January 28, 2014 NDS 2014-03

New Developments Summary

Simplified hedge accounting approach

ASU codifies practical expedient for private companies

Summary

The FASB recently issued guidance that provides a practical expedient for certain private companies that wish to apply hedge accounting to variable rate debt that is economically converted to a fixed rate borrowing using a receive-variable, pay-fixed interest rate swap. The new guidance, codified by Accounting Standards Update 2014-03, *Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps – Simplified Hedge Accounting Approach: a consensus of the Private Company Council,* provides certain private companies with greater flexibility in meeting the hedge accounting documentation requirements and with relief from certain fair value measurement provisions in the *FASB Accounting Standards Codification*®, provided that an entity intends to economically convert variable rate debt into fixed rate debt using a "plain vanilla" swap contract and meets certain criteria.

The new guidance is effective for annual periods beginning after December 15, 2014, and for interim periods within annual periods beginning after December 15, 2015, although early adoption is permitted. Therefore, private companies with a calendar year-end are permitted to early adopt the practical expedient for qualifying swaps existing on the date of adoption, as long as their financial statements have not been made available for issuance.

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A. Background

Many private companies are unable to obtain fixed rate debt financing and have resource constraints that preclude the application of hedge accounting guidance to interest rate swaps that economically convert variable rate debt into fixed rate debt, resulting in unnecessary income statement volatility. In response, the Private Company Council (PCC) developed guidance that provides a practical expedient for private

companies wishing to apply hedge accounting to such arrangements. The FASB endorsed the PCC's proposal and recently issued Accounting Standards Update (ASU) 2014-03, *Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps – Simplified Hedge Accounting Approach: a consensus of the Private Company Council*.

As originally proposed, the guidance would have permitted private companies to also use a combined instruments approach to account for the combination of variable rate debt and a receive-variable, pay-fixed interest rate swap as a single fixed rate debt instrument. Based on feedback obtained from constituents, however, the PCC asked the FASB staff to perform additional research on the combined instruments approach, which the PCC intends to discuss at a future meeting.

B. Scope

Private companies other than financial institutions may apply the practical expedient offered in ASU 2014-03. Private companies, as defined recently in the Master Glossary of the *FASB Accounting Standards Codification*® (ASC), include entities other than public business entities, not-for-profit entities, and employee benefit plans within the scope of ASC 960 through 965.[1]

Choosing to apply private company alternatives

Private companies should carefully consider whether to adopt accounting alternatives that are not available to public business entities. In the event that an entity that has historically applied private company accounting alternatives must transition to public company reporting, adjusting the historical results to reflect public company accounting alternatives would likely be difficult.

In particular, it is important for an entity to consider its investors' exit strategy. For instance, if an entity is owned by a private equity investor that might exit via an initial public offering or a sale to a public business entity, then electing a private company accounting alternative might not be appropriate since the entity could be precluded from applying private company accounting alternatives in the future.

A private company should also consider whether its investors include a public business entity holding an equity method investment. If so, then any benefit to the private company from electing private company accounting alternatives would be offset by the cost to the public company investor of applying public business entity requirements to account for its equity method investment.

Refer to NDS 2014-01, *Moving closer to private company GAAP alternatives,* for additional information about the definition of a public business entity and other considerations for entities deciding whether to adopt private company accounting alternatives.

The PCC decided to exclude financial institutions from the scope of the new guidance because financial institutions generally have the expertise to apply existing hedge accounting guidance and greater exposure to financial instruments than other types of entities. As a result, changes to the measurement

[1] ASC 960, *Plan Accounting – Defined Benefit Pension Plans*; ASC 962, *Plan Accounting – Defined Contribution Pension Plans*; and ASC 965, *Plan Accounting – Health and Welfare Benefit Plans.*

basis of certain financial instruments permitted under the practical expedient might be confusing to users of financial institutions' financial statements.

