ARG MEETING FEBRUARY 2010
AGENDA PAPER 5

International Financial Reporting Standards

Hedge Accounting

February 2010

The views expressed in this presentation are those of the presenter, not necessarily those of the IASC Foundation or the IASB

Hedging activities

Questions:

1. How do an entity's hedging activities affect your analysis and recommendations?
2. What information do you need to understand an entity's hedging activities? How do you use this information?

Hedge accounting

Questions:

1. Do you eliminate or adjust any ‘GAAP’ numbers that relate to hedge accounting for your analysis? (in particular for cash flow hedges)
2. Should hedge accounting be compulsory?
3. What existing disclosures, irrespective of whether they are in the financial statements or elsewhere (eg management reports, investor presentations), are useful?

The IASB's tentative approach to hedge accounting

Fair value hedge	Cash flow hedge
Cash flow hedge accounting mechanics	

Balance sheet

- Hedged item is not adjusted for effective portion of hedge
- Gains/losses on effective portion of hedge in OCI

Income statement

- Any ineffectiveness recognised in P/L each period

Presentation consequences:

- All hedging activities presented in OCI
- Hedged item measured on a consistent basis
- Equity volatility (possible negative equity values) > effects on debt equity ratios
- Change in total asset/liability values > change in net asset value
- Same income statement effect

The IASB’s tentative approach

Questions:

1. Do you think the proposed approach provides more useful information?
2. The tentative approach results in the effective portion of the hedge presented in OCI, would disaggregation of the OCI amount be useful? On what levels?
3. Would any other separate line items be useful for your analysis?
4. What additional note disclosures would you need for your analysis under this approach?

Another alternative to fair value hedges

- An alternative to the IASB's tentative treatment on fair value hedge would be to recognise the adjustment of the effective portion of a fair value hedge as a separate asset or liability on the balance sheet.
  – This approach limits OCI volatility but results in a separate line item that is neither an asset or a liability

1. Does this approach provide more useful information than the tentative approach?

Other questions

1. How do you use information about hedge ineffectiveness?
2. When hedging with options, what do you think is the most useful treatment of the option premium?
   – Some alternatives include:
     – Deferred in OCI and adjusted as the cost of the hedged item
     – Deferred in OCI and amortised over the hedging relationship
     – Deferred in OCI and amortised over the life of the hedged item
     – Recognised immediately in profit or loss
3. Is information relating to counter party credit risk of the derivative useful?

Appendix A - Example

- On 1 January an entity issued a CU1,000,000 five year 8 per cent fixed rate debt.
- Entity's risk management policy requires that all debt is at variable rate achieved either by issuing variable rate debt or by issuing fixed rate and swapping it into variable.
- The entity enters into an interest rate swap to 'convert' debt from fixed to variable (assume underlying terms of the swap and debt match).

	01/01/20X0	30/06/20X0	31/12/20X0
FV Debt (Hedged item)	1,000,000	1,060,000	1,040,000
FV Swap (Hedging instrument)	0	50,000	35,000

FV of the Swap and carrying amount of Debt adjusted for FV changes attributable to hedged risk.

Appendix A - Financial statement implications

	Fair value hedge accounting			Tentative approach		
	01-Jan '000	30-Jun '000	31-Dec '000	01-Jan '000	30-Jun '000	31-Dec '000
Assets						
Cash	1,000	1,000	1,000	1,000	1,000	1,000
Swap		50	35		50	35
	1,000	1,050	1,035	1,000	1,050	1,035
Liabilities						
Debt	(1,000)	(1,060)	(1,040)	(1,000)	(1,000)	(1,000)
	(1,000)	(1,060)	(1,040)	(1,000)	(1,000)	(1,000)
Equity						
Retained earnings		10	5		10	5
Hedge reserve	0	0	0	0	(60)	(40)
	0	10	5	0	(50)	(35)
Income statement						
Other (gain)/loss	0	10	5	0	10	5

Change in net asset value

Carrying amount of debt is <u>not</u> adjusted

OCI volatility

Same income statement effect