Interest Rate Swaps

Simplified Accounting for a Perfect Fair Value Hedge

By Josef Rashty

The U.S. economy has been improving steadily for the past seven years, and interest rates have remained at historical lows. Nevertheless, there will be an economic slowdown at some point in the future, and the economy will be better positioned if interest rates are relatively high when the downturn starts. In December 2015, the Federal Reserve raised its benchmark key interest rate by 0.25% for the first time in nearly ten years. Comments by chairwoman Janet Yellen indicated that interest rates might rise gradually for the remainder of the current up-cycle; however, it appears that the Federal Reserve intends to proceed cautiously on this matter, and as a result, it has introduced a certain level of uncertainty into the financial markets.

In June 2017, the Federal Reserve raised its benchmark key interest rate by a quarter-point for the third time since its first rate increase in December 2015. This latest increase, which brings the federal funds rate to between 1% and 1.25%, was highly anticipated by the markets. The rate hike "reflects the progress the econ-

omy has made and is expected to make toward maximum employment and price stability," Yellen said in a press conference, arguing that a gradual path of rate increases was the best way to avoid a more damaging scenario for the economy (Ana Swanson, "Fed Raises Interest Rate, Signaling Confidence in the Economy," *Washington Post,* June 14, 2017, http://wapo.st/2uQKeyC).

Companies routinely utilize interest rate swaps to reduce their exposure to changes in the fair value of assets and liabilities or cash flows due to fluctuations in interest rates. This article provides a background on interest rate swap programs and fair value hedging. It discusses the benefits and limitations of different methods of hedging programs and provides guidance for the use of the shortcut method on perfect fair value hedge contracts.

Hedge Programs

Hedging is a risk management strategy that companies use to limit or offset the probability of any losses in fluctuation of prices in commodities, currencies, securities, or interest rates. Companies must recognize their derivative instruments at fair value on their balance sheets. If a derivative does not meet the criteria for hedge accounting, any fluctuations in its fair value will be reflected in earnings.

Accounting Standards Codification (ASC) Topic 815, "Derivatives and Hedging," specifies three different types of hedges:

- Fair value hedges, which hedge the exposure to changes in fair value of recognized assets, liabilities, or any recognized firm commitment
- Cash flow hedges, which hedge the exposure to variability in expected future cash flows of recognized assets, liabilities, or any unrecognized forecasted transactions
- Hedges of net investment in foreign operations, which hedge the translation exposure to changes in foreign exchange rates in other comprehensive income.

Fair value and cash flow hedges are the most prominent and complex hedge types. Companies use fair value or cash flow hedge interest rate swap contracts to mitigate risks associated with changes in interest rates. A company can implement fair value hedges for its existing fixed-rate debt using a "pay-floating/receive-fixed" interest rate swap contract. The swap contract converts the fixed-rate payments into floating rates. The floating rates, which are market rates for the debt instrument, protect the instrument against fluctuations in its fair value. The use of an interest rate swap unlocks the fixed interest expense associated with the debt and results in variable interest rate expense that fluctuates with the market rate (i.e., the company benefits if the market interest rate declines and vice versa).

If a derivative does not meet the criteria for hedge accounting, any fluctuations in its fair value will be reflected in earnings.

In contrast to fair value hedges, cash flow hedges for interest rate swap contracts address risks that arise due to interest rates that are variable, either by contract or because they may be entered into at interest rates that would be in effect at a future date. Cash flow hedges allow companies to manage their risks by locking in or eliminating the variability of the interest rate in their debt, changing variable interest expense into a fixed interest expense. The fixed interest rate is immune from subsequent market rate fluctuations.

Hedgeable Risks

Hedgeable risks differ from one company to another and for financial instrument-related exposures and nonfinancial exposures (ASC 815-20-25-12).

ASC 815 identifies the following hedgeable risks for financial instrument-related exposures:

- Market price risk
- Interest rate risk
- Foreign exchange risk
- Credit risk.

Fair Value Measurements and Hedge Effectiveness

ASC Topic 820, "Fair Value Measurement," requires companies to reflect derivatives at fair value in their financial statements. Gains or losses for instruments that qualify as fair value hedges and the offsetting gains or losses on the hedged items attributable to the hedged risk are recognized in earnings in the same period and offset each other as long as the hedge program qualifies as a "highly effective" hedge contract.

