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Hedge Accounting

Outlook for proposed changes from the IASB
December 8, 2010



What would you like to grow?

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Agenda

The hedge accounting challenge
IASB direction
Assessment and outlook

The hedge accounting challenge

Does the existence of a hedge justify a unique accounting treatment, and if so, which hedges should qualify?

The core premise of fair value as the appropriate measurement basis for derivatives is a difficult one to challenge. Derivatives can place an organisation in a position of having rights and obligations, that are large in magnitude and semi-liquid. These positions are routinely entered into for nil consideration.

A question of timing

Hedge accounting is a pure timing question. Should unrealised fair value movements be brought to the P&L account as market conditions move, or deferred to be recognised concurrent with the item being hedged?

When derivatives are used for speculation, the rationale for fair value changes to be recorded in P&L is pretty clear. It is when the hedging intent is introduced that things become murky.

The hedge accounting challenge

A rose by any other name – the thorny problem of synthetic instrument accounting

Supporters of the need for hedge accounting often reach for the simplest of comparisons to make their case. For example, the comparison of fixed rate debt, against floating rate debt with a perfectly matching fixed for floating interest rate swap. Citing the identical net cash flows, they argue for a matching accounting outcome.

From a balance sheet management and risk management perspective, derivatives have an important role. In some cases, companies use these instruments to transform items such as borrowings to a suitable currency and interest rate basis.

The question therefore is whether some form of synthetic instrument treatment has a place in the accounting model. More troubling is the question of how wide this doorway should be left once opened.

IAS 39 – hedge accounting. A great deal of good.

In debating the issues associated with IAS 39, the rarest of discussion points is that of the good which it has done for accounting, and for all financial statement users.

- It has provided great transparency in relation to derivatives. These are way too important to be kept in the shadows
- Management, boards, investors, creditors and others have spent much more time on the question - what are they and why are they here? This is a great moral victory. This victory was won due to the requirement to record non-qualifying derivatives in P&L.
- When it works, it works. In many cases, hedge accounting provides both transparency and accounting / economic alignment. In many cases, good hedges are reported as good hedges and speculation is reported as just that.

The hedge accounting challenge

Where to draw the line on the threshold as to what is an acceptable hedge?



Introduces the risk of earnings management stemming from cherry picking the period in which hedges will be brought to account.

Sound hedges are treated as speculative investments, distorting results and impacting the ability of users to understand the financial statements.

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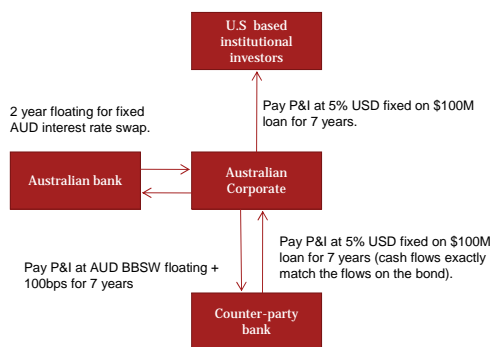
What would you like to grow?

The good and the bad

Currency and interest rate hedging of long term debt (the good)

Large Australian corporates routinely issue bonds in the global capital markets to ensure diversity and tenor of funding.

The funding and risk management steps are well understood and followed quite consistently in practice:



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A gold miner selling a leveraged option on gold (the bad)

A gold mining company has gold reserves expected to last 5 years, with hopes of further discoveries.

The company generates substantial cash to fund its expansion aspirations by selling a leveraged option.

If the gold price is between \$1000 and \$1500 per ounce, the bank can call for the purchase of one ounce at \$1000.

If the gold price exceeds \$1500 per ounce, the bank can call for the purchase of 3 ounces at \$1200 per ounce.

The miner argues the option is a hedge as it is potentially fixing the price at which it is able to sell its gold at an "acceptable level"

In this case, margin calls or production failures will likely spell the demise of the company

Hedge accounting in practice – general areas of challenge

- Understanding hedge accounting results
- Accounting that is inconsistent with sound economic risk management strategies.
- Dubious economic risk management strategies achieving hedge accounting
- Rules based and difficult to apply, inconsistently applied in practice
- The cost of compliance, and scarcity of specialists who know how to navigate the rules
- The hedge accounting overlay – the creation of business units whose sole purpose is to retrofit an accounting solution over a business process to try and achieve the right to report something similar to the economic substance!

