FINANCIAL ACCOUNTING STANDARDS BOARD

Staff Interpretations of Technical Inquiries Received on Update 2017-12 Discussed at the September 5, 2018 Board Meeting

Issue 1: Switching Hedge Effectiveness Assessment Methods for Net Foreign Investment Hedges

1. In Accounting Standards Update No. 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*, the Board made a technical correction that clarifies that entities are permitted to change the method of assessing effectiveness for a net investment hedge under Subtopic 815-35, Derivatives and Hedging—Net Investment Hedges. A stakeholder inquired whether an entity may change from the forward method to the spot method, or vice versa, after the transition to the amendments of the Update.

2. The staff communicated to the inquirer that the Board's intent through the amendment in the Update was to allow an entity to switch methods of assessing effectiveness for net investment hedges at transition or in any subsequent period. However, the staff notes that an entity will have to meet the requirements in paragraphs 815-20-55-55 through 55-56 and demonstrate that the revised effectiveness assessment method is an improved method in accordance with paragraph 815-20-35-19.

Issue 2: Timing of Initial Quantitative Hedge Effectiveness Assessment

3. The amendments in the Update allow an entity more time to perform the initial quantitative hedge effectiveness assessment; a list of earliest dates by which that assessment must be completed is provided in paragraph 815-20-25-3(b)(2)(iv)(02). A stakeholder inquired when an entity that hedges groups of forecasted transactions occurring during a range of time using a derivative that settles on a single date should complete the initial prospective quantitative hedge effectiveness assessment. The stakeholder provided its interpretation of the guidance that an entity should be required to complete the initial prospective quantitative hedge effectiveness assessment before the first forecasted transaction in the group of forecasted transactions occurs.

4. The staff agreed with the inquirer and believes that it was the Board's intent that the initial prospective quantitative assessment of hedge effectiveness required for a cash flow hedge of a group of forecasted transactions be completed before the first forecasted transaction occurs.

Issue 3: Simultaneous Designation of Hedged Item for Fair Value and Cash Flow Hedges

5. A stakeholder inquired whether an entity is permitted to simultaneously designate the same hedged item in a fair value hedge and a cash flow hedge if hedging different risk components. The stakeholder provided an example of a hedging strategy that an entity may want to employ related to Treasury Inflation-Protected Securities (TIPS), which are debt obligations issued by the U.S. Treasury that provide an investor with protection against inflation. The dollar amount of semiannual interest payments on TIPS varies and is calculated based on the fixed-rate coupon and the inflation-adjusted principal that fluctuates based on an inflation index. The stakeholder asked if an entity can designate the fixed-rate component in a fair value hedge of interest rate risk, and, if so, how the entity would define the benchmark component of the contractual coupon payment of the TIPS. The stakeholder also asked if an entity could simultaneously designate the variability associated with inflation on the interest coupon payments and the final principal payment in a cash flow hedge.

6. The staff believes that these securities are variable-rate financial instruments, and, therefore, an entity is allowed to designate only the variability in a contractually specified interest rate or overall cash flows as the hedged risk in a cash flow hedge. An entity cannot separately designate the benchmark rate component of the fixed-rate coupon as the hedged risk in a fair value hedge. The fixed-rate component and the variable-rate inflation index must be considered together as the contractually specified interest rate of the financial instrument. Furthermore, the guidance in paragraph 815-20-55-62A prohibits carving out an implied fixed rate in a variable interest rate.

Issue 4: Sale or Transfer of Assets out of a Closed Portfolio in a Last-of-Layer Hedge

7. The amendments in the Update allow an entity to hedge closed portfolios of prepayable financial assets and beneficial interest(s) secured by prepayable financial instruments in fair value hedges of interest rate risk under the last-of-layer method. Stakeholders asked how to interpret the term *closed portfolio* for purposes of applying the last-of-layer method. Specifically, stakeholders questioned whether an entity may voluntarily remove, by sale or transfer, prepayable financial assets from the closed portfolio without having to discontinue the existing hedging relationship.

8. The staff believes the Board's intent was to allow entities to voluntarily remove assets from the closed portfolio of which an amount is designated as the hedged item in a last-of-layer hedging relationship. Additionally, the discussion in paragraph BC121(a) of the Update demonstrates the Board's intent to allow the sale of a financial asset out of the closed portfolio without requiring dedesignation. The staff sees no substantive difference between a

reduction in the closed portfolio because of a sale or voluntary transfer of assets out of the portfolio.

