

A Deep Dive into Hedging

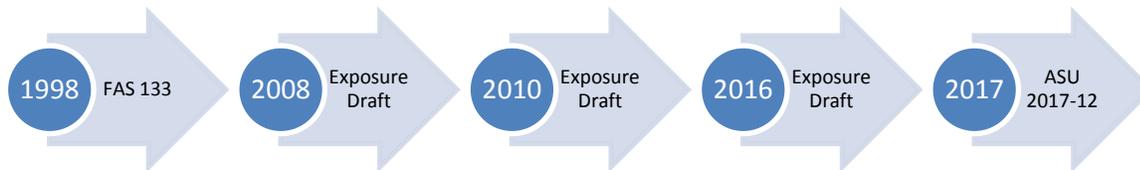
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Introduction

In August 2017, the Financial Accounting Standards Board (FASB) released Accounting Standards Update (ASU) 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*. This is FASB's third attempt in nine years to refresh guidance that financial statement preparers see as overly complicated and difficult for financial statement users in analyzing an entity's risk management activities. Both derivative markets and firms' risk management practices have substantially evolved since the 1998 issuance of Financial Accounting Standards (FAS) No. 133, which contained the first hedging accounting guidance.



The amendments better align hedge accounting with management's risk activities, make targeted changes to reduce the cost and complexity of applying hedge accounting and enhance financial statement understandability through new disclosure and presentation changes. Although the changes do not go as far as some had hoped, there are considerable benefits. Significant documentation relief is offered to private companies. Industries that can benefit the most from these changes include food and agribusiness, oil and gas, insurance and banking. Early adoption is permitted at the start of any interim or annual fiscal period before the standard's effective date.

Any types of items and transactions currently eligible for hedge accounting under Accounting Standards Codification Topic 815 continue to be eligible. The amendments expand the number and types of transactions that qualify for hedge accounting. The new standard does not affect the private company exception that provides a [simplified hedge accounting](#) method for certain variable to fixed rate interest rate swaps.

Early adoption may seem attractive with many investment firms pitching new hedging strategies. Company management should carefully review all the facts before choosing a course of action which also includes the optimal time for adoption. BKD can help entities prepare for the new standard by identifying key changes that may have the most effect on existing hedges, assessing potential new hedging strategies and determining transition election and timing.

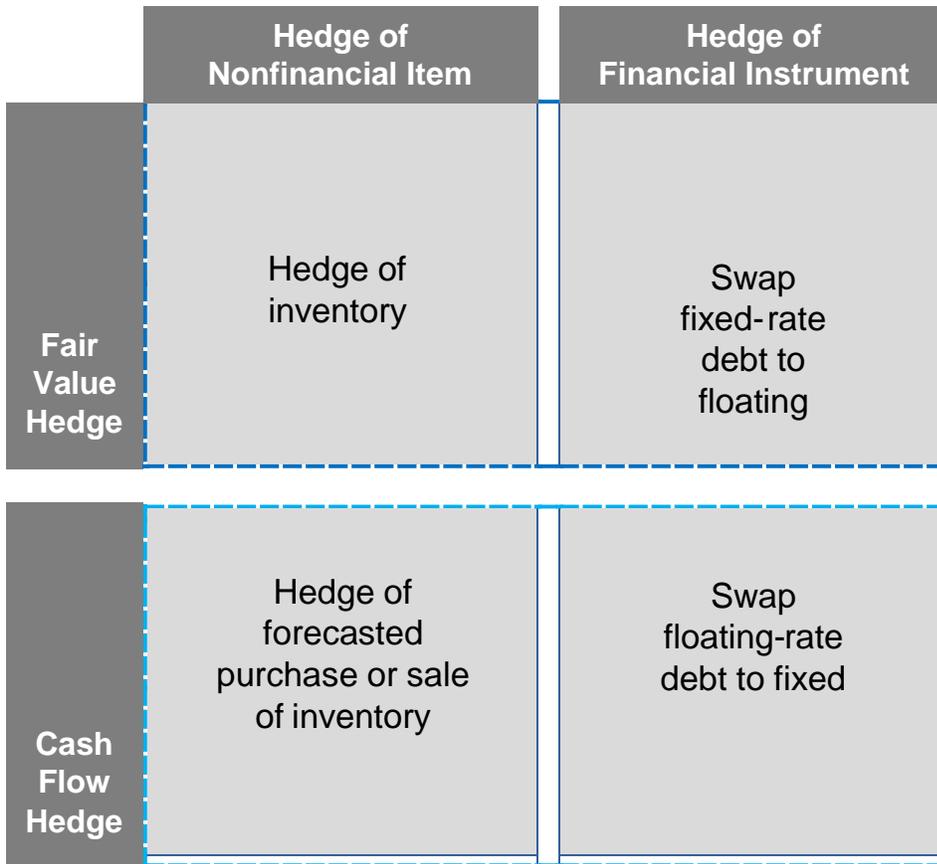
Current Hedge Accounting Guidance

Hedging is the process of mitigating a company's risk. Under current generally accepted accounting principles (GAAP), derivatives are recorded at fair value with changes in fair value reported in earnings. Hedge accounting is optional and prevents earnings volatility because the derivative's fair value change may be recorded in earnings in a different period than the earnings effect of a forecasted transaction or the derivative's fair value change may be recorded in earnings but the hedged asset or liability may be recorded at amortized cost or at fair value through other comprehensive income (OCI).

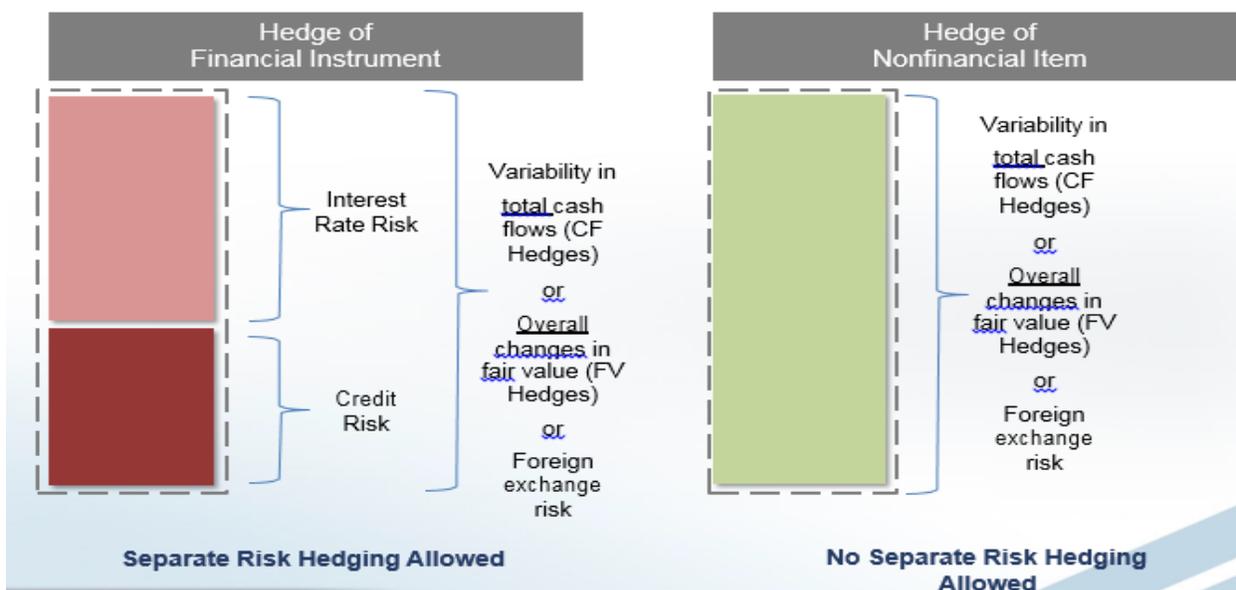
To qualify for hedge accounting, a company must complete documentation requirements and prove highly effective offset between the hedging instrument and hedged item through quantitative testing. For qualifying hedges, current GAAP provides special hedge accounting either for the hedging instrument (cash flow hedges) or the hedged item (fair value hedges) to minimize earnings volatility. Hedge accounting involves designating a derivative instrument to a hedged item and then recognizing gains and losses from both items in the same period.

