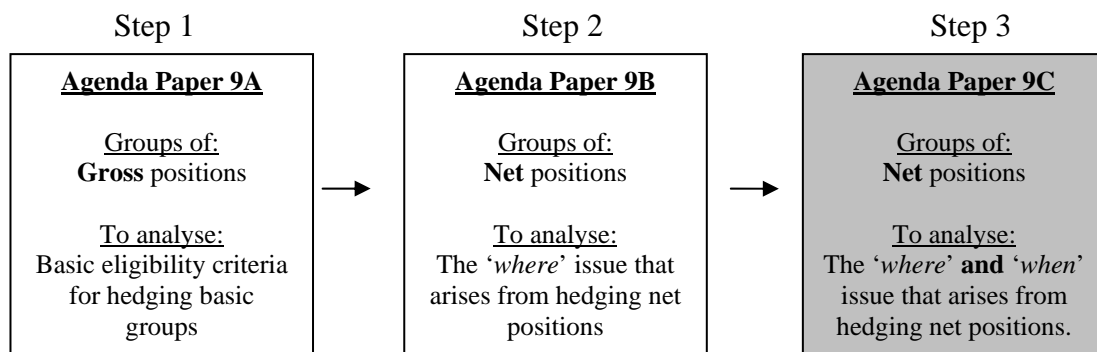




Project	Financial Instruments (Replacement of IAS 39) – Hedge Accounting
Topic	Eligible hedged items: Net positions (2)

Introduction

Background and purpose of this paper



1. This paper considers whether some types of net positions (that give rise to the ‘when’ issue) should be eligible for hedge accounting.
2. 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 *different* reporting periods, and
 - (c) that is a fair value hedge.
3. We will use an example to help you understand the issues that arise.
4. The example illustrates the ‘when’ issue identified in the cover paper (agenda paper 9, paragraph 24).

This paper has been prepared by the technical staff of the IASCF for discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRIC or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in *IASB Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

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5. The example assumes that the fair value hedge accounting mechanics are the same as existing cash flow hedge accounting mechanics¹ (in that effective gains or losses on the hedging derivative 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. It has multiple operations, of which some transact in foreign currencies thus giving rise to foreign exchange risk.
7. Some of the operations are exposed to USD risk on their sales (ie 'long dollar') whilst other operations are exposed to USD risk on their expenses (ie 'short dollar').
8. Company X uses a USD bank account, with an overdraft facility, to deposit USD cash receipts and fund USD cash payments.
9. Company X's risk management policy is to hedge foreign currency risk arising on firm commitments.
10. Having both long and short USD positions provides some natural hedge. However, settlements of firm commitments do not necessarily coincide and overall there is usually a net long USD position.
11. Company X has a policy of hedging the net FX risk that arises on firm commitments across all of its operations over a five-period time horizon. It uses a single forward FX contract to hedge this risk. [hereafter referred to as **strategy 1**].
12. When calculating the net exposure to hedge, it considers all USD firm commitments that are outstanding at a point in time (eg T0 in the example below). As the firm commitments settle in different periods, Company X

¹ Except for the 'lower of test' that applies to cash flow hedges but would not apply to fair value hedges.

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hedges the net position after the last firm commitment is settled (eg end of T5 in the example below).

13. It also takes into account current and forecast USD bank balances as part of the net position.
14. To illustrate, below is a summary of an example of a group of partially offsetting USD firm commitments that settle over five periods. The USD cash balance and the forward FX contract used to hedge the net risk are also shown.

\$'000	T0	T1	T2	T3	T4	T5
Firm commitments:						
Sales		0	80	30	30	10
Expenses		-100	0	-20	0	0
Net exposure		-100	80	10	30	10
\$ Cash	0	-100	-20	-10	20	30 ²
Forward 1 ³ :pay leg \$:receive leg £						-30 15
Net £ cash balance carried forward						15⁴

15. This example assumes that:
 - (a) all transactions settle at the end of each period;
 - (b) firm commitments affect profit or loss on settlement;
 - (c) The USD cash balance at T0 is nil;
 - (d) Spot FX rates equal forward FX rates at any point in time because of nil interest rates (hence nil forward points);
 - (e) FX rates at T0 = \$2/£ (spot and forward);

² This is the cash balance *before* the effect of the hedging derivative (forward 1).

