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

Topic **Hedge accounting – illustrative examples of basis adjustments and hedging FX risk of firm commitments**

Introduction

1. This paper contains illustrative examples of the different scenarios discussed in agenda papers 16A and 16B.

2. This paper contains the following three illustrative examples:

    (a) Example 1: hedging the foreign exchange (FX) risk of a forecast transaction to purchase a truck;

    (b) Example 2: hedging the FX risk of a firm commitment to purchase a ship; and

    (c) Example 3: hedging the FX risk of a forecast transaction to purchase a plane and the forecast transaction becomes a firm commitment.

Example 1 – forecast transaction to purchase a truck in foreign currency

1 January 2010

3. On 1 January 2010 an entity enters into a forward exchange contract to hedge the foreign currency risk of a highly probable purchase of a truck in a foreign currency for delivery on 31 December 2010 for FC 100. On 1 January the forward rate for 31 December is 1 FC:2 LC. The entity applies cash flow hedge accounting and the hedge is 100% effective.

31 December 2010

4. On 31 December 2010, the spot exchange rate is 1 FC : 1.5 LC and the entity paid LC 150. The fair value of the forward exchange contract is LC (50).

5. The entity estimates that the truck has an estimated useful life of 5 years.

6. The assumptions are summarised as follows:

Purchase of a truck denominated in a foreign currency.
The entity hedged its FX exposure using an FX forward.
The entity applied cash flow hedge accounting and the hedge was 100% effective.

	Local CU
Cost of truck	150
FV of derivative	(50)
Useful life (no. of years)	5

7.

Alternative 2: No Basis Adjustment – IAS 39.98(a)							
Year end	2010 CU	2011 CU	2012 CU	2013 CU	2014 CU	2015 CU	
Balance Sheet							
Property, Plant & Equipment	150	120	90	60	30	0	
Accumulated OCI (deferred effective portion)							
- Opening balance	(50)	(50)	(40)	(30)	(20)	(10)	
- Recycle to I/S	0	10	10	10	10	10	
- Closing balance	(50)	(40)	(30)	(20)	(10)	0	
Statement of Comprehensive Income							**Total**
Income Statement (I/S)							
- Deprn of PPE carrying amount	-	(30)	(30)	(30)	(30)	(30)	
- Recycle from AOCI	-	(10)	(10)	(10)	(10)	(10)	
Depreciation expense	-	(40)	(40)	(40)	(40)	(40)	(200)
Other Comprehensive Income							
- Recycle deferred effective portion to I/S	-	10	10	10	10	10	50
Comprehensive Income	-	**(30)**	**(30)**	**(30)**	**(30)**	**(30)**	**(150)**

8.

Alternative 3: Basis Adjustment – IAS 39.98(b)							
Year end	2010 CU	2011 CU	2012 CU	2013 CU	2014 CU	2015 CU	
Balance Sheet							
Property, Plant & Equipment	200	160	120	80	40	0	
Accumulated OCI (deferred effective portion)							
- Opening balance	(50)	-	-	-	-	-	
- Movement in OCI (basis adjustment to cost of plane)	50	-	-	-	-	-	
- Closing balance	-	-	-	-	-	-	
Statement of Comprehensive Income							**Total**
Income Statement (I/S)							
Depreciation expense	-	(40)	(40)	(40)	(40)	(40)	(200)
Other Comprehensive Income	50	-	-	-	-	-	50
Comprehensive Income	**50**	**(40)**	**(40)**	**(40)**	**(40)**	**(40)**	**(150)**

9.

Alternative 4: Basis Adjustment Option (directly from AOCI)							
Year end	2010 CU	2011 CU	2012 CU	2013 CU	2014 CU	2015 CU	
Balance Sheet							
Property, Plant & Equipment	200	160	120	80	40	0	
Accumulated OCI (deferred effective portion)							
- Opening balance	(50)	-	-	-	-	-	
- Basis adjustment directly to the cost of the plane	50	-	-	-	-	-	
- Closing balance	-	-	-	-	-	-	
Statement of Comprehensive Income							**Total**
Income Statement (I/S)							
Depreciation expense	-	(40)	(40)	(40)	(40)	(40)	(200)
Other Comprehensive Income	-	-	-	-	-	-	-
Comprehensive Income	**-**	**(40)**	**(40)**	**(40)**	**(40)**	**(40)**	**(200)**

Example 2 – firm commitment to purchase a ship

10. Entities A, B and C have the same local/functional currency. On 1 January 2010, all three entities enter into binding agreements to purchase a ship for delivery on 31 December 2010 with the following terms:

    (a) *Entity A*: purchase price is denominated in Entity A's local currency for LC 200.

    (b) *Entity B*: purchase price is denominated in foreign currency for FC 100.

    (c) *Entity C*: purchase price is denominated in foreign currency for FC 100.

    Entity B hedges its FX exposure by entering into a forward FX contract on 1 January 2010. The FX forward rate for 31 December 2010 is 1 FC : 2 LC. Entity B applies hedge accounting and the hedge is 100% effective. Entity C does not hedge its FX exposure. The spot FX rate on 31 December 2010 is 1 FC : 1.5 LC

