



ACCOUNTING MINI-SERIES

New Hedge Accounting

In the 2008 Annual Report, our accounting mini-series talked about hedging and how CLP used derivatives to hedge its foreign currency, interest rate and energy price risks. Accounting for these hedging transactions is complicated and has not yet been covered in that accounting mini-series.

Recently, the International Accounting Standard Board issued a new accounting standard, IFRS 9 (equivalent to HKFRS 9) Financial Instruments. HKFRS 9 includes some fundamental changes to HKAS 39 Financial Instruments: Recognition and Measurement which allows an entity to apply hedge accounting where they would not be allowed to do so under HKAS 39. HKFRS 9 has an effective date of 1 January 2018. CLP elects to early adopt this new standard in 2016.

This accounting mini-series will explain hedge accounting and the benefits for early adoption of HKFRS 9.

What is hedging? What benefits can we achieve by applying hedge accounting?

Hedging is a risk management tool with an objective to eliminate or reduce an entity's exposure to a particular risk by entering into a derivative transaction (i.e. a hedging instrument). Risk is reduced because the value or cash flows of the hedging instrument will move inversely and therefore offset, wholly or partly, changes in the value or cash flows of the hedged item. Two hedge accounting models are used in CLP. They are cash flow hedge and fair value hedge.

The accounting standard requires derivatives to be accounted for as if they are trading instruments which have their price movements reported in profit or loss. If the price movements of hedged items do not fall into the same accounting period, this leads to volatility in an entity's profit or loss.

The objective of hedge accounting is to reflect more closely a company's risk management strategies to its financial statements. To achieve this, hedge accounting results in gains or losses arising from the hedging instrument and the hedged item affecting profit or loss in the same accounting period. This reduces volatility in profit or loss and thus, can better reveal the underlying performance of an entity.

Cash Flow Hedge

An entity is exposed to variability in the cash flows of a specific asset or liability, or of a forecasted transaction.

How can I avoid paying more or getting less cash flows in future?

Cash flow hedge can lock in the cash flows that you will get or pay.

Variable cash flows → Cash flow hedge → Fixed cash flows

Fair Value Hedge

An entity is exposed to changes in fair market value in relation to recognised asset or liability or unrecognised firm commitment with fixed contractual terms.

How can I avoid paying or receiving a different amount from fair market price in future?

Fair value hedge can unlock the fixed terms so as the amount to be paid or received in future is in line with the market.

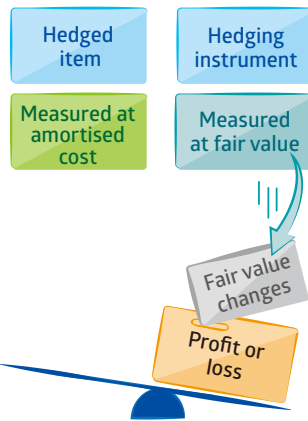
Fixed terms → Fair value hedge → Market price



Let me show you how hedge accounting makes gains or losses from both hedged item and hedging instrument reported in the same accounting period.

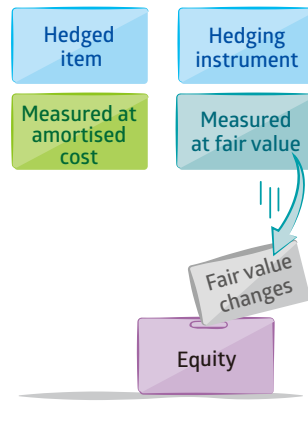


Without Hedge Accounting



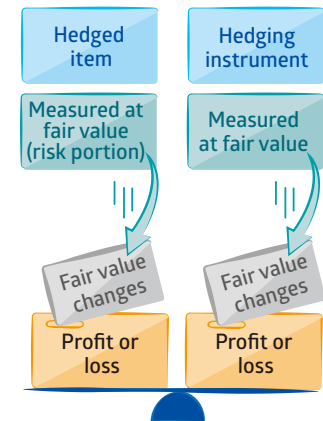
Hedging instrument is required to have its fair value changes recorded to profit or loss, but not the hedged item. The hedging activity creates volatility in profit or loss due to the timing mismatch.

Accounting for Cash Flow Hedge



Fair value gains or losses of hedging instrument are deferred to equity and will affect profit or loss when and only when the hedged item affects profit or loss.

Accounting for Fair Value Hedge



Both hedged item (the risk portion) and hedging instrument have their fair value gains or losses recorded to profit or loss in the same accounting period, therefore the effects offset in profit or loss.

OR

Why do we early adopt HKFRS 9?

Hedge accounting under HKAS 39 is regarded as being complex and ruled-based, thus leading to an entity's risk management activities not qualifying for hedge accounting. The purpose of replacing HKAS 39 by HKFRS 9 is to reflect the effect of an entity's risk management activities to the financial statements. The changes include replacing some of the arbitrary rules by more principle-based requirements. As a result, more risk management activities are now eligible to apply hedge accounting.

