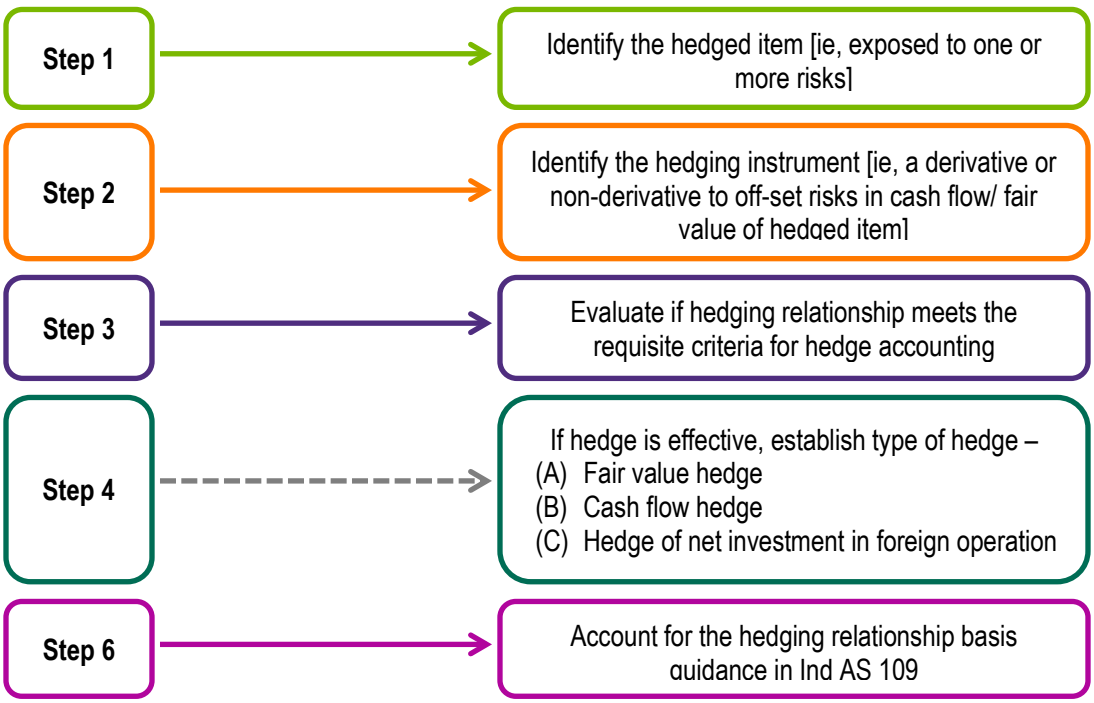
UNIT 6:
HEDGE ACCOUNTING

6.1 INTRODUCTION

The objective of hedge accounting is to **represent**, in the financial statements, **the effect of an entity's risk management activities that use financial instruments to manage exposures** arising from particular risks that could affect profit or loss (or other comprehensive income, in the case of investments in equity instruments for which an entity has elected to present changes in fair value in other comprehensive income).

An entity may choose to designate a hedging relationship between a hedging instrument and a hedged item, i.e, hedge accounting is an option provided qualifying criteria are met. In such a case, accounting for gain / loss arising on the hedging relationship, ie, including hedging instrument and hedged item shall be accounted in a specific manner as detailed further in the unit in order to avoid measurement and recognition inconsistencies which may arise otherwise if the hedging instrument and hedged item were accounted separately.

A step wise analysis has been presented using the following diagrammatic presentation –



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A hedge relationship can be evaluated for a single hedged item or group of items and the hedging instrument can also be a single instrument or multiple instruments hedging specific risk associated with the hedged item.

6.2 IDENTIFYING THE HEDGED ITEM AND DESIGNATION OF HEDGED ITEMS

- A hedged item can be a recognised **asset** or **liability**, an unrecognised **firm commitment**, a **forecast transaction** or a **net investment in a foreign operation**. The hedged item can be:

  (a) a single item; or

  (b) a group of items.

