Grant Thornton

Technical Accounting Alert

Cash flow hedging and changes to a forecast transaction

Introduction

The purpose of this alert is to provide guidance for an entity that designates a highly probable forecast transaction as a cash flow hedge and to highlight the accounting consequences if:

- the timing of the transaction changes;
- the transaction is no longer considered highly probable;
- the transaction is no longer expected to occur; and
- the transaction is expected to occur only partially?

Relevant Australian Standards

References in this TA alert are made to standards issued by the International Accounting Standards Board. The Australian equivalent to each standard included in this alert is shown below:

International Standard reference	Australian equivalent standard
IAS 39 Financial Instruments: Recognition and Measurement	AASB 139 Financial Instruments: Recognition and Measurement

Overview

The cash flow hedge accounting is an accounting policy option that is available only if the strict conditions in IAS 39.71 to 88 (and the related Application Guidance) are met. Cash flow hedge accounting is available in respect of forecast transactions, subject to the normal designation and effectiveness requirements (see IAS 39.88(a) and (b)) and provided that the forecast transaction is:

- highly probable; and
- presents an exposure to variations in cash flows that could ultimately affect profit or loss (IAS 39.88(c)).

The designation of the hedge relationship is very important. In particular, the hedged transaction should be identified in sufficient detail that the occurrence (or non-occurrence) of the transaction can be objectively determined (see IAS 39.IG.F.3.10). The necessary level of detail will depend on the circumstances. For example, if an entity hedges an exposure to exchange rate movements for US Dollar (US$) sales it would be acceptable to identify the hedged transaction as "the first US$10,000 of US$ sales in month X". As sales are made in month X, it will be determinable whether or not they are part of the hedged transaction. It is not necessary to identify the exact items to be sold, the customers to whom the sales will be made or the exact date of the transaction. By contrast, a designation of simply "sales of US$10,000" would be insufficient (see IAS 39.IG.F.3.10 for more guidance). The designation should also clearly identify the hedged risk and how effectiveness will be assessed (see IAS 39.88 (a) and (b)).

The mechanics of cash flow hedge accounting are set out in IAS 39.95 to 101. In summary, in a valid cash flow hedge:

- the portion of the fair value gain or loss on the hedging instrument that is an effective hedge is deferred in equity;
- any ineffectiveness is recognised immediately in profit or loss;
- when the forecast transaction occurs and results in the recognition of a **financial asset or liability**, the cumulative gain or loss is removed from equity and recognised in profit or loss in the same periods during which the assumed asset or liability affects profit or loss (IAS 39.97);
- when the forecast transaction occurs and results in the recognition of a **non-financial asset or liability**, the cumulative gain or loss is removed from equity and is either:
  - recognised in profit or loss when the asset or liability affects profit or loss (IAS 39.98(a)); or
  - applied as a "basis adjustment" ie an increase or decrease in the initial carrying amount of the asset or liability (IAS 39.98(b)).

In a cash flow hedge, ineffectiveness arises only if the cumulative change in the fair value of the hedging instrument **exceeds** the change in fair value of the expected cash flows of the hedged item attributable to the hedged risk. In other words, "under-hedging" (ie when the cumulative fair value change in the hedging instrument is less than the fair value change of the expected cash flows) does not give rise to ineffectiveness. This is an area where cash flow hedging differs from fair value hedging.

Changes to the forecast transaction

Because cash flow hedging is available for highly probable forecast transactions, the hedged transaction will not always occur as originally forecast. If an entity repeatedly designates such hedges and the transactions fail to occur, doubt will be cast on management's ability to forecast with sufficient accuracy to justify the designation.

Timing of the transaction changes

Changes in the **timing** of transactions are commonplace. Such changes do not invalidate the hedging relationship but may give rise to ineffectiveness. If the ineffectiveness is so great that the hedge is no longer highly effective, hedge accounting must be discontinued (see IAS 39.88(b)).

A highly probable forecast transaction continues to be eligible for cash flow hedge accounting even if the expected timing of the transaction changes. However, changes in the timing of forecast cash flows will affect the fair value of those cash flows. This is likely to reduce the effectiveness of the hedge.

Transaction is no longer considered highly probable

If the forecast transaction is no longer considered highly probable but is still expected to occur, it no longer meets the conditions for cash flow hedge accounting (see IAS 39.88). The detailed accounting requirements for the discontinuance then depend on whether or not the transaction is still expected to occur. Specifically:

- if the transaction is still expected to occur, IAS 39.101(b) requires that all future changes in the fair value of the hedging instrument are recorded in the income statement. Amounts deferred in equity whilst the hedge was effective remain in equity until the forecast transaction occurs; and
- if the transaction is no longer expected to occur, IAS 39.101(c) requires that all future changes in the fair value of the hedging instrument are recorded in the income statement, and also that amounts deferred in equity are removed and recognised in profit or loss.

Assessing whether a forecast transaction is "highly probable" and/or "expected to occur" requires judgment based on individual facts and circumstances. Also, IAS 39 does not specify a quantitative threshold to define these terms. As a broad indicator, we suggest that "highly probable" might be interpreted as a probability of 90% or more, and "expected" as more likely than not (ie a probability of over 50%).

Transaction is no longer expected to occur

If the forecast transaction is no longer expected to occur, amounts deferred in other comprehensive income are immediately removed from other comprehensive income and recognised in the statement of comprehensive income (IAS 39.101(c)).

