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Hedge accounting draft: A closer reflection of risk management

In a nutshell

The IASB has issued a draft of the new hedge accounting guidance that will form part of IFRS 9. The draft follows an exposure draft published in December 2010; the guidance is likely to be finalised early next year.

The draft includes amendments to hedge accounting requirements, made in response to criticism of IAS 39 which was often viewed as too stringent and not capable of reflecting risk management policies.

The three types of hedge accounting remain: cash flow; fair value and net investment hedges. However, there have been significant changes to the types of transactions eligible for hedge accounting, specifically a broadening of the risks eligible for hedge accounting of non-financial items.

Changes in the way forward contracts and derivative options are accounted for when they are in a hedge accounting relationship will reduce profit or loss volatility when compared with IAS 39 and therefore will be attractive for some entities.

In addition, the effectiveness test has been overhauled and replaced with the principle of an 'economic relationship'. Retrospective assessment of hedge effectiveness is no longer required.

The flexibility of the new accounting requirements is counter-balanced by enhanced disclosure requirements about an entity's risk management activities.

The accompanying Basis for Conclusions is lengthy as it includes extensive explanations of the differences between the new guidance and IAS 39.

Some things are unchanged from IAS 39:

- Applying hedge accounting remains a choice.
- Terminology from IAS 39 is retained in many cases (hedged items, hedging instruments, fair value hedges, cash flow hedges, hedge ineffectiveness etc.).
- The mechanics of fair value, cash flow and net investment hedge accounting have not been changed.
- With the exception of hedge ineffectiveness related to hedges of equity investments designated as at fair value through other comprehensive income, all hedge ineffectiveness is recognised in profit or loss.
- The method for determining how much ineffectiveness to recognise for cash flow hedges, often known as the 'lower of test' is unchanged.
- General prohibition on hedge accounting with written options is retained.

Introduction

On 7 September 2012, the International Accounting Standards Board (IASB) published a draft of the new hedge accounting requirements ("the draft") which will form part of IFRS 9 *Financial Instruments* which will ultimately replace IAS 39 *Financial Instruments: Recognition and Measurement*.

The draft follows the exposure draft (ED) that was issued in December 2010 and covers only what the IASB describes as the general hedge accounting model.¹

The IASB intends to issue a final standard before the end of 2012. The purpose of issuing a draft instead of directly issuing a final standard (which is what normally happens after the ED stage) is to:

- provide constituents with the opportunity to review the proposals and provide the IASB with feedback;
- allow the US standard setter, the Financial Accounting Standards Board (FASB), the opportunity to consider the proposals; and
- allow the IASB to undertake additional outreach.

It is not expected that this interim step of issuing a draft will result in substantial changes to the proposals (if any). However, in practical terms, what happens next will depend on the feedback the IASB receives and possible actions that the FASB might consider in terms of converging with the IASB requirements.

When finalised, the standard is expected to be mandatorily applicable from 1 January 2015 with early adoption permitted.

Why are the hedge accounting requirements in IAS 39 being replaced?

The hedge accounting requirements in IAS 39 have been criticised by some for having too many rules that are not connected with the entity's risk management activities. Not only have the complex rules in IAS 39 made it difficult for entities to apply hedge accounting, but they have also made it difficult for entities to explain the results of applying hedge accounting in the context of the entity's business and its risk management activities. This disconnect is because IAS 39 approaches hedge accounting as an exception to the normal recognition and measurement requirements in IFRSs, rather than as a means of portraying how an entity manages risk. This is what the IASB has sought to address with the hedge accounting draft.

The IASB has decided that hedge accounting should be a means for entities to communicate their risk management activities. In other words, the job of hedge accounting is to convey the purpose and effect of the hedging instruments (generally derivatives) and how they are used to manage risk. However, hedge accounting continues to be voluntary and represents an exception from the normal accounting requirements.

The sections below provide a brief overview of the major changes from the IAS 39 model. Where applicable, they also highlight some of the major changes the Board made to the exposure draft proposals published in December 2010.