  A hedged item can also be a component of such an item or group of items.

- The hedged item must be reliably measurable.

- If a hedged item is a forecast transaction (or a component thereof), that transaction must be highly probable.

- An entity may designate an item in its **entirety or a component of an item** as the hedged item in a hedging relationship.

  - An entire item comprises all changes in cash flows or fair value of an item.

  - A component comprises less than the entire fair value change or cash flow variability of an item. In that case, an entity may designate only the following types of components (including combinations) as hedged items:

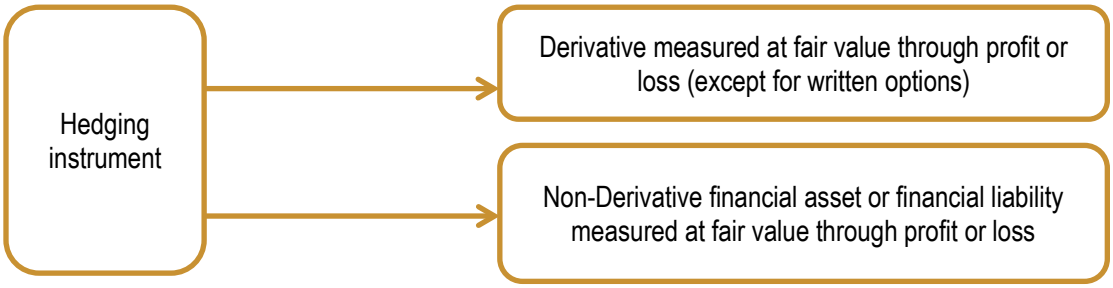
    (a) only changes in the cash flows or fair value of an item attributable to a specific risk or risks (risk component), provided that, based on an assessment within the context of the particular market structure, the risk component is separately identifiable and reliably measurable. Risk components include a designation of only changes in the cash flows or the fair value of a hedged item above or below a specified price or other variable (a one-sided risk).

    (b) one or more selected contractual cash flows.

    (c) components of a nominal amount, ie a specified part of the amount of an item

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6.3 QUALIFYING INSTRUMENTS FOR HEDGE ACCOUNTING AND DESIGNATION OF HEDGING INSTRUMENTS



- **Exceptions to designating non-derivative financial asset or non-derivative financial liability as hedging instrument:**
  - A financial liability designated as at fair value through profit or loss for which the amount of its change in fair value that is attributable to changes in the credit risk of that liability is presented in other comprehensive income.
  - For a hedge of foreign currency risk, the foreign currency risk component of a non-derivative financial asset or a non-derivative financial liability may be designated as a hedging instrument provided that it is not an investment in an equity instrument for which an entity has elected to present changes in fair value in other comprehensive income.
- For hedge accounting purposes, only contracts with a party external to the reporting entity (ie external to the group or individual entity that is being reported on) can be designated as hedging instruments.
- **A qualifying instrument must be designated in its entirety as a hedging instrument.** The only **exceptions permitted** are:

  (a) separating the intrinsic value and time value of an option contract and designating as the hedging instrument only the change in intrinsic value of an option and not the change in its time value;

