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New Developments Summary

Targeted improvements to hedge accounting

ASU 2017-12 simplifies accounting for hedging activities

Summary

The FASB recently issued ASU 2017-12, *Targeted Improvements to Accounting for Hedging Activities*, to improve how the economic results of an entity's risk management activities are portrayed in the financial statements and to simplify the application of the current hedge accounting guidance. The guidance in ASU 2017-12 expands and refines hedge accounting for both nonfinancial and financial risk components and aligns the recognition and presentation requirements for the effects of both the hedging instrument and the hedged item in the financial statements.

The transition guidance in ASU 2017-12 requires an entity to apply the amendments using a modified retrospective approach to hedging relationships that exist as of the date of adoption by recording a cumulative-effect adjustment to the opening balance of retained earnings as of the most recent period presented. Entities must apply the new and modified disclosure requirements prospectively from the date of adoption.

For public business entities, the guidance in ASU 2017-12 is effective for fiscal years beginning after December 15, 2018 and for interim periods within those fiscal years. For all other entities, the guidance is effective for fiscal years beginning after December 15, 2019 and for interim periods within fiscal years beginning after December 15, 2020.

Early application of the guidance is permitted, including in an interim reporting period. If adopting the guidance in an interim reporting period, an entity must reflect the effect of the adoption as of the beginning of the fiscal year that includes the interim reporting period in which the guidance is adopted.

Contents

A. Recognition and presentation of the effects of hedging instruments

The amended guidance in ASU 2017-12 requires an entity to present the earnings effect of the hedging instrument in the same income statement line item in which the earnings effect of the hedged item is reported. In addition, the amended guidance eliminates the requirement in current U.S. GAAP to separately measure and report hedge ineffectiveness. Therefore, the guidance in ASU 2017-12 requires the following presentation:

- For fair value hedges, the entire change in the fair value of the hedging instrument, as well as the change in fair value attributable to the hedged risk of the hedged item, should be presented in the same income statement line item.
- For cash flow and net investment hedges, the entire change in fair value of the hedging instrument included in the assessment of hedge effectiveness should be recorded in other comprehensive income (OCI). When the amounts recorded in OCI are reclassified to earnings, they should be presented in the same income statement line item as the effect of the hedged item.

The timing for recognizing the ineffective portion of the change in fair value of a hedging instrument could change compared to current U.S. GAAP, which requires immediate recognition of hedge ineffectiveness in earnings.

Amounts excluded from the assessment of hedge effectiveness

In addition to the changes related to time value (for example, option premiums and forward premiums) that an entity is permitted to exclude from its assessment of hedge effectiveness under current U.S. GAAP, the amendments in ASU 2017-12 allow an entity to exclude the portion of the change in fair value of a hedging instrument (for example, a currency swap) that is attributable to a cross currency–basis spread from the assessment of hedge effectiveness.

The guidance in ASU 2017-12 requires an entity to recognize in earnings the initial value of a component of the hedging instrument excluded from its assessment of hedge effectiveness (the "excluded component") using a systematic and rational method. An entity is permitted to make an accounting policy election to recognize the difference between (1) the periodic change in fair value of an excluded component, and (2) the amount recognized in earnings based on its systematic and rational method for the excluded component either in OCI or, consistent with current U.S. GAAP, in earnings. For fair value and cash flow hedges, amounts related to excluded component that are recognized in earnings must be presented in the same income statement line item as the earnings effect of the hedged item. Similar to current U.S. GAAP, the amendments in ASU 2017-12 do not provide presentation guidance for excluded components of net investment hedges.

B. Hedge documentation and effectiveness assessment

The guidance in ASU 2017-12 includes certain targeted improvements to existing guidance on quantitative and qualitative assessments of initial and ongoing hedge effectiveness, as follows:

- When initial quantitative testing of hedge effectiveness is required, an entity has the option, on a hedge-by-hedge basis, to perform subsequent assessments of hedge effectiveness qualitatively, unless facts and circumstances change so that the entity can no longer qualitatively assert that the hedging relationship was and will be highly effective. An entity that elects this assessment methodology must verify and document on a quarterly basis that facts and circumstances have not changed, requiring a new quantitative assessment.

