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# FASB Proposes Improvements to Hedge Accounting Guidance

## Overview

On September 25, 2024, the FASB issued a proposed ASU[1] that would amend certain facets of the hedge accounting guidance in ASC 815.[2] The proposed ASU is intended to address issues raised by stakeholders during the implementation of ASU 2017-12[3] and more recent concerns that have surfaced as a result of the global reference rate reform initiative. Comments on the proposal are due by November 25, 2024.

## Background

In 2019, the Board issued a proposed ASU, *Codification Improvements to Hedge Accounting*, with the intention of clarifying various aspects of the guidance that was amended by ASU 2017-12. However, stakeholders provided feedback that the proposed amendments would not sufficiently resolve certain issues and that the guidance needed further clarification. In addition, respondents to the FASB's 2021 invitation to comment, *Agenda Consultation*, expressed concerns that the current guidance in U.S. GAAP was negatively affecting the decision-usefulness of financial information provided to investors.

On the basis of this and other stakeholder input, the Board decided to address five discrete issues in the new proposal. The purpose of the amendments is to better enable "entities to achieve and maintain hedge accounting for a greater number of highly effective economic hedges" while reducing the occurrence of missed forecasted transactions and unintuitive hedge dedesignation events.

[1] FASB Proposed Accounting Standards Update (ASU), *Hedge Accounting Improvements*.
[2] FASB Accounting Standards Codification (ASC) Topic 815, *Derivatives and Hedging*.
[3] FASB Accounting Standards Update No. 2017-12, *Targeted Improvements to Accounting for Hedging Activities*.

## Main Provisions of the Proposed Amendments

### Similar Risk Assessment for Cash Flow Hedges

The proposed ASU would amend the existing requirement that cash flow hedges of groups of individual forecasted transactions that use a single derivative as the hedging instrument share the same risk exposure. Instead, the proposal would require such groups to have a *similar* risk exposure. Further, the proposed ASU would clarify that the quantitative threshold for *similar* is consistent with the *highly effective*[4] threshold used in the assessment of hedge effectiveness. The amended guidance is intended to expand the population of hedged risks eligible for aggregation in a single group or pool, thereby reducing cost, complexity, and the risk of unintuitive missed forecasts in the application of these hedging strategies.

In addition, the proposed ASU would restore the guidance that, before the issuance of ASU 2017-12, required entities to perform shared risk assessments at hedge inception and on an ongoing basis. The proposal also clarifies that in some cases, entities may conduct such assessments on a qualitative basis (on a hedge-by-hedge basis) in a manner similar to the approach described in the guidance in ASC 815-20-35-2A through 35-2F on qualitative effectiveness assessments.

Under the proposal, entities are also explicitly permitted to conclude that the risk exposures in a group of forecasted transactions are similar if the hedging instrument is highly effective against each risk in the group.

#### Connecting the Dots

In paragraph BC22 of the proposed ASU, the Board acknowledges that in current practice, some entities use a dual-purpose assessment, commonly known as the test-to-worst approach, in which they perform the same assessment to determine hedge effectiveness and shared risk exposure. Under this approach, entities have concluded that if a hedging instrument is highly effective against the least effective risk in the group, it must also be highly effective against all other risks in the group. The proposed amendments expressly permit entities to use this quantitative approach, which is expected to reduce the cost and complexity of hedge accounting for entities that seek to hedge a group of forecasted transactions that have a similar, but not necessarily the same, risk exposure and for which the hedging instrument may therefore have varying degrees of effectiveness against those risks. Entities using a test-to-worst approach should exercise caution and thoughtfully determine which risk or risks in the group are the least effective in any given period to ensure that the eligibility criteria for hedges of groups of forecasted transactions have been met.

### Hedging Forecasted Interest Payments on Choose-Your-Rate Debt Instruments

ASC 815 does not specifically address how an entity should consider the uncertainty (i.e., "optionality") associated with designating and continually assessing a cash flow hedge of interest payments on an existing choose-your-rate (CYR) debt instrument[5] (sometimes referred to as "you-pick-'em" debt). The proposed ASU seeks to eliminate diversity in practice by establishing prescriptive guidance on the designation and assessment of hedge effectiveness for cash flow hedges involving this ubiquitous debt instrument. The Board envisions that the proposed amendments will reduce the potential for "unintuitive accounting

[4] ASC 815 does not define *highly effective*, but in practice this term has been interpreted to be an 80 percent to 125 percent offset between the change in the fair value of the hedging instrument and the change in the cash flows of the forecasted transaction attributable to the hedged risk.

