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

Topic: **Eligibility of hedged items: Net positions cover paper**

Introduction

Background

1. This paper continues the discussion of hedge accounting of groups of hedged items that are net positions.

2. In May 2010 we considered an example of some FX-denominated firm commitment sales and purchases, in which the net FX risk (resulting from the fact that not all of the sale FX risk was offset by the purchase FX risk) was hedged by an FX forward (designated as a fair value hedge).

Presentation (or 'where' to present gains/losses arising from hedging a net position)

3. In one example[1], the sale/purchase happened in the same accounting period. That illustrated how existing presentation requirements of gains/losses arising from a hedged net position can be misleading. This is because either the FX rate at which (a) the sale is booked or (b) the purchase is booked is adjusted, but not both.

4. The Board tentatively decided that such gains/losses should be presented as a separate line in profit or loss.

[1] See Agenda Paper 9B from May 2010 IASB meeting

'When' gains/losses arising from hedging a net position should be recognised

5. In the second example[2], the FX denominated sales/purchases happened in *different* accounting periods.

6. In this example, the net exposure arising from the mismatch between the foreign currency sales, purchases and the resulting cash/overdraft balance remained constant throughout the periods and that net exposure was hedged by a single FX forward.

7. Economically, until the first forecast transaction happened (a purchase) it offset some of the FX risk on the later forecast transactions (eg sales). When the purchase occurred, the resulting FX-denominated overdraft effectively replaced the forecast purchase in economically offsetting the FX risk on the future sales yet to occur. Hence, economically the net FX exposure hedged by the FX forward remained constant.

8. To reflect these relationships, the Board tentatively decided that gains/losses could be recognised in profit or loss during the hedged period so that, in effect, all of the hedged items in the net position are recognised in profit or loss at the hedged rate (on a net basis subject to hedge ineffectiveness).

We only looked at firm commitments

9. In the above examples, we only considered firm commitments (of non-financial items).

10. This is important, because these exposures exist when the hedge is entered into.

11. So the approach described in the preceding paragraph is all about recognising, measuring and presenting assets/liabilities that exist throughout the hedge period.

Context of tentative decisions

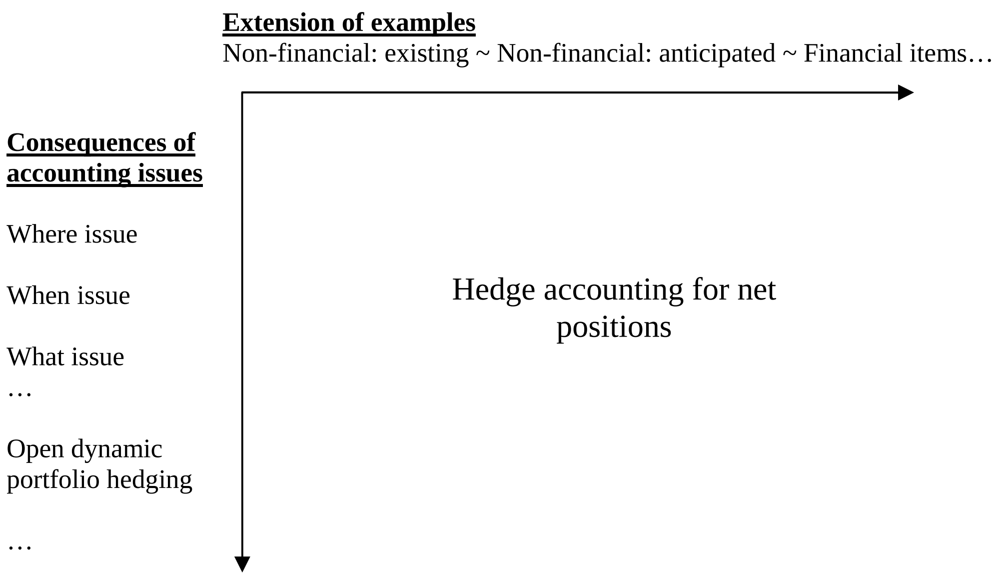
12. The Board took the tentative decisions described above to facilitate further development of this issue. Both in terms of:

[2] See Agenda Paper 9C from May 2010 IASB meeting

(a) The consequences of the accounting issues that arise (such as how to identify the hedged item for designation and effectiveness testing). Those accounting issues (ie the ‘where’, ‘when’ and ‘what’ issues) were described in the May 2010 cover paper 9, and are included in Appendix B to this paper; and

(b) Extension of the examples beyond existing non-financial items such as firm commitments.

13. As summarised in the following picture.



Extending the examples to forecast transactions

14. In **Agenda Paper 6A** we extend the examples to *forecast* non-financial sales/purchases.

15. We believe that these need to be considered separately from the examples of existing items (ie firm commitments) discussed last time.