- In assessing whether a group of forecasted transactions meets the criteria to use the critical-terms-match method to assess hedge effectiveness, an entity may assume that the hedging derivative matures at the same time as the forecasted transactions if the derivative matures within 31-days of, or in the same fiscal month as, when the forecasted transactions occur.
- An entity may perform its initial prospective quantitative assessment of hedge effectiveness any time after hedge designation, but no later than the first quarterly effectiveness testing date, using data applicable as of the date of hedge inception.
- An entity that applies the shortcut method is permitted to apply the long-haul method for assessing hedge effectiveness if it determines after hedge inception that the shortcut method was not or is no longer appropriate, provided that it documents its chosen long-haul methodology in its initial hedge documentation.

Hedge documentation relief for private companies

The guidance in ASU 2017-12 provides relief on the timing of hedge documentation for certain not-for-profit entities and private companies that are not financial institutions. The new guidance allows these entities to select the method of assessing hedge effectiveness and to perform the initial quantitative effectiveness assessment and all quarterly hedge effectiveness assessments before the date on which the next interim (if applicable) or annual financial statements are available to be issued. For example, a calendar-year private company that enters into a hedge on February 15 has until that fiscal year's financial statements are available to be issued to choose a method that it will use to assess hedge effectiveness and to perform the initial effectiveness test and all subsequent quarterly hedge effectiveness assessments.

C. Hedging of risk components

To address current limitations on how an entity can designate the hedged risk in certain cash flow and fair value hedging relationships, the guidance in ASU 2017-12 permits hedge accounting for certain risk components as follows:

- *Cash flow hedge of a forecasted purchase or sale of a nonfinancial asset:* The guidance permits an entity to designate as the hedged risk the variability in cash flows attributable to changes in a contractually specified component in the contract, thereby removing the existing requirement that only the overall variability in cash flows or variability related to foreign-currency risk is permitted to be designated as the hedged risk in a cash flow hedge of a nonfinancial asset.
- *Cash flow hedge of interest-rate risk of a variable-rate financial instrument:* The guidance eliminates the concept of a benchmark interest rate for cash flow hedges, and therefore permits an entity to designate as the hedged risk the variability in cash flows related to any contractually specified interest rate.
- *Fair value hedge of interest-rate risk:* The guidance adds the Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Rate as a benchmark interest rate for fair value hedges, permitting an entity that issues or invests in fixed-rate, tax-exempt financial instruments to

designate changes in fair value attributable to changes in this rate as the hedged risk in a fair value hedge.

D. Fair value hedges of interest-rate risk

ASU 2017-12 changes the guidance on designating the hedged item and measuring changes in the fair value of the hedged item in a fair value hedge of interest-rate risk, permitting an entity to

- Measure the change in fair value of the hedged item on the basis of the benchmark-rate component of the contractual coupon cash flows determined at hedge inception rather than the full contractual coupon cash flows as required by current U.S. GAAP.
- Measure the hedged item in a partial-term fair value hedge of interest-rate risk by assuming that the hedged item has a term that reflects only the designated cash flows being hedged.
- Consider only how changes in the benchmark interest rate affect a decision to settle a debt instrument before its scheduled maturity when calculating the change in the fair value of the hedged item attributable to the interest-rate risk of prepayable financial instruments.
- Designate as the hedged item an amount that is not expected to be affected by prepayments, defaults, or other events affecting the timing and amount of cash flows in a closed portfolio of prepayable financial assets or beneficial interests secured by a portfolio of prepayable financial instruments (this is referred to as the "last-of-layer" method). Under this designation, prepayment risk is not incorporated into the measurement of the hedged item.

E. Disclosures

To help financial statement users, the guidance in ASU 2017-12 enhances the required disclosures about hedging activities and their effect on the financial statements.

