Hedging in the time of COVID-19

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The impact of business disruptions and extreme market fluctuations on hedging relationships cannot be ignored.

Market conditions and expectations play an important role in applying hedge accounting, and this unprecedented period of market disruption may significantly impact hedging programs. After several years of low volatility and strong economic growth, many companies suddenly face a myriad of changes to their risk profiles.

Many existing hedging relationships were established during a time of minimal market or entity-specific volatility, when forecasting future transactions and exposures seemed straightforward. It’s important to remember that the way in which hedging relationships are documented at inception influences the accounting for the duration of the hedging relationship. Ongoing changes in the business environment may cause companies to rethink existing risk-management objectives, which will impact existing and future hedging strategies. With so much rapid market disruption, it’s time to take a closer look at hedging relationships.

“Our clients are asking us how existing hedging relationships of financial and non-financial risks are impacted by recent economic events. The answer rests in the details of your hedging relationship and requires cross-functional input to identify how operational and market risks impact the way you’ve chosen to manage your risk exposures.”

Molly Chilakapati, Partner, Accounting Advisory Services

Changes in the timing or amount of the hedged transaction

A hedged transaction must be defined with sufficient specificity so that it is identifiable. This requirement often results in companies designating a specified amount of sales/purchases over a period of time, interest payments or receipts on a specific debt instrument or portfolio of instruments, or a specified unrecognized firm commitment as the hedged item.

Recent uncertainty may lead to changes in the timing or amount of the hedged transaction. For example, a company may need to cancel or delay planned purchases or sales of nonfinancial items due to factory shutdowns, unavailability of employees, or customer cancellations. Certain companies may need to cancel, delay, or accelerate previously expected issuances of debt due to market...
Cash flow hedges

For cash flow hedges, companies must first determine if the hedged transaction will occur within the timeframe specified and documented at hedge inception. Changes in expected timing may be problematic for hedge accounting. When a company can no longer assert and support the probability of hedged transaction within the initially forecasted timeframe, hedge accounting is discontinued for those hedged transactions and the derivative is subsequently measured and recorded at fair value through earnings.

After a hedging relationship is discontinued, if a company determines it is probable that the previously hedged forecasted transaction will not occur within the initially specified timeframe or an additional two months, the company must reclassify deferred gains or losses on the related hedging derivatives from accumulated other comprehensive income (“AOCI”) to earnings.

For example, if a company expects to sell 80 units of inventory on March 31, 20 units of inventory on April 30, and 30 units of inventory on May 31, the company may enter into three separate forward contracts to lock in the price of each sale. Those forward contracts have notional amounts equal to 80 units, 20 units, and 30 units and mature on March 31, April 30 and May 31, respectively. If the company expects to sell only 40 units on March 31, the company must discontinue that hedging relationship since the hedged transaction is not probable of occurring as defined. However, the company should not automatically reclassify any remaining gain or loss in AOCI related to that first hedging relationship. The expected sale of 40 units instead of the 80 units originally documented represents a shortfall of 40 units. Before the company reclassifies any amount remaining in AOCI related to the forward contract that matures on March 31 (after terminating the first hedging relationship), the company must determine whether it is probable that the 40 units would not be sold by May 31 (the original specified time period of March 31 plus two months). If the company concludes that the sale of an additional 40 units is probable by May 31, then any remaining amounts in AOCI related to that hedging relationship would not be reclassified to earnings immediately.

Evaluating the probability of a forecast transaction is a continuous assessment for cash flow hedges. This monitoring process is especially critical in periods of significant market volatility when forecasts and expectations are changing rapidly.

Furthermore, companies should be mindful of how failing to meet forecasts impacts the ability to apply hedge accounting. A pattern of failing to meet forecasts could lead to a company losing its ability to apply hedge accounting altogether.

