Introduction

1. This paper addresses the feedback received on the proposals in the exposure draft *Hedge Accounting* (ED) regarding groups and net positions.

2. The paper contains three questions to the Board.

3. This paper does not address questions related to macro hedge accounting. These will be discussed as part of a separate work stream on macro hedge accounting.

Summary of the feedback received from comment letters and outreach

4. The feedback from comment letters and the outreach activities showed strong support for the proposals that would facilitate hedge accounting for groups and net positions.

5. Almost all the respondents to the invitation to comment and participants in the outreach activities either agree or conditionally agree with the proposals.

6. Respondents and participants in the outreach who agreed with the proposals highlighted the fact that the Board’s proposals are clear and reflect what is done for groups and net positions from a risk management perspective. The majority of the respondents within this group are in agreement with the proposed hedge accounting requirements for groups of items, net positions and with extending...
the possibility to designate layers to fair value hedges\(^1\). On the proposals for net positions it was noted that the proposals would better accommodate common risk management than the model in IAS 39 *Financial Instruments: Recognition and Measurement*, which allows only the designation of gross positions. This has created a disconnect from risk management and led to the designation of artificial hedging relationships on a gross basis.

7. Some of the respondents who agreed with the proposals would like to have more clarity as to whether these proposals would be extended to portfolio/macro hedge accounting. The staff note that the issue as to whether aspects of the general hedge accounting model should be extended to the macro hedge accounting model will be discussed by the Board as part of its deliberations of macro hedge accounting. That work stream will also deal with the issue as to whether an abstract net position can be designated as a hedged item (see paragraph 12(b) below).

8. Some other respondents who agreed with the proposals also commented on the designation of a layer that contains prepayable items. (Note: this issue has already been discussed by the Board as part of the redeliberations.\(^2\))

9. Finally, some commentators agreed with the Board’s rationale for not allowing the application of cash flow hedge accounting to net positions that consist of forecast transactions that will affect profit or loss in different reporting periods, because this has the potential for accounting abuse (‘earnings management’). Some within this group, despite agreeing with the proposals, asked the Board to provide additional guidance on the treatment of the amounts deferred in other comprehensive income (OCI) if, in a cash flow hedge of a net position, the offsetting cash flows that were initially expected to occur in the same period subsequently change and are expected to occur in different periods.

10. Most of the respondents who conditionally agreed asked the Board to further consider the application of hedge accounting to cash flow hedges of a net position.

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\(^1\) Under the current model the possibility of designating layers is only available for cash flow hedges.
\(^2\) Refer to agenda paper 5 (Nominal components) presented at the 27 April 2011 IASB meeting.
position with items that affect profit or loss in different reporting periods. In their view, the proposals impose constraints upon reporting the consequences of commonly used risk management strategies and give the impression that the Board is still thinking in terms of individual items. A few participants who conditionally agreed argued that entities subject to interim reporting would be at a disadvantage compared to entities that report on an annual basis. Hence, they suggested using an annual reporting period as the reference for the restriction instead of an interim reporting period.

11. The concern about the restriction on cash flow hedges of a net position mostly came from preparers who tend to look at this issue from a treasury perspective (ie from a cash flow perspective) and not from an accounting perspective (ie when the item affects profit or loss).

12. Few participants disagreed with the proposals. They did so mainly for these reasons:

(a) If the restriction on cash flow hedges is not eliminated, then the proposals are not useful, because they decrease comparability between entities and are complex to apply.

(b) The designation of gross identifiable amounts is not consistent with risk management. In their view, the possibility of designating an abstract net position is a preferable solution to the one in the ED that forces entities to track the gross positions that constitute the net position. This issue has been raised by financial institutions and some large corporations. These tend to run macro hedging programmes and hence it is difficult for their risk management to identify what gross items form part of the net position. These entities are much closer to a solution consistent with a macro hedge accounting model, which is a different work stream.
The issues

13. The feedback from the comment letters and the outreach activities highlighted the following issues:

(a) uncertainty as to whether the proposals on groups and net positions would be extended to portfolio/macro hedge accounting;

(b) a request for reconsidering the restriction on the application of hedge accounting to cash flow hedges of a net position with items that affect profit or loss in different reporting periods;

(c) a request for considering the annual reporting period as the basis for the restriction instead of any reporting period (ie including interim reporting periods);

(d) requests for additional guidance on the treatment of the amounts deferred in OCI if, in a cash flow hedge of a net position, the offsetting cash flows that were initially expected to occur in the same period subsequently change and are now expected to occur in different periods.

14. Because of the variety of issues that this paper entails, the staff split the paper into three different sections, each of which addresses a category of issues:

(a) **Section A—Restrictions for net position cash flow hedges**: Analysis of the restriction on the application of hedge accounting for net positions that contain forecast transactions affecting profit or loss in different reporting periods. This section contains one question to the Board.

(b) **Section B—Reporting period**: Analysis of whether the restriction on the application of hedge accounting for net positions should refer to a reporting period (ie including interim reporting periods) or an annual reporting period. This section contains one question to the Board.

(c) **Section C—Net Positions**: Changes in the timing of the forecast transactions within a net position that were initially expected to affect
profit or loss in the same reporting period. This section contains one question to the Board.

15. If the Board agrees with the staff recommendation in Section A, Sections B and C become irrelevant.

16. The issue of presentation of the gains or losses on the hedging instrument (ie gross or net presentation) in profit or loss is contingent on the decision taken in this paper. This is discussed in agenda paper 14.

Staff analysis and alternatives

Section A—Restrictions for net position cash flow hedges

Application of hedge accounting to cash flow hedges of a net position whose cash flows affect profit or loss in different reporting periods

17. The issue raised by respondents in the comment letters and participants in the outreach activities related to the eligibility criteria of a net position that involves forecast transactions or groups of forecast transactions that will affect profit or loss in different reporting periods.

18. The staff note that the request from respondents is limited to cash flow hedges of a net position with items that affect profit or loss in different reporting periods. The Board’s proposals in relation to groups and net positions received overwhelming support. This included the proposals on groups of items (both for fair value and cash flow hedges), fair value hedges of a net position and also the proposals in relation to cash flow hedges of a net position whose items affect profit or loss in the same reporting period.

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3 Refer to paragraphs 34(c) and B74 to B76 of the ED.
19. Commentators considered that the proposals will accommodate hedge accounting for more commonly used risk management strategies. Up to now, those risk management strategies have not achieved hedge accounting under IAS 39 because of the prohibition of designating net positions, the fact that the designation of a layer component was not available for fair value hedges or the rule on the proportionate change in fair value for the items within a group, which made the designations on a group basis difficult to implement. Hence, the request relates solely to whether the restriction in the ED can be lifted for the subset of net position cash flow hedges whose items affect profit or loss in different reporting periods thereby allowing more economic hedges to achieve hedge accounting.

Rationale for the restriction in the ED

20. During the deliberations on the ED, the Board decided to restrict the eligibility of a group consisting of items that have offsetting risk positions that provide a natural hedge for risks in that group, if those items affect profit or loss in different reporting periods.

