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FASB Proposes Improvements to Hedge Accounting Guidance

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On November 12, 2019, the FASB issued a [proposed ASU](#)¹ that would clarify certain amendments made by ASU 2017-12² to the guidance in ASC 815³ on hedging activities. The FASB issued the proposal in response to feedback and questions received from stakeholders related to their implementation of ASU 2017-12. Comments on the proposed ASU are due by January 13, 2020.

Overview of Proposed Changes

Background

On August 28, 2017, the FASB issued ASU 2017-12 to achieve two primary objectives: (1) to improve the hedge accounting model to better align financial reporting with the results of an entity's risk management strategy and (2) to simplify the guidance on hedge accounting. Since issuing the ASU, the Board has identified certain aspects of the amendments that need further improvement or clarification.

Main Provisions of the Proposed Changes

Changes in Hedged Risk in a Cash Flow Hedge

The proposed ASU addresses cash flow hedges of forecasted transactions in which a change in the hedged risk occurs. Under the proposed guidance, an entity may continue to apply hedge accounting if there is a change in the hedged risk as long as the hedge is still highly effective when the updated risk is used to measure effectiveness. A change in the hedged risk

¹ FASB Proposed Accounting Standards Update (ASU), *Codification Improvements to Hedge Accounting*.

² FASB Accounting Standards Update No. 2017-12, *Targeted Improvements to Accounting for Hedging Activities*.

³ FASB Accounting Standards Codification (ASC) Topic 815, *Derivatives and Hedging*.

also would not require a dedesignation and redesignation of the existing hedging relationship. However, such a change would need to be documented as an addendum to the hedge designation documentation.

Questions have arisen about when a change in the hedged risk would result in a missed forecast and therefore require amounts in accumulated other comprehensive income (AOCI) to be reclassified into earnings. The proposal clarifies that the forecasted transaction (i.e., the hedged item) and the hedged risk are distinct and that an entity must consider the forecasted transaction (not the hedged risk) in determining whether to apply the guidance for a missed forecast.



Connecting the Dots

An entity should apply the guidance in ASC 815-30-40-5 and 40-6 if it is probable that a forecasted transaction will no longer occur within two months of the originally specified timeframe. An entity does *not* need to apply that guidance if there is only a change in hedged risk related to a forecasted transaction.

In addition, the proposal clarifies the documentation requirements related to designating the hedged risk and identifying forecasted transactions as they occur. Specifically, the proposed ASU indicates that the designated hedged risk should be an entity's best estimate of the risk it is looking to hedge (i.e., the risk that will cause variability in the forecasted transaction's cash flows). The entity should also document the forecasted transaction with enough detail at the time of the hedge designation that it is obvious whether a transaction qualifies as the hedged item when it occurs.

The proposed ASU would allow an entity to use hindsight to identify a transaction with an undocumented hedged risk as the hedged item after the transaction has occurred. The entity would be required to disclose the method it uses to identify such transactions in the formal hedge designation documentation at hedge inception. In addition, the entity would have two months to use hindsight after the designated hedge period to identify a hedged transaction. It would use this method if its best estimate is that it will no longer fulfill the designated quantity of a forecasted transaction on the basis of the most recently documented hedged risk.



Connecting the Dots

Paragraph BC33 of the proposed ASU provides the following example:

For example, if halfway through the hedge period an entity identifies that its hedged risk has changed but not all forecasted transactions have occurred, then it would revise its hedged risk best estimate for forecasted transactions yet to occur (applying the guidance in paragraphs 815-30-35-37A through 37B). In that instance, if probable forecasted transactions with the revised hedged risk are insufficient to fulfill the designated amount of forecasted transactions documented at hedge inception, then the entity would identify hedged transactions that already occurred using hindsight in accordance with its designated method (in accordance with paragraph 815-30-35-37C) at that point in time.

The proposed guidance also clarifies that entities should always use their current best estimate of the hedged risk when assessing hedge effectiveness. If the estimate changes as of a particular measurement date, they should use the best estimate as of that date to perform their current effectiveness assessment. However, they would not need to use the updated best estimate to revise previous effectiveness assessments.

ASC 815 allows an entity to hedge multiple forecasted transactions as a group provided that the transactions share the same risk exposure. The proposed ASU clarifies that an entity uses its best estimate as of the particular measurement date to prospectively assess whether each forecasted transaction shares the same exposure. However, an entity's best estimate of the hedged risk for a group of forecasted transactions should be based on its best estimate of

each individual item in that group. Unless the entity expects every item in the group to be exposed to the same hedged risk, it would be inappropriate to assume that the entire group has the same hedged risk.

The proposed ASU specifically excludes hedges of foreign exchange risk and credit risk from the guidance on changes in hedged risk.

