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# FASB Issues Standard Bringing Targeted Improvements to Hedge Accounting

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On August 28, 2017, the FASB issued [ASU 2017-12](#),<sup>1</sup> which amends the hedge accounting recognition and presentation requirements in ASC 815.<sup>2</sup> The Board's objectives in issuing the ASU are to (1) improve the transparency and understandability of information conveyed to financial statement users about an entity's risk management activities by better aligning the entity's financial reporting for hedging relationships with those risk management activities and (2) reduce the complexity of and simplify the application of hedge accounting by preparers.

For public business entities, the ASU is effective for fiscal years beginning after December 15, 2018, and interim periods therein; however, early adoption by all entities is permitted upon its issuance. See the [Effective Date and Transition](#) section below for details.

This *Heads Up* summarizes the ASU's key provisions. The [appendix](#) of this *Heads Up* highlights important differences among the ASU's amendments, U.S. GAAP before the ASU's adoption, and the IASB's hedging model under IFRS 9.<sup>3</sup>

<sup>1</sup> FASB Accounting Standards Update (ASU) No. 2017-12, *Targeted Improvements to Accounting for Hedging Activities*.

<sup>2</sup> FASB Accounting Standards Codification (ASC) Topic 815, *Derivatives and Hedging*.

<sup>3</sup> IFRS 9, *Financial Instruments*, also allows entities to elect to continue to follow the hedge accounting provisions of IAS 39, *Financial Instruments: Recognition and Measurement*.

Join us on September 7 at 2:00 p.m. EDT for a ***Dbriefs*** webcast on the FASB's new hedging standard.

## The ASU at a Glance

### What Has Not Changed

- “Highly effective” threshold.
- Benchmark interest rate concept for fair value hedges (hedges of fixed-rate financial instruments).
- Voluntary hedge dedesignations.
- Required timing for preparation of all hedge documentation except that related to the initial quantitative prospective assessment (private companies that are not financial institutions and certain not-for-profit entities will receive additional relief).

### What Has Changed

- Elimination of the concept of recognizing periodic hedge ineffectiveness for cash flow and net investment hedges.
- Recognition and presentation of changes in the fair value of the hedging instrument.
- Recognition and presentation of components excluded from an entity's hedge effectiveness assessment.
- Addition of the ability to exclude cross-currency basis spreads for currency swaps from an entity's hedge effectiveness assessment.
- Addition of the ability to elect to perform subsequent effectiveness assessments qualitatively.
- Elimination of the benchmark interest rate concept for variable-rate instruments in cash flow hedges. An entity can now designate the contractually specified interest rate as the hedged risk.
- Addition of the Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Rate as a benchmark interest rate.
- Addition of the ability to designate a “fallback” long-haul method for the shortcut method.
- Addition of the ability to apply the shortcut method to partial-term fair value hedges of interest rate risk.
- Enhancement of the ability to use the critical-terms-match method for cash flow hedge of groups of forecasted transactions when the timing of the hedged transactions does not perfectly match the hedging instrument's maturity date.
- Addition of new disclosure requirements and amendments to existing ones.

### Additional Relief Provided by the ASU

- Certain fair value hedges of interest rate risk:
  - *Measurement of hedged item* — Option to use either the benchmark interest rate component of total contractual coupon cash flows or the total contractual coupon cash flows to calculate the change in the fair value of the hedged item attributable to changes in the benchmark interest rate.
  - *Prepayable financial instruments* — Ability to consider only how changes in the benchmark interest rate affect the decision to settle the hedged item before its scheduled maturity.
  - *Partial-term hedges* — Ability to measure the change in the fair value of the hedged item attributable to changes in the benchmark interest rate by “using an assumed term that begins when the first hedged cash flow begins to accrue and ends when the last hedged cash flow is due and payable.”
  - *Portfolio hedge of prepayable assets* — Addition of a “last-of-layer” method that enables an entity to fair value hedge a portion of a closed portfolio of prepayable assets (or one or more beneficial interests secured by a portfolio of prepayable financial instruments) without having to consider prepayment risk or credit losses when measuring those assets.
- Ability to hedge contractually specified components of the price of forecasted purchases and sales of nonfinancial assets.
- Although private companies that are not financial institutions and certain not-for profit entities would have to document certain aspects of a hedging relationship at hedge inception, they would not have to perform and document hedge effectiveness assessments until their next set of financial statements is available to be issued.

## Hedging Concepts Retained by the ASU

ASU 2017-12 significantly alters the hedge accounting model by making it easier for an entity to achieve hedge accounting and have that accounting better reflect its risk management activities. Although the changes are substantial, constituents should note the following key aspects of hedge accounting under preadoption guidance that the Board retained:

- The “highly effective”<sup>4</sup> threshold for qualifying hedging relationships.
- The ability for an entity to:
  - Voluntarily dedesignate a hedging relationship.
  - Designate certain component risks of the hedged item as the hedged risk.
  - Apply the critical-terms-match method or the shortcut method.
- The benchmark interest rate definition and concept for hedges of fixed-rate financial instruments (i.e., fair value hedges of financial instruments).
- The required timing for the preparation of all hedge documentation for public companies and private companies that are financial institutions, except for the documentation related to the initial prospective quantitative hedge effectiveness assessment (discussed below).
- A number of disclosure requirements.

## Key Changes to the Hedge Accounting Model

The ASU makes a number of improvements to the hedge accounting model, including those outlined below.

### **Elimination of the Concept of Separately Recognizing Periodic Hedge Ineffectiveness**

ASU 2017-12 eliminates the concept of separately recognizing periodic hedge ineffectiveness for cash flow and net investment hedges (however, under the mechanics of fair value hedging, economic ineffectiveness will still be reflected in current earnings for those hedges). The Board believes that requiring an entity to record the impact of both the effective and ineffective components of a hedging relationship in the same financial reporting period and in the same income statement line item<sup>5</sup> will make that entity’s risk management activities and their effect on the financial statements more transparent to financial statement users.

Under this rationale, even a portion of the change in a hedging instrument’s fair value that is excluded from a hedging relationship’s effectiveness assessment is considered part of the hedging relationship and should be recognized in the same income statement line item as the earnings effect of the hedged item (other than amounts excluded from the assessment of effectiveness of net investment hedges). However, in a departure from the proposed ASU, the Board determined that presentation should not be prescribed for “missed forecasts” in cash flow hedges. Thus, an entity that ultimately determines that it is probable that a hedged forecasted transaction will not occur will not be required to record the amounts reclassified out of accumulated other comprehensive income (AOCI) for that hedging relationship into earnings in the same income statement line item that would have been affected by the forecasted transaction.

<sup>4</sup> ASC 815 does not define “highly effective,” but practice has interpreted this term to be an 80 percent to 125 percent offset between the change in the fair value of the hedging instrument and the change in the fair value or cash flows of the hedged item or transaction attributable to the hedged risk.

<sup>5</sup> Note that it is possible that changes in the fair value of the hedging instrument may be presented in more than one income statement line item if the changes in the value of the hedged item affect more than one income statement line item.



## Connecting the Dots

In paragraphs BC145 and BC146 of the ASU, the Board acknowledges that, unlike the preadoption hedge accounting model, the new model under ASU 2017-12 will defer the timing of recognition of any economic ineffectiveness arising from cash flow or net investment overhedges<sup>6</sup> (and amounts recognized as net investment underhedges<sup>7</sup> under the preadoption hedge accounting model will no longer be recognized). However, the Board believes that the new model will benefit constituents by (1) reducing the costs of administering a hedging program and (2) allowing users to more clearly identify how an entity's hedging program has affected its financial statements, thereby resulting in more decision-useful information.

In addition, in paragraphs BC135 and BC136 of the ASU, the Board acknowledged concerns expressed by certain financial institutions that the ASU's requirement to record all changes in the fair value of the hedging instrument in interest income and expense for hedges of interest rate risk would generate increased volatility in those institutions' key interest rate margin metrics. These institutions have historically recorded the interest accruals for such hedges in a different income statement line item than the one for other changes in the fair value of the hedging instrument. However, the Board ultimately reiterated its belief that its requirement for an entity to include all effects of a hedging relationship in the same income statement line item increases the transparency of the entity's hedging strategy and provides more decision-useful information to investors.