21. This was because for a cash flow hedge of a net position that is a group of forecast transactions, the cumulative change in value (from the inception of the hedge) of some of those forecast transactions must be deferred through OCI. This deferral is necessary because the gain or loss that arises on the forecast transactions that occur in the early phase of the hedging relationship must be reclassified to profit or loss in the later phase of the relationship, when the last hedged item in the net position occurs, to recognise the transactions in the net position at the hedged rate.

22. However, the Board considered that this would be a significant departure from the general IFRS requirements for accounting for items that result from forecast transactions for those that occur in earlier phases of the net position hedge.

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4 Refer to paragraph 83 of IAS 39.
5 Refer to paragraphs BC168 to BC173 of the ED.
23. To achieve the stated objective (ie to report the transactions at the hedged rate), transactions that occur in earlier phases of the hedging relationship would have to be accounted for in a way that is more similar to a hedging instrument than to a hedged item. This is because the cumulative change in value of the earlier forecast transactions needs to be deferred in OCI to be recycled to profit or loss when the later forecast transaction affects profit or loss. Conversely, transactions that occur in the later stages of the hedging relationship will be accounted for in a way that is comparable to the accounting for the hedged item. These mechanics are reproduced in Appendix A using the example analysed by the Board during its deliberations for the ED⁶.

24. This restriction was also proposed on the basis of the following concerns⁷:

(a) the change in value (from the inception of the hedge) of a forecast transaction is not a gain or a loss arising from a contractual arrangement and hence should not be recognised in profit or loss or OCI.

(b) the mechanics required for cash flow hedge accounting need to be modified to accommodate net position hedging. The revised mechanics were considered too complex.

(c) if the first forecast transaction in a net position hedge of forecast transactions does not occur, hedge ineffectiveness might not be recorded.

25. The restriction also reflects concerns in the Board discussions that there was potential for earnings management because different hedged items included in the net position can affect profit or loss over significantly different periods. For example, if two forecast transactions of sales and expenses in a foreign currency are jointly designated in a net position, this can be easily designated in a way that meets the requirement of recognition in profit or loss in their entirety in the same reporting period. However, this fact pattern can be extended to more

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⁶ Refer to agenda paper 6A presented at the July 2010 IASB meeting.
⁷ Refer to agenda paper 19A presented at the October 2010 IASB meeting.
complex scenarios such as groups of forecast transactions (including layers) where, for example, forecast sales in a foreign currency are jointly designated with a layer of future purchases of property plant and equipment, inventory and other raw materials, all in the same foreign currency. This creates increased complexity and has the potential for earnings management because the entities can choose the profit or loss recognition pattern that is more suitable when allocating the cash hedge reserve to profit or loss.

_Treasury versus accounting perspective_

26. The issues outlined above and the difference in views in the feedback (ie some clearly agreeing with the Board in relation to the restriction while others think that the restriction is a constraint upon achieving hedge accounting for commonly used risk management strategies) highlight the difference between the two perspectives from which this issue can be approached.

27. If this issue is approached from a treasury perspective, it will be looked at from a cash flow perspective only. This is because the treasury perspective typically looks at the cash inflows and outflows arising from both sides of the net position (forecast foreign exchange (FX) receipts and forecast FX pay-outs). The treasury view stops at the level of the cash flows and does not take into account the time lag that may exist between the cash flow and recognition of related incomes or expense in profit or loss. From a treasury perspective, once the first forecast transaction is recognised the natural hedge lapses and the remainder of the net position will be hedged by entering into an additional derivative or alternatively by using the FX-denominated cash instrument that arises as a result of the occurrence of the first forecast transaction (eg by keeping the funds in an FX denominated bank account). Subsequently (ie at the time of settlement of the second transaction), the cash flows from the derivative/non-derivative financial instrument being used as a hedging instrument will be used to settle the payments resulting from the forecast transaction.

28. For accounting purposes, an additional issue is how to present the impact of these two forecast transactions on profit and in which accounting period. This goes beyond the cash flow view that is the treasury perspective, because the way
in which the item affects profit or loss can be different (e.g., span several reporting periods) while the cash flow is a point in time event. For example, while the purchase of services and sales of goods can be designated as part of a net position in a way that they will affect profit or loss in one reporting period, purchases of property, plant, and equipment affect profit or loss over several different reporting periods through the depreciation pattern. Similarly, if inventory is sold in the period after it was purchased, the cash flow and the related effect on profit or loss also occur in different periods.

Pros and cons of removing the restriction

29. The table below shows the overall pros and cons of lifting the restriction in relation to cash flow hedges of a net position. The staff subsequently explore the various alternatives to accommodate hedge accounting for this specific type of hedging relationship, together with specific pros and cons.

<table>
<thead>
<tr>
<th>Pros</th>
<th>Cons</th>
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<tbody>
<tr>
<td>• It improves the link between hedge accounting and risk</td>
<td>• The revised cash flow hedge mechanics would be a departure from the general model used for measuring forecast transactions (where those act like a hedging instrument).</td>
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<tr>
<td>management by accommodating hedge accounting for more</td>
<td>• It would increase complexity.</td>
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<tr>
<td>economic hedges.</td>
<td>• It might still not provide a comprehensive solution that would allow all economic net position cash flow hedges to achieve hedge accounting.</td>
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30. In addition, if the restriction in relation to cash flow hedges of a net position was lifted it would require deferring gains or losses on the forecast transactions within the net position if (and to the extent that) the items affect profit or loss in different periods.

31. The staff assess in the sections below whether in some situations hedge accounting can be accommodated for cash flow hedging relationships that are designated on a net basis and whose items affect profit or loss in different reporting periods.

32. The main concern expressed by the Board during the deliberations on the ED related to the fact that forecast transactions—by definition—involve some uncertainty, and that allowing them to play a dual role (ie both as a hedged item and as a hedging instrument) would be a significant departure from the general requirements for measuring those forecast transactions. In addition, Board members expressed the concern that, depending on the nature of the forecast transaction within the net position, there may be room for abuse.

Alternative 1—Remove the restriction but only for forecast transactions designated in a net position where the forecast transactions are of the same nature and this is specified at the inception of the hedge.

33. One alternative for extending the eligibility of net positions is to allow the designation of net positions that affect profit or loss in different reporting periods provided that the nature of all the items in each of the gross positions that together constitute the net position is specified at the inception of the hedging relationship. This alternative looks for homogeneity of items within the gross positions of forecast transactions that make up the net position.

34. For example, under this alternative an entity can designate as the net position the combination of two gross positions, each as a bottom layer: one bottom layer for the first 100 units of sales and a bottom layer of the 150 units of purchases of inventory, both in the same foreign currency, that are expected to affect profit or loss in different reporting periods. Both layers are made of homogeneous items whose nature is specified at the inception of the hedging relationship.
35. If this alternative type of designation is allowed, an entity can designate items based on their nature (i.e., their homogeneity) taking into account its own specific circumstances.

