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WHAT IS HEDGE ACCOUNTING? WHY IMPORTERS MIGHT CHOOSE TO APPLY HEDGE ACCOUNTING

The new financial instrument standard, NZ IFRS 9 *Financial Instruments* (applicable to Tier 1 and Tier 2 for-profit entities for annual periods beginning on or after 1 January 2018), significantly changes the rules for applying hedge accounting. These revised rules make hedge accounting far more achievable than is the case under the current rules of NZ IAS 39 *Financial Instruments: Recognition and Measurement*.

In this article we look at:

- What is hedge accounting
- Why do entities that are importers want to apply hedge accounting; and
- How effectiveness testing is much simpler under NZ IFRS 9.

In the December 2015 edition of Accounting Alert we will review the benefits of hedge accounting for exporters.

What is hedge accounting and why do importers want to apply hedge accounting?

The basic premise of NZ IAS 39 and NZ IFRS 9 is that all derivatives must be recorded at fair value at each reporting date.

Where an importer purchases inventories priced in foreign currencies, and takes out a forward contract to lock in the foreign currency purchase price, if it does not apply hedge accounting:

- The movement in the fair value of the derivative is recognised immediately in profit or loss
- On delivery, inventory is recorded at the spot price paid for the purchases designated in foreign currencies.

If the importer does apply hedge accounting:

- The movement in the fair value of the derivative is recognised in other comprehensive income until the derivative is settled
- On delivery, inventory is recorded at the spot price paid for the purchases designated in foreign currencies
- Any balance in other comprehensive income is recognised as part of the cost of the inventory, which means that inventory is recorded at the rate locked in by the forward contract.

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Example

1 October 2014

Entity A is an importer of goods. It enters into a contract to purchase goods from an overseas supplier. The goods will be delivered in six months' time and USD 500,000 is payable on delivery.

Entity A does not wish to be exposed to changes in the USD exchange rate. On 1 October 2014, it takes out a forward contract to purchase USD 500,000 in six months' time, at an exchange rate of USD 0.75/NZD 1.

Note: Economic risk management aims to lock in the purchase price for the goods at NZD 666,667 (USD 500,000/0.75).

31 December 2014

The forward rate is USD 0.70/NZD 1.

The derivative is now an asset worth NZD 47,619 [(USD 500,000/0.70) - (USD 500,000/0.75)], representing the gain the holder of the derivative will make by buying US dollars at USD 0.75/NZD 1 compared with the market forward price of USD 0.70/NZD 1.

Fair value movement of derivative from 1 October 2014 to 31 December 2014 is NZD 47,619 [(USD 500,000/0.70) - (USD 500,000/0.75)].

For simplicity, we have ignored the effect of time value of money and any credit/debit value adjustments.

No hedge accounting:

The journal entry if hedge accounting is not applied is as follows:

	DR	CR
DR Derivative asset	NZD 47,619	
CR Profit of loss		NZD 47,619

This accounting does not follow Entity A's hedge objectives of the transaction i.e. to lock in a purchase price for the goods at USD 0.75/NZD 1. Instead, it gives rise to significant profit or loss volatility, bringing forward a notional derivative gain of NZD 47,619 on 31 December 2014.

31 March 2015

If the USD/NZD exchange rate remains at USD 0.70/NZD 1 when the goods are delivered on 31 March 2015, then the journal entries will be:

	DR	CR
DR Inventory	NZD 714,286	
CR Cash (USD 500,000/0,70)		NZD 714,286

To recognise inventory and cash paid at the USD/AUD spot rate at 31 March 2015.

The impact on the income statement when there is no hedge accounting is as follows:

	2014	2015
Gain/loss from derivatives	NZD 47,619	-
Profit or loss	NZD 47,619	-

The impact on the balance sheet when there is no hedge accounting is as follows:

	2014	2015
Inventory	-	NZD 714,286

This obviously does not reflect the economic hedge objective which was to protect Entity A from price volatility on known purchases. The carrying amount of the inventory does not reflect the economic risk management to lock in the purchase price at NZD 666,667.