These amendments primarily affect cash flow and fair value hedges. There are minor revisions to the guidance on net investment hedges.

Common Hedging Strategies



Current – Component Hedging



Risk Component Hedging

Current GAAP limits how an entity can designate the hedged risk in hedging relationships. The ASU expands hedge accounting for financial and nonfinancial risk components, *e.g.*, purchases of ingredients and materials for production and operations.

Cash Flow Hedge

Nonfinancial Asset

For nonfinancial assets, current GAAP only permits an entity to designate the overall change in price as the hedged risk. However, most entities manage commodity risk on a component basis rather than a total price basis. Contracts for various types of commodities across various industries generally are priced based on a traded commodity index plus or minus a basis differential, which could include items such as transportation costs, quality or grade differentials and local supply and demand factors for the commodity. These basis differentials often create too much variability on a total-price-risk basis to enable an entity to qualify for hedge accounting. This limitation makes hedge accounting hard to achieve or results in earning volatility related to hedge ineffectiveness because an entity is required to incorporate aspects of the total price into the hedging relationship that the entity cannot or chooses not to hedge. As a result, many entities choose not to hedge at all.

The changes in ASU 2017-12 provide benefits such as:

- Easier hedge designation when using multiple suppliers
- Application of a cash flow hedge accounting to a not-yet-existing contract if certain criteria are met

For a cash flow hedge of a nonfinancial asset, an entity could designate as the hedged risk the variability in cash flows attributable to changes in a contractually specified component stated in the contract. Currently only foreign currency (FX) risk can be designated as the hedged risk for a nonfinancial item. This change would allow entities to benefit from hedge accounting for derivatives to offset risk from price changes in ingredients or inventory items, *e.g.*, a tire company's hedging against changes in rubber prices. A contractually specified component is defined as an 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.

Chatham Financial, a global risk management advisory firm, analyzed the filings of more than 1,500 public companies and determined that hedge accounting was applied in 80 percent of companies that hedged their interest rate risk and 90 percent of those with cash flow currency hedging programs but only 45 percent of companies that hedged commodities exposures.

Eligibility Criteria

For existing contracts, determining whether the variability in cash flows attributable to changes in a contractually specified component may be designated as the hedged risk in a cash flow hedge is based on the following:

- If the purchase contract is a derivative in its entirety and an entity applies the normal purchases and normal sales scope exception, any contractually specified component in the contract is eligible to be designated as the hedged risk. If the entity does not apply the normal purchases and normal sales scope exception, no pricing component is eligible to be designated as the hedged risk.
- If the contract is not a derivative in its entirety, *i.e.*, a bifurcated instrument, any contractually specified component remaining in the host contract is eligible to be designated as the hedged risk.

A Deep Dive into Hedging

The definition of a contractually specified component is considered to be met if the component is explicitly referenced in agreements that support the price at which a nonfinancial asset will be purchased or sold. For example, an entity intends to purchase a commodity in the commodity's spot market. If, as part of the governing agreements of the transaction or commodities exchange, it is noted that prices are based on a predefined formula that includes a specific index and a basis, those agreements may be used to identify a contractually specified component (see [Appendix A](#)).

Although these changes provide considerable benefit, some manufacturers and energy companies felt FASB could have gone further. In addition to the “contractually specified” components, some preparers wanted to include components that are not contractually specified but where a “market convention” component is used as an underlying basis for determining the overall product’s price. Under this approach, a contract exists, but the components to be designated as the hedged item are not contractually specified. This approach would mirror International Financial Reporting Standards language that allows an entity to hedge a risk component that is “separately identifiable and reliably measurable.” Many companies felt the “contractually specified” requirement is overly restrictive and limits the ability to take advantage of hedge accounting, e.g., spot or at-market noncontractual purchases or sales would be ineligible for inclusion in the pool of hedged forecasted transactions.

In the end, FASB felt the relief provided was a big step forward, and concerns about structuring and speculative hedging prevented going as far as the international guidance.

Forecasted Transactions – Nonfinancial Assets

For forecasted transactions, the component actually executed may differ from the contractually specified component originally designated. The standard creates consistency between how a change in the hedged risk is treated for cash flow hedges of both nonfinancial and financial items, such that a change in the designated hedged risk should not result in an automatic dedesignation of the hedging relationship. Under ASU 2017-12, the hedging relationship could be continued if the hedging instrument provided highly effective offset in relation to the revised hedged risk (see [Appendix B](#)).

An entity is NOT required to document all the possible hedge risk that might exist in the actual transaction when it occurs. At contract inception, an entity is only required to document the expected hedge risk and perform a single hedge effectiveness assessment based on the hedged risk currently expected to occur in the forecasted transaction.

A hedging relationship can be dedesignated, e.g., discontinued at any time. If an entity wishes to change any of the critical terms (other than the designated hedging risk as noted above) of the hedging relationship (including the method designated for use in assessing hedge effectiveness) as documented at inception, an entity must dedesignate the original hedging relationship and then redesignate a new hedging relationship that incorporates the desired changes.

Financial Asset

ASU 2017-12 eliminates current GAAP guidance on “benchmark” interest rates for hedges of variable-rate instruments; currently, only variability in cash flows related to one of three defined benchmark interest rates are permitted to be the hedged risk. Under the new rules, for a cash flow hedge of interest rate risk of a variable-rate financial instrument, an entity could designate as the hedged risk the variability in cash flows attributable to the contractually specified interest rate.

An entity may designate as the hedged risk only the change in cash flows of the contractually specified interest rate, **not** an implied rate embedded in the interest rate. For example, if an entity issues variable-rate debt based on its own prime rate, it cannot designate the change in cash flows of the federal funds target rate or **Wall Street Journal** prime rate as the hedged risk.

Fair Value Hedges

Current GAAP limits how an entity measures changes in fair value of the hedged item attributable to interest rate risk in certain fair value hedging relationships. The standard significantly expands derivative strategies eligible for hedge accounting.

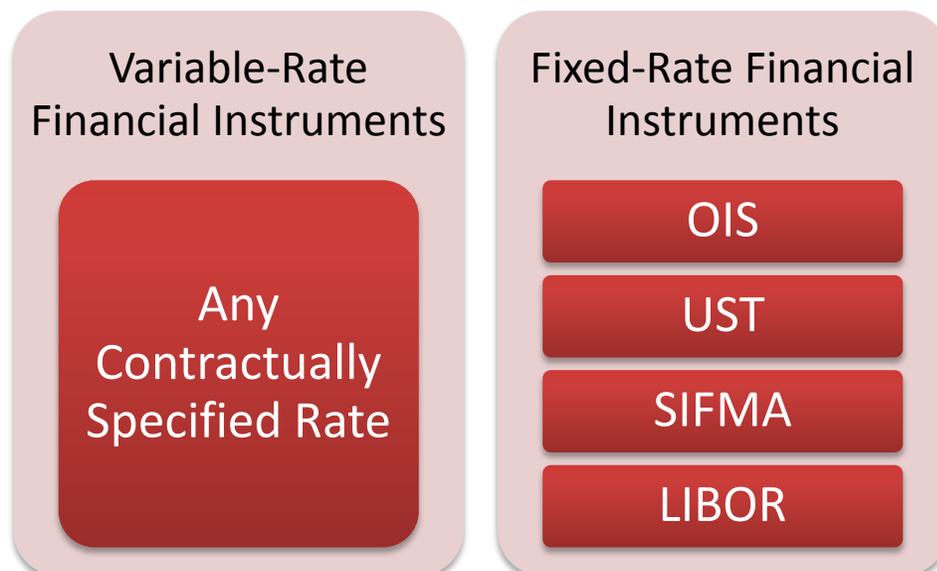
Benchmark Interest Rates

SIFMA

The concept of the benchmark interest rate was created in FASB Statement No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*, to permit entities to hedge interest rate risk without considering credit risk. Current GAAP defines the term benchmark interest rate based on stringent characteristics and specifically identifies three permissible rates—Direct Treasury Obligations of the U.S. Government (UST), the London Interbank Offered Rate (LIBOR) Swap Rate and the Fed Funds Effective Swap Rate (or Overnight Index Swap [OIS] Rate). FASB fell short of moving to a principles-based approach for determining benchmark rates, instead choosing to add the Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Rate to the list of permitted benchmark rates for hedges of fixed-rate financial instruments.

