
Project	Financial Instruments (Replacement of IAS 39)—Hedge Accounting
Topic	Example of ‘hedging’ a forecast purchase of an equity instrument

Background

1. At a previous IASB meeting¹ on hedge accounting the staff explained the issue of whether a forecast purchase of an equity instrument (measured at fair value through profit or loss) would qualify for hedge accounting. The Board requested that the staff provide a numerical example of that explanation, using a cash instrument as the hedging instrument in a cash flow hedge.
2. The purpose of this paper is solely providing that example as requested (ie for information purposes rather than for discussion by the Board).

Example

3. The example illustrates a ‘cash flow hedge’ of a forecast purchase (in t_2) of a share of company XYZ (Share XYZ) using another Share XYZ that the entity already owns. The hedging relationship is designated in t_0 and the entity sells in t_4 the share it purchased in t_2 .
4. The example illustrates that the gain of CU10² accumulated in other comprehensive income from t_0 to t_2 *cannot* be appropriately reclassified to profit or loss in or after t_2 . Reclassification in each of the potential points in time that

¹ IASB meeting on 15 April 2011.

² In this paper, monetary amounts are denominated in ‘currency units (CU)’.

This paper has been prepared by the technical staff of the IFRS Foundation for discussion at a public meeting of the IASB.

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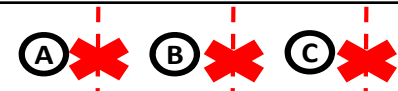
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might be considered (ie t_2 , t_3 and t_4 —scenarios A, B and C) would *create* (instead of mitigate) a mismatch and thus *distort* profit or loss—ie the gain/loss from the ‘hedging instrument’ never provides an offsetting effect in profit or loss consistent with the notion of hedge accounting. Hence this ‘hedging relationship’ cannot achieve the objective of hedge accounting.

[All amounts in CU]

Time	t_0	t_1	t_2	t_3	t_4
'Hedging instrument' (Share XYZ)					
Fair value	100	80	110		
Change in fair value		-20	30		
'Hedged item' (Purchase of Share XYZ in t_2)					
Fair value			110	150	200
Change in fair value				40	50
Statement of comprehensive income [dr/<cr>]					
Financial gain/loss		0	0	<40>	<50>
Profit or loss		0	0	<40>	<50>
'Cash flow hedge gain/loss'					
Other comprehensive income		20	<30>	0	0
Statement of financial position [dr/<cr>]					
Financial assets	100	80	110	150	200
Equity					
'Cash flow hedge reserve'		20	<10>		
Retained earnings		0	0	<40>	<90>
Other	<100>	<100>	<100>	<100>	<100>



Analysis of scenarios A, B and C

- In **scenario A** (t_2) the gain of CU10 accumulated in other comprehensive income from t_0 to t_2 *cannot* be appropriately transferred to profit or loss because the hedged risk does not affect profit or loss at that time (the asset is purchased and recognised at its fair value of CU110, which does not affect profit or loss).

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6. In **scenario B** (t_3) the gain of CU10 *cannot* be appropriately transferred to profit or loss because it is completely *unrelated* to the gain of CU40 on the purchased Share XYZ between t_2 and t_3 . A transfer to profit or loss would increase (not reduce and hence offset) the gain to CU50, which would *create* a mismatch.
7. In **scenario C** (t_4) the gain of CU10 *cannot* be appropriately transferred to profit or loss because it is completely *unrelated* to the gain of CU50 on the purchased Share XYZ between t_3 and t_4 (for the same reason that applies in scenario B). In particular, there is no gain or loss on the *sale* of Share XYZ (because all gains/losses in previous periods since the purchase in t_2 have already been recognised in profit or loss). Hence, the gain of CU10 *cannot* be appropriately transferred to profit or loss on the sale of Share XYZ.