Hedge accounting

In order to record the hedging effect on the price of inventory, Entity A would have to apply hedge accounting. While still following the basic requirement that all derivatives must be recorded at fair value at each reporting date, for 'cash flow' hedges, hedge accounting allows any gain or loss on the derivative to be deferred by making an entry into equity (other comprehensive income (OCI)).

The journal entry at 31 December 2014 if hedge accounting is applied is as follows:

	DR	CR
DR Derivative asset	NZD 47,619	
CR Hedge reserve		NZD 47,619

To recognise the derivative at fair value and the changes in equity (OCI).

When the goods are delivered and paid for on 31 March 2015, the journal entries are

	DR	CR
DR Inventory	NZD 714,286	
CR Cash		NZD 714,286

To recognise inventory and cash paid at the spot rate at 31 March 2015.

	DR	CR
Dr Cash	NZD 47,619	
CR Derivative asset		NZD 47,619

To derecognise the derivative asset and recognise cash as the derivative is closed out

	DR	CR
DR Hedge reserve (OCI)	NZD 47,619	
CR Inventories		NZD 47,619

To reclassify the gain in OCI to inventory

The impact on the statement of profit or loss and other comprehensive income when hedge accounting is applied is as follows:

	2014	2015
Gain/loss from derivatives	-	-
Profit or loss	-	-
Equity (OCI)	NZD 47,619	(NZD 47,619)

The impact on the balance sheet when there is hedge accounting is applied:

	2014	2015
Inventory	-	NZD 666,667

(Note: This example assumes all the hedge effectiveness criteria are met and the hedge is 100 per cent effective.)

When the hedging transaction is recorded, the hedging gain or loss is reclassified from OCI against that hedged item (i.e. inventory). This results in the carrying amount of inventory being recorded at NZD 666,667, reflecting the aim of economic risk management which is to lock in the purchase price at NZD 666,667.

Effectiveness testing is much simpler under NZ IFRS 9

Hedge accounting under NZ IAS 39 is very difficult, with numerous rules laid out as to the criteria that entities must satisfy in order to qualify for hedge accounting. One of the most troublesome criteria that has prevented entities from applying hedge accounting under NZ IAS 39 is the strict 80-125% hedge effectiveness test.

NZ IAS 39 contains very strict rules around hedge effectiveness in terms of requiring both:

- A hedging relationship to sit within an 80-125% effectiveness band, and
- Very strict rules as to how effectiveness will be calculated (which includes the mandatory requirement to perform both forward and backward looking mathematical effectiveness tests).

Effectiveness testing under NZ IFRS 9

The new standard, NZ IFRS 9, has simplified the hedge effectiveness testing criteria and has removed the 80-125 % highly effective threshold, as well as the mandatory requirement to perform forward and backward looking mathematical effectiveness tests.

Under NZ IFRS 9, if derivatives are entered into for the same quantity, timing and pricing index as the forecast sales or purchases (i.e. the 'critical terms match'), it may be sufficient to only carry out a forward looking qualitative test, without the need to perform any further mathematical calculations.

Example

Entity B has forecast purchases of USD 1million in six months' time. It does not wish to be exposed to changes in the USD exchange rate so it enters into a foreign exchange forward contract to purchase USD 1million in six months' time. Assume that credit risk is not expected to deteriorate significantly.