36. If the two gross positions are analysed individually, the revenue side (in the example, sales of goods) is in most scenarios less prone to abuse because those transactions are less diverse in terms of their profit or loss recognition pattern. Such items are often recognised in profit or loss in the same reporting period as the one in which the related cash flow occurs. However, for some income-type transactions there is a difference between the occurrence of the cash flow and the recognition of the income in profit or loss. An example are prepaid sales in a foreign currency that relate to different reporting periods. In that situation the selection of the sales by when they are recognised in profit or loss would influence the recycling of the cash flow hedge reserve to profit or loss.

37. The expenditure side is more diverse and hence more prone to abuse because it may include items with different timing of recognition in profit or loss. In the example above, an entity might choose to allocate the entire cash flow hedge reserve to one particular inventory or split it between different inventory items to influence the recycling of the cash flow hedge reserve to profit or loss based on the turnover of the inventory items. This means that concerns about earnings management will not be completely eliminated.

38. This alternative has however some significant advantages, because it provides further alignment with risk management, because entities often hedge net positions with items that affect profit or loss in different periods. The table below summarises the advantages and disadvantages of this alternative.

<table>
<thead>
<tr>
<th>Pros</th>
<th>Cons</th>
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<tbody>
<tr>
<td>• It improves the link between hedge accounting and risk management.</td>
<td>• It will require significant tracking efforts to allocate the cash flow hedge reserve to</td>
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39. However, the staff consider that there are other alternatives worth exploring. These are described below.

*Alternative 2—Remove the restriction for forecast transactions designated in a net position only where both the reporting period in which the transactions are expected to affect profit or loss (recognition pattern) and the nature of the transactions is specified at the inception of the hedge.*

40. Alternative 2 extends the rationale behind alternative 1 and incorporates the aspect of a reporting period into the analysis.

41. Alternative 1 simply looks at the nature of the item, without directly taking into consideration the rationale for the restriction in the ED that for cash flow hedges of a net position all items must affect profit or loss in the same reporting period.

42. If the interaction with that restriction is incorporated, then the aspect of homogeneity of the nature of the items is replaced by the aspect of in which reporting period(s) the forecast transactions would affect profit or loss. This criterion would only apply to the designation of cash flow hedging relationships on a net position basis.

43. This approach would result in the items within a net position being grouped by the reporting period(s) during which they are expected to affect profit or loss but the relationship between the nature of the item and the recognition pattern in profit or loss would still not be specified. This means that the recycling of the

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<th>Pros</th>
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<td></td>
<td>profit or loss.</td>
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<tr>
<td></td>
<td>• The concerns about earnings management will not be completely eliminated.</td>
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cash flow hedge reserve could still be influenced by the sequence in which the forecast transactions occur.  

44. This restriction significantly limits the use of layers of items and of nominal components defined as an abstract amount and moves the solution towards identifying and grouping ‘blocks’ of individual forecast transactions by the reporting period in which they are expected to affect profit or loss. This will alleviate some of the concerns about earnings management, but to be operational it will require a significant tracking capability.

45. For example, consider again that an entity designates two bottom layers of forecast transactions, which are designated in a net position cash flow hedge. Bottom layer A is made up of the first CU100 of sales and bottom layer B is made up of the first CU150 of purchases. Both sales and purchases are denominated in the same foreign currency and are expected to affect profit or loss in different reporting periods. Entity A specifies in the original hedge documentation that sales can be either be of product A or B for bottom layer A and purchases can be either of Machinery type A, Machinery type B or Raw material A for bottom layer B.

46. By specifying what items form part of each bottom layer, the potential for cherry-picking the items to which the cash flow hedge reserve deferred in accumulated OCI (AOCI) is allocated is greatly reduced but this alternative still leaves some room for abuse.

47. The room for abuse results from the fact that the sequence in which the forecast transactions occur can influence when the cash flow hedge reserve affects profit or loss if that sequence is not specified at the inception of the hedge. For example, if the first CU150 of purchases are purchases of Machinery type A this would result in the cash flow hedge reserve affecting profit or loss in different reporting periods than if the first CU150 of purchases were Machinery type B and Raw material A. If because of their nature these forecast transactions will

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8 Refer to paragraph 47.
affect profit or loss in different periods, an entity could try to influence in which period the cash flow hedge reserve affects profit or loss.

48. Similarly as for alternative 1, this alternative can only be applied by using the modified cash flow hedge mechanics described in Appendix A.

49. The pros and cons of Alternative 2 are:

<table>
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<tr>
<th>Pros</th>
<th>Cons</th>
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<tbody>
<tr>
<td>• Despite not accommodating all designations for groups of forecast transactions, it allows some net position cash flow hedges to achieve hedge accounting.</td>
<td>• It still leaves some potential for earnings management.</td>
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<tr>
<td>• It is more rigorous than Alternative 1 and hence has less room for earnings management.</td>
<td>• It will require significant tracking capability.</td>
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<td>• It will be necessary to create additional qualifying criteria to address one specific type of hedging relationship.</td>
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Alternative 3—Remove the restriction for forecast transactions designated in a net position only where the reporting period in which the transaction is expected to affect profit or loss (the recognition pattern), the nature and the volume of each forecasted transaction are specified at the inception of the hedge.

50. This alternative takes alternative 2 as a starting point but deals with the issues of:

(a) the recognition patterns that make-up the net position; and

(b) the sequence of the forecast transactions.
51. The first step is to specify the recognition patterns that make-up the net position. This is similar to ‘bucketing’ by time interval\(^9\). Each bucket will therefore correspond to amounts in the cash flow hedge reserve that will affect profit or loss in the respective reporting period(s).

52. Under this alternative, the reporting period in which forecast transactions are expected to affect profit or loss will be specified at the inception of the hedging relationship and will be used to feed the different time buckets. In addition, the nature of the item underlying the forecast transaction needs also to be specified, but not for the purposes of assessing similarity or homogeneity but rather to identify by their nature which items (forecast transactions) are designated within the net position and to provide the link to the reporting period (given by the time bucket).

53. In the staff’s view, the sequence can be defined on the basis of the hedged volume underlying each ‘block’ of forecast transactions. If this is combined with the identification of the reporting period in which the transactions are expected to affect profit or loss, the behaviour of the designated net position is on ‘autopilot’, because all of its features are pre-set at the inception of the hedge. These are:

(a) the nature of the items;
(b) the reporting periods in which the forecast transactions are expected to affect profit or loss (the recognition pattern); and
(c) the allocation (given by the volume of the forecast transactions within the net position).

54. Requiring all of the features described in paragraph 53 to be specified at the inception of the hedge takes away the flexibility that exists for less specific designations. Even when compared with alternative 2 the definition of the population of items is more stringent and significant tracking will be required.

