Public Roundtable Meeting
Targeted Improvements to Accounting for Hedging Activities
December 2, 2016
Session 1: 9:00 a.m.–12:00 p.m.
Session 2: 1:00 p.m.–4:00 p.m.

Financial Accounting Standards Board
401 Merritt 7
Norwalk, Connecticut

AGENDA

We have arranged this roundtable meeting to listen to your views and to further develop our understanding of the issues you raised or alternatives you proposed in your comment letters.

We expect to cover each of the following topic areas:

Topic 1: Component Hedging for Nonfinancial Items

Topic 2: Determining Benchmark Rates

Topic 3: Sub-Benchmark/Market Yield Test

Topic 4: Presentation

Break

Topic 5: Disclosures

Topic 6: Qualitative Testing

Topic 7: Private Company Hedge Documentation

Other Comments/Observations

* All paragraphs from the proposed Update referenced in the Topics can be found within Appendix A.

FASB FINANCIAL ACCOUNTING STANDARDS BOARD

Topic 1: Component Hedging for Nonfinancial Items

Topic Background

The Board decided that an entity would be permitted to designate the variability in cash flows attributable to changes in a contractually specified component as the hedged risk in a nonfinancial hedge. Additionally, the Board decided to provide eligibility criteria for designating a contractually specified component as the hedged risk.

The Board believes that an entity should be able to designate the variability in cash flow attributable to changes in a contractually specified component in a not-yet-existing contract if the requirements in paragraph 815-20-25-22A will be met in the future contract and all other requirements for cash flow hedge accounting are met. The proposed amendments included implementation guidance on hedging a contractually specified component in a not-yet-existing contract in paragraphs 815-20-55-26A through 55-26C. Paragraph 815-20-55-26B states "if the contract references a different contractually specified component than the designated ABC soybean index…Entity A should discontinue hedge accounting…because the designated hedged risk is not present in the executed contract."

Board's Basis for the Change

> BC42. The Board believes that by allowing component hedging for nonfinancial items, an entity would more accurately reflect the effects of its risk management on its financial reporting. Furthermore, the Board believes that designating the variability in cash flows attributable to changes in a contractually specified component as the hedged risk is objective and would be relatively straightforward to apply.

Alternative Views Previously Considered by the Board

> BC50. The Board considered, but rejected, a variation of the contractually specified component model. This model would have encompassed all contractually specified components included in the Board's decision plus components that are not contractually specified but for which it is the "market convention" to use the component as an underlying basis for determining the price of the overall product. That is, market participants in a particular commodities market would know the pricing conventions in that market. Under this alternative, a contract exists, but the components that would be eligible to be designated as the hedged item are not contractually specified. The Board rejected this model because it believes that the concept of market convention would be difficult to define across industries, would lead to confusion in instances in which there was no market convention or there were multiple market conventions, and potentially could be difficult to demonstrate objectively to third parties. The Board also observed that in situations in which a market convention exists contracts could be rewritten to contractually specify the convention,

thereby making the variability in cash flows attributable to changes in the component an eligible hedged risk.

BC58. The Board also considered, but rejected, a specialized nonfinancial cash flow hedging model based on a reasonably effective threshold. Under that model, if the change in the fair value of the hedging instrument and the change in the total price of the hedged item meet a reasonably effective threshold, an entity would:

a. Record the entire change in the fair value of the hedging derivative in other comprehensive income
b. Record no ineffectiveness during the life of the hedge
c. Reclassify to earnings amounts deferred in accumulated other comprehensive income when the hedged item affects earnings…

BC60. The Board also rejected this [approach] because it does not reflect that entities manage commodity price risk on a component basis.

Topics for Discussion

<u>Component Hedging Concept</u>

Some participants stated that component hedging for nonfinancial items should be expanded beyond those that are contractually specified. Some suggestions were:

- Separately identifiable and reliably measurable
- Market convention
- Component is highly correlated to the total price of the entire hedged item.

As laid out in the basis for conclusions, the Board considered and rejected the first two suggestions above for operability concerns and the last suggestion above due to inconsistencies with that approach and an entity's risk management activities.

1. Should component risks in nonfinancial hedges be eligible for hedge accounting?
2. At a minimum, should the variability in cash flows of a contractually specified component be an eligible risk to hedge?
3. Are there operability challenges to demonstrate objectively, across industries, a market convention or a risk is separately identifiable and reliably measurable?
4. What new information should the Board consider when evaluating an alternative that includes a market convention or a separately identifiable and reliably measurable risk?

Not-Yet-Existing Contracts for a Contractually Specified Component

In paragraph 815-20-55-26B, the example states that if the contractually specified component is not present in the executed contract, the entity must discontinue hedge accounting. It also is allowed to hold in accumulated other comprehensive income changes in value of the hedging instrument until the initially expected forecasted transaction affects earnings. Because of the comments received, the Board would like feedback on two specific areas in regards to this example:

5. Should nonoccurrence of the designated risk component result in an automatic discontinuation of the hedging relationship?
6. If/when should the nonoccurrence of the hedged risk result in an immediate reclassification of amounts from accumulated other comprehensive income to earnings?

Implementation of Contractually Specified Component

Based on the feedback received, the Board would like to solicit feedback on a few areas related to the implementation/operability of the contractually specified component model:

7. Are there operability issues concerning the additional eligibility criteria to designate a contractually specified component as the hedged risk in paragraph 815-20-25-22A?
8. Some participants noted cost-benefit concerns with implementing a contractually specified component concept. What are the one-time conversion costs to convert to contractually specified component hedging?
9. What would be a reasonable method of implementing the contractually specified component concept without having to rewrite contracts? For example, can supplemental documentation outside the written contract that is agreed upon by both parties be used to support a contractually specified risk?

Topic 2: Determining Benchmark Rates

Topic Background

The Board decided to retain the concept of benchmark interest rates for hedges of fixed-rate financial instruments and forecasted issuances or purchases of fixed-rate financial instruments, maintaining the existing list of permissible benchmark rates (with the addition of the SIFMA Municipal Swap Rate to the list).