"Hedge effectiveness" refers to the extent that changes in the fair value of hedge instrument (the notional amount) offsets

Exhibit 1
Application of the Shortcut Method

Semiannual Period Ended	Difference between Fixed Rates	Variable Rate Applicable on Swap (Libor rate)	Sum of Rates	Debt's Principal Amount	Semiannual Interest Expense*
1/15/2016	1.0%	5.0%	6.0%	$10,000	$300
7/15/2016	1.0%	6.5%	7.5%	$10,000	$375

* (Principal Amount × Rate) ÷ 2

changes in the fair value of the hedged item. The measurement of hedge effectiveness must be consistent with company's risk management strategies and the method of assessing hedge effectiveness that company has initially documented. Any ineffectiveness in a fair value hedge program may affect the earnings of the company.

Although there are no bright lines for determining whether a hedge is highly effective, FASB's staff has informally stated that the cumulative change in the value of the derivative instrument, expressed as a ratio of the cumulative change in the fair value of the hedged item, must fall within the range of 80% to 125%.

Perfect Hedges

If an interest rate swap contract meets certain criteria and its critical terms match the other conditions of ASC 815, the hedge contract may possibly be a perfect hedge and therefore qualify for adoption of a simplified accounting method (i.e., the "shortcut method").

ASC 815-20-25-102 through 25-111 and ASC 815-20-55-71 through 55-73 provide detailed guidance as to when an interest rate swap contract is perfectly effective; these criteria are referred to as the "shortcut method." The shortcut method simplifies hedge accounting for interest rate swap contracts significantly. It still requires preparation of all the initial formal hedge documentation at the inception date; however, it does not mandate any ongoing assessment of hedge effectiveness. The shortcut method for interest rate swaps requires that hedge programs meet certain criteria in addition to initial formal hedge documentation completed at the inception of the hedge contract. The following is a summary of these criteria:

- The notional amount of the swap must match the principal amount of the interest-bearing liability being hedged [ASC 815-20-25-104 (a)].
- The fair value of an interest-bearing swap (with one exception that is beyond the scope of this article) at the inception of the hedging relationship must be nil [ASC 815-20-25-104 (b)].
- The formula for computing net settlements under the interest rate swap agreement must be the same for each net settlement [ASC 815-20-25-104 (d)]. That is, the following two conditions must be met:
  - The fixed rate remains the same throughout the term of the contract.
  - The floating rate is based on the same index and includes the same constant adjustment or no adjustment.

The shortcut method simplifies hedge accounting for interest rate swap contracts significantly.

- The interest-bearing liability must not be prepayable; that is, either party having the ability to settle it before its scheduled maturity ASC 815-20-25-104 (e)].
- The index for the variable leg of the swap must match the benchmark interest rate designated as the interest rate risk being hedged [ASC 815-20-25-104(f)].

Furthermore, fair value interest rate swaps must meet the following additional criteria:

- The expiration date of the swap must match the maturity date of the interest-bearing liability [ASC 815-20-25-105(a)].
- There must not be any floor or ceiling on the variable interest rate of the swap [ASC 815-20-25-105(b)].
- The interval between repricings of the variable leg of the swap must be frequent enough to justify an assumption that the variable payment or receipt is at a market rate; six months or less is usually acceptable [ASC 815-20-25-105(c)].
- For fair value hedges of a proportion of the principal amount of the interest-bearing liability, the notional amount of the interest rate swap designated as the hedging instrument must match the portion of liability being hedged [ASC 815-20-25-105(e)].
- Finally, ASC 815-20-25-103 requires companies applying the shortcut method to initially review and document the creditworthiness of their counterparties and only consider the likelihood of the counterparty's compliance on an ongoing basis subsequent to initiation of the hedge program.

Risks and Benefits of Shortcut Method

At the 2006 AICPA National Conference on Current SEC and PCAOB Developments, Timothy Kviz, professional accounting fellow at the SEC's Office of the Chief Accountant, stated that there is no "spirit" or "principle" to the shortcut method (http://bit.ly/2v0LIUq). The SEC views the shortcut method as a rule-based exception to the ASC 815 framework and considers it subject to strict application of ASC 815 exception criteria. Improper application of the shortcut method may result in restatement; therefore, companies must carefully evaluate the application of shortcut method criteria to ensure that they are in compliance. In 2008, FASB proposed to eliminate the use of the shortcut method for fair value hedges of fixed rate debt after their initial issuance; however, the proposal was never finalized.

Nevertheless, application of the shortcut method for fair value hedges has remained appealing up to now despite the SEC's negative views, due to the following:

- Periodic evaluation of hedge effectiveness is not required.
- Changes in the fair value of hedged items are exactly the same as changes in

the fair value of derivatives, and as a result there is no impact on earnings.

- It does not require the existence of comparable credit risk between derivatives and hedged items.
- Accounting and related disclosures are generally more simplified.