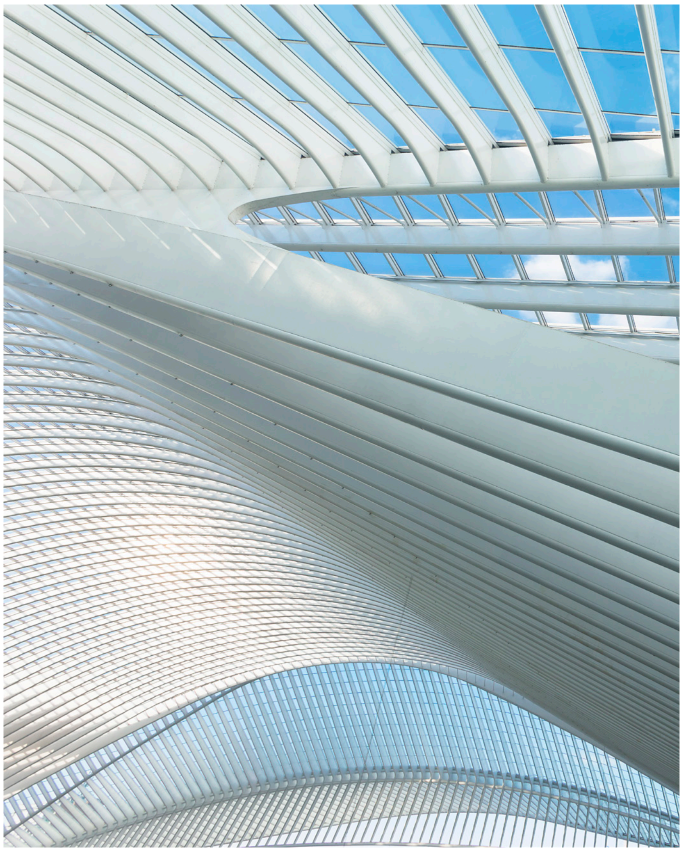
Effectiveness testing is satisfied by the 'critical terms match' test. The critical terms of the hedged item, being the forecast purchases, matches the critical terms of the derivative, i.e.:

- Same quantity – USD 1million
- Same underlying risk – USD/NZD exchange rate
- Timing match - settlement date of the contract matches the timing of the purchases in USD.

Effective date and early adoption

Although NZ IFRS 9 does not come into effect until 1 January 2018 for Tier 1 and Tier 2 for-profit entities, it can be early adopted.

For more on the above, please contact your local BDO representative



KEY JUDGEMENTS AND ESTIMATES WHEN REPORTING UNDER NZ IFRS RDR

As a result of recent changes to financial reporting requirements, a number of companies are now (or will soon be) reporting under the New Zealand equivalents to International Financial Reporting Standards Reduced Disclosure Regime ("NZ IFRS RDR").

NZ IFRS RDR has the same recognition, measurement and presentation requirements as full NZ IFRS, but offers considerable disclosure exemptions from the requirements of full NZ IFRS. For example, NZ IFRS RDR exempts preparers of financial statements from making a number of detailed disclosures in relation to fair value measurements and risks arising from financial instruments, which are two of the areas in which preparers of financial statements often find it difficult to comply with the detailed disclosure requirements of full NZ IFRS.

One of the disclosure requirements that entities reporting under NZ IFRS RDR are **not** exempted from, however, is the requirement to provide information on the **key judgements and estimates** made when preparing the financial statements. The information provided in relation to these should be sufficient to enable users of the financial statements to understand those key judgements and estimates, to understand their significance to the financial statements and to assess whether they consider those judgements and estimates to be appropriate.

The preparation of these disclosures requires the application of **considerable professional judgement**, both in determining what key judgements and estimates were made in preparing the financial statements and in providing appropriate disclosure about those judgements and estimates.

Key judgements frequently relate to the application of accounting policies. Key judgements might include the classification of financial assets, the determination of the equity and liability components in a compound financial instrument and the classification of a company in which the preparer owns 50% of the shares as a subsidiary, an associate or a joint arrangement.

Key estimates are often the inputs to valuation models used to determine fair value or value in use for the purpose of goodwill impairment testing.

In determining what disclosures to make in relation to key judgements and estimates, a useful source of guidance is frequently the financial reporting standard that addresees that issue. For example, for entities reporting under full NZ IFRS that use valuation methodologies to determine the fair value of assets and liabilities, NZ IFRS 13 *Fair Value Measurement* requires disclosure of, among other things, the valuation methodology that was used (including an explanation of the methodology), each key estimate made and the impact of a change in each key estimate on the valuation. An entity reporting under NZ IFRS RDR is not required to make those disclosures. **However**, if that entity has a property carried at fair value that is significant to the financial statements, it is likely that determination of its fair value will require key estimates, in which case such information should be disclosed.

This all means that, in some instances, entities reporting under NZ IFRS RDR will have to make some of the disclosures that they are exempted from, **so that they can adequately meet the requirement to provide information to users about the key judgements and estimates applied** in preparing the financial statements.

