



## iGAAP Alert.

### IASB issues Exposure Draft on Hedge Accounting

#### In a nutshell

The basic concepts in IAS 39 of fair value hedges, cash flow hedges and hedges of a net investment in a foreign operation are retained in the exposure draft. However, the proposed rules are more relaxed regarding what items can qualify for hedge accounting, what instruments can be designated and the effectiveness testing requirement.

As a result, many hedging relationships that do not currently qualify under IAS 39 would qualify under the ED's proposals.

Please note that the ED proposes a new general hedge accounting model. Proposals for a new portfolio hedge accounting model are expected to be issued separately in 2011.

#### Contents

- The proposals
- Scope
- Hedged items
- Hedging instruments
- Hedge effectiveness
- Changes to a hedging relationship
- Fair value hedge accounting
- Cash flow hedge accounting
- Disclosures
- Transition and effective date

#### The proposals

On 9 December 2010, the International Accounting Standards Board (IASB) published ED/2010/13 *Hedge Accounting*. Hedge accounting is the final phase of the project to replace IAS 39 *Financial Instruments: Recognition and Measurement*. The proposals in the ED would allow an entity to mitigate recognition and measurement differences between hedging instruments (e.g., derivatives) and hedged items (e.g., forecast sales) when certain requirements are fulfilled and include many changes to the current requirements, with the aim of better reflecting risk management activities in the financial statements. Many hedging relationships that do not qualify under IAS 39 would qualify under the ED's proposals.

The comment period for the ED ends on 9 March 2011 with a final standard expected in June 2011.

## Scope

The ED covers only what the IASB describes as the *general* hedge accounting model. A separate ED is expected in 2011 for the *portfolio* hedge accounting model.

It is expected that the ED for the portfolio model will include new proposals for portfolio fair value hedge accounting of interest rate risk (often referred to as the 'macro hedge accounting model'). This will mostly be relevant for financial institutions or corporates with consumer finance operations. The portfolio model is also expected to consider requirements for open-portfolio hedge accounting (i.e., where the hedged items and hedging instruments that are included in the hedging relationship continuously change over time) which may have a wider relevance. The general hedge accounting model includes requirements for hedged items that are *closed* portfolios of items. For such hedges the hedged items or amounts are specifically identified and designated at inception of the hedge, with any changes accounted for in the same way as for hedging relationships of single hedged items.

This ED does not propose any specific changes to the accounting for hedging a net investment in a foreign operation, commonly referred to as 'net investment hedges'. However, the proposed changes to the hedge effectiveness testing requirements apply to all hedging relationships and therefore would also be relevant when testing the effectiveness of a net investment hedge.

## Hedged items

The proposals would make more types of hedged items eligible for hedge accounting.

### Hedging a derivative with a derivative

A combination of an exposure and a derivative could be designated jointly as a hedged item. This proposed rule change acknowledges that in practice an aggregate or 'synthetic' exposure, which includes a derivative, may be hedged with a further derivative. This can arise for a variety of reasons but is usually because an entity hedges different risks at different points in time.

For example, consider an entity that has a forecast purchase requirement of a commodity denominated in a foreign currency (FC<sup>1</sup>). That entity may hedge the commodity price risk, in FC, two years in advance, fixing the price at say FC100 per unit. A year later, it may wish to hedge the currency risk. At that point, the 'hedged item' would be 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). Under the ED, the aggregate exposure would be an eligible hedged item whereas under current IAS 39 it is not.

#### Observation

The ED does not require the original hedge to be in a hedging relationship nor does it require all hedges of a single exposure to be of the same kind (i.e., the original hedge could be a fair value hedge and the subsequent hedge of the aggregate exposure could be a cash flow hedge). Furthermore, it does not limit the number of combinations of hedges and whether any of the subsequent hedges can reverse any of the original hedges. This could give rise to some complex hedge accounting scenarios.

### Hedging risk components

The ED aligns the requirements for eligible risk components for both financial and non-financial items. Risk components of any item would be eligible for hedge accounting provided that the risk component is:

- separately identifiable; and
- reliably measurable.

Under current IAS 39, this flexibility is available for financial items, whereas for non-financial items (e.g., a forecast commodity purchase) only foreign currency risk is an eligible risk component. The ED includes guidance and presents examples of situations where these conditions are satisfied.

<sup>1</sup> In this document FC is used for units of foreign currency and CU is used for units of functional currency of an entity.

For example, if the rentals in an operating lease are contractually linked to inflation, and the inflation component is considered 'separately identifiable and reliably measurable' then inflation would be an eligible risk component of the hedged item.