Some hedgers ask if the additional two months may be extended due to COVID-19 related delays that may be considered extenuating circumstances. Topic 815 provides an exception to extend the additional two month period when there are extenuating circumstances that are related to the nature of the forecasted transaction and outside the control or influence of the company. This exception allows the net derivative gain or loss to remain in AOCI until the forecasted transaction affects earnings. In a response to a recent technical inquiry, the Financial Accounting Standards Board (“FASB”) staff clarified that when cash flow hedge accounting has been discontinued, this exception may be applied to delays in the timing of a forecasted transaction beyond the additional two-month period that are both outside the control or influence of the company, and are caused by the effects of COVID-19. To apply this exception, the forecasted transaction must remain probable of occurring. If a company determines that the forecasted transaction is no longer probable of occurring because

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1Refer to Accounting Standards Codification (‘ASC’) 815-30-40-4
of the effects of COVID-19, then this exception does not apply and amounts previously recognized in AOCI must be reclassified into earnings immediately and disclosed in the company’s interim and annual financial statements.

A company will not be required to consider missed forecasts attributable to COVID-19 when determining whether it has exhibited a pattern of missing forecasts that would call into question its ability to accurately predict forecasted transactions and the propriety of using cash flow hedge accounting in the future for similar transactions.

Fair value hedges

For a fair value hedge, companies that are hedging firm commitments should assess whether recent economic events have impacted their assessment of whether performance remains probable. If the hedged item later ceases to meet the definition of a firm commitment (e.g. because performance is no longer probable), the hedge relationship is discontinued and any asset or liability resulting from the hedge relationship is recognized in earnings immediately. This is because the firm commitment no longer exists.

Companies should remember that it is important to actively monitor hedging relationships for changes in the timing or amount of the hedged transaction.

Changes to the counterparty credit in uncollateralized derivative instruments will impact its fair value

Many derivative instruments are exchange-traded or centrally cleared, which mitigates the effect of credit risk on the fair value of the derivative instrument because the counterparty is the exchange. The exchange absorbs the risk of non-performance of the third party derivative holder. However, some derivatives are negotiated bilaterally (e.g. over-the-counter derivatives that are not centrally cleared) and are exposed to credit risk of each party because the contract does not require full collateralization or variation margins to be posted. The fair value of these uncollateralized derivatives must consider the risk of non-performance of both parties to the derivative, commonly referred to as the credit valuation adjustment, or CVA. Historically, many companies and auditors may have determined that the impact of counterparty and own non-performance risk is immaterial to the fair value measurement; however, this determination that the amounts are immaterial may require closer examination as credit spreads widen as a result of current commercial and market activity.

Periodic effectiveness assessment may require closer review of methodology applied

Companies applying hedge accounting must assess effectiveness of the hedging relationship using a quantitative or qualitative methodology. A qualitative methodology is appropriate when a company can reasonably support an expectation of high effectiveness and there have been no adverse developments in counterparty credit (or the company’s own nonperformance) risk. However, some companies may conclude that, because of changes in facts and circumstances caused by recent economic events, they can no longer support that expectation without performing a quantitative assessment. In that situation, the hedging relationship can continue uninterrupted if the company performs a quantitative assessment and determines that the hedging relationship was—and is expected to be—highly effective, including consideration of counterparty credit and the company’s own nonperformance risk.

Regardless of the methodology applied, a company is required to consider whether adverse developments in counterparty credit (and own nonperformance) risk impact its ability to apply hedge accounting.
Market changes will impact certain hedging relationships more than others

While the considerations above are applicable broadly across most hedging relationships, there are a number of complexities that could arise in hedging relationships that are not considered to be a “plain vanilla” hedging relationship.

- **Portfolio hedges of similar assets or liabilities:**
  Companies may enter into hedges of an aggregated portfolio of similar exposures. For these hedging relationships, companies must demonstrate at inception and on an ongoing basis that its portfolio of assets or liabilities respond in a proportionate manner to the overall change in fair value of the aggregate portfolio attributable to the hedged risk, that is, they are considered similar. Consider, for example, a portfolio hedge of jet fuel where purchases are based on the negotiated index or pricing at each location. Individual hedged items within the portfolio may be impacted by different market forces and, therefore, may not respond proportionally to the portfolio as a whole, thus the portfolio will no longer be considered an eligible hedged item. It would be inappropriate to continue to apply hedge accounting, for example, if it were expected over the course of the next hedge assessment period that the portfolio would not continue to move in a similar fashion as a consequence of market factors.