For more on the above, please contact your local BDO representative

TIER 3 AND TIER 4 NOT-FOR-PROFITS TRANSITIONING TO SIMPLE FORMAT REPORTING

With the application date (annual periods beginning on or after 1 April 2015) of the new accounting frameworks for not-for-profits either fast approaching or already here, affected entities should be in the process of migrating to the new requirements.

For Tier 3 and Tier 4 not-for-profits, one of the biggest questions is what the transitional requirements are for comparative information when moving to the new simple format reporting frameworks.

Tier 3 Entities

There are four broad categories of not-for-profit entities that could be transitioning to the Tier 3 Simple Format Reporting (Accrual) Framework (SFR(A)), namely:

- Group 1: New entities – those that have started up in the current financial year.
- Group 2: Entities previously in Tier 4 (i.e. those who have complied with Tier 4 PBE Simple Format Reporting – Cash in the previous financial year).
- Group 3: Entities previously in Tier 2 (i.e. those who have complied with Tier 2 PBE Accounting Standards in the previous financial year).
- Group 4: Other entities – entities that have been operating and have either:
  - followed other accounting standards (for example, NZ IFRS PBE or Old GAAP); or
  - have not followed any accounting standard issued by the New Zealand Accounting Standards Board (NZASB) or the External Reporting Board.

For the coming year, we expect the majority of Tier 3 not-for-profit entities to fall into Group 4.

SFR(A) includes both general provisions and special provisions for transitioning, with the special provisions overriding the general transition provisions.

Transitional requirements – special provisions

For Group 2 and Group 4 entities, SFR(A) allows a choice as to whether comparative information is presented under SFR(A) requirements. If the entity elects not to apply SFR(A) to comparative amounts (and thus not present comparatives), then the entity is merely required to attach its previous period's financial statements (including a list of previous accounting policies applied).

Group 3 entities are also permitted to choose whether or not to provide comparative information under the requirements of SFR(A). Group 3 entities that elect to not provide comparative information under SFR(A) must provide comparative data based on the applicable information reported in their financial statements for the previous year (prepared in accordance with Tier 2 PBE Accounting Standards).

Group 1 entities will not have comparative information, as they are newly formed entities.

In summary:

Tier 3 not-for-profit comparatives transition requirements:

Group	Elect to apply SFR (A) from:	Are Comparatives Required under SFR (A)	Other Requirements:
Group 1	Current Period	No	-
Group 2 (Choice)	Current Period	No	Attach previous financial statements and list of previous accounting policies
	Beginning of comparative	Yes	-
Group 3 (Choice)	Current Period	No	Provide comaparatives based on Tier 2 PBE standards
	Beginning of comparative	Yes	-
Group 4 (Choice)	Current Period	No	Attach previous financial statements and list of previous accounting policies
	Beginning of comparative	Yes	-

Transitional requirements – general provisions

The general provisions require that, when an entity is reporting in accordance with SFR(A) for the first time, it comply with SFR(A) from the beginning of the earliest comparative period presented.

For example, if the performance report is being prepared in accordance with these general provisions for the year ended 31 March 2016, the beginning of the earliest comparative period would be 1 April 2014 and all assets and liabilities would be recorded from that date.

Separate disclosure of significant restatements is encouraged, but is not required.

Tier 4 Entities

There are 2 types of not-for-profit entities that could be transitioning to the Tier 4 Simple Format Reporting (Cash) Framework (SFR(C)); namely:

- Group 1: New entities – those that have started up in the current financial year.
- Group 2: Continuing Entities – entities that have been operating in previous periods, but not followed Tier 4 SFR(C) - i.e. entities that followed other accounting standards (for example, NZ IFRS PBE, Old GAAP or Tier 3 SFR(A)).

For the coming year, we expect the majority of Tier 4 not-for-profit entities to fall into Group 2.

Transitional requirements

For existing entities (Group 2), SFR(C) allows the entity a choice as to whether comparative information will be presented under SFR(C) requirements or not.

If the entity elects not to apply SFR(C) to comparative amounts (and thus not present comparatives), then the entity is merely required to attach its previous period's financial statements (including a list of previous accounting policies applied).

Group 1 entities will not have comparative information, as they are newly formed entities.

