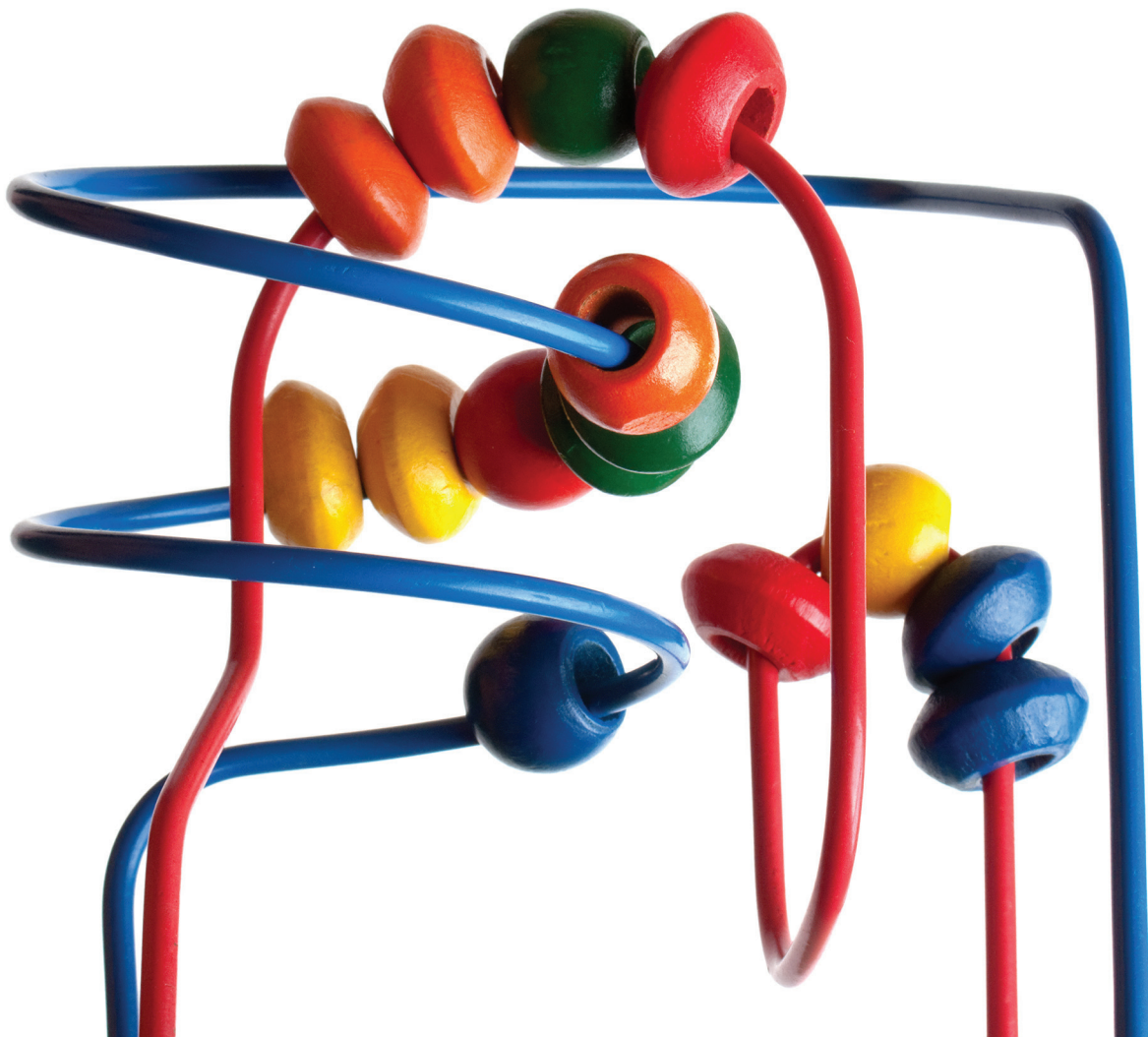
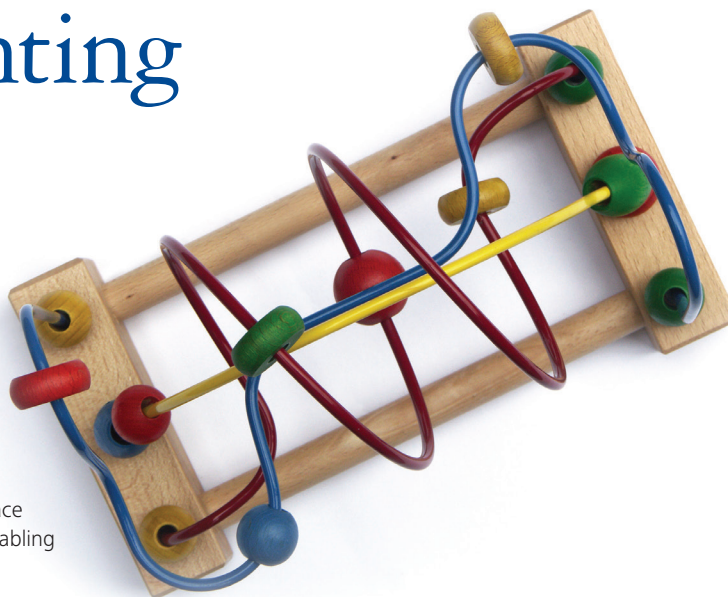


