Almost a year after finalising the redeliberations, the general hedge accounting project is now finally on the home straight. This forms part of the third phase of the IFRS 9 Financial Instruments project to replace IAS 39 Financial Instruments: Recognition and Measurement. A Review Draft (RD) of the final standard is available on the IASB's website and can be accessed for a period of 90 days. The final standard is expected to be issued in the fourth quarter of 2012.

In its redeliberations, the Board retained the aim of the project to provide better links between an entity’s risk management activities, the rationale for hedging and the impact of hedging on the financial statements. However, the Board has made some significant changes to certain aspects of the proposals contained in the Exposure Draft (the ED) that was issued in December 2010.

This edition of IFRS Developments summarises the main changes in the RD and compares them to the proposals in the ED.

**How to achieve hedge accounting**

1. Define risk management (RM) strategy and objective
2. Identify eligible hedged item(s) and eligible hedging instrument(s)
3. 
   1) Is there an economic relationship between the hedged item and the hedging instrument?
   2) Does the effect of credit risk dominate the fair value changes?
   3) Does the hedge ratio reflect an imbalance that creates hedge ineffectiveness?
4. To avoid ineffectiveness, the ratio may have to differ from the one used in RM
5. Formal designation and documentation
Hedge effectiveness requirements to qualify for hedge accounting

Exposure Draft

To qualify for hedge accounting, the hedge relationship must (prospectively) produce an unbiased result, minimise hedge ineffectiveness and achieve other than accidental offsetting.

The umbrella terms “unbiased result”, “minimise ineffectiveness” and “other than accidental offsetting” are withdrawn and replaced by a fuller explanation of the hedge effectiveness requirements. In order to qualify for hedge accounting, the three requirements are now, as follows:

- There must be an economic relationship between the hedged item and the hedging instrument.
- The effect of credit risk should not dominate the value changes in the hedging relationship.
- The weightings of the hedged item and the hedging instrument (i.e., hedge ratio) shall be designated based on the quantities of hedged item and hedging instrument that the entity actually uses to meet the risk management objective, unless so doing would deliberately create ineffectiveness.

Effectiveness assessment, rebalancing and discontinuation

The first requirement means that the hedging instrument and the hedged item must be expected to move in opposite directions as a result of a change in the hedged risk (i.e., there is causality and not just correlation). A perfect correlation between the hedged item and the hedging instrument is not required and, indeed, would not be sufficient on its own. To prove causality, there must be an economic relationship. For example, it would be possible to hedge a Brent crude oil exposure using a West Texas Intermediate derivative.

The impact of changes in credit risk should not be of a magnitude such that it dominates the value changes, even if there is an economic relationship between the hedged item and hedging derivative.

The third requirement indicates that the actual hedge ratio used for accounting should be the same as that used for risk management purposes, unless the ratio is inconsistent with the purpose of hedge accounting. The Board appears to be specifically concerned with deliberate under hedging, either to minimise recognition of ineffectiveness in cash flow hedges or the creation of additional fair value adjustments to the hedged item in fair value hedges.

Consistent with ED, the RD does permit a qualitative hedge effectiveness assessment.

Rebalancing

Exposure Draft

Hedge relationships must be rebalanced (i.e., adjustment of the hedge ratio) if they fail to meet the objective of hedge effectiveness while the risk management objective remains the same.

The RD has retained the requirement for rebalancing to be undertaken if the risk management objective remains the same, but the hedge effectiveness requirements are no longer met. However, in line with the new hedge effectiveness requirements, there is clearer guidance. Typically, accounting rebalancing will only be undertaken when adjustments are made to the actual quantities used for risk management purposes. A key exception to this would be where deliberate and inappropriate action or inaction is undertaken for actual risk management purposes to achieve an accounting result that is inconsistent with the purpose of hedge accounting.

In addition, there is more explicit confirmation in the RD that rebalancing only includes adjustments to the quantities of the hedged item or hedging instruments in order to maintain an appropriate hedge ratio and should not be applied any wider.

Discontinuing hedge accounting

Exposure Draft

Voluntary discontinuations are not permitted if the risk management objective remains unchanged.

The IASB did not change the proposals on discontinuation. However, further guidance has been added on how to distinguish between an entity’s risk management strategy and its risk management objective. Risk management strategy is established at the highest level at which an entity manages risk, and may include some flexibility to react to changes in circumstances without requiring a new strategy. The risk management objective however, applies at the particular hedge relationship level and is a means of executing the risk management strategy.
The guidance highlights certain common situations where the risk management objective changes, such that hedge discontinuation is required. One example is a dynamic hedging approach to an open interest rate portfolio, where an entity frequently adjusts the hedging instruments as the exposure changes. The example explains that the risk management strategy would be unchanged, but the individual short-term hedges would each have an individual risk management objective that changes as the hedging instruments are adjusted.

Designation of risk components

Exposure Draft

A risk component is an eligible hedged item if it is separately identifiable and reliably measurable. Unless contractually specified, inflation risk is not an eligible risk component for financial instruments.

