



On the Radar Hedge Accounting

Some entities mitigate certain risks by entering into separate contracts that meet the definition of a derivative instrument. For such circumstances, ASC 815 allows entities to use a specialized hedge accounting for qualified hedging relationships. If hedge accounting is not applied, changes in the fair values of derivative instruments are recognized in earnings in each reporting period, which may or may not match the period in which the risks that are being hedged affect earnings. Therefore, the objective of hedge accounting is to match the timing of income statement recognition of the effects of the hedging instrument with the timing of recognition of the hedged risk. For further discussion of derivatives not designated in qualifying hedging relationships, see Deloitte’s Roadmap [Derivatives](#).

Financial Reporting Considerations

What Are the Different Hedge Accounting Models?

ASC 815 provides three categories of hedge accounting, each with its own accounting and reporting requirements:

Fair Value Hedges	Hedges of the exposure to changes in the fair value of a recognized asset or liability or an unrecognized firm commitment.
Cash Flow Hedges	Hedges of the exposure to variable cash flows of an existing asset or liability or a forecasted transaction.
Net Investment Hedges	Hedges of the foreign currency exposure of a net investment in a foreign operation.

Fair Value Hedges

For a fair value hedge to qualify for hedge accounting, the exposure to changes in the hedged item's fair value attributable to the hedged risk must have the potential to affect reported earnings. Examples of eligible exposures (i.e., hedged items) may include fixed-interest-rate assets or liabilities, inventory on hand, foreign-currency-denominated assets or liabilities, a portion of a closed portfolio of prepayable financial assets (or one or more beneficial interests secured by a portfolio of prepayable financial instruments), or a fixed-price firm commitment.

Generally speaking, an entity with a fair value hedge that meets all of the hedging criteria in ASC 815 would record the change in the derivative's (i.e., hedging instrument's) fair value in current-period earnings. It would also adjust the hedged item's carrying amount by the amount of the change in the hedged item's fair value that is attributable to the risk being hedged. The adjustment to the hedged item's carrying amount would also be recorded in current-period earnings. For fair value hedges, both the change in the hedging instrument's fair value and the change in the hedged item's carrying amount are presented in the same income statement line item and should be related to the risk being hedged. As a result of applying hedge accounting in a qualifying fair value hedging relationship, an entity accelerates the income statement recognition of the impact of changes on the hedged item that are attributable to the hedged risk. Accordingly, the entity recognizes the changes in the same period as the changes in the derivative's fair value.

Cash Flow Hedges

To be eligible for designation as a hedged item in a cash flow hedge, the exposure to changes in the cash flows attributable to the hedged risk must have the potential to affect reported earnings. Examples of eligible hedged items may include variable-interest-rate assets or liabilities, foreign-currency-denominated assets or liabilities, forecasted purchases and sales, and forecasted issuances of debt. The objective of a cash flow hedge is to use a derivative to reduce or eliminate the variability of the cash flows related to a hedged item or transaction.

Generally speaking, an entity with a cash flow hedge that meets all of the hedging criteria of ASC 815 would record the change in the hedging instrument's fair value in other comprehensive income (OCI). Amounts would be reclassified out of accumulated other comprehensive income (AOCI) into earnings as the hedged item affects earnings. Those amounts would also be presented in the same income statement line item in which the earnings effect of the hedged item is presented. As a result of applying hedge accounting in a qualifying cash flow hedging relationship, an entity defers the income statement recognition of changes in the derivative's fair value. Accordingly, the entity recognizes the changes in the same period in which the hedged item affects earnings.

If it becomes probable that a hedged forecasted transaction either will not occur or will not occur without significant delay, an entity must immediately reclassify amounts from AOCI into earnings.

Net Investment Hedges

A net investment hedge is a hedge of the foreign currency exposure of a net investment in a foreign operation. Even though the translation of a net investment in a foreign operation is recognized as part of the currency translation adjustment in OCI, there is a potential earnings risk upon disposition of that investment in the foreign operation. Accordingly, the foreign currency exposure in a net investment in a foreign operation is a hedgeable risk. Generally speaking, an entity with a net investment hedge that meets all of the hedging criteria of ASC 815 would record the change in the hedging instrument's fair value in the cumulative translation adjustment portion of OCI.