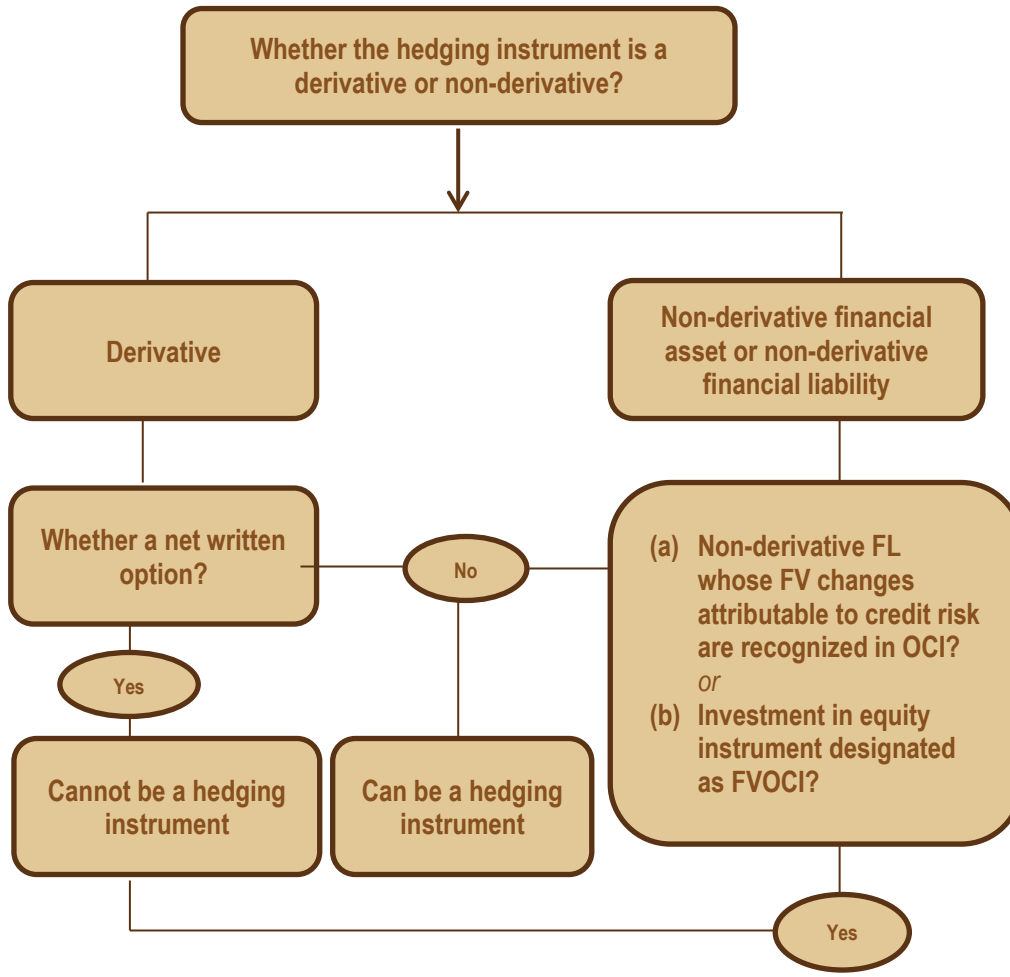
  (b) separating the forward element and the spot element of a forward contract and designating as the hedging instrument only the change in the value of the spot element of a forward contract and not the forward element; and

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(c) a proportion of the entire hedging instrument, such as 50 per cent of the nominal amount, may be designated as the hedging instrument in a hedging relationship. However, a hedging instrument may not be designated for a part of its change in fair value that results from only a portion of the time period during which the hedging instrument remains outstanding.

- **Written options are not hedging instruments:** A derivative instrument that combines a written option and a purchased option (for example, an interest rate collar) does not qualify as a hedging instrument if it is, in effect, a net written option at the date of designation.

The decision tree to determining if an instrument can be designated as a hedging instrument is as follows:



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6.4 QUALIFYING CRITERIA FOR HEDGE ACCOUNTING

A hedging relationship qualifies for hedge accounting only if all of the following criteria are met:

(a) Hedging relationship consists only of **eligible hedging instruments and eligible hedged items**.