Illustration

Entity A has a fixed-rate obligation and enters into a "receive-fixed, pay-floating" interest rate swap, with the variable leg of the swap set on the London Interbank Offered Rate (Libor), to avoid volatility in earnings as a result of fluctuation in fair value.

On July 15, 2015, Entity A issues a $10,000, non-callable, 6.5% fixed-rate note at par. The note is due on July 15, 2025, with semiannual payments interest payments due each January 15 and July 15 until maturity.

On the same day, Entity A enters into an interest rate swap contract for $10,000 notional amount. The swap receives interest at a fixed rate of 5.5% for the fixed leg of swap throughout the term of swap and pays interest at a variable rate equal to Libor plus 1% for the variable leg of swap throughout the term of the swap, with semiannual settlements and interest rate reset days due each January 15 and July 15 until maturity.

The shortcut method does not require that the fixed rate on a hedged item match the fixed rate on a swap. Similarly, it does not require the variable rate of the hedged item to match the rate of the variable leg of the swap (ASC 815-20-25-109). This is because the fixed and variable legs on a swap can be changed without affecting the net settlement if both are changed by the same percentage and amount. For example, a swap with a payment based on Libor and a receipt with a fixed rate of 6.5% has the same net settlement and fair value as a swap with a payment based on Libor plus 1% and a receipt based on a 5.5% fixed rate.

Exhibit 2
Benchmark Rate and Fair Value Changes

Date	Six-Month Benchmark Libor Rate	Swap Fair Value Asset (liability)	Debt Carrying Value
7/15/2015	5.0%	$–	$10,000
1/15/2016	6.5%	(1,500)	8,500
7/15/2016	4.0%	1,000	11,000

Entity A has designated the swap as a hedge of the changes in fair value of the fixed-rate note due to changes in the designated benchmark interest rate and Libor as the benchmark rate risk being hedged.

> Improper application of the shortcut method may result in restatement; companies must carefully evaluate the application of shortcut method criteria to ensure they are in compliance.

Therefore, Entity A qualifies to use the shortcut method. Since the critical terms (principal vs. notional amounts and maturity vs. expiration dates) of the debt and the interest rate swap match and other ASC 815 criteria are met, the hedge is considered to be perfectly effective.

Application of the shortcut method requires the following (Exhibit 1):

- First, calculate the difference between the fixed rate the company expects to receive on the swap and the fixed rate it expects to pay on the debt.
- Second, combine that difference with the variable rate applicable on the swap.
- Third, compute and recognize the semiannual interest expense using the combined rate and the fixed-rate debt's principal amount.

Exhibit 2 reflects the six-month benchmark Libor rates and the swap and debt corresponding fair values.

Below are sample journal entries reflecting the above fact pattern:

July 15, 2015, Journal Entry

1. Entity A makes the following journal entry at the initiation of the debt:

Cash	$10,000	
Debt		$10,000

January 15, 2016, Journal Entries

2. Entity A makes the following journal entries for interest payable. It accrues semiannual interest in the debt at an affixed rate of 6.5% [(6.5% × $10,000) ÷ 2] and pays the balance.

Interest expense	$325	
Accrued interest payable		$325
Accrued interest payable	$325	
Cash		$325

3. Entity A records the settlement of the semiannual swap-amount receivable at 5.5%, less the amount payable at LIBOR plus 1% at 5%, a decrease adjustment to the interest rate [((5.5% − 5.0%) × $10,000) ÷ 2]:

Cash	$25	
Interest expense		$25

In this scenario, Entity A has benefited from the execution of the swap, since the interest rate has declined.

4. Entity A records changes in the debt's fair value that are attributable to changes in the benchmark interest rate:

Debt	$1,500	
Gain on hedge activity		$1,500

5. Entity A records any changes in the fair value of the swap:

Loss on hedge activity	$1,500	
Swap contract		$1,500

Note that Entry 4 offsets Entry 5. Because Libor increased on January 15, 2016, it caused a decline in the fair value of the debt.

July 15, 2016, Journal Entries

6. Entity A makes the following journal entries for interest payable. It accrues semiannual interest at an affixed rate of 6.5% [(6.5% × $10,000) ÷ 2] and pays the balance.

Interest expense	$325	
Accrued interest payable		$325
Accrued interest payable	$325	
Cash		$325

7. Entity A records the settlement of the semiannual swap-amount receivable at 5.5%, less the amount payable at Libor plus 1% at 6.5%, an increase adjustment to the interest rate [((6.5% − 5.5%) × $10,000) ÷ 2]:

Interest expense	$50	
Cash		$50

In this scenario, Entity A has not benefited from the execution of the swap, since the interest rate has increased.