Michael Gullette, American Bankers Association's vice president of accounting and financial management, noted, "Banks are active in munis. Banks of all sizes. I think there will be a lot more hedge accounting in the municipal securities arena. This could have a significant impact." Municipal securities held by U.S. chartered banks totaled \$554 billion and credit unions hold an additional \$5 billion, according to Federal Reserve data.

Indexes Eligible to Be Designated in a Hedge of Interest Rate Risk



Interest Rate Risk

ASU 2017-12 updates the guidance for hedging interest rate risk of financial instruments in both fair value and cash flow hedges. The term “interest rate risk” is redefined for the purposes of designating changes in fair value or variability of cash flows attributable to interest rate risk, as follows:

- For variable-rate financial instruments, interest rate risk will be the risk of changes in the hedged item’s cash flows attributable to changes in the contractually specified interest rate in the agreement.
- For fixed-rate financial instruments, interest rate risk will be the risk of changes in the hedged item’s fair value attributable to changes in the designated benchmark interest rate.

Variable-Rate Instruments

Under current GAAP, if the explicit index in the variable-rate instrument is a nonbenchmark rate such as a composite prime index, the hedging relationship must include cash flow variability related to changes in all factors (including credit risk). This creates significant complexity in hedging portfolios of prime-based loans—any changes in the portfolio’s composition, *i.e.*, the prepayment of old receivables and the origination of new receivables with different credit spreads, could cause the hedging relationship to fall short of the highly effective threshold in subsequent periods and potentially necessitate a dedesignation and redesignation of a new hedging relationship. ASU 2017-12 eliminates the benchmark interest rate concept for hedges of variable-rate financial instruments.

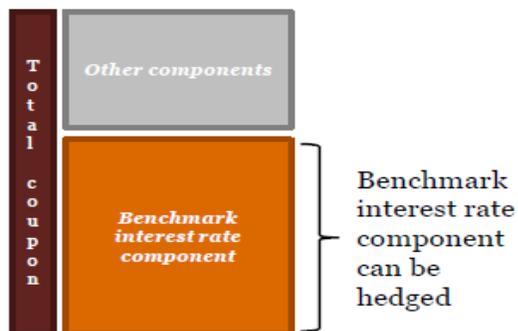
Contractually specified interest rates are not limited to market benchmark rates. An entity’s own prime rate or a variable rate set through an auction process qualifies as a contractually specified interest rate when it is the rate that is explicitly referenced in the variable-rate financial instrument being hedged.

Total Coupon Versus Benchmark Rate Coupon Cash Flows

Under current GAAP, entities must use the total contractual coupon cash flows in determining the fair value change in the hedged item related to interest rate risk. Using the total coupon cash flows can misrepresent hedge effectiveness because it includes credit factors. Under ASU 2017-12, an entity can also use benchmark rate coupon cash flows determined at hedge inception in calculating the fair value change of the hedged item related to interest rate risk.

*Entities can still use total coupon cash flows, *i.e.*, an entity may have a borrowing rate that is close to the benchmark rate and may not want to change its methodology because the effect would not be significant enough to justify the cost of complying with the change.*

Benchmark Coupon



Forecasted Issuances or Purchases of Debt Instruments

The decision to have different concepts for the designation of interest rate risk hedges for fixed-rate and variable-rate financial instruments affects the designation and documentation of hedges of forecasted issuances or purchases of debt instruments (or the instrument's associated coupon payments). For a cash flow hedge of interest rate risk related to a forecasted debt issuance or purchase, an entity would specify the nature of the interest rate risk being hedged as follows:

- For expected issuance or purchase of *fixed-rate debt*, the entity shall designate the variability in cash flows attributable to changes in the benchmark interest rate as the hedged risk.
- For expected issuance or purchase of *variable-rate debt*, the entity shall designate the variability in cash flows attributable to changes in the contractually specified interest rate as the hedged risk.

In some cases, an entity may know in advance if forecasted issuance or purchase will be a fixed- or variable-rate instrument. An entity may not know the final decision until closer to the debt's actual issuance date. When there's uncertainty, an entity can cover its exposure by designating the hedged risk as a rate that will qualify both as a benchmark interest rate (if the instrument ultimately issued is fixed rate) **and** as a contractually specified interest rate (if the instrument is variable rate). For example, if the entity designated the variability of the LIBOR rate as the hedged risk associated with a forecasted debt issuance, that rate will qualify as a benchmark rate if fixed-rate debt was issued and also will qualify as a contractually specified interest rate if variable-rate debt indexed to LIBOR was issued. In both cases, amounts recognized in OCI will not be immediately reclassified to earnings because the hedged cash flows are still probable of occurring.

Fair Value Hedges – Interest Rate Risk

Historically, fair value hedging has been more restrictive than cash flow hedging. Currently, fair value hedging requires the identified hedged item to be one of the following:

- All of a recognized asset or liability (or unrecognized firm commitment)
- A specific portion of a recognized asset or liability, unrecognized firm commitment or portfolio of similar items
- A portfolio of similar assets or similar liabilities as designated above, "similar assets test"

The portion of a recognized asset or liability must be a percentage of an entire asset or liability, one or more selected cash flows or a put or call option. In a portfolio, the portion must relate to each item in the portfolio. These limitations lead to recognizing hedge ineffectiveness or the inability to achieve hedge accounting.

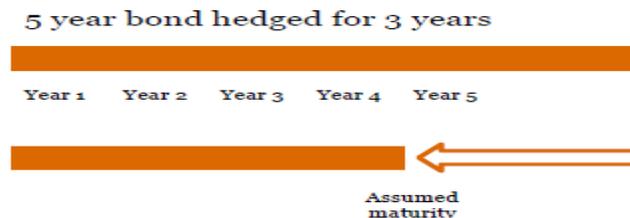
GAAP limits how an entity measures changes in the fair value of the hedged item attributable to interest rate risk in certain fair value hedging relationships. The standard expands the definition of interest rate risk, making it easier to hedge partial terms of financial instruments or hedge a portfolio of prepayable assets.

Interest Rate Risk Definition	
Current	New
Interest rate risk is the risk of changes in a hedged item's fair value or cash flows attributable to changes in the designated benchmark interest rate.	<p>For recognized variable-rate financial instruments and forecasted issuances or purchases of variable-rate financial instruments, interest rate risk is the risk of changes in the hedged item's cash flows attributable to changes in the contractually specified interest rate in the agreement.</p> <p>For recognized fixed-rate financial instruments, interest rate risk is the risk of changes in the hedged item's fair value attributable to changes in the designated benchmark interest rate. For forecasted issuances or purchases of fixed-rate financial instruments, interest rate risk is the risk of changes in the hedged item's cash flows attributable to changes in the designated benchmark interest rate.</p>

Partial-Term Hedges

Current GAAP effectively prohibits partial-term fair value hedges. Today an entity must consider all of an instrument's cash flows; therefore, a partial-term hedge compared to the entire bond will most likely result in an ineffective hedge. ASU 2017-12 creates equitable treatment for partial-term fair value hedges and cash flow hedges by allowing an entity to measure the hedged item in a partial-term fair value hedge of interest rate risk by assuming the hedged item has a term that only reflects the designated cash flows being hedged. For these partial-term hedges, an entity may measure the change in the fair value of the hedged item attributable to interest rate risk using an assumed term that begins when the first hedged cash flow begins to accrue and ends when the last hedged cash flow is due and payable. The assumed maturity of the hedged item occurs on the date in which the last hedged cash flow is due and payable.

