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Infrastructure Accounting Alert
Accounting developments affecting the infrastructure industry

IASB issues Hedge Accounting Draft

In a nutshell
On 7 September 2012 the International Accounting Standards Board (IASB) issued near final proposals on the new hedge accounting requirements set to replace those in IAS 39 *Financial Instruments: Recognition and Measurement.*

The proposals would allow entities to reduce profit or loss and balance sheet volatility by applying hedge accounting in more circumstances. The change in accounting treatment is expected to prompt some companies to review their risk management activities which may have been restricted by the current requirements in IAS 39.

Background
The IASB has an on-going project to improve and simplify financial instrument accounting under IFRS. The project is divided into three phases: classification and measurement, impairment and hedge accounting. Of these three phases, hedge accounting is likely to have the greatest impact on non-financial corporates. The hedge accounting draft is the last stage before the final hedge accounting requirements are issued and incorporated into IFRS 9 Financial Instruments – the replacement to IAS 39. Once finalised the requirements will be effective for periods beginning on or after 1 January 2015.

The IASB's objective with the hedge accounting phase has been to review comprehensively the current requirements and more closely align them with risk management, resulting in more useful information for users of financial statements. The proposed requirements are less rules based than IAS 39 and allow companies more opportunities to mitigate earnings volatility arising from current restrictions on hedge accounting. The key areas impacting the infrastructure industry are highlighted below along with links to more detailed information and contacts should you wish to discuss these changes further.

Points of focus for the infrastructure industry
Risk component hedging
The new proposals increase the range of economic hedges eligible for hedge accounting. For the infrastructure industry the proposals provide greater opportunity to achieve hedge accounting when hedging risk components such as inflation risk or commodity price risk. The current standard restricts hedge accounting for non-financial items to hedges of foreign exchange risk or all price risk. Therefore, if an entity is hedging only a component of risk, for example the inflation component of a non-financial contract, it cannot apply hedge accounting for that component in isolation. For a financial item, such as an issued bond, risk components are permitted, however, the current standard specifically disallows hedge accounting for inflation unless the inflation component is specified in the contract.

The draft proposals introduce two changes which could make hedge accounting for inflation more achievable. Firstly, a risk component of a non-financial item, such as an operating lease or construction contract, is eligible provided it is separately identifiable and reliably measurable (which would generally be the case if it is contractually specified).

Secondly, the IASB has introduced an exception to the restriction on hedging inflation in financial items applicable in limited cases where it can be demonstrated it is a separately identifiable and reliably measurable component despite not being contractually specified. This opens the door to hedge accounting that better reflects the economics of the hedge. Allowing a closer match between the hedged risk and the hedging derivative will result in better offset and more stable profit or loss.

Hedging with option contracts
Under the proposals, the accounting treatment of option contracts designated as hedging instruments would be less volatile in profit or loss than under IAS 39. The proposed treatment would apply to a variety of vanilla and structured option contracts including those that hedge commodity price risk, interest rate risk and foreign exchange risk. The proposals would require the change in the time value of an option, which can be volatile, to be recognised in other comprehensive income and reclassified to profit or loss on a more stable basis.

Synthetic exposures
Under the proposals, synthetic exposures that include derivatives can be designated as eligible hedged items. For example, consider a GBP entity with a forecast foreign debt issuance which will be hedged for FX risk when the debt is issued using a cross-currency interest rate swap (CCIRS) exchanging the foreign currency interest and principal flows for GBP. Unlike IAS 39, the proposals would allow the synthetic forecast GBP debt issuance to be designated in a pre-hedge of UK LIBOR interest rate risk even though the hedged item includes a derivative (ie the CCIRS). This change should enhance the effectiveness of such hedges and make hedge accounting more achievable in practice.

Effectiveness testing
Hedge accounting relationships would no longer have to meet the 80 to 125 per cent offset criteria currently required for prospective and retrospective effectiveness testing in IAS 39. Instead an entity would need to demonstrate that an 'economic relationship' exists between the hedged item and hedging instrument at the beginning of the hedge.

This could result in more hedging relationships qualifying for hedge accounting (especially when combined with other changes such as those noted above).

Timing
The proposals are expected to be issued as a final standard by the end of 2012. The effective date of the standard will be for accounting periods beginning on or after 1 January 2015 with early adoption permitted. For companies reporting in the European Union endorsement of the final standard will be necessary before it can be applied.

Things to consider now
The current IAS 39 requirements have caused some risk management activities to be restricted in order to limit periodic earnings volatility. Hence, the changes introduced in these proposals should be well understood by not only the accounting function but also those responsible for risk management. Risk management policies should be reviewed in light of these changes and their effect on longer term risk management decisions considered. Furthermore, they should be considered as part of any planning and decisions around risk management, treasury and accounting systems. Finally, the draft also provides an opportunity to raise any concerns about the proposals directly with the IASB before they are issued in final form.

Resources
A comprehensive summary of the proposals can be found in the Deloitte iGAAP Alert publication on the Hedge Accounting Draft at www.deloitte.com/view/en_GB/uk/services/audit/ba70548f30bb9310VgnVCM3000001c56f00aRCRD.htm

Also a podcast discussing the proposals is available at www.iasplus.com/en/publications/deloitte-ifrs-podcasts/deloitte-ifrs-podcast-2013-iasbs-draft-ifrs-on-general-hedge-accounting

Illustrative examples of the application of these proposed requirements can be found in the Deloitte A Closer Look publication at www.iasplus.com/en/publications/ifrs-in-focus/2012/a-closer-look

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