#### **Observation**

When a risk component is contractually specified, for example, an entity has a firm commitment to buy an item based on a specified pricing formula where parts of that price are linked to other prices or indices, it is easier to isolate part of that purchase price and designate only that component. Where a risk component is not contractually specified, for example, an entity has a forecast transaction to buy an item at future market prices, it is harder to isolate parts of that market price into identifiable and measurement components.

#### **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. All fair value changes are permanently recognised directly in other comprehensive income (OCI) except for dividends received on the investment. As all gains or losses recognised in OCI are never reclassified to profit or loss (ie not even in the event of sale or impairment) the ED prohibits hedge accounting from being applied to these investments.

#### **Observation**

A holding of a foreign equity investment designated as at FVTOCI could not be designated in a hedge accounting relationship for equity price risk or foreign exchange risk. The dividend income recognised in profit or loss could, however, be eligible for hedge accounting of foreign exchange risk if the other qualifying criteria are met (e.g., highly probable assertion).

#### **Groups and net positions**

The ED permits groups of individually eligible hedged items to be hedged collectively as a group, provided the group of items is managed together for risk management purposes. Such groups may be net positions (i.e., items with offsetting fair values or cash flows). However, for a cash flow hedge of a net position (i.e., a group of items with offsetting cash flows), the offsetting cash flows exposed to the hedged risk, must affect profit or loss in the *same*, and only in that, reporting period.

Examples of net positions that would be eligible include:

- A group of firm purchase commitments and sale commitments hedged together for foreign exchange risk.
- A group of fixed rate assets and fixed rate liabilities fair value hedged together for interest rate risk using one or more interest rate swaps.
- A group of recognised floating rate assets and floating rate liabilities cash flow hedged together for interest rate risk using one or more interest rate swap (assuming interest is accrued in profit or loss at the same time).
- A group of forecast sales and forecast expenses that affect profit or loss in the same reporting period (e.g., quarterly reporting period if the entity prepares quarterly interim financial statements) hedged together for foreign exchange risk using a single forward foreign exchange contract.

Examples of net positions that would not be eligible include:

- A group of forecast sales and forecast expenses that affect profit or loss in different reporting periods hedged with a single forward foreign exchange contract.

When an entity hedges a net position that affects different line items in the income statement, any hedging instrument gains or losses recognised in profit or loss must be presented in a separate line item from the items that are hedged.

### Hedging instruments

The ED expands the types of financial instruments that would be eligible for treatment as hedging instruments to include any financial instrument, other than a net written option, that is measured at fair value through profit or loss. This includes financial instruments that are required to be classified as at fair value through profit or loss as well as those *designated* as at fair value through profit or loss under the fair value option. Additionally, for a hedge of foreign currency risk, a financial asset or financial liability measured at amortised cost could be an eligible hedging instrument.

Derivatives embedded in financial assets are not separately accounted for under IFRS 9. As a result, embedded derivatives in financial assets accounted for under IFRS 9 are not eligible hedging instruments in their own right. However, a financial asset that contains an embedded derivative may be an eligible hedging instrument in its entirety if it is classified as at fair value through profit or loss and it is not a net written option.

### Financial options

The ED does not propose any change to the eligibility criteria for financial options as hedging instruments. However, a change to the accounting for the time value of an option when only the intrinsic value of the option is designated in a hedge is proposed.

A two step approach to accounting for the time value of such an option is proposed. The accounting would be similar to the accounting for hedging instruments designated in a cash flow hedge.

The first step would be to defer in OCI (over the term of the hedge) an amount of the fair value change of the time value component. This amount would be determined with reference to a hypothetical option that has matched terms to the hedged item. The second step of the accounting would be to reclassify amounts from equity to profit or loss. The basis of this reclassification depends on the nature of the hedged item which will be either:

- transaction related; or
- time period related.

For transaction related hedged items the cumulative change in fair value deferred in OCI would be 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 non-financial liability (or becomes a firm commitment for which fair value hedge accounting is applied) the amount from equity would be reclassified to the statement of financial position and recorded as part of the initial carrying amount of the hedged item. This amount would be 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 time period related hedged items, ie where the option hedges an item for the period the option is outstanding, the amount of the original time value of the option that relates to the hedged item (determined with reference to a hypothetical option with terms that match the hedged item) is amortised from equity to profit or loss on a rational basis over the term of the hedging relationship.

### Internal derivatives

As with IAS 39, the ED proposes that only contracts with a party external to the reporting entity be available for designation as hedging instruments.