³ This is a forward FX contract, entered into at T0, which settles in T5, to pay \$30,000 and receive £15,000 (FX rate = \$2/£).

⁴ This is the cash balance *after* the effect of the hedging derivative (forward 1)

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- (f) the group is a closed group (ie no new hedged items or hedging instruments are added to the group over the term of the hedge); and
 - (g) each T(X) period is a three month period.
16. The effect of this hedging strategy is to simply exchange the final residual USD cash balance (that remains after the USD inflows and outflows on the firm commitments have occurred) for GBP at an exchange rate fixed by the FX forward (ie the final cash balance of \$30,000 is exchanged for £15,000 by the forward FX contract entered into at T0).
17. Therefore, for this closed portfolio, Company X is hedged for all movements in the \$/£ exchange rate. Whatever happens to the \$/£ rate during the hedged period it will always be left with £15,000 of cash.

Example – application of IAS 39

18. In this example Company X uses the USD cash balance, combined with Forward 1, to economically hedge the net group of firm commitments.
19. IAS 39 does not allow hedge accounting for net positions. Therefore in order for Company X to apply hedge accounting it must identify a gross position to designate in the hedge.
20. This introduces the following issues:
- (a) A gross position that matches the terms of the hedging instrument may not exist. In this example the USD notional on the forward contract is \$30,000 which settles in T5. However, a gross position of \$30,000 of sales does not exist in the same period. Only \$10,000 of sales occur in T5.
 - (b) Where a matching gross position does exist, designating only some of the hedged items in a hedge accounting relationship can distort financial reporting. This is because the effective gains/losses on the hedging instrument will be reclassified when the designated hedged item (ie gross position) affects profit or loss – not when *each* item

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hedged by the commercial hedge affects profit or loss. This results in some of the commercially hedged items being presented in the financial statements at a hedged rate and some at an unhedged rate.

21. The effect of these issues on the accounting is demonstrated in Appendix A. It shows that the accounting result that is derived is not meaningful as it results in arbitrary volatility in profit or loss (as can be seen by the resulting effective exchange rates).
22. Therefore faced with the choice Company X chooses not to apply hedge accounting.

Staff analysis of example

23. The effect of IAS 39 prohibiting hedge accounting for net positions is that it ignores the offsetting risk positions within the portfolio of hedged items.
24. The IAS 39 hedge accounting model is hence better suited to one-on-one gross position hedges which do not utilise offsetting risk positions.
25. Therefore if hedge accounting was important to Company X, it could adopt an alternative one-on-one hedging strategy. This would involve hedging, at T0, the total *gross* cash flow for each period with a matching hedging instrument⁵ [here after referred to as **strategy 2**].
26. The accounting effect of this strategy is shown in Appendix B. This shows the strategy would achieve the exact same economic objective of fixing the cash flows in GBP leaving a final cash balance of £15,000.

⁵ The table summarises the matching forward contracts that would need to be executed to match each periods' sales and expenses individually.

\$ notional '000	T0	T1	T2	T3	T4	T5
Forward 1		100				
Forward 2			-80			
Forward 3				-30		
Forward 4				20		
Forward 5					-30	
Forward 6						-10

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27. However, the accounting result would be very different. Unlike strategy 1, the accounting result for strategy 2 shows that each firm commitment is hedged at the forward rate prevailing at T0 (\$2/£). Hence from an accounting perspective strategy 2 is preferred over strategy 1 as it demonstrates the hedged position. Although commercially strategy 1 would be preferred over strategy 2 for the reasons detailed in the cover paper (agenda paper 9, paragraph 11).
28. 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.

Hedge accounting alternatives for net positions discussed in this paper.

