Derivatives: Back to Basic/New Standard

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Today’s agenda

► Overview of ASC 815
► Overview of ASU 2017-12
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Derivative accounting

What is a derivative?

ASC 815 defines a derivative as a financial instrument that has all of the following characteristics:
1) One or more underlyings and notional amounts,
2) Requires little or no initial net investment, and
3) Requires or permits net settlement
Scope exceptions
Normal purchase and normal sale

- Typical purchase and sale of commodities, inventories and supplies, may not need to be accounted for as derivative instruments under ASC 815
- NPNS is a one-time election that must be applied consistently across contract types
- Must be consistent with the terms of the entity’s normal purchases and normal sales
- Quantity must be reasonable in relation to the entity’s business needs
- Must not settle net and result in physical delivery
Derivative accounting

► Accounting treatments:

► Non-Designated Hedge – “Mark to Market” with all gains and losses going through current earnings (Default treatment if hedge accounting is not elected – economic hedge).

► Fair Value Hedge – Gain/loss on the derivative is offset by the gain/loss on the hedged item for changes in the hedged risk.

► Cash Flow Hedge – The effective portion of the gain/loss on the derivative is recognized in OCI and reclassified into earnings in the periods during which the hedged transactions affect earnings.
Permissible hedged items

- An exposure that could affect reported earnings
- Cannot be related to an asset, liability or forecasted transaction that is or subsequently re-measured with the changes in fair value reported in earnings
- For a non-financial asset or liability or a forecasted purchase or sale of a non-financial asset, the designated risk being hedged must be the risk of changes in fair value or cash flows of the entire hedged asset or liability (except foreign currency risk)
ASU 2017-12
Overview

- Targeted amendments that enable entities to better portray the economics of risk management activities in their financial statements
  - Also simplifies certain aspects of hedge accounting

- Amendments are intended to:
  - Expand risks that are eligible to be hedged
  - Provide users with better insight into hedging strategies and their effectiveness
  - Reduce the complexity of applying hedge accounting

- Effective date
  - Public business entities — fiscal years beginning after 15 December 2018 and interim periods therein
  - Early adoption permitted in any interim or annual period
Guidance in ASC 815 not related to hedge accounting (e.g., definition of a derivative, bifurcation of embedded derivatives)

Types of hedge accounting relationships (i.e., cash flow hedges, fair value hedges, net investment hedges)

Requirement to assess hedge effectiveness prospectively and retrospectively

Existing methods to qualitatively assess hedge effectiveness (i.e., shortcut, critical terms match, simplified hedge accounting approach)

“Highly effective” threshold

Requirement to contemporaneously document hedging relationships

Ability for entities to voluntarily discontinue hedge accounting

ASU 2017-12
What’s staying the same?
ASU 2017-12
Key changes to hedge accounting model
Further aligns the timing of earnings recognition and income statement presentation of the hedging instrument with the hedged item.

In part this is accomplished by eliminating the need to separately measure and report hedge ineffectiveness.

Does not mean hedges are perfectly effective.

Timing of when change in fair value of hedging instrument is recognized in earnings.

Cash flow and net investment hedges – record entire change included in the assessment of hedge effectiveness in other comprehensive income (OCI) or currency translation adjustment section of OCI and reclassify when the hedged item affects earnings.

Fair value hedges – recognize in earnings every period (i.e., no change).
Presentation of change in FV of hedging instrument

- For all hedges, the *entire* effect of the hedging instrument included in the assessment of hedge effectiveness will be presented in the income statement line item affected by the hedged item
- When the earnings effect associated with the hedged item is reported in multiple line items (e.g., foreign denominated financial instrument), the change in fair value of the hedging instrument would be split and reported in the corresponding line items
- No separate presentation for “ineffective” portion of hedge
- Increases transparency and reduces diversity in practice

No presentation guidance provided for amounts released from OCI due to a forecasted transaction becoming probable of not occurring
ASU 2017-12
Hedging nonfinancial risk components

► Allows entities to hedge nonfinancial risk components in cash flow hedges of forecasted transactions

► Contractually specified nonfinancial components (i.e., index or price) may be designated as a hedged risk in existing contracts and those the entity expects to execute

► Normal purchases/normal sales scope exception must be applied to agreements that meet the definition of a derivative

► Previously, entities generally required to hedge total price risk of a forecasted purchase/sale of nonfinancial items
Entities can hedge contractually specified components in a not-yet-existing contract if the component is expected to be specified in the executed contract.

If a different component is ultimately specified in the contract, the entity is not required to automatically dedesignate the hedging relationship as long as hedge remains highly effective.

Guidance on change in designation of hedge risk applies broadly to all hedging relationships, not just nonfinancial risks.