Hedge accounting in practice – general areas of challenge

- The tail wagging the dog - accounting volatility has a real or perceived cost of capital impact. The ability to achieve hedge accounting therefore can impact the risk management decision in practice, and can lead to optimal risk management hedges being replaced with those which have a more favorable accounting treatment
- Another less popular alternative is to simply abandon hedge accounting, not because hedging does not take place, but because the accounting is seen as too problematic
- The challenges of hedge accounting can also encourage the use of alternative measures of performance that adjust for hedge accounting impacts

Hedge accounting in practice **specific areas of challenge**

- Effectiveness testing, thresholds, rules, bright lines, consistency.....
- Hedges of foreign currency debt
 - The requirement to record as ineffectiveness some components of fair value movements that some argue are quite arbitrary, for example foreign currency basis risk
 - Substantial problems maintaining accounting in line with the underlying economics when a second hedge such as an interest rate swap is periodically overlayed (IAS 39 precludes a derivative from being included in the hedged item)
 - This area is more important to Australia than many other jurisdictions
 - Applicable to all corporates and banks that fund any part of the balance sheet off shore

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Hedge accounting in practice **specific areas of challenge**

- Hedging components of non-financial items (IAS 39 precludes hedging any component other than FX risk)
 - Impacts miners of base metals who produce concentrates and hedge the contained metal component
 - Impacts mining companies, transport companies, electricity companies and any other significant users (and hedges) of fuels such as diesel
 - Impacts airlines hedging crude oil
 - Impacts producers and consumers of agricultural commodities
 - Impacts manufacturers who buy packaging or other inputs with high commodity content
 - Impacts regulated utilities seeking to hedge the inflation index that is referenced to adjust their revenue stream

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Hedge accounting in practice specific areas of challenge

- Hedging with options
 - The practical restriction on deferring the change in fair value of the extrinsic or time value of an option has widespread impact across the Australian market. Impacts hedges of interest rates, currency and commodities
- De-designations and re-designations
 - For risk management, hedges should be continuously monitored and adjusted to maintain the risk management protection as intended. This might be due to a re-balancing of the portfolio, or a re-financing of a debt facility
 - Preparers are currently paranoid to touch their hedging strategies, as the hedge accounting rules are very brittle, and small changes can have unintended accounting consequences.

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Hedge accounting in practice other areas of challenge

- The requirement for portfolios of items to have similar risk characteristics
 - Can give rise to the requirement to define the hedged item at an excessively granular level. Impacts portfolios of debt and deposits and some commodity hedges
- Hedging translation exposures
 - Currently topical in Australia with the AUD at parity. The issue stands apart from those discussed about (translation versus transaction, absence of a nexus to cash flows).

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The IASB direction – overall approach

- Overall approach:
 - Seeks to link risk management and financial reporting
 - This is what preparers have always asked for, and therefore is likely to be a popular choice
 - A brave new world, where managements (risk management) strategy is used to prescribe the timing of recognition of a transaction
 - Flexibility and a 'broad basis' for achieving hedge accounting
 - What will this look like in practice?

The IASB direction – overall approach

- Effectiveness testing
 - From – “bright line” effectiveness threshold of 80% - 125%
 - to
 - Some combination of a qualitative and quantitative test that references managements intended approach to managing risk

Effectiveness – existing IAS 39

Dollar offset approach:

Interest rate delta (\$ 000)	-100 bps	-50 bps	-25 bps	+25 bps	+50 bps	+100 bps
Hedge item	39	19.2	9.3	-9.3	-19.4	-39.8
Hedging derivative	-37.1	-18.5	-9.2	9.2	18.3	36.4
Prospective effectiveness ratios	-105.1%	-104.0%	-101.1%	-101.1%	-106.1%	109.3%

Effectiveness – existing IAS 39

Regression analysis approach:

Months	Loan fair value	Change in loan FV	Swap fair value	Change in swap FV
M1	10,000,000	-	-	-
M2	10,750,000	750,000	-720,000	-720,000
M3	10,200,000	-550,000	-210,000	510,000
M4	9,990,000	-210,000	9,500	219,500
M5	9,870,000	-120,000	130,000	120,500
M6	9,550,000	-320,000	412,500	282,500
M7	9,750,000	200,000	217,500	-195,000
M8	10,000,000	250,000	-1,150	-218,650
M9	10,050,000	50,000	-49,500	-48,350
M10	10,020,000	-30,000	-26,000	23,500
M11	9,900,000	-120,000	74,000	100,000
M12	9,850,000	-50,000	125,000	51,000

Criteria (Excel formula)	"Price vs price"	"Change in price vs change in price"
F-test (FTEST)	0.85	0.85
Slope coefficient (SLOPE)	-0.944	-0.943

The IASB direction – overall approach

- The current effectiveness testing model is often considered too brittle, resulting in the terrifying plummet to the bottom of the cliff at 79% offset and below.
- The IASB proposals seek to link the effectiveness test more directly to what management sets out to achieve. The implication is that a strategy to use the only hedge available, or a cheap hedge to remove 70% of the risk, could be considered perfectly effective.
- Management would determine an optimal hedge ratio by reference to the risk management approach
 - No expectation of systematic excess or deficiency
 - Offset is not accidental
- Currently not possible to conclude whether this approach will be a more strict, fair and balanced, or fast and free arbitrator of what is a good hedge and what is not.

