

IFRS Developments

A step forward in hedge accounting

What you need to know

The Board has tentatively decided that:

- ▶ A cash flow hedge of a net position can be an eligible hedged item even if the individual forecast transactions within the net position affect profit or loss in different periods.
- ▶ The forward points that exist at the inception of the hedging relationship may be recognised in profit or loss over time.
- ▶ An aggregated exposure qualifies as a hedged item.
- ▶ The fair value option is extended to 'own use' contracts.

The Board did not agree on how to account for hedges of credit risk. However, it plans to address this within the hedge accounting project.

Highlights

At its meetings in July, the International Accounting Standards Board (IASB, the Board) continued its redeliberations on the Exposure Draft Hedge Accounting (the ED) and made a significant step towards releasing a new standard on hedge accounting.

The tentative decisions of the Board are consistent with its intention to link an entity's risk management strategy with the rationale for hedging and the impact of hedging on the financial statements. This will allow many entities, both financial institutions and corporate, to apply hedge accounting to many more of their common hedging strategies. Nevertheless, some of the Board's decisions will increase the complexity and documentation requirements which is in contrast to the high-level aim to simplify hedge accounting.

The tentative decisions will allow many entities to reflect their hedging strategies more clearly in the financial statements.

Cash flow hedge of a group of net positions

The Board discussed cash flow hedges of net positions, such as foreign exchange hedges of the net purchases and sales of goods or services denominated in a foreign currency. The ED proposed that a net position resulting from a group of cash inflows and outflows would be an eligible hedged item if the cash flows in the group would individually be eligible hedged items and the group is managed on a group basis for risk management purposes. There was, however, a constraint that the individual cash flows in the group must all affect profit or loss in the same reporting period. If the individual cash flows affect profit or loss in different reporting periods, they will not offset each other in the income statement, i.e., there will be no 'natural hedge' for accounting purposes.

However, from a treasury perspective, net positions of forecast transactions are typically determined by adding the cash inflows and cash outflows for a given date, without taking into consideration when the individual cash flows affect profit or loss. The resulting net exposure is then hedged using a derivative. Some constituents raised concerns that the constraint in the ED conflicts with the broader goal of the hedge accounting project to align risk management strategies and the accounting outcome.

The Board has now tentatively decided to extend the eligibility for designation as a hedged item to net positions involving forecast transactions that affect profit or loss in different periods. This would, however, be limited to foreign exchange transactions only.

For a net position to qualify for cash flow hedge accounting, the hedge documentation would have to include the amount and nature of each individual item within the net position, as well as the reporting period in which it is expected to affect profit or loss.

Permitting cash flows within a net position to affect profit or loss in different periods means that the change in fair value of the cash flows that affect profit or loss in an earlier period must be carried forward. This is done to offset the change in fair value of cash flows that will occur in a later period. This is achieved by deferring the gain or loss on the earlier cash flows in other comprehensive income (OCI), with a reclassification to profit or loss once the later cash flows affect profit or loss.

How we see it

The proposal allows entities that hedge the net position of forecast transactions in a foreign currency on a cash flow basis to apply cash flow hedge accounting. This however requires increased documentation and tracking and entities will most likely need to change their processes to achieve the required accounting.

Hedge of a net position – presentation in the income statement

The Board has reconfirmed that the reclassification of gains or losses on a hedge of a net position should be presented in a separate line item in the income statement. As a consequence, the individual line items in the income statement affected by the forecast transactions will not be adjusted to reflect the result of the hedge.

The separate line item would also include the deferral of gains or losses on forecast transactions to later periods and their later reclassification to profit or loss, as discussed in the section before.

How we see it

The separate presentation in the income statement means that the hedged transactions that form part of the net position cannot be recorded at the hedged rate.

The approach is illustrated in the example below. Not that it is only the net impact in the income statement that is recorded at the hedged rate.

Example: Cash flow hedge of a group of net position

As an example, consider an entity anticipates sales of FC100 in 12 months' time and also intends to purchase fixed assets of FC80 in 12 months' time (both denominated in the same foreign currency). The net position is designated as a hedged group and hedged on a net basis with a forward contract for FC20. The fixed assets will be depreciated on a straight line basis over two years. For simplicity, assume the spot rate equals the forward rate.

Spot rate for FC at inception	1.50	
Spot rate for FC end of year 1	1.60	
Spot rate for FC end of year 2	1.40	
Year 1		
Sales of FC100 recognised at spot rate	160	100 * 1.60
Initial recognition of fixed assets at spot rate	128	80 * 1.60
Loss on derivative	-2	20 * (1.50 - 1.60)
Deferral of favourable change in spot rate on sales from P&L to OCI	-8	80 * (1.50 - 1.60)
Net impact in the income statement	150	100 * 1.50
Year 2		
Depreciation of fixed assets	-64	
Reclassification of deferral in OCI to P&L	4	
Net impact in the income statement	-60	80 * 1.50 * 50%
Year 3		
Depreciation of fixed assets	-64	
Reclassification of deferral in OCI to P&L	4	
Net impact in the income statement	-60	80 * 1.50 * 50%

The proposed accounting for forward points will allow financial institutions to better reflect the economic yield achieved in funding swap transactions.