Partial-Term Hedge



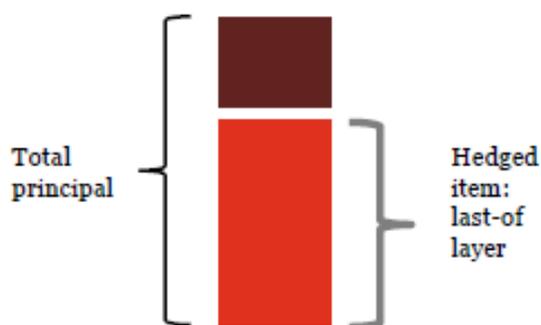
Prepayable Financial Instruments – Last-of-Layer Method

Current guidance limits portfolio hedging due to an underlying premise that hedge accounting generally should be applied to individual assets or liabilities or portions of them. Therefore, prepayment risk at an individual asset level must be considered because it has a significant effect on the fair value of fixed-rate prepayable financial instruments. This makes portfolio hedging operationally burdensome and requires frequent dedesignations and redesignations to comply with fair value hedge accounting requirements.

FASB created a new method, last-of-layer, allowing an entity to obtain hedge accounting for closed portfolios of prepayable assets without having to incorporate the risks arising from prepayments, defaults and other factors affecting the timing and amount of cash flows into the measurement of the hedged item. An entity would need to consider only how changes in the benchmark interest rate affect a decision to settle a debt instrument before its scheduled maturity in calculating the change in fair value of the hedged item attributable to interest rate risk.

This approach could apply to a mortgage-backed security, any other beneficial interest or a portfolio of beneficial interests collateralized by prepayable financial instruments.

Last-of-Layer Method for Closed Portfolios



The last-of-layer approach would allow an entity to designate as the hedged item the last dollar amount of either of the following:

- A prepayable asset, such as a prepayable mortgage-backed security
- A closed portfolio of prepayable assets, such as residential mortgage loans

Under this designation, prepayment risk is excluded from the measurement of the hedged item. The “last of” threshold should be set to an amount that the entity expects will be outstanding as of the hedged item’s assumed maturity date. An entity would be able to assume that if prepayments occur they are first applicable to the portion of the prepayable asset or to a closed portfolio of prepayable assets that is **not** part of the designated hedged layer. On each hedge effectiveness assessment date, an entity would use its expected performance of the asset(s) to determine if the amount remaining at hedge maturity is still expected to exceed or be equal to the last of layer.

As long as the remaining balances in the portfolio are expected to be greater than the amount designated in the hedging relationship, the hedged item would remain valid. The entity would consider all prepayments, defaults, etc., to occur first on the “unhedged” layer of the portfolio. If the last layer is breached by prepayments, the hedge must be dedesignated.

An entity must make several elections so that the portfolio passes the similar assets test to be eligible for hedge accounting. An entity is required to designate the prepayable financial assets by applying the partial-term guidance, such that the assumed maturity date of the prepayable financial assets within the closed pool is identical from a hedge accounting perspective. Using the benchmark rate component of the contractual coupon cash flows when all assets have the same assumed maturity and prepayment risk does not affect the measurement of the hedged item results in all hedged items having the same benchmark rate coupon. When those elections are made, and because the portfolio is closed, a similar assets test needs to be performed only at hedge inception.

In addition, all assets in the portfolio for hedge accounting purposes are considered nonamortizing and nonprepayable with the same maturity and coupon, resulting in the similar assets test being performed on a qualitative basis.

At inception and for ongoing effectiveness testing, an entity should complete and document an analysis to support its expectation that the designated last of layer is anticipated to be outstanding as of the hedged item's assumed maturity date. This analysis should incorporate the entity's current expectations of prepayments, defaults and other events affecting the timing and amount of cash flows associated with the closed portfolio of prepayable financial assets.

FASB acknowledges that determining the balance of the hedged item anticipated to be outstanding is an estimate. Entities are not held to the probable threshold in the cash flow hedge model. As long as a reasonable process exists to support the estimate of the outstanding balance, changes in this estimate should be considered only on a prospective basis similar to how changes in estimates are considered under current GAAP.

Basis Adjustments & Dedesignation

Throughout the hedging relationship's life, the basis of the hedged item needs to be adjusted for changes in interest rate risk. The ASU does not prescribe a specific method – for disclosure requirements, an entity may allocate the basis adjustment on an individual asset basis or portfolio basis using a systematic and rational method.

Partial dedesignation is permitted when expectations about the last of layer have changed such that the remaining amount expected to be outstanding at the end of the hedging relationship is less than the hedged item. Partial dedesignation is required for the amount no longer expected to be outstanding. The basis adjustment associated with the amount of the hedged item dedesignated is allocated to all remaining assets in the closed portfolio using a systematic and rational method.

When the last layer is breached, full dedesignation is required. An entity would recognize a portion of the basis adjustment immediately in earnings. The remaining outstanding basis adjustment would be allocated to all remaining individual assets in the closed portfolio using a systematic and rational method.

Hedge Effectiveness

The changes to requirements to determine hedge effectiveness will make hedge accounting more accessible and less burdensome for companies. Hedge effectiveness is the extent to which changes in the fair value or cash flows of the hedging instrument offset changes in the fair value or cash flows of the hedged item for the hedged risk. Current GAAP contains specific requirements for initial and ongoing quantitative hedge effectiveness testing as well as strict requirements related to the specialized methods of accounting, *i.e.*, "shortcut" and "critical terms match" methods, that allow an entity to forgo quantitative hedge effectiveness assessments. The specialized hedge accounting permitted under the shortcut and critical terms match methods was retained, even though they are not widely used today. FASB felt those methods are cost-effective for entities that do not have the resources to employ a quantitative method to assess effectiveness. ASU 2017-12 modifies some of the criteria that could make this a viable option for smaller companies.

Initial Assessment Documentation Timing

Entities will have more time to perform the initial prospective quantitative assessment of hedge effectiveness. An entity could perform that assessment at any time after hedge designation—but no later than the quarterly effectiveness testing date—using data applicable as of the date of hedge inception.

Private Company Documentation & Timing Relief

A private company that is not a financial institution is exempted from providing documentation that discloses any risk management activities. Instead, it will have to prepare a “statement of intent to hedge” featuring the hedging instrument, hedged item/transaction, the potential risk of the hedged item/transaction and the method used to review effectiveness.

FASB provided additional relief on hedge documentation timing to private companies that are not financial institutions as well as certain not-for-profits (NFP) that have not issued—or are a conduit bond obligor for—securities that are traded, listed or quoted on an exchange or an over-the-counter market. These entities may document the method of assessing hedge effectiveness and perform the initial quantitative effectiveness assessment and all quarterly hedge effectiveness assessments before the date on which the next interim (if applicable) or annual financial statements are available to be issued. This incremental relief does not affect the simplified hedge accounting approach for private companies.

The timing requirement for all other hedge documentation is unchanged.

Subsequent Qualitative Assessment

Entities are still required to make an initial quantitative effectiveness assessment at hedge inception, unless a scope exception applies, *i.e.*, shortcut method. Quantitative reassessment would be required only if changes in circumstances suggest that the hedging relationship may no longer be reasonably effective, under an accounting policy election. An entity would continue to assess effectiveness for similar hedges in a similar manner. If elected, an entity is required each quarter to verify and document that the facts and circumstances related to the hedging relationship have not changed such that the entity can assert qualitatively that the hedging relationship was and continues to be highly effective. An entity may still perform quantitative assessments on a hedge-by-hedge basis.

While not all-inclusive, the following are indicators that may—individually or in the aggregate—allow an entity to continue to qualitatively assert a hedging relationship is highly effective:

- An assessment of the factors that enabled the entity to reasonably support an expectation of high effectiveness on a qualitative basis has not changed such that the entity can continue to assert qualitatively that the hedging relationship was and continues to be highly effective.
- There have been no adverse developments regarding the risk of counterparty default.

