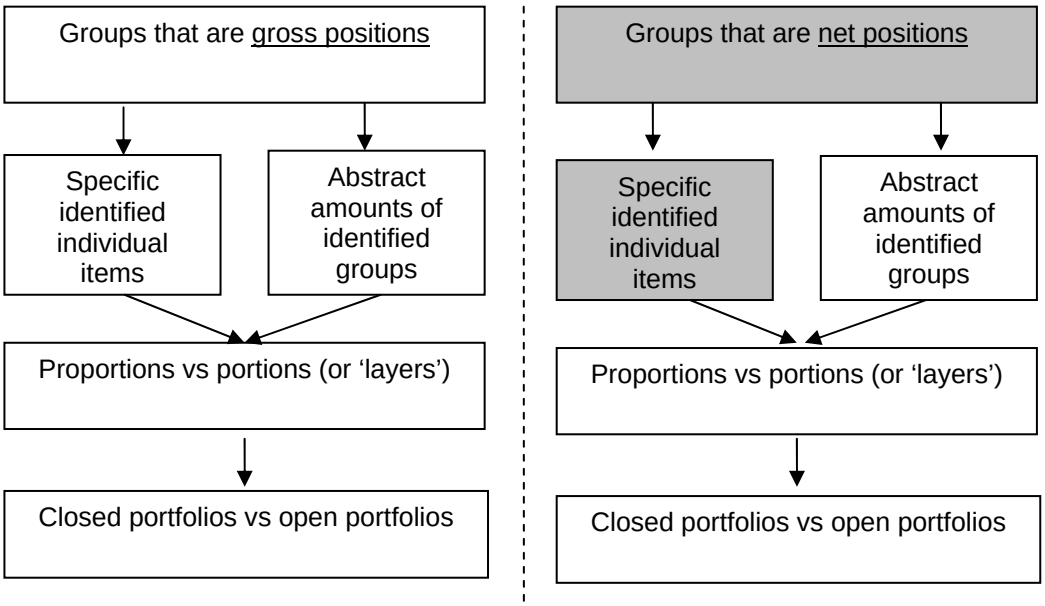
Project	**Financial Instruments (Replacement of IAS 39) – Hedge Accounting**
Topic	**Eligibility of hedged items: net positions – identifying the hedged item**

Introduction

Background and purpose of this paper



1. This paper considers further the consequences of permitting a net position to qualify as a hedged item. In particular it considers how to identify the hedged item (the 'what' issue described more fully in cover paper 6B).

2. This paper does not discuss whether, when the hedged item is a part of an item rather than the entire item, that part can be a proportion or a portion (eg bottom layer) of the entire amount. This will be the subject of a separate paper.

3. The purpose of this paper is to recommend to the board an alternative for identifying the hedged item when a net position is hedged.

4. This paper considers only net positions arising from a *closed* group of non-financial items.

A reminder about net positions

5. Net positions by their nature contain items that partially offset each other. In economic terms, items in the net position that offset each other provide a natural hedge of the common risks for the offset amounts. This natural hedge is not necessarily presented as part of financial reporting, for example if the items in the net position are recognised in different reporting periods or are measured on a different basis. Permitting a net position to qualify as a hedged item would allow two things:

   (a) firstly, to match gains/losses of hedging instruments (eg derivatives) with the net position as a whole, and

   (b) secondly, match gains/losses of the items within the net position that otherwise would affect different periods for financial reporting purposes.

   Since such hedging facilitates the matching of gains/losses between 'hedged items', the distinction between hedged item and hedging instrument becomes less relevant.

Alternatives for identifying the hedged item when a net position is hedged

6. Below is an analysis of two alternatives for identifying the hedged item when a net position is hedged. This analysis uses the following example:

An example - facts

7. Consider the following net positions of hedged items (which could all be either firm commitments or highly probable forecast transactions) denominated in a foreign currency that give rise to FX risk.

¥m	**T0**	**T1**	**T2**
Firm commitments/ highly probable forecast transactions:			
Sales		100	50
Purchases		(40)	(60)
Net		**60**	**(10)**
Cumulative net position across T1 & T2			**50**

8. In the above scenario assume that:

   (a) The entity has € functional currency, hence the transactions give rise to FX risk.