### ***Recognition and Presentation — Components Excluded From the Hedge Effectiveness Assessment***

ASU 2017-12 continues to allow an entity to exclude the time value of options, or portions thereof, and forward points from the assessment of hedge effectiveness. The ASU also permits an entity to exclude the change in the fair value of cross-currency basis spreads in currency swaps from the assessment of hedge effectiveness.

For excluded components in fair value, cash flow, and net investment hedges, the base recognition model under the ASU is an amortization approach. An entity still may elect to record changes in the fair value of the excluded component currently in earnings; however, such an election will need to be applied consistently to similar hedges.

Under the ASU's amortization approach, an entity recognizes the initial value of the component that was excluded from the assessment of hedge effectiveness as an adjustment to earnings over the life of the hedging instrument by using a "systematic and rational method." In each accounting period, the entity recognizes in other comprehensive income (OCI) (or, for net investment hedges, the currency translation adjustment (CTA) portion of OCI) any difference between (1) the change in fair value of the excluded component and (2) the amount recognized in earnings under that systematic and rational method.

If an entity derecognizes the hedged item in a fair value hedge or determines that it is probable that a hedged forecasted transaction in a cash flow hedge will not occur, the entity will recognize any amounts previously accumulated in AOCI under the amortization approach for those hedged exposures in current earnings. Otherwise, upon discontinuation of a hedging relationship that is accounted for under the amortization approach, amounts recorded in AOCI related to the changes in the fair value of the excluded components will be released to earnings either (1) when the hedged forecasted transaction affects earnings (for a cash flow or net investment hedge) or (2) in the same manner that the other components

<sup>6</sup> An overhedge occurs when the cumulative change in the fair value of the actual hedging derivative is greater than the cumulative change in the fair value of the hedged exposure.

<sup>7</sup> An underhedge occurs when the cumulative change in the fair value of the actual hedging derivative is less than the cumulative change in the fair value of the hedged exposure.

of the hedged item's carrying amount are ultimately recognized in earnings (for a fair value hedge).

The following example of the application of the amortization approach is derived from Example 31 of the ASU's implementation guidance (see ASC 815-20-55-235 through ASC 815-20-55-238):

### Example

On December 31, 20X0, in anticipation of its future purchase of 1,000 barrels of crude oil in December 20X4, an entity enters into a hedging relationship to manage its exposure to the potential change in cash flows that could result from an increase in oil prices. The entity purchases an at-the-money call option for 1,000 barrels of crude oil, designates it as the hedging instrument in the cash flow hedge of the forecasted oil purchase, and pays an initial premium of \$9,250. The entity elects to exclude the time value of the option (i.e., the premium paid at inception) from its assessment of hedge effectiveness and applies the amortization approach for recognition of the excluded time value component.

When the entity implements the amortization approach, it determines that a straight-line amortization pattern will be systematic and rational; accordingly, it will amortize the \$9,250 option premium (the initial value of the excluded component) into earnings ratably over the life of the option (i.e., \$2,313 per year, computed as the initial value of \$9,250 divided by four years). This pro rata amortization will be recognized in each reporting period regardless of the extent or direction of changes in the fair value of the option's other components.

In each reporting period, the entity will (1) adjust the option's recorded balance to reflect the changes in its fair value during the reporting period and recognize an offsetting adjustment to OCI and (2) separately recognize \$2,313 (representing that period's amortization of the option's initial time value) in earnings, with an offsetting adjustment to OCI. Over the life of the hedging relationship, the entity will record all amounts recognized in earnings related to the excluded component in the same income statement line item that it anticipates it will use to record the earnings effect of the hedged item (i.e., in cost of goods sold because the entity will record the purchased oil in inventory). The entity will not reclassify any amounts still recorded in AOCI at the option's expiration date into cost of goods sold until it ultimately sells the purchased oil.

## **Recognition and Presentation — Changes in the Fair Value of the Hedging Instrument and the Hedged Item**

The following table summarizes the recognition and presentation requirements for the hedging instrument and the related hedged item under the updated hedge accounting and presentation model in ASU 2017-12:

	Component of Hedging Instrument <i>Included</i> in the Assessment of Hedge Effectiveness		Component of Hedging Instrument <i>Excluded</i> From the Assessment of Hedge Effectiveness		Hedged Item
	Where Fair Value Changes Are Initially Recorded	When Hedged Item Affects Earnings	Systematic and Rational Amortization Method	Mark-to-Market Approach	
Fair value hedge					
Recognition	Income statement	N/A	Amortization of initial value — income statement  Record in OCI any difference between the change in fair value of the excluded component and amounts recognized in earnings under the systematic and rational method	Income statement	The entire change in fair value of the hedged item attributable to the hedged risk is recorded currently in income/loss and as an adjustment to the carrying amount of the hedged item
Presentation	Same income statement line item as the earnings effect of the hedged item	N/A	Same income statement line item as the earnings effect of the hedged item	Same income statement line item as the earnings effect of the hedged item	

(Table continued)

	Component of Hedging Instrument <i>Included</i> in the Assessment of Hedge Effectiveness		Component of Hedging Instrument <i>Excluded</i> From the Assessment of Hedge Effectiveness		Hedged Item
	Where Fair Value Changes Are Initially Recorded	When Hedged Item Affects Earnings	Systematic and Rational Amortization Method	Mark-to-Market Approach	
Cash flow hedge					
Recognition	OCI	Income statement	Amortization of initial value — income statement  Record in OCI any difference between the change in fair value of the excluded component and amounts recognized in earnings under the systematic and rational method	Income statement	When the hedged item affects earnings, amounts will be reclassified out of AOCI and presented in the same income statement line item in which the earnings effect of the hedged item is presented
Presentation	OCI/AOCI (balance sheet)	Same income statement line item as the earnings effect of the hedged item (income statement presentation not prescribed for missed forecasts)	Same income statement line item as the earnings effect of the hedged item	Same income statement line item as the earnings effect of the hedged item	

(Table continued)

	Component of Hedging Instrument <i>Included</i> in the Assessment of Hedge Effectiveness		Component of Hedging Instrument <i>Excluded</i> From the Assessment of Hedge Effectiveness		Hedged Item
	Where Fair Value Changes Are Initially Recorded	When Hedged Item Affects Earnings	Systematic and Rational Amortization Method	Mark-to-Market Approach	
Net investment hedge					
Recognition	OCI (CTA)	Income statement	Amortization of initial value — income statement  Record in OCI (CTA) any difference between the change in fair value of the excluded component and amounts recognized in earnings under the systematic and rational method	Income statement	When the hedged net investment affects earnings (i.e., upon a sale or liquidation), amounts will be reclassified out of the CTA and be presented in the same income statement line item in which the earnings effect of the net investment is presented (e.g., gain or loss on sale of investment)
Presentation	OCI /AOCI (CTA)	Same income statement line item as the earnings effect of the hedged item (e.g., gain or loss on sale of investment)	Income statement presentation not prescribed	Income statement presentation not prescribed	

## Hedge Effectiveness Assessments and Documentation Requirements

### ***Quantitative Versus Qualitative Assessments of Hedge Effectiveness***

ASU 2017-12 requires an entity to perform an initial prospective quantitative hedge effectiveness assessment (by using either a dollar-offset test or a statistical method such as regression) unless the hedging relationship qualifies for application of one of the expedients that permits an assumption of perfect hedge effectiveness (e.g., the shortcut method or critical-terms-match method).

An entity may perform the initial prospective quantitative hedge effectiveness assessment after hedge designation by using information available at hedge inception; however, the entity must complete that assessment by the earlier of:

- “The first quarterly hedge effectiveness assessment date.”
- “The date that financial statements that include the hedged transaction are available to be issued.”
- “The date that any [required hedging criterion] no longer is met.”
- “The date of expiration, sale, termination, or exercise of the hedging instrument.”
- “The date of dedesignation of the hedging relationship.”
- “For a cash flow hedge of a forecasted transaction . . . the date that the forecasted transaction occurs.”

If (1) an entity's initial prospective quantitative hedge effectiveness assessment of a hedging relationship demonstrates there is a highly effective offset and (2) the entity can, at hedge inception, “reasonably support an expectation of high effectiveness on a qualitative basis in subsequent periods,” the entity may elect to perform subsequent retrospective and prospective effectiveness assessments qualitatively. To do so, in the hedge documentation it prepares at hedge inception, the entity must (1) specify how it will perform the qualitative assessments and (2) document the alternative quantitative assessment method that it would use if it later concludes, on the basis of a change in the hedging relationship's facts and circumstances, that subsequent quantitative assessments will be necessary. The entity may make this election on a hedge-by-hedge basis.