If facts and circumstances change so an entity no longer can assert **qualitatively** that the hedging relationship was and continues to be highly effective, the entity shall revert to the **quantitative** effectiveness method identified in its initial hedge documentation. The quantitative assessments should begin as of the period that the facts and circumstances changed. If there is no identifiable event that led to the change in the facts and circumstances of the hedging relationship, the entity may begin performing quantitative assessments of effectiveness in the current period. An entity may resume a **qualitative** assessment if it can reasonably support an expectation of high effectiveness on a qualitative basis for subsequent periods. Management judgment will be required to determine whether a return to a qualitative assessment is appropriate. The standard includes the following factors to consider:

- Results of the quantitative assessment of effectiveness performed for the hedging relationship
- Alignment of the critical terms of the hedging relationship. If one or more of the critical terms of the hedging instrument and the hedged item are not aligned, an entity should consider whether changes in market conditions may cause the changes in fair values or cash flows of the hedging instrument and hedged item or hedged forecasted transaction attributable to the hedged risk to diverge as a result of those differences in terms.

- If underlyings of the hedged item and hedging instrument are different, an entity should consider the extent and consistency of the correlation between the two items. This may inform management if expected changes in market conditions could cause the changes in fair values or cash flows of the hedging instrument and the hedged item or hedged forecasted transaction attributable to the hedged risk to diverge. Management must evaluate if there is a reasonable expectation that the hedging relationship is expected to remain stable or if divergence is expected to continue or recur in the future.
- A specific event or circumstance may cause a temporary market disruption that results in an entity concluding that the facts and circumstances of the hedging relationship have changed such that it no longer can assert qualitatively that the hedging relationship was and continues to be highly effective. In those instances, if the results of the quantitative assessment of effectiveness do not significantly diverge from the results of the initial assessment of effectiveness, that market disruption should not prevent the entity from returning to qualitative testing in subsequent periods. If the results of the quantitative assessment of effectiveness do significantly diverge from the results of the initial assessment of effectiveness, the entity should continually monitor whether the temporary market disruption has been resolved when determining whether to return to qualitative testing in subsequent periods.

This is a significant change from the current requirement for a quarterly quantitative reassessment.

Critical Terms Match

The critical terms method allows companies to comply with hedge accounting standards without having to prove quantitatively that the hedge is effective. Under this approach, the critical terms of the hedged item and hedging instrument have to be perfectly matched. The changes in the fair value and cash flow of the derivative are likely to offset those of the hedged item, both retrospectively and prospectively. If they are, companies can conclude that the changes will exactly offset. This is available only for cash flow hedges. To ensure compliance with the critical terms method, the following criteria must be met:

- The notional amounts of the derivative and hedge items are equal
- The maturity of the derivative equals the maturity of the hedged position
- The underlying of the derivative matches the underlying hedged risk
- The fair value of the derivative is zero at inception
- No change in counterparty credit risk
- Critical terms must be checked at each effectiveness testing date

Because FASB expanded hedging strategies to include changes in a contractually specified component, some flexibility was needed to prevent automatic dedesignation if the hedged risk changes. FASB concluded that in a cash flow hedge of a forecasted transaction, an entity's expectation about the terms of the transaction as established at hedge inception may change during the forecast period, but the forecasted transaction may remain **probable** of occurring and the hedging relationship may remain highly effective based on the revised terms.

In assessing whether the qualifying criteria for the critical terms match method are met for a group of forecasted transactions, an entity may assume that the hedging derivative matures at the same time as the forecasted transactions if both the derivative maturity and the forecasted transactions occur within the same 31-day time period **or** fiscal month that captures certain to-be-announced products that have a fiscal calendar convention. By specifying a time frame, companies are spared a costly qualitative assessment (see [Appendix E](#)).

This change will make it easier to hedge a group of forecasted transactions.

Shortcut Method

The shortcut method is similar to the critical terms method but only is allowed in limited cases for interest rate swaps. Effectiveness is automatically assumed to be 100 percent between the hedged risk and the derivative (no ineffectiveness), and there is no need to perform effectiveness testing retrospectively or prospectively, which saves significant time. The following items must be met before this method can be used:

- Notional amount must match between the swap and hedged item
- Fair value of the swap is zero at inception
- Fixed rate on the swap, the index used for determining the floating rate and any spread adjustment (if any) must remain the same over the life of the swap
- No embedded options, *e.g.*, prepay option

The incorrect use of the shortcut method frequently results in costly financial statement restatements. ASU 2017-12 provides relief when an entity determines that the shortcut method should not have been applied, but the hedging relationship was and remains highly effective. If an entity elects to apply the shortcut method, and at some point during the life of the hedging relationship the entity determines that use of the method was not or no longer is appropriate, it may apply a long-haul method of accounting if both conditions are met:

- The entity documented at hedge inception which quantitative method it would use to assess effectiveness and measure hedge results if the shortcut method was not or no longer is appropriate during the life of the hedging relationship.
- The hedging relationship was highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk for the periods in which the shortcut criteria were not met.

There are a couple of situations when the shortcut method would not be applicable at a date after hedge inception:

- An entity did not meet the shortcut method criteria at inception of the hedging relationship because all of the terms of the hedging relationship required to be matched were not. In this case, an entity should perform quantitative assessments of effectiveness for all periods since hedge inception.
- An entity met all shortcut criteria at hedge inception, but a term of the hedged item or hedging instrument changed after hedge inception that prevented the shortcut method criteria from being met from that point forward. In this situation, quantitative assessments of effectiveness should be performed only for the periods in which a term of the hedging instrument or hedged item changed that resulted in the shortcut criteria no longer being met. However, if an entity is unable to identify the period in which the shortcut criteria ceased to be met, it is required to perform quantitative effectiveness assessments for all periods since hedge inception. FASB concluded that the terms of the hedged item and hedging instrument used to perform the assessment of effectiveness should be those existing as of the date that the shortcut criteria ceased to be met.

These changes make it less likely that a misapplication of the shortcut method for a highly effective hedge will result in restated financials, compared to current GAAP – a mismatch between the change in the fair value of the hedging instrument and the hedged item attributable to the hedged risk, as assessed under the specified quantitative method, likely will be immaterial to each prior reporting period and in the aggregate.

The shortcut method **cannot** be applied to any of the following hedging relationships:

- Those hedging interest rate risk that involve hedging instruments other than interest rate swaps

- For fair value hedges, those that involve hedged risks other than the risk of changes in fair value attributable to changes in the designated benchmark interest rate
- For cash flow hedges, those that involve hedging relationships in which the contractually specified interest rate of a recognized interest-bearing asset or liability does not match the interest rate index of the variable leg of the interest rate swap
- Those that do not involve a recognized interest-bearing asset or liability
- A cash flow hedge of a forecasted transaction, even if an entity determines that all critical terms of the hedging instrument and the hedged forecasted transaction are matched

Excluded Components

Recognition

Currently, companies are allowed to exclude changes in fair value related to time value, *i.e.*, option premiums and forward points from the assessment of hedge effectiveness. If an entity elects to exclude those components, their changes in value must be recognized currently in earnings. Topic 815 is silent on income statement presentation of these excluded components.

ASU 2017-12 offers a new accounting election for recognition of excluded components. Entities would be permitted to use a systematic and rational method to amortize the initial value of an excluded component into earnings over the life of the hedging instrument. If elected, any difference between the change in fair value of the excluded component and amounts recognized under the systematic and rational method is recognized in OCI. The standard also allows, as an accounting policy election, to apply a mark to market through earnings approach. For fair value and cash flow hedges, an entity should present amounts related to excluded components that are recognized in earnings in the same income statement line item that is used to present the earnings effect of the hedged item. For net investment hedges, the amendments do not specify a required presentation for excluded components.