CLP has carefully reviewed and assessed the new hedge accounting model and considers it will bring benefits to the Group by applying new hedge accounting on hedging activities. In particular, the introduction of 'costs

of hedging' and 'risk component hedge' will bring us the most value.

Costs of hedging

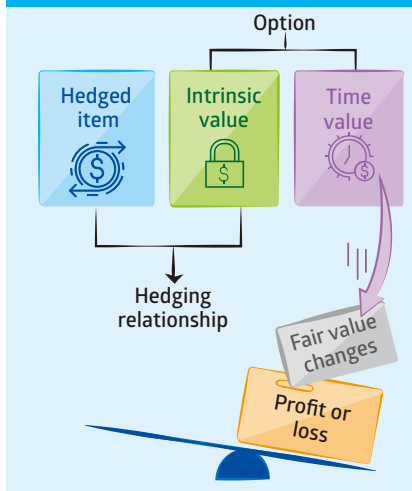
Certain components of a hedging instrument bear no economic relationship with a hedged item, which lead to an accounting mismatch in changes in the value or cash flows of the hedging instrument with those of the hedged item. These components include time value of options, forward element of forward contracts and foreign currency basis spread of financial instruments. They result in hedging ineffectiveness or no hedge designation which impact profit or loss.

Let us use an option for illustration. A purchased option can be used to hedge against foreign currency exchange risk of a foreign currency debt. The

fair value of an option consists of two elements: the intrinsic value and the time value. The intrinsic value is the difference between the underlying price and the strike price. It limits foreign currency exposure of the foreign currency debt and is qualified for hedge accounting. The time value, however, is unrelated to the hedged risk and therefore, is usually excluded from the hedge designation.

Under HKAS 39, fair value changes of the time value impact profit or loss immediately. This leads to fluctuations in profit or loss. This accounting treatment does not reflect the economic substance of the time value which could be considered as a premium for protection against risk (similar to an insurance premium).

Costs of Hedging Before HKFRS 9



Under the costs of hedging approach set out in HKFRS 9, fair value movements of the time value are recorded in other comprehensive income (part of equity). The initial time value will either be included in the initial cost of the transacted asset or released to profit or loss in a systematic manner depending on the nature of the transaction. The costs of hedging approach can also be applied to forward element of forward contracts and foreign currency basis spread.

Because of the financial market structure and its maturity, option is a more cost effective derivative in hedging foreign currency exposure in India. As at 31 December 2016, CLP India purchased foreign exchange options with a carrying value of HK\$37 million to hedge its foreign currency debts. By applying the costs of hedging approach, it will substantially reduce the volatility in profit or loss of CLP India.

Risk component hedge

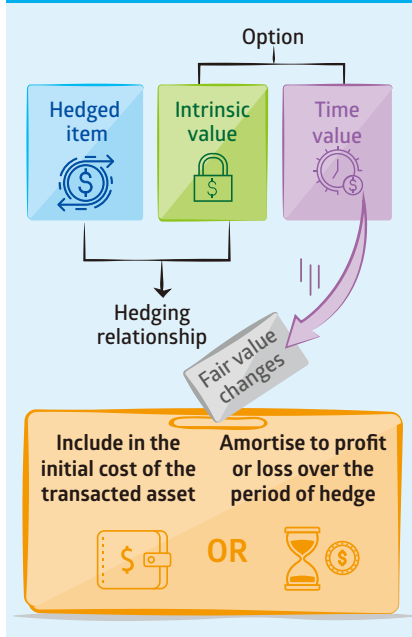
HKFRS 9 permits an entity to designate a risk component of a non-financial item as a hedged item in a hedging relationship, provided that it is separately identifiable and reliably measurable.

In power industry, purchase or sales agreements of an entity sometimes contain clauses that link the contract price to a benchmark price of a commodity. One typical example is natural gas contract, the price formula of which usually contains a component linked to a crude oil benchmark price. As the crude oil price is identified in the price formula, the exposure is

separately identifiable. There is also a market for crude oil and therefore, the crude oil price component can be reliably measured. As such, the crude oil price is a risk component of the natural gas contract and is eligible for designation as a hedged item. The hedging instrument is crude oil swap which fixes the price. Once the hedging activity is qualified for hedge accounting, unrealised fair value movements of the hedging instrument are recorded in other comprehensive income and affect profit or loss when and only when the hedged item affects profit or loss.

In Australia, we operate a retail business supported by our generation portfolio including coal, gas and renewables. To balance the portfolio position between generation and purchases from a central electricity pool and retail sales, we have entered into energy contracts and fuel supply contracts to minimise exposure to fluctuations in the spot prices. HKFRS 9 has given us potential opportunity to hedge designate derivative types that does not qualify for hedge accounting under HKAS 39.

Costs of Hedging Under HKFRS 9



Risk Component Hedge Under HKFRS 9