### Connecting the Dots

ASU 2017-12 notes that an entity's determination of whether it can reasonably support qualitatively an expectation of high effectiveness will require the use of judgment and that the entity should consider (1) the results of the initial prospective quantitative hedge effectiveness assessment, (2) the extent to which the critical terms of the hedging instrument and the hedged item are aligned, and (3) the degree and consistency of correlation between changes in the underlyings of the hedging instrument and the hedged item.

ASU 2017-12 also states that “[a]n entity must document that it will perform the same quantitative assessment method for both initial and subsequent prospective hedge effectiveness assessments.”

The new standard states that after an entity makes its initial election, it must “verify and document whenever financial statements or earnings are reported and at least every three months that the facts and circumstances related to the hedging relationship have not changed such that it can assert qualitatively that the hedging relationship was and continues to be highly effective.” Indicators that may (individually or in the aggregate) allow an entity to continue to assert qualitatively that a hedging relationship continues to be highly effective include:

- No events or circumstances have affected the factors that originally enabled the entity to assess that it could reasonably support, qualitatively, an expectation that the hedging relationship was and will continue to be highly effective. An entity's analysis of this indicator should consider the possible impact of any caps or floors that may be embedded in the hedged item on the overall effectiveness of the hedging relationship as well as changes in the effects of those features since the inception of the hedging relationship.
- No adverse developments have occurred related to the counterparty's risk of default.

An entity that initially elects to perform subsequent qualitative effectiveness assessments but later determines that the hedging relationship's facts and circumstances have changed to the extent that qualitative assessments are no longer sufficient will be required under the new standard to quantitatively assess effectiveness at the time of the change<sup>8</sup> by using the method specified in the initial hedge documentation. After the entity is required or elects (e.g., when it wishes to validate that its qualitative assessments of hedge effectiveness remain appropriate) to perform quantitative hedge effectiveness assessments, it may subsequently return to making qualitative assessments if it can support them on the basis of the same factors it had used in its original qualitative assessments.

## **Amendments to Benchmark Interest Rates and the Definition of Interest Rate Risk**

Previously, U.S. GAAP defined "interest rate risk" for both fair value and cash flow hedges as the "risk of changes in a hedged item's fair value or cash flows attributable to changes in the designated benchmark interest rate." ASU 2017-12 redefines "interest rate risk" as follows:

- "For recognized variable-rate financial instruments and forecasted issuances or purchases of variable-rate financial instruments, interest rate risk is the risk of changes in the hedged item's cash flows attributable to changes in the contractually specified interest rate in the agreement."
- "For recognized fixed-rate financial instruments, interest rate risk is the risk of changes in the hedged item's fair value attributable to changes in the designated benchmark interest rate. For forecasted issuances or purchases of fixed-rate financial instruments, interest rate risk is the risk of changes in the hedged item's cash flows attributable to changes in the designated benchmark interest rate."

Thus, ASU 2017-12 eliminates the benchmark interest rate concept for variable-rate financial instruments but retains it for fixed-rate financial instruments.

As indicated in the revised definition of interest rate risk, in cash flow hedges of interest rate risk associated with forecasted issuances or purchases of debt, the nature of the hedged risk will depend on the characteristics of the forecasted transaction. An entity that expects to issue or purchase fixed-rate debt would hedge the variability in cash flows associated with changes in the benchmark interest rate; for a forecasted issuance or purchase of variable-rate debt, the entity would hedge the variability in cash flows associated with changes in the contractually specified rate. If the entity is unsure about the nature of its forecasted transaction, it would designate as the hedged risk the variability in cash flows attributable to a change in a rate that would qualify both as a benchmark interest rate (if the forecasted transaction ultimately was fixed rate) and as a contractually specified rate (if the forecasted transaction ultimately was variable rate).

### **Example**

If Entity A does not know at the inception of a hedge of a forecasted debt issuance whether that debt will have a fixed or variable interest rate, it can designate the risk of changes in cash flows attributable to the changes in the London Interbank Offered Rate (LIBOR) as the hedged risk. The LIBOR will qualify both as a benchmark interest rate if fixed-rate debt is ultimately issued and as a contractually specified interest rate if variable-rate debt is issued.

<sup>8</sup> An entity that is unable to identify the event that led to the change in the facts and circumstances may begin to perform quantitative hedge effectiveness assessments in the current period.

ASU 2017-12 also adds the SIFMA Municipal Swap Rate to those benchmark interest rates already permitted under preadoption guidance<sup>9</sup> to make it easier for entities to hedge interest rate risk for fixed-rate tax-exempt financial instruments.



### Connecting the Dots

The SIFMA Municipal Swap Rate was identified by stakeholders as an interest rate that entities often sought to hedge, in addition to the benchmark rates already permitted before the ASU's adoption. As noted in paragraph BC71 of the ASU, the SIFMA Municipal Swap Rate is "the average rate at which high-credit-quality U.S. municipalities may obtain short-term financing and currently is the predominant rate referenced in issuances of municipal bonds."

The Board also considered adding prime composite indexes as a defined benchmark interest rate but ultimately rejected that concept out of a concern that doing so could potentially incorporate a high level of credit risk into the benchmark interest rate.

In addition, the Board rejected incorporating into the definition of a benchmark interest rate the notion of expectations that a rate will become widely used. Doing so would have allowed entities to potentially use other rates beyond the explicit list of eligible benchmark rates in the United States; however, the Board did not perceive a need for this change given its belief that it will be able to timely address any need to add benchmark interest rates if warranted by developments in the financial markets.

## Shortcut Method and Critical-Terms-Match Method

ASU 2017-12 retains both the shortcut method and critical-terms-match method and provides additional relief for entities applying those methods. As a response to concerns about the number of restatements that have resulted from attempted application of the shortcut method, ASU 2017-12 updates the shortcut method accounting requirements to allow an entity that determines that a hedging relationship no longer meets the shortcut criteria to continue that hedging relationship under a long-haul method (and avoid having to dedesignate the original hedging relationship) if the entity can show that:

- a. [It] documented at hedge inception . . . which quantitative method it would use to assess hedge effectiveness and measure hedge results if the shortcut method was not or no longer is appropriate during the life of the hedging relationship[; and]
- b. The hedging relationship was highly effective on a prospective and retrospective basis in achieving offsetting changes in fair value or cash flows attributable to the hedged risk for the periods in which the shortcut method criteria were not met.<sup>10</sup>

If criterion (a) is not satisfied, the hedging relationship would be invalid in the period in which the shortcut method criteria were not satisfied and all subsequent periods; otherwise (if criterion (a) is met), the hedging relationship would be invalid in all periods in which criterion (b) was not satisfied.

In addition, ASU 2017-12 updates certain shortcut-method criteria to allow partial-term fair value hedges of interest rate risk to qualify for the shortcut method.

ASU 2017-12 also expands an entity's ability to apply the critical-terms-match method to cash flow hedges of groups of forecasted transactions. If all other critical-terms-match criteria are satisfied, such hedges will qualify for the critical-terms-match method "if those forecasted transactions occur and the derivative matures within the same 31-day period or fiscal month."

<sup>9</sup> The other benchmark interest rates for the United States are (1) interest rates on direct Treasury obligations of the U.S. government, (2) the LIBOR swap rate, and (3) the Fed Funds Effective Swap Rate (also referred to as the Overnight Index Swap Rate).

<sup>10</sup> To make this effectiveness assessment, an entity should use the terms of the hedging instrument and hedged item that existed at the date the hedging relationship no longer met the shortcut method criteria. In cash flow hedges that use a hypothetical derivative as a proxy for the hedged item, the hypothetical derivative would be set to a value of zero as of hedge inception.

Under preadoption guidance, entities would have had to have shown that there was a de minimis amount of ineffectiveness when there was a mismatch in the timing of the forecasted transactions and the settlement of the derivative.



### Connecting the Dots

As discussed in the [Quantitative Versus Qualitative Assessments of Hedge Effectiveness](#) section above, an entity may qualitatively assess hedge effectiveness prospectively and retrospectively if certain criteria are satisfied. The entity may continue to perform qualitative assessments as long as it concludes that facts and circumstances have not changed to an extent that would preclude it from being able to make further qualitative assessments.