Hedge Accounting
Adapting to change



Hedge Accounting



Background

The Exposure Draft ("ED") on Hedge Accounting was released in December 2010. This is the final phase in the project to replace IAS 39 by IFRS 9. The ED aims to reduce complexity, thereby enabling more entities to apply hedge accounting.

Executive Summary

The proposals in the ED aim to relax many of the stringent rules encountered when applying the current hedge accounting model. The relaxation of rules-based effectiveness testing and introduction of the concept of rebalancing invokes a principle-based approach to hedge accounting. This may encourage and enable more entities to apply hedge accounting, but may also limit the ability to hedge account where entities have adopted hedge accounting in its current form to achieve a financial statement result, as opposed to executing a risk management strategy.

Benefits of Applying Hedge Accounting

- Aligning accounting treatment with risk management policy
- Reducing volatility in profit or loss
- Ability to defer unrealised gains or losses on hedging instruments in other comprehensive income until the hedged item is recognised in profit or loss
- Headline earnings per share better reflects the entity's economic performance for the year
- Gross profit margin better reflects the entity's economic profit
- Enables users of the financial statements to analyse operating and hedging activities separately
- Performance measurement can be improved as management can be rewarded for their operational performance, disregarding market risks that fall outside of the control of management



Claudette van der Merwe

Associate Director - Actuarial & Quantitative Solutions

+27 (0) 82 457 6891

cvandermerwe@deloitte.co.za

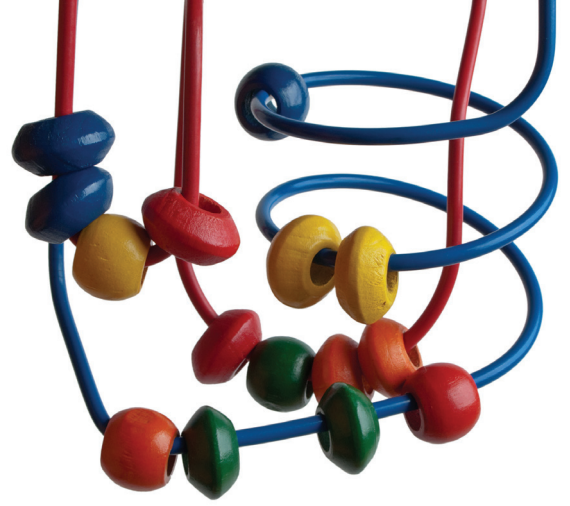


Trevor Derwin

Director - Accounting & Auditing

+27 (0) 82 419 4684

trderwin@deloitte.co.za



Key changes

Hedge accounting to be aligned to risk management activities.

It needs to be demonstrated that a degree of offset exists between the movement in the fair value of the hedging instrument and the movement in the fair value of the hedged item, and that the offset is not merely accidental. This is referred to as hedge effectiveness. Depending on a number of factors, this could be illustrated either qualitatively or quantitatively (using a statistical methodology).

Prospective effectiveness test still required, retrospective test no longer required.

Bright line threshold for hedge effectiveness testing is removed i.e. no 80% to 125% effectiveness required.

Hedge ratios (i.e. the quantity of the hedged item versus the quantity of the hedging instrument) could be mathematically altered ("rebalanced") to improve hedge effectiveness.

Proof is required that hedge ineffectiveness has been minimised by applying the appropriate hedge ratios. A quantitative approach would be required to demonstrate this.

Risk components of non-financial items can now be hedged, e.g. the component of the price of tyres that references the market price of rubber.

