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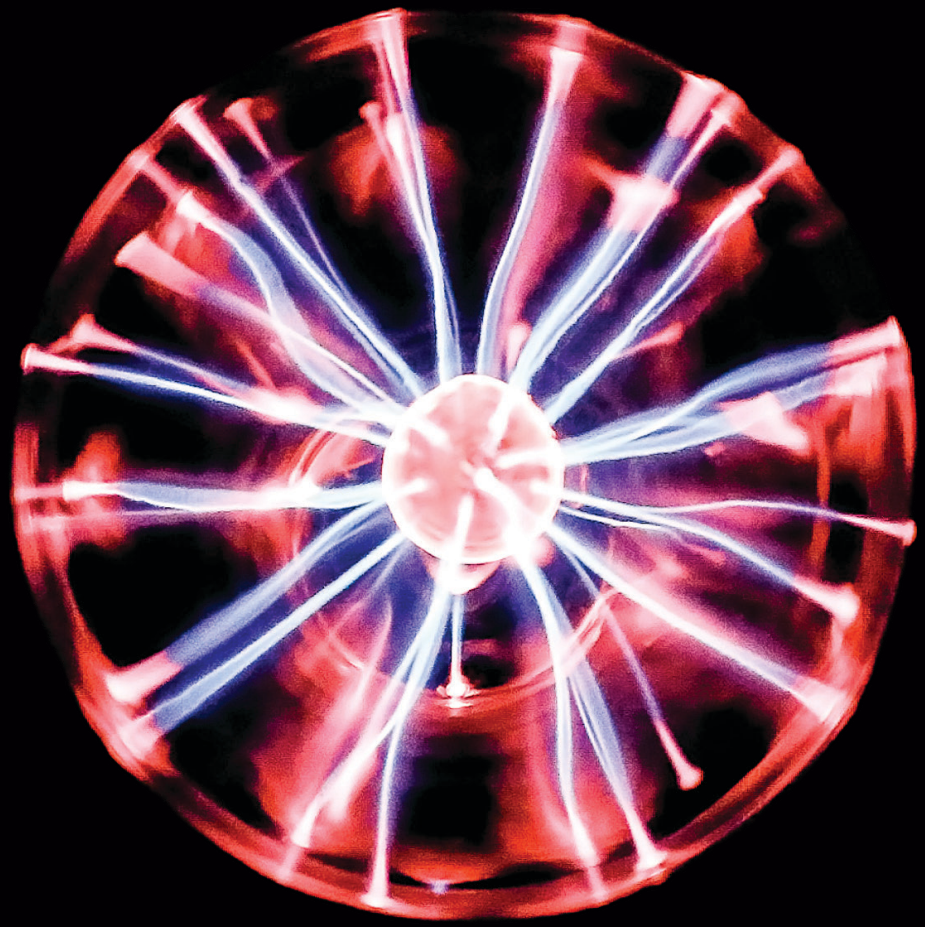
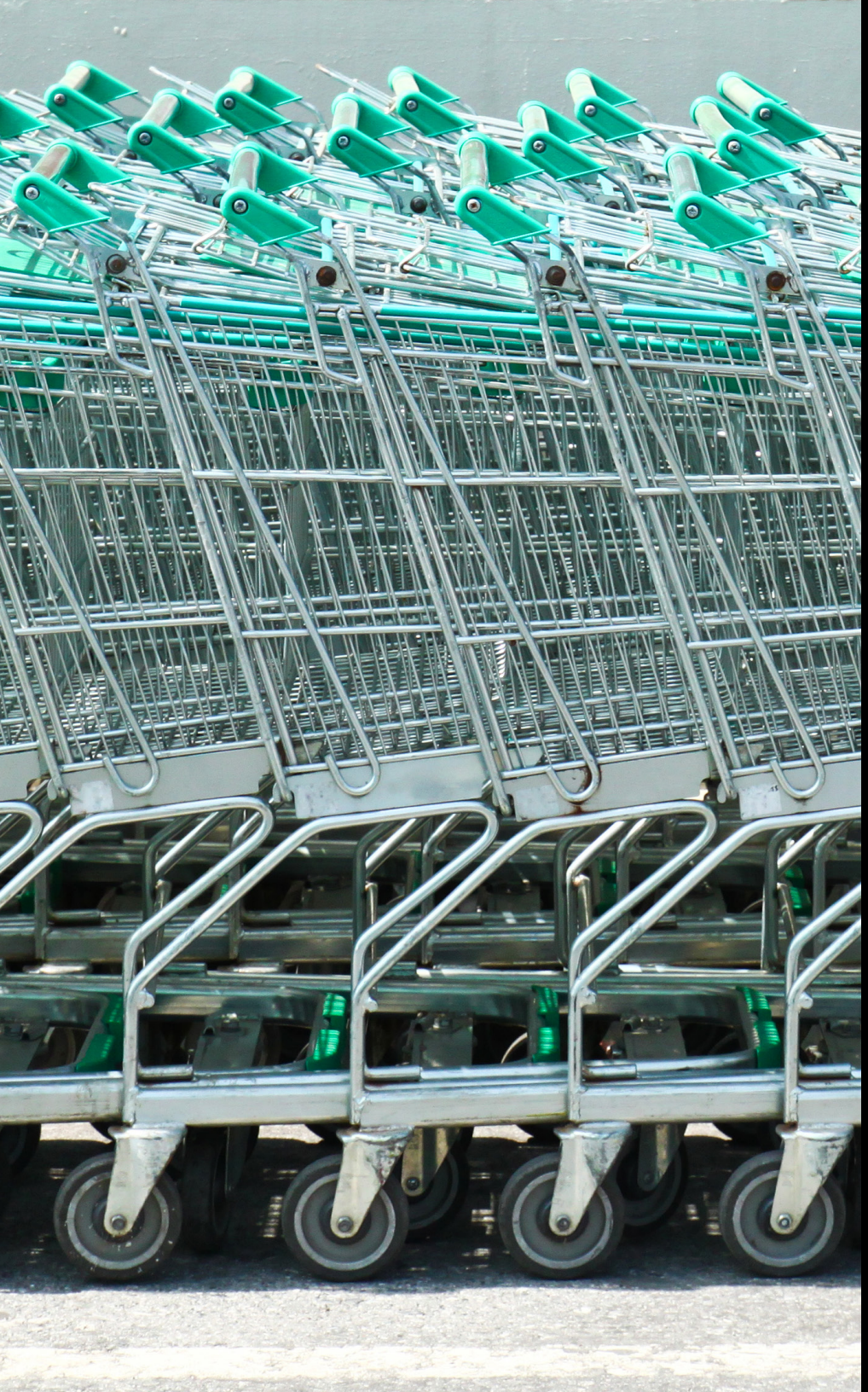


