Ernst & Young

Quality In Everything We Do

Financial Instruments Update

Agenda

- Major issues for corporates
- Recent Developments in IFRS accounting for financial instruments
- Focus topic
  - Hedge accounting
- FRS 25/26

Major issues for corporates

Financial instrument issues

- Hedge accounting
  - Foreign currency
    - Loans and other monetary items
    - Forecasted transactions
  - Interest rate risk
- Fair value derivatives
- De-recognition
- Equity versus liability
- Netting
- Disclosure

Recent Developments

Cash flow hedge accounting

Cash flow hedge accounting of forecast intragroup transactions

- Amended IAS 39 in April 2005
- Permits the foreign currency risk of a highly probable forecast intragroup transaction to qualify as a hedged item in consolidated financial statements if denominated in a currency other than the foreign currency of the entity entering into the transaction and the foreign currency risk will affect consolidated profit or loss

Fair value option

An entity can designate an item to be recorded at fair value through profit of loss where it meets one of two main criteria:

i) *"it eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as 'an accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases; or*

ii) *"a group of financial assets and/or financial liabilities is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and this is the basis on which information about the assets and/or liabilities provided internally to the entity's key management personnel …"*

IFRS 7 Financial instruments: Disclosures

- Final Standard issued August 2005
- Effective for annual periods beginning on or after 1 January 2007 with early adoption encouraged
- Adoption for annual periods beginning on or before 1 January 2006 provides certain exemptions from comparative disclosure
- Scope includes all entities in all industries

Hedge Accounting

Hedge Accounting: Recap

- 3 types of Hedge Relationships
  - Fair Value Hedge
  - Cash Flow Hedge
  - Hedge of Net Investment in Foreign Operation
- Accounting
  - Fair value – gains/losses to P/L
  - Cash Flow – effective portion (equity), ineffective (P/L)
- Hedged Item
  - Includes firm commitment and forecast transaction

Hedge Accounting: Recap (continued)

- Hedge relationship qualifies for hedge accounting if, and only if
  - Formally designated and documented
  - Expected to be highly effective
  - Forecast transaction – highly probable
  - Effectiveness can be reliably measured
  - Ongoing assessment
- A lot of work to achieve!

Documentation and Designation

- Identify
  - Hedge risk
  - Hedged item or transaction
  - Nature of risk being hedged
  - How effectiveness will be assessed
- Forecast Transaction
  - Identify date on, or time period in, which forecast transaction is expected to occur
  - Be specific about the transaction
  - Highly probable
    - Look to qualitative factors

Assessing Hedge Effectiveness

- Prospective Test
  - Demonstrate as appropriate
    - That hedge is expected to be effective – e.g. based on past changes in value of hedged item and hedging instrument
    - Over life of hedging relationship
    - That effectiveness can be measured reliably
    - Document how effectiveness will be assessed
    - If ‘no-brainer’ use qualitative analysis

Assessing Hedge Effectiveness (continued)

- Retrospective Test
  - Over the life of hedging relationship
  - Time value of money
  - Show actually highly effective – (80 – 125% range)

Assessing Hedge Effectiveness (continued)

- Dollar Offset Method
  - Uses calculations that have to be performed for bookkeeping
- Statistical Methods
  - Tend to be more forgiving
  - Require appropriate interpretation and an understanding of statistics
- Qualitative Methods
  - ‘Perfect’ hedges – document at outset and periodically re-examine
  - ‘Slightly imperfect’ – approximate ineffectiveness

Assessing Hedge Effectiveness (continued)

- Dollar Offset Method – Cash Flow Hedge
  - e.g. Company X expects to issue €100k one year floating debt instrument in three months. Instrument will pay quarterly with interest due at maturity
  - X hedges interest cash flows by entering a forward starting interest rate swap. X will pay fixed and receive variable
  - Risk being hedged – LIBOR-based interest component in the forecasted issue of debt
  - To compute effectiveness, measure change in the PV of the cash flows (or the value of the hedged forecast transaction)

Assessing Hedge Effectiveness (continued)

- Dollar Offset Method – Approaches
  - Compute fair value of hedged instrument (debt) using swapped rates and compare with expected fair value of hedged instrument at inception of hedging relationship – 'Change in Fair Value Method'
  - Compute present value of notional derivative which would perfectly match the hedged exposure (debt) and compare value to present value of hedging instrument (swap) – 'Hypothetical Derivative Method'
- Caveats
  - Law of small numbers
  - 'Like with like' e.g. spot with spot, coupon with coupon

Effectiveness of a purchased option

A purchased option is designated as the hedging instrument in a cash flow hedge, the change in the fair value of the option rather than just its intrinsic value, it has been suggested that the effectiveness test could consist of ensuring the nominal value of the option remains less than the nominal amount of the loans to be originated and, thereby, no ineffectiveness need be reported in profit or loss

- Is it possible to assume no ineffectiveness when a purchased option is used in a cash flow hedge?

Hedge accounting – First time adoption

- Any previously deferred assets/liabilities relating to hedges are reversed against retained earnings
- Hedge accounting is applied to transactions on date of transition that would qualify for hedge accounting under IAS 39

Hedge accounting – First time adoption (continued)

- Any hedge relationship not designated under previous GAAP cannot be retrospectively designated, even if it meets IAS 39 criteria
- Necessary to document and test effectiveness prior to transition to ensure that hedge accounting can be achieved once the new financial year begins

FRS 25/26

FRS 25 (Disclosure), FRS 26 (Measurement)

- Like IAS 32, 39
- Applies in 2005 for listed entities
- Issue for entities with debt listed on a regulated market
- Effective acceleration of compliance with IAS 32/39 from 2007