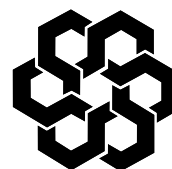




Financial Accounting
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This document is provided as a convenience to observers at the IASB and FASB Joint board meeting, to assist them in following the Boards' discussion. It does not represent an official position of the IASB or the FASB. Board positions are set out in Standards (IASB) or Statements or other pronouncements (FASB).

Note: These notes are based on the staff paper prepared for the joint board meeting. Paragraph numbers correspond to paragraph numbers used in the board paper. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: Joint IASB-FASB Meeting, 27 April 2006, London

Project: Financial Instruments - Meeting the Boards' Long-Term Objectives in Relation to Hedge Accounting (Agenda Paper 1) (This observer note is also issued for Agenda Paper 4 at the IASB Meeting)

BACKGROUND

1. At the joint meetings held in April 2005 and October 2005, the Boards established explicit long-term objectives to simplify and improve financial reporting requirements for financial instruments.
2. The long-term objectives, assuming that technical and practical hurdles can be overcome, are:
 - a. To require that all financial instruments be measured at fair value with realized and unrealized gains and losses recognized in the period in which they occur
 - b. To simplify or eliminate the need for special hedge accounting requirements
 - c. To develop a new standard for the derecognition of financial instruments.

3. The IASB and FASB staff (the staff) is working on one of the practical issues identified by the Boards—that is, what information to present about past changes in fair value and exposures to future changes in market factors. As requested by the Boards, the staff is currently asking users for their preliminary views about the type of information that is useful to those making investment or credit decisions. [Remainder of paragraph deleted]
4. This paper is concerned with the second long-term objective—to simplify or eliminate the need for special hedge accounting.
5. The Boards, at their April 2005 joint meeting, agreed that “efforts to converge their existing standards through amendments of specific provisions would require a significant commitment of Board and constituent resources for little marginal improvement in financial reporting.” (Source: IASB Update April 2005).
6. [Deleted]
7. Furthermore, in the IASB and FASB’s Memorandum of Understanding, the Boards committed to issue one or more due process documents relating to the accounting for financial instruments by 2008.
8. [Deleted]

PURPOSE OF THIS PAPER

9. This paper asks the Boards whether special accounting for some or all fair value hedges is needed if a fair value option is available.

STAFF RECOMMENDATION

10. This paper recommends that the Boards consider adding to their agendas a project to eliminate or at least significantly reduce fair value hedge accounting. If the Boards accept this recommendation, the staff will develop an agenda proposal.
11. If the Boards do not wish for the staff to develop such an agenda proposal, the staff seek additional guidance on possible alternatives to meeting the objectives of simplifying and improving financial reporting requirements for financial instruments as well as the possible contents of the due process documents required by the IASB and FASB’s Memorandum of Understanding.

LONG-TERM OBJECTIVES AND SUMMARY OF THIS PAPER

12. The staff described the long-term objective relating to hedge accounting in a project update posted to the IASB and FASB websites in January 2006 as follows:

The second long-term objective is to simplify the requirements for hedge accounting and, if possible, to reduce or eliminate the need for special accounting for fair value hedges. The following are the issues the Boards intend to address.

Fair Value Hedge Accounting

The need for special hedge accounting rules is caused, in part, by existing requirements to measure derivative instruments at fair value and (absent hedge accounting) to measure other types of assets and liabilities that are hedged by derivative instruments at amounts other than fair value. If all financial instruments were measured at fair value with realized and unrealized gains and losses recognized in the period in which they occur, fewer special hedge accounting rules would be necessary for the financial statements to faithfully represent the economic results of risk-management strategies involving financial instruments.

The fair value option in IAS 39 substantially reduces the need for special accounting of fair value hedges of financial instruments. Thus, it permits entities to avoid the related burden of designating hedging relationships, and tracking and analyzing hedge effectiveness. The FASB's project to establish a fair value option is intended to achieve the same result.

Even if all financial instruments were measured at fair value, special hedge accounting rules would still be required to address situations in which the hedged item is not a financial instrument and is not measured at fair value under existing accounting requirements (for example, a commodity).

Cash Flow Hedge Accounting

Requiring all financial instruments to be measured at fair value also would not eliminate the demand for special accounting in connection with some hedges of future cash flows (such as hedging the risk arising from forecasted future sales denominated in a foreign currency or hedging a variable interest rate financial instrument when changes in rates do not change the fair value of the financial instrument).

