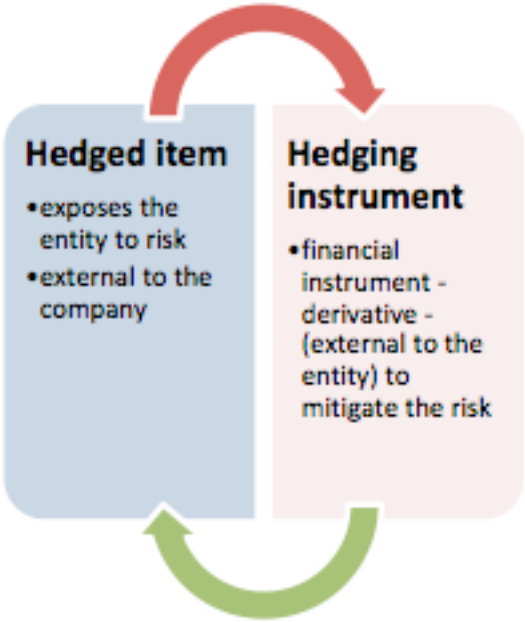
COLLEGE OF ACCOUNTING

FINANCIAL REPORTING | ADVANCED

Video Transcription: Hedge Accounting

Companies are exposed to financial risks – think of a company that imports products in US$ – the company is exposed to changes in the US$ price as well as exchange rate movements. These exposures introduce volatility, which, in most cases, will impact financial performance through profit/loss.

Many companies choose to use financial instruments, generally derivatives, as a way of mitigating this risk exposure. A derivative is an instrument that's value is derived from an underlying position. So, if you want to mitigate the risk of foreign exchange, you use an instrument such as a forward exchange contract whose value is linked to changes in the foreign exchange rate, but will move in the opposite direction to the impact of the exchange rate change. This is hedging, which is a bit like insurance. This video looks at how to account for these hedges in a way that reflects how the risk is being managed.

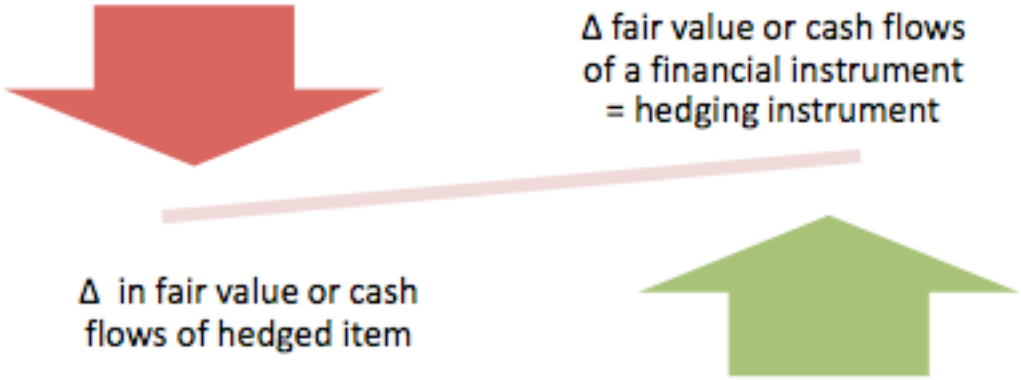


A common example is hedging a foreign currency creditor with a forward exchange contract. The creditor is the hedged item and the FEC, which is a derivative whose value is linked to foreign exchange rates, is the hedging instrument.

IFRS sets out guidance for accounting for these hedges. This video looks at hedge accounting in terms of IFRS9 at a high level.

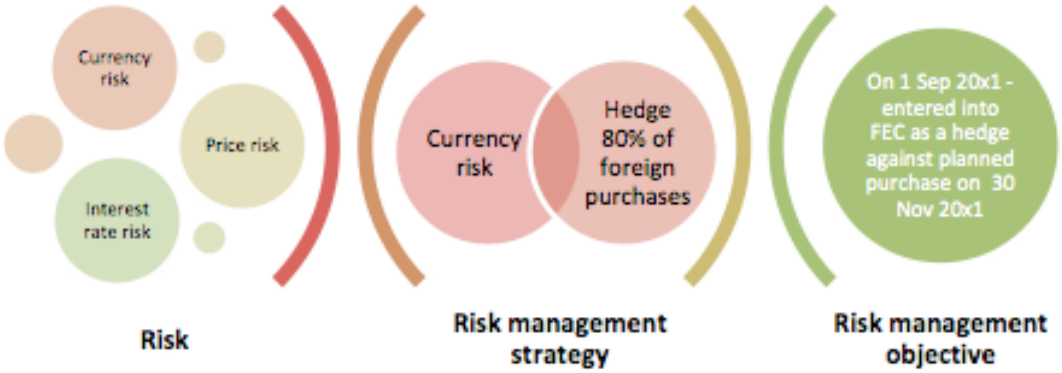
The two most important concepts from IFRS 9 are:

