Hedge Accounting under HKAS 39[1]

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HKAS 30 sets out hedge accounting which recognises the offsetting effects on profit or loss of changes in the fair values of

(a) the hedging instrument, and

(b) the hedged item.

In order to qualify for hedge accounting, an entity must establish and document a hedging relationship and fulfill certain criteria. HKAS 39 sets out 3 types of hedging relationships to which hedge accounting may be applied.

1. What is Hedge Instrument?

A hedging instrument is

(a) a designated derivative or,

(b) a designated non-derivative financial asset or non-derivative financial liability (for a hedge of the risk of changes in foreign currency exchange rates only)

whose fair value or cash flows are expected to offset changes in the fair value or cash flows of a designated hedged item. *(HKAS 39 para. 9)*

2. What is Hedge Item?

A hedged item is an asset, liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation that

(a) exposes the entity to risk of changes in fair value or future cash flows and

(b) is designated as being hedged. *(HKAS 39 para. 9)*

It implies that a hedged item is an exposure to risk to an entity that attempt to hedge. Firm commitment, probable forecast transaction and net investment in a foreign operation are defined in HKAS 39 and HKAS 21 *The Effects of Changes in Foreign Exchange Rates* as follows:

A firm commitment is a binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates. *(HKAS 39 para. 9)*

A forecast transaction is an uncommitted but anticipated future transaction. *(HKAS 39 para. 9)*

Net investment in a foreign operation is the amount of the reporting entity's interest in the net assets of that operation. Foreign operation is an entity that is a subsidiary, associate, joint venture or branch of a reporting entity, the activities of which are based or conducted in a country or currency other than those of the reporting entity. *(HKAS 21 para. 8)*

[1] *This note is sourced from HKAS 39 Financial Instruments: Recognition and Measurement. While the note is aimed at covering all critical points of HKAS 39, a complete and comprehensive coverage should still be the original standard, HKAS 39.*

3. Types of Hedging Relationships

Hedging relationships are of 3 types:

(a) fair value hedge:

a hedge of the exposure to changes in fair value of

(i) a recognised asset or liability or an unrecognised firm commitment, or

(ii) an identified portion of such an asset, liability or firm commitment,

that is attributable to a particular risk and could affect profit or loss.

(b) cash flow hedge:

a hedge of the exposure to variability in cash flows that

(i) is attributable to a particular risk associated with a recognised asset or liability (such as all or some future interest payments on variable rate debt) or a highly probable forecast transaction and

(ii) could affect profit or loss.

(c) hedge of a net investment in a foreign operation as defined in HKAS 21. *(HKAS 39 para. 86)*

A hedge of the foreign currency risk of a firm commitment may be accounted for as a fair value hedge or as a cash flow hedge.

4. Criteria for Hedge Accounting

A hedging relationship qualifies for hedge accounting if, and only if, all of the following conditions are met.

(a) At the inception of the hedge there is formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge.

That documentation shall include identification of the hedging instrument, the hedged item or transaction, the nature of the risk being hedged and how the entity will assess the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value or cash flows attributable to the hedged risk.

(b) The hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk, consistently with the originally documented risk management strategy for that particular hedging relationship.

(c) For cash flow hedges, a forecast transaction that is the subject of the hedge must be highly probable and must present an exposure to variations in cash flows that could ultimately affect profit or loss.

(d) The effectiveness of the hedge can be reliably measured, i.e. the fair value or cash flows of the hedged item that are attributable to the hedged risk and the fair value of the hedging instrument can be reliably measured.

(e) The hedge is assessed on an ongoing basis and determined actually to have been highly effective throughout the financial reporting periods for which the hedge was designated. *(HKAS 39 para. 88)*

Hedge effectiveness is the degree to which changes in the fair value or cash flows of the hedged item that are attributable to a hedged risk are offset by changes in the fair value or cash flows of the hedging instrument. *(HKAS 39 para. 9)*

A hedge is regarded as highly effective only if both of the following conditions are met:

(a) At the inception of the hedge and in subsequent periods, the hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk during the period for which the hedge is designated.

Such an expectation can be demonstrated in various ways, including a comparison of past changes in the fair value or cash flows of the hedged item that are attributable to the hedged risk with past changes in the fair value or cash flows of the hedging instrument, or by demonstrating a high statistical

correlation between the fair value or cash flows of the hedged item and those of the hedging instrument. The entity may choose a hedge ratio of other than one to one in order to improve the effectiveness of the hedge.