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\(^9\) That is typically used by entities that use net positions as a surrogate for dynamic hedges (refer to paragraphs 40 to 46 agenda paper 9 on voluntary discontinuation presented at the 2 June 2011 IASB meeting).
This is because an entity needs not only to be able to assess the recognition pattern by nature of the item, but also to have an understanding and specify the volumes of each type of forecast transactions (by their nature). However, alternative 3 eliminates the potential for earnings management because the recognition pattern will be set at the inception of the hedge and hence it is clear what amounts will affect profit or loss, when they will affect profit or loss and to which hedged volumes and types of items they relate.

55. To illustrate the way a hedging relationship would be designated under this alternative, consider the same example used for alternative 2, in which an entity designates two bottom layers of forecast transactions, which are designated as a net position hedge. Bottom layer A is made up of the first CU100 of sales and bottom layer B is made up of the first CU150 of purchases. Both sales and purchases are denominated in the same foreign currency. Entity A specifies in the original hedge documentation that sales can be of product A and B for bottom layer A and purchases can be of Machinery type A, Machinery type B and Raw material A for bottom layer B.

56. Under Alternative 3, the entity also needs to specify the volumes of transactions by each nature.\(^{10}\) For illustration purposes, consider that Entity A states that bottom layer A of CU100 is made up of a forecast sales volume of the first CU70 of product A and the first CU30 of product B, which are expected to affect profit or loss in different periods, and that bottom layer B is made up of purchases of the first CU60 of Machinery type A, the first CU40 of Machinery type B and the first CU50 of raw material A. Once these volumes are set the hedging relationship will be on autopilot as its specific composition that determines the effect on profit or loss is specified at the outset.

57. The pros and cons of Alternative 3 are:

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\(^{10}\) This would have to be done in a way that also specifies when the item will affect profit or loss. Depending on the circumstances, that might have to include aspects such as the depreciation pattern for items of property, plant and equipment, e.g. if the nature of the item is such that it could still involve different depreciation patterns depending on its use. In many cases specifying the nature of the item would at the same time also specify when it affects profit or loss and hence require no additional clarification or documentation.
Pros

- It accommodates hedge accounting for more risk management than the ED or IAS 39.
- It is more rigorous than Alternative 2 and eliminates the opportunity for earnings management.

Cons

- It will require significant tracking mechanisms to be operational.
- It will be necessary to create additional qualifying criteria to address one specific type of hedging relationship.

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*Alternative 4—Eliminate the restriction completely*

58. This alternative would altogether lift the restriction on when the items in the net position affect profit or loss and consequently all cash flow hedges of a net position would be allowed (ie achieve hedge accounting) *irrespective of* whether the forecast transactions affect profit or loss in the same or in different reporting periods.

59. This alternative is substantially different from all the alternatives explored above. In order to achieve this, a ‘cash flow perspective’ needs to be taken as the basis for lifting the restriction (refer to sections: ‘Treasury versus accounting perspective’ and ‘Rationale for the restriction in the ED’). In the staff’s view this is incompatible with the accounting view, which looks at the timing of recognition in profit or loss and hence at the recognition pattern of the cash flow hedge reserve.

60. Lifting the restriction also means that concerns about the issues described in paragraph 24, particularly about the potential for earnings management, would *not* be addressed.
Alternative 5—Retain the proposals in the exposure draft

61. This is the fall-back solution if the Board does not agree with any of the alternatives explored above. However, this approach involves an issue that would need to be addressed: what is the accounting consequence of a change in the timing of the forecast transactions within a hedging relationship being designated as a cash flow hedge of a net position if that means that the items will no longer affect profit or loss in their entirety in the same reporting period? This is described in the next main section ‘Section C—Cash flow hedging of a net position when the timing of the transactions changes’.

62. This is not an issue if any of alternatives 1 to 4 is chosen because these will be subject to the general hedge accounting requirements for cash flow hedges and to the specific requirements outlined for the respective alternative.

63. As a result of the analysis above, the staff consider that the Board has the following five alternatives:

(a) Alternative 1—Extend the eligibility criteria based on the homogeneity of the forecast transactions.

(b) Alternative 2—Extend the eligibility criteria based on the nature of the forecast transactions and recognition pattern (but ignore the sequence of recognition).

(c) Alternative 3—Extend the eligibility criteria based on the nature of the forecast transactions and recognition pattern but specify the sequence of the transactions. This requires specifying the hedged volume for each type of forecast transaction (by nature) within the net position.

(d) Alternative 4—Eliminate the restriction in the ED completely.

(e) Alternative 5—Retain the proposals in the ED.

64. Prior to outlining the staff recommendation and question to the Board, the staff evaluate the 5 alternatives.

65. Firstly, the staff dismiss Alternative 4, because despite providing a full alignment with risk management, this alternative represents a significant
departure from the current requirements for accounting for forecast transactions and creates a significant potential for earnings management (refer to paragraphs 20 to 24). It also requires taking a ‘cash flow view’, which is inconsistent with the hedge accounting model.

66. Secondly, the staff dismiss **Alternative 1**, because it would not sufficiently address the Board’s concerns, particularly the one related to earnings management.

67. Thirdly, the staff dismiss **Alternative 2**, because despite facilitating hedge accounting in more situations it still retains some potential for earnings management.

68. This leaves **Alternative 3** and **Alternative 5**.

69. **Alternative 3** extends the eligibility for designation as a hedged item to net positions involving forecast transactions that affect profit or loss in different periods in some circumstances. This alternative, despite being a limited solution and requiring significant tracking mechanisms (particularly for maintaining the link between the designated hedged item, the occurrence of transactions and the cash flow hedge reserve), would accommodate some additional hedging relationships and provides a better solution than the restriction in the ED. Moreover, the staff consider that because hedge accounting is optional, entities can elect to apply the proposed alternative if they have the mechanisms to comply with it. At the same time this alternative includes rigour that addresses the concerns about earnings management.

70. **Alternative 5** is to retain the proposals in the ED. This would neither require complex cash flow hedge accounting mechanics nor a departure from the current requirements for measuring forecast transactions. However, it would leave some hedging relationships that are valid economic hedges without hedge accounting and would require the Board to address the issue described in ‘Section C—Cash flow hedging of a net position when the timing of the transactions changes’. 
71. On balance, the staff recommend Alternative 3 because the associated benefits outweigh its relative complexity.

72. If the Board does not agree with the staff recommendation and like the majority of the respondents simply wants to address the issue described in ‘Section C—Cash flow hedging of a net position when the timing of the transactions changes’ then Alternative 5 is the second-best solution.

Question 1—groups and net positions

<table>
<thead>
<tr>
<th>Does the Board agree with the staff recommendation as outlined in paragraph 71?</th>
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<tr>
<td>If the Board disagrees with the staff recommendation, what alternative would the Board prefer instead and why?</td>
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Section B—Reporting period: interim versus annual [Not relevant if the Board agrees with the staff recommendation to pursue Alternative 3]

73. Some commentators suggested that the Board retain the restriction for cash flow hedges of a net position but change the period for which the restriction applies from a reporting period to an annual reporting period (ie ignoring the frequency of reporting).