13. This paper includes a preliminary discussion of some of the issues that would have to be addressed in any move to eliminate special accounting for fair value hedges.
14. Also, this paper discusses how the elimination of special accounting for fair value hedges would move towards the Boards' long-term objective of all financial instruments being measured at fair value with realized and unrealized gains and losses recognized in the period in which they occur.
15. Alternative approaches to simplifying hedge accounting are outlined at the end of this paper. One such approach might include modifying the fair value option to allow an entity to achieve an accounting result consistent with special accounting for fair value

hedges. The Boards may wish to consider such approaches if they reject the staff recommendation to consider adding to their agendas a project to eliminate or at least significantly reduce fair value hedge accounting.

16. Finally, this paper does not address cash flow hedge accounting beyond a brief discussion of the possible implications of eliminating special accounting for fair value hedges. Cash flow hedge accounting can be complex to apply, especially the effectiveness requirements and the *recycling* of gains and losses into earnings. In addition, the results may not be as transparent to users of the financial statements as they could be. However, the staff recommends that the Boards consider cash flow hedge accounting separately, in part because modifying or eliminating cash flow hedge accounting would not move closer to the goal of measuring all financial instruments at fair value with changes recognized in the period in which they occur. Changes in fair value of derivatives designated as cash flow hedges are already recognized in equity or other comprehensive income in the period in which they occur.
17. In many ways, the issues relating to cash flow hedge accounting are also more challenging than those related to fair value hedges. This challenge arises from two forces that are difficult, if not impossible, to reconcile:
 - a. The demand for special accounting for transactions designed to manage cash flow risk associated with forecast transactions and
 - b. The lack of conceptual justification for providing special accounting based solely on management's assertions about transactions expected to occur in the future.

ELIMINATING FAIR VALUE HEDGE ACCOUNTING

Introduction

18. The arguments for eliminating special accounting for fair value hedges arise because the fair value option is available. Under the fair value option an entity can elect to designate a financial asset or financial liability at fair value through profit or loss, hence eliminating the need for hedges of fair value exposures when there are natural

offsets (assuming, in the case of IAS 39 *Financial Instruments: Recognition and Measurement*, that one of the eligibility criteria is met¹).

19. Special accounting for fair value hedges is an alternative way to mitigate the effects on earnings of different existing recognition and measurement attributes. The fair value option enables preparers to eliminate some such mismatches without the need for special hedge accounting.
20. Eliminating fair value hedge accounting would significantly reduce the complexity of current accounting for financial instruments. For example, the requirement to test effectiveness of fair value hedges would be removed.
21. The staff assumes here that a consequence of eliminating fair value hedge accounting will be that greater use is made of the fair value option resulting in more financial instruments being measured at fair value—thereby contributing to the Boards’ overall long-term objectives for financial instruments. This assumption can be challenged, and a project plan would include research into how companies use the fair value option today.
22. Also, under the current fair value hedge accounting models of both Boards, the hedged asset or hedged liability may be adjusted further away from its fair value than it was at the inception of the hedge. This issue arises from the ability under IAS 39 to designate in a hedge relationship portions and the ability under Statement 133 to designate the changes in fair value due to specified risks—rather than all the changes in fair value of the asset or liability.
23. For example, if under IAS 39 an entity designates changes in the credit spread of a financial asset as the designated hedged risk in a fair value hedge, the carrying value of the underlying hedged item is adjusted as the credit spread changes. However, the carrying value of the hedged item will not be adjusted for changes in the benchmark interest rate. If the benchmark interest rate moves in an opposite direction to credit spreads, this hedge accounting is likely to result in the hedged item being adjusted further **away** from its fair value.

¹Paragraphs 9 and 11A of IAS 39 include a number of criteria under which designation upon initial recognition at fair value through profit or loss is permitted, including when designation “**eliminates or significantly reduces** a measurement or recognition inconsistency that would otherwise arise from measuring assets or liabilities or recognizing the gains and losses on them on different bases” [emphasis added].