However, the Board did not change the more stringent accounting requirements for critical-terms-match hedging relationship elections; therefore, if there is any change in the critical terms of the hedging instrument or the hedged item, an entity will have to (1) conclude that the change in fair value or cash flows attributable to the risk being hedged will not be completely offset and (2) cease application of the critical-terms-match method. The Board considers it reasonable that it will be more difficult for an entity to continue to be eligible to apply the critical-terms-match method than it will be for the entity to make qualitative assessments because the entity does not have to apply any judgment to assess effectiveness when using the critical-terms-match method (other than consideration of counterparty default risk) and because application of that method does not require the entity to perform an initial prospective quantitative assessment of hedge effectiveness.

## Fair Value Hedges of Interest Rate Risk

ASU 2017-12 makes a number of improvements that simplify the accounting for fair value hedges of interest rate risk and make that accounting better reflect an entity's risk management activities.

### ***Measurement of Changes in the Hedged Item's Fair Value by Using Benchmark Component Cash Flows***

Before the ASU, an entity had to use the total contractual coupon cash flows to determine the change in fair value of the hedged item attributable to changes in the benchmark interest rate. However, ASU 2017-12 allows an entity to choose to use either (1) the full contractual coupon cash flows or (2) the cash flows associated with the benchmark interest rate component determined at hedge inception to calculate the change in fair value of the hedged item in a fair value hedge of interest rate risk.

An entity's ability to use only the benchmark component cash flows for measurement allows the entity to reduce the net earnings effect of its hedge accounting by eliminating recognition of any economic ineffectiveness related to credit spreads.

The potential benefit of this approach is demonstrated in the following example, which is derived from Example 16 of the ASU's implementation guidance (see ASC 815-25-55-100 through ASC 815-25-55-108):

<b>Example</b>				
<p>On July 2, 20X0, Entity XYZ issues, at par, \$100 million of A1-quality, five-year, fixed-rate debt with an annual 8 percent interest coupon payable semiannually. On that same date, XYZ also enters into a \$100 million notional, five-year, receive-fixed 8 percent, pay-LIBOR + 200 basis points (i.e., current LIBOR is 6 percent) interest rate swap that settles semiannually, and XYZ designates it as the hedging instrument in a fair value hedge of interest rate risk of the \$100 million liability. Assume (1) a flat yield curve at the level of the current benchmark rate and (2) that the LIBOR swap rate increased 100 basis points, to 7 percent, on December 31, 20X0. Also assume that there are no changes in the counterparty's creditworthiness or credit or funding spreads that would change the effectiveness of the hedging relationship.</p> <p>The table below highlights the reduced impact on earnings that results from calculating the fair value change in the hedged item attributable to interest rate risk by using the benchmark interest rate component of the contractual coupon cash flows.</p>				
	<b>Interest Rate Swap Receive Leg</b>	<b>Interest Rate Swap Pay Leg</b>	<b>Calculation by Using Full Contractual Cash Flows</b>	<b>Calculation by Using Benchmark Component Cash Flows</b>
Initial fair value (swap shown as the net fair value of both legs)		\$ 0	\$ 100 million	\$ 100 million
Fair values at December 31, 20X0				
Discount rate (semiannual)	3.5%	3.5%	4.5%	3.5%
Number of remaining periods	Nine	Nine	Nine	Nine
Semiannual payment	\$ 4 million	\$ 4.5 million	\$ 4 million	\$ 3 million
Fair value	\$ 30,430,746	\$ (34,234,589)	\$ 96,365,605	\$ 96,196,157
Net change in fair value		\$ (3,803,843)	\$ 3,634,395	\$ 3,803,843
Net earnings effect of hedge			\$ 169,448	\$ 0

The ASU eliminates the proposed market-yield test, which would have required an entity to use the full contractual coupon cash flows for its calculation when, at hedge inception, the current market yield of the hedged item was less than the benchmark interest rate.

### **Measuring the Fair Value of a Prepayable Instrument**

For prepayable instruments such as callable debt, ASU 2017-12 states that an entity “may consider only how changes in the benchmark interest rate affect the decision to settle the hedged item before its scheduled maturity” when it calculates the change in the fair value of the hedged item attributable to interest rate risk. In other words, an entity would, when adjusting the carrying amount of the hedged item, consider the same factors that it considered when assessing hedge effectiveness.

Before the ASU, practice had evolved to require an entity to consider *all* factors that might lead an obligor to settle the hedged item before its scheduled maturity (e.g., changes in interest rates, credit spreads, or other factors) even if the entity had designated only interest rate risk as the risk being hedged. The ASU allows an entity to ignore factors other than changes in the benchmark interest rate that could affect the settlement decision when it assesses hedge effectiveness and makes it easier for the hedging relationship to meet the “highly effective” threshold.

For example, when an entity (1) assesses hedge effectiveness in a fair value hedge of interest rate risk of callable debt and (2) measures the change in the fair value of callable debt attributable to changes in the benchmark interest rate, it can now consider only how changes in the benchmark interest rate (and not changes in credit risk or other factors) would affect the obligor's decision to call the debt.

### ***Partial-Term Hedges of Interest Rate Risk***

ASU 2017-12 also provides relief to entities that wish to enter into fair value hedges of interest rate risk for only a portion of the term of the hedged financial instrument. Successful hedging of such partial-term exposures was typically unachievable under preadoption guidance because it was difficult to find a hedging derivative that would be highly effective at offsetting changes in the fair value of the hedged exposure as a result of the difference in timing between the hedged item's principal repayment and the maturity date of the hedging derivative.

Under ASU 2017-12, an entity may measure the change in the fair value of the hedged item attributable to changes in the benchmark interest rate by "using an assumed term that begins when the first hedged cash flow begins to accrue and ends when the last hedged cash flow is due and payable." Also, the hedged item's assumed maturity will be the date on which the last hedged cash flow is due and payable; therefore, a principal payment will be assumed to occur at the end of the specified partial term.

#### **Example**

An entity that issues \$100 million of five-year, noncallable, fixed-rate debt may designate a two-year, receive-fixed, pay-variable, \$100 million notional interest rate swap as a fair value hedge of the interest rate risk for the first two years of the debt's term.<sup>11</sup> When the entity calculates the change in the fair value of the debt attributable to changes in the benchmark interest rate to record the effects of hedging, it may assume for calculation purposes that (1) the term of the hedged debt is two years and (2) repayment of the outstanding debt occurs at the end of the second year.

As indicated above in the discussion about amendments to the shortcut method, ASU 2017-12 also makes it possible for entities to apply the shortcut method to partial-term fair value hedges of interest rate risk.

Also note that for prepayable instruments, if the specified hedged partial term ends on or before the date that the instrument may be repaid, the designated hedged item is essentially noncallable. Therefore, an entity does not need to consider prepayment risk for such hedging relationships when it determines hedge effectiveness or measures changes in the fair value of the hedged item (which also aligns with how an entity would consider prepayment risk in a cash flow hedge of a callable instrument).



#### **Connecting the Dots**

An entity should account for basis adjustments made to the carrying value of the hedged item in a partial-term hedging relationship in accordance with its hedging policies, which would typically require recognition over the life of the hedging relationship. Upon termination of the hedging relationship, the entity should amortize any carrying amount adjustments in a manner consistent with how it amortizes any other premiums or discounts for the hedged item.

<sup>11</sup> In a partial-term fair value hedge, the entity is not required to designate the hedged item beginning with the first contractual cash flow or payment. Rather, the entity could have designated any single interest payment or any consecutive payments as the hedged item.

## Last-of-Layer Method

To address constituent feedback received on the project after the initial proposal, the FASB added to ASU 2017-12 a last-of-layer method that enables an entity to apply fair value hedging to closed portfolios of prepayable assets without having to consider prepayment risk or credit risk when measuring those assets. An entity can also apply the method to one or more beneficial interest(s) (e.g., a mortgage-backed security) secured by a portfolio of prepayable financial instruments.

