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IASBriefing

This special issue of IASB*riefing* summarises the key points of the latest amendments to IAS 39 *Financial Instruments: Recognition and Measurement*.

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Overview

On 31 March 2004, the International Accounting Standards Board (IASB) issued a further amendment to IAS 39 (December 2003). The revisions made focus on (i) amendments to the 'prospective effectiveness test', and (ii) guidance on fair value hedge accounting for a portfolio hedge of interest rate risk (commonly known as 'macro hedging').

The amendments to the prospective effectiveness test make it easier for both banks and corporates to achieve hedge accounting in some circumstances. These amendments, which were not proposed in the exposure draft, were made to eliminate a difference with US GAAP.

The macro hedging amendments provide a model under which financial institutions may apply fair value hedge accounting for interest rate risk management.

This amendment must be applied for annual reporting periods beginning on or after **1 January 2005**.

The main impacts of the revision are summarised below.

Prospective effectiveness test

Paragraph AG105 of IAS 39 (December 2003) previously stated that a hedge qualifies for hedge accounting only if it met both of the following conditions:

- it is expected to be highly effective (the prospective effectiveness test). This test would have been satisfied if the entity could expect changes in the fair value of cash flows of the hedged item that are attributable to the hedged risk to be ***almost fully offset*** by the changes in the fair value or cash flows of the hedging instrument; and

- it was determined to have been highly effective (the retrospective effectiveness test). This test would have been satisfied if the actual results of the hedge were within a range of 80 to 125 per cent.

KPMG's bi-monthly update on International Financial Reporting Standards (IFRSs)

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The IASB decided to relax the prospective effectiveness test, but also considered earlier concerns raised that an entity might deliberately under-hedge to reduce reported ineffectiveness. To address both points, the IASB decided to make the following amendments to IAS 39 to:

- remove the words ***almost fully offset*** from the prospective effectiveness test in paragraph AG105, and replace them with a requirement that the hedge is expected to be ***highly effective*** in achieving offsetting changes in fair value or cash flows attributable to the hedged risk;

- include guidance on the application of the prospective effectiveness test, namely that the entity may, consistent with its risk management processes, demonstrate that the hedge is expected to be highly effective for at least the period until the amount of the hedging instrument is next adjusted; it no longer will be necessary to demonstrate this expectation over the full life of the hedge; and

- insert an additional paragraph in the Application Guidance to IAS 39 (AG107A) which states that if an entity hedges less than 100 per cent of the exposure on an item (e.g., 85 per cent), it must designate the hedged item as being the hedged per cent of the exposure (e.g., 85 per cent) and measure ineffectiveness based on the change in that designated per cent exposure.

The December 2003 revision to IAS 39 clarified that an entity may choose a hedge ratio of greater or less than one-to-one if that improves the expected effectiveness of the hedge. The amendment added application guidance by noting that this may be achieved by performing a regression analysis. If there is a valid statistical relationship between the two variables, the slope of the regression line can be used to establish the hedge ratio that will maximise the expected effectiveness.

Combining hedging instruments

The amendment clarifies that two or more derivatives (i.e., a portfolio of derivatives) or, in the case of a hedge of currency risk, two or more non-derivatives (or proportions of them), or a combination of derivatives and non-derivatives (or proportions of them), may be viewed in combination and jointly designated as the hedging instrument. This is allowed even when the risk(s) arising from some derivatives offset(s) those arising from others.

While two or more instruments (or proportions of them) may be designated as the hedging instrument, *none* of these instruments may be a written option or a net written option since IAS 39 does not permit such options to be designated as hedging instruments.

Application of the revised prospective effectiveness test

The relaxation of the ‘prospective effectiveness test’ to one where the entity is required to prove that the hedge is expected to be highly effective, rather than almost fully offset, should result in a greater tolerance for ineffectiveness and thus enable entities to better meet the hedge criteria in respect of hedging transactions of non-financial assets and non-financial liabilities. We expect that in practice *highly effective* will be interpreted as correlation within a range of 80 to 125 per cent for both the ‘retrospective’ and ‘prospective effectiveness tests’. The following examples identify the problem before the changes were made.

Under Paragraph 82 of IAS 39, if the hedged item is a non-financial asset or non-financial liability, it may be designated as a hedged item only (i) for foreign currency risks, or (ii) in its entirety for all risks, because of the difficulty of isolating and measuring the appropriate portion of the cash flows or fair value changes attributable to specific risks other than foreign currency risks.

In practice this gives rise to problems, particularly in respect of commodity hedging, because exchange-traded commodity derivatives refer to standard qualities and grades of that commodity, whereas the actual product (the delivery of which is the subject of the hedge) will differ depending upon specific future conditions, such as where the commodity comes from, purity of the actual product, harvest yield, or even consumer demand. Commodities that are traded in standardised forms and thus may be the subject of these types of hedging relationships include wheat, corn, coffee beans, other agricultural products and metals.

