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Hedge accounting moves closer to risk management

Proposals provide more hedging opportunities

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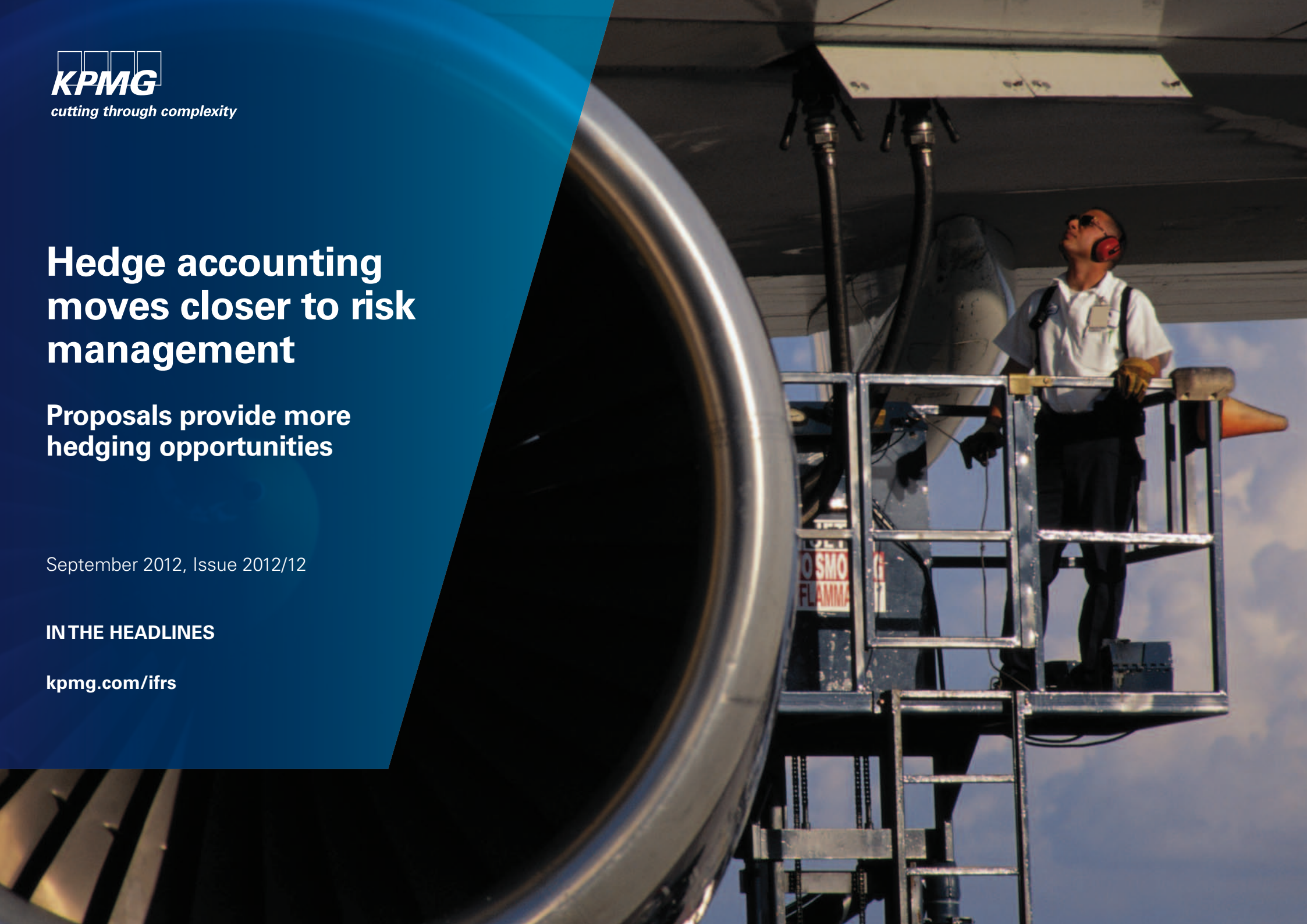

> “Many preparers will support these revised proposals. It appears that in redeliberating the December 2010 exposure draft, the IASB has responded to stakeholder requests for conceptual clarifications and more ‘meat on the bone’ for the new concepts.”
>
> – Enrique Tejerina, KPMG’s global IFRS Financial Instruments deputy leader

Proposals seek to align hedge accounting more closely with risk management

On 7 September 2012, the IASB issued a draft of its forthcoming IFRS on general hedge accounting (the ‘review draft’), which proposes to align hedge accounting more closely with risk management. The proposals would not fundamentally change the current types of hedging relationships, or the current requirement to measure and recognise ineffectiveness; however, the proposals would mean that more hedging strategies used for risk management would qualify for hedge accounting.

The review draft will remain on the IASB website until early December 2012. Interested parties may provide comments to the IASB during this period.

Hedge accounting available for broader range of hedging strategies

Risk components of non-financial items and non-contractually specified inflation

Separately identifiable and reliably measurable components, of both financial and non-financial items, may be hedged items under the proposals.

A non-contractually specified inflation component may qualify as a hedged item, subject to a ‘rebuttable presumption’ that unless inflation is contractually specified it would not be separately identifiable and reliably measurable.