#### Observation

If an entity lays-off the net risk from internal derivatives with external derivatives, it may overcome this restriction by designating the group of hedged items hedged by the internal derivatives in a group hedge with the external derivatives. The ED changes the eligibility criteria applicable for hedges of groups of items permitting more groups (including net positions) to qualify than under IAS 39.

## Hedge effectiveness

### Effectiveness threshold: other than accidental offset

For a hedge to qualify for hedge accounting, certain criteria must be fulfilled. Some of the criteria continue to relate to the effectiveness of the hedging relationship.

The ED replaces the current requirement for a hedge to be 'highly effective' (defined in IAS 39 as giving rise to offset of between 80 to 125 per cent) in order for it to be eligible for hedge accounting. Instead, the ED requires only that a hedging relationship must achieve 'other than accidental offset'.

For example, consider an entity that hedges the fair value risk associated with changes in the benchmark interest rate component of a fixed rate loan using a fixed to variable interest rate swap. The fixed leg of the swap closely matches the terms of the hedged item, and hence, the entity can expect the hedge to achieve other than accidental offset. However, if subsequent to the entity entering into the hedge, there were a severe deterioration in the credit rating of the swap counterparty, subsequent offset may be merely accidental because of the magnified effect of credit risk on the fair value of the derivative which is not replicated in the hedged item.

#### Observation

There is no definition of 'other than accidental offset' or a defined level of offset, or level of correlation between the hedged item and instrument. Hence, judgement will have to be applied to determine whether a hedging relationship qualifies for hedge accounting.

### Objective of the hedge effectiveness assessment

In addition to the 'other than accidental offset' requirement the hedging relationship would also have to 'meet the objective of the hedge effectiveness assessment'. This objective is to minimise expected hedge ineffectiveness. An entity would have to determine the appropriate weightings of its hedged item and its hedging instrument that minimises hedge ineffectiveness. The weightings should not give rise to *deliberate* hedge ineffectiveness.

#### Observation

This is not a requirement to use the hedging instrument that minimises hedge ineffectiveness. For example, an entity may have a hedging instrument that it considers will result in an acceptable degree of offset even though other instruments could be available in the market that would make the degree of offset higher. The entity's hedging instrument can be designated, but it must be designated in such a way as to minimise expected hedge ineffectiveness for the given hedging relationship.

### Quantitative vs qualitative analysis

In order to determine whether a hedging relationship satisfies the hedge effectiveness requirements (of achieving 'other than accidental offset' and meeting the 'objective of hedge effectiveness assessment', see above) an entity may need to perform some quantitative analysis. However, this is not a specific requirement of the proposals. In some cases a qualitative assessment may be sufficient to determine that a hedging relationship qualifies.

For example, consider an entity that hedges a forecast purchase of a particular grade of a commodity. However, forward contracts over this grade are not readily available and hence, to hedge its exposure the entity uses a forward contract referenced to a different 'benchmark' grade. This gives rise to basis risk. The benchmark grade is not a component of the grade of the commodity that the entity is buying. The entity is aware of, and accepts, that the quantum of this basis risk can vary. The entity would have to determine the appropriate weighting (i.e., amount) of the hedged item to designate against the forward contract so as to minimise the expected impact of basis risk between the two grades. A quantitative analysis would likely need to be performed by the entity.

#### Observation

Judgement will be required to determine whether, and what type of, quantitative analysis is required to determine whether a hedging relationship meets the hedge effectiveness requirements.

### Frequency of assessments

The hedge effectiveness requirements are forward looking. An entity would have to determine that a hedging relationship meets the hedge effectiveness requirements at inception of the hedging relationship and then on an ongoing basis. At a minimum, this would be at each reporting date or upon a significant change in the circumstances affecting the effectiveness of the hedging relationship.

### 'Prospective test' vs 'retrospective test'

Under IAS 39, in addition to the forward looking assessment (usually referred to as the 'prospective test') a further backward looking 'retrospective test' is required to determine whether hedge accounting can be applied. Under the ED, a retrospective test is not required for qualification purposes. Therefore, unlike IAS 39, a designation would not fail hedge accounting in a period simply because the hedge was not as effective as it was originally hoped.

For hedge accounting to be applied for the *next* reporting period, an entity would still have to determine that it satisfies the hedge effectiveness requirements on a forward looking basis at the reporting date.

### Measurement of hedge ineffectiveness

As with IAS 39 any hedge ineffectiveness would have to be *measured* (using a quantitative analysis) and immediately recognised in profit or loss.

### Changes to a hedging relationship

The ED provides guidance on how changes to a hedging relationship are accounted for. Changes to a hedging relationship may arise, for example, for one or more of the following reasons:

- a change in the risk management objective;
- a change in the expectation of hedge effectiveness;
- a change to the hedged item; or
- a change to the hedging instrument.