In summary:

Tier 4 not-for-profit comparatives transition requirements:

Group	Apply SFR from:	Comparatives Required (SFR)	Other Requirements:
Group 1	Current Period	No	-
Group 2 (Choice)	Current Period	No	Attach previous financial statements and list of previous accounting policies
	Beginning of comparative	Yes	-

For more on the not-for-profit tiers please refer to the December 2013, January 2013, and May 2011 editions of Assurance Alert

For more on the above, please contact your local BDO representative.

BDO RELEASES NEW PUBLICATION – NZ IFRS 9 FINANCIAL INSTRUMENTS

BDO is pleased to announce the release of its latest publication, NZ IFRS 9 *Financial Instruments*.

This publication sets out practical information and examples about the application of key aspects of NZ IFRS 9, which is applicable to Tier 1 and Tier 2 for-profit entities for annual periods beginning on or after 1 January 2018. Early application of the standard is permitted.

NZ IFRS 9 has had a phased release with earlier versions issued in 2009, 2010 and 2013.

NZ IFRS 9 (2014) has been developed to replace NZ IAS 39 *Financial Instruments: Recognition and Measurement* and requires significantly different accounting in some areas compared to current practice.

This final version of NZ IFRS 9 was issued by the External Reporting Board in September 2014. The standard incorporates the requirements of all three phases of the financial instruments project, being:

- Classification and Measurement (refer to the January 2015 edition of Accounting Alert),
- Impairment (refer to the July 2015 and August 2015 editions of Accounting Alert), and
- Hedge Accounting (refer to the July 2015 and July 2014 editions of Accounting Alert as well as the hedging article contained in this month's Accounting Alert)

Please click here to access the new publication.

NEW BDO PUBLICATIONS

The **Audit** section of our website (www.bdo.co.nz/audit) includes a range of publications on accounting standards issues. For example:

- **NZ IFRS Industry Issues** contains a high level overview of the impact of new standards on particular industries. Recent NZ IFRS Industry Issues include overviews of the impact of NZ IFRS 15 *Revenue from Contacts with Customers* on the manufacturing; retail; telecommunications, software; media, construction-real estate and professional services industries.
- **Summaries on a Page (SOAPs)** contain summaries of NZ IFRS Standards for for-profit entities and PBE Standards for public sector and not-for profit entities currently in effect in New Zealand.

Also look for the **'BDO International IFRS'** link which includes resources such as:

- **IFRS at a glance** – 'one page' and short summaries of all IFRS standards.
- **IFRS News at a glance** – provides high-level headlines of newly released documents by the IASB and IFRS related announcements by securities regulators.
- **Need to Knows** – updates on major IASB projects and highlights practical implications of forthcoming changes to accounting standards. Recent Need to Knows include IFRS 9 *Financial Instruments – Classification and Measurement* (April 2015), IFRS 9 *Financial Instruments - Impairment of Financial Assets* (Dec 2014), IFRS 15 *Revenue from Contracts with Customers* (Aug 2014), IFRS 9 *Financial Instruments* (May 2014), *Hedge Accounting* (IFRS 9 *Financial Instruments*) (Jan 2014).
- **IFRS in Practice** – practical information about the application of key aspects of IFRS, including industry specific guidance. Recent IFRS in Practice include IFRS 15 *Revenue from Contracts with Customers – Transition*; IFRS 15 *Revenue from Contracts with Customers* (Oct 2014), IAS 7 *Statement of Cash Flows*, *Distinguishing between a business combination and an asset purchase in the extractives industry* (March 2014), IAS 36 *Impairment of Assets* (Dec 2013) and *Common Errors in Financial Statements – Share-based Payment* (Dec 2013).
- **Comment letters on IFRS standard setting** – includes BDO comments on various projects of international standard setters, including Exposure Drafts and other Discussion Papers, when it is considered that the issue is significant to the BDO network and its clients. Latest comment letters include IASB ED 2015-2 Effective Date of IFRS 15, ED IAS ED 2015-1 *Classification of Liabilities, Basel Committee on Banking Supervision – Guidance on accounting for expected credit losses*, IASB ED 2014-06 *Disclosure Initiative*, IASB - ED 2014-4 *Measuring Quoted Investments in Subsidiaries*, IASB - ED 2014-3 *Recognition of Deferred Tax Assets for Unrealised Losse*s.

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