The Board retained the principle for financial and non-financial risk components to be separately identifiable and reliably measurable, the assessment of which must be made within the context of the particular market structure. The term “market structure” is undefined. Just because there exists a derivative instrument on rubber and rubber is a physical component of a car tyre, this does not automatically mean that the rubber component qualifies as an eligible risk component in a hedge of highly probable forecast car tyre purchases. We believe the RD requires additional analysis of how car tyres are actually priced in the market and how this relates to the price of rubber.

In a change to the ED, the RD now includes a rebuttable presumption that non-contractually specified inflation risk will not usually be an eligible component of a financial instrument. The proposal now also includes examples of two scenarios, one in which an inflation risk component is eligible for hedge accounting (i.e., the presumption is rebutted) and another in which it is not.

Accounting for fair value hedges

Exposure Draft

The gain or loss on the hedging instrument and the hedged item should be presented in other comprehensive income (OCI), with the ineffective portion presented in the income statement. The gain or loss on the hedged item that is attributable to the hedged risk should be presented as a separate line item in the statement of financial position.

To address the concern of constituents of possibly having several new line items in the statement of financial position, the Board decided to ignore the proposals in the ED and retain the current IAS 39 requirements for fair value hedge accounting.

Cash flow hedge of a group with offsetting positions

Exposure Draft

A net position resulting from a group of cash inflows and cash outflows would be an eligible hedged item in a cash flow hedge, if:

- The items in the group would individually be eligible hedged items
- The items in the group are managed on a group basis for risk management purposes

And

- The individual cash flows in the group all affect profit or loss in the same reporting period

A typical example for a hedge of a net position would be a foreign exchange hedge of the net purchases and sales of goods or services denominated in a foreign currency. If the individual cash flows within the net position affect profit or loss in different reporting periods, there will be no “natural hedge” for accounting purposes. This is why the ED prohibited such hedges from cash flow hedge accounting.

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.

To better align the risk management strategies commonly used with the accounting treatment, the Board has retained the first two requirements in the RD, but there is no longer a need for all hedged items to affect profit or loss in the same reporting period. However, cash flow hedge accounting for a net position is now limited to a hedge of foreign exchange risk.

In addition, for a net position to qualify for cash flow hedge accounting, the hedge documentation would need to specify the volume and nature of items within the net position, as well as the reporting period in which each item 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 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 OCI, with a reclassification to profit or loss once the later cash flows affect profit or loss.

However, the transactions that make up the net position would each need to be recorded when they arise at the spot foreign currency rate ruling at that time. Any effect of hedge accounting on profit or loss would need to be recorded in a separate and single line item in the income statement.
Many financial institutions hedge the credit risk arising from loans, bonds or loan commitments using credit default swaps (CDS). However, under IAS 39 and the proposed hedge accounting model in the ED, hedge accounting is not normally applied due to the difficulty in isolating and measuring the credit risk as a risk component that meets the eligibility criteria.

The IASB has decided that an entity undertaking economic credit risk hedging may, at any time, elect to account for a loan or loan commitment (i.e., the hedged item) at fair value through profit or loss (FVTPL). This election, which was one of the proposed alternatives in the ED, can only be made if the credit derivative reference asset has the same issuer and subordination as the hedged exposure. The measurement adjustment (i.e., the difference on switching from amortised cost to fair value) would be immediately recognised in profit or loss. The credit derivative would continue to be accounted for at FVTPL.

The election can also be revoked, in which case, the fair value of the loan at this date becomes its deemed amortised cost. The fair value of a loan commitment at this date is amortised over the remaining commitment period.

**Own use contracts**

Under IAS 39, a contract to buy or sell a non-financial item that can be settled net in cash and that is entered into and continues to be 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 accounted for as an executory contract, rather than within the scope of IAS 39 (the so-called “own use” scope exemption).

The IASB has changed the treatment for such own use contracts in the RD and 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. This means that the fair value measurement of own use contracts would be optional (under certain conditions) rather than mandatory.

**Looking ahead**

The US Financial Accounting Standards Board will also have sufficient time to analyse the IASB proposal during the 90-day period and to consider whether to reflect certain elements in its own proposal on hedge accounting. Meanwhile, the Board continues its deliberations on portfolio (or macro) hedge accounting. At the May 2012 meeting the IASB decided to decouple the macro hedge accounting project from the IFRS 9 project. Consequently, the Board also decided that entities could still make use of fair value hedge accounting for portfolio hedges of interest rate risk as defined in IAS 39 until the macro hedge accounting project is finalised and becomes effective. The implementation guidance on macro cash flow hedge accounting (IAS 39.IG.F.6.2 and F.6.3) is not carried forward, on the basis that macro cash flow hedge accounting should be achievable under the new general hedge accounting model.

This publication only summarises the key changes of the proposals in the RD compared with the proposals in the ED. We encourage entities to analyse the RD in detail to understand the impact the new hedge accounting model would have on their hedging activities. We will issue a comprehensive publication including application guidance once the standard is finalised.