Board's Basis for Retaining the List

> BC106. For fixed-rate financial instruments, the Board decided that the benchmark interest rate concept remains relevant for designating an interest rate risk hedge and should be retained.
>
> BC107. When developing the benchmark interest rate concept in Statement 138, the Board believed that the definition of *benchmark interest rate* should be very close to "risk-free" so that credit-risk elements would not be incorporated in a hedge of interest rate risk. In the deliberations leading to this proposed Update, the Board decided that the list of permissible benchmark rates should continue to be limited for that reason.

Alternative Views Previously Considered by the Board

> BC99. The Board considered, but rejected, an approach that would have broadened the definition of benchmark interest rate for all hedges of interest rate risk and that would have allowed a more principles-based approach in selecting rates that could be hedged. This approach would have eliminated both the requirement that a benchmark rate be risk free and the list of explicitly permissible benchmark rates under GAAP. Instead, an entity would have had the flexibility to select interest rate indexes based on market-driven factors or to choose rates important to the individual entity. However, the Board was concerned about allowing interest rate indexes as benchmark rates that potentially could incorporate a high level of credit risk. Although the Board rejected this proposal, it acknowledges a difference between hedging interest rate risk related to variable-rate financial instruments and fixed-rate financial instruments. Therefore, the Board decided to eliminate the benchmark interest rate concept for variable-rate financial instruments but retain it for fixed-rate financial instruments.
>
> BC109. Stakeholders expressed a concern that maintaining a list of eligible benchmark rates for interest rate risk hedges of fixed-rate financial instruments would necessitate a standard-setting project to allow new rates that become prevalent to be considered as eligible benchmark rates. However, the Board believes that the list of rates would not change frequently, and, therefore, it is

not concerned about additional future standard-setting activities related to that issue.

Topics for Discussion

Many agreed with the benchmark interest rate concept, but some disagreed. Those that disagreed wanted a principles-based approach.

10. Should a principles-based approach be based upon the current definition of *benchmark interest rate* or something different?
11. What would be the practical advantage to moving to a more principles-based approach? Would this approach result in different outcomes relative to current GAAP?
12. If the Board keeps the current approach of a definition of a benchmark interest rate and a list of eligible rates for the United States, what amendments do you propose to allow future rates to qualify more easily, especially when those rates are sponsored by the market to become a benchmark rate? For example, would you support including within the concept expectations that a rate will become widely recognized and widely used?

FINANCIAL ACCOUNTING STANDARDS BOARD

Topic 3: Sub-Benchmark/Market Yield Test

Topic Background

The Board decided to allow an entity to use either the total contractual coupon cash flows or the benchmark interest rate coupon cash flows in determining the change in the fair value of the hedged item attributable to interest-rate risk in a fair value hedge. The entity has a choice of which cash flows to use unless the relationship fails the market yield test. The market yield test would require that if the benchmark rate is greater than the market yield of the hedged item at hedge inception, the entity must use the total contractual coupon cash flows instead of the benchmark interest rate when measuring the change in fair value of the hedged item attributable to interest-rate risk.

Board's Basis for Change

> BC113. The Board decided that in determining the change in the fair value of the hedged item in a fair value hedge of interest rate risk, the estimated coupon cash flows used in calculating fair value would be based either on the full contractual coupon cash flows (total coupon) or the benchmark rate component of the contractual coupon cash flows (benchmark rate coupon) of the entire hedged item determined at hedge inception.
>
> BC118. Because the Board decided that an entity would be permitted to use benchmark rate coupon cash flows, an issue arises regarding how to determine the change in the fair value of the hedged item attributable to interest rate risk if the benchmark rate is greater than the total contractual coupon rate (sub-benchmark hedges). This issue can arise when a hedge is designated upon the issuance of a debt instrument for a high credit-quality borrower or in a hedging relationship designated after the issuance of the debt instrument (late hedge) as a result of changes in interest rates between the issuance date and the date of hedge designation. While sub-benchmark hedges are permitted under Topic 815, the guidance requires that the total coupon cash flows be used to determine the change in the fair value of the hedged item attributable to interest rate risk regardless of whether the total coupon cash flows are greater than, equal to, or less than the benchmark rate.
>
> BC119. This method is similar to that used in IAS 39, *Financial Instruments: Recognition and Measurement*, and IFRS 9. The Board believes this method would allow an entity to consider the market environment and the economics of the debt instrument being hedged at the time of hedge designation (as opposed to simply looking at the contractual coupon, which was based on the market environment at the time of the earlier debt issuance).

Alternative Views Previously Considered by the Board

The Board considered two other alternatives. The first would have required an entity to use the total contractual coupon cash flows when the benchmark interest rate was greater than total contractual coupon cash flows at hedge inception. The second would have allowed an entity to select the total contractual coupon cash flows or the benchmark rate coupon cash flows regardless of whether the benchmark interest rate was greater than or less than the total contractual coupon cash flows at hedge inception.

Topics for Discussion

While some participants agreed with the market yield test, others noted that the proposed cash flow hedging model for financial and nonfinancial hedged items allows the contractually specified interest rate and contractually specified component to be designated as the hedged risk even if the spread to the respective component is negative. Those participants stated that the market yield test creates asymmetry between fair value and cash flow hedges.

13. Should the cash flow and fair value hedging models be consistent in this regard or should there be some limit to the coupon cash flows used? Please explain why.

Topic 4: Presentation

Topic Background

The Board decided to require that the entire change in the fair value of the hedging instrument be presented in the same income statement line item as the earnings effect of the hedged item. This change applies to both amounts excluded from the assessment of effectiveness and for amounts reclassified from accumulated other comprehensive income to earnings for hedged forecasted transactions that become probable of not occurring.

