

# 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.



## Why hedge accounting may finally make sense

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IFRS 9 *Financial Instruments* (AASB 9 in Australia) was issued in November 2013 and is not mandatory until 1 January 2018. However, many entities may want to reconsider their hedging policies and assess whether AASB 9 should be adopted early because hedge accounting is far easier to achieve under AASB 9 than under the current standard, AASB 139 *Financial Instruments: Recognition and Measurement*.

In this article we look at the basic question of why entities want to apply hedge accounting. We then look at two areas of 'improvement' under the new AASB 9 standard compared to the existing AASB 139 standard, namely:

- Simplified effectiveness testing
- Hedging a price component of a non-financial item.

### Hedge accounting under AASB 139

It is often said that financial reporting should not drive business practice, however this is not the case for hedging. It has been widely stated that under AASB 139 (which has been applied in Australia since 2005), 'hedge accounting is a privilege not a right'. With its very complex rules on steps an entity must pass to achieve 'hedge accounting', the use of derivatives, forward FX contracts and interest rate swaps has significantly declined in the listed sector, particularly for smaller and medium entities that cannot afford the costs of proving that the AASB 139 hedge accounting thresholds have been met.

### Why do entities want to achieve hedge accounting?

The basic premise of AASB 139 and AASB 9 is that all derivatives must be recorded at fair value at each reporting date. Unless hedge accounting is applied, the movement in the fair value of the derivative is recognised immediately in profit or loss. This income 'volatility' is significant where the derivative has locked in an interest rate or exchange rate for a period of time.

Note: For simplicity, the effects of the time value of money and any credit/debit value adjustments have been ignored for all the examples in this article.)

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## Example 1

### 1 October 2014

Entity A enters into a contract to purchase inventories from an overseas supplier, to be delivered in six months' time. USD 500,000 is payable on delivery.

Entity A does not wish to be exposed to changes in the USD/AUD exchange rate. It takes out a forward contract to purchase USD 500,000 in six months' time at AUD/USD 0.75.

Note: The economic hedge objective is to lock in the purchase price of inventories at AUD 666,667 (USD 500,000/0.75).

### 31 December 2014

The forward rate for 31 March 2015 is AUD/USD 0.70.

The derivative is now an asset worth AUD 47,619 [(USD 500,000/0.70)-(USD 500,000/0.75)], representing the gain the holder of the derivative will make by buying US dollars at AUD/USD 0.75 compared with the forward rate of AUD/USD 0.70.

Journal entry if hedge accounting is **not applied**:

	DR	CR
DR Derivative asset	AUD 47,619	
CR Profit or loss		AUD 47,619

*Being the derivative at fair value and the changes recognised in profit or loss*

This accounting does not follow Entity A's economic hedge objective, which is to lock in a purchase price for the inventories at AUD/USD 0.75. Instead, it gives rise to significant 'profit and loss volatility', bringing forward a notional derivative gain on 31 December 2014 of AUD 47,619.

### 31 March 2015

Assume that the USD/AUD exchange rate remains at AUD/USD 0.70 when the inventories are delivered.

Journal entries if hedge accounting is **not applied**:

	DR	CR
DR Inventory	AUD 714,286	
CR Cash (USD 500,000/0.70)		AUD 714,286

*Being inventory and cash paid at the spot rate at 31 March 2015*

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	DR	CR
DR Cash	AUD 47,619	
CR Derivative asset		AUD 47,619

*Being the cash settlement of the derivative*

## Impact on the income statement without hedge accounting

	2014	2015
Cost of goods sold		AUD 714,286
Gain/loss from derivatives	AUD 47,619	-
Profit or loss	AUD 47,619	-

The above accounting treatment obviously does not reflect the economic hedge objective to protect Entity A from price volatility on known USD purchases. Cost of goods sold also does not reflect the hedge objective to lock in the purchase price at AUD 666,667.

In order to reflect the hedging effect on its USD purchases, Entity A would have to apply hedge accounting. While still following the basic requirement that all derivatives must be recorded at fair value at each reporting date, for cash flow hedges, hedge accounting allows any gain or loss on the derivative to be deferred by making an entry into equity (other comprehensive income (OCI)). (The below entries assume that all the hedge requirements are complied with and that the hedge is 100% effective.)