Further, paragraph 82 of IAS 39 prohibits an entity from designating a standardised commodity component, for example price risk of the actual purchase/sale, as the hedged item. Consequently, an entity will be obliged to designate the actual purchase/sale in its entirety as the hedged item. Owing to differences between the hedging instrument based on the standard commodity and the hedged item, hedge ineffectiveness is likely to arise. It also is difficult to prove, on a prospective basis, that the changes in the fair value or cash flows of the actual purchase/sale that are attributable to the hedged risk will be ***almost fully offset*** by the changes in the fair value or cash flows of the exchanged-traded commodity derivative.

A similar issue arises where an entity wishes to hedge an element of a non-financial item. For example, the price of jet fuel is derived from the prices of its various components, each of which is traded and thus has a quoted market price. An entity wishing to hedge its purchase of jet fuel may do so by hedging components of the jet fuel price (e.g., brent crude or gas oil) or hedging the entire price of the jet fuel. While economic hedges are available for components of the jet fuel price, IAS 39 prohibits hedge accounting for components of risk for non-financial items. Consequently, the entire price risk of the jet fuel purchase must be designated as the hedged item. In order to meet the hedging criteria, the entity must demonstrate a high degree of correlation between the price of the hedged element and the jet fuel price. Since the prices of the individual components of jet fuel generally move independently, it may be difficult to demonstrate (on a prospective basis) that the changes in the fair value or cash flows of the jet fuel price will be ***almost fully offset*** by the changes in the fair value or cash flows of the element-specific hedging instrument.

The amendment also will make it more likely that hedge accounting can be achieved for a number of interest rate hedges using swaps

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where, for example, ineffectiveness arises due to differences between (i) the fixed rate in the swap and that on the hedged item, or (ii) in the timing of cash flows on the hedged item and those on the swap. Although ineffectiveness will be recognised in profit or loss, it is less likely that the hedge relationship will fail entirely to qualify for hedge accounting.

Macro hedging

Hedged items

The revisions enable fair value hedge accounting to be used more readily for a portfolio hedge of interest rate risk. It broadens the definition of 'qualifying hedged items' to include (in a portfolio hedge of interest rate risk only) a portion of a portfolio of financial assets or financial liabilities that share the risk being hedged. Consequently, the hedged item may be designated as an amount of currency (e.g., an amount of Euros, GBP, or US dollars) rather than as individual assets or liabilities.

Although the portfolio may, for risk management purposes, include assets *and* liabilities, the amount designated as the hedged item is an amount of assets *or* an amount of liabilities. Designation of a net amount is not permitted. It follows that all of the assets or liabilities from which the hedged amount is drawn must be:

- items whose fair value changes in response to changes in the interest rate being hedged; and
- items that could have qualified for fair value hedge accounting if they had been hedged individually.

The amendment specifically notes that a financial liability with a demand feature cannot qualify for fair value hedge accounting for any time period beyond the shortest period in which the holder can demand payment. This is because IAS 39 specifies that the fair value of such a liability is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid.

Furthermore, the entity may hedge only a portion of the interest rate risk associated with the designated amount. For prepayable items the amendment permits this to be achieved by designating the hedged item in terms of the change in fair value that is attributable to changes in the hedged interest rate on the basis of *expected,* rather than *contractual*, repricing dates.

However, the effect that changes in the hedged interest rate have on those expected repricing dates must be included when determining the change in the fair value of the hedged item. Consequently, if a portfolio containing prepayable items is hedged with a non-prepayable derivative, ineffectiveness will arise as the dates on which items are expected to prepay are revised (e.g., to reflect a change in expected prepayments), or actual prepayment dates differ from those expected.

Conversely, changes in expected repricing dates that (i) clearly arise from factors other than changes in the hedged interest rate, and (ii) can be separated reliably from changes that are attributable to the hedged interest rate, are excluded when determining the change in the fair value of the hedged item since they are not attributable to the hedged risk.

When the hedged item is designated with respect to the risks associated with only a portion of its cash flows or fair value, effectiveness is measured by comparing the change in the fair value or cash flows of that portion with the change in fair value or cash flows of the designated hedging instrument.

It should be noted that if a portion of the cash flows of a financial asset or a financial liability is designated as the hedged item, that designated portion must be *less than* the total cash flows of the asset or liability. For example, a liability that bears interest at three per cent cannot be separated, for hedge accounting purposes, into a portion paying LIBOR at five per cent and a negative spread.

Hedging instruments

The amendment indicates that if a hedging instrument hedges the designated amount for more than one repricing time period, it is allocated to all of the time periods that it hedges. However, it is important to note that the entire hedging instrument must be allocated to those repricing periods since IAS 39 does not permit a hedging relationship to be designated for only a portion of the time period during which a hedging instrument remains outstanding.