In paragraphs 815-20-55-79V through 55-79Z, the proposed amendments clearly state the effect that this would have on fair value hedges of interest-rate risk and fair value hedges of interest-rate and cross-currency risk.

Board's Basis for the Change

> BC61. The Board decided that…the change in the fair value of a hedging instrument would be recognized and presented in the same income statement line item as the earnings effect of the hedged item when the hedged item affects earnings.
>
> BC62. The Board chose this recognition and presentation approach based on the view that if an entity enters into a derivative or nonderivative hedging instrument, the *entire* change in the fair value…should be displayed in the same income statement line item as the earnings effect of the hedged item (cost of hedging model).
>
> BC64. The Board also considered whether the presentation requirements in the cost of hedging model also should apply to cash flow hedges in which a hedged forecasted transaction is later determined not to occur. Current GAAP…[does not provide] specificity [with regard] to presentation. The Board believes that if an entity applied cash flow hedge accounting for that hedging relationship for one or more reporting periods, changes in the fair value of the hedging derivative represent a cost of hedging regardless of the end result (that is, whether the forecasted transaction occurs or not). Therefore, the Board decided that changes in the fair value of the derivative required to be reclassified from accumulated other comprehensive income to earnings should be presented in the income statement line in which the earnings effect of the hedged item would have been presented had the hedged forecasted transaction occurred.
>
> BC67. For fair value hedges of interest rate risk of an existing financial asset or liability in which the hedging instrument is an interest rate or cross-currency interest rate swap, the Board notes that in practice today some preparers recognize the current period interest accruals on the interest rate swap and the hedged item in an interest income or interest

expense line item while all other changes in fair value of the swap and the hedged item are recorded in an other income or other expense line item. The Board believes that under the cost of the hedging model, any mismatch between the change in the fair value of the hedging instrument and the hedged item recorded in an other income or other expense line item represents a cost of hedging that should be reflected in the same income statement line item as the earnings effect of the hedged item.

BC68. The Board understands that under current GAAP, some entities choose not to record hedge ineffectiveness in the same income statement line item as the earnings effect of the hedged item because of its distorting effect on margins or other financial statement metrics. Therefore, the Board believes that its proposed changes regarding income statement presentation of the hedging instrument may not have a significant effect when [the proposed changes to the measurement of the hedged item in a fair value hedge of interest rate risk] are employed [because the mismatch between the change in the fair value of the hedging instrument and the hedged item attributable to interest rate risk should be reduced].

BC73. Topic 815 is silent on income statement presentation. However, [under the proposed amendments,] the entity would present [amounts] excluded…[from the assessment of effectiveness] in the same income statement line item as the earnings effect of the hedged item.

BC75. Therefore, for cash flow hedges, the Board decided that an entity would recognize the change in the time value of a hedging derivative currently in earnings, but it would present…[the change in time value] in the same income statement line item as the earnings effect of the hedged item. If the hedged item has not yet affected earnings, the entity would record the amounts excluded from the assessment of effectiveness in the income statement line item expected for the hedged item.

Alternative Views Previously Considered by the Board

BC63. The Board also did not support the view under current GAAP that the ineffective portion of the change in the fair value of the hedging instrument should be treated like any other non-hedging derivative under Topic 815 (that is, recorded in current period earnings). The Board believes doing so makes an entity’s true cost of entering into the hedging strategy less transparent by presenting the effective and ineffective portions of the hedge potentially in … different line items in earnings and potentially in different financial reporting periods. Therefore, the Board also did not support the view under current GAAP that an entity should have a choice about the income statement presentation of the ineffective portion of the change in the fair value of the hedging instrument.

Topics for Discussion

There was broad support for the presentation of the effects of the hedging instrument in same income statement line item as the earnings effect of the hedged item. However, some participants were concerned with the effect that the cost of hedging concept would have on key operating metrics when hedging interest-rate risk in fair value hedges.

There was mixed feedback regarding presentation of excluded components in the same income statement line item as the earnings effect of the hedged item. However, there was general disagreement with the presentation of missed forecasts in the same income statement line item in which the hedged item would have been presented had the hedged forecasted transaction occurred.

14. Do you agree or disagree with presentation of amounts excluded from the assessment of effectiveness in the same income statement line item as the earnings effect of the hedged item? Please explain why.
15. Do you agree or disagree with presentation of missed forecasts in the same income statement line item as the earnings effect of the hedged item? Please explain why.
16. Below are specific questions related to the concerns that have been expressed regarding the effect that the cost of hedging concept would have on key operating metrics when hedging interest-rate risk in fair value hedges:
    a. Given the Board's proposed amendments to the measurement of the hedged item in interest-rate hedges, how volatile will this effect be both upon adoption and then quarter to quarter? Given the new disclosures showing the effects on the income statement line items, do you expect it to be easier to explain to analysts the amount of the mismatch?
    b. Additional items noted and questions are the following:
        i. The effect of credit valuation adjustments (CVA) / debit valuation adjustments (DVA) — Is this a material issue given the move to full collateralization of derivatives?
        ii. The effect of discounting at Overnight Indexed Swap (OIS) when the derivative is fully collateralized and London Interbank Offered Rate (LIBOR) is designated as the hedged risk—Why is this a concern if OIS can be designated as the benchmark interest rate?
        iii. The staff received comments that the Board should accept the future rate designated by ARRC as a benchmark rate. This rate is intended to replace LIBOR as a benchmark interest rate in the interest rate markets. Given this initiative, should the Board be concerned about the limited life of any LIBOR/OIS mismatch?

FINANCIAL ACCOUNTING STANDARDS BOARD

Topic 5: Disclosures

Topic Background

The Board decided to amend the existing income statement tabular disclosures and require two new disclosures regarding cumulative basis adjustments and an entity's quantitative hedging goals.