74. The ED stated that reporting periods include interim reporting periods as defined in IAS 34 Interim Financial Reporting\(^{11}\).

75. IAS 34 states that the frequency of an entity’s reporting (annual, half-yearly or quarterly) shall not affect the measurement of its annual results.\(^{12}\)

76. Hence, the restriction in the ED is an override of the general principle in IAS 34. This is because an entity with no interim reporting would get hedge accounting for a net position cash flow hedge whose forecast transactions will affect profit

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\(^{11}\) Refer to paragraph 34(c) of the ED.

\(^{12}\) Refer to paragraphs 4 and 28 of IAS 34.
or loss within an annual period. Conversely, another entity with the same hedging relationship but with interim reporting would not achieve hedge accounting because of the restriction given that the forecast transactions would affect profit or loss in different interim periods of that annual period. This also means that the annual results will be affected by the fact that an entity reports on an interim basis (albeit regarding the line item presentation in the income statement\textsuperscript{13}—not regarding the annual profit or loss).

77. However, this override of the general principle in IAS 34 is required because the issues that the restriction of net position cash flow hedges to those whose items affect profit or loss in the same reporting period addresses arise when hedge accounting would involve a balance in AOCI at a reporting date—irrespective of the length of the related reporting period. Hence, applying the restriction only at the reporting dates of annual periods would defeat the purpose of the restriction.

78. The staff also note that the general principle in IAS 34 sometimes conflicts with other requirements in IFRSs and in some cases has been overridden in order to resolve the conflict. Precedents are for example:

(a) IFRIC 10 \textit{Interim Financial Reporting and Impairment}. That interpretation overrides the general principle by requiring that an entity not reverse an impairment loss recognised in a previous interim reporting period in respect of goodwill\textsuperscript{14}.

(b) The frequency of the hedge effectiveness assessment\textsuperscript{15} under IAS 39, which at a minimum must be performed when preparing annual or interim financial statements. Hence, two entities with the same hedging relationship but with different reporting frequencies might have different effects from hedge accounting for their annual results if the

\textsuperscript{13} In this paper the term \textit{income statement} is used as a reference to a statement of profit or loss or the profit or loss section of a statement of profit or loss and other comprehensive income (ie the terminology used in the recent amendments to IAS 1 \textit{Presentation of Financial Statements}).

\textsuperscript{14} IFRIC 10.8.

\textsuperscript{15} IAS 39.AG106.
hedge effectiveness assessment was not passed in an interim period but was met for the annual reporting period.

79. Therefore, the staff consider that the restriction’s reference to a reporting period including interim reporting periods is an unavoidable conflict with the basic principle in IAS 34 but there is a justification to depart from that principle.

80. Hence, the staff recommend retaining the restriction as proposed in the ED (ie the reference to a reporting period including interim reporting periods—*if* the Board chose Alternative 5 in response to Question 1).

<table>
<thead>
<tr>
<th>Question 2—reporting period versus fiscal year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Does the Board agree with the staff recommendation in paragraph 80 that the reference to a reporting period (including interim reporting periods) should be maintained?</td>
</tr>
<tr>
<td>If the Board disagrees with the staff recommendation, what would the Board prefer instead and why?</td>
</tr>
</tbody>
</table>

**Section C—Cash flow hedging of a net position when the timing of the transactions changes** [Not relevant if the Board agrees with the staff recommendation to pursue Alternative 3]

81. The staff note that alternatives A to C are only relevant if the Board decides to retain the restriction in the ED (Alternative 5 in Section A).

82. This Section addresses the request for additional guidance on the accounting treatment for a cash flow hedge of a net position when the forecast transactions that were expected to affect profit or loss in the same period change in their timing such that they will no longer affect profit or loss in the same reporting period.

83. Because of the restriction in the ED, the fact that there are such changes in the timing of the forecast transactions makes the hedged item (net position)
ineligible for hedge accounting. Hence, the staff consider the logical result of such a change is a discontinuation of hedge accounting when the timing of the forecast transactions changes.

84. The staff consider that the following alternatives are available:

(a) **Alternative A**—Discontinue hedge accounting and immediately recycle the *full* amount of the cash flow hedge reserve to profit or loss.

(b) **Alternative B**—Discontinue hedge accounting and immediately recycle to profit or loss *only that part* of the cash flow hedge reserve that is attributable to the forecast transactions whose expected timing changed such that they no longer qualify as a hedged item (ie as part of a net position).

(c) **Alternative C**—Discontinue hedge accounting and retain the previously accumulated cash flow hedge reserve in AOCI if the transactions are still highly probable or expected to occur.

**Alternative A**

85. If the restriction in the ED is retained, a designated cash flow hedge of a net position that undergoes a change in the timing of the forecast transactions within the net position such that it no longer qualifies as a hedged item and therefore the hedging relationship is discontinued when the timing of the forecast transaction changes.

86. Alternative A might be perceived as consistent with a restrictive view that considers that the hedged item no longer meets the qualifying criteria in its entirety and therefore hedge accounting should not apply at all. This means that the entire net position would be treated as an ineligible hedged item upon any change in timing.

87. The staff note that even in those situations, the hedging relationship at the last reporting date still met all the qualifying criteria for hedge accounting. Hence, there is no error (ie non-compliance with the qualifying criteria). The staff also note that:
(a) The event of change in the timing of a forecast transaction is similar to a scenario where forecast transactions that were highly probable change their likelihood of occurrence and are no longer highly probable. This can also be the result of a change in the expected timing.\textsuperscript{16} The accounting consequence is that the hedging relationship is discontinued. If the forecast transaction is still expected to occur, the hedging gain or loss remains in AOCI until the future cash flows occur. Only if the forecast transaction is no longer expected to occur is the hedging gain or loss transferred to profit or loss at the time the expectation changes.\textsuperscript{17}

(b) The ED states that an entity shall discontinue hedge accounting prospectively (in its entirety or partially) when the hedging relationship ceases to meet the qualifying criteria.

88. Therefore, staff consider that always immediately recycling the cash flow hedge reserve to profit or loss when the cash flow hedge of a net position must be discontinued because of changes in the timing of when the items affect profit or loss would be inconsistent with the hedge accounting model. Hence, the staff dismiss Alternative A

\textsuperscript{16} Refer to IAS 39 IG F.3.11.
\textsuperscript{17} Refer to ED.30 (and IAS 39.101).
Alternative B

89. Under Alternative B (only) the part of the cash flow hedge reserve that is attributable to the forecast transaction volume for which the timing changed is immediately recycled to profit or loss as hedge ineffectiveness—irrespective of the fact that the forecast transaction might still be highly probable or probable to occur. This reflects the treatment for an item (which is a part of a net position) that is prohibited from being hedged for hedge accounting purposes, however only partially as the other forecast transactions that still meet the qualifying criteria would continue to qualify for hedge accounting. This would be consistent with the discontinuation requirements in the ED that result in partial discontinuation if only a part of the hedging relationship ceases to meet the qualifying criteria.18

90. This alternative would preserve a better link to risk management because the remainder of the relationship that still meets the qualifying criteria is a valid hedge for risk management and accounting purposes. However, it would still be a departure from the discontinuation requirements for other types of cash flow hedges and creates additional issues that need to be considered. These are described below.