Recognition of Excluded Components				
Method	Current GAAP	ASU 2017-12	Recognition & Measurement	I/S Presentation
Amortization			Excluded component measured at fair value. Initial value of excluded component recognized in earnings through a systematic and rational approach over the hedging instrument's life. Accumulated OCI is adjusted each period for the difference between the change in fair value of the excluded component and the amount remaining in OCI	Fair value and cash flow hedges, presentation in same income statement line item as hedged item (maybe multiple line items).
Mark to Market			Excluded component measured at fair value. Initial value of excluded component recognized in earnings through periodic changes in fair value	For net investment hedges, no presentation guidance

Derecognition

When a hedging relationship is discontinued and an amortization approach is used, the changes in fair value of excluded components recorded in accumulated OCI would be released to earnings consistent with existing GAAP for each respective type of hedging relationship, specifically:

- For a cash flow hedge in which the hedged forecasted transaction is still probable of occurring, at the time that the hedged forecasted transaction affects earnings
- For a fair value hedge, consistent with how fair value hedge basis adjustments are recognized in earnings for the related hedged item

Disclosure is required for the difference between the change in fair value of an excluded component and the initial value of that excluded component recognized in earnings under a systematic and rational method.

Cross-Currency Basis Spread

The cross-currency basis spread is a component used in the valuation of cross-currency basis swaps. It is the liquidity premium of one currency over the other that is added to the floating rate of one of the legs of the swap. ASU 2017-12 adds cross-currency basis spread to the list of excluded components for assessing hedge effectiveness. Currently, companies are only allowed to exclude changes in fair value related to time value (option premiums and forward points). This will benefit a company issuing fixed-rate debt in a foreign currency that uses a cross-currency swap to convert it back to floating functional currency debt.

Recognition & Presentation

ASU 2017-12 updates both measurement and presentation guidance to better align the recognition and reporting of the effects of the hedging instrument with the hedged item. Current GAAP provides special hedge accounting only for the hedge portion deemed to be “highly effective” and requires an entity to separately reflect the amount by which the hedging instrument does not offset the hedged item, which is referred to as the “ineffective” amount. This is difficult for financial statement users to understand and for preparers to explain. Under the new guidance, for qualifying fair value, cash flow and net investment hedges, entities would no longer separately measure and report hedge ineffectiveness. In addition, an entity would report the entire effect of the hedging instrument in the same income statement line item in which the earnings effect of the hedged item is reported.

ASU 2017-12 does not prescribe income statement presentation for cash flow hedges with a missed forecast, in which the hedged forecasted transaction is probable of not occurring. GAAP is retained for net investment hedges that do not prescribe presentation of excluded components because presenting those amounts together with the earnings effect of the hedged item in a net investment hedge could result in presentation in a line item such as “gain or loss on the sale of subsidiary.” However, the sale or liquidation of a subsidiary may not have occurred in the current period, may not occur within a reasonable time period or may not occur at all.

Financial institutions noted that net interest income and net interest margin are key performance indicators used internally and externally, and these amendments could distort these widely used metrics.

ASU 2017-12 Presentation & Measurement Summary			
Item	Type of Hedge		
	Net Investment	Cash Flow	Fair Value
Ineffectiveness measurement	Changes in included component's fair value in OCI, recognize when hedged item affects earnings		Current profit and loss
Included component presentation	Same income statement line item as hedged item		
Excluded component presentation	Not specified	Same income statement line item as hedged item	

Disclosures

The objectives of current derivative disclosure requirements remain unchanged. They enable users of an entity's financial statements to understand the following:

- How and why an entity uses derivative instruments (and nonderivative hedging instruments)
- How an entity accounts for its derivative instruments (and nonderivative hedging instruments) and related hedged items
- How derivative instruments (and nonderivative hedging instruments) and related hedged items affect an entity's financial position, financial performance and cash flows

The amendments would modify some current disclosures, most notably revising the tabular disclosure for fair value and cash flow hedges to focus on the effect of hedge accounting on income statement line items and eliminating the requirement to disclose ineffectiveness. Entities would be required to disclose the cumulative basis adjustment of fair value hedges, in addition to the current period amount. Certain additional disclosures are required for hedge relationships designated under the last-of-layer method.

Last of Layer

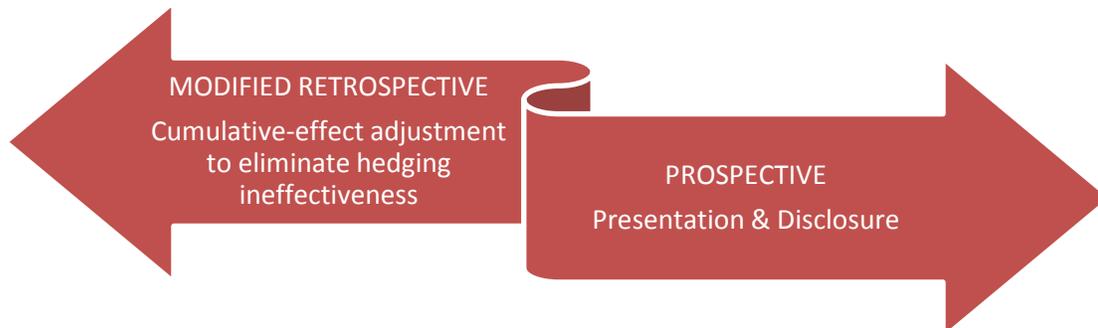
An entity is required to disclose the carrying amount of the hedged assets or liabilities, which allows it to disclose the amortized cost basis of the closed portfolio(s) linked to last-of-layer method hedging relationships or the hedged item for non-last-of-layer method hedging relationships. Given the unique nature of the last-of-layer method, the following information is required to be disclosed separately:

- The amortized cost basis of the closed portfolio(s) of prepayable financial assets or the beneficial interest(s)
- The amount that represents the hedged item(s), *i.e.*, the designated last of layer
- The basis adjustment associated with the hedged item(s), *i.e.*, the designated last of layer

Transition Disclosures

An entity shall provide the required disclosures within Topic 250 on accounting changes and error corrections, including the nature of and reason for the change in accounting principle and the cumulative effect of the change on the opening balance of each affected financial statement line item.

Transition



The amendments related to presentation and disclosure would be applied prospectively. All other changes should be applied on a modified retrospective basis with a cumulative-effect adjustment to the opening balance of retained earnings. Entities would apply the guidance to all hedging relationships existing on the adoption date, including hedging relationships in which the hedging instrument has not expired or been sold, terminated or exercised or the entity has not removed the designation of the hedging relationship.

Transition Elections

Certain **one-time** elections are offered to allow entities to apply these amendments to existing hedging relationships. For private companies that are not financial institutions and NFPs that have not issued—or are a conduit bond obligor for—securities that are traded, listed or quoted on an exchange or an over-the-counter market, the transition elections shall be determined before the next interim or annual financial statements are available to be issued. For all other entities, the elections above shall be determined before the first quarterly effectiveness assessment date after the adoption date.

Fair Value Hedges

Interest Rate Risk

- An entity may modify the measurement methodology for a prepayable financial instrument or partial-term hedge without dedesignation of the hedging relationship. When making this election, the benchmark rate component of the contractual coupon cash flows shall be determined as of the hedging relationship's original inception date. The cumulative effect of applying this election shall be recognized as an adjustment to the basis adjustment of the hedged item recognized on the balance sheet with a corresponding adjustment to the opening balance of retained earnings as of the initial application date. If the change in the measurement methodology is based on the benchmark rate component of the contractual coupon cash flows, an entity may elect to dedesignate a portion of the hedged item and reclassify the basis adjustment associated with the portion of the hedged item dedesignated to the opening balance of retained earnings as of the initial application date.

Currency Risk

- For existing fair value hedges in which FX risk is the hedged risk or one of the hedged risks and a currency swap is the hedging instrument, an entity may, without dedesignation, modify its hedge documentation to exclude the cross-currency basis spread component of the currency swap from the assessment of hedge effectiveness and recognize the excluded component through an amortization approach. The cumulative effect of applying this election shall be recognized as an adjustment to accumulated OCI with a corresponding adjustment to the opening balance of retained earnings as of the initial application date.

