tasman district council

Report No:	RFN11-08-17
File No:	
Date:	9 August 2011
Decision Required	

REPORT SUMMARY

Report to: Corporate Services Committee
Meeting Date: 18 August 2011
Report Author Bryce Grammer, Financial Accountant
Subject: **Hedge Accounting – RFN11-08-17**

EXECUTIVE SUMMARY

The purpose of this report is to ascertain whether Council should be hedge accounting for its interest rate swaps. Although achieving hedge accounting reduces the volatility of reported results, and adequately reflect the economic substance of hedging relationships we do not believe that these advantages outweigh the costs and disadvantages (increased accounting requirements, inflexibility of swaps etc) of hedge accounting.

It is therefore recommended that the Council does not hedge account interest rate swaps.

RECOMMENDATION/S

That the draft resolution be adopted

DRAFT RESOLUTION

THAT the Corporate Services Committee:

a) **receives the Hedge Accounting Report (RFN11-08-17); and**
b) **instructs Council staff not to undertake hedge accounting.**

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1. Purpose

1.1 The purpose of this report is to ascertain whether Tasman District Council should hedge account for their interest rate swaps.

2. Background

2.1 Interest rate swaps are commonly used to minimise interest costs on borrowings and to provide certainty over interest rates.

2.2 Council has a portfolio of interest rate swaps with a face value of $106.78 million, and a portfolio of loans totalling $133.07 million.

2.3 Swaps are agreements between two parties to exchange a series of cashflows in future periods according to an agreed formula.

2.4 The Council is swapping its variable interest rate debt cashflows to fixed rate debt cashflows to limit our exposure to rises in interest rates.

2.5 By undertaking these interest rates swaps Council is able to have certainty over the amount of its interest payments and also allows Council to 'fix' its interest rates for a longer period than banks will currently lend for. Perversely, undertaking swaps allows Council to gain certainty in its interest payments, but it can increase the volatility of the reported results in the Profit and Loss Statement.

2.6 Under NZ IFRS, the Council is required to recognise all interest rate swaps in the Balance Sheet and measure them at fair value.

2.7 Subsequent changes in value is accounted for through the Profit and Loss Statement (fair value accounting) unless hedge accounting can be achieved.

2.8 If hedge accounting is achieved then changes in fair value are deferred within equity reserves in the Balance Sheet.

2.9 Hedging means designating one or more hedging instruments so that the change in their fair value is an offset, in whole or in part, to the change in fair value or cash flows of a hedged item.

2.10 The objective of hedge accounting is to recognise and measure the hedging instrument and the position being hedged on symmetrical bases. They are then carried on the Balance Sheet at the same value, and offsetting gains and losses are reported in the Balance Sheet in the same period.

2.11 Hedge accounting can only be achieved if certain detailed rules are followed which include formally documenting the hedging relationship at inception and carrying out retrospective and prospective effectiveness testing at least every reporting period.

2.12 NZ IAS 39 does not specify a single method for assessing hedge effectiveness but, in practice, it usually involves regression analysis..

2.13 Application of hedge accounting is not mandatory and in principle can be chosen on a transaction by transaction basis.

2.14 Hedge accounting is usually regarded as the most complex aspect of financial accounting. In order to hedge account, Council would be required to use specialists.

3. Present Situation/Matters to be Considered

3.1 Tasman District Council currently does not hedge account. In the June 2010 Annual Report our interest rate swaps were recognised at the fair value of negative $706,000.

3.2 This resulted in an unrealised loss of $2.581m (2009: Unrealised gain of $1.875m) and a recognition of a liability of $0.76m (2009: Assets of 1.875m).

3.3 Sensitivity analysis undertaken on these interest rate swaps showed a movement in interest rates of plus or minus 1% had an effect on the swap value of plus $3.038m and minus $3.251m.

3.4 There have also been large movements in interest rates recently and thus fair values. As Council does not hedge account then this volatility will go through the Profit and Loss Statement.

3.5 Currently, we have volatility from gains/losses on forestry assets and investment properties, Joint Venture Income and Expenditure, and Share of Associates Surplus/Deficit going through the Profit and Loss Statement.

