A PEEK OVER THE HEDGE

THE IASB HAS ISSUED A REVIEW DRAFT OF THE ACCOUNTING STANDARD THAT WILL REPLACE IAS 39. JOHANN KRUGER AND GERRY DALY EXPLAIN WHAT'S IN STORE FOR DERIVATIVES

Since November 2008, the IASB has been working to replace IAS 39, *Financial Instruments: Recognition and Measurement* with an improved and simplified standard. The replacement project was divided into three phases. Phase one concerned the classification and measurement of financial assets and financial liabilities. This phase was completed early, but will require limited changes due to the development of other parts of the new standard and accounting for insurance contacts. Phase two is ongoing and concerns impairment methodologies for financial assets. Phase three, hedge accounting, is the subject of this article.

The eagerly anticipated first draft of the general hedge accounting model was issued late in 2010. But despite well-communicated intentions to improve the standard, many issues were identified both in the comment letters received by the IASB and through the outreach activities subsequently initiated by the IASB. After many delays, a review draft (RD) was issued on 7 September 2012. This draft will be available for comment on cosmetic changes until early December 2012, the final general hedge accounting standard being issued shortly thereafter. Due to the extensive consultation process it has followed over the past three years, the IASB does not plan to make any further fundamental changes to the proposed general hedge accounting model.

The proposals do not cover open portfolio hedging (macro hedging), which will proceed independently of the general hedge accounting module. The proposed mandatory effective date is any annual periods beginning on or after 1 January 2015, but early adoption will be permitted.

The standard will only become available for use in the UK and the rest of the EU after endorsement by the relevant European bodies, hopefully during 2013. This is provided that the EU does not insist on completion of both the impairment and portfolio hedging components before they begin the endorsement process.

Unlisted UK entities with calendar accounting year-ends must apply a form of IFRS for the first time on 31 December 2015 (with opening balance sheet necessary as at 1 January 2014). Therefore, current UK GAAP reporters are recommended to consider the RD as key IFRS guidance on hedge accounting that would apply to them.

Summary of changes

The RD fundamentally changes the current rules-based approach to hedge accounting to a principles-based approach. It seeks to align the management view and information produced internally for risk management purposes with the accounting recognition of gains and losses.

The general basis for a hedging instrument to qualify for hedge accounting is as follows:

- There must be an economic relationship between the hedged item and hedging instrument;
- The effect of credit risk should not dominate the value changes in the hedging relationship; and
- The hedge ratio must be based on the actual quantities of the hedged item and hedging instrument used to meet the risk management objective.

The required journal entries for the three hedge accounting models remain substantially the same.

Risk components in non-financial items

The RD allows any risk component (of fair value or cash flow) that can be separately identified and reliably measured to be designated as hedged separately. For non-financial items, IAS 39 currently only allows separation of FX risk. The RD provides considerable flexibility compared with current rules.

For example, inflation hedges of forecast revenues where the inflation component of future cash flows (for example, rent received) is explicit could now qualify as an eligible underlying item. This should align accounting presentation with common risk management practice, allowing companies to make choices on economic grounds only.

Many hedges of commodity components, such as the oil price component of jet fuel, should qualify for hedge accounting for the first time. Entities would also no longer have to adjust business practice, such as separating purchase contracts of commodities from any added-value manufacturing, to ensure appropriate financial reporting of activities.

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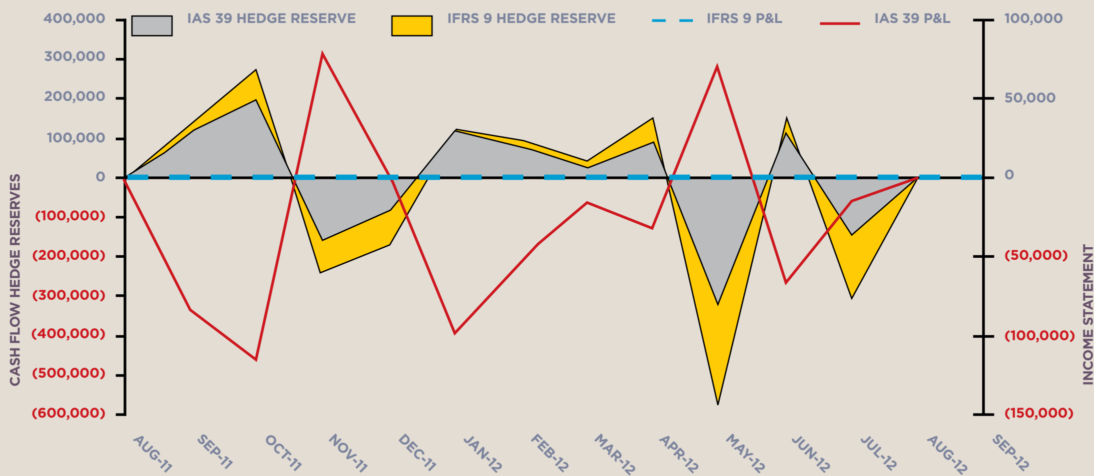
Abolition of the 80-125% effectiveness corridor

