Perspective

This is one of a series of articles where experts in assurance, reporting and regulatory matters discuss recent technical and policy developments in these areas.

Five questions you should be asking about the hedging guidance in AASB 9

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The AASB has made hedge accounting easier to achieve with its new financial instruments standard. By and large, the new guidance in AASB 9 is proving attractive; we have seen a few early adopters and a ramp up in inquiries about early adoption. In this article we suggest five questions you should be asking about the new standard. We also discuss the key changes the standard will bring and how these changes can be translated into benefits for your company.

1. What has changed for hedge accounting under AASB 9?

AASB 139 is well known for its strict rules and onerous compliance burden. On the face of it, the new hedge accounting guidance in AASB 9 doesn't look all that different. When you dig a little deeper, you'll find that the rigidity of AASB 139 has been replaced with flexibility and opportunities to apply hedge accounting where previously it would not have been possible. Corporate treasurers and boards should consider whether their current hedging strategies continue to be optimal in view of these changes, or whether strategies that previously failed the hedge accounting requirements would now be considered compliant.

2. What are the benefits of AASB 9 hedge accounting?

The new standard improves on existing guidance in the following areas:

Costs of hedging

The biggest drawcard for early adopting AASB 9 is the treatment of costs of hedging. The time value of options, the interest element (forward points) of forward contracts, and the currency basis spread in cross-currency swap contracts all fall in the scope of this change.

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An option's fair value includes a component of time value, which is a function of the time to expiry of the option and its volatility, but excludes the option's intrinsic value. Time value is generally not present in the value of the hedged item and this mismatch causes ineffectiveness. Under AASB 139, an entity can elect to designate only the intrinsic value of the option as the hedging instrument, which removes the ineffectiveness from the relationship. However, the option is still required to be measured at its full fair value in the balance sheet, and the changes in the time value component are accounted for directly in profit and loss (P&L). This causes volatility. AASB 9 has addressed this by stipulating that changes in time value are deferred in other comprehensive income (OCI).

The same is true for forward points. The fair value of a forward contract is driven by changes in the spot rate and forward points for the underlying currency. If the hedged item is not similarly affected by forward points, this mismatch will cause ineffectiveness. A company may choose to designate only the change in value of the spot element as the hedging instrument; however, the changes in fair value due to forward points would be immediately recognised in P&L. Now, under AASB 9, forward points may be deferred in OCI.

Companies hedging with cross-currency swaps will be charged a currency basis spread, which is not present in the hedged item, causing ineffectiveness. Under AASB 9, currency basis may also be excluded from the hedge designation and deferred in OCI.

AASB 9 provides guidance on accounting for the deferred costs of hedging. If the hedged item results in the recognition of a non-financial asset, the amount is capitalised to its carrying value. If, however, the hedged item is time-period related (for example, for a hedge of the foreign exchange exposure on foreign currency debt), the costs of hedging are reclassified from OCI to P&L over the term of the hedge. This results in the P&L showing the cost of debt at the original hedged rate.

Designating a hedge

AASB 9 relaxes the previous requirements for determining whether a hedge is highly effective. Previously, prospective and retrospective hedge effectiveness tests needed to be conducted, and the hedge needed to be within the range of 80-125% effective. The new guidance removes this bright line threshold and requires only a prospective effectiveness assessment. It is important to note that the requirement to measure ineffectiveness and report it in P&L remains.
In addition to removing the highly effective criteria, AASB 9 introduces the following criteria for designating a hedge:

- An economic relationship must exist between the hedged item and the hedging instrument.
- Credit risk does not dominate value changes in the hedged item or the hedging instrument.
- The designated hedge ratio is consistent with the company's risk management strategy.

AASB 9 also introduces the concept of 'rebalancing', which provides companies with an opportunity to 'reset' the hedge ratio when there is an imbalance causing ineffectiveness. Rebalancing is a pragmatic solution to avoid discontinuing hedging relationships that would have failed the effectiveness test under AASB 139.