91. The first issue is that irrespective of the nature of the change in the timing the outcome is always the same. This means that if a transaction changed its timing but it is still highly probable or expected to occur the cash flow hedge reserve would nonetheless be immediately recycled to profit or loss. Generally, immediate recycling only occurs when the transaction is no longer expected to occur.

92. The second issue is that requiring immediate recycling would create an opportunity for earnings management as the immediate recognition of the cash flow hedge reserve in profit or loss would already be triggered by a mere change in the timing of a transaction. In contrast, under the general requirements that is only the outcome if the forecast transaction is no longer expected to occur.

18 Refer to ED.24.
93. For these reasons the staff dismiss Alternative B.

*Alternative C*

94. If the transaction that changed in its timing is still highly probable or expected to occur, Alternative C would require discontinuing hedge accounting but retaining (‘freezing’) the hedging gain or loss in the cash flow hedge reserve until that transaction occurs.

95. The staff are of the view that this provides a better solution than the immediate recycling of the cash flow hedge reserve to profit or loss irrespective of the circumstances under Alternatives A and B because:

(a) it is consistent with the discontinuation requirements for other cash flow hedges; and

(b) it limits the potential for earnings management as the mere change in the expected timing of a transaction that is still expected to occur does not result in immediate recycling to profit or loss of the cash flow hedge reserve.

96. The staff note that for this alternative the Board needs to decide whether the hedging gain or loss that is ‘frozen’ in the cash flow hedge reserve on discontinuation of the hedging relationship:

(a) only comprises the gain or loss on the hedging instrument—this would be compatible with the approach in the ED in that no gains or losses on forecast transactions would be deferred in the cash flow hedge reserve to another period and presented in the income statement (ie the separate line item in the income statement would only include gains and losses from the hedging instrument); or

(b) could also include gains and losses on forecast transactions that settle first—this would not be compatible with the approach in the ED because it would in some situations require deferring gains or losses on forecast transactions in the cash flow hedge reserve to another period and presenting such gains or losses in the income statement.
97. This is best illustrated using an example. An entity hedges a net position of foreign currency (FC) cash in- and outflows.\textsuperscript{19} The entity initially expected that it has at least an inflow of FC100 and an outflow of FC70. The expected net inflow of FC30 was hedged with a foreign currency hedging instrument (FX hedge) that has a notional amount of FC-30. All cash flows were initially expected to occur in period t(n). The table below sets out four scenarios:

<table>
<thead>
<tr>
<th>Scenario</th>
<th>Period</th>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>t(n)</td>
<td>t(n+1)</td>
<td>t(n)</td>
<td>t(n+1)</td>
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<tr>
<td>Cash inflow</td>
<td></td>
<td>100</td>
<td>90</td>
<td>10</td>
<td>60</td>
</tr>
<tr>
<td>Cash outflow</td>
<td></td>
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<td>-70</td>
<td>-70</td>
<td>-70</td>
</tr>
<tr>
<td>Hedged net position</td>
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<td>20</td>
<td>10</td>
</tr>
<tr>
<td>Hedge (notional)</td>
<td></td>
<td>-30</td>
<td>-30</td>
<td>-30</td>
<td>-30</td>
</tr>
<tr>
<td>Thereof deferred</td>
<td></td>
<td>0</td>
<td>-10</td>
<td>-30</td>
<td>0</td>
</tr>
</tbody>
</table>

\textbf{Deferral for forecast transactions?} 

-10 20

98. **Scenario A**: the cash flows occur as expected (this scenario is only for reference—no discontinuation of hedge accounting is involved).

99. **Scenario B**: FC10 of cash inflows are expected to occur in t(n+1). This results in discontinued hedge accounting for cash inflows of FC10 at the end of t(n). The gain or loss on FC-10 of the notional amount of the FX hedge would be frozen in the cash flow hedge reserve and recycled in t(n+1) when the remaining FC10 cash inflow affect profit or loss. No deferral of gains or losses on forecast transactions that settle in t(n) is involved.

100. **Scenario C**: FC40 of cash inflows are expected to occur in t(n+1). This results in discontinued hedge accounting for cash inflows of FC40 at the end of t(n). The gain or loss on the entire FC-30 of the notional amount of the FX hedge would be frozen in the cash flow hedge reserve and recycled in t(n+1) when the

\textsuperscript{19} This example assumes that the cash flows affect profit or loss in the period of the cash flow.
remaining FC40 cash inflow affect profit or loss. However, the notional amount
of the FX hedge is less than the amount needed to offset the gain or loss on the
FC40 cash inflow that slipped into (n+1). This means:

(a) In order to achieve offset for that entire amount of FC40 the gain or
loss on the FC-10 net cash outflow in t(n) would have to be deferred
in the cash flow hedge reserve in addition to the gain or loss on the FX
hedge. Hence, this would involve a deferral of gains or losses on
forecast transactions that settle in t(n).

(b) If no gain or loss on forecast transactions that settle in t(n) is deferred in
the cash flow hedge reserve this results in recognising the gain or loss
on the amount of FC-10 net cash outflow in t(n)—ie the same result as
if FC-10 had not been hedged.

101. **Scenario D:** FC-20 of cash outflows are expected to occur in t(n+1). This
results in discontinued hedge accounting for cash outflows of FC-20 at the end
of t(n). The gain or loss on the entire FC-30 of the notional amount of the FX
hedge would be recycled from the cash flow hedge reserve to profit or loss in
t(n) when the FC50 net cash inflow affect profit or loss. However, the notional
amount of the FX hedge is less than the amount needed to offset the gain or loss
on the FC50 net cash inflow that now occurs in t(n). This means:

(a) In order to achieve offset for the amount of FC-20 cash outflow that
slipped into t(n+1) the gain or loss on an amount of FC20 net cash
inflow in t(n) that remains after taking into account the FX hedge
would have to be deferred in the cash flow hedge reserve. Hence, this
would involve a deferral of gains or losses on forecast transactions that
settle in t(n).

(b) If no gain or loss on forecast transactions that settle in t(n) is deferred in
the cash flow hedge reserve this results in recognising the gain or loss
on the amount of FC20 net cash inflow in t(n) that remains after taking

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20 The gain or loss on this forecast transaction is determined by comparing the exchange rate at the time
the forecast transaction settles with the exchange rate on designation of the hedging relationship.
into account the FX hedge—ie the same result as if FC20 had not been hedged.

102. The staff note that this accounting for discontinued hedging relationships would only apply in conjunction with Alternative 521 (ie if the Board decides to retain the restriction in the ED that gains and losses on forecast transaction in a cash flow hedge of a net position cannot be deferred in the cash flow hedge reserve).