Hedging instruments

Eligibility of hedging instruments

The only change to the rules in which hedging instruments are eligible for hedge accounting is the inclusion of non-derivative financial instruments measured at fair value through profit or loss.

Under IAS 39, hedging instruments are limited to those that meet the definition of a derivative, with a single exception that non-derivative financial instruments (e.g. a foreign currency loan) can be used to hedge foreign currency risk. Under the new model, the IASB decided not to focus the eligibility criteria on whether an instrument is a derivative or a non-derivative, but rather on whether it is measured at fair value through profit or loss.

In practice there have been limited examples of non-derivatives measured at fair value through profit or loss (FVTPL) used for economic hedging purposes. However, such a scenario could arise, for example, when an entity uses an investment in a fund where the fund invests in commodity linked instruments and uses that investment as a hedge of price risk of a forecast purchase of a commodity.

The bulk of changes in respect of hedging instruments relate to how they are accounted for, specifically, the accounting for options and forwards.

The broader project
The hedge accounting requirements form the third phase of the IASB's project to replace IAS 39. The first phase was classification and measurement which when finalised in 2009/2010 gave rise to IFRS 9. The second phase on impairment of amortised cost assets is not yet complete. As the Board completes each phase the new requirements are incorporated in IFRS 9.

¹ The Board is still deliberating the portfolio hedge accounting model (also referred to "macro hedging") and a discussion paper is expected to be issued by the IASB later in 2012.

Accounting for the time value of options

Under IAS 39, entities that hedge account with options generally recognise the fair value change in the time value component of the option in profit or loss. This can lead to volatility in earnings. However, risk management generally views the time value of an option (usually equal to the premium paid at inception) as a cost of hedging. In other words, a cost incurred to protect the entity against unfavourable changes in price.

Consequently, the IASB decided that the undesignated time value of an option contract should be accounted for in profit or loss on a cost basis rather than on a fair value basis. This accounting treatment hence results in less profit or loss volatility. The accounting of the time value can be viewed as a two step process (which in some ways is similar to the mechanics of cash flow hedge accounting).

The first step is to defer in other comprehensive income (OCI), over the term of the hedge, the fair value change of the time value component of the option contract (to the extent that it relates to the hedged item).

The second step is to reclassify amounts from equity to profit or loss. However, the basis of this reclassification depends on the categorisation of the hedged item which will be either:

- a “transaction related” hedged item (e.g. a hedge of a forecast *transaction*); or
- a “period related” hedged item (e.g. a hedge of an existing item, such as inventory, over a *period* of time).

For “transaction related” hedged items the cumulative change in fair value deferred in OCI is recognised in profit or loss at the same time as the hedged item. If the hedged item first gives rise to the recognition of a non-financial asset or a non-financial liability² the amount in equity is reclassified in the statement of financial position and recorded as part of the initial carrying amount of the hedged item. This amount is recognised in profit or loss at the same time as the hedged item affects profit or loss in accordance with the normal accounting for the hedged item.

For “period related” hedged items the reclassification of amounts deferred in equity is different. Instead of matching the option cost with a specific transaction, the amount of the original time value of the option that relates to the hedged item³ is amortised from equity to profit or loss on a rational basis (possibly straight line) over the term of the hedging relationship.

Forward points

In response to the IASB’s proposals to change the accounting treatment for the time value of options, a number of constituents requested that the IASB consider a similar approach to the accounting for forward points of a forward contract when the spot element is designated in a hedge. Under IAS 39, if only the spot component is designated in a hedge, the forward points are recognised in profit or loss on a fair value basis which gives rise to volatility in profit or loss. An example of why an entity may only designate the spot element of a forward contract is when a forward contract is used to hedge an existing asset, such as inventory, which is not exposed to forward rate risk but instead is exposed to changes in spot prices.

After debating the requests from respondents, the IASB agreed to provide an alternative accounting treatment for forward points which, unlike the accounting for the time value of options, is a choice rather than a requirement. If applied, the accounting treatment is similar to that of the time value of an option when hedging a period related hedged item as described above. That is, the fair value change of the forward points gets deferred in OCI and reclassified through profit or loss over the hedged period on a rational basis.