- **De-designation and re-designation of a combination of options:**
  Interest rate collars are a common strategy for managing upside and downside interest rate or commodity price risk simultaneously. These instruments are comprised of a purchased option and written option that at inception is a net zero fair value option or a net purchased option, which are important conditions to applying hedge accounting. If the hedging relationship is required to be de-designated due to changes in a company’s hedged exposures, a company may wish to re-designate the collar in a new hedging relationship. However, if the fair value of the written option exceeds the value of the purchased option, the collar now represents a net written option that likely will preclude designation in a new hedge relationship. Special care should be taken when re-designating hedge relationships involving a combination of options to determine whether they represent an eligible hedging instrument.

- **Interest rate floors embedded in the hedged transaction:**
  Hedge relationships that involve credit facilities or other debt instruments containing a LIBOR floor and an interest rate swap that does not contain a mirror-image floor may experience lowered effectiveness as a result of declining interest rates as the floor gains value. For example, many credit facilities contain a zero percent floor on the floating-rate benchmark. Companies should take inventory of the interest rate floors included in their credit facilities that are subject to a hedge of interest rate risk. Further, many companies have previously used a qualitative assessment that the floor has an immaterial impact on the hedging relationship. These companies may now be required to quantitatively assess effectiveness should that assertion no longer be supportable.

- **Layers of forecasted transactions when using multiple hedging instruments:**
  Many companies apply a layering approach to identify hedged forecasted transactions, which may result in complexities if shortfalls of forecasted transactions occur. Usually several derivatives are executed and designated in separate hedging relationships to hedge a series of forecast transactions. Consider a scenario where a company hedges €250 million of forecasted quarterly foreign currency purchases with two derivative instruments. If purchases are only probable of occurring on €150 million, the entity is required to reclassify amounts from AOCI into earnings for €100 million of forecasted transactions if those transactions are considered probable of not occurring in the period specified or within an additional two months. The company will need to determine how this change in forecasted transactions impacts its hedging relationship, such as whether the initial derivative instrument needs to be de-designated and re-designated and whether other derivatives need to have a different priority within the overall hedging program.
Performance of foreign operations:

Companies hedging their net investments in foreign operations should be mindful of the potential reduction in net investment due to operating losses or other impairments suffered by the subsidiary. To the extent that the net investment has been reduced to a level below the notional value of the derivative outstanding, companies will be required to evaluate whether amounts related to the overhedged position must be redesignated.

Evaluate whether the CARES Act impacts your hedging relationship:

The CARES Act is intended to help mitigate retail and commercial losses and repayment risks of financial services companies and may impact the amount of exposure available to be hedged. Additionally, companies in other industries may see an impact on their transactions, such as those subject to various excise tax reductions like the airline industry. Given the relief provided, the amount of forecasted interest payments or other forecasted transactions and hedged items may be impacted, including inputs to the assessment of effectiveness. Companies should read the CARES Act to understand how the relief impacts the risks associated with their assets, liabilities, and forecasted transactions designated in hedging relationships.

Key highlights

— Companies should review how their hedged transactions are defined to verify whether they are still eligible for hedge accounting.

— Companies should understand how changes in the timing or amount of a hedged transaction may impact the ability to apply hedge accounting.

— Companies that executed uncollateralized derivative instruments should evaluate the impact of counterparty and its own non-performance risk in measuring the fair value of its derivative.

— A qualitative assessment of hedge effectiveness may no longer be appropriate if sources of lowered effectiveness can no longer be clearly insignificant to the relationship.

— Each hedging relationship is subject to a set of unique risk factors that should be assessed in light of current market conditions.

How KPMG can help

Hedge accounting is one of the most complex subject matters of accounting, even more so in a period of unprecedented economic events. Choosing the right partner to help navigate the challenges presented in this period of uncertainty is key to your company’s success. KPMG has the experience to help make it a smooth journey.
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