16. Why? As noted previously, a net position arises from the fact that a group of hedged items has offsetting risk positions. That is, the risk exposure of an individual hedged item in the group will offset (fully or partially) the risk exposure of another individual hedged item in the group. We label such items as a whole the ‘hedged item’.

17. However, in a net position such items in fact serve a dual role of acting as both hedged item *and* hedging instrument[3]. So, in the context of a net position, the distinction between 'hedged item' and 'hedging instrument' becomes less meaningful.

18. This is important, because today only existing items qualify as 'hedging instruments' (normally derivatives but, in some cases, 'cash' instruments, see Appendix A for a summary of the types of instruments that qualify as hedging instruments.)

19. When we look at examples in **Agenda Paper 6A**, of highly probable forecast sales/purchases, we are obviously talking about cash flow hedges.

20. Under a cash flow hedge today, it is only the 'hedging instrument' gains/losses that are permitted to be deferred in OCI (subject to all the other criteria).

21. However, the question that arises in the context of a cash flow hedge of a net exposure arising from forecast transactions is whether

    (a) FX gains/losses from *recognised* hedged items (say, a purchase) that arise in a period before other yet unrecognised hedged items (eg forecast sales)

    (b) can be deferred in OCI until the last forecast transaction in the hedge relationship happens

    (c) so that all of the components (eg sales and purchases) of the hedge relationship are reported at the hedged rate, to the extent that the hedge is effective.

22. It is this question that **Agenda Paper 6A** considers.

[3] For example consider a EUR functional currency entity with a net position of a forecast sale of 100m ZAR and a forecast purchase of 80m ZAR hedged for FX risk with a forward that swaps 20m ZAR into EUR. 80m ZAR of purchases acts as a hedging instrument to 80m ZAR of sales which acts as hedged item. Whilst at the same time 80m ZAR of sales acts as hedging instrument to 80m ZAR of purchases which acts as hedged item.

What next?

23. We are yet to present examples of net positions consisting of financial hedged items (both existing and anticipated). Such groups are more often hedged on an open portfolio basis. Hence we propose considering hedge accounting for these as part of developing a portfolio hedge accounting model (ie applies to open, dynamic hedged portfolios).

24. Before we move on to such examples, we will consider the consequences of the accounting issues that arise for net positions as part of the general hedge accounting model (ie closed portfolios) for non-financial hedged items. For example, how the hedged item designated in a net position hedge can be identified for effectiveness testing and measurement purposes.

25. The staff also noted that the scope of this project will not cover economic hedging relationships that do not include a 'hedging instrument' as defined by the hedging model (eg derivatives in almost all situations under today's model). The board has previously decided to maintain the basic architecture of the current model in IAS 39 which requires a hedge relationship to include both a hedged item **and** a hedging instrument to qualify for hedge accounting.

Appendix A

A1. The table below analyses, between existing items and anticipated items, items that qualify under IAS 39 as a hedged item or a hedging instrument (or both).

A2. Under IAS 39, all hedging instruments are financial items that affect profit or loss as a consequence of their default measurement basis. For example, in the absence of hedge accounting, derivatives must be measured at fair value through profit or loss under IAS 39 and foreign currency monetary items must be retranslated through profit or loss under IAS 21.

Description	**Existing or anticipated?**	**Under IAS 39 permitted as: hedged item only; hedging instrument only; or both?**	**Staff comments**
Derivative	Existing item	Hedging instrument only[4]	The Board has tentatively agreed to allow derivative instruments to be hedged items in certain cases[5]
Foreign currency monetary item	Existing item	Both	IAS 39 allows a foreign currency monetary item to be *either* the hedged item or the hedging instrument in a hedge relationship.
Functional currency monetary item	Existing item	Hedged item only	
Firm commitments (not accounted for as derivatives)	Existing item	Hedged item only	The Board has agreed to further consider permitting hedge accounting for net positions consisting of firm commitments. This would permit firm commitments to act simultaneously as a hedged item and hedging instrument in a net position hedge (ie dual role, see paragraph 17).
Equity investments	Existing item	Hedged item only	
Highly probable forecast transaction	Anticipated	Hedged item only	

[4] Written options can qualify as hedged items in certain limited circumstances.
[5] See agenda paper 1A from the IASB meeting on 3 March 2010.

Appendix B

Extract from Agenda Paper 9 from May 2010 IASB meeting:

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24. The Staff has identified three key issues that arise from hedge accounting for groups of items:

(a) The ‘*where*’ issue: The **profit or loss geography** of gains and losses (from both hedged item and hedging instrument) is an issue when the hedged items in the group affect profit or loss in different line items.

(b) The ‘*when*’ issue: The **timing of recognition in profit or loss** of gains and losses (from both hedged item and hedging instrument) is an issue when the hedged items in the group affect profit or loss in different reporting periods.

(c) The ‘*what*’ issue: **Identifying the hedged item** is an issue when a group of hedged items is hedged for a specified amount but without identifying specific hedged items.

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