- The notion of economic offset i.e. changes in the fair value or cash flows of a financial instrument have an opposite effect to (and therefore offset) the changes in the fair value or cash flows of the risk exposure (hedged item).
- The financial reporting must reflect the company's risk management activities.



Let's think of an example

An entity is exposed to various financial risks. Currency risk is the major one. The company's strategy is to hedge 80% of its foreign purchases. In respect of a planned inventory purchase on 30 November 20x1, the entity's risk-management objective is to enter into a FEC on 1 September 20x1.



So, in our example, the hedging relationship is established on 1 September 20x1 in respect of the planned purchase of inventory and the FEC. Let's assume the transaction is for purchase of inventory for $1m. The forward rate is R10/$ on 1 September 20x1. On 30 November 20x1, the company acquires the inventory, settles the amount to the supplier and settles the FEC, when the spot rate is R11/$. The entity has a 31 December year-end. All inventory is sold in January 20x2.

Purchasing inventory with a $ price introduces currency risk if there is a time lag between deciding to make the purchase and paying the $ price. An FEC to buy $ is therefore an effective hedging tool to mitigate that risk. If the Rand weakens against the $, the entity will pay more to the foreign supplier and suffer a loss, but will make a gain on the FEC.

Using normal accounting principles:

	01/09/x1	30/11/x1		30/11/x1	January x2
	-	Dr. Bank 1m Cr. Foreign exchange gain (P/L) 1m		Dr. Inventory 11m Cr. Bank 11m	Dr. COS 11m Cr. Inventory 11m
Impact on SFP					
x1		Bank +R1m		Inventory +R11m Bank –R11m	
x2					Inventory – R11m
Impact on P/L					
x1		+R1m		-	
x2					-R11m
	Cumulative impact on P/L by 1/x2				-R10m

Using Hedge Accounting:

	01/09/x1	30/11/x1		30/11/x1	January x2
		Dr. Bank 1m Cr. Cash flow hedge (OCI) 1m		Dr. Inventory 11m Cr. Bank 11m	Dr. COS 10m Cr. Inventory 10m
		Dr. Cash flow hedge (OCI) 1m Cr. Cash flow hedge reserve (E) 1m			
		Dr. Cash flow hedge reserve 1m Cr. Inventory 1m			
Overall Impact on SFP					
x1		Bank +R1m Inventory – R1m		Inventory +R11m Bank –R11m	
x2					Inventory – R10m
Impact on P/L					
x1		-		-	-
x2		-		-	-R10m

1. The planned transaction i.e. the purchase of the inventory can only be recognised when the entity takes control of the inventory which is 30/11x1
2. So, in this case, hedge accounting changes the normal rules in respect of the FEC.
3. Initially, the gains or losses relating to the FEC are deferred in OCI, which is closed off to an equity account (CFHR).
4. When the entity recognises the inventory, the amount deferred in the hedging reserve is transferred to inventory.

5. The inventory is reflected at its economic cost – when the entity entered into the FEC, it effectively fixed the price at R10m (based on a forward rate of R10/$).
6. The cumulative impact by the 20x2 is the same as under the 'normal' accounting rules, but all of the impact hits the P/L when the inventory is sold. We have matched the risk exposure (foreign currency risk associated with the inventory purchase) and how it was managed (FEC).

Hedging Instruments

Remember that the hedging instrument is the financial instrument used to mitigate the risk. IFRS 9 allows the following financial instruments to be hedging instruments

- ✓ Derivative (e.g. FEC)
- ✓ Non-derivative
  - ✓ Measured at FVTPL
  - × Financial liability at FVTPL
- ✓ Not measured at FVTPL, but there is a foreign currency component e.g. a foreign loan
  - × Equity instrument at FVTOCI

This makes sense as they allow for the offsetting effect from fair value changes as discussed earlier.