The transaction is expected to occur only partially

A transaction might be expected to occur, or considered highly probable, only in part. For example, an entity might hedge its exposure to variability in cash flows related to a specified volume of foreign currency sales. The entity might then re-estimate its future sales and determine that only a proportion of the hedged amount is now expected and/or highly probable. In our view, if the full hedged amount is no longer considered highly probable:

- all **future** changes in the fair value of the hedging instrument should be recorded in the income statement; and
- **if the full hedged amount is still expected to occur**: amounts deferred in equity whilst the hedge was effective remain in equity until the forecast transaction occurs; or
- **if the hedged amount is expected to occur only in part**: a proportionate amount of the gains or losses deferred in equity are removed from equity and recognised in the income statement. To the extent the transaction is still expected to occur, that proportion of the deferred gains or losses continues to be deferred in equity until the forecast transaction occurs.

Examples

Example 1: Discrete transaction no longer highly probable

Company A, an Australian company whose functional currency is Australian Dollars (AUD), sells specialist machinery to customers in the European Union. Sales are commonly denominated in euros (€). In January 20X0, Company A determines that it has a highly probable forecast sale of a machine for €5 million to a customer with whom negotiations are at an advanced stage (although there is no firm purchase order). The customer has indicated that it intends to place a firm order in May 20X0, for delivery in July 20X0 and payment in September 20X0. In January 20X0, Company A enters into a forward contract to sell €5 million for AUD$7 million in September 20X0. It designates the forward contract as a cash flow hedge of the highly probable sale.

In May 20X0, the customer notifies Company A that, following a change in management, it is reconsidering its purchasing priorities. The customer indicates that it still expects to place an order but that a final decision will not be made until July 20X0.
Company A's management concludes that the transaction is no longer highly probable. However, management still expects the transaction to occur.

Analysis

Because the transaction is no longer highly probable, Company A discontinues hedge accounting prospectively from May 20X0. Accordingly, from May all future fair value movements in the forward contract are recognised immediately in profit or loss. Hedging gains and losses that were previously recognised in equity remain in equity until the hedged transaction occurs. If at any time the transaction is no longer expected to occur, the gains and losses deferred in equity are removed at that point and recognised in profit or loss.

Example 2: Partial occurrence of hedged future sales

In April 20X1, Company B (an AUD functional entity that makes regular export sales denominated in US Dollars) enters into a foreign currency forward contract to sell US$10 million in exchange for AUD. It decides to designate the forward contract as a hedging instrument in a cash flow hedge. The hedged item is the first US$10 million of US$ sales in September 20X1.The hedged risk is the change in fair value of the expected future cash flows due to exchange rate movements.

Sales are on average US$15 million per month. On this basis, Company B's management concludes that sales of at least US$10 million in September 20X1 are highly probable. In June 20X1, the order book indicates that September 20X1 sales are likely to be significantly less than originally expected. Management now expects sales of approximately US$8 million, of which only US$5 million is considered highly probable.
Between April and June 20X1, losses of AUD$ 0.5 million were incurred on the forward contract. Up to that point, the hedge relationship was determined to be 100% effective. Accordingly, the entire AUD$0.5 million loss was recorded in equity, in a cash flow hedging reserve.

Analysis

The hedge designation specifies highly probable forecasts sales of US$10 million in September 20X1. This level of sales is no longer considered highly probable. The entire hedge should therefore be discontinued prospectively. From June 20X1 all **future** gains and losses arising on changes in fair value of the foreign currency forward contract are recognised immediately in profit or loss.

Company B still expects sales of US$8 million in September 20X1 (80% of the sales specified in the hedge documentation). Of the AUD$ 0.5 million loss recorded in equity to June 20X1, 80% or AUD$ 0.4 million is therefore retained in other comprehensive income. The other AUD$0.1 million is removed from other comprehensive income and recognised as an expense in the statement of comprehensive income. The AUD$ 0.4 million is removed from other comprehensive income and recognised as an expense when the sooner of the following occurs:

- the sales expectations reduce further or no longer expected to occur at all; or
- the expected sales occur.

An alternative hedging strategy in these circumstances is to:

- at June 20X1 de-designate the original hedge relationship; and
- at the same time designate a new relationship. In the new hedge, the hedged item is the exchange risk associated with the first US$ 5 million of sales (the amount now considered highly probable). The hedging instrument is 50% of the original forward currency contract, for its remaining term to expiry.

If this strategy is used, the treatment of the loss deferred in other comprehensive income under the original hedge is exactly the same ie it remains in other comprehensive income to the extent the original transaction is still expected to occur, and recycled when the transaction does occur. Regarding the new hedge, IAS 39.75 permits a proportion of a derivative to be designated as a hedging instrument. It also permits a derivative to be designated as a hedging instrument at some time after its initial recognition. (It is not permitted to designate a derivative for only part of its remaining life).

This strategy will enable a portion of the future gains or losses on the forward contract to be recognised in equity until the revised highly probable sales occur. It might therefore be a better solution for many entities.

Note

On 12 November 2009, the IASB published IFRS 9 Financial Instruments (IFRS 9). IFRS 9 addresses the classification and measurement of financial assets. The publication of IFRS 9 represents the completion of Phase 1 of IASB's project to replace IAS 39. However, at this stage IFRS 9 only addresses the classification and measurement of financial assets. Financial liabilities therefore continue to be accounted for in accordance with IAS 39. Work has begun on Phases 2 and 3 of the project which addresses impairment and hedge accounting, respectively. Also, a separate project is now underway to replace IAS 39's requirements on derecognition.

IFRS 9 was issued in Australia as AASB 9 Financial Instruments with an effective date of 1 January 2013 and therefore AASB 9 requriements have not been considered for the purpose of this alert.

Further information

For further information on any of the information included in this TA alert, please contact your local Grant Thornton Australia contact member or a member of the National Audit Support team via the GTAL IT Service Desk http://gtassist.au.gt.local/