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Uncertain Times: The Case for Hedge Accounting

by Leanne Fredericks, CPA
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We have seen an uptick in the number of entities electing a hedge accounting designation on their derivative positions. This can largely be attributed to the recent changes in hedge accounting rules under Accounting Standards Update ("ASU") 2017-12, which relaxed a lot of the onerous guidelines that were deterring entities from a hedge accounting election. Those who are intimately familiar with (or confused by) the rules under FAS 133 – ASC 815's predecessor – are of the mindset that hedge accounting rules are too detailed and too complicated, so why bother? Most of the time, the fair value adjustments that are required to be reported under ASC 815 are immaterial to the bottom line, and for companies that focus on EBITDA rather than Net Income, the extra work for a hedge accounting designation is just not necessary.

For those of you who are new to the world of hedge accounting, let me take a step back. Accounting Standards Codification ("ASC") 815 is the guidance that governs all derivative accounting, and mandates that derivatives are always carried on the balance sheet at fair value. This means every reporting period an adjusting entry must be made in order to mark these instruments to their current market values. But what is the other side of the entry? This is where hedge accounting comes in. If a derivative does not qualify as a hedging instrument, or an entity does not elect hedge accounting, the other side of the entry is earnings. If the derivative qualifies (and is appropriately designated and documented as such), then the other side of the entry depends on whether the derivative is a fair value hedge, a cash flow hedge, or a net investment hedge.

For derivatives that qualify as cash flow hedges, the entire change in the fair value of the hedging instrument is reported in Other Comprehensive Income ("OCI"), a component of equity. While there are some other nuances to know, the main thing to recognize is the difference between the hedge accounting designation and none at all: the fair value adjustment can either affect OCI (the balance sheet) or earnings (the income statement).

We focus mostly on the cash flow hedge designation because the majority of our clients are hedging cash flows – the fluctuations associated with floating-rate interest payments, for example, that can be hedged with a pay-fixed interest rate swap. With this instrument, you have converted unknown cash flows to known cash flows, which is the very basis for the cash flow hedge designation.

After executing the swap, you are required to adjust the market value of this instrument on your balance sheet each period, with the offset either recorded in OCI or earnings. For entities not choosing hedge accounting, changes in value would flow through earnings. This, of course, exposes you to unwanted fluctuations in income, as the market value of a swap varies as interest rates move. As noted, these changes in earnings may be considered immaterial, and a lot of our clients would forgo the hedge accounting designation for exactly this reason. However, what if the change in market value *isn't* immaterial? What if you have to report a large, unexpected loss this quarter that has nothing to do with your operations or core business?

By now, several of you have received your March 31 quarter-end valuations and are seeing the impact of the recent decline in rates on your hedge valuations. The fact is, we saw an unprecedented move in interest rates between December and March, largely due to the financial markets' response to the global coronavirus outbreak. As normal economic activities have largely shut down, the world's central banks have reacted with aggressive rate cuts, with the US Fed taking overnight rates back to the 0%-0.25% range. Term rates have declined materially as well. The five-year USD LIBOR swap rate decreased 120 basis points in Q1, from 1.73% at year end to just over 0.52% at the end of March. Those companies that executed an interest rate swap in Q4 or early Q1 and did not elect hedge accounting, the fixed rate paid is now well above market (who knew?), resulting in unrealized losses in the income statement that were not anticipated.

The swing in rates from December to March highlights the merits of the cash flow hedge accounting designation. Let's look at an example to illustrate the point. An entity that entered into a five-year $100 million pay-fixed swap on January 31 would have paid around 1.25%, while receiving 1-month LIBOR (which, at the time, was 1.65%). Most people would have agreed at the time that this was an attractive hedge. We locked in a fixed rate of 1.25% for five years, and received positive cash flow for the first month since the fixed rate was below current LIBOR. Now let's fast forward to March 31, when we have to adjust our balance sheet for the fair value of the swap. That same five-year market swap rate was just over 0.40%. With the decline

in rates of 85 basis points, that swap now has an unrealized loss of over $4 million. Without the hedge accounting designation, that $4 million will now be included in earnings as a loss for this quarter.

In times of extreme volatility, changes in market values that are normally much smaller and immaterial to your financial statements may be impacting you in ways you did not think possible. No one knew that rates would come crashing down, and you would be reporting seven- and eight-figure losses that have no relevance to your earnings stream or core business line. From an accounting perspective, is this an accurate depiction of your quarterly results? It most certainly is not, but you still have to explain that number to your investors or stakeholders. Ouch. And what happens next quarter? How long will we be in this volatile environment? Every day we see double-digit moves in rates across the swap curve, some days a complete reversal from the day before. The daily volatility has also led to higher execution, credit, and termination costs, as dealers also try to protect themselves from adverse swings.

The bottom line is: no one knows. In times of uncertainty, we all hunker down and try to safeguard what we can. What about protecting earnings? We may not be able to shield our companies from decreased revenues, fewer sales, or lower margins, but here is one line item we can protect. The good news is, with all the changes in ASU 2017-12, the election and maintenance of hedge accounting is easier than ever. Whenever we are working with clients to determine the best route to take, we note that we see very little downside to the hedge accounting designation. While there still is upfront documentation, the ongoing entries and reporting is largely the same as no designation at all – but without the added benefit of insulating earnings from changes in market value. So why not protect what we can, while we have the chance? In times like these, we need all the help we can get.

For more information, please contact Leanne by email at leannefredericks@riversideadvisors.com.

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