

FASB IMPROVES HEDGE ACCOUNTING

DECEMBER 2025

SUMMARY

The Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2025-09¹, to improve hedge accounting by better reflecting the economic results of an entity's risk management activities. The ASU affects entities that elect hedge accounting under ASC 815² and addresses five issues by:

- ▶ Expanding the hedged risks that are permitted to be aggregated in a group of individual forecasted transactions in a cash flow hedge.
- ▶ Facilitating cash flow hedge accounting for forecasted interest payments on variable-rate debt that allows the borrower to change the interest rate index and tenor (commonly referred to as "Choose-your-rate debt instruments").
- ▶ Clarifying and expanding hedge accounting for forecasted purchases and sales of nonfinancial assets.
- ▶ Updating hedge accounting guidance on net written options as hedging instruments for differences in the loan and swap markets after cessation of the London Interbank Offered Rate (LIBOR).
- ▶ Resolving the recognition and presentation mismatch in dual hedge strategies involving foreign currency-denominated debt designated as both a hedging instrument in a net investment hedge and as the hedged item in a fair value hedge of interest rate risk.

These amendments generally will allow entities to achieve and maintain hedge accounting for highly effective economic hedges of forecasted transactions.

BACKGROUND

In 2017, the FASB issued ASU 2017-12³, to align hedge accounting more closely with an entity's risk management activities and simplify hedge accounting. Subsequently, the FASB received requests from stakeholders to clarify aspects ASU 2017-12 and to address other hedge accounting issues related to the cessation of LIBOR. Generally, the ASU allows hedge accounting to apply more broadly and reduces the risk of hedge dedesignation events or missed forecasts.

¹ *Hedge Accounting Improvements*

² *Derivatives and Hedging*

³ *Targeted Improvements to Accounting for Hedging Activities*

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MAIN PROVISIONS

Issue 1: Risk Similarity Assessment for Cash Flow Hedges

ASC 815 currently permits an entity to designate cash flow hedges of groups of forecasted transactions using a single derivative as the hedging instrument, if the individual forecasted transactions share the **same risk** exposure (among other hedge accounting requirements). Stakeholders said this requirement has become overly restrictive after LIBOR's cessation and the proliferation of alternative reference rates. The shift to multiple rates resulted in smaller, more granular loan pools and increased the risk of missed forecasts, limiting hedge accounting application.

WHAT THE ASU ADDRESSES

Expands the hedged risks that are permitted to be aggregated in a group of individual forecasted transactions in a cash flow hedge.

HOW THE ASU ADDRESSES IT

- ▶ Changes the requirement to designate a group of individual forecasted transactions that are hedged with a single derivative instrument from having a **shared risk** exposure to having a **similar risk** exposure.
 - An entity must perform a risk similarity assessment at hedge inception and on an ongoing basis (at a minimum, quarterly) during the hedge period.
- ▶ Allows the risk similarity assessment to be performed (using a selected method consistently for similar hedges) either:
 - **Individually**, by determining whether the derivative instrument used as the hedging instrument is highly effective in achieving offsetting changes in cash flows attributable to each hedged risk in the group.
 - **Collectively**, by determining whether each hedged risk related to a forecasted transaction hedged in a group is similar to each other hedged risk in the group. In this context, an entity will use the same threshold for determining whether a relationship is highly effective.
- ▶ In some cases, permits an entity to qualitatively perform the ongoing risk similarity assessment.
- ▶ If one or more hedged risks in the group are no longer similar, the entity must dedesignate the hedging relationship. Amounts previously recognized in accumulated other comprehensive income (AOCI) remain within AOCI until the forecasted transactions affect earnings or become probable of not occurring.

BDO INSIGHTS: DUAL PURPOSE ASSESSMENTS PERMITTED

BC25 of ASU 2025-09 acknowledges that an entity may apply a dual-purpose test that assesses both hedge effectiveness and risk similarity, thereby reducing cost and complexity. Many entities use a "test to worst" approach, which assumes that if a hedge is highly effective against the least effective risk in a group, the hedge is considered highly effective against all risks in the group. The amendments allow an entity to continue using this dual-purpose assessment.

Identifying the least effective risk in a group requires the application of professional judgment and may change over time, based on the facts and circumstances.

Issue 2: Hedging Forecasted Interest Payments on Choose-Your-Rate Debt Instruments

Before ASU 2017-12, ASC 815 broadly prohibited changes to the critical terms of a hedging relationship after initial hedge designation without dedesignation and redesignation. ASU 2017-12 introduced flexibility by allowing an entity to continue cash flow hedge accounting when the designated hedged risk changes if the hedging instrument remains highly effective against the revised hedged risk and the original risk management objective is maintained. However, stakeholders raised operability concerns with the amendments and asked the FASB to clarify them.

