IAS 39 (AC 133) Financial Instruments: Hedge Accounting

Effective Date
Periods commencing on or after 1 January 2005

ACCOUNTING

Fair value hedges

All gains or losses from remeasuring the hedging instrument at fair value (derivative) or foreign currency component of its carrying amount measured in accordance with IAS 21 (non-derivative) shall be recognised in profit or loss. The gain or loss on the hedged item attributable to the hedged risk shall adjust the carrying amount of the hedged item and shall be recognised in profit or loss (P/L).

Cash flow hedges

The effective portion of the gain or loss on the hedging instrument shall be recognised in other comprehensive income (OCI).

The ineffective portion of the gain or loss on the hedging instrument shall be recognised in P/L

- If a hedge of a forecast transaction results in the recognition of a financial item, gains or losses recognised in OCI are reclassified from equity to P/L when the hedged forecast cash flows affect P/L
- If a hedge of a forecast transaction results in recognition of a non-financial item the entity has accounting policy choice:
  - reclassify gains and losses recognised in OCI to P/L when asset or liability affects P/L
  - remove gains and losses recognised in OCI and include in initial cost or carrying amount of asset or liability.

Hedge of a net investment

Accounted for in the same manner as cash flow hedges. The gain or loss relating to the effective portion of the hedge shall be reclassified from equity to P/L on disposal or partial disposal of the foreign operation.

EFFECTIVENESS TESTING

A hedge is regarded as highly effective only if at inception and in subsequent periods the hedge is expected to be highly effective and the actual results of the hedge are within a range of 80-125 percent.

Both prospective and retrospective testing should be done to prove effectiveness. IAS 39 does not prescribe the method that should be used to perform prospective and retrospective effectiveness testing. Some frequently used methods include:

- Critical terms match – Comparing the critical terms of the hedging instrument with those of the hedged item. The hedge is expected to be highly effective if the critical terms match exactly. This method does not require any calculations and may only be used for prospective testing.
- Dollar offset method – Comparing the changes in the fair value or cash flows of the hedging instrument with those of the hedged item attributable to the hedged risk. This is a quantitative method.
- Regression analysis – This is a statistical method that investigates the strength of the statistical relationship between the hedging instrument and the hedged item.

DEFINITIONS

HEDGING INSTRUMENT

Designated derivative or (for a hedge of forex risk only) a designated non-derivative financial asset or financial liability whose fair value or cash flows are expected to offset changes in the fair value or cash flows of a designated hedged item.

HEDGE EFFECTIVENESS

The degree to which changes in the fair value or cash flows of the hedged item that are attributable to a hedged risk are offset by changes in the fair value or cash flows of the hedging instrument.

HEDGED ITEM

An asset, liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation that:

- Exposes the entity to risk of changes in fair value or future cash flows; and
- Is designated as being hedged.

OTHER

Firm commitment

A binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates.

Forecast transaction

An uncommitted but anticipated future transaction.

HEDGING INSTRUMENT

Qualifying instruments

Only instruments that involve external parties can be designated as hedging instruments. A non-derivative financial instrument may only be designated as a hedging instrument for a hedge of a foreign currency risk. There are generally no restrictions for derivatives as hedging instruments except for some written options.

Designation of hedging instruments

Normally a single fair value measure, thus hedging instruments designated in its entirety except:

- Intrinsic value and time value of options
- Interest element and the spot price of a forward contract.

A proportion of the hedging instrument may be designated however a hedging relationship may not be designated for only a portion of the time period during which a hedging instrument remains outstanding. A single hedging instrument may under certain circumstances be designated as a hedge of more than one type of risk.

TYPES OF HEDGES AND CRITERIA FOR HEDGE ACCOUNTING

IAS 39 provides for three types of hedging relationships, recognising that entities can hedge the exposure to changes in cash flows (i.e. a cash flow hedge) the exposure to changes in fair value (i.e. a fair value hedge) and a net investment in foreign operation.

Strict criteria must be met before hedge accounting is applied:

- At inception of the hedge there is formal designation and documentation of the hedging relationship and the entities risk management objective and strategy for undertaking the hedge.
- The hedge is expected to be highly effective in offsetting changes in fair values or cash flows attributable to the hedged risk.
- For cash flow hedges any forecast transaction being hedged is highly probable.
- Hedge effectiveness is reliably measurable (ie the fair value or cash flows of the hedged item attributable to the hedged risk and the fair value of the hedging instrument can be reliably measured).
- The hedge must be assessed on an ongoing basis and and determined to have been highly effective.

DISCONTINUE HEDGE ACCOUNTING

Fair value hedges

Discontinue prospectively if:

- Hedging instrument expires or is sold, terminated or exercised; or
- The hedge no longer meets the criteria for hedge accounting; or
- The entity revokes the designation.

Cash flow hedges

Discontinue prospectively if:

- Hedging instrument expires or is sold, terminated or exercised, the hedge no longer meets the criteria for hedge accounting, the forecast transaction is no longer expected to occur, or the entity revokes the designation.

HEDGED ITEMS

Qualifying items

Only hedged items that involve external parties can be designated as hedged items.

Designation as hedged items

Financial hedged items – may be hedged for risks associated with only a portion of cash flows or fair value. Non-financial hedged item – designated for foreign currency risks or in its entirety for all risks.