Update on Hedge Accounting Rules FASB Addresses Effectiveness Concerns

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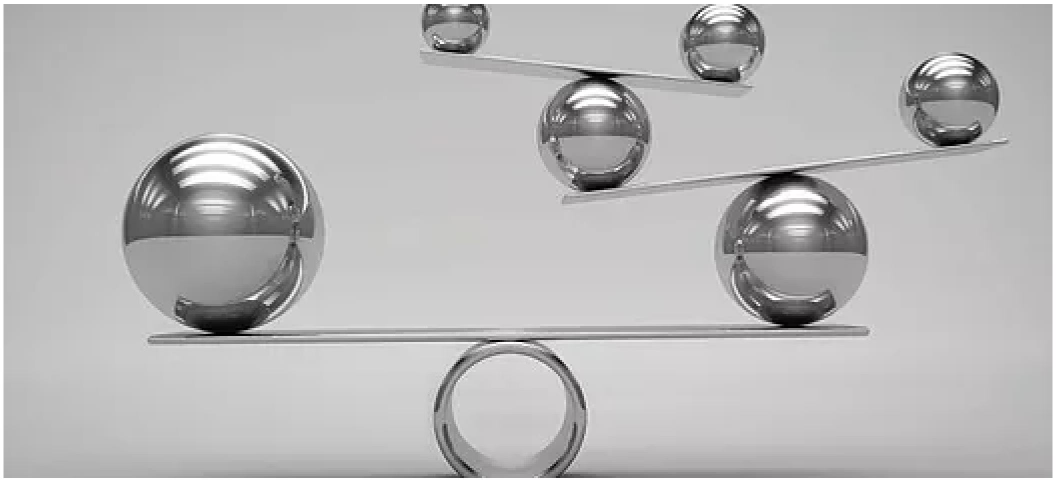

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In 1996, FASB underwent a major overhaul of its accounting rules pertaining to derivative instruments and hedging transactions; except for some minor tinkering, those rules are still in place today. The guidance relies on several key concepts:

- Derivatives are assets or liabilities and should be reflected on the balance sheet as such. Moreover, their appropriate carrying value should reflect contract market values.
- In specifically designated hedging transactions, special hedge accounting would apply, whereby hedge gains or losses would affect reported earnings concurrently with the earnings effects of the items being hedged. This treatment, however, is not automatic. Limiting criteria must be satisfied in order to qualify.
- For derivatives transactions where hedge accounting does not apply, both realized and unrealized gains or losses (i.e., settlements plus mark-to-market value changes) on derivatives are reported in earnings on a current basis.

Of these three concepts, the second has consistently been the most challenging. Hedge accounting is widely deemed to be the preferred treatment, as it allows for the economic motivation of hedges to be transparently reflected in reporting entities' financial statements. Additionally, for many hedging situations, hedge accounting serves to mitigate income volatility that would otherwise result in the absence of hedge accounting, and lesser volatility is generally seen as preferable. Qualifying for this treatment, however, has not been a trivial exercise.

Potential Changes to Hedge Accounting Requirements

When the hedge accounting standard was originally initiated, FASB appeared quite concerned about the prospect of reporting entities using hedge accounting rules to misrepresent their earnings; to protect against this contingency, strict documentation requirements were stipulated. As part of this documentation, hedgers must validate that their hedges would be—and, in fact, actually are—"highly effective" in offsetting the risks being hedged; these tests are referred to as "prospective" and "retrospective," respectively. These documentation and hedge effectiveness requirements may be more onerous than FASB may have intended, as reflected by the fact that the board liberalized them in Accounting Standards Update 2017-12, Derivatives and Hedging (Topic 815), issued August 2017.

The amended guidance made four significant adjustments. First, the testing methodologies now allow for qualitative effectiveness testing in certain cases. Second, FASB has extended the deadline for when prospective tests must be performed, allowing these tests to be completed as much as three months after the hedge has been initiated. Third, quantitative testing has been reduced to an initial prospective test, which, if satisfied, removes the need for further quantitative testing, prospective or retrospective, as long as the facts and circumstances of the hedge relationship remain unchanged and the hedge is expected to continue to be highly effective. Finally, the board has dispensed with the requirement to apply different accounting treatment to "effective" versus "ineffective" hedge results in cash flow hedges—the most widely used category of hedge accounting.

Regarding this last change, ineffective hedge results were previously posted to current earnings, while effective results were first recorded in other comprehensive income and later reclassified to earnings coincident with the earnings impacts of their associated hedged items. Under the new rules, this dichotomy is eliminated; all hedge results are treated uniformly, with gains or losses posted to other comprehensive income and subsequently reclassified to earnings.

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Consistent with this viewpoint, the revised rules also eliminate the requirement to disclose ineffective earnings. Thus, all of the hedge effectiveness measurement requirements have been removed from GAAP. An important caveat, though, is that FASB has carved out disparate treatment in situations where forward points or option time values are excluded from the assessment of hedge effectiveness. Previously, ineffective and excluded hedge results were often undifferentiated; under the revised rules, the two concepts will necessarily be treated differently. In other words, although the revised rules dispense with any distinct recognition of ineffective hedge results, the current practice of reporting and disclosing excluded amounts in current income, rather than allowing them to be deferred through other comprehensive income, remains unchanged—with one important caveat.