[5] As amended, ASC 815-20-25-3(d)(1)(viii) would define a CYR debt instrument as a "variable-rate debt instrument that permits the borrower to select at each reset period the interest rate index from a list of contractual options (including the tenor of the interest rate, if applicable) upon which interest is accrued."

outcomes" that often occur when entities make economically prudent decisions to exercise their purchased optionality and then change the rate on which interest is accrued on the CYR debt instrument. Key provisions of the proposed guidance — including requirements related to scope, hedge designation, and assessments of hedge effectiveness — are summarized as follows:

- *Scope* — Application of the guidance would be limited to cash flow hedges of variable interest payments on existing CYR debt instruments. That is, the proposed ASU would preclude entities from applying the guidance by analogy to other circumstances.
- *Hedge Designation:*
  - Entities would consider the contractual terms of the existing CYR debt instrument when designating the parameters of the hedging relationship. For example, an entity would not be permitted to hedge forecasted interest payments that extended beyond the stated maturity date of the CYR debt instrument.
  - Entities would designate the initially selected interest rate index (and tenor of that rate, if applicable) as the hedged risk.
  - If an entity selected a different interest rate index or tenor (or both) after hedge inception, the hedged risk would be changed to mirror that election.
    - Automatic hedge dedesignation would not be required if this selection altered the number and timing of hedged forecasted interest payments within the hedged period.
  - Entities would be permitted to designate at hedge inception that forecasted interest payments would also be derived from replacement debt for the specified hedged period.
    - Automatic hedge dedesignation would not be required if the initial interest rate index and tenor of the replacement debt instrument match an interest rate index and tenor available under the original CYR debt instrument.
- *Assessments of Hedge Effectiveness*:
  - Entities would not consider possible changes in cash flows that would occur if a different interest rate index or tenor was selected on a future date.
  - If an entity selected a different interest rate index or tenor (or both), the entity:
    - Would perform a final retrospective assessment of hedge effectiveness on the basis of changes in cash flows attributable to the previously selected interest rate index or tenor.
    - Would begin prospectively assessing hedge effectiveness solely on the basis of changes in cash flows attributable to forecasted interest payments on the newly selected hedged risk unless or until such hedged risk is subsequently changed.

## Cash Flow Hedges of Nonfinancial Forecasted Transactions

Under an approach in ASC 815 often known as the contractually specified component (CSC) model, entities may designate, as the hedged risk in a cash flow hedge of a forecasted purchase or sale of a nonfinancial asset, any variable price component explicitly referenced (or expected to be explicitly referenced) in the pricing formula of the associated purchase or sales agreement. After the issuance of ASU 2017-12, stakeholders consistently expressed concerns that under the CSC model, the application of hedge accounting is limited for common risk management strategies — most notably, forecasted nonfinancial transactions to be consummated in the spot market.

The proposed ASU would replace the CSC model with a principles-based approach that permits hedges of variable price components that are clearly and closely related (as described by ASC 815-10-15-32(a) and (b)[6] on the normal purchases and normal sales scope exception) to the nonfinancial asset being purchased or sold. This proposed guidance would expand the application of hedge accounting, most notably by expressly allowing entities to hedge price components in forecasted nonfinancial spot-market transactions. The proposal would add ASC 815-20-25-22C, which is reproduced below.

**ASC 815-20**

**Proposed Content**

**25-22C** An entity may designate the variability in cash flows attributable to changes in a component (or subcomponent) of the forecasted purchase price or sales price of a nonfinancial asset as the hedged risk in a cash flow hedge as follows:

a. If the purchase price or sales price of the nonfinancial asset is not determined pursuant to a pricing formula in an agreement, the hedged variable component is clearly and closely related (as described in paragraph 815-10-15-32(a) through (b)) to the nonfinancial asset being purchased or sold.
b. If the purchase price or sales price of the nonfinancial asset is determined pursuant to a pricing formula in an agreement, the hedged variable component is either:
    1. Explicitly referenced in the agreement's pricing formula and clearly and closely related (as described in paragraph 815-10-15-32(a) through (b)) to the nonfinancial asset being purchased or sold
    2. Clearly and closely related (as described in paragraph 815-10-15-32(a) through (b)) to a variable component that meets the conditions in (b)(1) (that is, a "subcomponent"). (Throughout Subtopic 815-20, reference to a subcomponent refers only to the designation guidance in this subparagraph.)

The Board observed[7] that the market (forward or spot) in which an entity expects to purchase or sell a nonfinancial asset may affect its determination of whether the forecasted transaction presents an exposure to cash flow variability that could affect reported earnings,[8] potentially limiting the population of eligible hedged risks in forecasted nonfinancial transactions consummated in the forward market (as compared with those consummated in the spot market). Accordingly, the FASB proposed ASC 815-20-25-22C, under which the eligibility criteria for hedge accounting would be bifurcated.

However, in addition to addressing hedges of variable price components explicitly referenced in an agreement's pricing formula that are clearly and closely related to the nonfinancial asset being purchased or sold (proposed ASC 815-20-25-22C(b)(1)), the proposal seeks to broaden the application of hedge accounting by permitting an entity transacting in the forward market to hedge variable price components that are clearly and closely related to any explicitly referenced variable component meeting the conditions in proposed ASC 815-20-25-22C(b)(1)). The proposal refers to these components as "subcomponents."