Voluntary de-designation of a hedging relationship would only be permitted when there is a change in the overall risk strategy.

Relief is provided for hedging with options.

A derivative could be designated as a hedged item.

What you need to be thinking about now...

Will your competitors hedge as a result of the new standard? This might have an impact on their cost and pricing strategy.

Are there less onerous alternatives available that might meet the entity's requirements, other than applying hedge accounting, considering the different designation options under IFRS 9?

Has the risk management strategy been appropriately defined by the right level of management and is the establishment of a risk management committee necessary?

Have the risk management objectives been appropriately documented?

Does the entity's current strategy meet the risk management objectives or will the entity have to re-designate, terminate or enter into additional derivatives to eliminate inconsistencies with risk management objectives?

What type of instruments will be used to hedge? There is often a trade-off between entering into an instrument that will match the critical terms of the hedged item and the cost of entering into the 'perfect' instrument.

What are the operational impacts of hedge accounting? Does the entity have the systems and processes capabilities to do the valuations and to obtain the disclosure elements required for hedge accounting purposes?

How will the prospective effectiveness of the hedge be proved, also considering the requirement for rebalancing? It might be more difficult to prove effectiveness and more onerous to rebalance using the dollar offset method than to use regression analysis.

Economic Hedging vs Hedge Accounting

Risks and Hedging

All entities are exposed to some form of market risk. For example, gold mines are exposed to the price of gold, airlines to the price of jet fuel, borrowers to interest rates, and importers and exporters to exchange rate risks.

The majority of market risks can be hedged economically by entering into derivative instruments. Forwards, futures, options and swaps can be entered into to hedge a variety of commodity, currency, equity and interest rate risks. The increase in the volume of the instruments traded over recent years indicates that more and more entities are using derivatives to offset their risk exposures.

Hedge accounting is an accountancy practice that allows entities to mitigate the profit or loss effect arising from financial instruments used for hedging. The existence of an economic hedge does not mean that an entity may automatically apply hedge accounting. IFRS 9 requires compliance with certain prerequisites before hedge accounting could be applied.

No hedge accounting:

Unless an entity complies with all the requirements of hedge accounting, all derivatives have to be marked-to-market, with the changes in fair value reflected in profit or loss, which could introduce unwanted volatility in profit or loss.

Requirements:

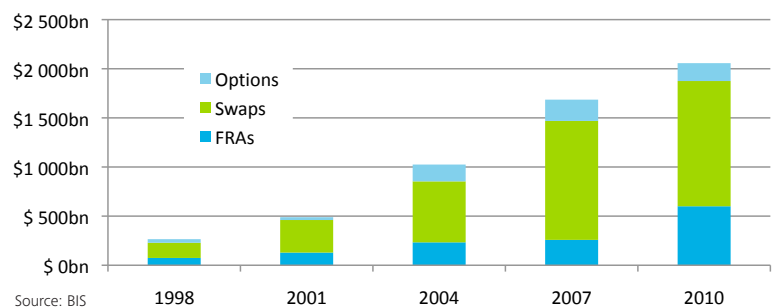
The current hedge accounting requirements are onerous and rules-based, whereas the new requirements are envisaged to be more principle-based, aligned with risk management policies and geared towards demonstrating the relationship between the hedging instrument and the hedged item.

Effectiveness problems:

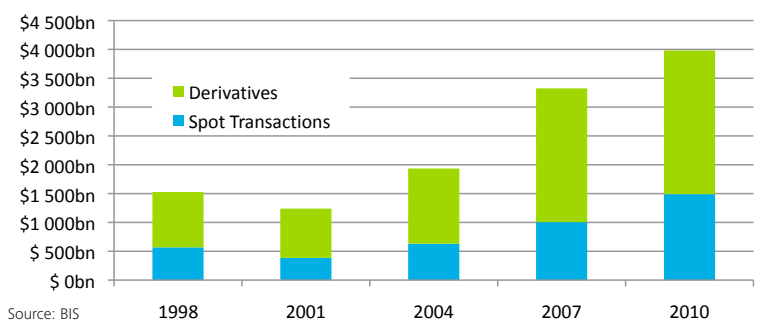
There are many reasons why hedges could be ineffective. Ineffectiveness can result when the critical terms, like payment dates, notional amounts, reference interest rates, commodity type or currency type of the hedging instrument and the hedged item do not match, or when significant fees are included in the price of the derivative.