The IASB did not make a distinction between “transaction related” and “period related” hedged items when accounting for forward points. This is because an entity can achieve an equivalent accounting outcome for transaction related hedged items by designating the forward rate as the hedged risk.

² Or becomes a firm commitment for which fair value hedge accounting is applied

³ This is determined with reference to a hypothetical option with terms that match the hedged item

Hedged items

The IASB made significant changes to the types of items that are eligible for hedge accounting and how entities can designate those hedged items. The most significant of these changes are discussed below.

Hedging risk components

Under IAS 39 an entity may hedge a specific risk (or risk component) in a financial item provided the risk is separately identifiable and reliably measurable. Hedging risk components is often referred to as 'hedging portions'. For example, the interest rate risk on a bond is often an eligible risk component or a portion as it is usually separately identifiable and reliably measurable. However, under IAS 39, an entity may only hedge a non-financial item for all risks, or solely for foreign currency risk. No other risk components or portions are permitted.

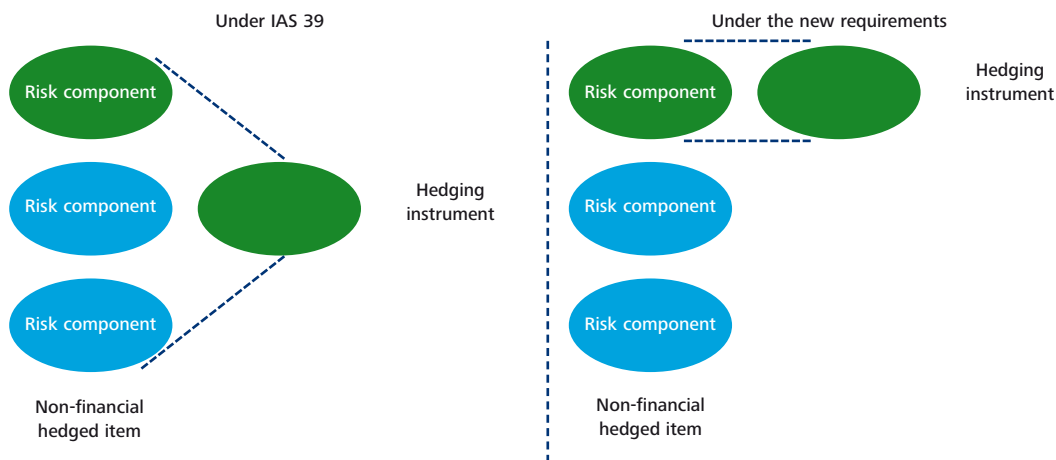
Because IAS 39 limits the types of eligible risks when hedging non-financial items entities are sometimes unable to apply hedge accounting of non-financial items or are forced to designate hedged items in a way that is contrary to how they manage the particular risk. This can result in hedge ineffectiveness that is inconsistent with their risk management view.

The draft extends the eligibility of risk components to include non-financial items, provided the component is separately identifiable and reliably measurable. Consequently, entities may apply hedge accounting for risk components of non-financial items that would not be permitted under IAS 39.

It is noteworthy that the risk component does not necessarily have to be contractually specified for it to be separately identifiable. However, if the risk component is not contractually specified it may be more difficult to isolate parts of the market price into identifiable and measurable risk components. In particular, it will be challenging for entities to analyse how market participants price (i.e., the market structure) certain non-financial items to determine whether a risk component is separately identifiable and reliably measurable.

One example of this is determining whether the price risk for jet fuel includes a particular benchmark crude oil price risk component.