Board's Basis for the Change

> BC148. In outreach following the 2010 Exposure Draft, many users expressed a desire for improved disclosures that would help them better understand an entity's risk exposures and risk management activities, the effects of hedging on future income and cash flows, and the degree of success of the entity's risk management activities. To respond to the needs of users, the Board decided that the amendments in this proposed Update would provide enhanced disclosures on hedging activities and the effect that those activities have on the financial statements.
>
> BC150. The amendments in this proposed Update would require an entity to disclose quantitative goals, if any, that it set when developing its hedge accounting objectives and strategies and whether it met those goals. For example, if the entity set a quantitative goal to apply hedge accounting to 80 percent of forecasted commodity purchases in the reporting period, it would be required to disclose that percentage and whether or not it actually met the goal.
>
> BC151. The Board decided that the scope of this proposed disclosure should be limited to hedge accounting activities that have occurred in the current and prior financial reporting periods to avoid including forward-looking information. Notwithstanding that limitation, the Board believes that this proposed disclosure would aid users in understanding an entity's objectives and success in hedging its risk exposures by applying hedge accounting. The Board believes that an entity would have readily available access to this information, and, therefore, costs should not increase.
>
> BC152. Current GAAP requires that an entity disclose the periodic basis adjustments to the hedged item in a fair value hedge either in tabular or nontabular format. To help users better understand the effect of hedge accounting on the balance sheet, the amendments in this proposed Update would require additional disclosures about the cumulative amount of fair value hedging adjustments included in the carrying amount of the hedged item, the line item in the balance sheet that includes the hedged item, and the cumulative amount of the fair value hedging adjustments remaining for any hedged items for which hedge accounting has been discontinued. The Board believes that information about the amount of those adjustments is needed for users to evaluate the amount, timing, and

uncertainty of prospective cash flows associated with hedged assets or liabilities.

BC155. The Board decided to amend the tabular disclosure of the effect of hedge accounting on the income statement as follows:

a. For fair value, cash flow, and net investment hedges, the current requirement to disclose the ineffective portion of gains and losses on hedging instruments and related hedged items would be eliminated.
b. For fair value hedges, the amount of periodic gains and losses on hedged items, as well as the amount of gains and losses on hedging instruments excluded from assessment of effectiveness, would be included in the tabular disclosure.
c. For fair value and cash flow hedges, the following additional requirements are proposed:
    1. An entity would disclose the total amount of each income and expense line item in the income statement in which hedge accounting adjustments have been recorded.
    2. The amount of gains and losses on hedging instruments and related hedged items would be shown by income and expense line item so that those amounts can be compared with the total amounts of income and expense line items presented in the income statement.

BC156. The Board believes that the proposed tabular format would better reflect the new cost of hedging model in which the full change in fair value of the designated hedging instrument would be presented in the same income statement line item as the earnings effect of the hedged item.

BC157. The Board decided that to help users of financial statements better understand the full effects of fair value and cash flow hedging on the income statement, all of the gains and losses of hedged items and hedging instruments should be included in the tabular disclosure. The Board believes the proposed tabular format would more clearly depict the effect of fair value and cash flow hedge accounting on individual income and expense line items. Furthermore, the proposed amendment that would require an entity to include the related income and expense item totals in the tabular disclosure would allow users to access the relevant information in one location, which would clearly depict how the effects of hedge accounting relate to overall performance results.

BC158. The Board believes that no new information would be required to generate the tabular disclosure and observes that it would not be an incremental requirement because it would replace two existing disclosure tables related to fair value and cash flow hedges. Therefore, this proposed disclosure should not increase an entity's costs significantly.

Topics for Discussion

Many participants disagreed with disclosing quantitative hedging goals and whether those goals were met.

17. Given the Board's objective for adding the quantitative goals disclosure in BC151, do you have concerns with disclosing this information?
18. Are there operability concerns with gathering the data needed to create the proposed cumulative basis adjustment disclosure?

FINANCIAL ACCOUNTING STANDARDS BOARD

Topic 6: Qualitative Testing

Topic Background

The Board decided to allow testing of hedge effectiveness on a qualitative basis after an initial quantitative prospective assessment of hedge effectiveness unless the hedging relationship is determined to be perfectly effective at hedge inception (for example, under the shortcut or critical terms match methods). Additionally, if facts and circumstances change to an extent that an entity no longer can qualitatively determine that the hedge remains highly effective, the entity must revert to quantitative testing for the remainder of the hedging relationship.

Board's Basis for Change

> BC79. The Board decided that an entity would be able to elect to apply a qualitative assessment of hedge effectiveness if an initial quantitative assessment demonstrates highly effective offset and at the inception of the hedging relationship the entity can reasonably support an expectation of high effectiveness on a qualitative basis in subsequent periods. The Board also decided that an entity would be required to perform subsequent quantitative effectiveness assessments only if facts and circumstances related to the hedging relationship have changed to an extent that it no longer can assert qualitatively that the hedging relationship was and continues to be highly effective. Absent those changes in facts and circumstances, an entity would be permitted to continue to assess hedging relationships on a qualitative basis in periods after the initial quantitative test is performed.

> BC84. The Board notes that when an entity elects to perform subsequent qualitative hedge effectiveness assessments and then determines that facts and circumstances have changed to an extent that it no longer can assert qualitatively that the hedging relationship was and continues to be highly effective, the entity must assess hedge effectiveness quantitatively beginning in the period when facts and circumstances changed and may not return to performing qualitative assessments in a subsequent period thereafter. The Board believes that at that point, the facts and circumstances have changed to a degree that the hedging relationship may be bordering on no longer meeting the highly effective threshold and continuing to assess the effectiveness of the hedging relationship qualitatively no longer may be reliable.

Topics for Discussion

Most participants stated that an entity should be able to return to qualitative testing after a subsequent quantitative test is performed to continue to assert the hedge relationship is highly effective.

19. How can an entity reasonably support an expectation of high effectiveness after being required to perform a quantitative test after facts and circumstances change?
20. Could the criteria in paragraphs 815-20-35-2A through 35-2E and the implementation guidance in paragraphs 815-20-55-79G through 55-79N be used to support this? Should new criteria be developed?

