13. Hedge accounting

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| **OVERVIEW** | * Hedge accounting allows an entity to selectively measure assets and liabilities on a basis different from that otherwise stipulated in IFRS, or to defer the recognition in profit or loss of gains or losses on derivatives.
* Hedge accounting is permitted only when strict documentation and effectiveness requirements are met.
* There are three hedge accounting models: fair value hedges of fair value exposures, cash flow hedges of cash flow exposures, and net investment hedges of currency exposure on a net investment in a foreign operation.
* Only derivative instruments – and for hedges of foreign exchange risk only, non‑derivative financial instruments – entered into with an external party qualify as hedging instruments.
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13.1 Purpose and scope

This document provides guidance and rules for applying hedge accounting in accordance with IFRS 9, Financial Instruments, as well as the required disclosures to be made in financial statements prepared according to International Financial Reporting Standards.

13.2 Definitions

NOTE: some definitions relevant to hedge accounting are captured and explained in the *Financial Instruments* policy.

A *firm commitment* is a binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates.

A *forecast transaction* is an uncommitted but anticipated future transaction.

A *hedging instrument* is a designated derivative or (for a hedge of the risk of changes in foreign currency exchange rates only) a designated non‑derivative financial instrument whose fair value or cash flows are expected to offset changes in the fair value or cash flows of a designated hedged item.

A *hedged item* is an asset, liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation that

(a) exposes the entity to risk of changes in fair value or future cash flows and

(b) is designated as being hedged.

A hedged item can be a recognized asset or liability, an unrecognized firm commitment, a highly probable forecast transaction or a net investment in a foreign operation.

The hedged item can be a single item, a group of items or, in a portfolio hedge of interest rate risk only, a portion of the portfolio of financial assets or financial liabilities that share the risk being hedged.

An entity can designate all changes in the cash flows or fair value of a hedged item in a hedging relationship. An entity can also designate only changes in the cash flows or fair value of a hedged item above or below a specified price or other variable (a one‑sided risk).

*Hedge effectiveness* is the degree to which changes in the fair value or cash flows of the hedged item that are attributable to a hedged risk are offset by changes in the fair value or cash flows of the hedging instrument.

13.3 Hedging relationships

Hedge accounting is voluntary and the decision to apply hedge accounting is made on a transaction‑by‑transaction basis.

As hedge accounting is permitted only when strict documentation and effectiveness testing requirements are met, **Corporate Finance should be consulted before any such transaction is entered into** to ensure the appropriate documentation is prepared.

Hedge accounting recognizes the offsetting effects on profit or loss of changes in the fair values of the hedging instrument and the hedged item. Hedging relationships are of three types, two of which are discussed below, as they may be applicable to the Group:

(a) *fair value hedge*: a hedge of the exposure to changes in fair value of a recognized liability, or an identified portion of such a liability that is attributable to a particular risk and could affect profit or loss.

(b) *cash flow hedge*: a hedge of the exposure to variability in cash flows that

(i) is attributable to a particular risk associated with a recognized liability (such as all or some future interest payments on variable rate debt) and

(ii) could affect profit or loss.

13.4 Qualifying for hedge accounting

A hedging relationship qualifies for hedge accounting if, and only if, all of the following conditions are met.

1. The hedging relationship consists only of eligible hedging instruments and eligible hedged items.

b) At the inception of the hedge 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) The hedging relationship meets all of the following hedge effectiveness requirements:

1. There is an economic relationship between the hedged item and the hedging instrument;
2. The effect of credit risk does not dominate the value of changes that result from that economic relationship; and
3. 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 recognized or not) that could result in an accounting outcome that would be inconsistent with the purpose of hedge accounting.

Qualifying hedged items

For hedge accounting purposes, only assets, liabilities, firm commitments or highly probable forecast transactions that involve a party external to the entity can be designated as hedged items.

