FASB's New Hedge Accounting Model

Implications for Currency Risk Management Strategies

Welcome

In the summer of 1998, the U.S. accounting rules for derivatives and hedging changed substantially following the release of the Financial Accounting Standards Board's (FASB) SFAS 133 (later renamed under the FASB's codification effort as ASC 815). Since then, the accounting rules for hedging instruments – which had been highly complex from the beginning and a challenge to many practitioners and finance professionals – have been accompanied by several revisions and improvements.

An update released in August 2017 is a major revision in the life of this complex accounting standard and one that simplifies its objectives considerably. This latest update has been highly anticipated by the risk management and treasury professionals' community for some time.

This paper addresses implications of the new guidance on foreign currency hedging strategies and answers the central question many treasurers and controllers have been asking: *How does the new hedge accounting guidance affect my currency hedging program and are there opportunities provided by these new rules?*

Derivatives Accounting Meets Foreign Currency Hedging

As a brief background, ASC 815 provides companies with a favorable accounting treatment that matches the risk management strategy and economic rationale for undertaking the hedge. For that purpose, the standard distinguishes between three categories of hedges:

- **Cash flow hedge –** This hedging instrument is tied to a forecasted transaction which has not yet affected current period earnings. Any gains or losses from marking-to-market the hedge should be deferred in Other Comprehensive Income (OCI) and recognized on the income statement in the same future period as a hedged item. The cash flow hedge accounting model is common in foreign currency risk management and is employed when the hedging program targets operating revenues or expenses beyond the current financial period.
- **Net investment hedge –** This hedging instrument is linked to the balance of the net investment in a foreign operation. Gains and losses on the hedge are recorded in OCI – Cumulative Translation Adjustment (CTA), usually in same line item as, and providing an offset to, the impact of translating the value of foreign investments in the functional currency and financial statements of the parent company. The net investment hedge accounting model is helpful for companies that enter into forward contracts or cross-currency swaps aimed at protecting the long-term value of their international investments.
- **Fair value hedge –** Designed primarily for hedges of interest rate or commodity risk, the fair value hedge accounting model is neither common nor very helpful in currency risk management. The reason is that fair value hedge accounting allows changing the accounting model for the hedged item from *cost* or *amortized cost* to *fair value* in order to match that of the hedging instrument. But since foreign currency monetary items are already recognized on the balance sheet at the period-end spot rate in accordance with ASC 830 (formerly FAS 52), and typically that change in the spot rate is also the primary driver for changes in value of the hedging instrument, the accounting models are largely matched. There should also be a significant degree of offset in current period earnings between the hedged item and the hedge, without a need for special hedge accounting treatment.

Challenges with Prior Model

In theory, the intended outcome should help users and preparers of financial statements, yet the application of hedge accounting for currency hedging strategies has often proved challenging. In many cases, it has dissuaded corporate treasurers from adopting hedge accounting, and sometimes companies have chosen not to hedge future foreign currency exposures at all, for fear that accounting for hedging strategies would be unfavorable and distort current period results.

Effectiveness testing in particular has been a treacherous area on the road to successfully applying hedge accounting for foreign currency hedging strategies. In order to qualify for applying the hedge accounting model, one of ASC 815's key requirements is that a hedging relationship be proven "highly effective," prospectively and retrospectively. In order to fulfill this requirement, many companies employ what's called the "critical terms match" approach, which involves a detailed description and comparison of the key economic terms of the hedge and of the hedged item. This requirement would easily be fulfilled for a variable loan hedged by an interest rate swap: Payment dates on both loan and swap are the same, and interest periods are exact, known in advance and follow the same interest calculation convention. But for a hedge of foreign revenues that may occur at different points in the future, this is a lot less straightforward as forecasts are often inaccurate.

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Consider a U.S.-based manufacturing company that hedges revenues incurred in Europe. While being able to forecast annual EUR-denominated sales in aggregate or even in total per month, the company is less able to pinpoint exactly what day of the month a particular EUR invoice will be issued and when such foreign-denominated revenues will be earned. For this reason, the company's use of foreign currency forwards that settle on a specific day of the month (e.g., last business day) may fail the exact definition of the critical terms match requirement if the hedged European revenues occur on different dates *throughout* the month.