   (b) T1 and T2 represent different reporting periods.

   (c) The net position across both periods is hedged with a single FX forward fixing the exchange rate on the net ¥50m exposure.[1]

   (d) All transactions settle and are recognised in profit or loss at the end of the relevant period.

   (e) Cash balances are retained in ¥ until the end of T2 when the FX forward settles.

Summary of the two alternatives

9. Alternative 1: The net position can be identified as multiple gross hedged items which may offset *within* and *across* reporting periods.

10. Alternative 2: The net position can be identified as multiple gross hedged items which may offset *only across* reporting periods, *not within* reporting periods. In

[1] It should be noted that alternative hedging strategies exist to achieve the same economic outcome. This strategy has been chosen to illustrate the accounting effect of using derivatives that hedge exposures recognised in multiple periods.

other words, alternative 2 does not permit gross hedged positions that offset in the same reporting period.

Comparison to IAS 39

11. Net positions are not eligible hedged items under IAS 39. Instead an entity must designate a gross hedged position as the hedged item. Alternative 2 broadens the set of possible eligible designations under IAS 39 by allowing gross positions from two or more different reporting periods to be hedged in combination as a net position. As a result alternative 2 would not change hedge accounting for hedge relationships where all the hedged items are recognised in the same single reporting period – only combinations of hedged items that affect profit or loss in different reporting periods. However, alternative 1 broadens the set further than alternative 2 by also allowing the gross positions to offset within a reporting period.

Example - Alternative 1

12. Under Alternative 1 the hedged item could be identified as four gross positions that offset both *within* each reporting period (ie T1 sale offsets T1 purchase) UUUand *across* both periods (ie T1 sale/purchase offsets T2 purchase/sale). For example, in order to achieve income statement presentation at a hedged rate (on a net basis) the hedged items could be identified as:

	¥m
Firm commitments/ highly probable forecast transactions:	
T1 Sales	100
T2 Sales	50
T1 Purchases	(40)
T2 Purchases	(60)
Net	**50**

Example - Alternative 2

13. Under alternative 2 the hedged item could be identified as two gross positions that offset only *across* periods (ie T1 sale/purchase offsets T2 purchase/sale). For example, in order to achieve income statement presentation at a hedged rate (on a net basis) the hedged items could be identified as:

	¥m
Firm commitments/ highly probable forecast transactions:	
T1 Sales	60
T2 Purchases	(10)
Net	**50**

Analysis of the alternatives

Compatibility with the Board's tentative decisions on net positions to date

14. Both alternatives are compatible with the Board's tentative decisions to date regarding other consequences of net positions.

15. For example, in response to the 'where' issue (regarding where in the income statement to report gains/losses from hedging instruments), hedging instrument gains/losses could be recognised in a separate income statement line. Whether this would be necessary for alternative 2 requires further analysis which would be undertaken if the board chooses alternative 2 over alternative 1.

16. Also, in response to the 'when' issue (regarding when to reclassify to profit or loss gains/losses previously recognised in OCI) gains/losses would be reclassified from equity when the designated gross hedged items affect profit or loss.

Accounting result of alternative 1 and alternative 2 – when there is no change in timing/amount of hedged item

17. If all hedging instrument gains/losses are presented in a single separate line both designations in paragraph 12 (alternative 1) and paragraph 13 (alternative 2) produce the same accounting result in profit or loss and other comprehensive income. This is illustrated in Appendix A.

18. The same accounting arises because the amount to be recognised in a given period is in effect based on the hedged net position in that period. That net position for each period (eg a net position of 60 in T1) can be created by one gross position (eg T1 sales of 60 under alternative 2 – paragraph 13) or a combination of offsetting gross items (eg T1 sales of 100 and T1 purchases of 40 under alternative 1 – paragraph 12). Either way the accounting result is the same because it is in effect based on the net position of 60 in T1.