Topic 7: Private Company Hedge Documentation

Topic Background / Topic for Discussion

The proposed amendments related to the timing of the preparation of hedge documentation and subsequent qualitative testing apply to both public business entities and private companies. The Board added Question 11 to the Exposure Draft to solicit additional feedback related to hedge documentation requirements for private companies.

In Update 2014-03, private companies that are not financial institutions are granted hedge documentation relief for the most common cash flow hedging strategy employed by private companies under the simplified hedge accounting approach.

21. Are there valid reasons why the content of or the timing of the preparation of hedge documentation should be different for private companies? If so, please describe the specific types of transactions for which different treatment should be considered.

Appendix A

815-20-25-22A If the price for the purchase or sale of a nonfinancial asset includes a **contractually specified component**, the variability in cash flows attributable to changes in that component may be designated as the hedged risk in a cash flow hedge if all of the following are met:

a. The purchase or sale contract for the nonfinancial asset creates an exposure related to the variability in cash flows attributable to changes in the contractually specified component throughout the life of the hedging relationship.
    1. If the variability in cash flows attributable to changes in the contractually specified component of the hedged forecasted transaction is limited by a cap or floor, an entity may designate a derivative as the hedging instrument that does not have a limited exposure to the contractually specified component risk. However, to make that designation, the entity shall establish that the hedging relationship is expected to be highly effective in achieving offsetting changes in cash flows attributable to changes in the contractually specified component during the period in which the hedging relationship is designated in accordance with paragraph 815-20-25-75.

b. The stated components of the price of the nonfinancial contract all relate to the cost of purchasing or selling the nonfinancial asset in the normal course of business in a particular market. The following are examples of items that may be individually stated price components or aggregated to form a single stated price component:
    1. Transportation costs
    2. Labor costs
    3. Quality or grade differentials between the hedged component and standard market prices that are quoted in purchases or sales contracts for the nonfinancial asset in the normal course of business
    4. Local supply and demand factors for the purchase or sale of the nonfinancial asset in the normal course of business.

c. All of the stated components of the price of the nonfinancial contract reflect market conditions at contract inception. For example, labor costs stated in the contract are in line with local markets, and transportation costs reflect market conditions for the distance between the supplier and the customer.

See paragraph 815-20-55-26D for implementation guidance on paragraph 815- 20-25-22A(c).

815-20-55-26A This guidance discusses the implementation of paragraph 815- 20-25-22B. Entity A's objective is to hedge the variability in cash flows attributable to changes in a contractually specified component to purchase soybeans in six months, on June 30, 20X1. Entity A only purchases soybeans from Supplier Z, and Entity A only has executed contracts to purchase soybeans from Supplier Z from January 1, 20X1, through March 31, 20X1. All of Entity A 's contracts to purchase soybeans from Supplier Z are based on the ABC soybean index price plus a variable basis differential representing transportation costs. Entity A expects that the forecasted transaction to purchase soybeans from Supplier Z on June 30, 20X1, will be based on the ABC soybean index price plus a variable basis differential. On January 1, 20X1, Entity A designates the variability in cash flows attributable to changes in the contractually specified ABC soybean index in the not-yet-existing contract in accordance with paragraph 815- 20-25-22B based on its assessment that the requirements of paragraph 815-20- 25-22A and all other requirements for cash flow hedge accounting will be met in the not-yet-existing contract.

815-20-55-26B On March 31, 20X1, Entity A enters into a contract with Supplier Z to purchase soybeans on June 30, 20X1. If the contract references a different contractually specified component than the designated ABC soybean index (for example, the contract references the XYZ soybean index price) or the contract is a fixed-price contact, Entity A should discontinue hedge accounting in accordance with paragraphs 815-30-40-1 through 40-6 because the designated hedged risk is not present in the executed contract. If the hedged forecasted cash flows are still probable of occurring, the net gain or loss on the hedging instrument in accumulated other comprehensive income should not be reclassified into earnings immediately. Entity A would reclassify amounts from accumulated other comprehensive income to earnings when the hedged forecasted transaction affects earnings in accordance with paragraphs 815-30- 35-38 through 35-41 and present those amounts in the same income statement line item as the earnings effect of the hedged item. Immediate reclassification would be required only if it becomes probable that the hedged forecasted transaction (that is, purchase of soybeans on June 30, 20X1) will not occur. As discussed in paragraph 815-30-40-5, 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.

815-20-55-26C Although Entity A designates this hedging relationship on January 1, 20X1, in applying the requirements in paragraph 815-20-25-22B, it may enter into a derivative and designate it as the hedging instrument in a hedging relationship at any time before it enters into the contract on March 31, 20X1.

815-20-55-79V The following scenarios illustrate application of the guidance in paragraphs 815-20-45-1A though 45-1F.

> > > Scenario A

815-20-55-79W Entity A designates an interest rate swap as the hedging instrument in a fair value hedge of interest rate risk in which the hedged item is a fixed-rate debt instrument. Because there is only one hedged item and one hedged risk designated in this hedging relationship, Entity A should present all changes in the fair value of the hedging instrument (that is, the interest accrual and all other changes in fair value) in a single income statement line item.

> > > Scenario B

815-20-55-79X Entity A designates an interest rate swap as the hedging instrument in a fair value hedge of interest rate risk in which the hedged item is a portfolio of fixed-rate loans. Because there is a portfolio of similar hedged items and one hedged risk designated in this hedging relationship, Entity A should present all changes in the fair value of the hedging instrument (that is, the interest accrual and all other changes in fair value) in a single income statement line item.