Does the Entity Want to Apply Hedge Accounting?

Not all derivatives will be designated as hedging instruments in qualifying hedging relationships under ASC 815. For example, an entity that owns shares of a publicly traded stock can economically hedge price changes in that stock by entering into financially settled options or forwards related to that stock. If both the hedging

instrument (i.e., the derivative) and the hedged item (i.e., the stock) are recognized on the balance sheet at fair value, with changes in fair value recognized in earnings in each reporting period, no specialized accounting is needed to match the recognition of gains and losses on the derivative with the recognition of those on the stock investment.

In addition, some derivatives may be entered into as economic hedges of risk but may not qualify for hedge accounting because they are related to an exposure that is not a qualifying hedge accounting exposure. Further, hedge accounting is optional, so some entities choose not to apply it to qualifying hedging relationships because they perceive that the costs of such accounting exceed its benefits.

Note that derivatives that are used as economic hedges but are not designated in qualifying hedging relationships require special consideration for financial reporting purposes. Finally, some derivatives are entered into for speculative purposes and are not part of a risk mitigation strategy.

Does the Hedging Relationship Qualify for Hedge Accounting?

ASC 815 outlines the types of items that qualify as the hedging instrument (generally, derivatives that are not written options) and the hedged item. In addition, the guidance permits an entity to hedge the risk of changes in the entire fair value of the hedged item or in all the item's cash flows, but an entity may hedge certain other risk components of the hedged item as well. The nature of the risks that may be hedged depends on whether the hedged item is a financial asset or liability or a nonfinancial asset or liability. An entity is permitted to hedge any of the risks individually or in combination with other risks. The most common component risks that entities hedge are interest rate risk, foreign currency risk, and the risk of changes in contractually specified components of the forecasted purchase or sale of nonfinancial assets.

Before a hedging relationship can qualify for the application of hedge accounting, an entity must demonstrate that the hedging instrument is "highly effective" at offsetting the changes in the fair value or cash flows of the hedged item. ASC 815 does not explicitly define a quantitative threshold that would be considered highly effective; however, in practice, a hedge is considered highly effective if the change in the hedging instrument's fair value provides offset of at least 80 percent and not more than 125 percent of the change in the fair value or cash flows of the hedged item that are attributable to the risk being hedged.

Finally, when issuing its initial accounting and reporting requirements for derivatives in FASB Statement 133 in June 1998, the FASB noted that "concurrent designation and documentation of a hedge is critical; without it, an entity could retroactively identify a hedged item, a hedged transaction, or a method of measuring effectiveness to achieve a desired accounting result." The way in which entities comply with those requirements is commonly referred to as the hedge designation documentation. Most aspects of the hedge designation documentation must be completed at the inception of the hedging relationship, including identification of the method of assessing whether the hedging relationship is highly effective.



Changing Lanes

[ASU 2017-12](#) added the "last-of-layer" method to ASC 815, which enables an entity to apply fair value hedging to closed portfolios of prepayable financial assets without having to consider prepayment risk or credit risk when measuring those assets. In March 2022, the FASB issued [ASU 2022-01](#), which expands the current single-layer model to allow multiple-layer hedges of a single closed portfolio of financial assets under this method. The last-of-layer method is renamed the "portfolio layer method" to reflect this change.

On the Horizon

On September 25, 2024, the FASB issued a [proposed ASU](#) that would make targeted improvements to hedge accounting. Comments were due on November 25, 2024. As of the date of this publication, the proposed ASU has not been finalized.

Deloitte's Roadmap *Hedge Accounting* provides an overview of the FASB's authoritative guidance on hedge accounting as well as our insights into and interpretations of how to apply that guidance in practice. For guidance on the identification, classification, measurement, and presentation and disclosure of derivative instruments, including embedded derivatives, see Deloitte's Roadmap *Derivatives*.

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