Net positions and layer components

A group of items, including a group of items that constitute a net position, may be a hedged item under the proposals if:

- it consists of items that are eligible hedged items; and
- the items in the group are managed together on a group basis for risk management purposes.

A layer component that includes a prepayment option may be a hedged item for a fair value hedge if the effect of the prepayment option is included in the effectiveness calculation.

Aggregated exposures

Under the proposals, an aggregated exposure (a combination of a derivative and a non-derivative exposure) that is managed together for risk management purposes may be designated as the hedged item in a hedging relationship.

If the components that make up the aggregated exposure already are designated in a hedging relationship, then an entity would account for the second hedging relationship without having to terminate and restart the initial hedging relationship.

Equity investments at fair value through other comprehensive income

Under the proposals, an entity may hedge the foreign exchange risk exposure or equity price risk exposure of equity investments at fair value through other comprehensive income with any hedge ineffectiveness recognised in other comprehensive income.

More judgement needed to apply requirements

More judgement would be needed to assess the effectiveness of the hedging relationship. A hedging relationship would need to be effective at inception and on an ongoing basis, and would be subject to a qualitative or quantitative, forward-looking effectiveness assessment. The following requirements would need to be met:

- an economic relationship exists between the hedging instrument and the hedged item;
- the effect of credit risk does not dominate the value changes that result from that economic relationship;
- the hedge ratio is the same as that resulting from actual amounts of hedged items and hedging instruments used for risk management; and
- an entity cannot intentionally weight the hedging instrument or hedged item to achieve an accounting outcome inconsistent with the purpose of hedge accounting.

No voluntary termination of otherwise qualifying hedging relationships but rebalancing may be required

An entity would not be allowed to voluntarily terminate a hedging relationship that continues to meet its risk management objective and all other qualifying criteria. An entity may be required to rebalance hedging relationships that are not behaving in the expected manner, by adjusting the quantities of the hedged item or the hedging instrument to maintain a hedge ratio that complies with the hedge effectiveness requirements.

Cash instruments may be hedging instruments in more cases

Generally, non-derivative financial assets or liabilities measured at fair value through profit or loss would be able to be designated as hedging instruments in hedging relationships of any risk, not only foreign currency risk.

For hedges other than hedges of foreign currency risk, the non-derivative financial instrument would be designated in its entirety or as a proportion of its nominal amount.

New fair value option for certain own-use contracts

The fair value option in IFRS 9 *Financial Instruments* would be extended to contracts that can be settled net in cash and meet the own-use scope exception if applying fair value accounting eliminates or significantly reduces an accounting mismatch.

This will address the accounting mismatch that occurs when:

- commodity contracts are outside the scope of IAS 39, and thus accounted for as executory contracts; and
- an entity enters into derivative transactions to economically hedge the commodity price exposure.

New fair value option for certain credit exposures that are managed for credit risk with credit derivatives

The review draft would permit certain credit exposures to be designated at fair value through profit or loss if a credit derivative that is measured at fair value through profit or loss is used to manage the credit risk of all, or a part of, the exposure on a fair value basis.

A credit exposure may be a financial instrument within or outside the scope of IFRS 9 (e.g. loan commitments) that is managed for credit risk. The designation would be permitted if:

- the name of the credit exposure matches the reference entity of the credit derivative; and
- the seniority of the financial instrument matches that of the instruments that can be delivered in accordance with the credit derivative.

Additional disclosure requirements on risk management and hedging activities

For all hedged risk exposures to which hedge accounting is applied, an entity would need to disclose additional information such as the risk management strategy and the effect of hedge accounting on its financial statements.

Effective date and transition

The proposals would be effective for annual periods beginning on or after 1 January 2015. Early application would be permitted only if all existing IFRS 9 requirements are applied at the same time or have already been applied.

Transition would be prospective with limited exceptions.

All qualifying criteria would need to be met on the date of initial application of the new hedging requirements in order to apply hedge accounting from that date.

> “Although the principles in the draft will provide welcome relief, the application guidance in some areas remains complex. Significant effort may be needed to analyse the requirements and determine how best to apply them to a company’s particular circumstances.”
>
> – Enrique Tejerina, KPMG’s global IFRS Financial Instruments deputy leader

Basic facts

Since November 2008, the IASB has been working to replace its financial instruments standard (IAS 39) with an improved and simplified standard.

The IASB structured its project in three phases:

- Phase 1: Classification and measurement of financial assets and financial liabilities
- Phase 2: Impairment methodology
- Phase 3: Hedge accounting.

The review draft of the general hedging standard will be available until early December 2012, after which time the IASB intends to proceed to finalise the draft.

The proposals do not cover open portfolio hedging (macro hedging). The IASB has an active project to develop a new macro hedge accounting model.

The proposed effective date is annual periods beginning on or after 1 January 2015.

Find out more

For more information on the proposals, please go to the IASB announcement on the general hedge accounting review draft, or speak to your usual KPMG contact.

Timeline

9 December 2010:
Exposure draft published

9 March 2011:
Comment period ended

7 September 2012:
Review draft published

Early December 2012:
Review period concludes

Late 2012 / Early 2013 – (IASB plan):
– Final standard on general hedge accounting
– Discussion paper on macro hedging

1 January 2015:
Effective date

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