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The smart way to manage financial risk

IAS 39 - Under the Hood

Issue 2

In keeping with our commitment to develop a comprehensive risk management solution, Visual Risk will be providing a regular article on the new IAS39 Accounting Standard. The aim of the articles is to build an understanding of the Standard from the ground up, beginning with the rationale for the Standard, reviewing the basics of hedge accounting and then taking a closer look at some of the many intricacies of the Standard.

What is Hedge Accounting?

As we noted in [Issue 1](#), the Standard requires all derivatives to be carried at fair value which could produce *increased* volatility in accounting earnings despite the fact that derivatives are generally implemented to *reduce* volatility in long term cash flow. Hedge Accounting will provide relief in that it “recognizes the offsetting effects on new profit or loss of changes in the fair values of the hedging instrument and the hedged item” (para. 85)**.

To achieve Hedge Accounting, the Standard requires a company to designate a hedging instrument (a derivative, in most cases) to a hedged item in a hedge relationship where a particular risk is being hedged (e.g. currency, interest rate risk etc). For all hedging relationships, there will be extensive initial and ongoing documentation requirements. “At the inception of the hedge, there is formal designation and documentation of the hedging relationship and the entity’s risk management objective and strategy for undertaking the hedge. That documentation shall include ... how the entity will assess the hedging instrument’s effectiveness ...” (para. 88(a)).

System Implications:

Each hedge relationship will have to be fully documented. The hedging strategy, the hedge objective and the results of effectiveness tests will need to be recorded and be consistent. The total proportions of any derivatives and hedged items that are in relationships will have to be monitored so changes in fair value are correctly dealt with in the accounts.

Hedge Accounting in Practice

There are 3 types of hedging relationships which qualify for Hedge Accounting:

1. Fair Value Hedge

“This is a hedge of the exposure to changes in the fair value of a recognised asset or liability or unrecognised firm commitment that is attributable to a particular risk and that will affect reported net income.” (para. 86(a))

Examples:

- hedging of a fixed rate bond with a fixed rate swap by the issuer or holder.
- hedging of inventory with a commodity future where the commodity price affects the inventory value.



Accounting for a Fair Value Hedge:

The gain or loss of the hedging instrument is recognised in profit and loss. The gain or loss on the hedged item attributable to the hedged risk is also recognised in profit and loss. In the case where the hedged item is measured at cost, this gain or loss adjusts the carrying amount of the hedged item. If the hedged item is a firm commitment, the cumulative change in valuation is recognised as an asset or liability.

System Implications:

Valuation splitting may be necessary so that the change in value of the hedged item attributable to the hedged risk is measured. Ongoing valuation changes will need to be recorded to adjust the hedged item's carrying value, or to recognise the cumulative changes on the balance sheet.

2. Cash Flow Hedge

“This is a hedge of the exposure to variability in cash flows that is attributable to a particular risk associated with a recognised asset or liability or a highly probable forecast transaction” (para. 86(b)).

Examples:

- hedging floating rate debt with a fixed rate swap.
- hedging a projected foreign currency inflow with a currency forward.

Accounting for a Cash Flow Hedge:

(Note: Hedges of a Net Investment will be accounted for similarly to cash flow hedges.)

The lesser of the cumulative gain or loss on the hedging instrument and the cumulative change in the fair value of the cash flows on the hedged item stays in equity as Other Comprehensive Income (OCI). Any remaining gain or loss on the hedging instrument flows through to profit and loss. Any gain or loss that is excluded from the relationship (e.g. time value of an option) also goes to profit and loss.

A recent change to the Standard (AG107A) prohibits under-hedging to reduce profit and loss variation. If 85% of an exposure is hedged, then the designated hedged item will be defined as 85% of the exposure rather than 100%.

A complication for cash flow hedges is that in some cases, if hedge accounting is discontinued, the cumulative gain or loss in equity remains separately recognised in equity until the forecast transaction occurs (for example, when the prospective effectiveness test fails or the hedging instrument is sold).

System Implications:

Again, valuation splitting may be necessary. For each relationship, cumulative ineffectiveness will have to be tracked (even after the relationship is discontinued in some cases).



3. Portfolio Hedging

Portfolio hedging has been a hotly debated issue. According to the Standard “A hedge of an overall net position ... does not qualify for Hedge Accounting” (AG101). The initial solution proposed was to designate particular assets or liabilities as the hedged item. However this could easily lead to accounting complexities if any of the underlying items change or terminate and the hedge is no longer effective.

In response to sustained lobbying, the Standard was amended to allow fair value hedging of a net interest rate position. The reason that the concession was exclusively made for interest rates is probably that the main lobbyists were big banks. BHP Billiton in their comment on this draft argued persuasively (but to no avail) that this hedging method should be allowed for all risks.

The approach is to designate a fixed amount of assets or liabilities (rather than choosing actual assets or liabilities) as the hedged item. Ineffectiveness then arises due to timing mismatches, changes in repricing dates, or items in the portfolio being de-recognised. This approach looks extremely difficult to implement on an ongoing basis as variables such as expected repricing dates and prepayment optionality must be considered and tracking ineffectiveness will also be problematic.

Next Issue

Our next issue of Under the Hood will discuss hedge effectiveness testing in detail for cash flow and fair value hedges.

** All references to the standard are to Pending Accounting Standard AASB 139 (updated April 2004)