[6] ASC 815-10-15-32(a) and (b) state that "[t]he underlying in a price adjustment incorporated into a contract that otherwise satisfies the requirements for the normal purchases and normal sales scope exception shall be considered to be not clearly and closely related to the asset being sold or purchased in any of the following circumstances:

a. The underlying is extraneous (that is, irrelevant and not pertinent) to both the changes in the cost and the changes in the fair value of the asset being sold or purchased, including being extraneous to an ingredient or direct factor in the customary or specific production of that asset.
b. If the underlying is not extraneous as discussed in (a), the magnitude and direction of the impact of the price adjustment are not consistent with the relevancy of the underlying. That is, the magnitude of the price adjustment based on the underlying is significantly disproportionate to the impact of the underlying on the fair value or cost of the asset being purchased or sold (or of an ingredient or direct factor, as appropriate)."

[7] See paragraph BC51 of the proposed ASU.

[8] See ASC 815-20-25-15(c)(2).

The proposed amendments are expected not only to expand the application of hedge accounting for nonfinancial forecasted transactions but also to reduce the risk of missed forecasts for highly effective economic hedges. For example, the Board notes in paragraph BC66 of the proposed ASU that "an entity [that] experiences an unexpected shortfall in the forecasted amount of a nonfinancial asset to be purchased under a forward contract and makes up the shortfall through a spot market purchase" can preserve hedge accounting under this revised model if (1) the component that is being hedged is clearly and closely related to the forward price and the spot price of the nonfinancial asset and (2) all other requisite conditions for the application of cash flow hedge accounting have been met.

### *Hedging Nonfinancial Components in Contracts Accounted for as Derivatives*

The proposed ASU would also "clarify that entities may designate a variable price component in a contract that is accounted for as a derivative as the hedged risk if the associated forecasted purchase or sale of the nonfinancial asset qualifies to be a hedged forecasted transaction." In proposing this guidance, the FASB seeks to address the diversity in practice related to whether hedge accounting can be applied in these situations.

## Net Written Options as Hedging Instruments

The proposed ASU would permit an entity to assume that certain terms of a hedged forecasted transaction match those of the hedging instrument (if such instrument is a compound derivative composed of a written option and a non-option derivative) when performing the net written option (NWO) test in ASC 815-20-25-88 through 25-97 to determine eligibility for cash flow hedge accounting.

**Connecting the Dots**

Lending institutions that make variable-rate loans to customers frequently hedge their interest rate exposure by using pay-variable, receive-fixed interest rate swaps. When those loans include a floor on the variable rate, lending institutions may choose to enter into interest rate swaps with mirror-image floors (i.e., a written option with a non-option derivative) to better mitigate their exposure to cash flow variability attributable to interest rates. After cessation of the London Interbank Offered Rate (LIBOR), it is common for lending institutions to make floored loans that are tied to the term Secured Overnight Financing Rate (SOFR) and enter into floored interest rate swaps in which the variable leg is tied to Daily SOFR. Under current GAAP, these lending institutions would not be eligible to apply cash flow hedge accounting because in accordance with the NWO test, different underlyings in the hedged item and hedging instrument are indicative of the absence of symmetry between potentially favorable and unfavorable cash flows.

As amended, ASC 815-20-25-88 would specify that for cash flow hedges of interest rate risk in which the hedging instrument is a combination of a written option and any other non-option derivative instrument, "an entity may make the following simplifying assumptions when performing the [NWO] test":

- "The underlying interest rate embedded within the hedged forecasted transaction matches the interest rate in the hedging instrument if that interest rate is a derivation of the same nonleveraged index (for example, the underlying interest rate in the hedging instrument is based on Daily SOFR, and the underlying interest rate in the hedged forecasted transaction is based on SOFR Term)."

- "The timing in which the hedged forecasted transaction is expected to occur and the settlement of the hedging instrument match if the hedged forecasted transaction occurs and the hedging instrument settles within the same 31-day period or fiscal month."
- "The interest rate reset date of the hedging instrument and the hedged forecasted transaction match if the reset date associated with the hedged forecasted transaction and the hedging instrument occurs within the same 31-day period or fiscal month."

### Foreign-Currency-Denominated Debt Instrument as Hedging Instrument and Hedged Item (Dual Hedge)

Under ASC 815, entities are permitted to simultaneously designate a single foreign-currency-denominated debt instrument as both (1) a hedging instrument in a hedge of a net investment in foreign operations and (2) a hedged item in a fair value hedge of interest rate risk. In practice, this combination of hedging relationships is commonly referred to as a "dual hedge."

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 accumulated other comprehensive income [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 an imperfect offset between the changes in fair value of (1) the derivative hedging instrument for the fair value hedge that is recognized in earnings and (2) 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 entities to exclude the fair value hedge basis adjustment 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 the remeasurement of the derivative that is designated as the hedging instrument.

## Proposed Effective Date and Transition

### Effective Date

The Board will determine the effective date after considering stakeholder feedback on the proposed ASU.

### Transition

Entities would be required to apply the proposed guidance in the ASU prospectively for existing hedging relationships as of the date of adoption, with early adoption permitted. In addition, "entities may either be required or permitted to modify critical terms of certain existing hedging relationships, without dedesignating the hedge."

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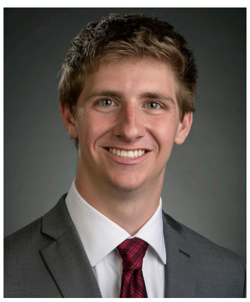

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