Under the last-of-layer method, an entity would designate as the hedged item in a fair value hedge of interest rate risk a stated amount of the asset or assets that the entity does not expect “to be affected by prepayments, defaults, and other factors affecting the timing and amount of cash flows” (the “last of layer”). This designation would occur in conjunction with the partial-term hedging election discussed above.<sup>12</sup>

To support the designation, the entity would include in the initial hedge documentation evidence that the entity performed an analysis that supported its expectation that the hedged item (i.e., the last of layer) would be outstanding as of the assumed maturity date of the hedged item that was documented in the partial-term hedge election. That analysis should reflect the entity’s current expectations about factors that can affect the timing and amount of the closed portfolio’s (or, for beneficial interests, the underlying assets’) cash flows (e.g., prepayments and defaults); however, the ASU allows the entity to assume that the effects of any events that occur, such as prepayments or defaults, would first apply to the portion of the closed portfolio or beneficial interests that is not part of the hedged item (last-of-layer) designation.

At each subsequent hedge effectiveness assessment date, the entity must continue to prepare and document its analysis supporting the expectation that the hedged item (i.e., the last of layer) will be outstanding at the assumed maturity date. The updated analysis should reflect the entity’s current expectations about the level of prepayments, defaults, or other factors that could affect the timing and amount of cash flows, and it should use the same methods as those used at hedge inception.



### Connecting the Dots

ASU 2017-12 does not change the requirement that a hedged portfolio in a fair value hedge must consist only of “similar” assets that share the risk exposure for which they are designated as being hedged. However, an entity applying the last-of-layer method may satisfy this criterion by combining the partial-term fair value hedge election and the election to measure changes in the hedged item by using the benchmark rate component of the contractual coupon cash flows. As paragraph BC112 of the ASU states:

Using the benchmark rate component of the contractual coupon cash flows when (a) all assets have the same assumed maturity and (b) prepayment risk does not affect the measurement of the hedged item results in all hedged items having the same benchmark rate coupon. When those elections are made, and because the portfolio is closed, a similar assets test needs to be performed only at hedge inception. Additionally, all assets in the portfolio for hedge accounting purposes are considered nonamortizing and nonprepayable with the same maturity and coupon, resulting in the similar assets test being performed on a qualitative basis.

<sup>12</sup> Paragraph BC125 of the ASU further clarifies that an entity that designates a hedged item under the last-of-layer method is precluded from applying the shortcut method to such a hedging relationship.

As noted above, when an entity accounts for a hedging relationship designated under the last-of-layer method, it may exclude prepayment risk and credit risk when it measures the change in the fair value of the hedged item that is attributable to changes in interest rate risk. Also, on each reporting date, the entity will adjust the basis of the hedged item for the gain or loss on the hedged item attributable to changes in the hedged risk (i.e., interest rate risk), as it would do for any other fair value hedge. The entity may allocate this basis adjustment to the closed portfolio as a whole or, by using a systematic and rational method, to individual assets in the portfolio.



### Connecting the Dots

When an entity considers how it will allocate the basis adjustments that result from hedge accounting by using the last-of-layer method, it should factor in possible interactions with the application of other accounting requirements. For example, adjustments to the carrying value of the assets in the closed portfolio that are being hedged under the last-of-layer method might affect multiple pools of financial assets for which credit losses will be estimated on a collective basis. The identification of such pools may become an even more significant issue when an entity adopts ASU 2016-13.<sup>13</sup>

An entity that concludes on any hedge effectiveness assessment date that it no longer expects the entire hedged last of layer to be outstanding at its assumed maturity date must, at a minimum, discontinue hedge accounting for that portion of the hedged last of layer that is not expected to be outstanding. Moreover, the entity must discontinue the entire hedging relationship on any assessment date on which it determines that the hedged last of layer currently exceeds the outstanding balance of the closed portfolio of prepayable assets or one or more beneficial interests in prepayable assets. A full or partial hedge discontinuation will also trigger the need for the entity to allocate, in a systematic and rational manner, the outstanding basis adjustment (or portion thereof) that resulted from the previous hedge accounting to the individual assets in the closed portfolio. Such allocated amounts must be amortized over a period “that is consistent with the amortization of other discounts or premiums associated with the respective assets” under U.S. GAAP. The last-of-layer method does not, however, incorporate a tainting threshold; therefore, an entity that is required to discontinue a last-of-layer hedging relationship is not precluded from designating similar hedging relationships in the future.

#### Example

Assume the following about Entity XYZ:

- It has a closed portfolio (“Portfolio X”) of fixed-rate prepayable financial assets with stated maturities of up to 30 years. The fixed rates and the maturities of the assets vary.
- Portfolio X’s outstanding unpaid principal balance is \$300 million.
- It wants to hedge its exposure to changes in the fair value of the financial assets in Portfolio X attributable to changes in the benchmark interest rate over the next five years.
- It expects that on the basis of its current expectations about the level of prepayments, defaults, or other factors that could affect the timing and amount of cash flows in Portfolio X, the outstanding unpaid principal balance will not fall below \$150 million at the end of the five-year period.
- It executes a nonamortizing, five-year, receive-variable and pay-fixed interest rate swap with a notional amount of \$150 million to hedge the interest rate risk.

<sup>13</sup> FASB Accounting Standards Update No. 2016-13, *Measurement of Credit Losses on Financial Instruments*.

## Example (continued)

### Last-of-Layer Method — Application at Inception

- Entity XYZ designates the hedged item as interest receipts on the last \$150 million of unpaid principal balance within Portfolio X over the next five years (i.e., a partial-term hedge election), and elects to measure the hedged item (i.e., last of layer) using the benchmark rate component (LIBOR) of the contractual coupon cash flows.
- Entity XYZ performs an analysis to support its (1) expectation that the hedged item will be outstanding as of its assumed maturity date in accordance with its partial-term hedge election and (2) its conclusion that the assets in Portfolio X are similar in accordance with ASU 2017-12.
- Entity XYZ can ignore prepayment risk and default risk when assessing whether the hedging relationship is expected to be highly effective since the designated \$150 million of unpaid principal balance (the last of layer) is expected to be outstanding at the end of the specified hedge term.

### Last-of-Layer Method — Application in Subsequent Reporting Periods

- The combined effect of XYZ's elections related to the partial-term hedge, use of the benchmark rate component of the coupon, and last-of-layer designation essentially transforms the hedged last of layer into a homogenous group of loans and cash flows within Portfolio X and allows XYZ to ignore prepayments and defaults for measurement purposes and avoid having to assess after hedge inception whether the assets in Portfolio X are similar.
- The designated hedging relationship will pass the quarterly hedge effectiveness assessment given that the key terms of the hedging relationship match.
- Entity XYZ may choose to account for the hedge accounting basis adjustments that arise during the hedging relationship at either the Portfolio X level as a whole (i.e., at the level of the designated hedged item) or at the level of individual assets within Portfolio X by using a systematic and rational method.
- At each effectiveness testing date, XYZ will perform an analysis to support its expectation that the unpaid principal balance at the end of the hedged term will be no less than \$150 million (i.e., the designated hedged exposure). If XYZ concludes on any assessment date that it expects the outstanding balance of Portfolio X will be less than \$150 million at the assumed maturity date, XYZ would be required to discontinue hedge accounting for at least the portion of the designated last of layer that it no longer expects to be outstanding at the assumed maturity date and allocate the related portion of the outstanding basis adjustment to individual assets in the closed portfolio by using a systematic and rational method.

## Ability to Designate Components of Nonfinancial Assets as Hedged Items

Under U.S. GAAP before the ASU's adoption, when an entity desired to cash flow hedge a risk exposure associated with a nonfinancial asset, it could designate as the hedged risk only the risk of changes in cash flows attributable to (1) all changes in the purchase or sales price or (2) changes in foreign exchange rates. Alternatively, for cash flow hedges of financial instruments, an entity could designate as the hedged risk either the risk of overall changes in cash flows or one or more discrete risks.

The restriction on hedging exposures associated with components of nonfinancial assets often resulted in misalignment between an entity's hedge accounting results and its actual risk management activities. Further, the requirement to hedge all price changes made it challenging for an entity to hedge portfolios of commodities, even when the commodities' pricing was based on the same index, because of the ineffectiveness that arose as a result of other basis differentials, such as different transportation costs for commodities received in different locations.

ASU 2017-12 provides relief by enabling an entity to designate the “risk of variability in cash flows attributable to changes in a contractually specified component” as the hedged risk in a hedge of a forecasted purchase or sale of a nonfinancial asset. The ASU defines a contractually specified component as “[a]n index or price explicitly referenced in an agreement to purchase or sell a nonfinancial asset other than an index or price calculated or measured solely by reference to an entity’s own operations.” The Board believes that enabling an entity to component hedge purchases or sales of nonfinancial assets better reflects its risk management activities in its financial reporting and will allow the entity to more easily hedge cash flow variability associated with commodities received from multiple suppliers or delivered to multiple locations. The ASU also creates greater symmetry in the hedging models for financial and nonfinancial items by allowing an entity to hedge components of the total change in cash flows for both types of items.