29. To address this issue three alternatives are discussed below.
30. Of course, the Board could decide to carry forward the existing prohibition on hedge accounting for net positions – although this would not address the issues noted in paragraph 20 above.

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

31. Under alternative 1:
 - (a) A group of hedged items that make up a net position and affect profit or loss in different reporting periods would qualify for hedge accounting (subject to other eligibility criteria); and
 - (b) when each hedged item affects profit or loss the relevant offsetting gain/loss from the hedging instruments and from other unrecognised firm commitments would be reclassified to each line item affected.
32. Using the above example, each firm commitment is recorded at the hedged forward rate that exists at T0 for settlement at the same time as the firm commitment. In this example, as the forward rates at T0 are all equal to the spot rate at T0, the hedged rate is \$2/£.

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33. Appendix C, paragraph C1, summarises the accounting result of this strategy. Note that this is the same accounting result as that achieved for the gross one-on-one hedge under IAS 39 today (ie strategy 2 illustrated in Appendix B).

Alternative 2 – allow net position hedge accounting and adjust a separate income statement line item

34. Under alternative 2:
- (a) A group of hedged items that make up a net position and affect profit or loss in different reporting periods would qualify for hedge accounting (subject to other eligibility criteria);
 - (b) the designated hedged items would *not* be adjusted; instead
 - (c) the offsetting gain/loss from the hedging instruments and from other unrecognised firm commitments would be reclassified to a separate line in the income statement.
35. Appendix C, paragraph C2 summarises the effect of this strategy. Note that the net effect on profit or loss of alternative 2 is the same as alternative 1.

Alternative 3 – allow net position hedge accounting and only reclassify gains/losses deferred on hedging instruments at the end of the hedged period.

36. Under alternative 3:
- (a) A group of hedged items that make up a net position and affect profit or loss in different reporting periods would qualify for hedge accounting (subject to other eligibility criteria);
 - (b) the designated hedged items would *not* be adjusted; instead
 - (c) the effective gain/loss on the hedging instruments would be deferred in equity until the end of the hedged period and then reclassified to a separate line item in the income statement.
37. Appendix C, paragraph C3 summarises the effect of this strategy.

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Analysis of the alternatives

38. All the alternatives avoid the need to identify a specific hedged item as a gross position for hedge designation purposes. In addition to this:
39. Alternative 1:
- (a) Achieves the same hedge accounting result for both strategy 1 and strategy 2 which are economically the same;
 - (b) Acknowledges that the group of hedged items has offsetting risk positions. It recognises offsetting gains/losses on unrecognised hedged items in the group (earlier or later than they would otherwise be recognised) to offset the gain/loss on recognised hedged items; **but**
 - (c) Can result in the grossing up of gains and losses on one hedging derivative into amounts that do not exist for one hedging derivative. This is because gross FV changes of the derivative are created and posted to separate income statement lines which together net to the actual FV change of the hedging derivative (see agenda paper 9B for an illustration of this).
40. Alternative 2:
- (a) Avoids the distortion of profit or loss line items affected by the gross items from the net position that are designated in the hedge accounting relationship;
 - (b) Informs users of financial statements, through separate presentation, that the entity has a risk management strategy of hedging net exposures; and
 - (c) Acknowledges that the group of hedged items has offsetting risk positions. It recognises offsetting gains/losses on unrecognised hedged items in the group (earlier or later than they would otherwise be recognised) to offset the gain/loss on recognised hedged items; **but**
 - (d) May be complex to implement because net positions can be complex. For example they can be combinations across business segments or

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items that affect various components of profit or loss. Presenting such hedges may be complicated as it will require additional income statement line items and result in additional disaggregation of information on the face of the income statement; and

- (e) Results in hedges of net positions being presented differently to hedges of gross positions. For a hedge of a gross position, hedging instrument gains/losses would be reclassified to the income statement 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).

