Project **Financial Instruments (Replacement of IAS 39) – Hedge Accounting**

Topic **Eligible hedged items: Net positions – forecast transactions**

Introduction

Background and purpose of this paper

1. This paper extends the examples to consider net positions consisting of *forecast transactions*.
2. This paper looks at:
   (a) a closed group that results in a net position of highly probable *forecast* non-financial transactions, that
   (b) affect profit or loss in *different* reporting periods; and
   (c) is managed on a net basis for risk management purposes.
3. Like the example you discussed in May 2010, this example also addresses the 'where' and the 'when' issue. (May 2010 Agenda Paper 9 identified three broad accounting issues that arise from permitting hedge accounting for net positions).

An example and the issue

Example – facts

4. Entity A has a EUR functional currency. At time T0 it has two $ denominated forecast transactions (summarised below). Time T0 and periods T2 and T4 all lie in different reporting periods.
5. Summary of transaction in $:

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$'000	T0	T1	T2	T3	T4
Sales	-	-	-	-	300
Cost of sales	-	-	(200)	-	-

Hence the cumulative net risk to the end of T4 is the receipt of $100k.

6. For illustration purposes this example assumes that:

   (a) all transactions settle at the end of each period;

   (b) spot FX rates equal forward FX rates at any point in time because of nil interest rates (hence nil forward points); and

   (c) Spot FX rates are:

$/€	T0	T1	T2	T3	T4
Exchange rate	2.0	1.6	1.8	1.9	1.5

Example – outcome with no economic hedging

7. If Entity A decided <u>not</u> to economically hedge, the sales and cost of sales are recorded at the transaction spot rate as shown below:

€000	T0	T1	T2	T3	T4
Sales	-	-	-	-	200[1]
Cost of sales	-	-	(111)[2]	-	-

8. The cumulative net profit to the end of T4 would be €89k (€200k – €111k).

[1] $300k/1.5 = €200k
[2] $200k/1.8 = €111k

Example – risk management facts

9. The risk management policy of Entity A is to use forward FX contracts to hedge its net foreign exchange risk arising from forecast foreign currency transactions.
10. Therefore at T0 Entity A enters into a single FX forward contract ('forward 1') that settles in T4 to hedge the net risk of $100,000 from T0 to T4.
11. After the purchase takes place in T2, the net risk changes from $100,000 to $300,000, hence the entity enters into an additional derivative ('forward 2') at T2 with notional $200,000[3].
12. For T0 to T4 the entity has economically hedged the net risk of the group of forecast transactions at a rate of $2/€(the rate at T0).

Example – application of IAS 39

13. Net positions do not qualify for hedge accounting under IAS 39. Hence to apply hedge accounting Entity A must designate a gross position.
14. At T0 Entity A designates forward 1 in a cash flow hedge of the first $100,000 (of the total $300,000) of sales arising in T4.
15. At the end of T2, Entity A also designates forward 2 in a cash flow hedge of the next $200,000 of sales arising in T4.
16. The hedge accounting result of this designation in profit or loss is as follows[4]:

€000	T0	T1	T2	T3	T4
Sales	-	-	-	-	161[5]
Cost of sales	-	-	(111)[6]	-	-

[3] This forward is necessary because the entity does not fund the purchase with $ borrowings. If it did, the $200k of borrowings needed would hedge $200k of sales and the forward would not be needed.
[4] See Appendix B for balance sheet and double entry to support this.
[5] €161k = [transaction at spot] + [forward 1 gain/loss] + [forward 2 gain/loss] = $300,000/1.5 + ($100,000/2 - $100,000/1.5) + ($200,000/1.8 - $200,000/1.5) = €200,000 - €16,666 – €22,222 = €161,112.
[6] $200,000/1.8 = €111,111.

17. The *cumulative* net profit at the end of T4 is €50k (€161k-€111k) (reflecting the group hedge rate of $2/€).

18. However, the reported effective FX rate for each period does not reflect this (see table below). Instead the cost of sales is translated at the spot rate in T2 and the sales are translated at a blend of hedged rates in T4[7].

