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Accounting alert

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Hedge accounting using non-zero fair value derivatives

There are a number of scenarios where an entity may designate an existing derivative into a new hedging relationship. On designation of the new hedging relationship the derivative may have a fair value other than zero as a result of changes in market conditions.

This non-zero fair value element may give rise to unexpected ineffectiveness in the hedging relationship, which may result in the derivative being disqualified from hedge accounting.

Entities need to be cautious when using these derivatives and be aware that ineffectiveness may result.

This *Accounting Alert* raises awareness of this issue.

The designation of a non-zero fair value derivative in a hedging relationship frequently occurs.

Common scenarios where an entity may designate a non-zero fair value derivative in a hedging relationship

There are a number of scenarios where an entity may choose to designate a non-zero fair value derivative in a hedging relationship. In many of these scenarios the entity would not be aware that they are exposed to any ineffectiveness on the hedge, for example:

- **subsequent designation** – Hedge relationship does not qualify for hedge accounting as the entity failed to meet the designation or documentation requirements of AASB 139. Subsequently the entity completes the required documentation and designates the derivative into a hedging relationship
- a**cquired in a business combination** – After the business combination the entity may wish to designate an acquired derivative in a new hedging relationship or continue to hedge account the acquired hedge relationships at the group level
- **revoke and redesignate** – An entity may revoke an existing hedging relationship in terms of AASB 139 and then subsequently elect to re-designate the relationship as a hedge
- **disqualify and redesignate** – Hedge relationship is disqualified for hedge accounting as a result of unanticipated ineffectiveness. The derivative is designated into a new hedging relationship.

In these scenarios the derivative is unlikely to have a zero fair value at the date that the derivative is designated in the 'new' hedging relationship. This is because the market conditions at this date are likely to be different to the market conditions at the date the derivative was originated.

What causes the ineffectiveness

The non-zero fair value component of the derivative introduces an additional exposure to fair value changes that may not be inherent in the hedged item.

The non-zero fair value component of the derivative introduces an additional exposure to fair value changed that may not be inherent in the hedged item. Subsequent changed in fair value of the derivative may therefore not be equal and opposite to the subsequent changes in the hedged item.

The non-zero fair value of the derivative is best broken into two components:

- a derivative with on market terms (thus a zero fair value)
- an embedded loan or deposit for a derivative in a liability position and derivative in an asset position respectively.

The loan or deposit represents the amount that would have to be paid to settle a derivative liability or the amount that would be received for a derivative asset at the date that the entity decides to re-designate the derivative in a new hedge relationship ("finance element"). Over the remaining life of the derivative, the finance element will be settled through net payments on the derivative.

The finance element will impact the derivative's fair value. The finance element changes in fair value for two reasons:

- the appropriate discount rate to evaluate the financing cash flows will change in each period
- the period over which the cash flows are discounted reduce as the derivative moves towards maturity.

It is this change in fair value of the financing element that represents potential hedge ineffectiveness, not the eventual settlement of the financing element.

The impact of the finance element would be different depending on whether the derivative is designated into a cash flow hedging relationship or a fair value hedging relationship.

Cash flow hedge relationship

The embedded finance element potentially impacts a cash flow hedge relationship on the effectiveness of the hedge and the amount deferred and released from equity.

The use of a non-zero fair value derivative in a cash flow hedge can impact on two areas:

1) amount deferred in equity

2) effectiveness (both anticipated and actual results)

In terms of AASB 139 the entity can only defer in equity the effective portion of the hedge which is the lesser of:

- The cumulative gain or loss on the hedging instrument from inception of the hedge
- The cumulative change in fair value of the expected cash flows on the hedged item from inception of the hedge.

In order to measure the effective portion of the hedge, entities commonly create a hypothetical derivative. This would be a derivative with a zero fair value at the inception of the hedge and have the same critical terms as the hedged item. Gains and losses on the hypothetical derivative represent the effective portion of the cash flow hedge. Other movements on the actual derivative represent ineffectiveness. Fair value movements attributable to the embedded finance element may be a source of ineffectiveness. At a minimum the ineffectiveness will be the interest component of the fair value at the inception of the new hedge relationship.

Ineffectiveness may still exist even where the derivative was included in a previous effective cash flow hedge relationship.

Where the derivative was designated in a previous highly effective cash flow hedge relationship, the fair value of the derivative at the inception of the new hedge would have been deferred in equity. As the previous hedge relationship has been terminated, the entity is required to amortise the amount deferred in equity as the original hedged cash flows effect earnings. It would not be appropriate to defer in equity further fair value gains or losses in respect of that old hedge (i.e. fair value change arising from the finance element) as this represents hedge ineffectiveness on the new relationship, which can never be deferred in equity.

An entity is required to separate out the embedded finance element and only defer the effective portion of the hypothetical zero fair value derivative in equity. The amount deferred in equity will not equate to the change in fair value of the derivative from the inception of the hedge.

Fair value hedge relationship

The impact of the embedded finance element on a fair value hedge relationship will depend on the hedged item.

The use of a non-zero fair value derivative in a fair value hedge can impact effectiveness (both anticipated and actual results) of the hedge relationship.

Depending on the hedged item, the use of non-zero fair value derivatives in a fair value hedge may create ineffectiveness but could equally reduce the ineffectiveness in the fair value hedge relationship.

For example:

An interest rate swap is designated as a hedge of a fixed rate bond. The bond was originated in the same historic interest rate environment as the swap. In this case, the fixed rate leg of the interest rate swaps is more likely to approximate the critical terms of the fixed rate debt and therefore effectively offset subsequent changes in fair value. The fair value of the derivative at inception of the hedge arising from interest rate changes would be equal and opposite to that of the hedged item. As the exposure to the finance element component is within both instruments, any subsequent changes in fair value as a result of this component will impact both instruments and therefore increase effectiveness.

Careful analysis of the hedged item and the cause of the fair value change of the derivative at the inception of the hedge should be performed.

What to do?

AASB 139 does not preclude the use of non-zero fair value derivatives in a hedging relationship. A hedgers need to be aware of the potential impacts.

AASB 139 does not preclude the use of non-zero fair value derivatives. However, entities need to be cautious when using them and be aware of potential ineffectiveness. Entities may also need to adopt a different method of assessing effectiveness in their hedges.

Irrespective of the hedging relationship, the ineffectiveness needs to be quantified and incorporated in the assessment of the effectiveness of the hedge. This may result in a hedge being disqualified from hedge accounting as either the hedge is not expected to be highly effective at the inception of the hedge relationship, or during the hedge the actual results of the effectiveness testing may be outside of the 80% – 125% requirement.

Entities should perform an analysis of the potential ineffectiveness that the finance element may cause.

Potential ineffectiveness likely to increase where market conditions have changed significantly, there derivative has multiple payments and has a long period to maturity.

The degree of ineffectiveness is likely to increase where:

- market conditions have changed significantly since the origination of the derivative such that the fair value is significantly off zero at the inception of the hedge relationship
- the derivative has multiple cash flow payments over its life
- there is a relatively long time to maturity of the derivative or the series of payments extend for a significant period of time.

Feedback and assistance

We welcome your feedback on the matters covered in this Accounting Alert – please email your comments to **accounting_alerts@deloitte.com.au**

For assistance in applying the requirements to your organisation, please contact your local Deloitte office, our Lead National Technical Partner, **Bruce Porter** on **(03) 9208 7490**, or by e-mail to **bruporter@deloitte.com.au** or our Financial Instruments specialist, **John Kidd** on **(03) 9208 7357**, or by e-mail to **jkidd@deloitte.com.au**