> > > Scenario C

815-20-55-79Y Entity A designates a cross-currency interest rate swap as the hedging instrument in a fair value hedge of foreign exchange risk and interest rate risk in which the hedged item is an issued fixed-rate debt instrument denominated in a currency other than the functional currency of Entity A. Because there is one hedged item and two hedged risks designated in this hedging relationship, Entity A should present the changes in the fair value of the hedging instrument in two separate line items in the income statement if the risks being hedged are presented in different line items. For example, if Entity A presents the change in the fair value of the hedged item attributable to foreign exchange risk in a foreign currency transaction gain or loss line item and changes in fair value of the hedged item attributable to interest rate risk in an interest expense line item, the change in the fair value of the hedging instrument due to foreign exchange risk and interest rate risk also should be allocated to those line items in the income statement.

> > > Scenario D

815-20-55-79Z Entity A designates an interest rate basis swap as the hedging instrument in a cash flow hedge of contractually specified interest rate risk to mitigate the fluctuations in the basis differential between interest receipts associated with an existing floating-rate asset and interest payments associated with an existing floating-rate liability. Because there are two hedged items in accordance with paragraph 815-20-25-51 (that is, the floating-rate asset and the floating-rate liability) and only one hedged risk designated in this hedging relationship, Entity A should present the effects of the basis swap in two separate line items in the income statement if the earnings effect of the two hedged items are presented in different line items. For example, if Entity A presents the change in fair value of the hedged asset attributable to interest rate risk in an interest income line item and changes in fair value of the hedged liability attributable to interest rate risk in an interest expense line item, the change in the fair value of the hedging instrument also should be allocated to those line items in the income statement.

815-20-35-2A An entity may qualitatively assess hedge effectiveness both retrospectively and prospectively in accordance with paragraph 815 -20-25- 3(b)(2)(iv)(03) if both of the following criteria are met:

a. An entity performs an initial quantitative test of hedge effectiveness on a prospective basis (that is, it is not assuming that the hedging relationship is perfectly effective at hedge inception as described in paragraph 815-20-25-3(b)(2)(iv)(01)(A) through (H)), and the results of that quantitative test demonstrate highly effective offset.
b. At hedge inception, an entity can reasonably support an expectation of high effectiveness on a qualitative basis in subsequent periods.

See the discussion in paragraphs 815-20-55-79G through 55-79N for implementation guidance on how an entity can reasonably support an expectation of high effectiveness subsequent to hedge inception.

815-20-35-2B The requirement that an entity shall assess effectiveness for similar hedges in a similar manner in accordance with paragraph 815-20-25-81 applies to an entity's selection of hedging relationships for which qualitative assessments are elected.

815-20-35-2C Whenever financial statements or earnings are reported and at least every three months, an entity shall verify and document that the facts and circumstances related to the hedging relationship have not changed to an extent that it no longer can assert qualitatively that the hedging relationship was and continues to be highly effective. While not all-inclusive, the following is a list of indicators that may, individually or in the aggregate, allow an entity to continue to assert qualitatively that the hedging relationship is highly effective:

a. The factors that were assessed at the inception of the hedging relationship that enabled the entity to reasonably support an expectation of high effectiveness on a qualitative basis have not changed to an extent that the entity no longer can assert qualitatively that the hedging relationship was and continues to be highly effective.
b. There have been no adverse developments regarding the risk of counterparty default.
c. In a cash flow hedge of a variable-rate financial instrument with an interest rate cap or interest rate floor in which effectiveness is assessed in accordance with paragraph 815-20-25-100, the variable rate does not approach or move above or below the rate associated with the cap or floor.
d. In a cash flow hedge of the variability in cash flows attributable to changes in a contractually specified component in a forecasted purchase or sale of a nonfinancial asset with a cap or floor in which effectiveness is assessed in accordance with paragraph 815-20-25-100, the price associated with the contractually specified component does not approach or move above or below the price associated with the cap or floor.

815-20-35-2D An entity shall assess effectiveness on a quantitative basis if it elects to subsequently assess hedge effectiveness on a qualitative basis and then the facts and circumstances discussed in paragraph 815-20-35-2C change to an extent that the entity no longer can qualitatively assert that the hedging relationship was and continues to be highly effective in achieving offsetting changes in fair values or cash flows. The entity shall apply the quantitative method that it identified in its initial hedge documentation in accordance with paragraph 815-20-25-3(b)(2)(iv)(03). An entity shall begin performing subsequent quantitative assessments of hedge effectiveness as of the period that the facts and circumstances changed. If the entity cannot identify the period in which the facts and circumstances changed, it shall perform quantitative assessments of hedge effectiveness for all prior periods of the term of the hedging relationship that previously were assessed on a qualitative basis. The entity shall not return to performing qualitative assessments of hedge effectiveness in a period after it begins performing quantitative assessments of hedge effectiveness because of a change in facts and circumstances.

815-20-35-2E If an entity determined that a change in facts and circumstances precluded qualitative testing in a prior period and the quantitative testing performed to assess effectiveness for that prior period resulted in the hedging relationship not being highly effective, the guidance on error corrections in Topic 250 shall be applied to the difference between the results recorded from applying hedge accounting and the results of not applying hedge accounting.

815-20-55-79G An entity should use judgment in determining whether it can reasonably support performing assessments of effectiveness after hedge inception on a qualitative basis. That judgment should include careful consideration of the following factors:

a. Results of the quantitative assessment of effectiveness performed at hedge inception.
b. 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 at inception, an entity should consider whether changes in market conditions may cause the changes in fair values 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.
    1. In cases in which the underlyings of the hedged item and hedging instrument are different, an entity should consider the extent and consistency of the correlation exhibited between the changes in the underlyings of the hedged item and hedging instrument. This may inform the entity about whether expected changes in market conditions could cause the changes in fair values of the hedging instrument and the hedged item or hedged forecasted transaction attributable to the hedged risk to diverge.

815-20-55-79H In the following scenarios, assume that the entity is required to perform a quantitative assessment of effectiveness at hedge inception in accordance with paragraph 815-20-25-3(b)(iv)(01). For each scenario, a discussion of whether the entity could reasonably support performing qualitative assessments of effectiveness after hedge inception is included in paragraphs 815-20-55-79L through 55-79N.