Excluded Components

An entity may modify the recognition model for the excluded component from a mark-to-market approach to an amortization approach without dedesignation of the hedging relationship. The cumulative effect of applying this election shall be recognized as an adjustment to accumulated OCI with a corresponding adjustment to the opening balance of retained earnings as of the initial application date.

Hedge Documentation

An entity may modify documentation without dedesignating an existing hedging relationship for the following:

- Switch from quantitative to qualitative assessment for subsequent prospective and retrospective effectiveness assessments
- Update documentation for the shortcut method to include which long-haul method it would use if the use of the shortcut method was not or no longer is appropriate

Cash Flow Hedges

For existing cash flow hedges in which the hedged risk is designated as the variability in total cash flows that meet the requirements to designate as the hedged risk the variability in cash flows attributable to changes in a contractually specified component or contractually specified interest rate, an entity may:

- Modify the hedging relationship, without dedesignation, to specify the hedged risk is the variability in the contractually specified component or contractually specified interest rate
- Create the terms of the instrument used to estimate changes in the value of the hedged risk in the assessment of effectiveness on the basis of market data as of the inception of the hedging relationship

Held-to-Maturity – Available-for-Sale Classification

An entity may reclassify a debt security from held-to-maturity (HTM) to available-for-sale (AFS) if the debt security is eligible to be hedged under the last-of-layer method. Any unrealized gain or loss at the date of the transfer shall be recorded in accumulated OCI.

Frequently financial institutions classify beneficial interests in the HTM category rather than AFS because the collateral's prepayment features make fair value hedge accounting difficult to obtain. With the introduction of the last-of-layer method, applying the fair value hedging model for beneficial interests will be less burdensome. This will benefit financial institutions.

Other Transition Guidance

SIFMA

If an entity is hedging the total price risk of a tax-exempt security and wishes to designate SIFMA in a benchmark hedge of interest rate risk, it would need to dedesignate and immediately redesignate the hedging relationship. Transition relief is provided so that an entity would not have to carry forward the basis adjustment from the dedesignated relationship (a hedge of total price risk) into the redesignated relationship (a hedge of the changes in fair value attributable to changes in the benchmark interest rate). The cumulative basis adjustment would be amortized to earnings on a level-yield basis over the life of the hedge.

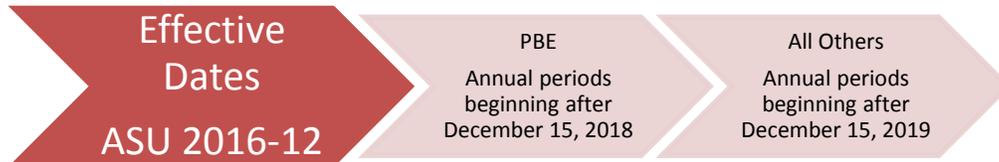
Similar Assets Test

The standard provides relief so that an entity is not required to apply the “similar” guidance when comparing hedging relationships executed before and after the adoption date for any of the following:

- Amending documentation elections for the shortcut method

- Designating the hedge risk as the variability in cash flows attributable to changes in a contractually specified component or interest rate
- Electing an amortization approach for excluded components

Effective Date



The amendments will be effective for public business entities for fiscal years beginning after December 15, 2018, and interim periods therein. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020. Entities may early adopt as of the standard's issuance date.

BKD can help entities prepare for the new standard by identifying key changes that may have the most effect on existing hedges, assessing potential new hedging strategies and determining transition election and timing.

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Appendix A – Variable Price Component of a Purchase Contract as Hedged Item

An entity enters into a contract that requires it to pay a total contract price based on the VWX sugar index on the purchase date plus a variable basis differential related to transportation costs. The entity may use a derivative instrument whose underlying is the price of sugar or any other underlying for which the derivative would be highly effective in achieving offsetting cash flows in a cash flow hedge of its forecasted purchases under the contract. The entity may designate as the risk being hedged the risk of changes in the cash flows relating to all changes in the purchase price of the items being acquired under the contract. The entity also may designate the variability in cash flows attributable to changes in the contractually specified component (VWX sugar index) as the hedged risk. In both scenarios, the entity must determine that all the criteria for cash flow hedges are satisfied, including that the hedging relationship is highly effective in achieving offsetting cash flows attributable to the hedged risk during the term of the hedge.

Appendix B – Contractually Specified Component in a Not-Yet-Existing Contract

Entity A's objective is to hedge the variability in cash flows attributable to changes in a contractually specified component in forecasted purchases of a specified quantity of soybeans on various dates during June 20X1. Entity A has executed contracts to purchase soybeans only through the end of March 20X1. Entity A's contracts to purchase soybeans typically are based on the ABC soybean index price plus a variable basis differential representing transportation costs. Entity A expects that the forecasted purchases during June 20X1 will be based on the ABC soybean index price plus a variable basis differential.

On January 1, 20X1, Entity A enters into a forward contract indexed to the ABC soybean index that matures on June 30, 20X1. The forward contract is designated as a hedging instrument in a cash flow hedge in which the hedged item is documented as the forecasted purchases of a specified quantity of soybeans during June 20X1. As of the date of hedge designation, Entity A expects the contractually specified component that will be in the contract once it is executed to be the ABC soybean index. Entity A documents as the hedged risk the variability in cash flows attributable to changes in the contractually specified ABC soybean index in the not-yet-existing contract. On January 1, 20X1, Entity A determines that all requirements for cash flow hedge accounting are met and that the other requirements will be met in the contract once executed.

As part of its normal process of assessing whether it remains probable that the hedged forecasted transactions will occur, on March 31, 20X1, Entity A determines that the forecasted purchases of soybeans in June 20X1 will occur but that the price of the soybeans to be purchased will be based on the XYZ soybean index rather than the ABC soybean index. As of March 31, 20X1, Entity A begins assessing the hedge effectiveness of the hedging relationship on the basis of the changes in cash flows associated with the forecasted purchases of soybeans attributable to variability in the XYZ soybean index. Because the hedged forecasted transactions, *i.e.*, purchases of soybeans, are still probable of occurring, Entity A may continue to apply hedge accounting if the hedging instrument (indexed to the ABC soybean index) is highly effective at achieving offsetting cash flows attributable to the revised contractually specified component (the XYZ soybean index). On April 30, 20X1, Entity A enters into a contract to purchase soybeans throughout June 20X1 based on the XYZ soybean index price plus a variable basis differential representing transportation costs.

If the hedging instrument is not highly effective at achieving offsetting cash flows attributable to the revised contractually specified component, the hedging relationship must be discontinued. As long as the hedged forecasted transactions, *i.e.*, the forecasted purchases of the specified quantity of soybeans, are still probable of occurring, Entity A would reclassify amounts from accumulated OCI to earnings when the hedged forecasted transaction affects earnings. The reclassified amounts should be presented in the same income statement line item as the earnings effect of the hedged item. Immediate reclassification of amounts from accumulated OCI earnings would be required only if it becomes probable that the hedged forecasted transaction *i.e.*, the purchases of the specified quantity of soybeans in June 20X1, will not occur.

A pattern of determining that hedged forecasted transactions are probable of not occurring would call into question both an entity's ability to accurately predict forecasted transactions and the propriety of applying cash flow hedge accounting in the future for similar forecasted transactions.

Appendix C – Documentation When the Critical Terms of the Hedging Instrument & Hedged Forecasted Transaction Match

On January 1, 20X1, Entity A, a U.S. dollar (USD) functional currency entity, executes a forward contract to hedge a portion of its exposure to Canadian dollar- (CAD) denominated forecasted sales expected to occur in December 20X1. Entity A determines that all the critical terms of the hedging instrument and hedged forecasted transaction match. It documents the hedging relationship concurrently with the execution of the forward contract as follows:

- Risk management objective: To hedge against movements in the USD/CAD exchange rate that will affect the USD value of future CAD sales
- Hedged forecasted transaction: The first CAD 500,000 sales in December 20X1
- Hedging instrument: FX forward contract to sell CAD 500,000 and receive USD 400,000 on December 31, 20X1. The fair value of the forward contract at hedge inception is zero.
- Method of assessing hedge effectiveness: Entity A will assess the effectiveness on a qualitative basis at hedge inception. The critical terms of the hedging instrument and hedged forecasted transaction can be considered to match because the notional amounts and underlyings of the hedging instrument and hedged forecasted transaction are the same and the forecasted sales are expected to occur in the same fiscal month as the maturity date of the hedging instrument. Therefore, the hedge is expected to be perfectly effective. Subsequent assessments of effectiveness will be performed by verifying and documenting whether the critical terms of the hedging instrument and hedged forecasted transaction have changed during the period in review and whether it remains probable that the counterparty to the hedged item and hedged forecasted transactions will not default. If there are no such changes in critical terms or counterparty credit risk, Entity A will continue to conclude that the hedging relationship is perfectly effective.

