
The proposed changes would expand hedge accounting for both financial and nonfinancial risk components to better portray the results of an institution's risk management activities in its financial statements. Specifically, the proposed amendments permit more flexibility in hedging interest rate risk for both variable rate and fixed rate financial instruments, and introduce the ability to hedge risk components for nonfinancial hedges. The following indexes are eligible to be designated when hedging interest rate risk and the following risks are eligible to be designated when hedging a nonfinancial item:

Indexes Eligible to be Designated in a Hedge of Interest Rate Risk



**The contractually specified rate and Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Rate are newly allowed based upon the proposed amendments.*

Eligible Hedged Risks for Non-Financial Items



Note: The proposed amendments do not modify the guidance on hedges of foreign exchange risk.

Current GAAP contains limitations on how an institution can measure changes in fair value of the hedged item attributable to interest rate risk in certain fair value hedging relationships. As a result of the following changes, the proposed amendments are intended to permit certain strategies undertaken for risk management purposes to qualify for fair value hedge accounting:

a. An institution may measure the hedged item in a partial-term fair value hedge of interest rate risk by assuming the hedged item has a term that reflects only the designated cash flows being hedged.

b. For prepayable financial instruments, an institution may consider only how changes in the benchmark interest rate affect a decision to settle a debt instrument before its scheduled maturity when calculating the fair value of the hedged item attributable to interest rate risk.

c. An institution may measure the fair value of the hedged item attributable to interest rate risk using the benchmark rate component of the contractual coupon cash flows determined at hedge inception (this is only allowed when the market yield of the hedged item at hedge inception is greater than the benchmark interest rate).

The proposed amendments would enhance the presentation of hedge results in the financial statements and disclosures about hedging activities by:

a. Requiring changes in the value of the hedging instrument be presented in the same income statement line item as the earnings effect of the hedged item

b. Amending the current tabular disclosure of hedging activities to focus on the effect of hedge accounting on individual income statement line items

c. Requiring a new disclosure that will provide investors with more information about the remaining basis adjustments to be amortized in fair value hedges of interest rate risk

d. Requiring a new qualitative disclosure about quantitative hedging goals, if any, set to achieve hedge accounting objectives.

To simplify the reporting of hedge results for financial statement preparers and decrease the complexity of understanding hedge results for investors, the FASB has eliminated the separate measurement and reporting of hedge ineffectiveness. Mismatches between changes in value of the hedged item and hedging instrument may still occur but they will no longer be separately reported. For cash flow and net investment hedges, all changes in value of the hedging instrument included in the assessment of effectiveness will be deferred in other comprehensive income and released to earnings when the hedged item impacts earnings.

The proposed ASU also includes targeted improvements to simplify assessment of hedge effectiveness. Those simplifications would:

a. Allow an institution to perform subsequent assessments of hedge effectiveness qualitatively if certain conditions are met

b. Allow an institution more time to perform the initial quantitative hedge effectiveness assessment

c. Allow an institution to apply the "long-haul" method for assessing hedge effectiveness when use of the shortcut method was not or no longer is appropriate if certain conditions are met

d. Clarify that an institution may apply the critical terms match method for a group of forecasted transactions if the transactions occur and the derivative matures within the same 31-day period, and the other requirements for applying the critical terms match method are satisfied.

Who Will Be Affected by the New Guidance?

The standard will apply broadly to any institution that elects to apply hedge accounting in accordance with current GAAP (Topic 815).

How Does the FASB's Proposed ASU Compare with IFRS?

Although the language used to describe the hedge accounting guidance in the proposed ASU and in IFRS 9, *Financial Instruments,* differs, it is expected that many common hedge accounting strategies will have similar outcomes for the following reasons:

- The designation of a contractually specific component or interest rate within the proposed amendments and a "separately identifiable and reliably measurable" risk component in IFRS 9 will result in similar hedged risk designations.

- Both standards would allow an institution to use the benchmark rate component cash flows when measuring the fair value of the hedged item in a fair value hedge of interest rate risk.
- The proposed ASU and IFRS 9 provide similar methodologies for measuring the hedged item in a partial-term fair value hedge of interest rate risk.
- The proposed ASU would allow qualitative assessments of hedge effectiveness if certain conditions are met. IFRS 9 permits quantitative or qualitative assessment of hedge effectiveness.

The main differences between this proposed ASU and IFRS 9 relate to presentation of the changes in the fair value of hedging instruments, as follows:

- The proposed amendments would eliminate the concept of hedge ineffectiveness, while IFRS 9 retains this concept.
- The proposed amendments would require an institution to record the entire change in the fair value of the hedging instrument in the same income statement line item as the earnings effect of the hedged item, while IFRS 9 does not provide broad guidance on presentation.

When Will the Proposed ASU Be Effective?

The Board will determine an effective date in its redeliberations after a 75-day comment period.

Earlier application of the proposed amendments would be permitted at the beginning of any fiscal year before the effective date.

How Can Stakeholders Participate in the Deliberation Process?

Stakeholders are encouraged to review and provide comment on the proposal by Tuesday, November 22, 2016. Two roundtable meetings are tentatively scheduled to be held on Friday, December 2, 2016, at the FASB offices in Norwalk, Connecticut. Those interested in participating in one of the roundtables are asked to submit comments by Friday, November 4, 2016.

What about Transition?

The proposed ASU would require an institution to apply the proposed changes through a modified retrospective approach where the cumulative effect of application would be recorded as an adjustment to retained earnings as of the beginning of the most recent fiscal year presented on the date of adoption. New and modified disclosure requirements and designation of new hedging strategies, excluding the exception discussed below, would be required only prospectively.

Certain one-time transition elections would also be available. Under those elections, an institution may:

a. Modify hedge documentation to allow for assessments of effectiveness subsequent to hedge inception to be performed qualitatively
b. Modify hedge documentation for hedges where the shortcut method is elected to specify the long-haul method that would be used to assess effectiveness if use of the shortcut method was not or is no longer appropriate
c. For existing cash flow hedges where the hedged risk is designated as the variability in total cash flows, dedesignate the hedging relationship and immediately redesignate the same hedging instrument and hedged item to a new hedging relationship. An institution may then document the hedged risk as the variability in cash flows attributable to changes in a contractually specified component or a contractually specified interest rate and set the terms of the hypothetical derivative to have a fair value of zero as of the original hedge inception date.

For more information about the project, please visit the FASB's website at www.fasb.org.

FASB FINANCIAL ACCOUNTING STANDARDS BOARD
401 Merritt 7, PO Box 5116
Norwalk, Connecticut 06856-5116
T: 203.847.0700 | F: 203.849.9714