IASB Meeting | Agenda reference **9B**

Staff Paper | Date **Week beginning 17 May 2010**

Project	**Financial Instruments (Replacement of IAS 39) – Hedge Accounting**
Topic	**Eligible hedged items: Net positions (1)**

Introduction

Background and purpose of this paper

Step 1		Step 2		Step 3
Agenda Paper 9A Groups of: **Gross** positions To analyse: Basic eligibility criteria for hedging basic groups	→	**Agenda Paper 9B** Groups of: **Net** positions To analyse: The '*where*' issue that arises from hedging net positions	→	**Agenda Paper 9C** Groups of: **Net** positions To analyse: The '*where*' **and** '*when*' issue that arises from hedging net positions.

1. This paper considers whether some types of net positions (that give rise to the '*where*' issue) should be eligible for hedge accounting.

2. Types of net positions vary significantly. Therefore the staff has selected a particular type of net position for the Board to consider first. The Board's view on this type of net position will inform the staff how to proceed.

3. This paper looks at:

   (a) a *closed* group of existing, non-financial hedged items, with different risk characteristics, that

   (b) affect profit or loss in the *same* reporting period, and

   (c) that is a fair value hedge.

4. We will use an example to help you understand the issues that arise.

5. The example assumes that the fair value hedge accounting mechanics are the same as existing cash flow hedge accounting mechanics (in that effective gains or losses on the hedging instrument are deferred and recognised in profit or loss when the hedged item affects profit or loss).

An example and the issue

Example – facts

6. Company X has a GBP functional currency. At time T0 it enters into two firm commitments. One firm commitment is to buy $20,000 of materials that will be received, paid for and recorded as cost of sales in period T3. The other firm commitment is to sell $30,000 of goods, for cash received and revenue recorded in T3. Time T0 and period T3 lie in different reporting periods. The period T3 is a narrow period of time which lies fully within a reporting period.

7. Summary of transaction in $:

$	T0	T3	
Sales	-	$30,000	
Cost of sales	-	$(20,000)	
Gross profit	**-**	**$10,000**	*Net risk*

8. This example assumes that:

(a) all transactions settle at the end of period T3;

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

(c) FX rates are: T0 = $2/£ (spot and forward) and T3 = $1.6/£ (spot and forward).

9. If Company X decided not to economically hedge, the sales and cost of sales are recorded at the transaction spot rate as shown below:

£	T0	T3
Exchange rate	$2/£	$1.6/£
Sales	-	£18,750
Cost of sales	-	£(12,500)
Gross profit	**-**	**£6,250**

10. However, the risk management policy of Company X is to use forward FX contracts to hedge its foreign exchange risk that is not naturally hedged by on-balance sheet $ receivables or $ payables (including $ cash deposits and $ overdrafts). However, in this example it does not have any $ receivables or $ payables, and so decides to use forward FX contracts.

11. Company X has a policy of applying hedge accounting and will designate any FX forward it enters into as a hedge of FX risk on the firm commitments.

12. Company X can either enter into:

    (a) two forward contracts to hedge the FX risk arising from each firm commitment individually (‘strategy A’); or

    (b) a single FX forward to hedge the net risk of $10,000 (‘strategy B’).

Example – application of IAS 39

13. Under IAS 39 the presentation of the hedged transaction in profit or loss will differ depending on whether strategy A or strategy B is used. This is because IAS 39 does not allow hedge accounting for net positions.

14. The accounting result in profit or loss for each strategy is shown below in paragraphs 15 to 18[1].

Strategy A – hedge gross risks using two forward contracts [2]

15. Hedge accounting under IAS 39:

£	T0	T3
Sales	-	£15,000[3]
Cost of sales	-	£(10,000)[4]
Gross profit	-	**£5,000**

16. Both sales and cost of sales are ultimately recorded at the commercially hedged rate of $2/£.

Strategy B – hedge net risk of $10,000 using one forward contract[5]

17. No net positions qualify as hedged items under IAS 39. Hence under strategy B, Company X must identify an amount of a gross position to designate in a hedge.

18. Company X identifies the first $10,000 of sales arising in T3 as the hedged item in a fair value hedge of FX risk. After applying hedge accounting the profit or loss looks as follows:

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[1] This only considers the effect on profit or loss and assumes no accounting ineffectiveness.