24. If fair value hedge accounting was eliminated, such an adjustment away from fair value would no longer be possible. Furthermore, by removing the hybrid measurement basis for hedged items, financial statements will be more understandable.
25. However, a number of significant issues would arise from eliminating fair value hedge accounting. The issues that are discussed in the following sections are:
- a. The purpose of hedge accounting and *unrepresentative earnings volatility*
 - b. The requirement under the fair value option to designate at initial recognition and to account for changes in the entire fair value of a financial instrument
 - c. Hedging nonfinancial assets and liabilities
 - d. Unrecognized firm commitments for nonfinancial items
 - e. Implications for a cash flow hedge accounting model
 - f. Implications for financial instrument accounting if fair value hedge accounting was eliminated

The Purpose of Hedge Accounting and Unrepresentative Earnings Volatility

26. Paragraphs 364–366 of the basis for conclusions of Statement 133 include a discussion of the purpose of hedge accounting. Those paragraphs state that the principal purpose of hedge accounting is to mitigate the effects on earnings of different existing recognition and measurement attributes.
27. With the fair value option available for **financial assets** and **financial liabilities**, an entity is able to avoid the recognition and measurement mismatches arising from the current-mixed attribute model for fair value relationships, if it wishes. This could therefore be argued to remove the need for special rules for such situations.
28. Paragraph 365 of Statement 133 also focuses on the comments from some respondents to the original Statement 133 Exposure Draft. Specifically, that requiring the full change in fair value of the hedged item to be recognized (to the extent of an offsetting gain or loss on the hedging instrument) would cause “unrepresentative earnings volatility and would be misleading in reflecting the entity’s hedging activities.”

29. However, financial statements are not trying to report the hedging activities of an entity in a vacuum. Instead, financial statements are trying to represent the entity's financial position and changes therein—this includes transparency as to those fair value risks that are not being offset.
30. Management's use of hedge accounting is often part of a larger risk-management program (for example, a hedging strategy using cash instruments to hedge other cash instruments may be used). Alternatively, an entity may have decided to retain exposure to a particular risk. Faithful representation of all of these risk management activities would be to require the changes in fair value to be recognized in earnings when those changes occur.

The requirement under the fair value option to designate at initial recognition and to account for changes in the entire fair value of a financial instrument

31. Under the fair value option an entity is permitted to designate a financial asset or financial liability (or groups of financial assets, financial liabilities, or both) at **initial recognition** only, and is not subsequently permitted to change that designation. This is a key requirement of the fair value option aimed at removing the ability of an entity to *cherry-pick* the recognition of gains or losses. The FASB included the same requirement for fair value options in FASB Statements No. 155, *Accounting for Certain Hybrid Financial Instruments*, and No. 156, *Accounting for Servicing of Financial Assets*, and the FASB Exposure Draft on *The Fair Value Option for Financial Assets and Financial Liabilities*.
32. This contrasts with fair value hedge accounting requirements under which an entity is permitted to designate (and dedesignate) hedge relationships at will. However, the price for such flexibility is the requirement to test effectiveness.
33. A further issue worth highlighting is that the fair value option does not permit a portion (or component) of a financial asset or financial liability to be designated at fair value.
34. Some constituents maintain that use of the fair value option does not faithfully represent the economic substance of transactions in which all components are not risk managed on a fair value basis or where not all the components of the underlying item can be fair valued reliably (for example, credit risk of retail loans or mortgages).

Some of these comments (and a counterpoint) are discussed in more detail later in this paper. [Remainder of paragraph deleted]

Hedging Nonfinancial Assets and Liabilities

35. The fair value options, as currently drafted, do not permit a nonfinancial asset or liability or be designated at fair value through profit or loss.² However, current accounting literature does permit a nonfinancial asset or liability to be designated as a hedged item.³
36. Hedge accounting reflects the (declared) relationship between a financial instrument (derivative) and a nonfinancial asset or liability, and attempts to mitigate the effects on earnings of differing recognition and measurement attributes of financial instruments and nonfinancial assets or liabilities.
37. Eliminating fair value hedge accounting would not mitigate the effects on earnings of differing recognition and measurement attributes of financial instruments and nonfinancial assets or liabilities.
38. Assuming that the Boards believe that the accounting for nonfinancial assets and nonfinancial liabilities should be affected by how a financial instrument is accounted for, then one possible approach to mitigating the effect on earnings of the differing recognition and measurement attributes of financial instruments and nonfinancial assets or liabilities is to retain fair value hedge accounting for non-financial assets and nonfinancial liabilities.
39. An alternative approach to mitigating the effect on earnings of the differing recognition and measurement attributes of financial instruments and nonfinancial assets or liabilities would be to consider extending the fair value option to allow nonfinancial assets and nonfinancial liabilities to be designated at fair value, with changes in fair value recognized in profit or loss when those changes occur.