(b) The actual results of the hedge are within a range of 80-125 per cent.

For example, if actual results are such that the loss on the hedging instrument is $120 and the gain on the cash instrument is $100, offset can be measured by $120/$100, which is 120%, or by $100/$120, which is 83%. In this example, assuming the hedge meets the condition in (a) the entity would conclude that the hedge has been highly effective.

Effectiveness is assessed, at a minimum, at the time an entity prepares its annual or interim financial statements. *(HKAS 39 para. AG105 – 106)*

5. Hedging accounting

5.1 Fair Value Hedges

If a fair value hedge meets the criteria for hedging accounting (see section 4 above) during the period, it shall be accounted for as follows:

(a) the gain or loss from remeasuring the hedging instrument at fair value (for a derivative hedging instrument) or the foreign currency component of its carrying amount measured in accordance with HKAS 21 (for a non-derivative hedging instrument) shall be recognised in profit or loss; and

(b) the gain or loss on the hedged item attributable to the hedged risk shall adjust the carrying amount of the hedged item and be recognised in profit or loss. This applies if the hedged item is otherwise measured at cost.

Recognition of the gain or loss attributable to the hedged risk in profit or loss applies if the hedged item is an available-for-sale financial asset. *(HKAS 39 para. 89)*

5.2 Cash Flow Hedges

If a cash flow hedge meets the criteria for hedging accounting (see section 4 above) during the period, it shall be accounted for as follows:

(a) the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge shall be recognised directly in equity through the statement of changes in equity; and

(b) the ineffective portion of the gain or loss on the hedging instrument shall be recognised in profit or loss. *(HKAS 39 para. 95)*

5.2.1 Hedge of forecast transaction resulting in recognition of financial instruments

If a hedge of a forecast transaction subsequently results in the recognition of a financial asset or a financial liability, the associated gains or losses that were recognised directly in equity shall be reclassified into profit or loss in the same period or periods during which the asset acquired or liability assumed affects profit or loss (such as in the periods that interest income or interest expense is recognised).

However, if an entity expects that all or a portion of a loss recognised directly in equity will not be recovered in one or more future periods, it shall reclassify into profit or loss the amount that is not expected to be recovered. *(HKAS 39 para. 97)*

5.2.2 Hedge of forecast transaction resulting in recognition of non-financial instruments

If a hedge of a forecast transaction subsequently results in the recognition of a non-financial asset or a non-financial liability, or a forecast transaction for a non-financial

asset or non-financial liability becomes a firm commitment for which fair value hedge accounting is applied, then the entity shall adopt (a) or (b) below:

(a) It reclassifies the associated gains and losses that were recognised directly in equity into profit or loss in the same period or periods during which the asset acquired or liability assumed affects profit or loss (such as in the periods that depreciation expense or cost of sales is recognised).

However, if an entity expects that all or a portion of a loss recognised directly in equity will not be recovered in one or more future periods, it shall reclassify into profit or loss the amount that is not expected to be recovered.

(b) It removes the associated gains and losses that were recognised directly in equity, and includes them in the initial cost or other carrying amount of the asset or liability. *(HKAS 39 para. 98)*

An entity shall adopt either (a) or (b) in the above paragraph as its accounting policy and shall apply it consistently to all hedges to which the above paragraph relates. *(HKAS 39 para. 99)*

For cash flow hedges other than those covered by in above sections 5.2.1 and 5.2.2, amounts that had been recognised directly in equity shall be recognised in profit or loss in the same period or periods during which the hedged forecast transaction affects profit or loss (for example, when a forecast sale occurs). *(HKAS 39 para. 100)*

5.3 Hedges of a Net Investment in a Foreign Operation

Hedges of a net investment in a foreign operation, including a hedge of a monetary item that is accounted for as part of the net investment (see HKAS 21), shall be accounted for similarly to cash flow hedges:

(a) the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge shall be recognised directly in equity through the statement of changes in equity; and

(b) the ineffective portion shall be recognised in profit or loss.

The gain or loss on the hedging instrument relating to the effective portion of the hedge that has been recognised directly in equity shall be recognised in profit or loss on disposal of the foreign operation. *(HKAS 39 para. 102)*

6. Discontinuing Hedge Accounting

An entity shall discontinue prospectively the hedge accounting if:

(a) the hedging instrument expires or is sold, terminated or exercised;

(b) the hedge no longer meets the criteria for hedge accounting;

(c) the entity revokes the designation; or

(d) in case of a cash flow hedge, the forecast transaction that is hedged is no longer expected to occur.