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Featured Articles

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Planned Update to Hedge Accounting May Be a Step Toward Simplicity

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by Nicola M. White

Summary: *The FASB is expected to soon publish an update to one of the most complex parts of U.S. GAAP - hedge accounting. The board hopes more business risk management techniques can qualify*

for the specialized accounting treatment, and many companies have told the FASB they are ready to apply the revised accounting as soon as they are able.

Customer orders for high fructose corn syrup come into Archer Daniels Midland Co. in a high volume and a steady stream.

At such volumes, small changes to the price of corn, the syrup's main ingredient, can have a big effect on the company's profits. It is up to ADM's financial officers to protect the company's income from swings in corn prices caused by unpredictable weather, competition, or crop yields, and futures contracts are their chief weapon.

The company uses the derivative instruments to lock in the price of corn for a date in the future, typically near the date the syrup has to be delivered to the customer. By locking in the price of corn with a futures contract, ADM has a better idea what its profits will be when it sells the syrup.

ADM considers transactions like these the company's "bread and butter" - essential business tools that manage, or hedge, the risk of price changes for important ingredients to make final products, said Vice President and Corporate Controller John Stott.

Soon, the Chicago company believes its financial statements will better reflect the results of these deals.

The FASB by the end of August plans to update U.S. GAAP's complex hedge accounting standard, making it easier for companies like ADM to use hedge accounting for components of final products.

"We're a fan," Stott said. "We believe that this change in the accounting standards will bring the requirements for accounting for derivatives closer to how our management thinks about running the business."

Topic 815, *Derivatives and Hedging*, formerly **SFAS No. 133** , requires that derivatives be recorded at fair value on the income statement, which means earnings can fluctuate from quarter to quarter depending on the volatility of the derivatives' value. Under certain conditions, companies may employ hedge accounting, which involves designating a derivative instrument to a hedged item and then recognizing gains and losses from both items in the same period. When done right, the specialized accounting keeps the price swings out of reported earnings and lessens the effect on the stock price and executive compensation.

Developed in the aftermath of high-profile financial derivatives blowups in the 1990s, the requirements to qualify for hedge accounting are stringent. The hedged transaction must be documented at inception and must be considered "highly effective." Businesses must periodically assess the transactions for their effectiveness.

A hedge is highly effective when a change in the derivative's fair value or cash flow offsets the change in the price or cash flow of the item being hedged. Companies have to support their declaration of an effective hedge with documentation and quarterly testing.

Some businesses have criticized Topic 815 as overly strict because legitimate risk management techniques often do not qualify. Others told the FASB they avoid trying to use hedge accounting because the guidance is too complicated, and the potential for errors is too high. Hedge accounting problems are a significant reason companies have to restate earnings.

Existing GAAP also limits the use of hedge accounting for nonfinancial items to changes in the fair value of the entire hedged asset or liability and the risks associated with fluctuations in foreign currency rates. Hedging can also be used to offset the risk of changes in the purchase price or sale price of cash flow hedges. But hedge accounting is not permitted for other individual risks, including changes in the value of a principal ingredient or component. Changes in the value of the corn futures contract must be recorded in the income statement each quarter.

"That generates a gain or loss that isn't really a gain or loss," Stott said, adding that the company has to have frustrating conversations to explain not only to investors but also to people inside the company how the accounting for these transactions does not match the realities of the business.

The forthcoming update to U.S. GAAP is expected to change this. A draft version was released in September 2016 as Proposed Accounting Standards Update **(ASU) No. 2016-310** , *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*. One of the proposal's most significant changes involves the permission to use hedge accounting for nonfinancial components - the raw ingredients and materials to make end products. But it is not the only significant change.

Under the forthcoming update, the FASB will no longer require the separate measurement and reporting of what is called "hedge ineffectiveness," a calculation companies had to do every reporting period as part of an assessment about how well a derivative instrument is hedging an underlying asset or liability. Investors found the number meaningless, the FASB said, and companies saw little use in calculating it if the overall hedge was considered effective.

"The number is usually small because you have a very effective relationship," said Joseph Soviero, executive director, in the derivatives and financial instruments group at Ernst & Young LLP. "It wasn't meaningful, or even slightly confusing for the investor."

In addition, the FASB is proposing to eliminate what critics have called an onerous penalty in the "shortcut" method of hedge accounting, a simplified hedge accounting technique that can be used for interest rate swaps that meet specific criteria. Under current GAAP, if the shortcut method is applied and then it is determined that using the shortcut method was not appropriate, hedge accounting cannot be applied to that transaction. With the forthcoming update, the FASB is expected to let the so-called long-haul method for assessing hedge effectiveness apply to the transactions if the hedge if highly effective.

The FASB also plans to allow hedge accounting for an expanded list of interest rate risk management strategies, which is likely to please banks. Banks holding portfolios of prepayable assets like fixed-rate mortgages can use hedge accounting to manage interest rate risk fluctuations associated with specific portions or "layers" of the portfolios versus the portfolios as a whole.

Other changes include adding the Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Rate to a list of acceptable benchmark interest rates for hedges of fixed-interest-rate items.

The FASB kept the core of Topic 815 in place, as it did not set out to entirely rewrite the guidance.

"The FASB addressed a lot of major things that people struggled with in the past, and addressed that with very tailored, targeted improvements," Soviero said. "But in large part the standard is similar. There are still compliance aspects in place. The hope is you can use this for existing strategies and for new strategies you never thought you could do."

In addition to the recognition and measurement changes, the FASB is calling for more disclosures to explain hedge accounting's effect on individual income statement line items, a move FASB member Harold Schroeder, a former investor, said would help analysts better understand a company's risk management strategies.

"This is a blind spot for many investors," Schroeder said at a meeting in June when the FASB gave its final approval to the amended standard.

The update will be effective for public companies after December 15, 2018. Private companies and other organizations will have another year to comply. Early adoption will be allowed, and the FASB expects many companies to take advantage. At a conference in June, FASB Chairman Russell Golden said the FASB has been fielding calls urging it to publish the standard as quickly as possible.

The forthcoming update is not expected to make hedge accounting easy. Hedging is likely to remain an inherently complicated area of accounting long after the update is released, largely because of the complex judgments businesses must make to set up derivatives contracts to manage their risks.

In addition, one of the more important changes expected for the final update - the easing of the requirements for component hedging - will not cover all scenarios because the FASB's forthcoming update requires that the component be "contractually specified." In some cases, it is not realistic for a raw ingredient or component to be spelled out in a contract for a finished product, said Chandu Chilakapati, managing director in the valuation services practice at Alvarez & Marsal in Houston.

"When you are entering into a sale contract for that product, you're rarely going to reference that raw material; you're simply going to buy or sell that refined product," Chilakapati said.

An oil refiner in Eastern Europe, for example, may have a hard time convincing a Russian distributor to agree to a specified price for petroleum products that might be based on a Dubai exchange. Without a contract specifying the raw material cost, hedge accounting cannot be used, he said, and many companies will find it a burden to go back and open up old contracts to change them to qualify for the accounting.

Still, the FASB's forthcoming update represents a big advance for financial reporting, he said.

"This update is actually a huge step forward, and the FASB has in fact made a lot of progress with this," he said. "I do believe that it will benefit a tremendous number of companies because they did simplify hedge accounting in a lot of ways."