> > > > Scenario A

815-20-55-79I The following factors are present in the hedging relationship:

a. The results of the initial quantitative assessment of effectiveness performed indicate that the hedging relationship is close to achieving perfect offset.
b. All critical terms of the hedging relationship match except for the underlyings of the hedged item and hedging instrument.
    1. The changes in the underlyings of the hedged item and hedging instrument have been consistently highly correlated such that expected changes in market conditions are not anticipated to prevent the hedging relationship from achieving highly effective offset.

> > > > Scenario B

815-20-55-79J The following factors are present in the hedging relationship:

a. The results of the initial quantitative assessment of effectiveness performed indicate that the hedging relationship is close to failing the effectiveness test.
b. All critical terms of the hedging relationship match except for the underlyings of the hedged item and the hedging instrument.
    1. The changes in the underlyings of the hedged item and the hedging instrument have not been consistently highly correlated such that expected changes in market conditions could prevent the hedging relationship from achieving highly effective offset.

> > > > Scenario C

815-20-55-79K The following factors are present in the hedging relationship:

a. The results of the initial quantitative assessment of effectiveness performed indicate that the hedging relationship is neither close to achieving perfect offset nor close to failing the effectiveness test.
b. All critical terms of the hedging relationship match except for the underlyings of the hedged item and the hedging instrument.
    a. The changes in the underlyings of the hedged item and the hedging instrument have not been consistently highly correlated such that expected changes in market conditions could prevent the hedging relationship from achieving highly effective offset.

815-20-55-79L In Scenario A, the entity could reasonably support performing qualitative assessments of effectiveness after hedge inception. The initial assessment of effectiveness was close to achieving perfect offset and past observations of changes in the underlyings of the hedged item and hedging instrument (that is, the only critical term that did not match) consistently exhibited high correlation. This indicates that the results of subsequent assessments of effectiveness may not significantly differ from those observed from the assessment of effectiveness performed at hedge inception.

<u>**815-20-55-79M** In Scenario B, the entity could not reasonably support performing qualitative assessments of effectiveness after hedge inception. The lack of consistent high correlation exhibited between the changes in the underlyings of the hedged item and the hedging instrument could prevent the entity from concluding that the results of subsequent assessments of effectiveness will be similar to the results observed from the initial assessment of effectiveness. Had the changes in underlyings of the hedged item and the hedging instrument been consistently highly correlated, the entity may conclude that it is still unable to reasonably support performing subsequent assessments of effectiveness on a qualitative basis. Because the hedging relationship is close to failing its initial prospective assessment, minimal changes in the relationship between the hedged item and hedging instrument could result in the hedging relationship not being highly effective.</u>

<u>**815-20-55-79N** In Scenario C, the entity could not reasonably support performing qualitative assessments of effectiveness after hedge inception. Although this hedging relationship is not close to failing the initial quantitative assessment of effectiveness as in Scenario B, the lack of consistent high correlation exhibited between the changes in the underlyings of the hedged item and the hedging instrument prevent the entity from concluding that the results of subsequent assessments of effectiveness will be similar to the results observed from the initial assessment of effectiveness. Had the changes in value of the underlyings of the hedged item and the hedging instrument consistently been highly correlated, the entity may conclude that it could reasonably support performing subsequent assessments of effectiveness on a qualitative basis.</u>

815-20-25-12 An asset or a liability is eligible for designation as a hedged item in a fair value hedge if all of the following additional criteria are met:

a. The hedged item is specifically identified as either all or a specific portion of a recognized asset or liability or of an unrecognized firm commitment.
b. The hedged item is a single asset or liability (or a specific portion thereof) or is a portfolio of similar assets or a portfolio of similar liabilities (or a specific portion thereof), in which circumstance:
    1. If similar assets or similar liabilities are aggregated and hedged as a portfolio, the individual assets or individual liabilities shall share the risk exposure for which they are designated as being hedged. The change in fair value attributable to the hedged risk for each individual item in a hedged portfolio shall be expected to respond in a generally proportionate manner to the overall change in fair value of the aggregate portfolio attributable to the hedged risk. See the discussion beginning in paragraph 815-20-55-14 for related implementation guidance. An entity may use different stratification criteria for the purposes of Topic 860 impairment testing and for the purposes of grouping similar assets to be designated as a hedged portfolio in a fair value hedge.

2. If the hedged item is a specific portion of an asset or liability (or of a portfolio of similar assets or a portfolio of similar liabilities), the hedged item is one of the following:
    i. A percentage of the entire asset or liability (or of the entire portfolio). An entity shall not express the hedged item as multiple percentages of a recognized asset or liability and then retroactively determine the hedged item based on an independent matrix of those multiple percentages and the actual scenario that occurred during the period for which hedge effectiveness is being assessed.
    ii. One or more selected contractual cash flows, including one or more individual interest payments during a selected portion of the term of a debt instrument (such as the portion of the asset or liability representing the present value of the interest payments in any consecutive ~~the first~~ two years of a four-year debt instrument). Paragraph 815-25-35-13B discusses the measurement of the hedged item in hedges of **interest rate risk**.
    iii. A put option or call option (including an interest rate cap or price cap or an interest rate floor or price floor) embedded in an existing asset or liability that is not an embedded derivative accounted for separately pursuant to paragraph 815-15-25-1.
    iv. The residual value in a lessor's net investment in a direct financing or sales-type lease.

