US companies with investments in foreign operations are taking a fresh look at net investment hedging due to a confluence of two events. One is well-known: Risk-free interest rates in the United States are currently higher than in many other parts of the world. The other event took place on August 28, 2017. On that day, the Financial Accounting Standards Board (FASB) issued new guidance that makes hedge accounting considerably less complex than it was before.

The new standard is formally known as Accounting Standards Update (ASU) 2017-12, Derivatives and Hedging (Topic 815), “Targeted Improvements to Accounting for Hedging Activities,” and was effective for calendar year-end public companies on January 1, 2019. ASU 2017-12 aims to simplify this area of accounting, with net investment hedging becoming one of the risk management strategies to benefit. To understand why, let’s begin with a refresher on why companies use net investment hedges.

Reducing income statement volatility

The value of an investment in a foreign operation can fluctuate not only based on its operational success or failure, but also from changes in the exchange rate between the local currency and the investor’s reporting currency. It’s this latter risk, which is outside of the investor’s control, that a net investment hedge is designed to mitigate.

The idea is to reduce income statement volatility by offsetting a rise or fall in the value of the investment (due to fluctuations in exchange rates) with an instrument whose value moves in the opposite direction. A net investment hedging instrument can be a derivative, such as a foreign currency forward or a cross-currency interest rate swap. Alternatively, it can be a non-derivative instrument, such as foreign currency-denominated debt. Either way, the more efficient the instrument is at offsetting the changes in the value of the investment, the more effective a net investment hedge can be.

The timing mismatch

As is so often the case, however, timing is everything with derivatives and hedge accounting. For example, if the hedged exposure is a net investment in a foreign operation, absent the application of hedge accounting, the earnings effect of the hedged item may occur in later periods compared with the derivative that was purchased to offset that risk. The result is a mismatch between what’s happening economically and what the company is reporting in its financial statements. That could lead to short-term income statement volatility—the same volatility the hedging strategy was supposed to help the company avoid.

Net investment hedging under ASU 2017-12: What CFOs and CROs should know
ASU 2017-12 addresses this timing mismatch by clarifying that, depending on how the hedge is designated, some or all of the changes in the fair value of a net investment hedging derivative instrument may not be reported in the income statement immediately. Instead, they will be recognized in other comprehensive income—that is, the cumulative translation adjustment (CTA) account—and remain in accumulated other comprehensive income (AOCI)/shareholders’ equity until the hedged net investment is sold or substantially liquidated.

**Methods for assessing hedge effectiveness**

How can companies gauge the effectiveness of a net investment hedging relationship? There are two ways:

- The forward method (based on changes in forward exchange rates)
- The spot method (based on changes in spot exchange rates)

If the hedging instrument is a derivative, companies can use either method so long as they use the same method for all hedging relationships where a derivative is the hedging instrument. However, only the spot method can be used for net investment hedges where a non-derivative is the hedging instrument. ASU 2017-12 has made the spot method potentially more attractive to any company thinking about net investment hedging. We’ll get into the reasons for that next.

**The spot method**

When a company applies the spot method under ASC 815, it would exclude all changes in the fair value of the hedging instrument other than those attributable to changes in the spot rate from the assessment of hedge effectiveness. In other words, companies would exclude spot-forward differences, as well as the cross-currency basis spread, and recognize the initial value of the excluded component in earnings using either a systematic and rational amortization approach or a mark-to-market approach.

If a qualifying plain-vanilla cross-currency interest rate swap is used as the hedging instrument, then under the spot method a company recognizes the periodic interest settlements on that swap directly in earnings. The FASB has also indicated that this periodic recognition of the interest settlements would be considered a systematic and rational way of amortizing the initial value of the excluded component when the amortization approach is applied. ASU 2017-12 doesn’t prescribe the income statement classification of amounts excluded from the assessment of effectiveness in net investment hedges, but many companies that elect the amortization approach will recognize the periodic interest settlements as interest expense (or a reduction in interest expense).

Before the issuance of ASU 2017-12, however, many entities were reluctant to apply the spot method. Why? The previous requirement to recognize changes in the fair value of the excluded component currently in earnings created the potential for unpredictable income statement volatility. Moreover, companies would have been required to recognize periodic hedge ineffectiveness in earnings, creating the potential for additional income statement volatility.

The new ASU mitigates many of those concerns. First, under the amortization approach, any excess of the change in the fair value of the excluded component over the systematic and rational (and, therefore, predictable) amortization amount is recorded in CTA instead of current earnings. In addition, no periodic ineffectiveness is recognized for an effective hedging relationship.
Cross-currency interest rate swaps

The aforementioned changes to the hedge accounting guidance have boosted the appeal of using the spot method to assess hedge effectiveness for net investment hedges in which the hedging instrument is a qualifying cross-currency interest rate swap. This is particularly so for companies with foreign operations in jurisdictions with lower risk-free interest rates than in the United States. For them, applying the spot method may result in lower reported interest expense and, therefore, a lower effective interest rate (refer to case study).

At the same time, a company that amortizes the initial value of the excluded component can avoid the unpredictable income statement volatility that could otherwise result from recognizing changes in the fair value of the excluded component in current earnings. At the end of the hedging relationship, any accumulated net gain or loss deferred in CTA related to the cross-currency swap remains in CTA until the related net investment is sold or substantially liquidated. This accounting result may better align with the company’s risk management objective for the net investment hedge.