Hedging risk components

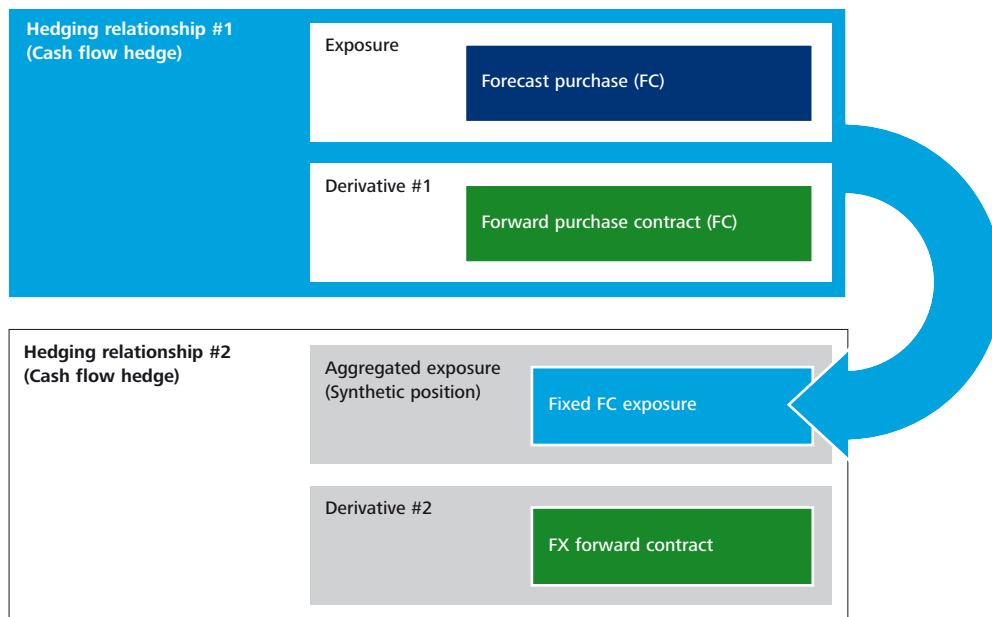


Hedged items that include derivatives (or “synthetic positions”)

The draft permits an aggregated exposure that includes a derivative to be an eligible hedged item. This is a change to IAS 39 as that standard explicitly prohibits a derivative from being designated as a hedged item. This has proved challenging in practice for some entities that manage risk exposures that include derivatives.

Consider the following example, an entity has a forecast purchase requirement of a commodity denominated in a foreign currency (FC). That entity may manage the commodity price risk (in FC) two years in advance by transacting a net settled forward contract that fixes the price at FC100 per unit. A year later, it may wish to hedge the foreign currency risk that arises on the combination of the forecast purchase and the commodity derivative (i.e., the aggregate or synthetic foreign currency exposure of its purchase of commodities at FC100 per unit).

The draft permits the aggregated exposure to be designated in a hedge accounting relationship as illustrated below.



Groups and net position

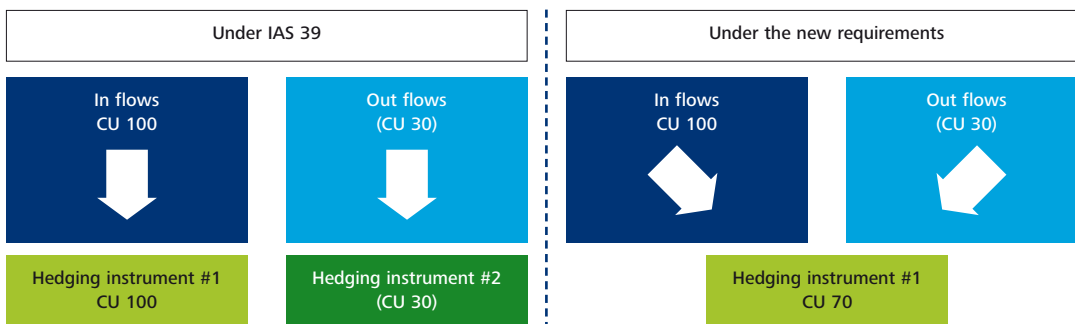
In order to efficiently hedge risk exposures, risk management strategies often analyse risks on an aggregated portfolio basis. This approach allows an entity to take advantage of naturally offsetting risk positions rather than, for example, hedging individual exposures with offsetting derivatives.

IAS 39 restricts the application of hedge accounting for groups of items and net positions such that in some cases hedge accounting cannot be achieved resulting in an accounting outcome that doesn't match the risk management view.