C. Qualifying for the simplified hedge accounting approach

Entities within the scope of the new guidance may apply the practical expedient to receive-variable, pay-fixed interest rate swaps that meet *all* of the following conditions:

- The variable rate on both the swap and the borrowing is based on the same index and reset period. For example, arrangements in which the variable rate on both the swap and debt is based on three-month LIBOR would meet this condition, unlike arrangements in which the rate on the swap is based on three-month LIBOR and the rate on the debt is based on one-month LIBOR.
- The swap is a "plain-vanilla" interest rate swap that does not include a cap or floor on the variable interest rate, unless the debt has a comparable cap or floor.
- The repricing and settlement dates of the swap and the debt either match or differ by no more than a few days.
- The swap's fair value at inception is at or near zero.
- The notional amount of the swap matches the hedged principal amount of the debt.
- All interest payments on the debt are designated as hedged during the term of the swap, or during the effective term of a forward starting swap, either in total or in proportion to the hedged principal amount of the debt.

An entity may apply the practical expedient to a forward starting swap that meets the requirements listed above, if it is probable that the forecasted variable rate interest payments to be swapped to a fixed rate will occur.

Flexible application criteria for practical expedient

One of the primary criticisms of the existing "short cut" method for hedge accounting is that its stringent application requirements make it too restrictive and difficult for entities to apply. Because the PCC did not want the criteria for applying the simplified hedge accounting approach to be similarly restrictive, several of the criteria provide flexibility:

- An entity may apply the simplified hedge accounting approach on a swap-by-swap basis. In other words, an entity is not required to apply the simplified hedge accounting approach to either all or none of its qualifying arrangements.
- An entity may apply the simplified hedge accounting approach to arrangements in which the variable rate is based on an index other than one of the benchmark interest rates described in ASC 815-20-25-6A, *Derivatives and Hedging: Hedging – General* (LIBOR, U.S. Treasury rate, or Fed Funds Effective Swap Rate). For example, an entity would be permitted to apply the simplified hedge accounting approach to an arrangement in which the swap and the variable rate debt are indexed to the Prime Rate with the same reset period, provided the other criteria are met.
- If the swap has a cap or floor on the variable rate, then the variable rate on the debt must have a "comparable" cap or floor. For example, the floors would be comparable if debt has

an interest rate based on three-month LIBOR plus 2.5 percent, subject to a floor of 4 percent, and an interest rate swap is based on three-month LIBOR subject to a 1.5 percent floor.

- The repricing and settlement dates of the swap and debt do not have to match exactly—they can differ by "a few days."
- The swap's fair value at inception does not have to be zero, but can be "near zero."

The PCC did not provide any additional guidance about what it means by "a few days" and "near zero." Its intent was to provide flexibility, and we believe that judgment will be necessary, based upon facts and circumstances, to determine whether a hedge meets the criteria for the simplified hedge accounting approach.

D. Applying the simplified hedge accounting approach

The simplified hedge accounting approach provides the following relief from existing hedge accounting guidance:

- An entity may assume that there is no ineffectiveness in the cash flow hedging relationship.
- An entity may measure the swap at its settlement value rather than fair value. The primary difference between *settlement value* and *fair value* is that the former does not reflect nonperformance risk. One method of estimating settlement value is to calculate the present value of the swap's remaining estimated cash flows using a valuation technique that excludes nonperformance risk.
- An entity may defer completing the hedge documentation required by ASC 815-20-25-3, *Derivatives and Hedging: Hedging – General*, until the date when the first annual financial statements are available to be issued after the hedge's inception. Currently an entity is required to complete this documentation concurrently with the hedge designation.

Settlement value

Swap counterparties (for example, banks) often provide entities with periodic confirmation of the swap contract's value, which does not necessarily represent the settlement value.

The PCC has described "settlement value" in terms of how it differs from fair value, noting that the primary difference between the two is that the settlement value does not reflect nonperformance risk. Swap counterparties might compute a swap's value, as reported on a confirmation, using a variety of methodologies. It would not be appropriate for an entity to presume that the value confirmed by the swap counterparty is equivalent to the settlement value described in the ASU.

Therefore, entities applying the simplified hedge accounting approach must establish a methodology for estimating a swap's settlement value, which could include the methodology described in ASU 2014-03.

If an entity determines that a hedge no longer satisfies the criteria for applying the simplified hedge accounting approach, then as of the date when the hedge ceases to qualify, an entity must follow the general guidance in ASC 815 on a prospective basis, including recognition of gains and losses deferred in accumulated other comprehensive income.