Hedge Accounting

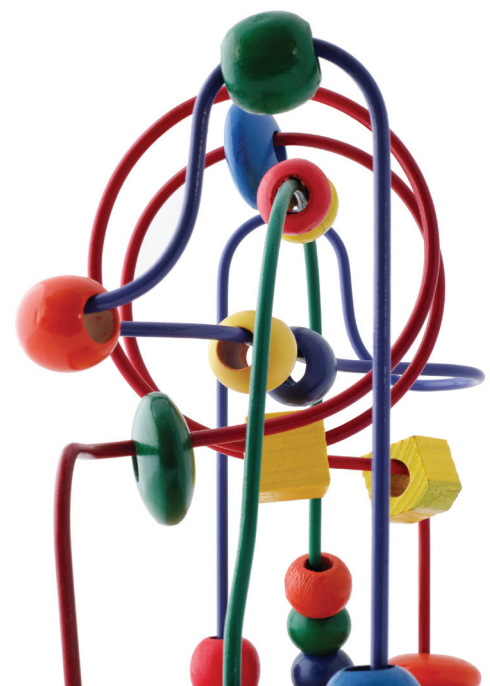
Global Daily Average Over the Counter Interest Rate Derivatives



Global Daily Average Spot vs Derivative Foreign Exchange Transactions



Increased use of derivatives = more sources of volatility in the profit or loss statement = greater incentive to apply hedge accounting



Examples of causes of ineffectiveness:

Economic Hedges

Entities are often exposed to changes in the prices of certain commodities or currencies for which no matching derivatives exist in the market, forcing an entity to resort to proxy hedging strategies. For example, long-dated jet fuel exposure might be hedged using crude oil futures, long-dated Botswana Pula exposure might be hedged using a basket of currency forwards, or a prime-linked loan might be hedged using a JIBAR swap.

An entity that raises capital in foreign markets at a fixed rate would often enter into a cross-currency swap to convert the fixed rate foreign currency loan to a domestic floating rate loan and eliminate the interest rate risk and currency risk components of the foreign currency borrowing.

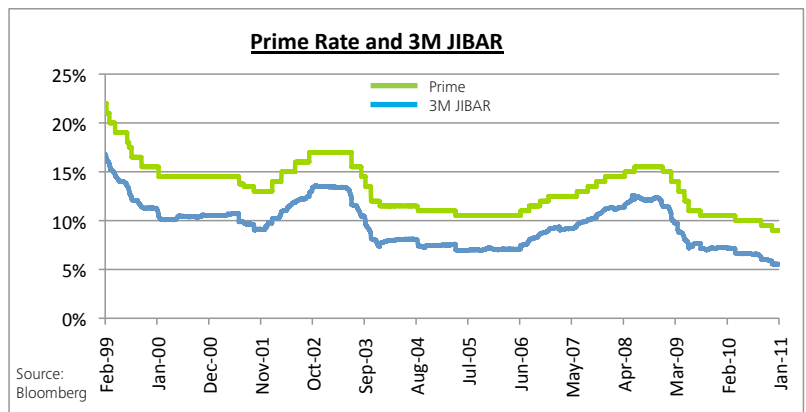
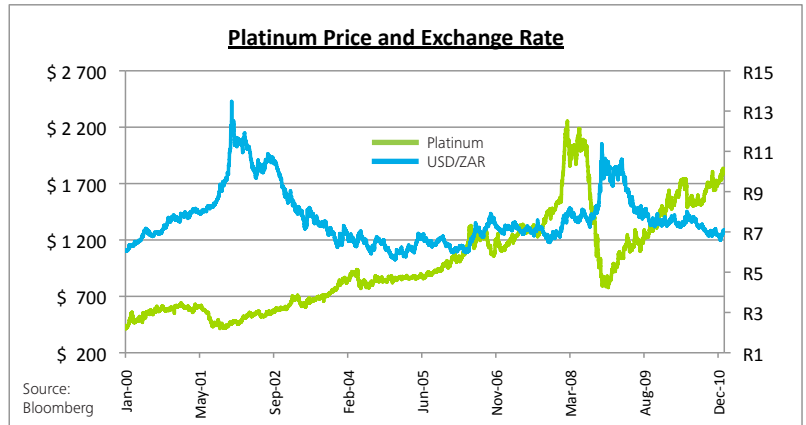
Hedge Accounting

The proxy hedge might be the best economic hedging alternative available, but the mismatch in critical terms (or basis risk) could render the hedge ineffective from an accounting perspective.