41. Alternative 3:

- (a) Is more simple to apply in that all effective gains and losses on the hedging instrument are deferred in equity until maturity of the hedge; but
- (b) Does not achieve offset in profit or loss because all hedged items are recognised at spot rates and the reclassification of deferred gains/losses on the hedging instruments are arbitrarily recognised at the end of the hedged period.

Staff conclusions

- 42. 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 users.
- 43. 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 39(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

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on a net basis. Thus, the difference in risk management approaches would be obscured.

44. The staff also dismisses alternative 3. This is because it does not match gains/losses on the hedging instruments with the hedged items. Reclassification of deferred gains/losses at the end of the hedge term is arbitrary as the hedged items affect profit or loss over the hedged period. This alternative can significantly distort financial reporting and is not deemed a better alternative to the current requirements of IAS 39.
45. This leaves alternative 2 and, as a fourth alternative, carrying forward the requirements in IAS 39 (see paragraph 30).
46. Alternative 2 appropriately addresses the ‘when’ issue that arises from hedging groups of items that impact profit or loss over more than one reporting period (see cover paper paragraph 24).
47. It does this by recognizing gains/losses on hedging instruments and other unrecognised hedged items in the group to offset gains/losses on the hedged items when they are recognised.
48. 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 (the ‘what’ issue explained in the cover paper) for hedge effectiveness assessment and measurement purposes.
49. Despite the challenges that alternative 2 would introduce, the staff favours alternative 2 over carrying forward the requirements of IAS 39.
50. If an entity hedges risk on a net basis, the staff does not believe that due to the problems identified in paragraph 20(a) an entity should be prevented from applying hedge accounting. Also, if an entity can overcome the problems in paragraph 20(a) the staff does not believe that recording items that are not the subject of the economic hedge (ie the designated gross position) at the hedged rate provides much useful information.

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51. Alternative 2 is consistent with the hedge accounting principles⁶ 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

52. **The staff recommends alternative 2. That is, allow hedge accounting for net positions (as identified in paragraph 2) and record effective gains/losses from the hedging instrument and other hedged items in the same hedged group in a separate line in the income statement.**
53. **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 48).**

Question – Permit hedge accounting for net positions and present them in accordance with alternative 2.

Does the Board agree with the staff recommendation in paragraph 52 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?

⁶ The general hedge accounting principles were recently presented to the Board at the April 2010 Board meeting.

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Appendix A- Strategy 1: Commercial hedge of net FX risk across reporting periods

A1. This appendix summarises the current IAS 39 accounting effect of strategy 1 for the following two scenarios:

- (a) Scenario A: no hedge accounting applied;
- (b) Scenario B: hedge accounting applied.

A2. The summary of firm commitments, cash balance and forward contract is reproduced below:

\$'000	T0	T1	T2	T3	T4	T5
Firm commitments:						
Sales		0	80	30	30	10
Expenses		-100	0	-20	0	0
Net exposure		-100	80	10	30	10
<hr/>						
\$ Cash	0	-100	-20	-10	20	30 ⁷
Forward 1 ⁸ :pay leg \$:receive leg £						-30 15
Net £ cash balance carried forward						15⁹

A3. This example assumes the following spot exchange rates at the end of each period (all assumptions in paragraph 15 also apply):

\$/£	T0	T1	T2	T3	T4	T5
USD/GBP exchange rate	2.0	2.2	2.6	1.6	2.0	2.4

⁷ This is the cash balance *before* the effect of the hedging derivative (forward 1).

⁸ This is a forward FX contract, entered into at T0, which settles in T5, to pay \$30,000 and receive £15,000 (FX rate = \$2/£).

⁹ This is the cash balance *after* the effect of the hedging derivative (forward 1)

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Scenario A: no hedge accounting

A4. Where hedge accounting is not applied:

- (a) all sales and expenses are recorded at the prevailing spot rate on settlement;
- (b) IAS 21 FX translation on the cash balance is recorded in profit or loss; and
- (c) Fair value gains and losses on the hedging instrument (Forward 1) are recorded in profit or loss.