9. At its March 28, 2018 Board meeting, the Board decided to add a new short-term project to its technical agenda to address implementation issues regarding the last-of-layer method, including whether multiple layers may be designated as hedged items and how to account for the fair value hedge basis adjustments resulting from last-of-layer hedging relationships in certain circumstances. The staff plans to add clarifying guidance on how the term *closed portfolio* should be interpreted as part of that project. However, entities currently applying or intending to apply the last-of-layer method before the issuance of any amendments to the last-of-layer method are not precluded from selling or transferring assets out of a last-of-layer pool.

Issue 5: Documentation of Fallback Long-Haul Hedge Effectiveness Assessment Method

10. In the Update, if an entity that applies the shortcut method determines that using that method was not or no longer is appropriate, the entity may apply a long-haul method for assessing effectiveness if the hedge is highly effective and the entity documents at inception which long-haul method it will use in those circumstances. Stakeholders inquired whether an approach consistent with that for the misapplication of the shortcut method can be applied when an entity subsequently determines that it no longer can apply a critical-terms-match method to a hedging relationship. Those stakeholders stated that the current guidance is unclear on how to account for the misapplication of a critical-terms-match method.

11. The staff believes that paragraph 815-20-35-12 clearly allows an entity to assess the effectiveness of a hedging relationship using a long-haul method when the critical terms change or adverse developments regarding the risk of counterparty default occur. Because the amendments in the Update did not meaningfully change the guidance concerning the misapplication of a critical-terms-match method, the staff believes that entities should retain their current practice for accounting for those scenarios.

Issue 6: Change in Hedged Risk Guidance for a Cash Flow Hedge of Forecasted Issuance of Fixed-Rate Debt

12. The amendments in the Update provide entities with relief such that an entity may retain hedge accounting when the hedged risk in a cash flow hedge of a forecasted transaction changes and the derivative designated as the hedging instrument remains highly effective. Additionally, under previous and amended GAAP, entities are allowed to designate the variability in a benchmark rate in a hedge of the forecasted issuance of a fixed-rate financial instrument as discussed in paragraph 815-20-25-19A(a).

13. A stakeholder asked if an entity could maintain hedge accounting under the change in hedged risk guidance when changing the hedged risk associated with its borrowing program from the variability in cash flows on a floating-rate debt instrument caused by changes in a contractually specified interest rate to the benchmark rate component of a forecasted issuance of a rolling series of fixed-rate debt instruments. The interest rate coupon on the rolling series of fixed-rate debt instruments would be reset with each new issuance. Taken individually, both the hedge of the floating-rate debt instrument's contractually specified interest rate and the benchmark component of a forecasted fixed-rate debt issuance qualify for cash flow hedging. The stakeholder indicated that if this strategy was permitted, the hedged contractually specified interest rate of the floating-rate debt instrument could match the benchmark rate designated as the hedged risk in the revised hedging relationship of the forecasted issuance of the rolling series of fixed-rate debt instruments (for example, both the contractually specified rate of the floating-rate debt instrument and the benchmark rate on the rolling series of fixed-rate debt instruments could be designated as LIBOR).

14. The staff believes that the change in hedged risk guidance should not be applied in conjunction with the guidance in paragraph 815-20-25-19A(a). The change in hedged risk guidance does not encompass allowing an entity to recharacterize its borrowing during the hedging relationship from a variable-rate instrument to a series of fixed-rate debt instruments and then to amend the designation to the variability of a benchmark rate component as the hedged risk. If the entity did so, it would have to cease hedge accounting at each interest rate reset date because at the point of each reset the variability in cash flows of the forecasted issuance of fixed-rate debt is eliminated. Thus, the entity could not continue hedge accounting as proposed. However, the staff informed the stakeholder that an entity could treat the rolling series of fixed-rate instruments as a variable-rate instrument (as demonstrated in paragraph 815-30-55-54) and designate the hedged risk as the variability in the contractually specified interest rate or all of the cash flows related to the revised variable rate, not just a benchmark component of those variable cash flows as proposed.

Issue 7: Reclassification of Prior Period Information

15. In the Update, the Board decided to change the recognition and presentation guidance for hedge accounting to increase the understandability of the financial statement results of an entity's hedging strategies. Stakeholders inquired whether comparative financial information from periods before the adoption of the Update may be reclassified to conform to the new presentation requirements in the Update.

16. The staff believes that entities may choose, but are not required, to conform pre-adoption financial statement presentation to post-adoption presentation. The staff believes that this issue relates to an entity's financial statement presentation policies, which it may amend at any time.