Hedge accounting: highly probable requirement

Reporting Update

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Highlights

- Background
- Highly probable requirement for forecast transactions
- Application of IFRIC Agenda Decisions

Background

At its March 2019 meeting, the International Financial Reporting Standards Interpretations Committee (IFRIC) finalised its decision about the application of AASB 9 *Financial Instruments* and AASB 139 *Financial Instruments: Recognition and Measurement* in relation to the requirement for a forecast transaction to be 'highly probable' in order to qualify as a hedged item in a cash flow hedge relationship.

IFRIC received a request about how an entity would apply the highly probable requirement when the notional amount of the derivative designated as a hedging instrument varies depending on the outcome of the hedged item. An example of this is an instrument where under the terms of the derivative, the timing and magnitude of the notional amount equals those of the hedged item.

In Australia, this decision is expected to impact some organisations as the use of such instruments, generally known as load following swaps, to hedge forecast energy transactions have become increasingly common.

Highly probable requirement for forecast transactions

What is the decision?

In a cash flow hedge, a forecast transaction can be a hedged item if, and only if, it is highly probable.

Forecast transaction must be sufficiently specific in terms of magnitude and timing of occurrence

When assessing whether a forecast transaction – such as a forecast purchase or sale of energy – is highly probable, an entity considers the uncertainty over both the timing and magnitude of the forecast transaction.

For hedge accounting purposes, the entity must document the forecast transaction with sufficient specificity in terms of magnitude and timing at inception of the hedge so that when such transactions occur, the entity can identify whether the transaction is a hedged transaction. For example, forecast energy sales cannot be specified solely as a percentage of sales during a period.

In addition, the terms of the hedging instrument do not affect the highly probable assessment of the hedged item. For example, it cannot be assumed that the hedged item is highly probable in a hedging strategy simply when the timing and magnitude of the hedging instrument will align with the hedged item as and when it occurs.

What does this mean?

Previously designated forecast energy transactions may no longer qualify as hedged items

Some entities may have to revisit their highly probable assessments and documentation of the hedged item. They have to consider the level of uncertainty and whether the amount and timing have been documented with sufficient specificity. In some instances, previously designated forecast transaction, such as forecast energy sales or purchases, may no longer qualify as a hedged item for the purposes of hedge accounting.

Entities will have to change their accounting policies if they have previously adopted a policy that forecast transactions are considered to be highly probable where the terms of the hedging instrument vary with the forecast hedged item.

A change in accounting policy will be applied retrospectively, with the cumulative changes recognised in opening retained earnings, in accordance with AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors.*

Application of IFRIC Agenda Decisions

IFRIC agenda decisions may result in a change in accounting policy under AASB 108

Entities to determine when they can implement the change, and it is not expected to take extensive periods of time

In December 2018, the Vice Chair of the International Accounting Standards Board (IASB) and Chair of IFRIC explained that an entity may determine that it needs to change an accounting policy as a result of an IFRIC agenda decision.

The Board expects an entity to be entitled to sufficient period of time to make the determination and implement any change (e.g. obtain the new information or adapt its systems to implement a change). Having indicated this, the Board does not anticipate that entities would require extensive periods of time, given IFRIC agenda decisions usually have a narrow focus.

"If an entity has to change its accounting policy as a result of an IFRIC agenda decision, management should consider when it could implement the change.

Prior to implementation of the IFRIC agenda decision, the entity should consider including disclosures of the potential change in accounting policy, the expected impact and when the change will occur, similar to disclosures required in AASB 108."

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