Assessing ineffectiveness

When macro hedging is used, ineffectiveness is measured by distinguishing revisions to the estimated repricing dates of existing assets or liabilities from the origination of new assets or liabilities, with only the former giving rise to ineffectiveness. This ineffectiveness is determined either:

- as the difference between the change in the fair value of the hedging instrument and the change in fair value of the entire hedged item that is attributable to the changes in the hedged interest rate (i.e., a direct calculation); or
- by using the following approximation:
  - calculate in each repricing time period the percentage of assets or liabilities that was hedged on the basis of the estimated repricing dates at the last date of effectiveness testing;
  - apply the above percentage to the revised estimate of the amount in that repricing time period to calculate the amount of the hedged item based on the revised estimate;
  - calculate the change in the fair value of the revised estimate of the hedged item that is attributable to the hedged risk; and
  - determine the ineffectiveness as the difference between the amount determined in the previous step and the change in the fair value of the hedging instrument.

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Presentation of fair value hedge adjustment

The gain or loss attributable to the hedged item, which is a portion of a portfolio of financial assets and/or liabilities, should be presented either:

- in a single separate line item within assets, for those repricing time periods for which the hedged item is an asset; or
- in a single separate line item within liabilities, for those repricing time periods for which the hedged item is a liability.

These separate line items must be presented next to financial assets and liabilities. Amounts included in these line items must be removed from the balance sheet when the assets or liabilities to which they relate are derecognised. To achieve this, it is necessary to know the repricing time period(s) to which derecognised items were scheduled.

Therefore, when an item is derecognised, it is removed from the time period in which it was included, if that can be determined. If not, if the derecognition resulted from higher than expected prepayments, it is removed from the earliest time period, or it is allocated to all time periods containing the derecognised item on a systematic and rational basis if the item was sold or became impaired.

Amortisation of the fair value adjustment

Any adjustment made, in the course of applying fair value hedge accounting, to the carrying amount of a hedged financial instrument that is measured at amortised cost (or, in the case of a portfolio hedge of interest rate risk, to the separate balance sheet line item) is amortised to profit or loss. Amortisation begins at the latest when the hedged item ceases to be part of a hedging relationship. IAS 39 (December 2003) requires this to be done by recalculating the effective interest rate at the date that amortisation begins.

However, the amendment acknowledges that amortisation using a recalculated effective interest rate may not be practicable in the case of a fair value hedge of the interest exposure of a portfolio of financial assets or financial liabilities. In this case the adjustment is amortised on a straight-line basis, so that it is amortised fully by expiry of the relevant repricing time period.

Redesignation

An entity may wish to apply the macro hedging approach in the amendment to a portfolio hedge that previously had been accounted for under IAS 39 as a cash flow hedge. This may be achieved by discontinuing the previous designation of a cash flow hedge in accordance with the current provisions of IAS 39. The entity then would redesignate the hedge as a fair value hedge and apply the macro hedging approach introduced by the amendment.

Transition provisions

The amendment must be applied for annual reporting periods beginning on or after 1 January 2005. Earlier application is permitted, however an entity may not apply the amendment for annual reporting periods beginning before 1 January 2005 unless it also applies IAS 39 (December 2003) and IAS 32 (December 2003).

Changes from the exposure draft (ED)

Some of the key differences from the ED are discussed below, including some changes that had not been proposed originally.

- Hedged items – the amendment expands on the principle that fair value hedge accounting cannot be used for financial liabilities with a demand feature.
- Designation of a portion of the exposure – the amendment requires that if a portion of the exposure on a financial asset or financial liability is designated as the hedged item, that designated exposure must be less than the total exposure inherent in the asset or liability. The ED did not address this issue.
- Hedging instruments – the amendment addresses the use of a hedging instrument to hedge the designated amount for more than one repricing time period. The ED did not cover this issue.
- Assessing ineffectiveness – the amendment indicates that ineffectiveness may be calculated directly as the difference between the change in fair value of the hedging instrument and the change in fair value of the entire item that is attributable to changes in the hedged interest rate. The ED discussed only the 'approximation' approach to calculating effectiveness.
- Removal of the separate line item from the balance sheet – when removing amounts from the separate line items in the balance sheet, if an entity is unable to determine in which time period the derecognised item was included, the ED indicated that, upon derecognition, such an item (e.g., a loan) should be removed from the earliest available time period. The amendment clarifies that this should be done only when derecognition resulted from higher than expected prepayments. Otherwise (i.e., in the event of sale or impairment), the derecognition of the hedged item should be allocated to all relevant time periods on a systematic and rational basis.
- Amortisation of the fair value adjustment – the amendment addresses amortisation of the adjustment to the separate balance sheet item arising from fair value hedge accounting a portfolio hedge of interest rate risk. This issue was not covered in the ED.

If you would like further information on any of the matters discussed in this IASB*riefing*, please talk to your usual local KPMG contact or call any of our member firm offices.

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