When there is a change in the risk management objective for a hedging relationship, or a hedge is no longer expected to achieve other than accidental offset, that hedging relationship would have to be discontinued.

In cases where there is a change in expectation of hedge effectiveness, a change in the weightings of the hedged item and hedging instrument may be required in order to continue to comply with 'the objective of hedge effectiveness assessment' (see above).

This could arise for a variety of reasons. For example, the expected behaviour of the basis risk that is known to exist in a hedging relationship may change part way through the term of the hedge.

The change in weightings is referred to as a 'rebalancing' of the hedging relationship. This could give rise to an increase or decrease in the weightings of either the hedged item or hedging instrument. The ED proposes that such changes should not be treated as a de-designation of the original hedging relationship and re-designation of a new 'rebalanced' hedging relationship. Instead, the part of the hedging relationship that remains after 'rebalancing' would be treated as a continuing hedge, with the part that is no longer hedged after rebalancing treated as a discontinued hedge.

#### Observation

It is mandatory for an entity to rebalance a hedging relationship if without doing so an entity would fail to continue to meet the objective of the hedge effective assessment.

A change in a hedging relationship may also be required when there is a change in the eligibility of part of the hedged item. For example, consider a cash flow hedge of a highly probable forecast purchase of 100 units of a commodity. If during the hedging relationship the entity's purchase requirements change such that now only 90 units are highly probable, the hedging relationship in respect of the 10 units is no longer eligible. To accommodate this change, hedge accounting for 10 units of the hedged item is (mandatorily) discontinued whilst the remaining 90 units continue to be designated with no change.

### Observation

Removal of the formal de-designation and re-designation of a hedging relationship when only part of the relationship changes would avoid some of the accounting anomalies that have arisen with IAS 39. For example, in a cash flow hedge, it can avoid the resetting of the hypothetical derivative used to measure the hedged item and consequently would in some cases reduce the amount of hedge ineffectiveness recognised compared with IAS 39 (i.e., the nominal amount of the original hypothetical derivative is reduced to match the hedged item without a 'reset' of its terms). Also, for a fair value hedge where part of the hedged item continues to be hedged with the original hedging instrument, avoiding a formal de-designation can avoid premature amortisation of the fair value hedge adjustment (relating to the hedged item that continues to be hedged) in profit or loss (eg in a fair value hedge of fixed rate debt where only part of the debt is no longer hedged).

### Dedesignation of existing hedges

When there has been no change to a designated hedging relationship, and the risk management objective for the hedge remains the same, an entity would not be permitted to discontinue voluntarily hedge accounting. This is a change to the IAS 39 model where an entity can de-designate a hedging relationship (prospectively) if it chooses to.

### Fair value hedge accounting

The ED proposes a change to the presentation of fair value hedges in the financial statements.

In the statement of financial position, the fair value hedge adjustment (which represents the change in fair value of the hedged item for changes in the hedged risk) would be presented in a separate line item next to the hedged item whereas under IAS 39 the hedge adjustment is recorded as part of the carrying value of the hedged item (resulting in a potential mix of amortised cost and fair value measurement). The presentation proposed by the ED preserves the original measurement basis for the hedged item by segregating any fair value measurement.

The other proposed change in presentation of fair value hedges is to recognise the gain or loss on the hedging instrument and hedged item (for changes in the hedged risk) in OCI, with any hedge ineffectiveness recognised in profit or loss. This is different from IAS 39 where all amounts are recognised in profit or loss.

### Example

The fair value risk of a fixed rate loan liability issued at par of €100,000 is hedged with a receive fixed, pay float interest rate swap. The hedge is designated from the issue date of the loan which is the beginning of an annual reporting period and all interest is settled at the end of the reporting period. The gain on the swap at the end of the year is €5,000. This partially offsets the fair value loss on the loan of €6,000 (i.e., hedge ineffectiveness is €1,000).

Under the proposals, the financial statements for the first year of the hedge would include the following line items and balances. The line item descriptions are for illustrative purposes only.

Statement of financial position	
Interest rate swap	5,000
Loan	(100,000)
Fair value hedge adjustment	(6,000)
Income statement	
Loan interest expense	(x) <sup>2</sup>
Hedge ineffectiveness (loss)	(1,000)
Statement of other comprehensive income	
Fair value change of hedged item (loan)	(6,000)
Fair value change of hedging instrument (IRS)	5,000
Hedge ineffectiveness	1,000

### Observation

In order to preserve the measurement basis of hedged items in a fair value hedge, additional line items will be required in the statement of financial position. The amounts in these line items will require tracking to ensure they are derecognised at the same time as the item to which they relate.