Effective rate ($/€)	T0	T1	T2	T3	T4
Sales	-	-	-	-	1.9[8]
Cost of sales	-	-	1.8[9]	-	-

Example – an alternative approach

19. An alternative approach is to permit designating *both* the forecast purchase and the forecast sale in a single *net* hedge relationship. When each hedged item affects profit or loss, the offsetting hedge gain/loss is presented in a separate line to achieve a net economic hedged rate of $2/€

20. The accounting result in profit or loss would be as follows (see **Appendix A** for balance sheet and double entry that supports this):

€000	T1	T2	T3	T4
Forecast Sale	-			200
Forecast Purchase	-	(111)	-	-
(Net) hedge gain/loss	-	11	-	(50)
Net	**-**	**(100)**[10]	**-**	**150**[11]

[7] Of the total sales of $300k, $100k is translated at a hedged rate of $2/€ (ie effect of forward 1) and $200k is translated at $1.8/€ (ie effect of forward 2).
[8] $300k/€161k = 1.9 ($/€)
[9] $200k/€111k = 1.8 ($/€)

21. Please read the backing calculations in **Appendix A** before continuing to the next section.

Cash flow hedge accounting mechanics under the described approach

22. The approach set out in the previous section requires recognition of the fact that items in a net hedged position can have a dual role. That is, some items can act as both hedged item and hedging instrument (see discussion in cover paper).

23. In the approach detailed above, this dual role is reflected in that an item in the net hedged position will sometimes be treated as a 'hedged item' and sometimes treated as a 'hedging instrument' (for the purpose of determining the amount to be deferred in equity).

24. As background for you, the role today of the label 'hedging instrument' and 'hedged item' in a cash flow accounting hedge is described in **Appendix C**. A description of how those labels apply in a net position hedge of forecast transactions is also described in **Appendix A**.

What does the amount deferred in equity represent in a cash flow hedge of a net position of forecast transactions under the alternative approach?

25. As shown in **Appendix A** the amount deferred in equity at any one time is the lesser of the following (in absolute amounts):

    (a) cumulative gain/loss of hedging instruments and *recognised* hedged items from inception of the hedge; and

    (b) the cumulative change in present value of the cash flows of the (as yet) *unrecognised* hedged items.

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[10] Effective rate = $2/€($200k/€100k)
[11] Effective rate = $2/€($300k/€150k)

26. It is important to note that amounts deferred in equity represent gains/losses that have economically been realised. They **do not** represent anticipated gains/losses[12].

Staff analysis of alternative approach

27. The key objective of applying hedge accounting for a net position that affects profit or loss in *different* reporting periods is to demonstrate the effect of the hedge in *each* period that a hedged item from the net position is recognised.

28. As shown in **Appendix A**, this can be achieved within the boundaries of financial reporting using the alternative approach set out above, and in compliance with the hedge accounting principles in **Appendix D**.

29. The benefits of applying hedge accounting for net positions might include:

    (a) avoiding distortion of financial reporting caused by designating gross hedged positions in hedge relationships when the economic basis for the hedge is to hedge a net position.

    (b) providing useful information to users of financial statements about how an entity manages risks arising from assets, liabilities, firm commitments and forecast transactions that are managed together on a net basis.

    (c) informing users of financial statements, through separate presentation, that the entity has a risk management strategy of hedging net exposures.

30. However, some of the consequences of permitting hedge accounting for net positions of forecast transactions are:

    (a) Increased use of equity to defer gains and losses from *recognised* hedged items (ie acting as hedging instruments) to be later reclassified

[12] This is achieved by using the 'lower of' test in the way described in Appendix E.

to match the timing of recognition of gains/losses on other hedged items.

(b) Increased complexity of applying hedge accounting due to

  (i) the dual role of hedged items in the net position (ie sometimes acting as hedged item and sometimes acting as hedging instrument).

  (ii) potential changes in timing and amount of anticipated transactions (because by their nature the transactions are not certain to occur).

(c) The dual role of hedged items acting as hedging instruments results in circumstances where anticipated transactions are treated as hedging instruments (*although consistent with Principle 3 in* ***Appendix D****, this does not result in the recognition of gains/losses that do not exist as it only defers gains/losses when the anticipated transaction is recognised (ie becomes an existing transaction)*).

Staff conclusion

31. The decision of whether hedge accounting should be permitted for certain net positions of forecast transactions requires balanced consideration of the advantages and disadvantages noted in paragraphs 29 and 30 and the Board's objective for the hedge accounting model.

