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Consumer Speaks: Episode 4
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Hedge accounting considerations for the consumer industry

Guests:
- Rich Paul, Host, Audit & Assurance Partner and Consumer industry leader
- Jon Howard, Audit & Assurance Partner, National Office financial instruments accounting and reporting services group
- Chris Monteilh, Audit & Assurance Partner

Rich Paul (Rich): Hello, it's Rich Paul, the leader of our consumer industry audit and assurance practice of Deloitte & Touche. Welcome to our Consumer Speaks podcast series, where you'll hear from industry leaders as they share their perspective and insights on emerging topics impacting financial reporting in the consumer industry. Today I have with me Jon Howard and Chris Monteilh, who will be discussing the Financial Accounting Standards Board (FASB) hedge accounting standard and considerations for companies in the consumer industry. Jon is an audit and assurance partner and the leader of the financial instruments group of the accounting and reporting services in Deloitte & Touche's national office. Chris is an audit and assurance partner who leads the accounting and reporting advisory project management team for hedge accounting within Deloitte and Touche LLP. Thank you both for joining us. Jon, as one of our first repeat participants in the Consumer Speaks podcast series, let's start with you. When was the new hedge accounting standard introduced by the FASB? Can you provide an overview of the standard?

Jon Howard (Jon): Sure, thanks Rich. The new hedge accounting standard was issued in August of 2017, and it was really a culmination of about 10 years of the FASB with an on-again, off-again project to simplify hedge accounting. There were a lot of complaints that the standard was too complex and just minor errors would cause you to not get hedge accounting. And so the point of the standard was really to revisit what entities were doing to do their proper risk management strategies and get the accounting to align with that. So it really is a simplification to try to make it easier to qualify for hedge accounting for a lot of the most common hedging practices and also simplify the ongoing financial reporting process.

Rich: Hey Chris, welcome to consumer speaks. Can you provide some examples of how the hedge accounting standard will be applied in the consumer industry?

Chris Monteilh (Chris): Let me share an example of cash flow hedges of nonfinancial contractual-specified components. So suppose company ABC enters into a contract to purchase oil from a supplier. The price is based on the West Texas intermediate benchmark plus an additional amount pending on what facility its supplier brings to it, i.e., the transportation-costs component. Before ASU 2017-12, company ABC would have had to designate the total price risk of the forecasts that transaction as the hedged item in the cash flow hedge when attempting to achieve hedge accounting. Inclusion of this transportation-costs component and the hedged item would reduce the overall effectiveness of the hedge relationship, often to the extent that hedge accounting would be prohibited. Under the new standard, company ABC can designate any component of the purchase price as the hedged risk, so long as it is contractually specified.

Rich: Hey Jon, could you help us think about spot transactions as part of the ASU on hedge accounting?

Jon: Sure. Just to kind of go off what Chris talked about there. So the new concept from ASU 2017-12 is that for purchases in sales of nonfinancial assets, you can hedge a contractually specified component. And it would seem like it shouldn't be difficult to figure out what a contractually specified component is, right? It seems like it's something that would be in a purchase or sale contract, but it's a little bit more complicated when you get into the area of what we call spot transactions, which is really just going and buying something at the current market price or selling something at the current market price where you may not have a long-term supply contract; you just might go and negotiate the price or just buy it right off an exchange. And so, you know, when does a contract need to be in place ahead of time, or is something as simple as just a receipt that says, hey, you know, in Chris's example, I bought something that wasn't at the West Texas intermediate, you know, WTI hub. I bought it at another location, but my price comprised the WTI price plus a spread. So is a receipt after the fact sufficient to say that you had a contraction-specified component of that purchase or sale, that forecasted transaction all along. The FASB did announce recently at a board meeting that they're going to try to clarify the codification to address what sort of things are included in contractually specified components and what sort of evidence would be enough to support that, including receipts. It's not current GAAP yet. We're going to have to wait and see where they go, but we should see an exposure draft sometime later this year.

Rich: So it's helpful that FASB took that on. Hey Chris, maybe some other examples that are coming up as you work with clients in the consumer industry.

Chris: So multinational consumer companies are exposed to foreign exchange risks that arise from the requirement to translate the net assets of their foreign subsidiaries into their reporting currency. To insulate themselves from this risk, companies may elect to enter into a cross-currency interest rate swap and designate that swap as the hedging instrument in a net investment hedge. In recent years, because of monetary policy decisions and increased banking regulation, it has brought about a resurgence in the cross-currency basis spread. This is when the interest rate differential between two currencies in the cash money markets diverge from the differential between the forward and spot exchange rates. The ineffectiveness and associated P&L volatility resulting from the presence of the spread under the old standard was often enough to deter companies from employing this risk management strategy. However, simplified accounting under ASU 2017-12 allows entities to ignore the theoretical forward points, which is the interest rate differential and the cross-currency basis spread through application of what's called the spot method. All changes in the fair value of the derivative, including those excluded components, are recognized in a cumulative translation adjustment component of other comprehensive income, which sits in equity with the initial difference between the forward spot exchange rates amortized into earnings over the life of the hedging relationship.