### Connecting the Dots

In the ASU, the Board declined to provide additional guidance on the nature and form of contracts that could contain a contractually specified component; however, ASC 815-20-55-26A states that 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.”

An entity’s determination of whether it may designate as the hedged risk the variability in cash flows attributable to changes in a contractually specified component for the purchase or sale of a nonfinancial asset depends on the nature of the contract, as follows:

- If the contract is a derivative in its entirety and the entity applies the normal purchases and normal sales scope exception, the entity may designate any contractually specified component in the contract as the hedged risk (failure to apply the normal purchases and normal sales scope exception precludes designation of any contractually specified component).
- If the contract is not a derivative in its entirety, the entity may designate any remaining contractually specified component in the host contract (i.e., after bifurcation of any embedded derivatives) as the hedged risk.

In addition, the ASU permits an entity to designate a hedge of a contractually specified component (1) for a period that extends beyond the contractual term or (2) when a contract does not yet exist to sell or purchase the nonfinancial asset if the criteria specified above will be met in a future contract and all the other cash flow hedging requirements are met. When the entity executes the contract, it will reassess the criteria specified above to determine whether the contractually specified component continues to qualify for designation as the hedged risk. If, at the time the contract is executed, there is a change in the contractually specified component (e.g., the hedge documentation specified a commodity grade different from that in the executed contract), the entity will not be required to automatically dedesignate the hedging relationship; however, the entity will be required to demonstrate that the hedging relationship continues to be highly effective at achieving offsetting cash flows attributable to the revised hedged risk to justify continuation of hedge accounting.



### Connecting the Dots

The ASU’s amendments do not limit this guidance on changes in the designated hedged risk to hedges of nonfinancial items. Therefore, for example, an entity also would be permitted to continue applying hedge accounting to a cash flow hedge of a financial item if (1) the designated hedged risk changes during the life of the hedging relationship (e.g., if the interest rate index referenced in the final transaction differs from that specified in the hedge documentation for the forecasted transaction) and (2) the entity can conclude that the hedging instrument is still highly effective at achieving offsetting cash flows attributable to the revised hedged risk.

## Documentation Relief for Certain Private Companies and Not-for-Profit Entities

### ***Timing of Initial Prospective Quantitative Hedge Effectiveness Assessment***

For private companies that are not financial institutions as well as for not-for-profit entities,<sup>14</sup> ASU 2017-12 provides additional relief related to the *timing* of the (1) performance of an entity's initial and subsequent hedge effectiveness assessments and (2) preparation of the related documentation. Such entities must document only certain aspects of the hedging relationship at hedge inception and are not required to perform and document all initial and subsequent hedge effectiveness assessments (whether quantitative or qualitative) until their next set of interim (if applicable) or annual financial statements is available to be issued.

Under the ASU, an entity will specify the following information about the hedging relationship at hedge inception:

- a. The hedging relationship . . .
- b. The hedging instrument . . .
- c. The hedged item . . . including (if applicable) firm commitments or forecasted transactions . . .
- d. The nature of the risk being hedged.

At hedge inception, an entity does not need to specify the method it will use to assess hedge effectiveness; therefore, it can defer documenting the method it will use until it performs and documents its hedge effectiveness assessments.



#### **Connecting the Dots**

The ASU's documentation relief relates solely to the *timing* of when qualifying entities perform and document their assessments of hedge effectiveness and document the method they use to perform those assessments; no relief is given in regard to the documentation's content or the frequency of effectiveness assessments. The ASU clarifies that "[e]ven though the completion of the initial and ongoing assessments of effectiveness may be deferred to the date on which financial statements are available to be issued the assessments shall be completed using information applicable as of hedge inception and each subsequent quarterly assessment date when completing this documentation on a deferred basis."

The ASU's amendments do not supersede the documentation timing relief granted under the simplified hedging approach in ASC 815.

## Disclosure Requirements

ASU 2017-12 adds new disclosure requirements and amends existing ones. It also updates the illustrative disclosure examples in ASC 815. Also, to align the disclosure requirements with the updates to the hedge accounting model, the ASU removes the requirement for entities to disclose amounts of hedge ineffectiveness. In addition, an entity must now provide tabular disclosures about:

- Both (1) the total amounts reported in the statement of financial performance for each income and expense line item that is affected by fair value or cash flow hedging and (2) the effects of hedging on those line items.
- The carrying amounts and cumulative basis adjustments of items designated and qualifying as hedged items in fair value hedges. As part of such disclosures, an entity also must provide details about hedging relationships designated under the last-of-layer method, including (1) the closed portfolio's (beneficial interest's) amortized cost

<sup>14</sup> The additional relief does not apply to not-for-profit entities "that have issued, or are a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market."

basis, (2) the designated last-of-layer amounts, and (3) the related basis adjustment for the last of layer.

These disclosures are required for every annual and interim reporting period for which a statement of financial position and statement of financial performance are presented.

The ASU also indicates that an entity may need to allocate basis adjustments arising from last-of-layer method hedging relationships to satisfy disclosure objectives in other areas of U.S. GAAP. Such allocations should be made in a systematic and rational manner and may be made at either a portfolio or an individual asset level.

## Effective Date and Transition

### Effective Date

For public business entities, the ASU is effective for fiscal years beginning after December 15, 2018, and interim periods therein.

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

In addition, entities are permitted to early adopt the new guidance in any interim or annual period after issuance of the ASU. If an entity early adopts the updated guidance in an interim period, any transition adjustments should be reflected as of the beginning of the fiscal year that includes that interim period.

### Transition

Entities will adopt the ASU's provisions by applying a modified retrospective approach to existing hedging relationships<sup>15</sup> as of the adoption date. Under this approach, entities with cash flow or net investment hedges will make (1) a cumulative-effect adjustment to AOCI so that the adjusted amount represents the cumulative change in the hedging instruments' fair value since hedge inception (less any amounts that should have been recognized in earnings under the new accounting model) and (2) a corresponding adjustment to opening retained earnings as of the most recent period presented on the date of adoption.

In each annual and interim reporting period in the fiscal year of adoption, entities will also be required to provide certain disclosures required by ASC 250 about (1) the nature and reason for the change in accounting principle and (2) the cumulative effect of the change on the opening balance of affected components of equity or net assets as of the date of adoption.

In all interim periods and fiscal years ending after the date of adoption, entities should prospectively (1) present the entire change in the fair value of a hedging instrument in the same income statement line item(s) as the earnings effect of the hedged item when that hedged item affects earnings (other than amounts excluded from the assessment of net investment hedge effectiveness, for which the ASU does not prescribe presentation) and (2) provide the amended disclosures required by the new guidance.

<sup>15</sup> This refers to hedging relationships in which "the hedging instrument has not expired, been sold, terminated, or exercised" and that have not been dedesignated by the entity as of the date of adoption.

## Transition Elections

The ASU provides the following transition elections, and entities may choose to apply any election. Private companies that are not financial institutions as well as not-for-profit entities (except those that have issued, or are a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market) must make the transition elections before their next set of interim (if applicable) or annual financial statements is available to be issued. All other entities must make the elections before the first effectiveness testing date after adoption.

### *Transition Elections for All Hedges That Exist at the Date of Adoption*

- An entity may modify the recognition model for excluded components from a mark-to-market approach to the amortization approach without having to dedesignate the hedging relationship by making (1) a cumulative-effect adjustment to AOCI and (2) a corresponding adjustment to opening retained earnings as of the initial application date.
- An entity may modify hedge documentation without dedesignating those hedges to specify the following:
  - That subsequent prospective and retrospective hedge effectiveness assessments will be performed qualitatively.
  - For hedging relationships for which the entity uses the shortcut method, the quantitative method that the entity will use to perform assessments of effectiveness if it determines at a later date that use of the shortcut method was not or no longer is appropriate.