Appendix D – Effectiveness of Cash Flow Hedge of a Forecasted Purchase of Inventory with a Forward Contract

Assume the entity elected to perform subsequent quarterly hedge effectiveness assessments on a quantitative basis and all hedge documentation requirements were satisfied.

Entity G forecasts the purchase of 500,000 pounds of Brazilian coffee for U.S. dollars in six months. The agreement outlining purchase terms between Entity G and its supplier contains a contractually specified component referencing a Brazilian coffee index denominated in U.S. dollars. Entity G designates the variability in cash flows related to its forecasted purchase of Brazilian coffee attributable to changes in the contractually specified component (Brazilian coffee index) as the hedged risk. Rather than acquire a derivative instrument based on Brazilian coffee, Entity G enters into a six-month forward contract to purchase 500,000 pounds of Colombian coffee for U.S. dollars and designates the forward contract as a hedging instrument in a cash flow hedge of the variability in cash flows attributable to changes in the contractually specified Brazilian coffee index component of its forecasted purchase of Brazilian coffee.

Entity G bases its assessment of hedge effectiveness and measure on changes in forward prices, with the resulting gain or loss discounted to reflect the time value of money. Both at inception and on an ongoing basis, Entity G could assess the effectiveness of the hedge by comparing changes in the expected cash flows from the Colombian coffee forward contract with the expected net change in cash outflows attributable to changes in the contractually

specified component for purchasing the Brazilian coffee for different market prices. (A simpler method that should produce the same results would consider the expected future correlation of the prices of Brazilian and Colombian coffee, based on the correlation of those prices over the past six-month period.)

In assessing hedge effectiveness on an ongoing basis, Entity G also must consider the extent of offset between the change in expected cash flows on its Colombian coffee forward contract and the expected net change in expected cash flows for the forecasted purchase of Brazilian coffee attributable to changes in the contractually specified component. Both changes would be measured on a cumulative basis for actual changes in the forward price of the respective coffees during the hedge period.

Because the only difference between the forward contract and forecasted purchase relates to the type of coffee (Colombian versus Brazilian), Entity G could consider the changes in the cash flows on a forward contract for Brazilian coffee to be a measure of perfectly offsetting changes in cash flows for its forecasted purchase of Brazilian coffee. For example, for given changes in the U.S. dollar prices of six-month and three-month Brazilian and Colombian contracts, Entity G could compute the effect of a change in the price of coffee on the expected cash flows of its forward contracts on Colombian and Brazilian coffee as follows:

Estimate of Change in Cash Flows

Forward price of Colombian and Brazilian coffee

	Forward Contract <u>on Colombian Coffee</u>	Forward Contract <u>on Brazilian Coffee</u>
At hedge inception—6-month price	\$ 2.54	\$ 2.43
3 months later—3-month price	\$ 2.63	\$ 2.53
Cumulative change in price—gain	\$ 0.09	\$ 0.10
× 500,000 pounds of coffee	× 500,000	× 500,000
Estimate of change in cash flows	\$ 45,000	\$ 50,000

Using the amounts above, Entity G could evaluate effectiveness three months into the hedge on its first subsequent quarterly effectiveness assessment testing date by comparing the \$45,000 change on its Colombian coffee contract with what would have been a perfectly offsetting change in cash flow for its forecasted purchase—the \$50,000 change on an otherwise identical forward contract for Brazilian coffee. Entity G concludes that the hedging relationship would be highly effective, and it would record the \$45,000 change in the fair value of the forward contract on Colombian coffee in OCI.

Appendix E – Assessing Effectiveness of a Cash Flow Hedge of a Forecasted Purchase of Inventory with a Forward Contract (Contractually Specified Component)

This example illustrates the application of the guidance in Subtopic 815-20 and this Subtopic for assessing effectiveness for a cash flow hedge of a forecasted purchase of inventory with a forward contract for which the hedged risk is variability in cash flows attributable to changes in a contractually specified component. Assume the entity elects to perform subsequent assessments of hedge effectiveness on a quantitative basis using a cumulative-dollar-offset approach and all hedge documentation requirements were satisfied at inception.

Entity J manufactures keys for door locks on buildings and cars. The keys are cut from sheets of metal called key plates. Entity J primarily purchases its key plates from Supplier 1 as needed. Supplier 1 and Entity J have an

A Deep Dive into Hedging

outstanding agreement specifying that the per-unit cost of each key plate will be determined by Supplier 1 on the first business day of each month on the basis of the following pricing formula:

- a. Spot price of COMEX Zinc per pound \times 0.2 pounds, plus
- b. Spot price of COMEX Copper per pound \times 0.1 pounds, plus
- c. The current cost of refining copper and zinc into key plates, plus
- d. The current cost of transporting the key plates to Entity J

In January 20X1, Entity J expects to purchase 100,000 key plates in July 20X1, which requires 10,000 pounds of copper for the manufacturing process. Entity J decides that it wishes to hedge only the change in value of the price of COMEX Copper used to create the key plates being purchased in July 20X1.

On January 15, 20X1, Entity J enters into a forward contract maturing on July 1, 20X1, *i.e.*, the date on which the price of copper used to manufacture the key plates is fixed, to purchase 10,000 pounds of COMEX Copper at \$2.10 per pound. Any settlement amount on the forward contract will be based on the difference between the contract price of \$2.10 per pound and the spot price of COMEX Copper on the maturity date (July 1, 20X1), multiplied by the notional amount of 10,000 pounds.

Entity J designates a cash flow hedge in which the hedging instrument is the forward contract, the hedged item is the forecasted purchase of key plates in July 20X1 and the hedged risk is the variability in the purchase price of the key plates attributable to changes in the COMEX Copper price index, which is a contractually specified component within the frame agreement. Entity J documents in its hedge documentation that the requirements to designate variability in cash flows attributable to changes in a contractually specified component as the hedged risk.

Entity J bases its assessment of hedge effectiveness on cumulative changes in the fair value of the hedging instrument and the hedged item attributable to changes in the hedged risk. In assessing hedge effectiveness on an ongoing basis, Entity J must consider the extent of offset between the change in expected cash flows on the hedging instrument (the copper forward contract) and the hedged item attributable to changes in the hedged risk (change in expected cash flows associated with forecasted purchases of key plates attributable to changes in the COMEX Copper price index). The table below illustrates the cumulative changes in the hedging instrument and hedged item attributable to changes in the hedged risk as of the first subsequent quarterly effectiveness assessment date.

Estimate of Change in Cash Flows

Forward price of copper (dollars per pound)

	Hedging <u>Instrument</u>	Hedged Item Due to <u>Fluctuation in Hedged Risk</u>
At hedge inception (Jan 15, 20X1)	\$ 2.10	\$ 2.10
At first subsequent assessment date (March 31, 20X1)	\$ 2.25	\$ 2.25
Change in forward price of copper	\$ 0.15	\$ 0.15
Cumulative change in copper (per pound) \times 10,000 pounds	\$ 1,500	\$ 1,500

Entity J could assess effectiveness as of March 31, 20X1, by comparing the \$1,500 change in the hedging instrument with the \$1,500 change in the hedged item attributable to changes in the hedged risk because the hedging instrument's maturity date and the date on which the price of copper will be fixed match, *i.e.*, July 1, 20X1.