The International Accounting Standards Board completed its latest deliberation in September 2011 to make significant changes to proposals in the Hedge Accounting exposure draft issued in December 2010, being the proposals for the third part of IFRS 9, the project to replace IAS 39 Financial Instruments: Recognition and Measurement.

The main objective in the exposure draft is to simplify hedge accounting to provide a better linkage between an entity’s risk management, the rationale for hedging and the impact of hedging on the financial statements. The proposals represent a fundamental shift from the way entities have applied hedge accounting in the past.

Market participants have welcomed the board’s efforts to reduce the complexity of hedge accounting that can be applied for both financial services and corporate entities. However, although participants are supportive of the overall intent and direction of the proposals, they are interested in clarifying the wording of the draft to make it more operational.

A review draft of the final standard is expected to be available on the IASB’s website early this year for 90 days. This article summarizes the reasons for the project and discusses the differences between the new hedge accounting model and current requirements under IAS 39.

**Proposed hedge accounting review draft**
The soon-to-be-released IASB review draft on hedge accounting will allow many entities to better reflect their risk management activities in the financial statements. The review draft is designed to provide a stronger link between an organization’s risk management activities, the rationale for hedging and the impact on the financial statements.

The IASB’s new hedge accounting model in the review draft is based more on principle, less complex, more linked to an entity’s risk management activities and can be consistently applied by all industry sectors. The current hedge accounting model includes complex rules and prescriptive hedge effectiveness testing that often result in an entity not being able to apply hedge accounting to its economic hedging relationships resulting in additional “volatility” in profit or loss.

Entities in Greater China are expected to significantly benefit from a number of aspects in the review draft. For example, the ability to include a derivative within a hedged item, referred to as an aggregated exposure, would make hedge accounting easier to achieve, implement and manage for entities in Greater China that enter into foreign-currency-denominated debt financing or foreign-currency-denominated commodity contracts. This is important as the yuan is not freely convertible offshore for funding purposes and many commodity contracts are still denominated in U.S. dollars, in which they are actively traded.

It is expected that non-financial services entities will benefit most from the review draft. These entities typically enter into contracts to buy or sell non-financial items such as commodities that are subject to various types of risks such as foreign exchange risk and price risk. Hedge accounting will now be permitted for individual risk components of non-financial items provided the entity can separately identify and reliably measure the risk component that is actually hedged. As China’s appetite for commodities continues to grow and the nation becomes a global net consumer of commodities, more active hedging strategies will be deployed to better match the economics.

Entities in Greater China that use option-based strategies will also benefit from the review draft. Under the current hedge accounting requirements, option-based hedging strategies result in significantly more profit or loss volatility even if hedge accounting is applied. The board has proposed a change to the treatment of options under hedge accounting such that profit or loss volatility from option-based strategies can be reduced. Although option-based strategies are not yet very common in Greater China, it would now provide more incentive for such strategies to be developed and for the market to respond with more tailored option hedging products.

Although many financial institutions are waiting for the IASB to develop a separate proposal on the so-called “macro hedging” model, they will also benefit from the review draft. Many Asian financial institutions are starting to hedge the credit risk arising from loans, bonds or loan commitments using credit derivatives, which are more common outside Asia. Hedge accounting cannot normally be applied under the current rules.

Lee Yin-toa explains how opportunities and challenges arising from the latest exposure draft could create a fundamental shift in corporate risk management.
The IASB has now decided that an entity may at any time elect to account for a loan or loan commitment at fair value through profit or loss in circumstances where credit-risk hedging is undertaken. Given the competitive landscape for credit in Asia, the trend to use credit derivatives to better manage credit risk would be a matter of necessity.

Financial institutions in Asia can also expect to benefit from the review draft. Asian financial institutions commonly enter into “funding swap” transactions to manage foreign-exchange risk that arises from borrowing in one currency and lending in another. The review draft proposes a change to the treatment of forward contracts such that the net interest margin can be presented in a way consistent with the underlying economics of “funding swap” transactions.

**Presenting challenges**
The understanding of key improvements of the draft is particularly relevant for accountants, treasurers and all those involved in hedging activities in both financial services and corporate entities. Although the new hedge accounting proposals are more closely aligned with entities’ risk management activities, the draft appears to present some new challenges.

The first is that hedge accounting may no longer be possible in the case of certain risk management objectives. This contrasts with IAS 39, which allows hedge accounting for any eligible hedging instrument and hedged item that are matched with a relationship that complies with the 80 percent to 125 percent effectiveness test. This applies even in cases when the relationship does not align with an entity’s actual risk management strategy.

The second challenge is that, in relation to hedging risk components, there are several practical issues in identifying the valid risk components and measuring them reliably as required by the exposure draft, especially when the components are not contractually specified. The IASB clarified that the market structure is key to determining whether an eligible risk component exists.

The final standard will include additional guidance and illustrative examples. For example, the final standard will include a rebuttable presumption that non-contractually specified inflation risk will usually not be an eligible hedged item. Examples of two scenarios will be provided, one in which an inflation risk component may be eligible for hedge accounting and another where it may not.

The third challenge created by the draft is the replacement of the prospective and retrospective 80 percent to 125 percent effectiveness test with the requirement for the hedging relationship to meet the effectiveness criteria:

- If there is an economic relationship between the hedged item and the hedging instrument
- If applying the actual quantities used, results in weightings of the hedged item and the hedging instrument (the hedge ratio) that would not deliberately create hedge ineffectiveness
- If the effect of credit risk does not dominate the value changes that result from the economic relationship

**Conclusion**
The draft provides more opportunities to better align hedge accounting and economic hedging activities. Entities in both financial services and corporate sectors may want to review their current economic hedging activity to identify new opportunities. They may also want to revisit their risk management objectives and strategies and clarify them as necessary to apply hedge accounting under the new model.

Finally, entities could facilitate a smoother transition by determining what hedge relationships will need to be designated in the future and by developing the related hedge documentation by the mandatory adoption date of 1 January 2015.

Given the changes proposed by the IASB, organizations are encouraged to analyze the review draft in detail to understand the impact of the new hedge accounting model on their hedging activities. The review draft presents organizations with opportunities to better align hedge accounting and their economic hedging activities, simplify and reduce operational costs. Organizations could explore and consider the possible benefits from early adoption to better present their risk governance results to calm the market’s concern for Chinese listed companies as capital is moving from the West to the East.