In their ED, the IASB proposed that groups of items (e.g. a group of assets) and a net position (e.g. the net of assets and liabilities, or net of forecast sales and purchased) can be hedged collectively as a group, provided the group consists of individually eligible hedged items and those items are managed together for risk management purposes. There was an additional restriction specifically for cash flow hedges of net positions which required the offsetting cash flows exposed to the hedged risk to affect profit or loss in the same and only in that reporting period. This restriction was intended to avoid an accounting anomaly that would otherwise arise where a net gain or loss on a single hedging instrument is grossed up and recognised in different periods. However, this restriction received strong criticism as many felt it was not in line with how entities manage risk. In light of the feedback received, the IASB lifted this restriction from the final proposals. However, to limit the use of cash flow hedges of net positions it is permitted only for foreign exchange risk.

For presentation of net position hedges, the IASB decided that hedges in net positions that affect different line items in the income statement should be presented in a separate line item from the items that are hedged.

Cash flow hedges of net positions for foreign exchange risk



Equity investments designated as at fair value through other comprehensive income

When IFRS 9 was issued in November 2009, it introduced the 'fair value through other comprehensive income' (FVTOCI) category for certain equity investments. Under this classification all fair value changes are permanently recognised directly in OCI except for dividends received on the investment. Because the fair value changes do not affect profit or loss, the IASB proposed in its ED that these equity investments should not be eligible as hedged items.

However, the IASB did not receive much support for this proposal. This is because many entities would manage the market risks of equity investments irrespective of the accounting classification.

After redeliberations, the IASB conceded that the risk management activities should be reflected irrespective of the accounting classification of these equity investments. The IASB also decided that because all fair value changes are permanently recognised in OCI for these equity investments, any hedge ineffectiveness should also be recognised in OCI. As a result, for such hedges both the effective and ineffective fair value changes are recognised in OCI with no recognition in profit or loss.

Qualifying criteria for applying hedge accounting

The draft overhauls the hedge effectiveness assessment requirements compared with IAS 39. These changes represent a significant change to what is seen by many as one of the main problems with the hedge accounting requirements in IAS 39 today. The key changes are described below.

Objective of the hedge effectiveness assessment

To qualify for hedge accounting under IAS 39 a hedge has to be highly effective, both prospectively and retrospectively. The term 'highly effective' refers to the degree of offset between the changes in fair value or cash flows of the hedging instrument and the hedged item. IAS 39 defines a hedge as highly effective if the offset is in the range of 80-125 per cent. This results in entities being required to perform numerical effectiveness tests to demonstrate offset within this range if it wishes to qualify for hedge accounting.

These requirements are seen to be onerous, not in line with risk management practices and vulnerable to technical failures (rather than a breakdown in the economics of the hedge). In addition, it is difficult to explain an entity's risk management strategy when hedge accounting is not allowed because of an 'accounting-based threshold' of 80-125 per cent.

As a result, the IASB decided to replace the qualifying criteria in IAS 39 with more principles-based qualifying criteria, avoiding any specific offset thresholds that could be inconsistent with risk management approaches.

The new effectiveness requirements to qualify for hedge accounting state that:

- there should be an *economic relationship* between the hedging instrument and the hedged item;
- the effect of *credit risk should not dominate* the value changes that result from that economic relationship; and
- the *hedge ratio should reflect the actual quantity* of hedging instrument used to hedge the actual quantity of hedged item (provided this does not deliberately attempt to achieve an inappropriate accounting outcome).

Quantitative vs qualitative assessment of the "economic relationship" and "hedge ratio"

The new effectiveness assessment regime will require judgement to determine whether an economic relationship exists between the hedged item and hedging instrument. Depending on how complex the hedging relationship is, that judgement may need to be supported by a qualitative or a quantitative assessment of the economic relationship.

For example, the critical terms (timing, amounts, rates, etc) of the hedging instrument and the hedged item may match and in such instances a qualitative analysis may be sufficient to conclude that an economic relationship exists. However, consider an entity that hedges an item using an instrument that introduces significant basis risk. To demonstrate an economic relationship a numerical assessment may be required. It is expected in such cases the assessment may already be performed as part of the risk management process to assess the suitability of the hedging instrument. In some cases a numerical assessment may also be required to support the hedge ratio used for the hedging relationship.