103. Hence, the staff consider that the requirements for discontinuing cash flow hedge accounting if the timing of items in a net position change such that they no longer qualify under the restriction in the ED should not involve deferring gains and losses on forecast transactions. If the Board is prepared to facilitate the deferral of such gains and losses the staff consider that Alternative 3 would be the more appropriate solution (in which case this section would be irrelevant).

104. The remaining question is whether a history of revising the timing of transactions such that hedge accounting for cash flow hedges of net positions must be discontinued should disqualify an entity from designating cash flow hedge relationships on a net position basis that involve forecasting similar transactions.

105. This issue is similar to revisions of the probability of forecast transactions occurring. Hence, the staff consider that the issue regarding the forecasts of the timing of transactions for cash flow hedges of net positions could be addressed with a provision similar to the one in the ED dealing with the issue of a history of revising the probability of the forecast transaction such that it is no longer expected to occur. This would mean that entities will lose the ability to designate net position cash flow hedges involving the transactions for which a history has developed of revising the timing of transactions such that hedge accounting for cash flow hedges of net positions must be discontinued.

106. The staff consider that of all the alternatives Alternative C would be most robust against earnings management.

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21 Refer to paragraph 15.
22 Refer to ED.B65(b).
107. In summary, the accounting under Alternative C would be as follows:

(a) Gains or losses on forecast transactions that have settled in a period could not be deferred in the cash flow hedge reserve (which would only include gains and losses on the hedging instrument);

(b) Gains or losses in the cash flow hedge reserve are not recycled to profit or loss if the transaction subject to a change in timing is still highly probable or expected to occur;

(c) If an entity has a history of revising the timing of forecast transactions that resulted in discontinuing hedge accounting for net position cash flow hedges the entity loses the ability to designate net positions that include similar forecast transactions.

**Staff recommendation and question to the Board**

108. For the reasons set out in the analysis of Alternatives A to C the staff recommend Alternative C (if the Board chose Alternative 5 in response to Question 1).

<table>
<thead>
<tr>
<th>Question 3—changes in the timing of forecast transactions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Does the Board agree with the staff recommendation as outlined in paragraph 108 to adopt alternative C?</td>
</tr>
</tbody>
</table>

If the Board disagrees with the staff recommendation, what would the Board prefer instead and why?
Appendix A—Cash flow hedge mechanics for a net position whose forecast transactions affect profit or loss in different periods (Extract of agenda paper 19A presented at the IASB meeting on 19 October 2010)

Example A: Cash flow hedge for FX risk on two forecast transactions

Date: 1/1/X0

Hedging entity functional currency: EUR

Description of hedge: cash flow hedge for spot FX risk on net position of hedged item 1 and hedged item 2.

Hedged item 1: forecast transaction to pay for advertising expense of $200k, in 12 months’ time (on 31/12/X0).

Hedged item 2: forecast transaction to sell finished goods at $300k, in 24 months’ time (on 31/12/X1).

Hedging instrument 1: forward foreign currency (FX) derivative, entered into on 1/1/X0, with 24-month term, pay $100k, receive €50k (exchange rate = 2:1). This is to hedge the net position of $100k.

Hedging instrument 2: forward foreign currency (FX) derivative, entered into on 1/1/X1, with 12-month term, pay $200k, receive €50k (exchange rate = 4:1). This is to hedge, in combination with hedging instrument 1, the revised open position of $300k.

Term of hedge: 24 months.

Assumptions: assume interest rates = 0% (hence spot rates = forward rates) and assume 100% effective hedge.

Effect of applying hedge accounting (scenario 1): hedging instrument gain/loss shown in separate line item. In combination with this line, hedged item 1 and hedged item 2 are both recorded in profit or loss at the hedged spot rate. In other words, on a net basis, both transactions appear fully hedged.
Illustrative numerical example for example A

This appendix provides a numerical illustration for scenarios 1-4 of example A.

The following summary of originally expected transactions applies to all four scenarios:

\[
\text{minus} = \text{Credit}
\]

<table>
<thead>
<tr>
<th></th>
<th>T0</th>
<th>T1</th>
<th>T2</th>
<th>T3</th>
<th>T4</th>
</tr>
</thead>
<tbody>
<tr>
<td>$/€</td>
<td>1/1/X0</td>
<td>30/6/X0</td>
<td>31/12/X0</td>
<td>30/6/X1</td>
<td>31/12/X1</td>
</tr>
<tr>
<td>Exchange rate</td>
<td>2</td>
<td>2.5</td>
<td>4</td>
<td>3.2</td>
<td>2.5</td>
</tr>
<tr>
<td>Forward 1:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pay $</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
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<td>Receive €</td>
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<td>Pay $</td>
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<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Receive €</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Forecast expense $</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Forecast sale $</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>-</td>
</tr>
</tbody>
</table>
Scenario 1—transactions arise as originally expected

Overview

A1. The following illustration is intended to show how the mechanics of cash flow hedge accounting for a net position would work in practice. A summary of the steps involved for each scenario is provided below.

A2. At T0 a hedge relationship is designated between the two forecast transactions (net position = $100k) and Forward 1.

A3. During T1 and T2, the fair value change of Forward 1 is deferred in equity because the hedge is 100 per cent effective.

A4. At the end of T2 the following three things happen:
   
   (a) the hedged purchase occurs and is recorded in profit or loss;
   
   (b) the value change of the hedged purchase is deferred in OCI—this results in the net profit or loss reflecting the purchase at the initial hedged rate of 2:1
   
   (c) Forward 2 is transacted to cover the revised open position (the net position changed because the purchase occurred).

A5. During T3 and T4, the hedge is equivalent to a gross hedge of the sale that occurs at the end of T4. The gain/loss of Forward 1 and Forward 2 is deferred in equity because the hedge is 100 per cent effective.

A6. At the end of T4, the sale occurs and affects profit or loss. Amounts deferred in OCI are reclassified to profit or loss. On a net basis the sales are recorded at the initial hedged rate of 2:1.
## Profit or loss and OCI

<table>
<thead>
<tr>
<th></th>
<th>30/6/X0</th>
<th>31/12/X0</th>
<th>30/6/X1</th>
<th>31/12/X1</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Profit or loss</strong></td>
<td>Dr/(Cr)</td>
<td>Dr/(Cr)</td>
<td>Dr/(Cr)</td>
<td>Dr/(Cr)</td>
</tr>
<tr>
<td>Forecast sale</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>120,000</td>
</tr>
<tr>
<td>Forecast expense</td>
<td>-</td>
<td>50,000</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Net hedge gain/loss</td>
<td>50,000</td>
<td>-</td>
<td>30,000</td>
<td></td>
</tr>
<tr>
<td><strong>Net</strong></td>
<td>-</td>
<td>100,000</td>
<td>-</td>
<td>150,000</td>
</tr>
<tr>
<td><strong>OCI</strong></td>
<td></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Cash flow hedge reserve</td>
<td>-10,000</td>
<td>- 65,000</td>
<td>18,750</td>
<td>56,250</td>
</tr>
</tbody>
</table>