Simplified hedge accounting:
consumer industry considerations



To many companies in the consumer industry, hedge accounting has seemed like a gift they couldn't keep. On the one hand, it was designed to let companies match their input purchases with an offsetting position so they can minimize their bottom-line impact. On the other hand, hedge accounting has been notoriously complicated.

Now much of that is changed. On August 28, 2017, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2017-12, Derivatives and Hedging (Topic 815): "Targeted Improvements to Accounting for Hedging Activities." The new standard allows entities to revisit their current hedge accounting strategies and better align accounting with risk management strategies.

The result is that the guidance on hedge accounting is considerably less complex than it was before. And with ASU 2017-12 already going into effect for public entities, the vanguard is taking advantage. Gone are the days of having to forgo the benefits of hedge accounting and relying instead on non-GAAP (generally accepted accounting principles) information to convey the impact of a hedge.

Still on the fence? Consider the following examples of how the revised standard can play out across different consumer industry scenarios.

Example 1:

Cash flow hedges of nonfinancial contractually specified components

Suppose Company ABC enters into a contract to purchase oil from a supplier. The price is based on the West Texas Intermediate (WTI) benchmark, plus an additional amount depending on which facility the supplier brings it to—i.e., the transportation cost component.

Before ASU 2017-12, Company ABC would have had to designate the total price risk of this forecasted transaction as the hedged item in the cash flow hedge when attempting to achieve hedge accounting. Inclusion of this transportation cost component in the hedged item would reduce the overall effectiveness of the hedge relationship, often to the extent that hedge accounting would be prohibited.

But 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. As a result, Company ABC is eligible to designate the WTI benchmark component as the hedged item in the cash flow hedge, thereby resulting in a more effective hedging relationship.

Example 2: Spot transactions

As discussed in Example 1 above, ASU 2017-12 expands the permissible hedging strategies for nonfinancial assets by allowing any contractually specified component of a forecasted transaction to be designated as the hedged risk. However, much debate has ensued as to whether a contractually specified component may be evidenced by documentation that does not exist at the time of the transaction and in what form that documentation must be received.

During a recent board meeting, the FASB addressed these concerns by announcing its intention to clarify the codification to state explicitly that documentation completed after a transaction is consummated—i.e., a receipt—is sufficient evidence to support the existence of a contractually specified component for purposes of hedge accounting. This clarification serves to significantly expand the pool of permissible hedging relationships. (This doesn't yet fall under GAAP, and the FASB is expected to issue an exposure draft proposing to amend ASC 815.)

Example 3:

Net investment hedges of foreign currency risk

Multinational consumer companies are exposed to foreign exchange risk that arises from the requirement to translate the net assets of a foreign subsidiary 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, the confluence of dovish monetary policy and increased banking regulation 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 diverges from the differential between the forward and spot exchange rates. The ineffectiveness and associated profit-and-loss (P&L) volatility resulting from the presence of this spread under the old standard was often sufficient to deter companies from employing this risk management strategy. Simplified accounting under ASU 2017-12 allows entities to ignore the theoretical forward points (the interest rate differential) and the cross-currency basis spread through application of the spot method. All changes in the fair value of the derivative (including the excluded components) are recognized in the cumulative translation adjustment component of other comprehensive income, with the initial difference between the forward and spot exchange rates amortized into earnings over the life of the hedging relationship. This simplification has created renewed interest in the strategy. Now, not only can a properly applied hedging strategy produce a perfectly effective hedging relationship, but companies also have the opportunity to reduce overall interest expense when those hedged assets are domiciled in a region with favorable interest rates.

Example 4: Partial-term hedges

It is common for consumer companies to issue fixed-rate debt that they can pay off early after an initial period. Because this debt is callable—that is, it can be repaid before its contractual maturity date—investors generally receive a higher interest or coupon rate.

Under the old standard, companies opting to hedge these instruments had to do so all the way through to the maturity date. Those companies also had to mirror the prepayment option in the swap, but there was a significant source of ineffectiveness in the fact that the debt would be prepaid based on changes in overall rates (including credit spreads), however, the termination of the swap would not consider changes in credit spreads.

This source of ineffectiveness would oftentimes be large enough to preclude hedge accounting. ASU 2017-12 allows two things: An entity can partial-term hedge and can elect the benchmark component of the coupons as the hedged item. In doing so, the change in fair value of the debt attributable to changes in the designated risk is based on a theoretical debt instrument with an assumed maturity that matches the swap and assumed coupons that also match the swap. In addition, if the instrument is prepayable, an entity may consider only how changes in the benchmark interest rate would affect the prepayment option, which allows entities to ignore changes in credit risk. These changes are potential solutions for the ineffectiveness noted above.

A new day for consumer companies

The goal of hedge accounting is to dampen the effect that hedging relationships have on a company's P&L statement. With the introduction of ASU 2017-12, hedge accounting is now simpler for companies across the consumer landscape to plan and execute.

The revised standard enables companies to devise new hedging strategies, enhance or improve existing strategies, and remove some complexity from the financial reporting process. Even so, some consumer companies may continue to struggle with hedge accounting's legacy reputation as a process fraught with challenges and risk. With the four examples outlined here, we hope we have clarified the possibilities and encouraged reconsideration of a potentially beneficial accounting practice now made more accessible than ever.

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