Project **Financial Instruments: Replacement of IAS 39**

Topic **Hedge accounting – interaction between basis adjustments and hedges of foreign currency risk of firm commitments**

Introduction

Background

1. Agenda paper 16A sets out alternatives for how the Board could proceed in relation to accounting for hedges of forecast transactions that will result in the recognition of non-financial items and a staff recommendation.

2. Agenda paper 16B set outs the alternatives for how the Board could proceed for hedges of foreign currency (FX) risk of a firm commitment and a staff recommendation.

3. Appendix A in agenda paper 16 provides a high level overview of the interaction between the alternatives as set out in agenda papers 16A and 16B.

4. Agenda paper 16D contains illustrative examples of the different interaction aspects addressed in this paper. **The staff strongly encourage the Board to consider the examples in agenda paper 16D before proceeding with the rest of this paper.**

Purpose

5. This paper analyses:

(a) the implications of the interaction between the alternatives set out in agenda papers 16A and 16B; and

(b) ask the Board for decisions on whether to retain the current requirements in:

(i) paragraph 98 of IAS 39 for hedges of forecast transactions that result in recognition of non-financial items or hedges of forecast transactions for non-financial items that becomes firm commitments (agenda paper 16A); and

(ii) paragraph 87 of IAS 39 for hedges of FX risk of firm commitments (agenda paper 16B).

Interaction of the alternatives

6. For hedges of FX risk, the interaction between agenda papers 16A and 16B is demonstrated in graphical form in the diagram in Appendix A of agenda paper 16 as well as in Example 3 of agenda paper 16D.

7. Agenda paper 16A discusses the accounting at t1 and t2 where an FX hedge of a highly probable forecast transaction results in the recognition of a non-financial item or becomes a firm commitment that would subsequently result in the recognition of a non-financial item. Agenda paper 16B discusses the accounting from t1 to t2 for which the hedge is an FX hedge of a firm commitment.

Carrying amount of the recognised non-financial item

8. An implication of the interaction between agenda papers 16A and 16B is that if the choice to account for hedges of FX risk of firm commitments is available but entities are prohibited to apply basis adjustments (ie combination of alternative 2 of agenda paper 16A and alternative A of agenda paper 16B), the non-financial item will be recognised at different carrying amounts depending on whether the entity chooses to cash flow hedge or fair value hedge the firm commitment.

9. Agenda paper 16D example 2, illustrates this situation. In paragraph 11 of agenda paper 16D, Entity B in scenario 2 applies cash flow hedge accounting

with no basis adjustment and in scenario 3, Entity B applies fair value hedge accounting. The ship is recognised at CU 150 in scenario 2 and is recognised at CU 200 in scenario 3.

10. The staff notes if the hedge results in an 'underhedge[1] and hence not 100% effective, due to the 'lower of' test,, the carrying amount of the non-financial item will be adjusted differently depending on whether the entity applies cash flow hedge accounting and 'basis adjust' or if the entity applies fair value hedge accounting.

Split of the hedging gain or loss

11. Agenda paper 16D example 3 illustrates another implication of the interaction between the alternatives in agenda papers 16A and 16B.

12. The example contains a scenario where there is a split of the hedging gain or loss from a single hedging transaction (with one part remaining in OCI and another part adjusting the cost of the hedged item).

13. Under scenario 1B (see paragraph 16 of agenda paper 16D), when the FX forecast transaction becomes a firm commitment the entity leaves the hedging gain or loss in OCI while subsequently applying fair value hedge accounting for the firm commitment for which the hedging gain or loss is presented as a separate line item on the balance sheet. This results in a split of the hedging gain or loss from one single hedging transaction being presented in part in OCI and in part as an asset or a liability in the balance sheet.

14. The following table summarises combinations of the different alternatives and whether it results in a split of the hedging gain or loss. (The staff notes that the Board should consider the following table along with the analysis in agenda paper 16A and 16B on each of the different alternatives.):

[1] Where the cumulative fair value change of the hedged item is less than those of the hedging instrument.

<table>
<tr><td></td><td colspan="4">FX hedge of firm commitment (agenda paper 16B)</td></tr>
<tr><td rowspan="5">Forecast transactions that result in the recognition of a non financial item (agenda paper 16A)</td><td>Alternatives</td><td>A
(choice to apply CFH or FVH)</td><td>B
(CFH)</td><td>C
(FVH)</td></tr>
<tr><td>1
(permit the accounting policy choice)</td><td colspan="3">Allows entities the flexibility to choose so that it does not result in a split of hedging gain or loss</td></tr>
<tr><td>2
(leave hedging gains and losses in OCI)</td><td>Results in different carrying amounts depending on whether the entity applies CFH or FVH</td><td>All hedging gain or loss presented in OCI (ie no split of hedging gain or loss)</td><td>Split of hedging gain or loss</td></tr>
<tr><td>3
(basis adjustment)</td><td rowspan="2">Results in the same carrying amount[2] (regardless of whether the entity chooses to CFH or FVH)</td><td rowspan="2">All hedging gain or loss presented as asset/liability (ie no split of hedging gain or loss)</td><td rowspan="2">All hedging gain or loss presented as asset/liability (ie no split of gain or loss)</td></tr>
<tr><td>4
(basis adjustment (directly from equity))</td></tr>
</table>

Implications of the staff recommendations

15. The staff notes that the interaction of the staff recommendations in agenda papers 16A (alternative 4) and 16B (alternative A):

    (a) would result in the non-financial item being recognised at the same carrying amount (except for the effect of the ‘lower of’ test) regardless of whether an entity chooses to account for the hedged transaction as a cash flow hedge or as a fair value hedge; and

[2] Except for the effect of ‘lower of’ test.

(b) would not result in an artificial split of hedging gain or loss from a single hedging transaction.

Questions to the Board

Basis adjustments

16. For hedges of forecast transactions that result in the recognition of non-financial items, or for a forecast transaction for a non-financial item that becomes a firm commitment for which fair value hedge accounting is applied, the staff recommends the Board adopt **alternative 4.** That is, the entity shall remove the associated gains and losses that were recognised in equity (AOCI) and include them in the initial cost or other carrying amount of the non-financial item. The reasons for the staff recommendation are set out in paragraphs 68 to 80 of agenda paper 16A.

Question 1– Basis adjustments
Does the Board agree with the staff recommendation as set out in paragraph 16 above? If the Board does not agree, which alternative does the Board prefer and why?

Hedges of FX risk of firm commitments

17. For hedges of FX risk of firm commitments, the staff recommends **alternative A.** That is, to permit a hedge of the FX risk of a firm commitment to be treated as either a fair value hedge or a cash flow hedge (ie to retain the requirement in IAS 39.87). The reasons for the staff recommendation are set out in paragraphs 31 to38 of agenda paper 16B.

Question 2– FX risk of firm commitment
Does the Board agree with the staff recommendation as set out in paragraph 17 above? If the Board does not agree, which alternative does the Board prefer and why?