A5. The accounting effect of this on profit or loss is shown below:

£'000	T0	T1	T2	T3	T4	T5
Sales		-	30.8	18.8	15.0	4.2
Expenses		(45.5)	-	(12.5)	-	-
Derivative FV change		1.4	2.1	(7.3)	3.8	2.5
FX retranslation of cash			7.0	(4.8)	1.3	(1.7)
Net profit/loss		(44.1)	39.9	(5.8)	20.1	5.0

A6. The effective exchange rate applied to net profit or loss is as follows¹⁰:

\$/£	T0	T1	T2	T3	T4	T5
effective FX rate		2.3	2.0	1.7	1.5	2.0

Scenario B: hedge accounting applied

A7. Under this scenario the USD cash balance and the hedging derivative are designated in a hedge relationship with an identified gross position.

A8. Many options exist for identifying the gross hedged item to designate in the hedge. For example there are \$150,000 of sales that settle in T2 to T5, hence at T0, any of these sales can be designated in a hedge with the forward contract that has a notional of \$30,000. This example assumes that the cash flow that is the furthest out will be hedged first. If there are no cash flows beyond the next period to hedge then the hedging instrument will be left undesignated as there will be a natural hedge in the current period.

¹⁰ This is calculated by dividing the net USD profit or loss by the net GBP profit or loss. For example for T1, the calculation is 100/44.1 = 2.27.

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A9. As the cash balance changes each period a new hedge relationship is designated each period. A summary of the hedge designation for each period is shown paragraphs A10 and A11 below.

A10. The notional amount of the forward contract is designated as follows:

- (a) For periods T1, T2 and T3 (ie designated at T0 until end of T3),
 - (i) \$20,000 of \$30,000 notional is designated as a hedge of \$20,000 sales in T4; and
 - (ii) \$10,000 of \$30,000 is designated as a hedge of \$10,000 sales in T5.
- (b) For period T4 (ie designated at beginning of T4 until end of T4),
 - (i) \$10,000 of \$30,000 is designated as a hedge of \$10,000 sales in T5; and
 - (ii) \$20,000 of \$30,000 is undesignated.
- (c) For period T5, the full \$30,000 is undesignated.

A11. The USD cash balance is designated as follows:

- (a) For period T1, the cash balance is nil (as the first transaction happens at the end of T1).
- (b) For period T2,
 - (i) \$10,000 of \$100,000 is designated as a hedge of \$10,000 of sales in T4; and
 - (ii) \$30,000 of \$100,000 is designated as a hedge of \$30,000 of sales in T3; and
 - (iii) \$60,000 of \$100,000 is undesignated.
- (c) For period T3,
 - (i) \$10,000 of \$20,000 is designated as a hedge of \$10,000 of sales in T4; and

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(ii) \$10,000 of \$20,000 is undesignated.

(d) For period T4 and T5 the cash balances of \$(10,000) and \$20,000 respectively are undesignated.

A12. The accounting effect of this on profit or loss is shown below:

£'000	T0	T1	T2	T3	T4	T5
Sales		-	30.8	20.9 ¹¹	10.8 ¹²	4.2 ¹³
expenses		(45.5)	-	(12.5)	-	-
FV of undesignated derivative		-	-	-	2.5	2.5
FX on undesignated cash		-	4.2	(2.4)	1.3	(1.7)
Net profit/loss		(45.5)	35.0	6.0	14.6	5.0

A13. The effective exchange rate applied to net profit or loss is as follows¹⁴:

\$/£	T0	T1	T2	T3	T4	T5
effective FX rate		2.2	2.3	1.7	2.1	2.0

¹¹ £20.9k = £18.8k + £2.1k = [sales recorded at the spot rate] + [amounts reclassified from hedge designation with USD cash].

¹² £10.8k = £15k - £2.5k - £1.7k = [sales recorded at spot rate] + [amounts reclassified from hedge designation with forward 1] + [amounts reclassified from hedge with USD cash]

¹³ £4.2k = £4.2k + £nil = [sales recorded at spot rate] + [amounts reclassified from hedge designation with forward 1]

¹⁴ This is calculated by dividing the net USD profit or loss by the net GBP profit or loss. For example for T1, the calculation is 100/45.5 = 2.2.