### *Transition Elections for Fair Value Hedges That Exist at the Date of Adoption*

- For fair value hedges of interest rate risk, an entity may elect to apply the revised measurement methods related to (1) using the benchmark rate component of contractual coupon cash flows to measure changes in fair value of the hedged item attributable to changes in the benchmark interest rate or (2) considering only changes in benchmark interest rates in calculating the change in the fair value of prepayable financial instruments attributable to interest rate risk, without having to dedesignate the hedging relationship. When making this election, an entity should:
  - Adjust the amount of any existing cumulative basis adjustment to what it would have been as of the adoption date had the entity applied the revised measurement method throughout the life of the hedging relationship and make a corresponding adjustment to the opening balance of retained earnings as of the initial application date.
  - Determine the benchmark rate component of the contractual coupon cash flows as of the hedging relationship's original inception date.
- An entity that elects to revise its measurement method to use the benchmark rate component of the contractual coupon cash flows also may elect to dedesignate a portion of the hedged item and reclassify the related basis adjustment to the opening balance of retained earnings as of the initial application date.
- An entity that uses cross-currency swaps to fair value hedge foreign exchange risk may, without dedesignating the hedging relationship, modify its hedge documentation to exclude the cross-currency basis spread component of the currency swap from its assessment of hedge effectiveness and recognize that excluded component through an amortization approach. The entity should adjust AOCI for the cumulative effect of applying this election as if it has been applied since the inception of the hedging relationship and make a corresponding adjustment to opening retained earnings as of the initial application date.

### *Transition Elections for Cash Flow Hedges That Exist at the Date of Adoption*

- For cash flow hedges (1) in which the entity previously designated as the hedged risk the variability in total cash flows and (2) that now qualify for designation of the variability in cash flows attributable to changes in a contractually specified component or interest rate as the hedged risk, the entity may:
  - Modify the hedging relationship documentation to designate the variability in the contractually specified component or contractually specified interest rate as the hedged risk, without having to dedesignate the hedge.
  - Establish the terms of the instrument that it uses to estimate changes in the value of the hedged risk (either under the hypothetical derivative method or another acceptable method) in its hedge effectiveness assessment on the basis of market data as of the inception of the hedging relationship.
  - Consider any hedging relationship ineffectiveness previously recognized as part of the transition adjustment for cash flow hedges.

### *Additional Transition Election*

- An entity may reclassify a debt security from held to maturity to available for sale if the debt security is eligible to be hedged under the last-of-layer method. Any unrealized gain or loss at the transfer date should be recorded in AOCI in accordance with ASC 320-10-35-10(c).<sup>16</sup>

With respect to the above transition elections to (1) amend shortcut method hedge documentation, (2) change the designated hedged risk to the variability in cash flows attributable to changes in a contractually specified component or a contractually specified interest rate, and (3) apply the amortization approach to recognized excluded components, an entity is not required to apply the guidance in ASC 815-20-25-81, which states that “[o]rdinarily, an entity shall assess effectiveness for similar hedges in a similar manner, including whether a component of the gain or loss on a derivative instrument is excluded in assessing effectiveness for similar hedges.” Therefore, an entity may account for postadoption hedging relationships differently from how it accounts for similar preadoption hedging relationships.

For fair value hedges existing at the adoption date in which the hedged item is a tax-exempt financial instrument, an entity may change the hedged risk to interest rate risk related to the SIFMA Municipal Swap Rate. An entity should (1) consider this modification a hedge dedesignation and immediate redesignation of the hedging relationship and (2) amortize the cumulative basis adjustment associated with the dedesignated hedge to earnings on a level-yield basis over an appropriate period on the basis of other applicable U.S. GAAP.

<sup>16</sup> FASB Accounting Standards Codification Subtopic 320-10, *Investments — Debt and Equity Securities: Overall*.



### Connecting the Dots

An entity that is considering early adoption of the ASU's provisions should ensure that it has appropriate financial reporting internal controls in place to ensure compliance with the ASU's accounting and disclosure requirements. The entity also should give appropriate advance consideration to determining which transition elections it wishes to make since, as discussed above, those elections must be made within a specified time period after adoption. Also, ASC 815's general requirement for an entity to assess effectiveness for similar hedges in a similar manner, including the identification of excluded components, will apply to hedging relationships entered into postadoption; therefore, it will be important for the entity to determine its desired future methods for assessing the effectiveness of its hedging relationships when it adopts the ASU. (As discussed above, the ASU's transition provisions provide some relief from this requirement with respect to certain preadoption and postadoption hedging relationships.)

### Comparison With U.S. GAAP Before Adoption of ASU 2017-12 and IFRSs

ASC 815's hedge accounting guidance is similar to the hedge accounting model in IAS 39. To align the guidance on hedge accounting with an entity's risk management activities, the IASB issued amendments to IFRS 9 in 2013 that introduced a new general hedge accounting model to IFRSs. By contrast, ASU 2017-12 retains many aspects of the preadoption hedge accounting framework and makes targeted improvements to the hedge accounting model. Accordingly, many aspects of the hedge accounting models under IFRS 9 and U.S. GAAP will differ significantly. See Deloitte's November 26, 2013, *Heads Up* for additional information about the IFRS 9 hedge accounting model. Also, refer to the [appendix](#) of this *Heads Up*.

## Appendix — Comparison of Hedge Accounting Models

The table below compares certain aspects of the hedge accounting model under ASU 2017-12 with U.S. GAAP before the ASU's adoption and IFRS 9.

Subject	U.S. GAAP Before Adoption of ASU 2017-12	ASU 2017-12	IFRS 9
<b>Amendments Applicable to All Hedges</b>			
"Highly effective" threshold to qualify for hedge accounting	The hedging instrument must be highly effective at achieving offsetting changes in fair value or cash flows.	No changes were made in ASU 2017-12.	A "highly effective" threshold concept does not exist; instead, IFRS 9 requires that (1) there is an economic relationship between the hedging instrument and the hedged item, (2) credit risk does not dominate the value changes that result from the economic relationship, and (3) the hedging relationship's hedging ratio reflects the actual quantity of the hedging instrument and the hedged item.
Quantitative assessment of hedge effectiveness	Entities must perform initial and ongoing quantitative prospective and retrospective assessments of effectiveness (unless the shortcut method is applied).	Generally requires an initial prospective quantitative hedge effectiveness assessment; however, if certain criteria are met, entities can elect to subsequently perform prospective and retrospective effectiveness assessments qualitatively, unless facts and circumstances change.	Does not specify a method for assessing effectiveness. Requires entities to make ongoing qualitative or quantitative assessments (at a minimum at each reporting date).
Hedge documentation and initial prospective quantitative hedge effectiveness assessment	Entities must complete all documentation at hedge inception.	Entities still must complete most hedge documentation at hedge inception; however, they generally need not complete the initial prospective quantitative hedge effectiveness assessment until the first quarterly hedge effectiveness assessment date (i.e., up to three months). Some circumstances may require earlier completion of the initial prospective quantitative effectiveness assessment. Private companies that are not financial institutions and certain not-for-profit entities need not perform and document the initial and subsequent quarterly effectiveness assessments until the date the next interim (if applicable) or annual financial statements are available to be issued (however, these entities must document certain aspects of the hedging relationship at hedge inception).	Requires all documentation to be completed at hedge inception.

(Table continued)

Subject	U.S. GAAP Before Adoption of ASU 2017-12	ASU 2017-12	IFRS 9
<b>Amendments Applicable to All Hedges</b>			
Income statement presentation	Income statement presentation of hedging results is not prescribed.	Requires presentation of the change in the hedging instrument's fair value in the same income statement line item(s) as the earnings effect of the hedged item (other than any fair value changes that are excluded from the hedge effectiveness assessment of net investment hedges, for which no specific income statement presentation is prescribed). Also, no presentation is prescribed for amounts released from AOCI when it is probable that a hedged forecasted transaction will not occur.	Does not prescribe income statement presentation of hedging results. Time value components that are not designated as part of the hedging instrument will generally be initially deferred in OCI and not recognized in current earnings.
Voluntary dedesignation of a hedging relationship	Entities may voluntarily discontinue hedge accounting at any time by removing the designation of the hedging relationship.	No changes were made by ASU 2017-12.	Entities may perform dedesignation only when the hedging relationship (or a part of a hedging relationship) ceases to meet the qualifying criteria.
Shortcut method	Permitted for hedging relationships involving an interest rate swap and an interest-bearing financial instrument that meet specific requirements.  Cannot be applied to partial-term fair value hedges of interest rate risk.	Existing model retained; however, application of the long-haul method is permitted if an entity determines that use of the shortcut method was not or is no longer appropriate as long as: <ul data-bbox="829 1241 1138 1629" style="list-style-type: none"><li>• The entity documented at hedge inception the quantitative method it would use to assess hedge effectiveness and measure hedge results if the shortcut method could not be applied.</li><li>• The hedge was highly effective for the periods in which the shortcut method criteria were not met.</li></ul> The qualifying criteria also enable partial-term fair value hedges to qualify for shortcut accounting.	Not permitted.