Accounting for forward points

Forward contracts are widely used for hedging exposures to foreign exchange risks. Currently, an entity can designate either the forward contract in its entirety, or only the changes in the spot element of the contract price as the hedging instrument. If the entity designates the spot element only, changes in the fair value of the forward points (i.e. the forward premium or discount compared to the spot rate) are recognised as a trading gain or loss in profit or loss. The ED originally proposed to retain this approach.

Following feedback from comment letters and outreach activities, the Board has now tentatively decided to align the accounting for forward points with the proposed accounting for the time value of options used as a hedging instrument. This would permit the forward points that exist at the inception of the hedging relationship to be recognised as interest income or expense in profit or loss over time and subsequent changes in the fair value of the forward points to be accumulated in other comprehensive income.

The forward points reflect the difference in interest rates between the two currencies for the term of the contract. By recognising the forward points that exist at inception of the hedging relationship as interest income or interest expense, the economic substance of the forward points is reflected in profit or loss.

Financial institutions often hedge their exposure to financing and investing activities in different currencies using forward contracts. These are often referred to as funding swaps. These institutions would now be able to reflect the economic yield achieved as a result of the hedging more effectively.

Entities would also continue to be permitted to designate the forward contract in its entirety.

How we see it

The proposed changes are a further step in providing a better link between an entity's risk management strategy and the impact of hedging on the financial statements. However, non-financial institutions using this type of hedging strategy may prefer to designate the entire contract as it is simpler.

Aggregated exposures

Entities often hedge an exposure using a derivative (which can be termed the 'first level relationship') before deciding later to hedge the aggregated exposure resulting from the first relationship with another derivative (i.e., a 'second level relationship'). Under IAS 39 *Financial Instruments: Recognition and Measurement*, an entity cannot add a second derivative as a joint designation after the inception of the hedging relationship without first discontinuing the original hedging relationship. The ED would allow an aggregated exposure to be designated as a hedged item.

The feedback the IASB has received supports the proposal. The Board has therefore reconfirmed its position in the ED. To clarify the accounting mechanism for a hedge of an aggregated exposure, the IASB tentatively decided to add three illustrative numerical examples to accompany the final standard. The examples clarify that the individual items within the aggregated exposure are accounted for separately. However, hedge ineffectiveness is measured and recognised for the aggregated exposure as a whole.

How we see it

Applying hedge accounting to aggregated exposures will allow many entities to better reflect their risk management strategies in the income statement.

The own use scope exception

A contract to buy or sell a non-financial item that can be settled net in cash and is held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements, is outside the scope of IAS 39 (the so-called *own use* scope exemption). Such own use scope contracts are accounted for as executory contracts rather than using derivative accounting. The ED proposed that derivative accounting should be applied to an own use contract if it is entered into in accordance with a fair value-based risk management strategy and the entity manages the net risk position to nil or close to nil.

Although the aim of this proposal was to eliminate accounting mismatches arising when hedging an exposure from an own use contract, some respondents pointed out scenarios where the proposal would create an accounting mismatch. An example of a mismatch would be if an entity manages own use contracts and inventory on a fair value basis, but the inventory is measured in accordance with IAS 2 *Inventories* at the lower of cost and net realisable value while the own use contracts are measured at fair value. Therefore, the IASB has now tentatively decided to extend the fair value option in IFRS 9 *Financial Instruments* to own use contracts in situations in which it eliminates or significantly reduces an accounting mismatch. In other words, the fair value measurement of own use contracts would be optional (under certain conditions) rather than mandatory.

How we see it

A fair value option will help to avoid unintentional accounting mismatches, particularly for commodity traders and in the power utilities industry.

Hedges of credit risk using credit derivatives

Many financial institutions hedge the credit risk arising from loans, bonds or loan commitments using credit default swaps (CDS). However, under IAS 39, hedge accounting cannot normally be applied due to the difficulty in isolating and measuring the credit risk as a risk component that meets the eligibility criteria. The resulting accounting mismatch creates profit or loss volatility.

The ED did not propose any changes in this area, however, the IASB asked its constituents to comment on three alternative approaches. The feedback from the comment letters shows that accounting for credit risk hedging strategies is a major concern for many constituents, especially financial institutions, who did not favour any of the three approaches.

In its redeliberations the Board tentatively decided to further address this issue in the hedge accounting project. Nevertheless, the Board could not agree on any of the three alternatives set out in the ED. There was a particular concern about the relationship between this issue and the project on impairment of financial assets. Therefore, the Board asked the staff to present further analysis at the next meeting.

Looking ahead

The IASB will continue its redeliberations at the September board meeting, including disclosures and transition. The Board will also develop proposals related to macro hedge accounting, a subject which was not covered in the ED.

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EYG no. AU0926

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