The draft only requires a hedge effectiveness assessment to be performed prospectively, that is to assess whether the hedging relationship is expected to be effective going forward. This removes the burden of the retrospective hedge effectiveness assessment as currently required in IAS 39 which in turn eliminates the uncertainty of whether hedge accounting will fail in future periods. It should be noted, however, that hedge ineffectiveness must still be measured and recognised at the end of each reporting period.

Accounting for qualifying hedges

Like IAS 39, the draft continues to distinguish between three hedge accounting treatments:

- Cash flow hedge accounting.
- Fair value hedge accounting.
- Hedging a net investment in a foreign operation.⁴

Cash flow hedge accounting and basis adjustments

There is only one aspect of cash flow hedge accounting that has changed from IAS 39. This change relates to what is commonly referred to as 'basis adjustment'. When hedging a forecast transaction that results in the recognition of a non-financial item, basis adjustment refers to the removal of the amount that has been accumulated in the cash flow hedge reserve and recording it as part of the recognised non-financial item. Under IAS 39, applying basis adjustment for such a hedge is a choice (the alternative is to retain the deferred gain or loss in reserves and reclassify to profit or loss when the hedged item affects profit or loss). This also applies in cases where a forecast transaction in a cash flow hedge becomes a firm commitment for which fair value hedge accounting is subsequently applied.

The draft has eliminated the choice for basis adjustment that exists under IAS 39. Instead, an entity shall be *required* to apply a basis adjustment when a forecast transaction in a cash flow hedge results in the recognition of a non-financial item.

Fair value hedge accounting

Despite the IASB originally proposing to eliminate fair value hedge accounting and requiring all hedges to be accounted for using cash flow hedge mechanics, the final position in the draft retains the current IAS 39 mechanics of fair value hedge accounting. This position was reached after opposition to the equity volatility that would arise by applying cash flow hedge mechanics to fair value hedges. The proposals in the ED to change the presentation of fair value hedges by using an OCI presentation of gains and losses was also dropped following lack of support. This leaves fair value hedge accounting in familiar territory.

Modifying and discontinuing a hedging relationship

Modifying a hedging relationship ("Rebalancing")

Under IAS 39, changes to a hedging relationship would generally require the entity to discontinue hedge accounting and restart with a new hedging relationship that captures the desired changes.

However, for risk management purposes hedge relationships are sometimes adjusted in reaction to changes in circumstances. For example, consider an entity that hedges an exposure to foreign currency A using a currency derivative that references foreign currency B. Currencies A and B are pegged (i.e. their exchange rate is maintained within a band or at an exchange rate set by a central bank or other authority). If the pegged exchange rate between currencies A and B changes to a new band or rate the hedge might be adjusted for risk management purposes to re-align the quantities of the hedging instrument needed to hedge the exposure. Under IAS 39, such a change in the hedging relationship would give rise to a de-designation and discontinuation of the original hedging relationship in its entirety. If an entity wanted to continue to apply hedge accounting, a new hedging relationship would commence. This can result in hedge ineffectiveness that is not consistent with the risk management view of the hedge (e.g. ineffectiveness caused by resetting the hypothetical derivative to measure the hedged item in a cash flow hedge).

Consequently, the IASB allows certain changes to the hedge relationship after inception as part of a continuing hedging relationship without forcing discontinuation for the entire hedging relationship.

Discontinuing hedge accounting

Under IAS 39, hedging relationships are discontinued when the:

- hedging instrument expires or is sold, terminated or exercised;
- the hedged forecast transaction, for cash flow hedges, is no longer highly probable;
- hedge no longer meets the criteria for hedge accounting; or
- entity amends or revokes the designation.

⁴ The hedge accounting mechanics for hedges of net investment in a foreign operation are unchanged.