The amendments in ASU 2017-12 remove the current requirement for an entity to disclose the ineffective portion of gains and losses on hedging instruments. For cash flow hedges, the guidance requires entities to disclose the amounts of gains and losses on hedging instruments that are reclassified from OCI to earnings for forecasted transactions that are probable of not occurring in a table by income and expense line item.

In addition, for fair value and cash flow hedges, the amended guidance requires tabular disclosures, including information about

- The total amount of each income and expense line item in the income statement for which hedge accounting adjustments have been recorded
- The amount of gains and losses on hedging instruments and related hedged items by each income and expense line item
- The amount recognized in earnings for amounts excluded from the assessment of effectiveness. These amounts should be disclosed separately for amounts recognized under either an amortization approach or a mark-to-market through earnings approach.

For fair value hedges, the amendments in ASU 2017-12 require additional tabular disclosures, including information about

- The carrying amount of hedged assets and liabilities as well as the balance-sheet line item that includes the hedged assets and liabilities
- The cumulative amount of fair value hedging adjustments included in the carrying amount of hedged assets and liabilities
- Hedging relationships designated under the last-of-layer method, including the amortized-cost basis of the closed portfolio(s) that includes the designated assets, the amount that represents the designated last-of-layer, and the basis adjustment associated with the last-of-layer

F. Transition

Entities must use a modified retrospective approach to apply the guidance in ASU 2017-12, recording a cumulative-effect adjustment to retained earnings as of the beginning of the fiscal year of adoption. The new and modified disclosure requirements are required only on a prospective basis.

For cash flow hedges and net investment hedges existing as of the date of adoption, the transition guidance requires an entity to present the cumulative effect of the elimination of the separate measurement of ineffectiveness by recording an adjustment to accumulated OCI, with a corresponding adjustment to the opening balance of retained earnings as of the beginning of the fiscal year of adoption.

The transition guidance provides certain elections, listed below, to help entities transition existing hedging relationships to the guidance in ASU 2017-12. Private companies that are not financial institutions, as well as not-for-profit entities that have not issued securities that are traded, listed, or quoted on an exchange or an over-the-counter market and that are not conduit bond obligors with respect to these securities, may make these elections prior to the date when the next interim or annual financial statements are available to be issued after the adoption of the new guidance. For all other entities, the elections should be made prior to the first quarterly effectiveness assessment date after the adoption of the new guidance:

- For a fair value hedge of interest-rate risk, an entity may modify the measurement methodology for the hedged item to (1) consider only how changes in the benchmark interest rate affect the decision to settle an instrument before maturity, or (2) reflect only the benchmark interest-rate component of the contractual coupon cash flows without dedesignating the hedging relationship. If an entity elects to modify its measurement methodology, the cumulative-basis adjustment carried forward should be adjusted to an amount that reflects the cumulative-basis adjustment that would have existed had the entity used the modified measurement methodology in all past periods. Under this election, the benchmark-rate component of the contractual coupon cash flows is determined as of the hedging relationship's original inception date. The cumulative effect of applying this election is recognized as an adjustment to the basis adjustment of the hedged item recognized on the balance sheet, with a corresponding adjustment to the opening balance of retained earnings as of the beginning of the fiscal year of adoption.
- For a fair value hedge of interest-rate risk for which an entity chooses to modify the measurement methodology for the hedged item to reflect only the benchmark-rate component of the contractual cash flows (subject to the exception discussed in the previous bullet), the entity may elect to dedesignate a portion of the hedged item and reclassify the basis adjustment associated with the dedesignated portion to the opening balance of retained earnings as of the beginning of the fiscal year of adoption.
- For fair value hedges of foreign-exchange risk using a currency swap as the hedging instrument, an entity may, without dedesignation, modify its hedge documentation to exclude the cross currency–basis spread component of the currency swap from the assessment of hedge effectiveness and

recognize this excluded component through an amortization approach. The cumulative effect of applying this election must be recognized as an adjustment to accumulated OCI, with a corresponding adjustment to the opening balance of retained earnings as of the beginning of the fiscal year of adoption.