Before applying this kind of strategy, though, remember that the same method of assessing hedge effectiveness must be used for all net investment hedges in which the hedging instrument is a derivative. So, companies with multiple net investment hedges may not see a favorable rate differential in all jurisdictions.

Also bear in mind that although a company that currently uses the forward method to assess effectiveness of a net investment hedge will be able to switch to the spot method (by de-designating the existing hedging relationship and re-designating a new hedge), it likely would not be able to subsequently change back to the forward method if the interest rate or foreign exchange environment changes. This is because it would be difficult to demonstrate at that time that the forward method has returned to being an improved method of assessing effectiveness.

Finally, companies should be aware that additional accounting challenges may arise if they designate instruments with off-market terms as the hedging instrument in a net investment hedge, which might occur, for example, if a company that has designated a cross-currency interest rate swap as the hedging instrument in an existing net investment hedge (1) changes its effectiveness assessment method from the forward method to the spot method and (2) uses the same hedging swap in the re-designated hedging relationship.

Methods for recognizing the excluded component under the spot method

**Amortization** is a systematic and rational method that recognizes the initial value of the excluded component in earnings over the life of the hedging instrument. Any differences between changes in the fair value of the excluded component and the periodic amortization amount are recorded in CTA.

**Mark-to-market** is an approach in which changes in the fair value of the excluded component are recognized currently in earnings, consistent with the requirements before the issuance of ASU 2017-12. If elected, this method must be applied consistently to similar hedges.
Case study: A cross-currency swap using the spot method

Caveats aside, the new hedge accounting standard has encouraged more companies with operations and subsidiaries overseas to explore net investment hedging strategies. Let’s look at a hypothetical example of how this can play out.

XYZ Co. is a US-headquartered company with a €50 million investment in a German subsidiary. Realizing a decline in the value of the euro could negatively affect the value of its investment, XYZ hedges the risk by entering into a cross-currency interest rate swap with Counterparty Inc.

At inception, XYZ pays Counterparty $56.175 million and receives €50 million in return, reflecting a spot exchange rate of 1.1235 US dollars for 1 euro. As part of the transaction, XYZ agrees to pay Counterparty an interest rate of 1.75 percent for the borrowed euros, while Counterparty agrees to pay XYZ an interest rate of 3.5 percent for the loaned US dollars.

If XYZ elects to use the spot method of assessing hedge effectiveness (provided all applicable criteria are met), under the new ASU guidance it can do the following:

- Exclude from its effectiveness assessment all changes in the fair value of the cross-currency interest rate swap (other than those due to changes in spot foreign currency exchange rates)
- Recognize periodic “interest” settlements in earnings (typically as part of net interest expense)
- Recognize the initial value of the excluded component (i.e., spot-forward differences and the cross-currency basis spread) through a “systematic and rational” amortization approach. Periodic recognition in earnings of the interest settlements is considered a systematic and rational amortization of the initial value of the excluded component.

Now let’s suppose the first periodic interest settlement occurs one year after initiation. Let’s also assume the spot USD/EUR exchange rate has not changed. In that case, XYZ and Counterparty would exchange the following periodic interest settlements at the end of year one:

- XYZ pays to Counterparty: $983,062 (EUR 50,000,000 *1.75 percent*1.1235)
- XYZ receives from Counterparty: $1,966,125 ($56,175,000 *3.5 percent)
XYZ Co. would therefore record a net reduction to interest expense of $983,063 ($1,966,125–$983,062) at the end of year one. All other changes to the fair value of the cross-currency swap are recognized outside of earnings, as a separate component of other comprehensive income (CTA).

This is different from the old accounting rules, which would have required XYZ to also recognize in its income statement any change in the fair value of the excluded component of its cross-currency interest rate swap. Under the new rules, if a company applies the amortization method only the net interest settlements resulting from the cross-currency swap will affect the income statement. Other changes in the fair value of the cross-currency interest rate swap are recorded in other comprehensive income (CTA) and would not be recognized in earnings until the related net investment is sold or substantially liquidated. Similarly, translation adjustments related to the hedged net investment are recorded in other comprehensive income (CTA) and are not recognized in earnings until the hedged net investment is sold or substantially liquidated. Therefore, the new hedge accounting rules mitigate the income statement timing mismatch that existed when applying the old hedge accounting rules.
Summing it up

With the release of ASU 2017-12, the guidance on hedge accounting is considerably less complex than it was before. This has many companies with overseas operations and subsidiaries revisiting net investment hedging as an effective strategy for managing risk.

For CFOs and CROs, the benefits of hedging an investment in a foreign operation with a qualifying cross-currency interest rate swap and applying hedge accounting using the spot method may be twofold. A properly applied hedging strategy can produce an economically effective hedging relationship, thereby mitigating the effects of fluctuations in foreign currency exchange rates on an investment in a foreign operation. Additionally, under the amended guidance, companies have an opportunity to report reduced overall interest expense when those hedged operations are domiciled in a region with lower risk-free interest rates and avoid potential income statement volatility associated with the recognition of certain changes in fair value of the hedging instrument. Given these new opportunities, multinational companies are encouraged to take another look at net investment hedges as an effective tool for risk management.

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