[2] **Derivative 1 =** FX forward, traded at T0, settling in T3, to pay $30,000 and receive £15,000, equivalent to a rate of $2/£ (ie the forward rate at T0). **Derivative 2 =** FX forward, traded at T0, settling in T3, to receive $20,000 and pay £10,000, equivalent to a rate of $2/£ (ie the forward rate at T0).

[3] £15,000 = sale at spot price + derivative gain/loss = $30,000/1.6 + [$30,000/2.0 - $30,000/1.6] = £18,750 - £3,750.

[4] £(10,000) = purchase of materials at spot price + derivative gain/loss = $(20,000)/1.6 + [$(20,000)/2.0 - $(20,000)/1.6] = £(12,500) + £2,500.

[5] **Derivative 3** = FX forward, traded at T0, settling in T3, to pay $10,000 and receive £5,000, equivalent to a rate of $2/£ (ie the forward rate at T0).

£	T0	T3
Sales	-	£17,500[6]
Cost of sales	-	£(12,500)[7]
Gross profit	-	**£5,000**

Staff analysis of example

19. Both strategies, A and B, achieve the same economic outcome. That is the net cash inflow in T3 of $10,000 is hedged at a rate of $2/£.

20. However, as can be seen above in paragraphs 15 and 18, the presentation of the transactions in profit or loss varies under each strategy.

21. Whether an entity adopts strategy A or strategy B depends on its risk management policy. In normal circumstances a risk management function is likely to hedge the net risk (ie strategy B) for one or more of the commercial reasons for this which are detailed in the cover paper (agenda paper 9, paragraph 11).

22. However, an entity may adopt strategy A over strategy B, so that it can record both sales and cost of sales at the hedged rate (of $2/£) rather than, as in strategy B, have to allocate the gains and losses on derivative 3 to the sales line.

23. Many constituents have told us that they do not believe the accounting of hedges should unduly influence the manner in which an entity commercially hedges. Especially where it results in the entity incurring additional costs or leaving itself open to risks it would have otherwise hedged.

[6] £17,500 = sales at spot price + derivative gain/loss = $30,000/1.6 + [$10,000/2.0 - $10,000/1.6] = £18,750 - £1,250.

[7] £(12,500) = materials purchase at spot rate = $(20,000)/1.6.

Hedge accounting alternatives for net positions discussed in this paper

24. To address this issue two alternatives are discussed below.

25. Of course, the Board could decide to carry forward the existing prohibition on hedge accounting for net positions – although this would not address the issue raised above. As illustrated in the example, selecting the hedged item is arbitrary and may be inconsistent with the risk management strategy. Furthermore, identifying a gross hedged position and reclassifying the hedging instrument gains/losses to a single line item associated with that designated gross position can distort financial reporting and ratios based on accounting information.

Alternative 1 – allow net position hedge accounting and adjust all affected income statement line items

26. Under alternative 1:

    (a) a group of hedged items that make up a net position and that affect profit or loss in the same accounting period would qualify for hedge accounting (subject to all other eligibility criteria);

    (b) when the hedged item affects profit or loss the offsetting gain/loss from the hedging instrument would be reclassified to each line item affected.

27. Using the above example, each hedged item is recorded at the hedged rate (meaning essentially that the hedging instrument gain or loss is grossed up and allocated to the individual income statement lines affected by the hedged items).

28. Under alternative 1, strategy B would be presented in the exact same way as strategy A (paragraph 15), as shown below.[8]

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£	Spot rates	Hedge reclassification	T3
Sales	£18,750	£(3,750)	£15,000
Cost of sales	£(12,500)	£2,500	£(10,000)
Subtotal	£6,250	£(1,250)	£5,000

£	T0	T3
Sales	-	£15,000
Cost of sales	-	£(10,000)
Gross profit	-	**£5,000**

Alternative 2 – allow net position hedging and adjust separate income statement line item

29. Under alternative 2:

    (a) a group of hedged items that make up a net position and that affect profit or loss in the same accounting period would qualify for hedge accounting (subject to all other eligibility criteria);

    (b) the designated hedged items would not be adjusted; instead, the offsetting gain/loss from the hedging instrument would be recorded in a separate line.