Requirement that a hedge be dedesignated and redesignated in order to change any critical terms of the relationship was amended to exclude changes to the hedged risk.
ASU 2017-12
Hedging financial risk components

Prior to ASU 2017-12

Variable and fixed-rate financial instruments

- U.S. Treasury rate
- Overnight index swap rate (OIS)
- LIBOR swap rate

After ASU 2017-12

Variable-rate financial instruments

- Any contractually specified interest rate

Fixed-rate financial instruments

- U.S. Treasury rate
- OIS
- LIBOR swap rate
- SIFMA municipal swap rate
ASU 2017-12
Excluded components – what can be excluded

Prior to ASU 2017-12
- Change in fair value included in hedging relationship
- Time value of option
- Forward points

After ASU 2017-12
- Change in fair value included in hedging relationship
- Time value of option
- Forward points
- Cross-currency basis spread

Entity can elect to exclude from hedging relationship
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Excluded components – recognition and presentation

- Amortization approach is default recognition model
  - Initial value of excluded component amortized into earnings using systematic/rational method
  - Difference between change in fair value of the excluded component and amount amortized for period is recorded in OCI
  - Entity can make a policy election to recognize on a mark-to-market basis

- Presentation requirements
  - Cash flow and fair value hedges – present in the income statement line affected by the hedged item
  - Net investment hedges – no presentation guidance provided
Consistent with legacy GAAP, non-zero FV derivatives will not be perfectly effective hedges, however the recognition pattern of the off-market component will change.

Amounts related to the initial FV that are recorded in OCI during the hedging relationship are reclassified to earnings on a systematic and rational basis.

Multiple approaches may be acceptable as no specific application guidance.

Over the life of the hedging relationship the total amount recognized in earnings will be the same, however, different approaches will lead to different recognition patterns.
ASU 2017-12
Hedge documentation and effectiveness testing

► Public companies will generally have until the end of the quarter to complete the quantitative testing portion of initial hedge documentation requirements
  ► All other documentation requirements will continue to be required contemporaneously, including a description of how the hedging relationship will be assessed
► Quantitative effectiveness testing continues to be required at inception (unless relationship qualifies for the critical terms match, shortcut, or simplified hedge accounting method)
► Subsequent hedge effectiveness testing can be performed qualitatively unless “facts and circumstances change” to an extent that the entity cannot qualitatively assert hedge was, and continues to be, highly effective
  ► Election to perform subsequent hedge effectiveness assessments qualitatively must be documented at hedge inception, along with how this assessment will be performed
  ► Applies to hedging relationships that are not assumed to be perfectly effective, but entity must be able to reasonably support at hedge inception an expectation of high effectiveness on a qualitative basis
  ► May require entities to modify or implement new controls and processes to monitor changes in facts and circumstances
Revised tabular disclosures

- Increases quantitative disclosures that must be shown in tabular form
- Separately disclose the effect of hedging instrument and hedged item on each income statement line item

Excluded components

- Amounts recognized in OCI during the period when amortization approach used
- Portion of gains and losses recognized in earnings during the period split between amortization approach and mark-to-market

Cumulative amount of fair value hedge adjustments

- Split between existing and discontinued hedging relationships
- Does NOT apply to fair value hedges of FX risk
ASU 2017-12
Transition

► Application of new guidance generally applied on a modified retrospective basis
  ► Cumulative-effect adjustment reflected as of beginning of fiscal year for hedging relationships existing on date of adoption
    ► For existing cash flow and net investment hedges adjustment relates to hedge ineffectiveness that was previously recognized in earnings
    ► Transition adjustment is reclass between AOCI and beginning retained earnings

► New presentation requirements and new and modified disclosure requirements applied prospectively

► Early adoption permitted in any interim or annual period
  ► Adoption other than as of the beginning of a fiscal year may be more complex
ASU 2017-12
Fair value hedges of interest rate risk

► Additional flexibility provided in measuring the change in the fair value of the hedged item under the long-haul method:
  ► Measure the changes in fair value of the hedged item using only the portion of the contractual cash flows related to the benchmark rate, not the entire coupon
  ► For partial-term hedges of fixed-rate financial instruments, measure the change in fair value of the hedged item by assuming that its term matches the derivative designated as the hedging instrument
  ► For hedges of prepayable financial instruments, consider only how changes in the benchmark interest rate affect the decision to settle the hedged item prior to its scheduled maturity
ASU 2017-12
One-time transition elections for existing hedges

Modifications to existing hedges without dedesignation

► Modify measurement methodology for fair value hedges of interest rate risk from use of contractual coupons to benchmark component cash flows*^
► Exclude cross-currency basis spread from effectiveness assessment in fair value hedges of foreign exchange risk using currency swaps*
► Change recognition model for excluded components from mark-to-market approach to amortization approach*^
► Modify hedged risk to contractually specified component in qualifying cash flow hedges*^
► Amend shortcut hedge documentation to specify which quantitative method would be used for assessment if the shortcut method is inappropriately applied^*
► Change subsequent assessment method from quantitative to qualitative^*

Modifications to existing hedges requiring dedesignation

► Modify hedged risk to SIFMA municipal swap rate for fair value hedges of interest rate risk

Other

► Reclassify debt securities eligible to be hedged under the last-of-layer method from held-to-maturity to available-for-sale

* Impact of election recorded as cumulative effect adjustment to beginning retained earnings
^ Allows for different treatment for “similar hedges” initiated before and after adoption
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