Solutions around this usually involve either

a) Tweaking the hedging program by using window forwards, average-rate forwards, or more frequent, smaller notional, single-date forwards.

b) Preparing a quantitative analysis at inception to substantiate that even if the hedge was perfect and targeting every single date of the hedged revenues, the effect of using the actual hedge vs. the ideal one would be *de minimis*.

Even if a company can pinpoint with accuracy when the hedged item is expected to occur, mismatches may still surface when revenues fall below estimate for a particular hedged period (month or quarter) and are recaptured in the following period. This may lead to an "over-hedged" position. Aside from triggering near-term hedge ineffectiveness and adverse P&L impact, this may call into question the company's entire cash flow hedging program through its apparent inability to accurately predict forecasted transactions.

Quantitative methods for testing hedge effectiveness and measuring hedge ineffectiveness, and advanced designation tools such as rolling exposure buckets, are often overly complex, are burdensome on corporate treasury and accounting teams, and have made the application of hedge accounting for currency hedges very challenging.

New Model: Positive Impact on Currency Hedging

Following an extended comment and drafting process, in August 2017 the FASB issued the update to Topic 815 Hedge Accounting.

The FASB's goal was for targeted amendments to better align an entity's risk management activities with financial reporting for hedging relationships. This was enacted through changes to (a) the designation and effectiveness assessment guidance for hedging relationships and (b) the presentation of hedge results.

The standard offers many positive changes to hedging in general, such as the addition of contractually specified risk, which significantly improves the accounting model for commodity hedging. The standard also relaxes the documentation requirements, which until now have been very stringent, through the requirement that complete hedge documentation be prepared contemporaneously with executing the hedge. In the new model, a company has a three-month window to complete relevant documentation for effectiveness testing or until the end of the quarter in which the hedge was executed.

While there are many targeted improvements, our focus in this paper is the impact on foreign currency hedging.

Removal of the Requirement to Measure Hedge Ineffectiveness

For cash flow and net investment hedges, the *entire change in the hedge value* included in the assessment of hedge effectiveness shall be recorded in OCI (for cash flow hedges) or in the CTA section of OCI (for net investment hedges). Previously, only the portion deemed effective following a measurement of hedge ineffectiveness was allowed to be recorded, which often required a quantitatively intense and laborious exercise, and potentially resulted in unwanted P&L volatility.

Many companies used to use the *hypothetical derivative method*, which as the name implies involved building a hypothetical hedge with terms that perfectly offset the hedged item. The hypothetical hedge would then have to be run through a valuation model, in order to calculate any lack or surplus (over-hedging) of offset between the actual hedge and the hypothetically perfect one.

This exercise of periodically measuring hedge ineffectiveness was expensive, inconsistent – only over-hedging would lead to P&L noise from hedge ineffectiveness, but not under-hedging – and outside the reach of many corporate practitioners without dedicated quantitative resources. Therefore, the removal of this requirement is a welcome improvement.

Importantly, in addition to reducing the ongoing work associated with successfully maintaining a hedge accounting treatment, the financial statement impact should also be more clear when mismatches exist between the hedging instrument and the hedged item, as the income statement is no longer cluttered with noise from recording hedge ineffectiveness.

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Presentation

According to the new guidance, amounts taken to OCI as changes in fair value of qualifying hedges are *reclassified to the income statement in the same line item as that used for the hedged item*. Prior GAAP did not specify a required presentation of the change in fair value of the hedging instrument in the income statement, which in practice led to doubt, differing interpretations and a wide array of outcomes. The impact of the new standard is a better alignment of the income statement recognition of the hedging instrument with that of the hedged item. Companies that hedge foreign revenues no longer have the option to choose between recording hedge impact in "Other income/expense" or "Sales," but must record the effect of hedges directly under "Sales," which would lead to a more accurate presentation of revenues and gross operating margin.