²However other accounting literature does permit nonfinancial items to be remeasured. For example, IAS 2, *Inventories*, requires that commodity broker-traders who measure their inventories at fair value less costs to sell recognize changes in that value in profit or loss in the period of change.

³For example, paragraph 82 of IAS 39 requires that a nonfinancial asset or nonfinancial liability be designated as a hedged item: (a) for foreign currency risks or (b) in its entirety for all risks. Paragraph 21(e) of Statement 133 requires that the risk of changes in the fair value of the entire hedged nonfinancial asset or liability be designated.

40. The FASB has committed to consider permitting the fair value option for selected nonfinancial assets and liabilities in Phase 2 of its fair value option project, and has asked a number of questions to recipients of the FASB Exposure Draft on the fair value option.
41. The staff notes that the Boards could be accused of extending the requirement for measurement of items at fair value by allowing nonfinancial assets and liabilities to be designated at fair value under the fair value option. However, the staff note that:
- a. An entity need not elect to use the fair value option
 - b. Any extension of the fair value option largely reflects the **option** that is currently available under fair value hedge accounting for nonfinancial assets and nonfinancial liabilities
 - c. An extension of the fair value option would help mitigate problems for reported earnings caused by the mixed-attribute model.
42. Any extension of the fair value option to nonfinancial assets and liabilities also raises issues relating to the fair value measurement of non-financial assets and liabilities and revenue recognition (for example, the feasibility of measuring the fair value of nonfinancial items and the fact that fair value gains and losses may be recognised in advance of the point at which revenues would otherwise be recognised).
43. Another, not insignificant, question arises when the character of nonfinancial assets changes. A fair value measurement of, say, jet fuel is straightforward. The fuel will either be consumed or sold. Other nonfinancial assets are used in the production process. Does the fair value of an inventory of gold cease when the gold is used in the manufacture of computer components?
44. An alternative approach to amending the fair value option for nonfinancial assets and liabilities could be to consider such exposures *only* in the context of the cash flow hedge accounting model. That is, any hedging instrument would be considered as managing the variability of expected future cash flows of the anticipated future cash flow that is expected to arise when the designated non-financial item is either purchased or realized.

45. In summary, there are at least three possible ways of dealing with nonfinancial items (if desired):

- a. Retain fair value hedge accounting for nonfinancial items
- b. Extend the fair value option to nonfinancial items
- c. Permit only cash flow hedge accounting for nonfinancial items.

Unrecognized Firm Commitments

46. Under both IAS 39 and Statement 133 an unrecognized firm commitment is eligible for designation in a fair value hedge (subject to specific criteria being met). An asset or a liability is recognized as a result of an adjustment to the carrying amount for the firm commitment.

47. The FASB Exposure Draft on the fair value option would permit the election of the fair value option for a firm commitment that would otherwise not be recognized at inception under existing GAAP and involves only financial instruments (although the Exposure Draft on the fair value option includes a scope exception for written loan commitments that are not accounted for as derivative instruments under Statement 133).

48. Hence, under both the Exposure Draft on the fair value option and IAS 39, in the absence of fair value hedge accounting provisions, entities would be unable to mitigate problems for reported earnings caused by the mixed-attribute model for unrecognized firm commitments for **nonfinancial assets** or **liabilities** that are treated as executory and not recognized.

49. One could argue that excluding such firm commitments is appropriate (despite the fact that the current hedge accounting models permit it) because the accounting requirements for financial instruments should not change the recognition (and measurement) of commitments that would otherwise not be recognized.

50. However, a common risk management practice hedges the foreign currency risk of a commitment to (for example) purchase a piece of machinery. If an entity is unable to link the hedging instrument (derivative) with a firm commitment (that would otherwise be unrecognized), it could be argued that the financial statements would not faithfully represent the effects of the transactions.

51. Alternatively, if the same firm commitment is not hedged (or hedge accounting is not obtained) then some changes in fair value remain unrecognized even though they are real. This could also be argued not to faithfully represent the effects of the transactions in the financial statements.

52. [Deleted]

53. This topic raises issues such as:

- a. Should there be recognition and measurement of unrecognized firm commitments for nonfinancial assets and liabilities?
- b. Should the foreign currency exposure (or indeed, exposure created by indexation to any market price variable) in the firm commitments be separately recognized and measured as if it contained a foreign currency denominated financial instrument (or financial instrument created by indexation to other market price variables)?
- c. Should linkage between the derivative and firm commitments be appropriate in any case?