Rich: Thanks, Chris. Hey Jon, back over to you. I've heard this term, partial-term hedges and for lay folks, maybe you could help us understand what that means and how the accounting works for that, under the hedge ASU?

Jon: You know, in the fixed-rate debt space for issuers, it's really common, especially if they issue registered debt securities, that the debt will be termed debt, but it has usually got prepayment options in it. You know, for example, a company might issue ten-year debt but it's callable by them at any time after year five. In order to have that prepayment option, they'll pay a little bit more on the fixed rate debt. So a partial term hedge, generally speaking, entities you know, prefer to really just hedge the noncall period. So the first five years, in my example, whether it's the issuer of the debt or whether it's the investor in the debt, and they want to put an interest rate swap that effectively converts that to a variable rate for those five years. Prior to the issuance of ASU 2017-12, you couldn't actually do that because you had to hedge the fair value of the entire debt instrument, and the reasons why the debt would get called weren't just due to changes in the benchmark interest rate—right. And the swap has usually got a benchmark rate as its variable leg. So even if you tried to mirror up the swap with the debt and get a ten-year swap and put a termination option in that swap at the end of five years, it's still, there was a great source of ineffectiveness because credit spreads have a significant impact on whether an entity is going to prepay their debt. So if their credit spread narrows, then it's cheaper for them to go ahead and call that debt and issue new debt. But the swap in theory wouldn't necessarily go away because the swap would terminate just based on changes in LIBOR. So partial term hedging allows entities to hedge a part of the term of that debt—the five years. And for all intents and purposes, now that's considered noncallable five-year debt. And when you're marking that item or changes in its fair value due to the attributable hedged risk, you can actually consider that debt as theoretically five-year debt. And you can say the component of the coupons that I'm hedging are the benchmark component of the coupon. So all the different sources of ineffectiveness, when you're calculating fair value changes on this theoretical debt, it should line up a lot better with the swap. And so things that might not have even been "hedgeable" before because the source of ineffectiveness was so great, now actually become perfect. You can even apply a shortcut method accounting. So there's zero ineffectiveness, and it becomes a perfect hedge. And even if you don't line everything up, a lot of the ources of ineffectiveness go away enough that if you apply what we call the long-haul method, you know, not shortcut, you're still going to get a highly effective hedge and very little volatility in your income statement.

Rich: Yeah, I'm sure practitioners are happy about that. Any other ways in which the ASU has changed hedging interest payments?

Jon: Yes so on the variable rate side, we're now seeing a lot of questions. Companies are wanting to hedge what you used to have to hedge what was called a benchmark interest rate component or all of the changes in cash flows and the FASB, consistent with what Chris talked about before with contractually specified components of nonfinancial assets, you can hedge a contractually specified interest rate. So if I have a variable rate agreement and it varies based on prime, I can hedge just the prime rate component, even if my credit spread might change due to different covenants, I can say, look, I'm just hedging the prime component of that. Or, what we've seen a lot lately too is how this gets applied to what we call choose your rate debt, which is very common in the consumer space with bank debt. A lot of entities with their bank debt, they can choose in different periods between various variable rates. So they might have a choice between one-month LIBOR, three-month LIBOR, and six-month LIBOR. And you know, every payment period they can choose which rate they would like to use. They can stick with the same rate the whole time or they can pick another. There are questions about how to apply this new model and whether the contractually specified rate, which is worded as if it's one, how that applies when I have multiple that I can choose from. It's not that different from some of the questions we're getting today. But the FASB staff is trying to ease the reins on this a little bit more too and allow entities to change their forecasted transactions, change their designated risks, and minimize the penalties. As usually, if I say, hey, I'm always going to pick my transactions three-month LIBOR payments and it's always going to be a three-month LIBOR payment if that ends up not happening, we kind of have this tainting notion of, you know, you can't forecast transactions appropriately and you always have to assert that your transactions are probable in occurring. So they are going to try to ease the penalties associated with forecasted transactions changing and minimize the volatility on that as well.

Rich: Jon, Chris, I really appreciate both of your time and your insights discussing the FASB's new hedge accounting standard and considerations for companies in the consumer industry. With the introduction of ASU 2017-12, it's clear to me that hedge accounting is now simpler to apply and to account for, and so I expect consumer companies across the landscape to use the hedge accounting a lot more often. If you have any questions about today's topic, please feel free to reach out to me, rpaul@deloitte.com, Jon at jonahoward@deloitte.com, or Chris at cmonteilh@deloitte.com. Thanks, and talk to you next time.