What the practical expedient does *not* provide relief from

Although entities that elect the simplified hedge accounting approach have until the date the financial statements are available to be issued to complete their hedge documentation, they must nevertheless comply with the cash flow hedge documentation requirements in ASC 815-20-25-3. Among other things, this guidance requires entities to document the methods that will be used to (a) retrospectively and prospectively assess hedge effectiveness and (b) measure hedge ineffectiveness.

In our view, an entity that elects the simplified hedge accounting approach may prepare its hedge documentation in a manner similar to entities that apply the so-called “critical terms match” approach. Under this approach, an entity might state in its hedge documentation that it expects no ineffectiveness because the critical terms of the hedging instrument and the hedged item match. On a quarterly basis, the entity would then be required to re-assess and document whether the critical terms continue to match.

Entities that apply the critical terms match approach often document the methods they intend to use to assess effectiveness and measure ineffectiveness in the event that the critical terms no longer match in the future. Such documentation provides a degree of flexibility in continuing to apply hedge accounting if the critical terms no longer match but the hedge is still expected to be highly effective.

It is also important to note that entities applying the simplified hedge accounting approach must assess counterparty credit risk in accordance with ASC 815-20-25-122. An entity could not apply the simplified hedge accounting approach if it is not probable that the swap counterparty will not default.

E. Disclosures

Even though swap contracts designated as hedging instruments under the simplified hedge accounting approach may be measured at settlement value rather than fair value, they are still subject to the fair value disclosures in ASC 815 and ASC 820, *Fair Value Measurement*. To comply with those disclosure requirements for qualifying swap contracts, settlement value should be disclosed in place of fair value. An entity using the simplified approach is required to clearly state that such amounts are settlement values, and to disclose them separately from fair value measurements.

A swap contract designated as a hedging instrument under the simplified hedge accounting approach is not considered a derivative instrument for purposes of applying the guidance in ASC 825-10-50-3, *Financial Instruments*, which determines whether an entity is required to disclose certain information about the fair value of financial instruments. In addition, the fair value disclosures in ASC 825-10-50-10 through 50-16 are not required for a swap contract designated as a hedging instrument under the simplified hedge accounting approach.

F. Transition and effective date

The new guidance is effective for annual periods beginning after December 15, 2014 and for interim periods within annual periods beginning after December 15, 2015. Early adoption is permitted.

Early adoption permitted

Entities whose financial statements are not yet available to be issued may apply the simplified hedge accounting approach to any qualifying swap contracts existing as of the date of adoption.

For example, a calendar-year entity within the scope of this guidance that did not previously apply hedge accounting could apply the simplified hedge accounting approach, and document its compliance with those criteria, before its 2013 financial statements are available to be issued, provided that the qualifying swap contract exists as of the date the entity adopts the guidance in ASU 2014-03.

To determine whether a previously existing swap contract qualifies for the simplified hedge accounting approach, an entity must evaluate the swap's fair value on the date it was entered into or acquired. As long as the swap's fair value was near zero on that date, the simplified hedge accounting approach would not be precluded, provided the other criteria are met.

An entity may apply either a modified retrospective or full retrospective approach upon adopting the guidance in ASU 2014-03:

- Under a *modified retrospective approach,* an entity would adjust the assets, liabilities, and opening balance of accumulated other comprehensive income and retained earnings (or other appropriate components of equity) as of the beginning of the current period, to reflect its application of hedge accounting from the date the qualifying swap contract was entered into or acquired.
- Under a *full retrospective approach*, an entity must adjust the prior-period financial statements to reflect the period-specific effects of applying hedge accounting from the date the qualifying swap contract was entered into or acquired. An entity applying the full retrospective approach would adjust the assets, liabilities, and opening balance of accumulated other comprehensive income and retained earnings (or other appropriate components of equity) as of the beginning of the earliest period presented, to reflect its application of hedge accounting from the date the qualifying swap contract was entered into or acquired.

In the period an entity adopts the guidance in ASU 2014-03, it must provide the disclosures in ASC 250-10-50-1 through 50-3, *Accounting Changes and Error Corrections*.

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