32. It should also be noted that in practice it is less likely that a net position of forecast transactions will be hedged on a closed portfolio basis as potential changes in expectations of the net position is likely to result in it being hedged on an open portfolio basis.

Staff recommendation and question to the Board

33. On balance and subject to consideration of further potential consequences of hedging net positions, the staff believe that hedge accounting for a net position of forecast transactions described in paragraph 2 should be

permitted, subject to other qualification/eligibility criteria, such as hedge effectiveness, being met.

Question 1 –
Does the Board agree with the Staff recommendation in paragraph 33? If the Board disagrees with the staff recommendation what are the reasons for this and what alternatives does it propose?

Appendix A

A1. This appendix presents the balance sheet, income statement and OCI effect of applying hedge accounting, with double entry, under the alternative approach described in paragraphs 19, 20 and C2 to C5.

A2. This approach reflects the dual role played by hedged items in the net position. That is, acting as both hedged item and hedging instrument.

A3. Under this approach the effective cumulative fair value change of the hedging instrument, less amounts already recognised, is recognised in OCI.

A4. To calculate the effective amount, a hedged item (with the dual role of acting as both hedged item and hedging instrument) is:

(a) *treated as the hedged item* in all periods before being recognised, but

(b) *treated as a hedging instrument* in the period that it is recognised in accordance with the normal recognition requirements that apply in the absence of hedge accounting **if there are unrecognised hedged items outstanding**.

A5. Summary of transaction (minus = credit, functional currency = €):

$/€	T0	T1	T2	T3	T4
Exchange rate	2	1.6	1.8	1.9	1.5
Forward 1:					
Pay $					*100,000*
Receive €					*50,000*
Forward 2:					
Pay $					*200,000*
Receive €					*111,111*
Forecast purchase $			200,000		
Forecast sale $					-300,000

A6. Double entry (minus = credit, functional currency = €)

		T1		
Dr		Cash flow hedge reserve (OCI)	12,500	
	Cr	Forward 1(B/S)		12,500
		To recognise Forward 1 at FV on balance sheet, recognise effective gain/loss in OCI and ineffective gain/loss in P/L.		

		T2		
Dr		Forward 1(B/S)	6,944	
Dr		Cash flow hedge reserve (OCI)	4,167	
Dr		Forecast purchase (P/L)	111,111	
	Cr	Cash (B/S)		111,111
	Cr	Net hedge gain/loss (P/L)		11,111
		To recognise Forward 1 at FV on balance sheet, recognise $200,000 purchase in P/L, and defer effective gain on Forward 1 (Cr 6,944) *and* loss on purchase (Dr 11,111) in OCI (net = Dr 4,167). Balancing figure is taken to P/L 'net hedge gain/loss'		

		T3		
Dr		Forward 1(B/S)	2,924	
Dr		Forward 2 (B/S)	5,848	
	Cr	Cash flow hedge reserve (OCI)		8,772
		To recognise Forward 1 and Forward 2 at FV on balance sheet, recognise effective gain/loss in OCI and ineffective gain/loss in P/L.		

		T4		
Dr		Cash flow hedge reserve (OCI)	42,105	
	Cr	Forward 1(B/S)		14,035
	Cr	Forward 2 (B/S)		28,070
		To recognise Forward 1 and Forward 2 at FV on balance sheet, recognise effective gain/loss in OCI and ineffective gain/loss in P/L.		
Dr		Cash (B/S)	200,000	
	Cr	Forecast sale (P/L)		200,000
		To recognise $300,000 sale		

Dr		Net hedge gain/loss (P/L)	50,000	
	Cr	Cash flow hedge reserve (OCI)		50,000
		To reclassify remaining gains/losses from OCI.		
Dr		Forward 1 (BS)	16,667	
Dr		Forward 2 (BS)	22,222	
	Cr	Cash		38,889
		To recognise cash settlement of Forward 1 and Forward 2		

A7. Lower of tests:

LOWER OF TEST FOR T1

cumulative FV movements		
Forward 1	12,500	*treated in T1 as hedging instrument*
Forecast sale	-37,500	*treated in T1 as hedged item*
Forecast purchase	25,000	*treated in T1 as hedged item*
Cumulative FV movement of hedging instrument =	12,500	
Cumulative FV movement of hedged item =	-12,500	
Cumulative (absolute) lower of =	12,500	
Amounts already recognised in OCI	-	
Cumulative lower of amount of hedging instrument	12,500	
Amount to recognise in OCI in T1	12,500	

LOWER OF TEST FOR T2

In the period in which the hedged item is recognised in profit or loss, it is treated as a hedging instrument for the purpose of applying the 'lower of test'.

cumulative FV movements		
Forward 1	5,556	*treated in T2 as hedging instrument*
Forecast sale	-16,667	*treated in T2 as hedged item*
Forecast purchase	11,111	*treated in T2 as hedging instrument*
Cumulative FV movement of hedging instrument =	16,667	
Cumulative FV movement of hedged item =	-16,667	
Cumulative (absolute) lower of =	16,667	
Amounts already recognised in OCI	12,500	
Cumulative lower of amount of hedging instrument	16,667	
Amount to recognise in OCI in T2	4,167	

A8. 8. Balance sheet summaries:

	T1 **Dr/(Cr)**	T2 **Dr/(Cr)**	T3 **Dr/(Cr)**	T4 **Dr/(Cr)**
Assets				
Forward 1				
Forward 2			5,848	-
Cash				50,000
Liabilities				
Forward 1	-12,500	- 5,556	- 2,632	-
Forward 2				
Overdraft		-111,111	-111,111	
Equity				
Cash flow hedge reserve	12,500	16,667	7,895	-
P/L reserve	0	100,000	100,000	-50,000

A9. Profit or loss and OCI summaries:

Profit or loss	T1 **Dr/(Cr)**	T2 **Dr/(Cr)**	T3 **Dr/(Cr)**	T4 **Dr/(Cr)**
Forecast Sale	-	-	-	-200,000
Forecast Purchase	-	111,111	-	-
Net hedge gain/loss		-11,111		50,000
Net	**-**	**100,000**	**-**	**-150,000**
OCI				
Cash flow hedge reserve	12,500	4,167	-8,772	-7,895

Appendix B

B1. This appendix shows the balance sheet and OCI that corresponds to the profit or loss result shown in paragraph 16.

	T1 Dr/(Cr)	T2 Dr/(Cr)	T3 Dr/(Cr)	T4 Dr/(Cr)
Assets				
Forward 1				
Forward 2			5,848	-
Cash				50,000
Liabilities				
Forward 1	-12,500	-5,556	-2,632	-
Forward 2				
Overdraft		-111,111	-111,111	
Equity				
Cash flow hedge reserve	12,500	5,556	-3,216	-
P/L reserve	-	111,111	111,111	-50,000

Profit or loss	T1 Dr/(Cr)	T2 Dr/(Cr)	T3 Dr/(Cr)	T4 Dr/(Cr)
Forecast Sale	-	-	-	-161,111
Forecast Purchase	-	111,111	-	-
Net	-	111,111	-	**-161,111**
OCI				
Cash flow hedge reserve	12,500	-6,944	-8,772	3,216

Appendix C What is the importance of the 'hedging instrument' and 'hedged item' label for a cash flow hedge?

C1. The label of 'hedged item' in the cash flow hedge accounting model is important for the following:

(a) *Assessing* hedge effectiveness (which compares the change in fair value of the expected future cash flows on the hedged item with the change in fair value of the hedging instrument).

(b) *Measuring* hedge effectives (the cash flow hedge reserve is adjusted to the lesser of (i) the cumulative gain/loss on the hedging instrument from inception of the hedge; and (ii) the cumulative change in the fair value of the expected future cash flows on the hedged item from inception of the hedge).

(c) Determining *when* to reclassify gains/losses from equity to profit or loss (amounts deferred in equity are reclassified to profit or loss when the hedged item affects profit or loss).

Application to net positions

C2. For the purpose of measuring and assessing hedge effectiveness (paragraph C1(a)/C1(b)) *items in the net hedged position* are treated as 'hedged items' if they have not yet been recognised.

C3. The only time *items in the net hedged position* may be treated as 'hedging instruments' for assessing and measuring hedge effectiveness will be in the period they are recognised in profit or loss (under normal accounting requirements that apply in the absence of hedge accounting) [13].