c. The hedged item presents an exposure to changes in fair value attributable to the hedged risk that could affect reported earnings. The reference to affecting reported earnings does not apply to an entity that does not report earnings as a separate caption in a statement of financial performance, such as a not-for-profit entity (NFP), as discussed in paragraphs 815-30-15-2 through 15-3.
d. If the hedged item is all or a portion of a debt security (or a portfolio of similar debt securities) that is classified as held to maturity in accordance with Topic 320, the designated risk being hedged is the risk of changes in its fair value attributable to **credit risk**, **foreign exchange risk**, or both. If the hedged item is an option component of a held-to- maturity security that permits its prepayment, the designated risk being hedged is the risk of changes in the entire fair value of that option component. If the hedged item is other than an option component of a held-to-maturity security that permits its prepayment, the designated hedged risk also shall not be the risk of changes in its overall fair value.
e. If the hedged item is a nonfinancial asset or liability (other than a recognized loan servicing right or a nonfinancial firm commitment with financial components), the designated risk being hedged is the risk of changes in the fair value of the entire hedged asset or liability (reflecting its actual location if a physical asset). That is, the price risk of a similar asset in a different location or of a major ingredient shall not be the hedged risk. Thus, in hedging the exposure to changes in the fair value of gasoline, an entity may not designate the risk

of changes in the price of crude oil as the risk being hedged for purposes of determining effectiveness of the fair value hedge of gasoline.

f. If the hedged item is a financial asset or liability, a recognized loan servicing right, or a nonfinancial firm commitment with financial components, the designated risk being hedged is any of the following:
    1. The risk of changes in the overall fair value of the entire hedged item
    2. The risk of changes in its fair value attributable to changes in the designated benchmark interest rate (referred to as interest rate risk)
    3. The risk of changes in its fair value attributable to changes in the related foreign currency exchange rates (referred to as foreign exchange risk)
    4. The risk of changes in its fair value attributable to both of the following (referred to as credit risk):
        i. Changes in the obligor's creditworthiness
        ii. Changes in the spread over the benchmark interest rate with respect to the hedged item's credit sector at inception of the hedge.
    5. If the risk designated as being hedged is not the risk in paragraph 815-20-25-12(f)(1), two or more of the other risks (interest rate risk, foreign currency exchange risk, and credit risk) may simultaneously be designated as being hedged.

g. The item is not otherwise specifically ineligible for designation (see paragraph 815-20-25-43).

815-20-25-6 Hedges involving <u>a</u> ~~the~~ benchmark interest rate are addressed in paragraph 815-20-25-12(f) (for fair value hedges) and <u>paragraph 815-20-25-15(j) (for cash flow hedges). Hedges involving a contractually specified interest rate are addressed in</u> paragraph 815-20-25-15(j) (for cash flow hedges). The **benchmark interest rate** <u>or the contractually specified interest rate</u> being hedged in a hedge of **interest rate risk** shall be specifically identified as part of the designation and documentation at the inception of the hedging relationship. <u>Paragraphs 815-20-25-19A through 25-19B provide guidance on the interest rate risk designation of hedges of forecasted issuances or purchases of debt.</u> An entity shall not simply designate prepayment risk as the risk being hedged for a financial asset. However, it can designate the option component of a **prepayable** instrument as the hedged item in a fair value hedge of the entity's exposure to changes in the overall fair value of that prepayment option, perhaps thereby achieving the objective of its desire to hedge prepayment risk. The effect of an **embedded derivative** of the same risk class shall be considered in designating a hedge of an individual risk. For example, the effect of an embedded prepayment option shall be considered in designating a hedge of interest rate risk.

Public Roundtable Meeting
Targeted Improvements to Accounting for Hedging Activities
Friday December 2, 2016
FASB Office, 401 Merritt 7, Norwalk, CT
Session 1: 9:00 a.m.–12:00 p.m.

PARTICIPANTS

External Participants

Jeff Bryan	Dixon Hughes Goodman
Steve Castleton	Chatham Financial
Chandu Chilakapati	Alvarez and Marsal
Chip Currie	PricewaterhouseCoopers LLP
Gautam Goswami	BDO USA LLP
Jon Howard	Deloitte & Touche LLP
Rahim Ismail	U.S. Securities and Exchange commission
Jeannette Paul	Federal Home Loan Banks
Mark Scoles	Grant Thornton LLP

FASB Participants

Russ Golden	Board Chair
Jim Kroeker	Board Vice Chair
Christine Botosan	Board Member
Daryl Buck	Board Member
Hal Schroeder	Board Member
Marc Siegel	Board Member
Larry Smith	Board Member
Harold Monk	Incoming Board Member
Sue Cosper	Technical Director
Matt Esposito	Assistant Director
Chandy Smith	Senior Investor Liaison
Jeff Gabello	Supervising Project Manager
Julie Um	Assistant Project Manager
Adam Kamhi	Practice Fellow
Rosemarie Sangiuolo	Project Consultant
Caro Baumann	Postgraduate Technical Assistant
Josh Seward	Postgraduate Technical Assistant

Public Roundtable Meeting
Targeted Improvements to Accounting for Hedging Activities
Friday December 2, 2016
FASB Office, 401 Merritt 7, Norwalk, CT
Session 2: 1:00 p.m.–4:00 p.m.

PARTICIPANTS

External Participants

Lou Fanzini	TD Bank
Rahim Ismail	U.S. Securities and Exchange Commission
Helen Kane	Hedge Trackers
Thomas Karafin	American Council of Life Insurers
Kevin Kispert	Ernst & Young LLP
Mark Northan	KPMG LLP
Daniel Palomaki	International Swaps and Derivatives Association
Laurin Smith	JP Morgan Chase
Cindy Steward	National Oilseed Processors Association
David Wendt	Archer Daniels Midland Company

FASB Participants

Russ Golden	Board Chair
Jim Kroeker	Board Vice Chair
Christine Botosan	Board Member
Daryl Buck	Board Member
Hal Schroeder	Board Member
Marc Siegel	Board Member
Larry Smith	Board Member
Harold Monk	Incoming Board Member
Sue Cosper	Technical Director
Matt Esposito	Assistant Director
Chandy Smith	Senior Investor Liaison
Jeff Gabello	Supervising Project Manager
Julie Um	Assistant Project Manager
Adam Kamhi	Practice Fellow
Rosemarie Sangiuolo	Project Consultant
Caro Baumann	Postgraduate Technical Assistant
Josh Seward	Postgraduate Technical Assistant