Notably, the new guidance also requires amounts excluded from the assessment of hedge effectiveness to be presented in same income statement section as the hedged item.

Amounts Excluded from Assessment of Hedge Effectiveness

Previously, changes in the excluded component had to be included in current earnings, along with any ineffectiveness that resulted under the defined method of assessing ineffectiveness. Under the new guidance, the initial value of the component excluded from the assessment of effectiveness shall be recognized in earnings using *a systematic and rational method over the life of the hedge*. Any difference between the change in fair value of the excluded component and amounts recognized in earnings under that systematic and rational method shall be recognized in OCI.

Excluding parts of a derivative value from the effectiveness test allows an entity to pre-determine the way in which the value of this component is recorded to earnings over time (e.g., an amortization schedule for an option premium, for forward points or cross-currency basis). The result is the elimination of the impact in the P&L of the volatility of the period-to-period changes in value of the excluded component.

Previously only forward points and time value of options were permitted to be amortized in this way. However, because in practice cross-currency basis spreads are included in the measurement of the hedging instrument but not in the measurement of the hedged item, they have been an unpredictable source of P&L noise. The new guidance now also allows cross-currency basis spread to be excluded from hedge effectiveness assessment, which should help reduce P&L volatility. This change is relevant, for example, when using a cross-currency swap as a hedge of the net investment in a foreign operation.

Critical Terms Match

As highlighted above, a very common issue in applying hedge accounting for foreign currency hedges was represented by slight differences between terms of hedge and hedged item in hedging anticipated cash flows (e.g., mismatched cash flow dates).

The new guidance provides significant relief: In a cash flow hedge of a group of forecasted transactions, an entity may assume that (a) the timing in which the hedged transactions are expected to occur and (b) the maturity date of the hedge *match if such forecasted transactions occur and the derivative matures within the same 31-day period or fiscal month*. No quantitative effectiveness assessment is required at inception if these criteria are met.

Practically, this means that companies no longer have to execute complex average rate hedges to perfectly mimic the accounting exposure and that simple, plain vanilla forward contracts settling at the end of the month would qualify as effective hedges of revenues that occur throughout that month. Such contracts may not provide the absolute perfect offset economically, but would be significantly easier to administer value and to execute.

Use of Qualitative Assessments of Hedge Effectiveness

The new guidance introduces detailed steps to undertake in order to avoid heavy calculations that tripped some, and deterred many, from adopting hedge accounting strategies – provided, of course, that the relevant hedging relationship meets key criteria. In instances in which initial quantitative testing is required, an entity may perform *subsequent assessments of hedge effectiveness qualitatively*.

Once making this election, all one has to do is to verify and document on a quarterly basis that the facts and circumstances related to the hedging relationship have not changed. A *company can assert qualitatively* that the hedging relationship was and continues to be highly effective, which leads to a significant potential reduction in the volume of work required to maintain the favorable hedge accounting treatment (e.g., no more periodic regression analyses needed during life of hedge).

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Shortcut Method – Now with a Safety Net

In another move that further simplifies the ongoing hedge qualification criteria, if an entity that applies the shortcut method determines that use of that method was not or no longer is appropriate, the entity may apply a quantitative method for assessing hedge effectiveness as long as the hedge is highly effective and the entity documents at inception which methodology it will use.

This *ability to designate a "fallback" long-haul method for the shortcut method* is a major improvement to the standard, given that so many companies were previously backed into a corner and forced to give up hedge accounting if at some point during the life of the hedge the key criteria for the shortcut method were no longer fulfilled.

Conclusion: Impact and New Strategies

Overall, the improvements to the hedge accounting standard are significant and a breath of fresh air to the corporate risk management community. The changes will likely lead to

- More hedging strategies qualifying for favorable accounting treatment.
- The same strategies that qualified before, but will now require less ongoing work under the new regime.
- Better overall presentation of hedge performance and risk management activities in a company's financial statements.

In turn, this may result in potentially greater volume of foreign currency transactions and more robust currency hedging activity in the marketplace.

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