C4. If, when they are recognised, they are part of a hedge relationship with yet unrecognised hedged items, they are treated as hedging instruments of those

[13] What characterises a 'hedging instrument' in a net position hedge relationship is the recognition of gains/losses under 'normal accounting rules' (ie those that apply in the absence of hedge accounting) *before* the recognition of other items in the hedge relationship that it offsets (ie 'hedged items').

unrecognised hedged items. Hence the effective gain/loss of those items (along with other hedging instruments) will be deferred in equity to be later reclassified.

C5. However, if when the item is recognised it is at or after termination of the hedge relationship, the item is treated as a hedged item. As a result this will trigger reclassification of amounts, if any, deferred in equity in respect of that hedged item (ie this determines when to reclassify amounts deferred in equity).

C6. Therefore, for a net position hedge, reclassification of gains/losses from equity only arises at or after termination of the hedge relationship. At all times before then amounts are only deferred in equity which automatically achieves the net economically hedged rate in profit or loss (see double entry in T2 in **Appendix A**).

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Appendix D

Extract from November, 2006 Board paper. Broad principles for a hedge accounting model.

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Principle 1 - derivative contracts create rights and obligations that meet the definitions of assets and liabilities and, as a result, should be recognized.

Principle 2 - fair value is the only relevant measurement basis for derivatives because, for example, it is the only measurement basis that can communicate to the users of financial statements the nature of the rights and obligations inherent in derivatives (such as the level of risk arising from the leveraged nature of a derivative).

Principle 3 – items that do not meet the definition of assets and liabilities (such as deferred gains and losses) should not be recognised as if they were assets and liabilities[14].

Principle 4 – hedge accounting is a departure from normal accounting treatment that would otherwise be applied to the items in the hedge accounting relationship.

Principle 5 – because hedge accounting is a departure from normal accounting treatment, hedge accounting principles are required to provide discipline over the use of hedge accounting. Such principles prevent a free choice over when to recognize gains and losses.

Principle 6 – the criteria to be met to qualify for hedge accounting include that:

(a) there must be exposure to changes in the fair value of a recognized asset or liability or an unrecognized firm commitment, or exposure to variability in cash flows that is attributable to a particular risk

[14] So for special cash flow hedge accounting, qualifying gains and losses on the hedging instrument are reported as a component of equity until the offsetting gain or loss is recognized in profit or loss.

associated with a recognized asset or liability or a highly probable forecast transaction, that could affect profit or loss,[15]

(b) a hedging relationship must be designated and documented at the inception of the hedge as well as the entity's risk management objective and strategy for undertaking the hedge, and

(c) the effectiveness of a hedging relationship must be reliably measurable and is expected to be, and actually was, highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk, consistent with the originally documented risk management strategy for that particular hedging relationship.

Principle 7 – if a hedging relationship is not effective, the ineffectiveness is recognised immediately in profit or loss.

[15] Including identified portions for certain exposures.

Appendix E

Extracts from IAS 39 regarding the accounting of cash flow hedges and the 'lower of test':

95 If a cash flow hedge meets the conditions in paragraph 88 during the period, it shall be accounted for as follows:

(a) the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge (see paragraph 88) shall be recognised in other comprehensive income; and

(b) the ineffective portion of the gain or loss on the hedging instrument shall be recognised in profit or loss.

96 More specifically, a cash flow hedge is accounted for as follows:

(a) the separate component of equity associated with the hedged item is adjusted to the lesser of the following (in absolute amounts):

(i) the cumulative gain or loss on the hedging instrument from inception of the hedge; and

(ii) the cumulative change in fair value (present value) of the expected future cash flows on the hedged item from inception of the hedge;

(b) any remaining gain or loss on the hedging instrument or designated component of it (that is not an effective hedge) is recognised in profit or loss; and

(c) if an entity's documented risk management strategy for a particular hedging relationship excludes from the assessment of hedge effectiveness a specific component of the gain or loss or related cash flows on the hedging instrument (see paragraphs 74, 75 and 88(a)), that excluded component of gain or loss is recognised in accordance with paragraph 55 of this Standard and paragraph 5.4.1 of IFRS 9.