8. Entity A records changes in the debt's fair value that is attributable to changes in the benchmark interest rate:

Loss on hedge activity	$2,500	
Debt		$2,500

9. Entity A records any changes in the fair value of the swap:

Swap contract	$2,500	
Gain on hedge activity		$2,500

Note that Entry 8 offsets Entry 9. Libor declined on July 15, 2016 and caused an increase in the fair value of the debt.

Disclosures

ASC 815-10-50 requires that the notes to financial statements discuss how and why a company uses derivatives, how derivatives are accounted for, and their impact on the financial position of the company (including the results of operations and cash flows). These discussions should include the underlying risks (e.g., interest rates), their accounting designation (e.g., fair value hedges), and the levels of derivative activities.

Centene Corporation uses the shortcut method in its fair value interest rate swap program and made the following note disclosure in its Form 10-K for the fiscal year ended December 31, 2016:

> The Company uses interest rate swap agreements to convert a portion of its interest rate exposure from fixed rates to floating rates to more closely align interest expense with interest income received on its cash equivalent and variable rate investment balances. The Company has $2,100 million of notional amount of interest rate swap agreements consisting of: $600 million, expiring on February 15, 2021; $500 million, expiring on May 15, 2022; and $1 billion expiring on February 15, 2024. Under the Swap Agreements, the Company receives a fixed rate of interest and pays an average variable rate of the three-month LIBOR plus 3.92% adjusted quarterly. At December 31, 2016, the weighted average rate was 4.83%.
>
> The Swap Agreements are formally designated and qualify as fair value hedges and are recorded at fair value in the Consolidated Balance Sheets in other assets and/or other liabilities. Gains and losses due to changes in fair value of the interest rate swap agreements completely offset changes in the fair value of the hedged portion of the underlying debt. Therefore, no gain or loss has been recognized due to hedge ineffectiveness. Offsetting changes in fair value of both the interest rate swaps and the hedged portion of the underlying debt both were recognized in interest expense in the Consolidated Statement of Operations. The Company does not hold or issue any derivative instrument for trading or speculative purposes.
>
> The fair values of the Swap Agreements as of December 31, 2016 were assets of $4 million and liabilities of $62 million, and are included in other long-term assets and other long-term liabilities, respectively in the Consolidated Balance Sheet. The fair value of the Swap Agreements as of December 31, 2015 were assets of $11 million and liabilities of $2 million, and are included in other long term assets and other long term liabilities, respectively in the Consolidated Balance Sheet. The fair value of the Swap Agreements excludes accrued interest and takes into consideration current interest rates and current likelihood of the swap counterparties' compliance with its contractual obligations (http://bit.ly/2tTI3Gt).

ASU 2017-12 not only retains both the shortcut method and critical-terms-match method, but also provides additional relief for entities applying those methods.

Latest Developments

In August 2017, FASB issued ASU 2017-12, *Targeted Improvements to Accounting for Hedging Activities*, to improve the transparency and understandability of information conveyed to users and to simplify the application of hedge accounting by preparers. This ASU is effective for public business entities for fiscal years beginning after December 15, 2018, and interim periods therein. For all other entities, this ASU is effective for fiscal years beginning after December 15,

2019, and interim periods within fiscal years beginning after December 15, 2020. FASB permits early adoption of this ASU for all entities.

This ASU does not change the "highly effective" threshold in hedge accounting that this article discussed earlier. It neither changes the benchmark interest rate concept for fixed-rate financial instruments classified as fair value hedges even though it eliminates it for variable-rate financial instruments classified as cash flow hedges. Furthermore, this ASU not only retains both the shortcut method and critical-terms-match method, but also provides additional relief for entities applying those methods. Finally, this ASU adds new disclosure requirements, for example, entities must disclose the carrying amounts and cumulative basis adjustments of items designated and qualifying as hedged items in fair value hedges.

Ensuring Compliance

Fair value hedges address risks that arise due to interest rates that are fixed. For example, a company may use a fair value hedge (a "pay-floating/receive-fixed" interest rate swap) to hedge its fixed-rate debt. In this example, the use of an interest rate swap unlocks the fixed interest expense associated with the debt and creates interest rate expenses that vary with the market rate (the company will benefit if the market interest rate declines). Companies may use the shortcut method for their perfect hedge programs if certain criteria are met.

The SEC views use of the shortcut method as a rule-based exception to ASC 815 framework and emphasizes strict application of FASB's exception criteria. Any material inappropriate application of the shortcut method may result in restatement of financial statements. Therefore, companies must carefully evaluate the criteria for application of the shortcut method prior to its adoption to ensure that they meet the requirements of the guidance. Nevertheless, use of the shortcut method in fair value hedges has remained very popular due its accounting simplicity and lower administrative burden. ❑

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