Contractually Specified Components in Cash Flow Hedges of Nonfinancial Forecasted Transactions

ASU 2017-12 allows entities to designate a component of a nonfinancial asset as a hedged item as long as that component meets the definition of a “contractually specified component.” Under ASU 2017-12, a contractually specified component is defined 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.” In the proposed ASU, the FASB addressed the documentation required as evidence of a contractually specified component and clarified that any type of documentation that supports the price of the nonfinancial asset (such as an agreement or receipt) would be sufficient. Further, such documentation may be obtained before or after the forecasted transaction occurs as long as the entity expects, on the basis of prior experience at the time of hedge designation, that the contract will explicitly refer to the contractually specified component.



Connecting the Dots

Under the proposed ASU, an entity would be able to hedge a contractually specified component in a forecasted purchase or sale of a nonfinancial asset by using, as the required evidence, the confirmation or spot purchase receipt obtained at the time the transaction occurs provided that the confirmation or spot purchase receipt explicitly refers to the contractually specified component. The FASB recognizes that because of industry-specific marketplace norms, the contractually specified component would not always be explicitly referenced.

The proposed ASU also clarifies that to determine the eligibility of a contractually specified component in a forecasted transaction, an entity would need to apply only the portion of the normal-purchases-and-normal-sales (NPNS) scope exception that requires the underlyings to be clearly and closely related to the asset being sold or purchased. In other words, once the contract exists, the entity would neither need to apply the NPNS scope exception to the contract nor expect to apply it to a not-yet-existing contract.

The price of a nonfinancial asset must be determined on the basis of a contractually specified component. Questions have arisen regarding how that guidance applies when the asset is bought or sold in the spot market as opposed to a preexisting supply contract. In the case of a spot-market transaction, the pricing formula that includes the contractually specified component must be the formula for determining the price in that nonfinancial asset’s spot market.

The proposed ASU would allow an entity to designate a forecasted purchase or sale that is accounted for as a derivative as the hedged item in a cash flow hedge if physical settlement is probable and the asset will not be subsequently remeasured at fair value, with changes in fair value reported in earnings.

Foreign-Currency-Denominated Debt Instrument as Hedging Instrument and Hedged Item

In what is known as a “dual hedge,” entities may use a single foreign-currency-denominated debt instrument as both (1) a hedging instrument in a hedge of a net investment in a foreign entity and (2) a hedged item in a fair value hedge of interest rate risk.

ASC 815 requires entities to record the gain or loss on remeasurement of a foreign-currency denominated debt instrument that is designated in a highly effective net investment hedging relationship as a cumulative-translation adjustment (as part of AOCI) until the net investment is substantially liquidated. In a dual hedge, because the basis of the foreign-currency denominated debt instrument is also adjusted for changes in its fair value that are attributable to changes in the designated interest rate before its remeasurement for changes in foreign currency exchange rates, the gain or loss on the remeasurement of the fair value hedge basis adjustment is also deferred in AOCI as a result of the net investment hedge. Consequently, there is a lack of perfect offset between the changes in fair value of the derivative hedging instrument for the fair value hedge that is recognized in earnings and the changes in fair value of the foreign-currency denominated debt, a portion of which is recognized in OCI under the net investment hedging relationship.

The proposed guidance would remove this mismatch by requiring the fair value hedge basis adjustment to be excluded from the assessment of the effectiveness of the net investment hedge when the hedging instrument is debt that is part of a dual hedge. As a result, the remeasurement for changes in spot rates on the fair value hedge basis adjustment would be recognized in earnings and offset against remeasurement of the derivative that is designated as the hedging instrument.

Replacement of Term “Prepayable” With “Early Settlement Feature” in Shortcut Method Application

As a result of ASU 2017-12, the term “prepayable” is used in two separate contexts in ASC 815 and has different meanings. Accordingly, the proposed ASU would change the word “prepayable” to “early settlement” and the term “prepaid” to “settled early” in the context of applying the shortcut method.



Connecting the Dots

An entity may apply the shortcut method for assuming perfect hedge effectiveness if certain conditions in both the hedging instrument and hedged item are met. One such condition is that the hedged item must not have a provision that is considered an “early settlement feature” (or, before the proposed ASU’s amendments, the hedged item cannot be “prepayable”) unless the hedging instrument has an embedded feature that perfectly mirrors that provision.

Proposed Effective Dates and Transition

Effective Dates

The proposed ASU’s amendments would be effective for all entities for fiscal years after December 15, 2020. For public business entities, the amendments would be effective for interim periods within fiscal years beginning after December 15, 2020, and for all other entities, they would be effective for interim periods within fiscal years beginning after December 15, 2021.

Transition

Entities would apply the same transition method used for ASU 2017-12 if they are adopting both ASUs on the same date. For entities that have already adopted ASU 2017-12, the proposed amendments would permit them to apply the amendments either (1) prospectively from the date of adoption or (2) retrospectively to the date of adoption of ASU 2017-12, with certain exceptions. Further, all entities would be required to update their hedge documentation as of the date of adoption for all existing hedges within the scope of the change in hedged risk guidance to include their method for identifying a hedged transaction by using hindsight.

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