The first three of these criteria for discontinuing hedge accounting were carried over to the hedge accounting draft. However, the IASB did not deem it appropriate for entities to voluntarily discontinue hedge accounting when the risk management objective has not changed for the hedging relationship. Hence the IASB eliminated the ability for entities to voluntarily revoke its hedge accounting designations. This means that when an entity chooses to apply hedge accounting, it cannot be discontinued until the risk management objective for the hedging relationship has changed or the hedge expires or is no longer eligible.

Extending the fair value option rather than using hedge accounting

Hedging credit risk

Many entities use credit derivatives to manage their credit risk exposures arising from lending activities. However, to hedge the credit risk component of a financial item (e.g. debt security or loan commitment) IAS 39 and the new proposals require the credit risk component to be separately identifiable and reliably measurable (just like any other risk component, see earlier). In practice this can be challenging for credit risk hence the IASB considered other alternative approaches.

The draft permits an entity to elect FVTPL accounting for credit exposures (such as loans, bonds and loan commitments) when it is hedged with a credit derivative (e.g. credit default swap) and certain conditions are met (e.g. matching the name and security of the financial instrument delivered under the credit derivative with that of the hedged credit exposure). This would permit:

- electing FVTPL at initial recognition or subsequently (if elected subsequently, the difference between the then carrying amount and fair value is recognised immediately in profit or loss); and
- making that election for a component of nominal amounts (instead of the entire nominal amount).

Hedging “own use” contracts to buy or sell a non-financial item

Certain contracts to buy or sell a non-financial item that qualify for “own use” are not subject to derivative accounting as they are outside the scope of IAS 39 and are treated as regular sales or purchase contracts. A typical example includes a purchase of a commodity by an entity that uses it to produce goods for sale.

Some entities, e.g. commodity processors, hedge the economic risk exposure of their purchase and sale contracts of non-financial items along with commodity inventories and derivatives measured at fair value. As some of the purchase and sale contracts may not be recognised in the statement of financial position this can lead to accounting mismatches. Because of the large number of transactions that these entities enter into and the constant changes in the net exposure, hedge accounting is currently an onerous and sometimes impractical way of accounting for these transactions.

To mitigate the need for hedge accounting, the draft extends the fair value option in IFRS 9 to contracts that meet the 'own use' scope exception if doing so eliminates or significantly reduces an accounting mismatch.

It is worth noting that the draft differs in this respect from what the IASB initially proposed in its ED. The original proposal in the ED was to require entities to fair value such contracts if it is in line with their business model and they manage those contracts on a fair value basis. However, some entities raised some concerns about potential unintended consequences that this could have. Consequently, the IASB changed the original proposal and rather extended the use of the fair value option.

Disclosures and Transition

Disclosures

As part of its project to replace the hedge accounting requirements in IAS 39, the IASB also changed the related disclosure requirements in IFRS 7 *Financial Instruments: Disclosures* which introduce more disclosure requirements than currently required.

The new hedge accounting requirements focus on providing users of financial statements with information about that entity's risk management activities. In other words, provide information about the purpose and effect of the hedging instruments (generally derivatives) and how they are used to manage risk. It is worth noting that the disclosures need only be provided if an entity applies the hedge accounting requirements.

To give effect to the objective of hedge accounting, the new disclosure requirements are built around three objectives that shall provide information about:

- an entity's risk management strategy and how it is applied to manage risk;
- how the entity's hedging activities may affect the amount, timing and uncertainty of its future cash flows; and
- the effect that hedge accounting has had on the entity's statement of financial position, statement of comprehensive income and statement of changes in equity.

Transition

Once finalised, the new requirements will apply prospectively with limited exceptions.

Retrospective application of the accounting for the time value of options would, however, be required for all hedging relationships in which the intrinsic value of an option is designated under IAS 39. This retrospective application applies to those hedging relationships that exist at the beginning of the comparative period, or later.

Retrospective application would be permitted for hedging relationships in which the hedging instrument designated under IAS 39 is the spot element of a forward contract. The Board also decided that if an entity elects retrospective application in respect of undesignated forward points it would have to be applied to all hedging relationships of this type (i.e. the transition accounting is not available on a hedge-by-hedge basis).

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