Accounting result of alternative 1 and alternative 2 – in the event of a change in timing/amount of hedged item

19. It should be noted that if the hedged items changed in timing or amount the accounting result of the two designations could be different. For example if the hedged items were highly probable forecast transactions and in T1 the sales forecast to occur in T2 reduced from the original expectation of ¥50m to ¥30m (with ¥20m being reforecast to occur later in T3), under alternative 2, this would *not* give rise to any hedge ineffectiveness because *no* sales are designated for T2 (see paragraph 13). However, under alternative 1 it *would* give rise to hedged ineffectiveness because the *full* ¥50m of sales is designated (see paragraph 12).

20. Furthermore, changes in timing of hedged items will change the timing of reclassification of hedging instrument gains/losses previously recognised in OCI under a cash flow hedge to match recognition of the hedged items. For example,

under alternative 1, gains/losses deferred in respect of the ¥20m of sales that have been delayed from T2 to T3 would be reclassified in T3 instead of T2 as originally expected.

Comparison of alternative 1 and alternative 2

21. Alternative 1 allows a broader range of hedged item combinations than alternative 2 because alternative 2 does not permit hedged items that offset in the same reporting period, whereas alternative 1 does.

22. Any designation permissible under alternative 2 is also permissible under alternative 1 (ie alternative 2 is a subset of alternative 1).

23. Presentation aside, allowing only designations available under alternative 2 in effect would allow an entity to only designate net positions *across* periods and not *within* periods. Hence this would be a limited change to the IAS 39 model. This would solve some of the accounting issues arising from not allowing net positions from qualifying for hedge accounting (explained more fully in paper 9 and 9C from May 2010 IASB meeting and paper 6A at this board session). However, it could restrict hedge designations from reflecting the risk management basis for transacting hedging instruments.

Conclusion of analysis

24. In summary the main difference between the two alternatives only arises when there is a change in the timing or amount of the originally designated hedged items. The effects are explained in paragraphs 19 to 20.

25. Certain designations under alternative 1 could give rise to more hedge ineffectiveness than designations of the same net size under alternative 2 (see paragraph 19)[2]. However, those same designations could also facilitate better matching of hedging instrument gains/losses with the losses/gains arising on the

[2] However, the amount of ineffectiveness, if any, does depend on how a hedged part less than the entire item is identified – eg a proportion or a portion/bottom layer. As mentioned in paragraph 2 this will be considered in a separate paper.

hedged items if timings change (see paragraph 20.). Hence there is a trade-off for such designations.

26. Under a hedge accounting model where hedge accounting is elective, an entity can choose an amount of the hedged item up to the maximum amount of the hedged item available and permissible for designation. In determining this amount an entity is likely to consider the cost-benefit of the trade-off described in paragraph 25[3].

27. In conclusion the staff believe that an entity should be permitted to identify the hedged items in a net position hedge in accordance with alternative 1 in paragraph 9 if that is how it manages risk. That is as a combination of gross hedged items that may offset both within and across reporting periods. Noting that in practice an entity may not avail itself of this opportunity and may only designate net positions *across* periods (ie alternative 2) as this solves some of the accounting issues arising from not being able to designate net positions under IAS 39.

Question to the Board
Does the Board agree with the staff recommendation in paragraph 27 that hedged items in a net hedged position may be identified in accordance with alternative 1? If not, what does the board propose instead and why?

[3] The discussion of whether hedge accounting should be elective or mandatory will be the subject of separate staff papers. They will also consider whether the designated hedged amounts in a hedge relationship should be a free choice or whether it should be tied to risk management.

Appendix A

A1. This appendix illustrates that the accounting effect of the different designations under alternative 1 and alternative 2 (shown in paragraphs 12 and 13) give rise to the same accounting result (in the event that the timing or amount of the hedged transactions do not change and hedging instrument gains/losses are presented in the same single line).

A2. Summary of transaction (minus = credit). The entity has € functional currency, hence the transactions give rise to FX risk.