## Balance sheet

<table>
<thead>
<tr>
<th></th>
<th>30/6/X0</th>
<th>31/12/X0</th>
<th>30/6/X1</th>
<th>31/12/X1</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Forward 1</td>
<td>10,000</td>
<td>25,000</td>
<td>18,750</td>
<td></td>
</tr>
<tr>
<td>Forward 2</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td></td>
<td></td>
<td>50,000</td>
<td></td>
</tr>
<tr>
<td><strong>Liabilities</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Forward 1</td>
<td>-</td>
<td>-</td>
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<td></td>
</tr>
<tr>
<td>Forward 2</td>
<td>-</td>
<td>- 12,500</td>
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<tr>
<td>Overdraft</td>
<td>- 50,000</td>
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<tr>
<td><strong>Equity</strong></td>
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<tr>
<td>Cash flow hedge reserve</td>
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<tr>
<td>P/L reserve</td>
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<td>- 50,000</td>
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<tr>
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### Double entry

#### 30/6/X0

<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>Forward 1 (B/S)</td>
<td></td>
<td>10,000</td>
</tr>
<tr>
<td>Cash flow hedge reserve (OCI)</td>
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<td>10,000</td>
</tr>
<tr>
<td><strong>To recognise Forward 1 at FV on balance sheet, recognise effective gain/loss in OCI and ineffective gain/loss in P/L.</strong></td>
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</table>

#### 31/12/X0

<table>
<thead>
<tr>
<th>Dr</th>
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</thead>
<tbody>
<tr>
<td>Forward 1 (B/S)</td>
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<td>15,000</td>
</tr>
<tr>
<td>Forecast expense (P/L)</td>
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<td>50,000</td>
</tr>
<tr>
<td>Net hedge gain/loss (P/L)</td>
<td></td>
<td>50,000</td>
</tr>
<tr>
<td>Cash (B/S)</td>
<td></td>
<td>50,000</td>
</tr>
<tr>
<td>Cash flow hedge reserve (OCI)</td>
<td>65,000</td>
<td></td>
</tr>
<tr>
<td><strong>To recognise Forward 1 at FV on balance sheet, recognise $200,000 expense in P/L, and defer effective (1) gain on Forward 1 (Cr 15,000) and (2) favourable value change on expense (Cr 50,000) in OCI (net = Cr 65,000).</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

#### 30/6/X1

<table>
<thead>
<tr>
<th>Dr</th>
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<tbody>
<tr>
<td>Cash flow hedge reserve (OCI)</td>
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</tr>
<tr>
<td>Forward 1 (B/S)</td>
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<td>6,250</td>
</tr>
<tr>
<td>Forward 2 (B/S)</td>
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<td>12,500</td>
</tr>
<tr>
<td><strong>To recognise Forward 1 and Forward 2 at FV on balance sheet, recognise effective gain/loss in OCI and ineffective gain/loss in P/L.</strong></td>
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<td></td>
</tr>
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### 31/12/X1

<table>
<thead>
<tr>
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<th>Cash flow hedge reserve (OCI)</th>
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</thead>
<tbody>
<tr>
<td>Cr</td>
<td>Forward 1 (B/S)</td>
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</tr>
<tr>
<td>Cr</td>
<td>Forward 2 (B/S)</td>
<td>17,500</td>
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</tbody>
</table>

To recognise Forward 1 and Forward 2 at FV on balance sheet, recognise effective gain/loss in OCI and ineffective gain/loss in P/L.

<table>
<thead>
<tr>
<th>Dr</th>
<th>Cash (B/S)</th>
<th>120,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cr</td>
<td>Forecast sale (P/L)</td>
<td>120,000</td>
</tr>
</tbody>
</table>

To recognise $300,000 sale

<table>
<thead>
<tr>
<th>Dr</th>
<th>Cash flow hedge reserve (OCI)</th>
<th>30,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cr</td>
<td>Net hedge gain/loss (P/L)</td>
<td>30,000</td>
</tr>
</tbody>
</table>

To reclassify remaining gains/losses from OCI.

<table>
<thead>
<tr>
<th>Dr</th>
<th>Forward 2 (BS)</th>
<th>30,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cr</td>
<td>Forward 1 (BS)</td>
<td>10,000</td>
</tr>
<tr>
<td>Cr</td>
<td>Cash</td>
<td>20,000</td>
</tr>
</tbody>
</table>

To recognise cash settlement of Forward 1 and Forward 2
### LOWER OF TEST FOR 30/6/X0

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Forward 1</td>
<td>-10,000</td>
<td>treated in T1 as hedging instrument</td>
</tr>
<tr>
<td>Forecast sale</td>
<td>30,000</td>
<td>treated in T1 as hedged item</td>
</tr>
<tr>
<td>Forecast expense</td>
<td>-20,000</td>
<td>treated in T1 as hedged item</td>
</tr>
<tr>
<td>Cumulative FV movement of hedging instrument</td>
<td>-10,000</td>
<td></td>
</tr>
<tr>
<td>Cumulative FV movement of hedged item</td>
<td>10,000</td>
<td></td>
</tr>
<tr>
<td>Cumulative (absolute) lower of</td>
<td>-10,000</td>
<td></td>
</tr>
<tr>
<td>Amounts already recognised in OCI</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Cumulative lower of amount of hedging instrument</td>
<td>-10,000</td>
<td></td>
</tr>
<tr>
<td>Amount to recognise in OCI in T1</td>
<td>-10,000</td>
<td></td>
</tr>
</tbody>
</table>

### LOWER OF TEST FOR 31/12/X0

In the period where the hedged item is recognised in profit or loss, it is treated as a hedging instrument for the purpose of applying the 'lower of test'.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Forward 1</td>
<td>-25,000</td>
<td>treated in T2 as hedging instrument</td>
</tr>
<tr>
<td>Forecast sale</td>
<td>75,000</td>
<td>treated in T2 as hedged item</td>
</tr>
<tr>
<td>Forecast expense</td>
<td>-50,000</td>
<td>treated in T2 as hedging instrument</td>
</tr>
<tr>
<td>Cumulative FV movement of hedging instrument</td>
<td>-75,000</td>
<td></td>
</tr>
<tr>
<td>Cumulative FV movement of hedged item</td>
<td>75,000</td>
<td></td>
</tr>
<tr>
<td>Cumulative (absolute) lower of</td>
<td>-75,000</td>
<td></td>
</tr>
<tr>
<td>Amounts already recognised in OCI</td>
<td>-10,000</td>
<td></td>
</tr>
<tr>
<td>Cumulative lower of amount of hedging instrument</td>
<td>-75,000</td>
<td></td>
</tr>
<tr>
<td>Amount to recognise in OCI in T2</td>
<td>-65,000</td>
<td></td>
</tr>
</tbody>
</table>

Note that the lower of test for T3 is performed, but has not been presented here.