The board has decided that the earnings impact from the excluded components could be reflected in earnings using "a systematic and rational method" (e.g., an amortization approach), as opposed to recording these effects on the basis of market value changes. The market value approach would still be acceptable, but reporting entities would likely favor the alternative, as it would inevitably foster more stability. Moreover, the determination of the earnings amounts would be calculated much more simply using the amortization approach. Most hedging entities that exclude forward points and option time values from hedge effectiveness assessments will likely embrace this change.

Returning to the effectiveness testing issues, it is important to note that reporting entities still need to assess the performance of their hedges no less frequently than quarterly. In many hedging instances, however, the proposed revisions allow for this assessment to be made qualitatively. The term "qualitative testing" is actually a bit of a misnomer; it should be understood simply to mean that no quantitative test would be required when certain conditions are satisfied.

FASB's Rationale

FASB's sensibilities seem clear: The board wants to eliminate the requirement to perform quantitative testing when it is intuitively obvious that the hedge will perform well. The revised guidance is not a blank check, however; quantitative tests are still required when the criteria for qualitative testing are not met. Conceptually, it should be clear that any hedging circumstance that involves an inherent basis risk would still require quantitative testing; in reality, however, it is uncertain whether these tests will still have to be performed quarterly. FASB appears to want to liberalize this requirement by dispensing with the need for ongoing quantitative testing if the facts and circumstances underlying the hedge relationship remain unchanged and the hedge is expected to remain highly effective, but this provision is slippery. If the original qualitative test passes by a sufficiently comfortable margin, most likely no further quantitative tests would be needed; again, this is not certain. By this author's reading, FASB's guidance suggests that one can only validate whether it is correct to use qualitative testing by performing a quantitative test. In the author's opinion, this is not much of an improvement.

While entities may bristle at performing effectiveness tests for hedges that they "know" will perform well, these qualitative tests do serve a control function for senior management. Failing a quantitative test forces scrutiny of the hedging relationship in question; without such testing, management could be blissfully unaware of a problem until it becomes too big to ignore. Thus, dispensing with quantitative tests could very well compromise the discipline over hedging that management might otherwise be able to exert. More perniciously, if hedge accounting is applied on the basis of a qualitative test and an auditor belatedly disallows the qualitative test, taking advantage of this seemingly liberalized process might very well lead to an earnings restatement or error correction. Performing and passing periodic quantitative tests as a matter of course would preclude this possibility.

This consideration aside, FASB has listed explicit criteria for when qualitative testing would be unequivocally appropriate. Under current GAAP, entities may assume zero ineffectiveness and thus qualify for hedge accounting under two umbrella situations: 1) when shortcut criteria hold in connection with interest rate swap hedges, and 2) when “critical terms match” in other types of hedges. In both situations, validating the criteria is sufficient, and no quantitative testing is required. The amended guidance expands the circumstances under which this same orientation would apply; in particular, it allows qualitative testing when critical terms almost match. Specifically, if forecasted cash flows in a cash flow hedge occur within the same month as the expiration of the derivative, the effectiveness test can be qualitative. The same goes for long option hedges and zero-cost collars—although in those cases, the options must be European options (i.e., exercisable only on their expiration dates).

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Beyond that, private, nonfinancial companies may apply what amounts to the shortcut method when some of the shortcut criteria are not necessarily satisfied. FASB has also clarified that whenever a company can assert that the hedging derivative and the hypothetical derivative are identical, no quantitative test is required; reporting entities must simply document that the qualifying conditions are satisfied. Again, this attestation is not a one-time event; reporting entities must revisit the issue quarterly to assure that the stated documentation is still valid.

Under the previous guidance, any time the facts and circumstances of a hedge relationship deviate from those detailed in the hedge documentation, new documentation was needed in order to continue hedge accounting. In many such cases, the new documentation required reformulation of the hypothetical derivative (i.e., the ideal derivative that would perfectly offset the risk being hedged). Such reformulation inevitably resulted in the prospect of realizing ineffective earnings that otherwise would not have occurred under the original hypothetical derivative. This earnings impact, however, has always been an artifact of the design requirements of hypothetical forwards or swaps, which stipulate that hypothetical derivatives must have starting market values (at the time of hedge designation) equal to zero. Under the revised guidance, since ineffectiveness is no longer recorded in earnings for cash flow hedges, FASB has taken the sting out of redocumenting hedges. The revision of hedge documentation will still be a necessary chore, but one that will not foster unintended earnings recognition.

FASB’s stated goals in putting forth these changes were to improve financial reporting and simplify the rules for hedge accounting, and the board deserves high grades on both accounts. Large segments of derivatives users will see improvements, making both the process and the presentation of hedge accounting more intuitive and understandable.

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