	T0	**T1**	**T2**
¥/€ exchange rate	**0.0100**	**0.0090**	**0.0095**
Forward 1:			
Pay ¥			50,000,000
Receive €			500,000
Forecast sale ¥		-100,000,000	
Forecast sale ¥			-50,000,000
Forecast purchase ¥		40,000,000	
Forecast purchase ¥			60,000,000
Cash balance ¥		60,000,000	
Cash balance €			500,000

A3. Summary balance sheet:

	T1 Dr/(Cr)	**T2 Dr/(Cr)**
Assets		
Forward 1	50,000	-
Cash	540,000	500,000[4]
Liabilities		
n/a	-	-
Equity		
Hedge reserve	10,000	0
P/L reserve	- 600,000	-500,000

[4] This includes the cash settlement on the forward 1of €25k .

A4. Summary profit or loss and OCI:

	T1	T2
Profit or loss	**Dr/(Cr)**	**Dr/(Cr)**
Forecast Sale	-900,000	-475,000
Forecast Purchase	360,000	570,000
Net hedge gain/loss	- 60,000[5]	5,000[6]
Net	**-600,000**	**100,000**
OCI		
Hedge reserve	10,000	- 10,000

A5. Double entry:

T1				
			Dr	**Cr**
Dr		Cost of sales (P/L)	360,000	
	Cr	Cash (BS)		360,000
		To recognise cash purchases at prevailing spot rates.		
Dr		Cash (BS)	900,000	
	Cr	Sales (P/L)		900,000
		To recognise cash sales at prevailing spot rates.		
Dr		Forward (BS)	50,000	
	Cr	Hedge reserve (OCI)		50,000
		To recognise Forward 1 at FV on balance sheet with effective gain/loss in OCI. Assume the hedge is 100% effective (the exposure of Yen 50m is equal to the Yen notional on Forward 1).*		
Dr		Hedge reserve (OCI)	60,000	
	Cr	Net hedge gain/loss (P/L)		60,000
		*This represents the deferral of the net FX loss on sales and purchases in T1 (-100m*0.009)-(-100m*0.01) + (40m*0.009)-(40m*0.01) = 60,000*		

[5] This represents the deferral of the net FX loss on sales and purchases in T1 (-100m*0.009)-(-100m*0.01) + (40m*0.009)-(40m*0.01) = 60,000.

[6] This represents the reclassification of the remaining amounts from OCI to P/L = [net balance of OCI at the end of T1] + [FX gain on cash balance in T2] + [loss on forward 1 in T2] = 10k - 30k + 25k = 5k.

T2				
			Dr	**Cr**
Dr		Cost of sales (P/L)	570,000	
	Cr	Cash (BS)		570,000
		To recognise cash purchases at prevailing spot rates.		
Dr		Cash (BS)	475,000	
	Cr	Sales (P/L)		475,000
		To recognise cash sales at prevailing spot rates.		
Dr		Hedge reserve (OCI)	25,000	
	Cr	Forward (BS)		25,000
		To recognise Forward 1 at FV on balance sheet with effective gain/loss in OCI. *Assume the hedge is 100% effective (the exposure of Yen 50m** is equal to the Yen notional on Forward 1).*		
Dr		Net hedge gain/loss (P/L)	5,000	
	Cr	Hedge reserve (OCI)		5,000
		To reclassify the remaining amounts from OCI to P/L to offset hedged items = [net balance of OCI at the end of T1] + [FX gain on cash balance in T2] + [loss on forward 1 in T2] = 10k - 30k + 25k = 5k		
Dr		Cash (BS)	30,000	
	Cr	Hedge reserve (OCI)		30,000
		To recognise FX retranslation of Yen cash balance in OCI		
Dr		Cash (BS)	25,000	
	Cr	Forward (BS)		25,000
		To recognise cash settlement of Forward 1.		

* the exposure of Yen 50 in T1 is made up as follows:

Alternative 1:	**Yen m**
T1 Sales	100
T2 Sales	50
T1 Purchases	-40
T2 Purchases	-60
Net	**50**

Alternative 2:	**Yen m**
T1 Sales	60
T2 Purchases	-10
Net	**50**

** the exposure of Yen 50m in T2 is made up as follows:

Alternative 1:	**Yen m**
T2 Sales	50
T2 Purchases	-60
Cash	60
Net	**50**

Alternative 2:	**Yen m**
T2 Purchases	-10
Cash	60
Net	**50**