4. Options

4.1 Council undertakes hedge accounting for its interest rate swaps, which means fair value movements will be reported in the balance sheet.

4.2 Council does not undertake hedge accounting for its interest rate swaps, which means fair value movements will be reported in the Profit and Loss Statement.

5. Pros and Cons of Options

5.1 **Advantages of hedge accounting**

- The primary advantage of achieving hedge accounting is that it reduces the volatility of reported results. Increased predictability of results will assist the Council with its long term financial forecasting and in communication with its external stakeholders.

- While mark to market adjustments through the Profit and Loss Statement in the core Council financial statements will not impact on the calculation of rates, it may be difficult to explain to external stakeholders why variances in reported results are arising from interest rate swap transactions that are intended to make cash flows more predictable.

- In essence then, achieving hedge accounting ensures that the financial statements adequately reflect the economic substance of hedging relationships – the purpose of entering into interest rate swap hedge transactions is to provide a greater degree of certainty regarding interest expense and it is therefore inappropriate for such transactions to increase the volatility of reported results.

5.2 Disadvantages of hedge accounting

- Meeting the requirements for hedge accounting will impose additional workloads on treasury/accounting staff through increased documentation and journal entry processing requirements.

- Early close out of interest rate swaps, blending etc has implications for hedge accounting. Blending may cause the interest rate swap to become ineffective, therefore, causing the value of the swap to impact on the Profit & Loss statement. If we hedge account and decide to blend or otherwise change a swap then effectiveness calculations and journal entries would be required to reflect this.

- This is a complex area of hedge accounting and specialist advice would be required. Hedge accounting requires regression analysis skills as well as subscriber access to forecast future interest rates calculated by companies such as Bloomberg and Reuters. Based on the number of interest rate swaps we currently have, and effectiveness testing twice a year, the estimated additional cost of hedge accounting could be in excess of $10,000 per year. If blends etc were undertaken during the year, then this cost would be higher.

- From an enquiry posted on the SOLGM Finance Listserve, the general theme is that most councils do not hedge account because they felt they were being locked into the hedges undertaken and were missing out on economic gains. Namely if they wanted to shorten, lengthen or blend and extend swaps then they ran into problems with hedge accounting. One of the underlying reasons for using swaps is to take advantage of economic opportunities that present themselves in the market and, therefore, most Council's decided that they can live with a volatile income statement being happy to take the gains and losses on the swap transactions they undertake, as they are only accounting entries.

- The only councils that undertake hedge accounting are usually the larger ones, such as Wellington City Council, with most medium/smaller councils not hedge accounting. When the IFRS requirements came in around hedge accounting, most councils that were hedge accounting under the old standards ceased due to the increased complexity and cost.

6. Evaluation of Options

6.1 Although achieving hedge accounting reduces the volatility of reported results, and adequately reflects the economic substance of hedging relationships we do not believe that these advantages outweigh the increased costs and disadvantages (increased accounting requirements, inflexibility of swaps etc) of hedge accounting.

6.2 Council currently has volatility from gains/losses on forestry assets and investment properties, Joint Venture Income and Expenditure, and Share of Associates Surplus/Deficit going through the Profit and Loss Statement, so additional volatility from not hedge accounting can be explained in conjunction with those.

6.3 It is therefore recommended that the Council does not hedge accounting for derivative instruments.

6.4 The accounting standard related to hedge accounting is currently being reviewed to investigate whether the complexity and onerous requirements of hedge accounting can be simplified without reducing the integrity of accounting for derivatives such as interest rate swaps. In the future, if it became advantageous for Council to undertake hedge accounting then this can happen through a simple change to the Council resolution. A decision today on not to undertake hedge accounting does not automatically lock Council into the position of not being able to hedge account in the future.

7. Significance

7.1 This is not a significant decision according to the Council's Significance Policy.

8. Recommendation/s

8.1 That the draft resolution be adopted.

9. Draft Resolution

THAT the Corporate Services Committee:

a) **receives the Hedge Accounting Report (RFN11-08-17) and;**
b) **instructs Council staff not to undertake hedge accounting.**