Straight away
An overview of financial reporting developments

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IASB issues exposure draft on hedge accounting

What's new?

On December 9, 2010, the IASB released its exposure draft on hedge accounting. The exposure draft proposes changes that aim to reduce the complexity associated with the current hedge accounting model, align risk management practices with financial reporting, and provide more useful information regarding an entity's risk management strategies.

Key Provisions

Hedge effectiveness tests and eligibility for hedge accounting
The proposed guidance relaxes the requirements for hedge effectiveness assessment and consequently, the eligibility for hedge accounting. Under the current hedging rules, the hedge must both be expected to be highly effective (a "prospective" test) and be demonstrated to have actually been highly effective (a "retrospective" test) with "highly effective" defined as a "bright line" quantitative test of 80-125%. The exposure draft replaces this guidance with a requirement for the hedge to be designated so as to be neutral and unbiased, and in a way that minimizes expected ineffectiveness. This could be demonstrated qualitatively or quantitatively, depending on the characteristics of the hedge. For example, in a simple hedge where all the critical terms match, a qualitative test might be sufficient. Any hedge ineffectiveness must still be measured and reported in net income.

Hedged items
A number of changes are proposed to the rules for determining what can be designated as a hedged item. For example, the exposure draft proposes that risk components can be designated for non-financial items provided the risk component is separately identifiable and measurable. In addition, the exposure draft would make the hedging of groups of items more flexible, although it does not cover macro hedging, which will be the subject of a separate exposure draft in 2011**.**

Hedging instruments
The proposed guidance relaxes the rules on using purchased options and non-derivative financial instruments as hedging instruments. For example, under the current hedging rules, the time value of purchased options is recognized on a mark-to-market basis in net income. In contrast, the exposure draft proposes that the initial time value (that is, the premium paid) will be recognized in net income–either over the period of the hedge if the hedge is time related, or when the hedged transaction affects net income if the hedge is transaction related. Any changes in the option's fair value associated with time value will be recognized in other comprehensive income (OCI).

Presentation and disclosure

The proposed guidance changes the presentation of fair value hedge accounting. The hedged item in such hedges will no longer be adjusted for changes in fair value attributable to the hedged risk. Instead, those fair value changes will be presented as a separate line item in the balance sheet. Also, only the ineffective portion of the hedge will be reflected in net income with the effective portion recognized in OCI, an approach similar to the current cash flow hedge model.

Am I affected?

All entities that prepare their financial statements in accordance with IFRS and engage in risk management activities regardless of whether they use hedge accounting today will potentially be affected by the changes.

The new requirements are proposed to be effective for accounting periods beginning on or after January 1, 2013, with earlier application permitted. However, the IASB has recently issued a discussion paper on effective dates and transition, the results of which may impact the effective date of the proposed hedge accounting guidance.

We also understand that the FASB is planning to seek feedback from its constituents on the IASB's exposure draft. U.S. companies should remain tuned to the FASB's development in this area and may begin to consider the implications of the IASB's proposed model on their existing hedging strategies.

What do I need to do?

The comment letter period ends on March 9, 2011, and a final standard is expected mid-2011. Given the potential impact on accounting and operations, management should assess the implications of the proposals on existing hedging strategies and consider commenting on the exposure draft.

If you have questions about this issue, please contact the PwC IFRS team or your engagement partner.