(Table continued)

Subject	U.S. GAAP Before Adoption of ASU 2017-12	ASU 2017-12	IFRS 9
<b>Amendments Applicable to All Hedges</b>			
Accounting for amounts excluded from the assessment of hedge effectiveness	Changes in the fair value of such amounts are recognized in current period earnings. The income statement presentation is not prescribed.	<p>An entity will amortize the initial value of an excluded component into earnings over the life of the hedging instrument by using a systematic and rational method.</p> <p>In subsequent periods, an entity would recognize in OCI (CTA for net investment hedges) any difference between the change in fair value of the excluded component and amounts recognized in earnings under that systematic and rational method.</p> <p>All excluded component amounts (other than those related to net investment hedges) are recognized in the same income statement line item as the earnings effect of the hedged item.</p> <p>Alternatively, an entity can elect to apply a mark-to-market through earnings approach in a manner consistent with preadoption guidance.</p>	<p>The change in fair value of the excluded component is initially recognized in OCI to the extent that it relates to the hedged item and is accumulated in a separate component of equity.</p> <p>The subsequent accounting will vary on the basis of whether (1) it has been determined that the hedged item is transaction related or time-period related and (2) the hedged item will result in the recognition of a nonfinancial asset or nonfinancial liability.</p> <p>IFRS 9 generally does not prescribe where such amounts should be recognized in the income statement (i.e., other than amounts that are recognized as basis adjustments to nonfinancial assets or liabilities).</p>
<b>Amendments Applicable to Cash Flow Hedges</b>			
Measurement and recognition of hedge ineffectiveness — cash flow hedges	Entities must perform periodic measurement and recognition of hedge ineffectiveness (other than that arising from cumulative cash flow underhedges).	Eliminates the requirement for entities to recognize hedge ineffectiveness each reporting period.	Requires entities to perform measurement and recognition of hedge ineffectiveness (other than that arising from cumulative cash flow underhedges) in each reporting period.
Ability to designate a component of a forecasted purchase or sale of a nonfinancial asset as a hedged item	Entities are prohibited from designating changes in cash flows of a component of a nonfinancial item as the hedged risk, with the exception of the risk of changes in the functional-currency-equivalent cash flows attributable to changes in the related foreign currency exchange rate.	Permits entities to designate the “risk of variability in cash flows attributable to changes in a contractually specified component” as the hedged risk in a cash flow hedge of a forecasted purchase or sale of a nonfinancial asset, if the hedge meets certain criteria.	Entities may designate nonfinancial components as hedged items under the principle that a component may be designated as a hedged item if it is separately identifiable and reliably measurable. There is no requirement that the component be contractually specified.
Hedges of interest rate risk for variable-rate financial instruments	The only hedgeable component is the change in cash flows attributable to changes in the benchmark interest rate.	Entities may designate the contractually specified interest rate as the hedged risk. The concept of benchmark interest rate hedging is eliminated.	Entities may designate components that are separately identifiable and reliably measurable.

(Table continued)

Subject	U.S. GAAP Before Adoption of ASU 2017-12	ASU 2017-12	IFRS 9
<b>Amendments Applicable to Cash Flow Hedges</b>			
Application of critical-terms-match method to a cash flow hedge of a group of forecasted transactions	Entities need to consider whether the amount of hedge ineffectiveness that arises from differences between the hedging derivative's maturity date and the dates of the forecasted transactions is more than de minimis; if so, entities cannot apply this method and may need to view this as an accounting error.	Entities may use the critical-terms-match method when cash flow hedging a group of forecasted transactions if (1) those forecasted transactions occur within the same 31-day period or the same fiscal month as the maturity of the hedging derivative and (2) all other method requirements are met.	No formal approach exists; however, entities may be able to qualitatively assess hedge effectiveness when the critical terms of the hedging instrument and those of the hedged item match.
<b>Amendments Applicable to Fair Value Hedges of Interest Rate Risk</b>			
Eligible benchmark interest rates	The SIFMA Municipal Swap Rate is not an eligible benchmark interest rate. The only permissible U.S. benchmark interest rates are rates for U.S. Treasuries, LIBOR swap rates, and the Fed Funds Effective Swap Rate (Overnight Index Swap Rate).	The SIFMA Municipal Swap Rate is an eligible benchmark interest rate in the United States in addition to those rates permitted under U.S. GAAP before the ASU's adoption.	Entities may designate components that are separately identifiable and reliably measurable.
Partial-term fair value hedges of interest rate risk	Although not explicitly prohibited, such hedges would rarely satisfy all the hedging criteria (e.g., being highly effective).	Entities may designate a partial-term hedge by assuming that (1) the term of the hedged item begins with the first hedged cash flow and ends when the last hedged cash flow is due and payable and (2) the maturity of the hedged item occurs on the date on which the last hedged cash flow is due and payable. This greatly increases the likelihood that the hedging relationship will meet the "highly effective" criterion.	Entities may perform partial-term hedging.
Measuring the change in fair value of a hedged prepayable instrument (e.g., callable debt)	In a hedge of benchmark interest rate risk on fixed-rate debt containing a call or put feature, entities must consider the effect of that embedded prepayment option on the change in value of the debt (unless the shortcut method is applied). This consideration includes all factors that might lead to debt prepayment (interest rates, credit spreads, and other factors), even if only interest rate risk is being hedged.	Allows entities to consider only how changes in the benchmark interest rate (as opposed to how all variables, such as interest rate, credit, and liquidity factors) would affect the exercise of the call or put option when assessing hedge effectiveness and measuring the change in fair value of the debt attributable to changes in the benchmark interest rate.	Does not provide specific guidance; however, for a layer component containing a prepayment option to be eligible for fair value hedging, entities must include the changes in the fair value of the prepayment option as a result of changes in the hedged risk when measuring the change in the hedged item's fair value.

(Table continued)

Subject	U.S. GAAP Before Adoption of ASU 2017-12	ASU 2017-12	IFRS 9
<b>Amendments Applicable to Fair Value Hedges of Interest Rate Risk</b>			
Measuring the change in fair value of the hedged item attributable to the change in the benchmark interest rate in a fair value hedge of interest rate risk	An entity must measure the change in the hedged item's fair value attributable to changes in the benchmark interest rate by considering all contractual coupon cash flows of the hedged item.	Permits an entity to use either the benchmark rate component of contractual coupon cash flows or the full contractual coupon cash flows when calculating the change in fair value of the hedged item.	Entities may designate the benchmark interest rate cash flows as the hedged item if they are separately identifiable and reliably measurable; however, a designated benchmark component of the cash flows must be less than or equal to the total cash flows of the entire item.
Fair value hedges of interest rate risk in a closed portfolio of prepayable financial instruments or a beneficial interest therein	Existence of prepayment risk in the individual assets and the likely inability of such portfolio hedges to qualify for partial-term hedge accounting can be operationally challenging and require frequent dedesignations and redesignations of the hedging relationship. Satisfying the similar assets test also can be challenging.	Interplay of partial-term fair value hedge and benchmark coupon measurement elections makes it easier for an entity to fair value hedge a portion of a closed portfolio of prepayable assets without having to consider prepayment risk or credit risk when assessing hedge effectiveness and measuring hedge results. An entity can also apply the method to one or more beneficial interest(s) (e.g., a mortgage-backed security) in a closed portfolio of prepayable financial instruments.	Does not include a model for fair value hedging interest rate risk for an open (or closed) portfolio of financial assets or financial liabilities. While the IASB is exploring the development of a model to address measurement inconsistencies that arise from this "macro hedging" or dynamic risk management strategy, it allows entities to apply the specific hedge accounting requirements in IAS 39.  Under IAS 39, in a fair value hedge of interest rate risk of a portfolio of prepayable items, an entity can designate the hedged item as an amount of currency instead of as individual financial instruments. Also, for such hedges, an entity can hedge changes in fair value attributable to changes in the hedged interest rate on the basis of expected rather than contractual repricing dates. However, ineffectiveness will arise if the estimated repricing dates change.

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