(b) At the inception of the hedging relationship, 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, the nature of the risk being hedged and how the entity will assess whether the hedging relationship meets the hedge effectiveness requirements (including its analysis of the sources of hedge ineffectiveness and how it determines the hedge ratio)

(c) Hedging relationship **meets all** of the following **hedge effectiveness requirements**:

i. there is an **economic relationship** between the hedged item and the hedging instrument;

ii. the effect of **credit risk does not dominate** the value changes that result from that economic relationship; and

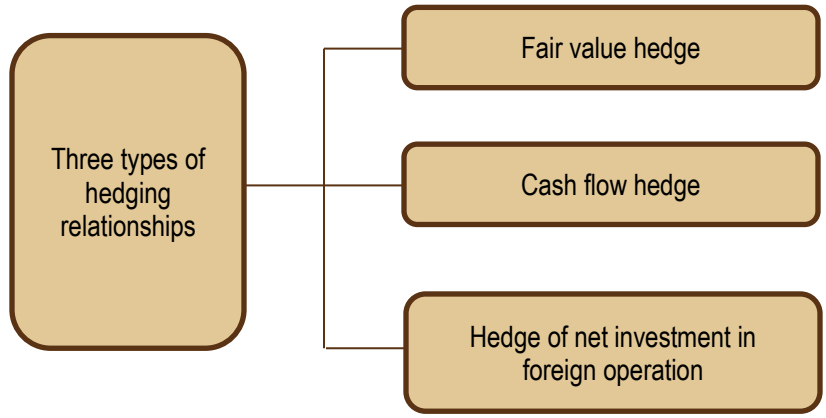
iii. the **hedge ratio** of the hedging relationship is the same as that resulting from the quantity of the hedged item that the entity actually hedges and the quantity of the hedging instrument that the entity actually uses to hedge that quantity of hedged item. However, that designation shall not reflect an imbalance between the weightings of the hedged item and the hedging instrument that would create hedge ineffectiveness (irrespective of whether recognised or not) that could result in an accounting outcome that would be inconsistent with the purpose of hedge accounting.

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6.5 ACCOUNTING FOR QUALIFYING HEDGING RELATIONSHIPS

- An entity applies hedge accounting to hedging relationships that meet the qualifying criteria.

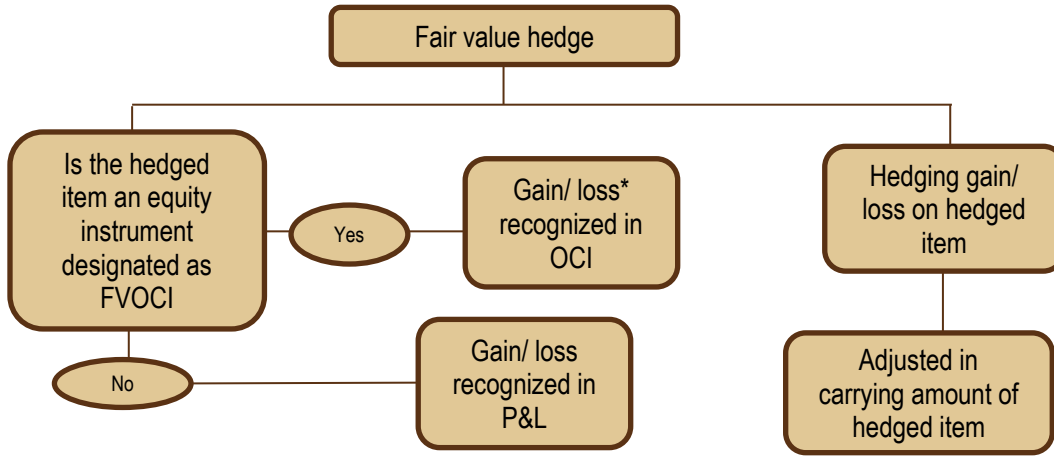
- **Types of hedging relationships:**



- **Fair value hedge**

A fair value hedge is a hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or a component of any such item, that is attributable to a particular risk and could affect profit or loss.

Where a fair value hedge meets the qualifying criteria, fair value hedge shall be accounted as follows:



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***Gain/ loss comprises both hedging instrument and hedged item**

- If the hedged item is a financial asset (or a component thereof) that is measured at fair value through other comprehensive income (FVOCI) other than equity instrument designated as FVOCI in accordance with Ind AS 109, the hedging gain or loss on the hedged item shall be recognised in profit or loss.
- When a hedged item is an unrecognised firm commitment (or a component thereof), the cumulative change in the fair value of the hedged item subsequent to its designation is recognised as an asset or a liability with a corresponding gain or loss recognised in profit or loss.