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Appendix B -Strategy 2: Individual hedges of gross items

- B1. This appendix summarises the accounting effect of strategy 2 where hedge accounting is applied.
- B2. This strategy results in more forward contracts than strategy 1 and the cash balance is held in GBP.
- B3. All other assumptions are the same as for strategy 1.
- B4. The following table summarises the firm commitments and forward contracts¹⁵ that are executed at T0 along with the cash balance that exists at the end of each period.

\$'000	T0	T1	T2	T3	T4	T5
Sales		0	80	30	30	10
Expenses		-100	0	-20	0	0
Net exposure		-100	80	10	30	10
Forward 1		100				
Forward 2			-80			
Forward 3				-30		
Forward 4				20		
Forward 5					-30	
Forward 6						-10
Cash balance £		-50	-10	-5	10	15

- B5. For hedge accounting purposes, each forward contract is designated in a hedge of the firm commitment that settles in the same period. Eg Forward 1 is designated in a hedge of \$100,000 of sales that occur in T1.¹⁶
- B6. The accounting effect of this on profit or loss is shown below:

£'000	T0	T1	T2	T3	T4	T5
Sales		-	40.0	15.0	15.0	5.0
Expenses		(50.0)	-	(10.0)	-	-

¹⁵ It is assumed that forward 3 and forward 4 are with different counterparties (such that they are not treated in combination as one contract).

¹⁶ Note that the cash balance does not form part of the hedge because the cash balance is denominated in GBP.

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Net profit/loss		(50.0)	40.0	5.0	15.0	5.0
Cash balance £	0	(50.0)	(10.0)	(5.0)	10.0	15.0

B7. The effective exchange rate applied to net profit or loss is as follows ¹⁷:

\$/£	T0	T1	T2	T3	T4	T5
effective FX rate		2.00	2.00	2.00	2.00	2.00

¹⁷ This is calculated by dividing the net USD profit or loss by the net GBP profit or loss. For example for T1, the calculation is 100/50= 2.0.

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Appendix C - Alternative hedge accounting for net positions discussed in this paper

C1. Hedge accounting effect on profit or loss, and the effective exchange rate, for alternative 1 is shown below:

£'000	T0	T1	T2	T3	T4	T5
Sales		-	40.0	15.0	15.0	5.0
Expenses		(50.0)	-	(10.0)	-	-
Net profit/loss		(50.0)	40.0	5.0	15.0	5.0
\$ Cash	0	-100	-20	-10	20	-
£ Cash		-	-	-	-	15
Effective exchange rate		2.0	2.0	2.0	2.0	2.0

C2. Hedge accounting effect on profit or loss, and the effective exchange rate, for alternative 2 is shown below:

£'000	T0	T1	T2	T3	T4	T5
Sales		-	30.8	18.8	15.0	4.2
Expenses		(45.5)	-	(12.5)	-	-
Hedge recycling		(4.5)	9.2	(1.3)	-	0.8
Net profit/loss		(50.0)	40.0	5.0	15.0	5.0
\$ Cash	0	-100	-20	-10	20	-
£ Cash		-	-	-	-	15
Effective exchange rate		2.0	2.0	2.0	2.0	2.0

C3. Hedge accounting effect on profit or loss, and the effective exchange rate, for alternative 3 is shown below:

£'000	T0	T1	T2	T3	T4	T5
Sales		-	30.8	18.8	15.0	4.2
Expenses		(45.5)	-	(12.5)	-	-
Hedge recycling		-	-	-	-	4.3
Net profit/loss		(45.5)	30.8	6.3	15.0	8.5
\$ Cash	0	-100	-20	-10	20	-
£ Cash		-	-	-	-	15
Effective exchange rate		2.2	2.6	1.6	2.0	1.2

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