<sup>2</sup> The interest expense line will include the fixed interest payable on the loan and an amount equivalent to the net interest accrual on the interest rate swap.

## Cash flow hedge accounting

### Lower of test

For measuring hedge ineffectiveness for a cash flow hedge, the ED retains the 'lower of test'. That is, the cumulative change in fair value of the hedging instrument in a cash flow hedge that can be deferred in equity, is the lower of:

- the cumulative gain or loss of the hedging instrument from inception of the hedge; and
- the cumulative change in fair value (present value) of the hedged item from inception of the hedge.

### Basis adjustment

When a forecast transaction in a cash flow hedge results in the recognition of a non-financial asset or a non-financial liability it is proposed that an entity should be required to apply a 'basis adjustment'. That is, an entity would remove the amount that has been accumulated in the cash flow hedge reserve and recognise it as part of the recognised asset or liability. This would also apply to cases where a forecast transaction in a cash flow hedge becomes a firm commitment that an entity chooses to fair value hedge (i.e., the amount deferred in OCI in respect of the hedge would be reclassified to a line item in the statement of financial position which would subsequently have fair value hedge adjustments posted to it).

This represents a change to the requirements under IAS 39 where an entity has a choice as to whether to basis adjust or to retain the accumulated gain or loss in equity and only reclassify to profit or loss when the hedged item affects profit or loss (e.g., when the asset arising from the hedged forecast transaction is depreciated through profit or loss).

### Disclosures

The disclosure requirements in the ED focus on presenting information on:

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

It is proposed that disclosures be disaggregated by risk category on the basis of risks that an entity decides to hedge and for which hedge accounting is applied. The proposals require quantitative disclosures of risk exposures and amounts hedged. The ED also includes a requirement for disclosures, in a tabular format, that provide information about the amounts included in the primary financial statements that are a result of hedge accounting.

#### Observation

Under these proposals the effects of hedge accounting on the financial statements will be more prominent and transparent.

### Transition and effective date

When finalised, the hedge accounting requirements will form part of IFRS 9. An entity that wishes to adopt the new hedge accounting requirements may only do so if at the same time it adopts (or has already adopted) the other requirements of IFRS 9.

The effective date of the proposals, if finalised, would be for periods beginning on or after 1 January 2013 with earlier application permitted although IFRS 9 will be subject to endorsement for use in the EU. Application of the standard would be prospective. To apply hedge accounting under the new model from the date of adoption of the standard all the qualifying criteria must be met as at that date.

On adoption of the new requirements, any hedging relationships designated under IAS 39, that also qualify under the new model, shall be treated as continuing hedging relationships.

#### Observation

The qualifying criteria for a hedging relationship are different under the new proposals. An entity wishing to continue to apply hedge accounting post-adoption of the new requirements will need to ensure processes are in place to migrate appropriately hedging relationships that exist under IAS 39. Failure to comply with the requirements by the date of adoption will prevent hedge accounting from being applied from that date. Any hedge designation post adoption shall be treated as a new hedging relationship (i.e., failure to comply with the new hedge accounting requirements in time for adoption can cause a break in the hedging relationship which can trigger the amortisation of previous fair value hedge adjustments or reset the hypothetical derivative used in a cash flow hedge).

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited (“DTTL”), a UK private company limited by guarantee, and its network of member firms, each of which is a legally separate and independent entity. Please see [www.deloitte.co.uk/about](http://www.deloitte.co.uk/about) for a detailed description of the legal structure of DTTL and its member firms.

Deloitte LLP is the United Kingdom member firm of DTTL.

This publication has been written in general terms and therefore cannot be relied on to cover specific situations; application of the principles set out will depend upon the particular circumstances involved and we recommend that you obtain professional advice before acting or refraining from acting on any of the contents of this publication. Deloitte LLP would be pleased to advise readers on how to apply the principles set out in this publication to their specific circumstances. Deloitte LLP accepts no duty of care or liability for any loss occasioned to any person acting or refraining from action as a result of any material in this publication.

© 2011 Deloitte LLP. All rights reserved.

Deloitte LLP is a limited liability partnership registered in England and Wales with registered number OC303675 and its registered office at 2 New Street Square, London EC4A 3BZ, United Kingdom. Tel: +44 (0) 20 7936 3000 Fax: +44 (0) 20 7583 1198.

Designed and produced by The Creative Studio at Deloitte, London. 8683A

**Member of Deloitte Touche Tohmatsu Limited**