### 31 December 2014

Journal entry **with hedge accounting**:

	DR	CR
DR Derivative asset	AUD 47,619	
CR Equity (OCI)		AUD 47,619

*Recognise the derivative at fair value and the changes in equity (OCI)*

### 31 March 2015

Journal entry **with hedge accounting**:

	DR	CR
DR Inventory	AUD 714,286	
CR Cash		AUD 714,286

*Being inventory and cash paid at the spot rate at 31 March 2015*

	DR	CR
DR Cash	AUD 47,619	
CR Derivative asset		AUD 47,619

*Being the cash settlement of the derivative*



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	DR	CR
DR Equity (OCI)	AUD 47,619	
CR Inventory		AUD 47,619

*Reclassify the gain in OCI to inventory*

## Impact on income statement with hedge accounting

	2014	2015
Gain/loss from derivatives	-	-
Cost of goods sold		AUD 666,667
Equity (OCI)	AUD 47,619	-

When the purchase transaction is recorded, the hedging gain or loss is reclassified from OCI to the hedged item i.e. inventory. This is then subsequently reflected in cost of goods sold at year end. Under hedge accounting, the amount recorded for cost of goods sold reflects the hedge objective, which is to lock in the purchase price at AUD 666,667.

## Problems in achieving hedge accounting under AASB 139

Under AASB 139, qualifying for hedge accounting is very difficult, with numerous criteria that entities must satisfy in order to qualify. Two of the troublesome criteria that have prevented many corporates from applying hedge accounting under AASB 139 are:

- The strict 80-125% hedge effectiveness test and
- The prohibition to hedge pricing components.

These two restrictions have resulted in a number of hedging transactions failing hedge accounting under AASB 139.

## Simplified hedge effectiveness testing

AASB 139 contains very strict rules around hedge effectiveness, in terms of both requiring a hedging relationship to sit within an 80-125 % effectiveness band, and how effectiveness will be calculated.

The 80 -125 % rule means that if an entity steps outside this range, it is banned from applying hedge accounting. An instrument can be 79.9 % effective but be disqualified from hedge accounting because the 80-125 % threshold has been broken.

The new standard has simplified the hedge effectiveness testing criteria. It has removed the 80-125% highly effective threshold as well as the mandatory requirement to perform forward and backward looking mathematical effectiveness tests.

Under AASB 9, if the derivative is entered into for the same quantity, timing and pricing index as the forecast sales/purchase transaction, it may be sufficient to merely carry out a forward looking qualitative test (e.g. critical terms match test), without the need to perform any further mathematical calculations to qualify for hedge accounting.



## **Example 2**

Entity B has highly probable forecast sales of USD1M in six months' time. It does not wish to be exposed to changes in the USD exchange rate, so enters into a foreign exchange forward contract to sell USD 1M in six months' time. Assume that counter party credit risk is not expected to deteriorate significantly.

### **Question: How is effectiveness testing satisfied under AASB 9?**

Effectiveness testing can be satisfied by the 'critical terms match' test. The critical terms of the hedged item, being the forecast sales, matches the critical terms of the derivative because:

- They are for the same quantity – USD 1M
- They represent the same underlying risk – USD/AUD exchange rate
- The timings match - settlement date of the contract matches the timing of the sales receipts in USD.

However, if the terms are not closely matched, more complex mathematical calculation may be required for effectiveness testing.

### **Hedging pricing component of non-financial items**

Under AASB 139, hedge accounting must be applied to the entire contract, as a whole, for non-financial items. It does not allow hedge accounting to be applied to components of the contract e.g. the benchmark index pricing component for many commodity contracts. This often leads to the breaching of the highly effective (i.e. offset must be within 80-125%) requirement, and hedge accounting failing when entities try to use the benchmark commodities index to hedge commodity supply/purchase contracts.

The new AASB 9 standard is less restrictive and allows hedge accounting to be applied to price components within a commodity contract. (e.g. crude oil component of jet fuel, diesel benchmark index component of diesel purchases, iron ore benchmark index component in iron ore supply contracts, coffee benchmark index in coffee purchase/supply contracts, sugar benchmark index in sugar purchase/supply contracts, etc.)