WHAT THE ASU ADDRESSES

Facilitates cash flow hedge accounting for forecasted interest payments on variable-rate debt that allows the borrower to change the interest rate index and tenor

HOW THE ASU ADDRESSES IT

- ▶ Provides a model for hedging forecasted interest payments on choose-your-rate debt instruments classified as liabilities, and allows entities to apply the guidance to existing, forecasted issuances, and subsequent replacements of choose-your-rate debt instruments.
- ▶ For forecasted issuances, requires that:
 - The entity (1) document the interest rate indexes and tenors included in choose-your-rate debt being offered in the market, (2) designate the contractually specified interest rate and tenor as the entity's best estimate of the interest rate index and tenor it will initially select when the choose-your-rate debt instrument is issued (which it will use to assess hedge effectiveness before debt issuance), and (3) assert that it is probable it will issue the debt instrument.
 - If the entity's best estimate of the interest rate index and tenor that it will select upon issuance changes to another rate that was documented at hedge inception, the entity must determine whether hedge accounting can continue, as discussed in ASC 815-30-35-37F and 35-37G.
 - If it becomes probable the interest rate index and tenor that the entity will select will be a rate that was not documented at hedge inception, or that the choose-your-rate debt will not be issued, the entity must immediately reclassify any gain or loss on the hedging instrument from AOCI into earnings. The entity also must assess whether it has demonstrated a pattern of determining that forecasted transactions are probable of not occurring and the propriety of using hedge accounting for similar forecasted transactions in the future.
- ▶ For existing choose-your-rate debt and replacement debt, requires that:
 - The entity (1) document the interest rate indexes and tenors included in the existing choose-your-rate debt, (2) designate the contractually specified interest rate and tenor as the then-selected interest rate index and tenor (which it will use to assess hedge effectiveness), and (3) assert that it is probable the forecasted interest payments on choose-your-rate debt or replacement debt will be made using one of the documented rates in (1).
 - If the contractually specified interest rate index and tenor changes to another that was documented at hedge inception, the entity must determine whether hedge accounting can continue, as discussed in ASC 815-30-35-37L and 35-37M.
 - If the entity selects an interest rate index and tenor that was not documented at hedge inception, or it is probable it will not make the forecasted interest payments using one of the documented rates, the entity must cease hedge accounting immediately with all gains or losses in AOCI reclassified in earnings.
- ▶ Allows simplified assumptions about the probability of forecasted transactions and hedge effectiveness.
- ▶ Prohibits applying the guidance by analogy, including choose-your-rate debt instruments classified as assets.

Issue 3: Cash Flow Hedges of Nonfinancial Forecasted Transactions

ASU 2017-12 introduced a model allowing cash flow hedges of forecasted purchases or sales of nonfinancial assets based on a contractually specified component explicitly referenced (or expected to be explicitly referenced) in the pricing formula of an agreement. Also, to designate a component in a forward contract that is a derivative in its entirety, ASU 2017-12 required an entity to apply the normal purchases and normal sales (NPNS) scope exception to avoid hedging speculative or extraneous price components. After ASU 2017-12 was issued, stakeholders requested clarification on issues such as the type and timing of supporting contracts, how component hedging interacts with the NPNS scope exception, and the ability to hedge component risks in spot market forecasted transactions.

WHAT THE ASU ADDRESSES	HOW THE ASU ADDRESSES IT
Clarifies and expands hedge accounting for forecasted purchases and sales of nonfinancial assets.	▶ Allows hedge accounting for eligible components of forecasted spot-market transactions, forward-market transactions, and subcomponents of explicitly referenced components in an agreement's pricing formula. ▶ Allows an entity to designate the variability in cash flows attributable to changes in a component (or subcomponent) of the forecasted purchase price or sales price of a nonfinancial asset as the hedged risk in a cash flow hedge: • If the purchase price or sales price of the nonfinancial asset is not determined using a pricing formula in an agreement, the hedged variable component must be clearly and closely related to the nonfinancial asset being purchased or sold. • If the purchase price or sales price of the nonfinancial asset is determined using a pricing formula in an agreement, the hedged variable component is either of the following: – Explicitly referenced in the agreement's pricing formula and clearly and closely related to the nonfinancial asset being purchased or sold. – Clearly and closely related to a variable component that meets the conditions in the preceding bullet (a subcomponent).⁴ ▶ Clarifies that an entity may designate a variable price component in a contract that is accounted for as a derivative as the hedged risk if all other hedge criteria are met.

