WHO ARE THE EARLY ADOPTERS OF THE NEW AASB 9 HEDGE ACCOUNTING REQUIREMENTS?

The new financial instruments standard, AASB 9 *Financial Instruments* significantly changes the rules regarding hedge accounting. Although AASB 9 does not come into effect until 1 January 2018, a number of companies have been early adopter's of the standard.

The new hedging model makes applying hedge accounting easier, allowing entities to apply hedge accounting more broadly and reducing 'artificial' profit or loss volatility. The new hedging requirements provide a better link to risk management and treasury operations, and are less complex.

> **'AASB 9 (2013) introduced a new hedge accounting model to simplify hedge accounting outcomes and more closely align hedge accounting with risk management objectives.'**
>
> ***QANTAS CONSOLIDATED INTERIM FINANCIAL REPORT HALF-YEAR ENDED 31 DECEMBER 2014***

This article examines the Australian experience of early adoption, and summarises the information disclosed in the early adopters' most recent financial statements. Early adoption has taken place across a wide range of industries including – airlines, telcos, miners, consumer products, retailers, and materials.

Reasons for early adoption

To date it appears that the most significant driver for early adoption is that it is easier to reduce profit or loss volatility from the:

- Time value component in options
- Price components of non-financial items
- Forward element of currency forward contracts
- Foreign currency basis spread in cross currency swaps.

Time value of options

A study of Australian companies who have early adopted indicates that the accounting treatment for time value of options under AASB 9 is one of the key drivers for this decision.

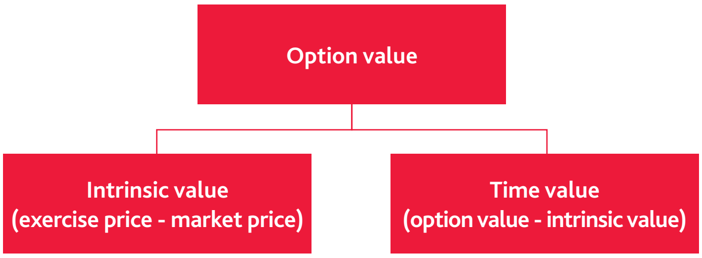
An option's fair value contains two components: intrinsic value and time value. Intrinsic value is the difference between the exercise price and the spot price.

Example:
An entity enters into an option to buy gold at $1,300 when the gold spot price is $1,400.

Fair value of the option is $150.

The option's intrinsic value is $100 ($1,400-$1,300) and the time value is $50 ($150-$100).

At expiry, options have no time value.



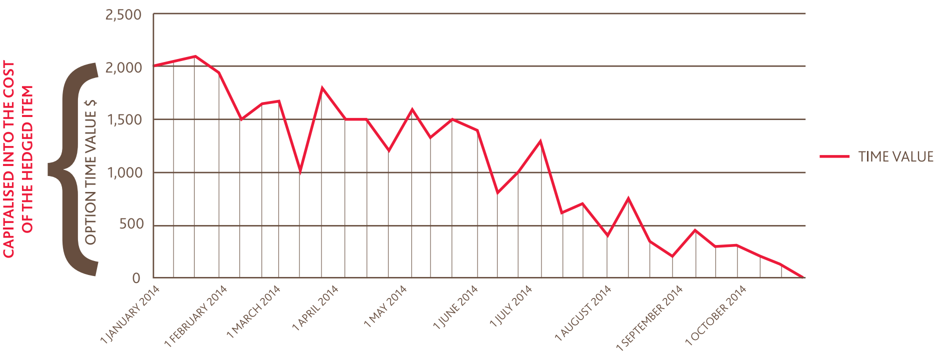
Applying hedge accounting to options
The basic premise of AASB 139 and AASB 9 is that all derivatives, including options, must be recorded at fair value at each reporting date.

When hedge accounting is applied to options, AASB 139 only allows the movements in the intrinsic value component to be deferred to other comprehensive income (OCI) for a cash flow hedge. The movements in the time value component are recorded in profit or loss, (in the same way as a derivative that is not designated in a hedging relationship) and this results in profit or loss volatility.

Under AASB 9, the movements in time value are recorded in OCI instead of profit or loss, meaning that profit or loss volatility is reduced. The option premium (which usually equals initial time value if the option is transacted at market rates) is treated as a hedging cost with the following accounting being applied:

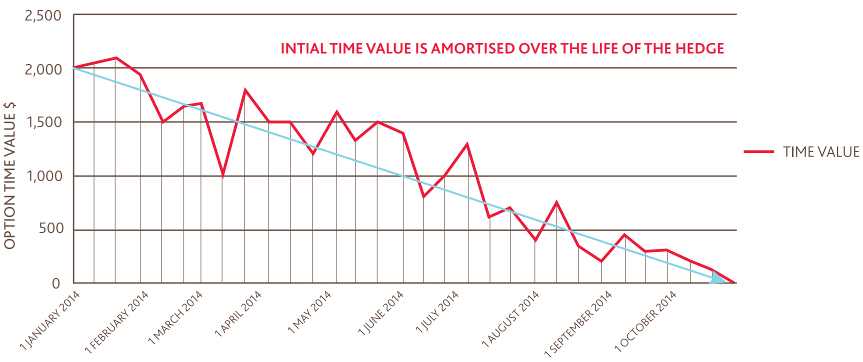
- If the entity is hedging a forecast purchase or sale (i.e. the hedged item is transaction related) the initial time value is capitalised into the cost of the forecast purchase or sale

Time value of options - transaction related hedged item



- If the entity is seeking price protection over a period of time e.g. interest rate cap (i.e. the hedged item is time period related) the initial time value is amortised to profit or loss over the term of the hedging relationship.

Time value of options - transaction related hedged item



The table below summarises the subsequent accounting treatment of options required by AASB 139 *Financial Instruments: Recognition and Measurement* compared to AASB 9.

	AASB 139	AASB 9
Subsequent changes in time value of option	Recognise in profit or loss	Recognise in other comprehensive income (OCI)

The resulting effect under AASB 9 is that profit or loss volatility is eliminated.

Other key drivers for early adoption include:

- The ability to apply hedge accounting to price components of non-financial items (e.g. components of jet fuel and iron ore contracts)
- The ability to treat the forward element of forward currency contracts and foreign currency basis spread as a cost of hedging because the movements are recorded in OCI rather than in profit or loss, therefore reducing profit or loss volatility.

Summary of early adoption comments

The table below summarises comments from the annual reports of Australian companies that have been early adopter's of AASB 9.

NAME	IMPACT OF EARLY ADOPTING AASB 9 HEDGE ACCOUNTING
Qantas Airway Limited	Qantas uses jet kerosene, gas oil and crude oil options and swaps to hedge exposure movements in the price of aviation fuel. Hedge accounting can now be applied to these hedges, reducing profit or loss volatility. Time value of options, the forward element of forward contracts and foreign currency basis spreads are now treated as a cost of hedging which reduces profit or loss volatility. Hedge effectiveness is now forward looking and does not prescribe defined effectiveness parameters. The 80-125% range of effectiveness has been removed.
Wesfarmers Limited	Cross currency interest rate swaps – foreign currency basis adjustments separated out and recognised as cost of hedging, reducing profit or loss volatility. Hedge effectiveness testing on a prospective basis – more simplified hedge effectiveness testing criteria.
Virgin Australia Holdings Limited	The Group now applies hedge accounting to hedges of components of jet fuel which is common in the aviation industry. Movements in time value of options are now recognised in OCI rather than profit or loss, reducing profit or loss volatility. Derivatives on balance sheet: • Fuel hedging contracts • Forward foreign exchange contracts.
Telstra Corporation Limited	Cross currency interest rate swaps – for foreign currency borrowings, foreign currency basis adjustments separated out and recognised as cost of hedging over the remaining life of the financial instrument, reducing profit or loss volatility. The forward element of forward contracts can be separated out and treated as a cost of hedging which reduces profit or loss volatility. Derivatives on balance sheet: • Cross currency swaps • Interest rate swaps • Forward exchange contracts.
BC Iron Limited	Can now apply hedge accounting in hedging the benchmark component of iron ore supply contracts, reducing profit or loss volatility.
Dulux Group Limited	Movements in time value of options are now recognised in OCI rather than profit or loss, reducing profit or loss volatility.
Murray Goulburn Co-Operative Co Limited	Movements in time value of options are now recognised in OCI rather than profit or loss, reducing profit or loss volatility. Derivatives on balance sheet: • Foreign currency derivatives.
Incitec Pivot Limited	Movements in time value of options are now recognised in OCI rather than profit or loss, reducing profit or loss volatility. Derivatives on balance sheet: • Cross currency interest rate swaps • Option contracts • Forward exchange contracts • Interest rate swaps • Commodity contracts.
McPhersons Limited	Movements in time value of options are now recognised OCI rather than profit or loss, reducing profit or loss volatility.
Coca-Cola Amatil Limited	Movements in time value of options are now recognised in OCI rather than profit or loss, reducing profit or loss volatility. Derivatives on balance sheet: • Cross currency swaps • Foreign currency forwards • Currency options • Aluminium, sugar and coffee futures.

For more information on AASB 9

If you would like more information about the new AASB 9 hedge accounting requirements please contact Wayne Basford.

We can assist with implementation of the new AASB 9 standard including:

- Providing accounting advice on the application of hedge accounting
- Drafting hedge accounting documentation to comply with accounting standards
- Drafting a hedge accounting risk management policy to comply with accounting standards
- Assist in complying with the hedge effectiveness testing requirements.