The IASB direction – overall approach

- If a hedge accounting model is to remain, there is no avoiding the implication that following or not following hedge accounting can give rise to substantial financial reporting differences for the same economic fact pattern.
- These differences can and do impact decisions about the allocation of resources.
- Little alternative then but to try and write better rules about what is an acceptable hedge and what is not.
- The IASB direction clearly would seem to address some common problems, without significantly changing the overall model

The IASB direction – overall approach

- Rebalancing
 - Greater flexibility to rebalance, adjust and optimise the hedge, in accordance with the original strategy.
 - This is important, but for what is acceptable and what is not, see previous discussion on effectiveness testing.

The IASB direction – some common problems sensibly addressed

- Derivatives as hedged items in some circumstances (see earlier for hedges of foreign currency borrowings and subsequent interest rate hedges).
- Hedging components – aligning the rules for financial and non-financial.
 - Reference those risks which are separately identifiable and reliably measureable
 - With regard to the particular market structure
 - This removes a very arbitrary distinction in the current rules
- Hedging net positions
 - Banks most affected. Has the potential to bring the accounting thought process closer in line with the actual risk management process. May reduce the “accounting overlay” industry

The IASB direction – some common problems sensibly addressed

- Time value of options – the ability to recognise the option cost together with the hedged item. This will bring options conceptually in line with other hedges. (Insurance analogy)
- Elective fair value designation for own use executory contracts
 - Ironically, some desire to fair value certain contracts and are precluded under the current model
 - Commodity contracts that are physically delivered (power sales, wheat, barley etc)
 - Some market participants hedge these and wish to fair value both the hedge and the sales contract through the P&L
 - Currently the commodity usage and sales exemption is mandatory if eligible (contrast US GAAP)
 - Proposal to allow opt out as per the fair value option for financial instruments

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The IASB direction – presentation

Presentation

- Single line item presentation for fair value hedges. Carrying basis of the hedged item not affected
 - Removal of the 'tainting' of the carrying amount of debt, inventories etc will be welcomed
 - Relieves financial reporting of a 'mongrel' measurement basis for the hedged item, but what's this new thing on the balance sheet?
- Mandatory basis adjustment on acquisition of the hedged item in a cash flow hedge.
 - Almost always done this way in practice, therefore minimal impact
- Fair value or cash flow choice for firm commitments retained

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The IASB direction

Other items – indicative direction

- No elective fair value accounting for component parts (credit). This was intended to address the fact that hedges of credit risk are problematic for hedge accounting.
 - The idea was that the component of fair value movement due to credit risk could be fair valued in isolation
- No hedge accounting for hedges of equity instruments designated at fair value through OCI
 - Will create a further barrier to this designation for those already concerned about being precluded from recording ultimately realised gains in income
- With the arrival of TOFA, Australia has some unique considerations

The IASB direction – disclosure and transition

Disclosure - main current criticisms of disclosures may remain:

- Requirements focus on disclosure of risk mitigation – if commodity price or FX risk exists in the business model, but is completely unhedged, no requirement to disclose. Only as derivatives are used to reduce risk is disclosure required
- The concept is very sound – telling users about complex risks will always be a good thing, however as with transactional level hedge accounting, the accounting direction is bottom up. Risk managers tend to focus top down
- How much of the risk reporting to boards belongs in financial statements. Fulsome disclosure is widely encouraged, but take up is patchy.

Transition

- The most frequently early adopted standard we will ever see?

FASB

- Simplified, qualitative test for hedge effectiveness
- No elective de-designation
- Bifurcation by risk for non-financial not allowed
- Lesser of test removed – record a gain to income if the future favourable price change on a forecast sale exceeds the unfavourable movement on the derivative
- Only re-assess if circumstances change

Outlook and assessment

A promise of less rules, more principles.

- Many argue hedge accounting rules exist to the detriment of high quality financial reporting standards, this may be true.
- That hedge accounting delivers more good than harm to financial statement users may also be true.
 - Hedge accounting has greatly increased transparency around the use of derivatives, and been a significant catalyst for increased education and focus on risks and risk management. In a complex and risky world, that is good.
- Accounting for some hedges as hedges provides the best information for users. The same applies to accounting for some hedges as speculative trades

Outlook and assessment

- Are we then stuck on a path of writing better rules as to what are good hedges and what are not?
- Is there benefit in a better in principal description of what an acceptable hedge is?
 - Reducing risk in line with the risk appetite?
 - How much risk and whose appetite will always be a challenge
- As long as a hedge accounting model is retained, high quality rules for deferral and recognition will be important

Setting the bar high...

“I believe the development of IFRS 9 has shown how 21st century standard setting should be done, and the legacy of the project will be a high quality , principle based standard that provides increased, useful information to investors and other users of financial statements”

Sir David Tweedie, 22 November 2010