A qualitative prospective test will be the main effectiveness qualification criteria. Ineffectiveness must be recognised in the income statement as per current

HEDGE ACCOUNTING FOR AN OPTION UNDER EACH FRAMEWORK



methodology. More hedges should therefore qualify for hedge accounting. The cost of hedge accounting compliance should decrease for most entities.

Rebalancing and overlay hedges

The RD permits hedge relationships to be adjusted with the aim of improving effectiveness without necessarily terminating and potentially restarting hedge accounting from scratch. The so-called 'derivative-on-derivative' prohibition is also effectively abolished. This should, at a minimum, simplify restructuring of hedges and management of synthetic interest rate exposures using short-dated swaps, thereby reducing the costs of hedging.

FX forwards

Income statement recognition of forward points on FX contracts may be spread over the life of the contract.

Hedging of net positions

Hedging of net positions can, subject to certain restrictions, qualify for hedge accounting. However, cash flow hedging of net positions is limited to FX risk.

'Time value' of options

IAS 39 has been heavily criticised for its treatment of the time value of options. The IASB proposes to consider options as analogous to insurance and therefore recognise gains and losses of option time value based upon the purpose of a hedge. For example, for so-called transaction-based hedges (such as cash flow hedges of forecasted transactions), subject to certain conditions, the full fair value changes of the option are deferred in reserves and released to the income statement to match the timing of the impact of the underlying hedged item.

The chart above illustrates this change to the treatment of the time value of a purchased $10m USD put/GBP call option hedging a forecast $10m sale. The left axis shows the amounts deferred in the cash flow hedge reserve and the right axis shows the impact of the time value on the income statement under the existing IAS 39 framework. As expected, this income statement volatility is quite significant in contrast to the impact on the income statement under the new RD model.

In general, Basel III capital and liquidity costs are likely to make options become more attractive compared with forward-based instruments. In future, corporates will be able to take advantage of the flexibility offered by options without worrying about misaligned financial reporting.

Potential pitfalls

The RD is not without bad news, though. Corporates with experience of managing liabilities using cross-currency swaps will be aware of the volatility currency basis risk can cause if it cannot be reported as part of a hedging reserve. The cross-currency basis spread represents the difference in credit cost between domestic rate quotes and the liquidity premium charged for exchanging one currency for another. Currency basis is not a component of single currency debt, but certainly affects the valuation of a cross-currency swap.

Before 2008, this was not an issue at all due to the relative stability of currency basis. When the crisis hit in 2008, currency basis widened significantly due to the increased demand for dollars combined with a decrease in supply as US banks held cash to conserve liquidity. The impact of this non-cash volatility on cash flow hedges was mitigated by calculating hedge ineffectiveness using the hypothetical derivative method as a proxy for fair value changes in the underlying exposure. Unfortunately, the RD indicates that the hypothetical derivative cannot include features that only exist in the hedging instrument and that are not included in the hedged item, for example, currency basis. This will lead to increased income statement volatility, which is not decision-useful to users. Isolating currency basis at inception, excluding it from the hedge relationship, similar to option premium, and amortising it to the income statement over the term of the hedge, would provide a simple solution. However, the RD would have to be amended to allow this.

An entity is also prohibited from voluntarily de-designating a hedge that continues to meet its risk management objective. Once adopted, hedge accounting is mandatory and cannot be revoked unless the risk management objective itself changes.

In summary

IAS 39 is rule-based, a legacy of having been modelled on the equivalent standard in the US. The IASB has now taken the lead to transform accounting for financial instruments to be based upon principles, supplemented by rules to prevent abuse. In essence, the changes in the RD are overwhelmingly positive.

Companies relying on 'underlying profit' reporting to accurately reflect the results of their commercial activities may in future not have to adjust for non-cash IAS 39 volatility. It is hoped the US standard-setters will follow this initiative in support of global convergence towards standards of the highest quality.

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