
Straight away

IFRS bulletin from PwC

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IASB issues exposure draft on hedge accounting

What is the issue?

The rules on hedge accounting in IAS 39 have frustrated many preparers, as the requirements have not been well linked with common risk management practices. The detailed rules have at times made achieving hedge accounting impossible or very costly, even when the hedge has been an economically rational risk management strategy. Users have also found the current distinction between achieving hedge accounting or not as meaningless; they have often struggled to fully understand an entity's risk management activities based on its application of the hedge accounting rules. The IASB is addressing several of these concerns in this third phase of its efforts to replace IAS 39 with IFRS 9.

Key provisions

Hedge effectiveness tests and eligibility for hedge accounting

The exposure draft (ED) proposes relaxing the requirements for hedge effectiveness assessment and consequently the eligibility for hedge accounting. Under IAS 39 today, the hedge must both be expected to be highly effective (a prospective test) and be demonstrated to have actually been highly effective (a retrospective test) with 'highly effective' defined as a 'bright line' quantitative test of 80-125%. The exposure draft replaces this with a requirement for the hedge to be designated so as to be neutral and unbiased, and in a way that minimises expected effectiveness. This

could be demonstrated qualitatively or quantitatively, depending on the characteristics of the hedge. For example, in a simple hedge where all the critical terms match, a qualitative test might be sufficient. On the other hand, in highly complex hedging strategies, some type of quantitative analysis – such as that required under current rules – would need to be performed. The 80-125% 'bright line' rule would be removed; however, hedge ineffectiveness must still be measured and reported in the profit or loss.

Hedged items

A number of changes are proposed to the rules for determining what can be designated as a hedged item. The proposed changes primarily remove restrictions that today prevent some economically rational hedging strategies from qualifying for hedge accounting. For example, the exposure draft proposes that risk components can be designated for non-financial hedged items provided the risk component is separately identifiable and measurable. This is good news for entities that hedge non-financial items for a commodity price risk that is only component of the overall price risk of the item, as it is likely to result in more hedges of such items qualifying for hedge accounting.

In addition, the ED would make the hedging of groups of items more flexible, although it does not cover macro hedging – this will be the subject of a separate exposure draft in 2011. Treasurers commonly group similar risk exposures and hedge only the net position (for

example, the net of forecast purchases and sales in a foreign currency). Under IAS 39 today, such a net position cannot be designated as the hedged item. The ED proposes that this be permitted if it is consistent with an entity's risk management strategy. However, if the hedged net positions consist of forecasted transactions, all hedged transactions have to relate to the same period.

Hedging instruments

The ED relaxes the rules on using purchased options and non-derivative financial instruments as hedging instruments. For example, under the current hedging rules, the time value of purchased options is recognised on mark-to-market basis in net income, which can create significant volatility in profit or loss. In contrast, the ED views a purchased option as similar to an insurance contract such that the initial time value (that is, the premium paid) will be recognised in profit or loss – either over the period of the hedge if the hedge is time related, or when the hedged transaction affects profit or loss if the hedge is transaction related. Any changes in the option's fair value associated with time value will only be recognised in 'other comprehensive income' (OCI). This should result in less volatility in profit or loss for these types of hedges.

Presentation and disclosure

The ED changes the presentation of fair value hedge accounting. The hedged item will no longer be adjusted for changes in fair value attributable to the hedged risk. Instead, those fair value changes will be presented as a separate line item in the balance sheet. The other side of that entry as well as the fair value changes of the hedging instrument will be presented in OCI on a gross basis. Any ineffectiveness is then reported in profit or loss. This is so the results of all hedge accounting are reflected in the same statement (OCI).

This new presentation proposal, as well as the proposed new disclosure requirements in the ED, is designed to give the user of the financial statements more decision-useful information about how the entity's risk management activities relate to its use of hedge accounting, and also about the effectiveness of its hedges.

Am I affected?

All entities that engage in risk management activities regardless of whether they use hedge accounting today will potentially be affected by the changes. As many of the changes remove restrictions, it may be beneficial for entities to revisit their risk management strategies that currently do not achieve hedge accounting to see if they will now be permitted. The impact of the new eligibility criteria – unbiased hedging relationships – may make it necessary to evaluate existing hedge accounting strategies that work today and consider whether they will continue to be eligible.

The new requirements are proposed to be effective for accounting periods beginning on or after 1 January 2013, with earlier application permitted. However, the IASB has recently issued a discussion paper on effective dates and transition, the results of which may impact the IASB's decision on the ultimate timing of IFRS 9 application.

What do I need to do?

The comment letter period ends on 9 March 2011; a final standard is expected mid-2011. Given the potential impact on accounting and operations, management should assess the implications of the proposals on existing hedging strategies and consider commenting on the ED to ensure its views are considered.