Eligible hedged items

AASB 9 permits a derivative to be combined with another exposure to form a hedged item, which was not previously allowed. This resolves an issue for companies that raise funding denominated in a foreign currency and swap the foreign currency cash flows back to AUD floating interest rate cash flows using cross currency interest rate swaps. The restrictions in AASB 139 prevent the synthetic floating rate exposure from being hedged using fixed interest rate swaps because the hedged item would be a combination of the borrowing and a derivative. This hedge designation will now be possible under AASB 9.

An important development for companies in many sectors is that it is now possible to hedge risk components of non-financial items under AASB 9, provided the component is separately identifiable and the changes in fair value or cash flows of the item are reliably measurable. Such hedges were often ineffective under the old standard. To meet the criteria, it is generally necessary for the price of the entire item to be built up from various components using a 'building block' approach. Typical examples of components of non-financial items might be the oil in jet fuel or aluminium in an aluminium can.

For multinationals, another hedging strategy has involved offsetting exposures (such as purchases and sales in the same foreign currency) and hedging the net position. This approach did not qualify for hedge accounting under AASB 139. Instead, companies achieved approximately the same effect by designating part of one of the gross positions, equal in amount to the net position. AASB 9 now allows hedging a net position in certain circumstances.

3. What are the pitfalls of AASB 9 hedge accounting?

Companies will be pleased to know that there are only a few areas where the new standard is more prescriptive than AASB 139 was.

There is an explicit requirement in AASB 9 to consider the time value of money when measuring hedge ineffectiveness. This means that mismatches in timing between the hedged item and the hedging instrument can cause ineffectiveness. This change may have a significant impact on companies who currently ignore timing differences by using a spot designation or partial term hedging strategy.

AASB 9 has removed the policy choice for presenting deferred hedging gains and losses in the balance sheet when the hedged item results in recognition of a non-financial asset. The new guidance requires the hedging gains and losses deferred in the cash flow hedge reserve to be reclassified to the cost of the asset.

Although hedging of net positions is permitted, presentation remains an issue, as the post-hedging results for the offsetting line items may not be presented in a single line item. Instead, the hedging gains and losses are reflected as a separate line item in P&L (separate from the hedged items).

Like most new standards, AASB 9 introduces expanded disclosures in the form of detailed information about:

- the company's risk management strategy
- how the company's hedging activities might affect the amount, timing and uncertainty of its future cash flows
- the effect that hedge accounting has had on the company's financial statements.

4. What do I need to do on transition?

The hedge accounting requirements apply prospectively from the date of transition, with the exception of the change in the treatment of costs of hedging when these are excluded from the hedge relationship. The deferral of the costs in OCI must be applied retrospectively in the case of time value of options.

Existing hedge relationships that qualify under AASB 9 are continued, provided that the criteria of AASB 9 are met at the transition date. Hedge documentation will need updating for AASB 9's additional requirements, such as the hedge ratio, the expected sources of ineffectiveness and removing the retrospective effectiveness test.

5. Should your board consider early adoption?

Early adopters are seeing benefits from a better alignment between the new hedge accounting guidance and their own commercial hedging strategies. They are attracted by the opportunity to report less volatility in P&L and the lower costs of implementing hedges that are compliant for accounting purposes.

Those seeking to adopt the December 2013 version of AASB 9 may transition to the new guidance in the limited window during which it is possible to adopt only the hedge accounting and the classification and measurement chapters of AASB 9 (i.e. without the impairment chapter). Companies considering early adoption for reporting periods beginning on or after 1 February 2015 will need to consider the impact of all three chapters simultaneously.

For those in the banking sphere, the International Accounting Standards Board is working on a separate project to address accounting for hedges of open portfolios ('macro hedge accounting'). Until this project is completed, companies have a policy choice. Companies may either transition to AASB 9 but continue to apply AASB 139 requirements for fair value macro hedges or they may continue to apply the hedge accounting requirements of AASB 139 for all hedges until the macro hedging project is finalised.

AASB 9 is Australia's equivalent to the International Accounting Standards Board's IFRS 9. The European Union has not endorsed any aspects of IFRS 9 and, as a result, companies within the European Union are prevented from adopting it. Australian and New Zealand companies, together with a few other countries, such as Canada, are able to take advantage of this opportunity.