Due to the credit spread component of the foreign funding rate, the swap would be structured with a spread over the domestic floating rate. This fixed component of the floating leg of the swap re-introduces interest rate risk into the hedging relationship, and could render the hedge ineffective, specifically due to the dual currency nature of the hedging instrument.

Overcoming Hedge Accounting Obstacles

Correct designation of the hedging relationship and appropriate design of the method to demonstrate the effectiveness of the hedge could overcome the causes of ineffectiveness. Applying rebalancing methodologies could also improve effectiveness.



Exposure to volatile market factors = incentive to enter into hedges



- Derivatives may qualify as hedged items.
- The overlay of hedges may lead to complex hedge accounting mechanics.
- Separating risk components that are not contractually specified may be difficult to isolate and reliably measure.
- The requirement for the hedged item to affect profit or loss remains unchanged; therefore equity instruments designated at fair value through other comprehensive income ("FVOCI") may not be hedged items.
- Prepayment options require attention, particularly for fixed rate instruments.

- Relaxed requirements elsewhere in the hedge accounting requirements may impact responses to the qualitative effectiveness testing in the ED.
- Entity does not need to seek the optimal hedging instrument.
- The ability to rebalance a hedging relationship may eliminate ineffectiveness to a negligible level.
- No voluntary revoking of designated risk relationships.
- The requirements to demonstrate an "other than accidental offset" and to rebalance the hedging relationship could be facilitated through the application of an effective regression analysis tool.

Hedged items

The proposals broaden the types of hedged items to which hedge accounting may be applied. The proposals would require a basis adjustment for a non-financial hedged item.

Combined hedged item

The combination of an exposure and a derivative may qualify as a hedged item. The ED acknowledges that entities may hedge risk exposures differently at different times depending on its risk management strategy at a particular point.

Hedging risk components

The requirements align the eligible risk components of financial and non-financial items. Risk components of any item may qualify as a hedged item provided they can be separately identified and reliably measured. For example, the entity may hedge its exposure to the steel price that impacts its exposure to the forecast purchase of machinery.

Groups and net positions

The ED permits groups of individually eligible hedged items to be hedged collectively as a group provided the group is managed together for risk management purposes. However, for a cash flow hedge of a net position, the offsetting cash flows must affect profit or loss in the same period.

Hedge effectiveness

Other than accidental offset

The ED replaces the bright line 80-125% effectiveness threshold with a more qualitative threshold.

The entity must demonstrate that the hedging instrument achieves an "other than accidental offset" against the hedged item.

Objective of effectiveness assessment

The proposals require that the hedge effectiveness assessment must seek to minimise ineffectiveness such that the hedging relationship achieves an unbiased outcome.

Qualitative versus quantitative assessment

Hedge effectiveness will be assessed to consider if the relationship achieved an "other than accidental offset" and minimised ineffectiveness to derive an unbiased outcome. The proposals do not mandate a quantitative assessment; therefore for "a simple hedge" where an entity can prove that the critical terms match exactly, the entity may merely perform a qualitative assessment of the relationship.

Prospective versus retrospective assessment

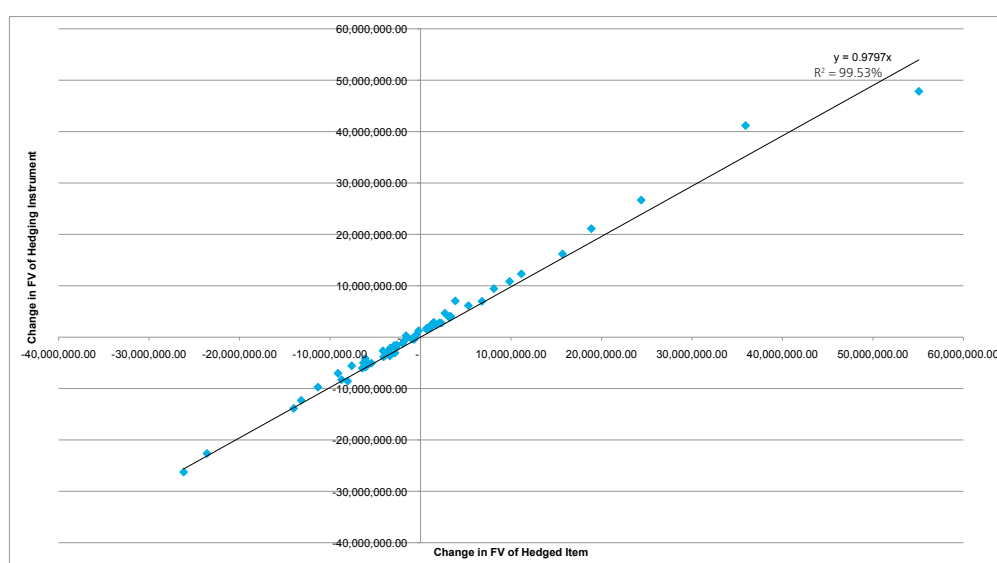
Under the ED, the retrospective test is not a prerequisite for hedge accounting. However, as with IAS 39, ineffectiveness is recognised immediately in profit or loss. This will require the entity to analyse the gains and losses of the hedged item and the hedging instrument and evaluate the degree of actual offset and ineffectiveness. However, the degree of ineffectiveness in a particular period will not impact the ability to continue hedge accounting prospectively provided the requirements for hedge accounting are still satisfied.