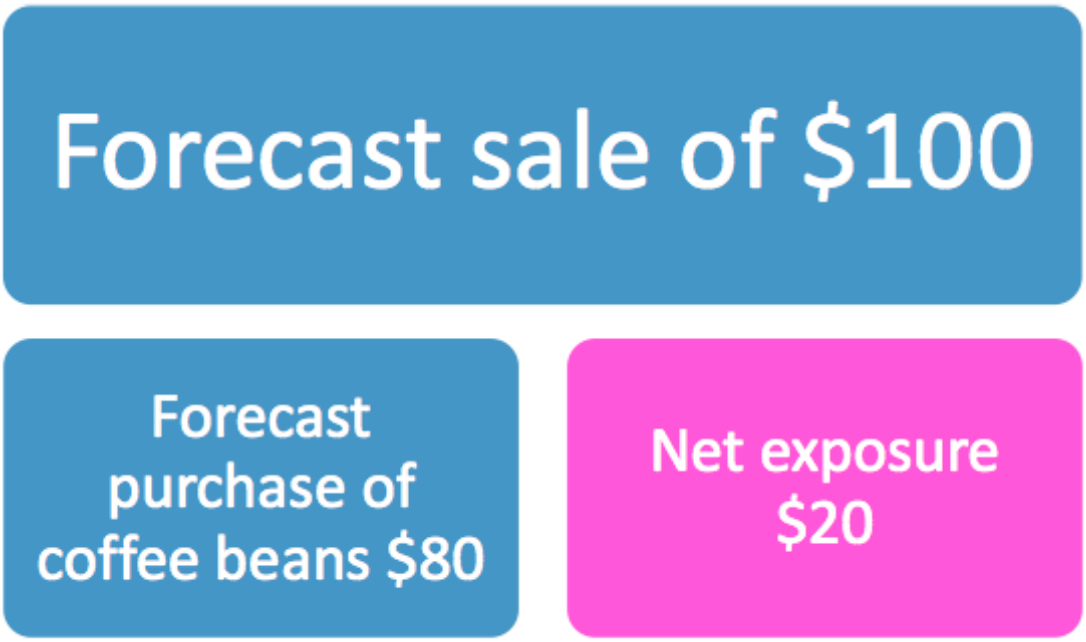
Hedged Items

A hedged item is the item that results in the risk exposure.

1. This can be a recognised asset or liability, a derivative or a future transaction or a net investment in a foreign operation. IFRS 9 allows hedged items to be individual items, groups of items or risk components. The following are examples that illustrate the link between the risk exposure, the management of that risk and the hedging instrument.

2. Think of a SA entity that is importing coffee beans. The price is denominated in $.
    - The purchase of the coffee beans is a hedged item.
    - Alternatively, the purchase of the coffee beans comprises various risk components:

    - Alternatively, the entity could fix the $ price by entering into a futures contract. The entity is now exposed to only the currency risk.
    - The entity could be importing coffee beans and exporting another good (priced in $). The net exposure could be a hedged item.



Accounting depends on type of hedge. Three types:

Fair value	Hedges of exposure to fair value changes relating to hedged item	• Hedging instrument at FVTPL • Hedged item at FVTPL (FV hedge accounting changes normal accounting for hedged item) *There is an exception that applies to investments in equity instruments measured at FVTOCI (in this case the hedging instrument and the investment are measured at FVTOCI)*
Cash flow	Hedges of exposure to variability in future cash flows relating to hedged item	• Hedging instrument at FV, with adjustments in OCI • As cannot recognise the future cash flows (until they actually occur), CF hedge accounting changes normal accounting for hedging instrument
Hedge of a net investment in a foreign operation	Hedges of exposure to foreign currency risk relating to foreign operation	Similar to cash flow hedges

Critical Thinking and Conclusion

In deciding on the type of hedge, think about the risk that the entity is exposed to and how that risk is being managed. For example, think of an interest-bearing loan:

- If the loan has a variable interest rate, changes in interest rates will cause a change in the interest payments. The company is exposed to variability in future cash flows. A cash flow hedge is appropriate.
- If the loan has a fixed interest rate, the entity is not exposed to changes in interest rates. However, the fair value of a loan will change when interest rates change, hence a fair value hedge is appropriate.

The purpose of this video was a high-level overview of hedge accounting in terms of IFRS9. It did not consider:

- The criteria that must be met to apply hedge accounting, including the concept of hedge effectiveness
- The specific details and examples of applying the accounting mechanics for different types of hedges.
- Some of the more complex issues, such as the time value effect of options
- Discontinuing hedge accounting
- Presentation and disclosure

Thank you.