The foreign currency risk of an intercompany monetary item (e.g., a payable/receivable between two subsidiaries) may qualify as a hedged item in the consolidated financial statements if it results in an exposure to foreign exchange rate gains or losses that are not fully eliminated on consolidation (using translation policies documented elsewhere in this manual).

Qualifying hedging instruments

For hedge accounting purposes, only instruments that involve a party external to the reporting entity (i.e. external to the Company or individual entity that is being reported on) can be designated as hedging instruments.

A proportion of the entire hedging instrument, such as 50 percent of the notional amount, may be designated as the hedging instrument in a hedging relationship. However, a hedging relationship may not be designated for only a portion of the time period during which a hedging instrument remains outstanding.

13.5 Hedge accounting: Cash flow hedge

If a cash flow hedge meets the conditions above to qualify for hedge accounting during the period, it shall be accounted for as follows:

(a) the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge shall be recognized in equity (see “Hedge effectiveness” section below); and

(b) the ineffective portion of the gain or loss on the hedging instrument shall be recognized in profit or loss.

More specifically, a cash flow hedge is accounted for as follows:

(a) the separate component of equity associated with the hedged item is adjusted to the lesser 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 expected future cash flows on the hedged item 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 (i.e. the portion that is offset by the change in the cash flow hedge reserve calculated in accordance with (a)) shall be recognized 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 recognized 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:

1. 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 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 liability. This is not a reclassification adjustment and hence it does not affect other comprehensive income.
2. 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
3. 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.

For cash flow hedges, amounts that had been recognized in equity shall be reclassified from equity to profit or loss as a reclassification adjustment in the same period or periods during which the hedged transaction affects income or loss.

The Group’s subsidiaries periodically enter into forward contracts related to the purchase of inventory or the payment of intercompany royalties denominated primarily in US dollars which are designated as cash flow hedges. The Group also enters into interest rate hedges designated as cash flow hedges.

*Illustration of the cash flow hedge accounting model*



13.6 Assessing hedge effectiveness

IFRS 9 removed the quantitative requirement to test for effectiveness using the 80-125% threshold. Under IFRS 9, a hedge is effective if the relationship meets all of the following hedge effectiveness requirements:

1. There is an economic relationship between the hedged item and the hedging instrument;
2. The effect of credit risk does not dominate the value changes that result from that economic relationship
3. 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.

IFRS 9 does not specify a method for assessing whether a hedging relationship meets the hedge effectiveness requirements. However, an entity may use a method that captures the relevant characteristics of the hedging relationship, including the sources of hedge ineffectiveness. Depending on those factors, the method can be a qualitative or quantitative assessment.

When the critical terms (such as the nominal amount, maturity and underlying) of the hedging instrument and the hedged item match or are closely aligned, it might be possible for an entity to conclude on the basis of a qualitative assessment of those critical terms that the hedging instrument and the hedged item have values that will generally move in the opposite direction because of the same risk and hence that an economic relationship exists between the hedged item and the hedging instrument.

If the hedge relationship does not meet hedge effectiveness criteria, the entity discontinues hedge accounting from the last date on which compliance with hedge effectiveness was demonstrated.

13.7 Disclosure

The Group shall disclose the following separately for each type of hedge (i.e. fair value hedges and cash flow hedges)

(a) a description of each type of hedge;

(b) a description of the financial instruments designated as hedging instruments and their fair values at the end of the reporting period; and

c) the nature of the risks being hedged.

For cash flow hedges, the Group shall disclose:

(a) the periods when the cash flows are expected to occur and when they are expected to affect profit or loss;

(b) the amount that was recognized in equity during the period;

(c) the amount that was reclassified from equity to profit or loss for the period, showing the amount included in each line item in the income statement; and

The Company shall disclose separately:

(a) in fair value hedges, gains or losses:

(i) on the hedging instrument; and

(ii) on the hedged item attributable to the hedged risk; and

(b) the ineffectiveness recognized in profit or loss that arises from cash flow hedges.

13.8 Illustrative examples

