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

Topic **Eligible hedged items: groups and net positions**

Introduction

Background

1. At the 5 October 2010 meeting, the Board tentatively agreed not to allow *risk components* of cash instruments[1] to be eligible hedging instruments (except for hedging FX risk)[2].

2. Some board members are concerned that allowing hedge accounting for a net position of hedged items would allow ('by the back door') an entity to use:

   (a) a *risk component* of a cash instrument; or

   (b) a *risk component* of a non-financial instrument or transaction[3] (referred to here after as 'other' instruments),

   as an eligible hedging instrument. In other words, they are concerned that allowing hedge accounting for a net position might be inconsistent with the tentative decision not to allow *risk components* of cash (or other) instruments to be hedging instruments.

3. The staff believe there is a distinct difference between an entity wanting to:

[1] Cash instruments in that paper were defined as non-derivative financial assets and non-derivative financial liabilities.
[2] Agenda paper 5
[3] This includes firm commitments not accounted for as a derivative and forecast transactions.

(a) apply hedge accounting for an economic hedge of a net position with an eligible hedging instrument; and

(b) an entity that wants to apply hedge accounting where a *risk component* of a cash (or other) instrument is designated as an eligible hedging instrument against another hedged item.

4. Hence, the staff recommended that the Board not allow risk components of cash (or other) instruments to be eligible hedging instruments[4] but still recommends that the Board allow hedge accounting for a net position (subject to any constraints decided in the previous paper).

Purpose of this paper

5. The purpose of this paper is to:

(a) explain why the staff draws the distinction noted in paragraph 3 (see paragraphs 7 to 10); and

(b) discuss guidance that could explain when a net position hedge is, or is not, eligible for hedge accounting (see paragraphs 11 to 16).

6. There are no questions to the Board in this paper.

[4] With the exception that FX risk components of cash instruments that can be an eligible hedging instrument. See agenda paper 5 from 5 October 2010 meeting. The Board agreed with this recommendation.

Staff Analysis

Distinction between a net position hedge and risk components of cash instruments being eligible hedging instruments

7. If an entity has two cash (or other) instruments with fully offsetting risk components, it would consider itself 'hedged'[5]. In other words, a change in the offsetting risk variable will give rise to a gain on one instrument, offset by a loss on the other.

8. Such a 'hedged' position does not usually *arise from* risk management activities[6]. Instead, the instruments arise *as a result of* an entity's day-to-day business activities. The instruments themselves *give rise to risks*, which an entity may manage using derivatives, etc. In other words, risk components of cash (or 'other') instruments are rarely used as a risk management tool *to hedge* risks but instead usually represent instruments that *are hedged*.

9. Reasons why risk components of cash (or other) instruments are rarely used as risk management tools *to hedge* include:[7]

   (a) Cash instruments involve upfront cash payment/receipt which is not a necessary feature for hedging the underlying risk (ie they do more than is needed for risk management).

   (b) Cash instruments give rise to additional risks that are not part of the hedging activity (eg credit risk arising from the initial cash investment).

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[5] This may only be for a partial term of one instrument and may not be the full term of both cash instruments.

[6] The staff excludes foreign currency cash instruments from this analysis as these *are* used for risk management. At the 5 October 2010 meeting, the Board has tentatively agreed that such instruments should continue to be eligible hedging instruments.

[7] However, the staff notes that in the wake of the financial crisis and debates of regulatory reform of derivative transactions the aspect of credit risk associated with derivatives has become important. This may result in greater collateralisation in the derivatives markets, which will economically move derivatives closer to cash instruments. Depending on the credit standing and collateral available to counterparties the use of cash instruments might change. Hence, the reasons given in this paragraph might also change accordingly.

(c) Forecast transactions are not contractual and hence cannot provide the certainty that is the objective of a hedge; and

(d) Derivative instruments provide a better, lower cost, more focused alternative.

10. For various reasons, entities often hedge items on a group net basis[8]. For hedge accounting to be consistent with this risk management approach it is necessary to recognise the offsetting effect of hedged items in a net position (ie the offsetting effect of risk components of cash (or other) instruments). However, that is not to say that risk components of cash (or other) instruments should be permitted to be eligible hedging instruments (because they are rarely used *to hedge*). As a result, the staff believe a hedging relationship involving a hedged item that is a net position should only be eligible if combined with an eligible hedging instrument.

Potential guidance that could explain when a net position hedge is, or is not, eligible for hedge accounting

11. Some Board members are concerned that recognising the offsetting effect of hedged items in a net position (as noted in paragraph 10) has the similar (albeit unintended) effect to permitting risk components of cash (or other) instruments to be eligible hedging instruments.

12. To address this concern the staff proposes the following application guidance to be included with the proposals on net position hedges. The objective of this guidance is to make clear that using the ability to hedge account a net position solely as a means to apply hedge accounting between two or more risk components of cash (or other) instruments is not permitted.[9]

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[8] See agenda paper 9 from the May 2010 Board meeting.

[9] Note that transacting an eligible hedging instrument to designate in a hedge solely for accounting purposes involves transaction and other costs that would otherwise not be incurred.

Application guidance

13. A net position hedge is eligible when

    (a) risk management is on a net basis (for example, monitoring and reporting of risks on a net basis); or

    (b) hedging instruments executed reduce overall net exposure to the hedged risk arising from eligible hedged items (for this purpose, foreign currency monetary items in a hedging relationship are all treated as *either* hedged items or as hedging instruments).

Example 1

14. Entity A, with Euro functional currency, has a firm commitment to pay $150,000 for advertising expenses in nine months' time and a firm commitment to sell finished goods for $150,000 in 15 month's time. Entity A transacts a foreign currency forward rate derivative that settles in nine months' time that receives $100 and pays €70. Entity A has no other exposures to USD. Can Entity A apply hedge accounting between the forward contract and a net position of $100 (consisting of $150,000 of the firm purchase commitment—ie advertising services—and $149,000 of the firm sale commitment) for a nine month period[10]?

15. If there is a substantive business purpose for entering into the hedging instrument, and the entity manages the hedged risk on a net basis, then hedge accounting could be permitted. Judgement will be required to determine this. For example, circumstances when hedge accounting should not be permitted can include when:

    (a) the hedging instrument increases the entity's overall net risk exposure to the hedged risk (in this case USD);

    (b) the entity does not manage risks on a net basis; or

[10] As part of a rolling strategy for the full term hedge of 15 months.

(c) the sole purpose of transacting the hedging instrument is to achieve hedge accounting between (the majority of) two or more hedged items neither of which would qualify as a hedging instrument (in this case two firm commitments).

16. In this example, the hedging instrument increases the entity's overall risk exposure to USD (which is net zero) and hence it is concluded that the hedging instrument has not been transacted for genuine *net* risk management purposes. Therefore, hedge accounting should not be permitted in this case.

Conclusion

17. Application guidance can be used to reinforce the requirement that hedge accounting for a net position hedge must be consistent with an entity's risk management strategy.