In cases where there is a change in the expectation of effectiveness, an alteration in the weighting of the hedged item and the hedging instrument may be required to comply with the objective of hedge accounting. This dynamic approach is referred to as rebalancing. Rebalancing the relationship may result in the removal of a portion of the hedging relationship, which may improve effectiveness and eliminate the complexities around the revoking and redesignation of relationships in terms of the current requirements.



Deloitte's R³ Hedge Effectiveness Assessment Model

- The R³ model can be used to determine the hedging relationship between a hedged item and its hedging instrument
- The R³ model can calculate periodic fair values (either all-in or clean prices) using a historical Monte Carlo Simulation approach, with the ability to select various reporting periods such as daily, monthly or quarterly
- Using the simulated historical prices, the R³ model determines the relationship between the two instruments by means of regression analysis
- Outputs include the slope parameter, indicating the hedge effectiveness percentage, the appropriateness of the regression model, warnings to indicate if the hedge effectiveness percentage is not within an acceptable range, and the Relative Risk Reduction parameter, indicating the reduction in volatility as a result of the hedge
- The R³ model produces a chart to graphically represent the hedging relationship
- The R³ model generates the fair values as required to process accounting entries
- The R³ model also informs rebalancing of the hedging relationship to improve effectiveness of the hedge, per the new hedge accounting requirements



Hedge effectiveness percentage = 97.97%, and 99.53% of the change in the fair value of the hedging instrument is explained by the change in fair value of the hedged item.

Hedging instruments

The proposals maintain many of the eligible instruments for treatment as hedging instruments.

Embedded derivatives

The removal of the bifurcation of embedded derivatives with financial asset hosts means that these embedded derivatives may no longer be used in a hedging relationship as the embedded derivative may not be separated and separately accounted for under IFRS 9.

Hedging with options

The ED permits the entity to defer the premium paid for an option in other comprehensive income. The premium is reversed based on the hedged item's impact on profit or loss.

Splitting hedging instruments

A hedging instrument must be designated in its entirety in a hedging relationship. The only exceptions permitted are:

- separating the intrinsic value and time value of an option contract
- separating the interest element and the spot price of a forward contract

- The ability to hedge risk components may result in more sophisticated hedging instruments being utilised.
- The ability to rebalance the hedge ratio may derive more cost effective hedging strategies.
- Option premium proposals will improve effectiveness and may lead to increased application of these derivatives as hedging instruments.

Risk management

The proposals are intended to align the manner management run their businesses to the presentation of these risk management strategies.

Designating hedging relationships without careful consideration of the entity's documented risk management strategy may result in the entity not achieving hedge accounting.

The effective portion of a fair value hedging instruments and hedged item will be deferred in other comprehensive income. This proposal seeks to reflect all hedging related risk management strategies (i.e. cash and fair value hedging) in other comprehensive income.

Disclosure

The proposed disclosure requirements would require presentation of:

- The entity's risk management strategy;
- The effects of the entity's risk management activities on the nature, timing and uncertainty of cash flows; and
- The effect that hedge accounting has on the primary financial statements.

- The granularity and sophistication of risk management policies may lead to diversity in practice.
- The entity may be required to apply hedge accounting.
- Hedging relationships that contradict the risk management strategy may not qualify for hedge accounting.

Transition

Prospective application for annual periods beginning on or after 1 January 2013 with earlier application permitted. This is subject to the IASB's Request for Views on effective dates.