30. Using the above example, all designated hedged items would be recorded at spot rates:

£	T0	T3
Sales	-	£18,750
Cost of sales	-	£(12,500)
Hedging instrument reclassification	-	*£(1,250)*[9]
Gross profit	-	**£5,000**

[9] Note that this is equal to the net of the two gross adjustments posted in alternative 1 which is equal to the terminal FV of the hedging instrument (derivative 3).

Analysis of the alternatives

31. Alternative 1:

    (a) avoids the need to identify a specific hedged item as a gross position for accounting purposes when such an item is not identified for risk management purposes; and

    (b) achieves the same hedge accounting result for both strategy A and strategy B which are economically the same; **but**

    (c) it is necessary to gross up the gains and losses on one hedging derivative into amounts that do not exist for one hedging derivative (ie the £(1,250) is grossed up into £(3,750) and £2,500 per footnote 8). In other words the single derivative used is treated as if two derivatives existed and were used. This gives rise to the recognition of gross gains and losses that do not exist.

32. Alternative 2:

    (a) avoids the need to identify a specific hedged item as a gross position for accounting purposes when such an item is not identified for risk management purposes;

    (b) avoids the distortion of separate profit or loss line items affected by the gross items from the net position that are designated in the hedge accounting relationship; and

    (c) separate presentation informs users of financial statements that the entity has a risk management strategy of hedging net exposures; **but**

    (d) net positions can be complex. For example with combinations across business segments or with items that impact various components of profit or loss. Presenting such hedges may be complicated as it will require additional profit or loss line items and result in additional disaggregation of information on the face of the income statement; and

(e) hedges of net positions would be presented differently to hedges of gross positions. For a hedge of a gross position, hedging instrument gains/losses would be reclassified to the profit or loss line item affected by the hedged item without the use of a separate line item (ie same as treatment under current hedge accounting model in IAS 39).

Staff conclusions

33. The staff believes that the accounting of a hedge should, if consistent within the objectives and framework of financial reporting, reflect the way in which an entity commercially manages its risk. The staff believes that provides the most useful information to investors.

34. From the three alternatives, the staff first dismisses alternative 1. This is because alternative 1 gives rise to the recognition of gross (partially offsetting) gains/losses from the hedging instrument that do not exist (see paragraph 31(c)). This is not consistent with basic accounting recognition principles. Moreover, the hedge accounting outcome would be the same as for a hedging strategy that hedges item by item on a gross basis even though the actual strategy is hedging on a net basis. Thus, the difference in risk management approaches would be obscured.

35. This leaves alternative 2 and, as a third alternative, carrying forward the requirements in IAS 39 (see paragraph 25).

36. Alternative 2 may have consequences. For example the staff will need to consider the different possible income statement presentation for hedges of net positions. In addition, the staff will need to consider how to identify and measure the hedged item for hedge effectiveness assessment and measurement purposes (the ‘what’ issue identified in the cover paper).

37. Despite the challenges that alternative 2 would introduce, the staff favours alternative 2 over alternative 3 of carrying forward the requirements in IAS 39.

38. If an entity hedges risk on a net basis, the staff does not believe that applying alternative 3 and presenting only an item that is not the subject of the economic hedge (ie the designated gross position) at the hedged rate provides much useful information.

39. Alternative 2 is consistent with the hedge accounting principles[10] and at the same time results in financial reporting that is consistent with the way in which the business manages risk exposures.

Staff recommendation and question to the Board

40. **The staff recommends alternative 2. That is, allow hedge accounting for net positions (as identified in paragraph 3) and record effective gains/losses from the hedging instrument in a separate line in the income statement.**

41. **If the Board agrees with the staff recommendation, further analysis is required to address any consequences of such an approach (such as those identified in paragraph 36).**

Question 1 – Permit hedge accounting for net positions and present them in accordance with alternative 2.
Does the Board agree with the staff recommendation in paragraph 40 to allow the hedging of net positions in the scenarios covered by this paper and present them in accordance with alternative 2? If the Board disagrees with the staff recommendation what are the reasons for this and what alternatives does it propose?

[10] The general hedge accounting principles were recently presented to the Board at the April 2010 Board meeting.