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

Topic **Eligible hedged items: nil net positions**

Introduction

Background and purpose of this paper

1. The Board has been discussing whether net positions should be eligible hedged items.

2. The purpose of this paper is to ask the Board whether, for an entity that manages (and hedges) risks on a net basis, a **nil net position** should ever be eligible for hedge accounting. In other words, can a hedge relationship consist of two or more, fully offsetting, hedged items, none of which are eligible as hedging instruments?

Staff analysis

3. This issue is best explained using the following example.

4. Entity B, with EUR functional currency, makes purchases and sales denominated in GBP. It manages and hedges the FX risk across the entity on a net basis. The entity has a policy of transacting FX forward rate derivatives to hedge the net (spot) FX risk over a time horizon of 18 months.

5. On 1 January 2010 it only has two GBP FX exposures over the next 18 months. The entity has one firm commitment to pay for £1m of advertising expense in 9 months' time and one firm commitment to sell £1m of finished goods in 18

months' time. Hence, the net position of the two transactions is nil (for nine months from 1 January 2010). Should hedge accounting be permitted for the nine months from 1 January 2010?

Alternative 1

6. No. There is no hedged item to be hedged in this case because the two hedged items fully offset for the hedged period. Such a hedging relationship is outside the scope of this hedge accounting model because it does not include any financial instruments. Furthermore, this approach would be inconsistent with the basic requirement that a hedging relationship must contain both an eligible hedged item and an eligible hedging instrument.

Alternative 2

7. Yes. The entity manages GBP risk on a net basis. It would be inconsistent not to allow hedge accounting in this case simply because the net position is nil. The accounting result in periods where hedge accounting is permitted (because a net position exists and is hedged with a hedging instrument) would show transactions at an overall hedged rate. However, where hedge accounting is not permitted (because the net position is nil) the transactions would be recorded at prevailing spot rates. This would be inconsistent and not result in useful information.

Staff recommendation and question to the Board

8. The staff believe nil net positions in practice would be rare. However, of the two alternatives, the staff recommends Alternative 2 for the reasons stated in paragraph 7. Under this alternative, additional guidance would need to be provided to be clear when nil net positions are eligible for hedge accounting.

Question – Eligibility of net positions as hedged items
Does the Board agree with the staff's recommendation in paragraph 8? If not, why and what alternative does it propose?