BDO INSIGHTS: APPLYING THE CLEARLY AND CLOSELY RELATED TEST

In determining whether a variable component (or subcomponent) is clearly and closely related, as discussed in the table above, an entity applies ASC 815-10-15-32(a) and 15-32(b) of the NPNS scope exception. This precludes hedge accounting when the variable component (or subcomponent) includes speculative or leveraged terms that are inconsistent with "normal" purchases and sales.

Determining whether a variable component (or subcomponent) is clearly and closely related to the nonfinancial asset being purchased or sold (or to the variable component) requires the application of professional judgment and may change over time, based on the facts and circumstances.

⁴ Examples of subcomponents include ingredients, factors in production, and fair value inputs.

Issue 4: Net Written Options as Hedging Instruments

ASC 815 requires that for a cash flow hedge involving a net written option (such as an interest rate swap with a written cap or floor) as the hedging instrument, the combined hedged item and net written option must have symmetrical gain and loss potential, as discussed in ASC 815-20-25-94 and 25-95 (net written option test). Lending institutions often use interest rate swaps with mirror-image options to manage interest rate risk and therefore apply the net written option test for hedge eligibility. After LIBOR's cessation and the introduction of the Secured Overnight Financing Rate (SOFR), mismatched reference rate tenors between interest rate swaps and loans (such as Daily SOFR vs. Term SOFR) disrupted this symmetry, making similar economic relationships ineligible for hedge accounting. Stakeholders requested amendments to the test, noting it was not designed for post-LIBOR environments where underlyings differ.

WHAT THE ASU ADDRESSES	HOW THE ASU ADDRESSES IT
Updates hedge accounting guidance for differences in the loan and swap markets after LIBOR cessation.	▶ Eliminates the requirement to apply the net written option test to compound derivatives comprising a swap and written option designated as the hedging instrument in cash flow or fair value hedges of interest rate risk if the notional amount of the written option matches the notional amount of the swap.

Issue 5: Foreign-Currency-Denominated Debt Instrument as Hedging Instrument and Hedged Item (Dual Hedge)

ASU 2017-12 removed the separate recognition of ineffectiveness for net investment hedges, requiring amounts included in the assessment of effectiveness to be recognized in AOCI until the foreign entity is substantially liquidated. For dual hedges involving foreign-currency-denominated debt (where the debt instrument is designated as the hedging instrument in a net investment hedge and also as the hedged item in a fair value hedge of interest rate risk), the remeasurement gain or loss on the fair value hedge basis adjustment at the spot rate is therefore deferred in AOCI. Before ASU 2017-12, that remeasurement was recognized in earnings as ineffectiveness and offset by the derivative's foreign exchange remeasurement; that offset no longer exists after ASU 2017-12.

WHAT THE ASU ADDRESSES	HOW THE ASU ADDRESSES IT
Resolves the recognition and presentation mismatch in dual hedge strategies involving foreign currency-denominated debt designated as both a hedging instrument in a net investment hedge and as the hedged item in a fair value hedge of interest rate risk.	▶ Requires an entity to exclude from the net investment hedge effectiveness assessment the fair value hedge basis adjustment resulting from designating the foreign-currency-denominated debt instrument in the fair value hedge. • Results in recognizing immediately in earnings the gains and losses from remeasuring the debt instrument's fair value basis adjustment at the spot exchange rate. ▶ Prohibits applying the guidance by analogy.

EFFECTIVE DATE AND TRANSITION

The following table summarizes the effective dates and transition for the ASU:

	PUBLIC BUSINESS ENTITIES	ALL OTHER ENTITIES
Effective date	Fiscal years beginning after December 15, 2026, and interim periods within those annual periods.	Fiscal years beginning after December 15, 2027, and interim periods within those annual periods.
Early adoption	Allowed on any date on or after ASU 2025-09’s issuance.	
Transition	▶ Prospective basis for all hedging relationships. ▶ An entity is allowed to change specific critical terms of certain existing hedging relationships without dedesignating the hedge. ▶ See ASU 2025-09 for more transition requirements. ▶ An entity must disclose the nature of and reason for the change in accounting principle, as well as the method of applying the change, in both the interim reporting period and the annual reporting period that the entity adopts ASU 2025-09.	

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Link to [ASU 2025-09](#)

CONTACTS

THOMAS FAINETEAU
Professional Practice Principal, Accounting
tfaineteau@bdo.com

ROSCELLE HOLGADO
Professional Practice Principal, Accounting
rholgado@bdo.com

ADAM BROWN
Professional Practice National Managing Principal, Accounting
abrown@bdo.com

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