- For hedges that exclude a portion of the hedging instrument from the assessment of effectiveness (such as time value components, including option premiums), an entity may modify the recognition model for the excluded component, from a mark-to-market approach to an amortization approach, without dedesignating the hedging relationship. The cumulative effect of applying this election is recognized as an adjustment to accumulated OCI, with a corresponding adjustment to the opening balance of retained earnings as of the beginning of the fiscal year of adoption.
- An entity may modify its hedge documentation without dedesignating the hedging relationship to specify
  - That subsequent prospective and retrospective effectiveness assessments will be performed qualitatively for hedging relationships whose effectiveness is currently assessed using a quantitative method
  - The quantitative method that will be used to assess hedge effectiveness if the hedge no longer qualifies for the shortcut method in the future for hedging relationships whose effectiveness is assessed using the shortcut method
- For cash flow hedges that meet the requirements in ASU 2017-12 to designate as the hedged risk the variability in cash flows attributable to changes in a contractually specified component or a contractually specified interest rate, an entity may
  - Modify the hedging relationship from specifying the variability in total cash flows as the hedged risk to specifying the variability in cash flows attributable to changes in a contractually specified component or a contractually specified interest rate as the hedged risk without dedesignation
  - Create the terms of the instrument that will be used to estimate changes in value of the hedged risk (either under the hypothetical derivative method or another acceptable method) on the basis of market data as of the inception of the hedging relationship
  - Recognize any ineffectiveness previously recognized on the hedging relationship as part of the transition adjustment, with an adjustment to accumulated OCI and a corresponding adjustment to the opening balance of retained earnings as of the beginning of the fiscal year of adoption
- An entity may reclassify a debt security from held-to-maturity to available-for-sale if the security is eligible to be hedged under the last-of-layer method. Unrealized gains and losses associated with the reclassified security must be recorded as an adjustment to OCI, with a corresponding adjustment to the opening balance of retained earnings as of the beginning of the fiscal year of adoption.

The transition guidance in ASU 2017-12 provides that if an entity modifies the hedged risk of a tax-exempt financial instrument from total-price risk to interest-rate risk related to the SIFMA Municipal Swap Rate, the modification is considered a dedesignation and an immediate redesignation of the hedging relationship. The cumulative-basis adjustment of the hedged item from the dedesignated hedging relationship must be amortized to earnings on a level-yield basis.

The transition guidance also states that an entity is not required to similarly assess the effectiveness for similar hedges when comparing hedges established before and after adoption of the guidance in ASU 2017-12, provided the differences are due to one of the following elections:

- To amend hedge documentation for certain hedges designated under the shortcut method to specify a quantitative assessment approach that will be used if the shortcut method is no longer applicable
- To designate a contractually specified component or interest rate as the hedged risk in a cash flow hedge
- To apply an amortization approach to the recognition of an excluded component

For hedging relationships that exist on the date of adoption, an entity is required to prospectively present the entire change in the fair value of the hedging instrument in the same income statement line item in which the earnings effect of the hedged item is presented when the hedged item affects earnings.

For each interim and annual financial statement period in the fiscal year of adoption, the transition guidance also requires entities to disclose certain information about the change in the accounting principle due to the adoption of ASU 2017-12, as well as the cumulative effect of the change on the opening balance of each affected component of equity or net assets as of the date of adoption.

G. Effective date

For public business entities, the guidance in ASU 2017-12 is effective for fiscal years beginning after December 15, 2018 and for interim periods within those fiscal years.

For all other entities, the guidance is effective for fiscal years beginning after December 15, 2019 and for interim periods within fiscal years beginning after December 15, 2020.

Early application of the guidance is permitted, including in an interim reporting period. If an entity adopts the guidance in an interim reporting period, the effect of the adoption must be reflected as of the beginning of the fiscal year that includes the interim reporting period in which the guidance is adopted.

H. Other resources

The FASB has released *FASB In Focus*, which provides an overview of ASU 2017-12, and hosted an educational webcast, "IN FOCUS: FASB Accounting Standards Update on Hedging," on September 25 that can be accessed.