11. Balance sheets for entities A, B and C on 31 December 2010 are set out below (note: minus = credit):

Entity A		Entity B [1]				Entity C	
Balance sheet		**Balance sheet (CFH basis adj)**		**Balance sheet (CFH no basis adj)**		**Balance sheet**	
	CU	*Scenario 1*	CU	*Scenario 2*	CU		CU
Assets	**205**	**Assets**	**205**	**Assets**	**155**	**Assets**	**155**
Other assets	5	Other assets	5	Other assets	5	Other assets	5
Ship	200	Ship	200	Ship	150	Ship	150
Liabilities	**(5)**	**Liabilities**	**(5)**	**Liabilities**	**(5)**	**Liabilities**	**(5)**
Other liabilities	(5)	Other liabilities	(5)	Other liabilities	(5)	Other liabilities	(5)
Equity	**(200)**	**Equity**	**(200)**	**Equity**	**(150)**	**Equity**	**(150)**
Capital	(200)	Capital	(200)	Capital	(200)	Capital	(200)
Retained earnings	0	Retained earnings	0	Retained earnings	0	Retained earnings	50
AOCI	0	AOCI	0	AOCI	50	AOCI	0
		Balance sheet (FVH)					
		Scenario 3	CU				
		Assets	**205**				
		Other assets	5				
		Ship	200				
		Liabilities	**(5)**				
		Other liabilities	(5)				
		Equity	**(200)**				
		Capital	(200)				
		Retained earnings	0				
		AOCI	0				

[1] Assuming the accounting option in IAS 39.87 is available where an FX hedge of firm a commitment can be accounted for as either a cash flow hedge or a fair value hedge.

Example 3 – FX forecast transaction becomes a firm commitment

1 January 2010

12. On 1 January 2010, an entity enters into a forward exchange contract to hedge the FX risk of a highly probable purchase of a plane in a foreign currency for delivery on 31 December 2010.

13. The forecast purchase price of the plane is FC 100. The FX forward for 31 December 2010 is 1 FC: 2 LC.

14. The entity applies cash flow hedge accounting and the hedge is 100% effective.

30 June 2010

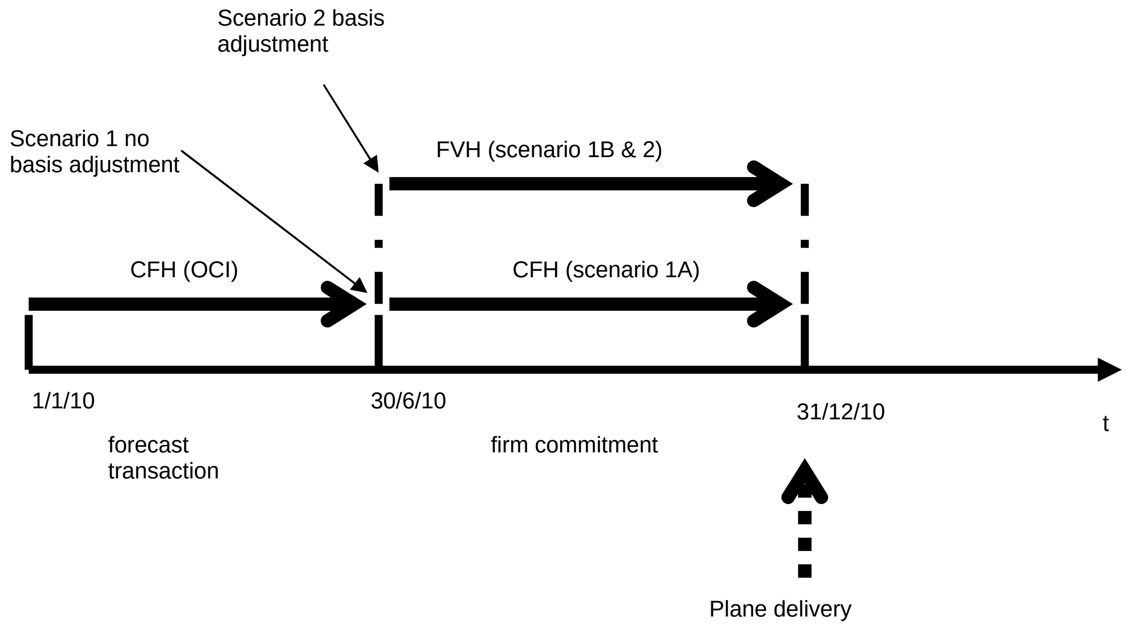
15. On 30 June 2010, the entity enters into a *binding agreement* to purchase a plane for FC 100 for delivery on 31 December 2010. The FX forward rate for 31 December 2010 is 1 FC: 1.7 LC.

Scenario 1: *No Basis adjustment (IAS 39.98(a))*		*Scenario 2:* *Basis adjustment (IAS 39.98(b))*	
Balance sheet 30/6/10		**Balance sheet 30/6/10**	
Assets	**5**	**Assets**	**35**
Other assets	5	Other assets	5
		Firm commitment	30
Liabilities	**(30)**	**Liabilities**	**(30)**
Derivatives	(30)	Derivatives	(30)
Equity	**25**	**Equity**	**(5)**
Capital	(5)	Capital	(5)
AOCI	30	AOCI	-

30 September 2010

16. On 30 September 2010, the FX forward rate for 31 December is 1 FC: 1.5 LC.

Scenario 1A No basis adjustment and CFH		*Scenario 1B No basis adjustment and FVH*		*Scenario 2 Basis adjustment and FVH*	
Balance sheet 30/9/10		**Balance sheet 30/9/10**		**Balance sheet 30/9/10**	
Assets	**5**	**Assets**	**25**	**Assets**	**55**
Other assets	5	Other assets	5	Other assets	5
		Firm commitment	20	Firm commitment	50[2]
Liabilities	**(50)**	**Liabilities**	**(50)**	**Liabilities**	**(50)**
Derivatives	(50)	Derivatives	(50)	Derivatives	(50)
Equity	**45**	**Equity**	**25**	**Equity**	**(5)**
Capital	(5)	Capital	(5)	Capital	(5)
AOCI	50	AOCI	30	AOCI	-



[2] The carrying amount consists of basis adjustment of 30 on 30/6/2010 and fair value hedge adjustment of 20 from 1/7/2010 to 30/9/2010.