♦ **Cash flow hedge**

A cash flow hedge is a hedge of the exposure to variability in cash flows that is attributable to a particular risk associated with all, or a component of, a recognised asset or liability (such as all or some future interest payments on variable debt), or a highly probable forecast transaction, and could affect profit or loss.

Where a cash flow hedge meets the qualifying criteria, it shall be accounted as follows:

(a) the separate component of equity associated with the hedged item (**cash flow hedge reserve**) is adjusted to the lower of the following (in absolute amounts):

  (i) the cumulative gain or loss on the hedging instrument from inception of the hedge; and

  (ii) the cumulative change in fair value (present value) of the hedged item (ie the present value of the cumulative change in the hedged expected future cash flows) from inception of the hedge.

(b) the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge (ie the portion that is offset by the change in the cash flow hedge reserve calculated in accordance with (a)) shall be recognised in other comprehensive income.

(c) any remaining gain or loss on the hedging instrument (or any gain or loss required to balance the change in the cash flow hedge reserve calculated in accordance with (a)) is hedge ineffectiveness that shall be recognised in profit or loss

(d) the amount that has been accumulated in the cash flow hedge reserve in accordance with (a) shall be accounted for as follows:

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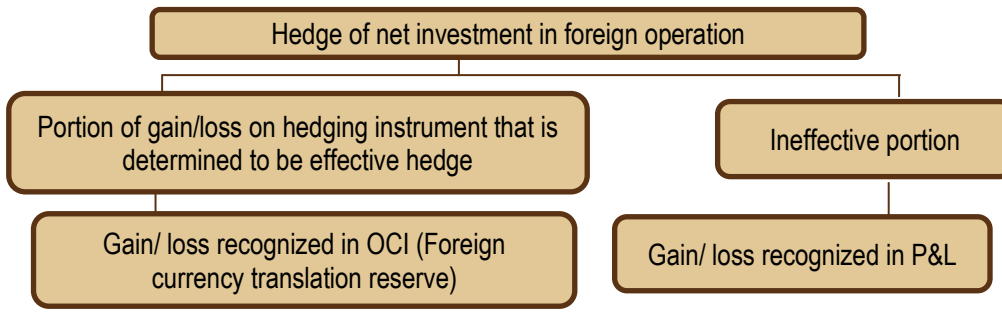
(i) If a hedged forecast transaction subsequently results in the recognition of a non-financial asset or non-financial liability, or a hedged forecast transaction for a non-financial asset or a non-financial liability becomes a firm commitment for which fair value hedge accounting is applied, the entity shall remove that amount from the cash flow hedge reserve and include it directly in the initial cost or other carrying amount of the asset or the liability. This is not a reclassification adjustment as defined in IAS 1 and hence it does not affect other comprehensive income.

(ii) For cash flow hedges other than those covered by (i), that amount shall be reclassified from the cash flow hedge reserve to profit or loss as a reclassification adjustment in the same period or periods during which the hedged expected future cash flows affect profit or loss (for example, in the periods that interest income or interest expense is recognised or when a forecast sale occurs).

(iii) However, if that amount is a loss and an entity expects that all or a portion of that loss will not be recovered in one or more future periods, it shall immediately reclassify the amount that is not expected to be recovered into profit or loss as a reclassification adjustment.

- **Hedge of net investment in foreign operation**

Hedge of a net investment in foreign operation, including a hedge of a monetary item that is accounted for as part of the net investment, shall be accounted for similarly to cash flow hedges:



The cumulative gain or loss on the hedging instrument relating to the effective portion of the hedge that has been accumulated in the foreign currency translation reserve shall be reclassified from equity to profit or loss as a reclassification adjustment on the disposal or partial disposal of the foreign operation.

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