## **Example 3**

On 1 January 2015, to secure a fixed price for diesel, Entity C enters into a derivative to buy 10,000 barrels of diesel at \$120 per barrel, which is price based on a benchmark diesel index - ULSD 10PPM SG Index (ultra-low sulphur diesel 10 parts per million with Singapore delivery) settling in 12 months' time.

The actual price Entity C pays for the diesel is the terminal gate price which is calculated based on the ULSD 10PPM SG Index adjusted for excise duties, freight, insurance and terminal charges.

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## AASB 139

Under AASB 139, hedge accounting can only be applied to the terminal gate price of diesel. This results in hedge ineffectiveness being recorded in respect of the movements of the other pricing adjustments (i.e. excise duties, freight, insurance and terminal charges). These pricing adjustments can vary substantially and breach the 80-125% range and fail hedge accounting.

Assume the following forecasted prices:

	ULSD 10PPM SG diesel index	Pricing adjustments	Terminal Gate Price
1 January 2015	\$120	\$85	\$205
30 June 2015	\$130	\$90	\$220
31 December 2015	\$100	\$60	\$160

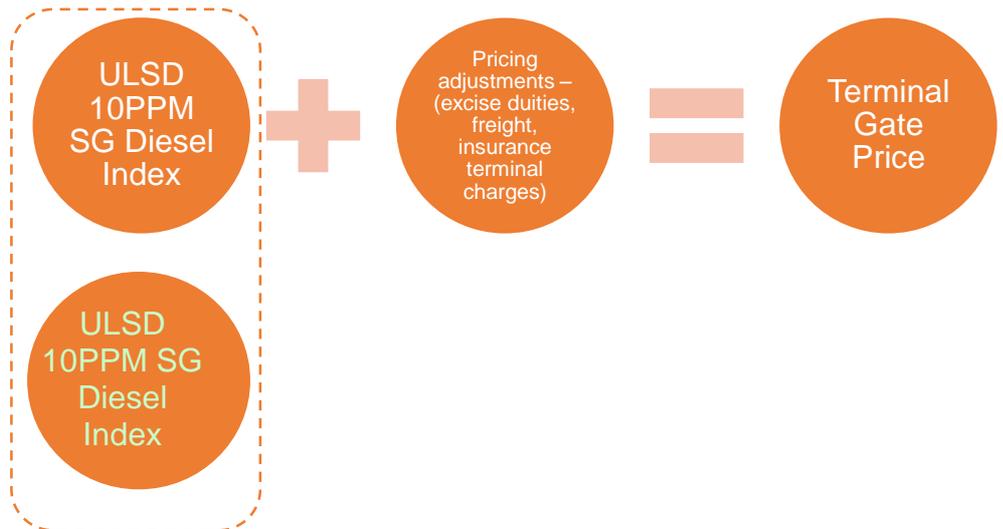
	Cumulative FV change in forecast Terminal Gate Price (hedged item)	Cumulative FV change in derivative (based on diesel index) (hedging instrument)	Hedge Effectiveness under AASB 139
30 June 2015	\$(15) (\$205-\$220)	\$10 (\$130-\$120)	153% (\$15/\$10)
31 December 2015	\$45 (\$205-\$160)	(\$20) (\$100-\$120)	225% (\$45/\$20)

Conclusion under AASB 139: Fail hedge accounting because hedge effectiveness is outside the 80-125% range

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## AASB 9

Under AASB 9, Entity C can apply hedge accounting to the ULSD 10PPM SG Index pricing component only, instead of to the terminal gate price. The new standard has also removed the 80-125% effectiveness range (discussed above), making hedge accounting for diesel hedges a lot easier to achieve.



### Hedge Accounting under AASB 9

	Cumulative FV change in diesel index component of the forecast terminal gate price (hedged item)	Cumulative FV change in derivative (based on the diesel index) (hedging instrument)	Hedge Effectiveness under AASB 9
30/6/2015	\$(10) (\$120-\$130)	\$10 (\$130-\$120)	100% (\$10/\$10)
31/12/2015	\$20 (\$120-\$100)	(\$20) (\$100-\$120)	100% (\$20/\$20)