54. One possibility could be to allow exposures arising from firm commitments to be hedged items in the cash flow hedge accounting model. The previous version of IAS 39 required a hedge of a firm commitment to be accounted for as a cash flow hedge. Some believe this to be appropriate because cash flow hedge accounting for hedges of firm commitments avoids partial recognition of the firm commitment that would otherwise not be recognised.

55. However, in paragraphs BC149–BC154 of IAS 39 the IASB discussed the hedge accounting of firm commitments and used the argument that, in the absence of hedge accounting, a firm commitment is recognized but because it is measured at historical cost, the carrying value is usually zero. When hedge accounting is applied, this has the effect of recognizing part of an asset (or a liability), which is the same effect that applying fair value hedge accounting to other items has (in terms of recognizing amounts as assets or liabilities that would otherwise not be recognized⁴).

⁴It should be noted that in hedging only the foreign currency risk of a firm commitment, the reported changes could move in an opposite direction to the total change in fair value of the firm commitment if some other risk is larger and moves in an opposite direction than foreign currency rates.

56. Furthermore, in IAS 39 (as revised in 2003) the IASB required hedges of firm commitments to be treated as fair value hedges⁵ because the fair value of a firm commitment changes with changes in the hedged risk.

Implications for Cash Flow Hedge Accounting Model

57. Eliminating fair value hedge accounting will not resolve any of the issues involving cash flow hedge accounting.

58. If special accounting for fair value hedges was eliminated (and assuming that the Boards did not amend the fair value option to permit election of specific risks or portions as described in paragraph 62a), the requirement to put all changes in fair values of financial instruments designated under the fair value option through profit or loss would arguably be inconsistent with the ability of an entity to obtain cash flow hedge accounting for specified risks or portions of an exposure.

59. However, cash flow hedge accounting does not affect the accounting for any asset or liability other than the derivative. As the entire value of the derivative (with some exceptions) must be considered in a hedge accounting relationship, continuing to permit portions or specified risks to be the hedged item in a cash flow hedge would not be inconsistent with eliminating fair value hedge accounting.

Implications for Financial Instrument Accounting if Fair Value Hedge Accounting was Eliminated

60. Beyond the issues already discussed, modifying the requirements of the fair value options (as currently drafted) would have other implications for financial instrument accounting if fair value hedge accounting was eliminated (for example, the IAS 39 provisions regarding fair value hedge accounting for a portfolio hedge of interest rate risk would be effected). The staff has not attempted to identify or analyse these issues, but will consider them if the Boards conclude that an approach of eliminating some or all special accounting for fair value hedges is appropriate.

⁵With the exception of the hedge of foreign currency risk of a firm commitment which may be treated as either a fair value hedge or a cash flow hedge because foreign currency risk affects both the cash flows and the fair values of the hedged item.

OTHER POSSIBLE APPROACHES TO SIMPLIFYING HEDGE ACCOUNTING

61. This paper has focussed on whether special accounting for some or all fair value hedges is needed if a fair value option is available.
62. The staff notes that eliminating special accounting for some or all fair value hedges is not the only way of moving towards the Boards' overall long-term objective to simplify the requirements for hedge accounting. The Boards may wish to consider other approaches if the staff recommendation is rejected.
63. Other possible approaches to simplifying or eliminating special hedge accounting include:
- a. Adding an election to subsequently measure a nonderivative financial asset or financial liability by adjusting it for changes arising from specific factors⁶ affecting its fair value but not others (for example, changes in interest rates but not changes in credit risk), to the fair value option, or
 - b. Removing or simplifying some or all of the existing requirements for hedge effectiveness testing (for example, removing the requirement for prospective effectiveness tests at inception of the hedge)
 - c. Prohibiting hedge accounting for **portions** or specified risks of hedged items (possibly in combination with [a]).
64. The staff notes that these approaches may have implications for other aspects of the accounting of financial instruments (for example, the impairment requirements for financial assets might be affected by the approach in paragraph 62a).
65. With respect to modifying the fair value option to allow an entity to fair value a 'portion' (as set out in paragraph 62a above), the IASB has previously discussed whether the fair value option should be applied to a component or portion (rather than the entirety) of a financial asset or financial liability (see paragraphs BC85–86A of IAS 39). The IASB decided that the fair value option should not be extended to components because of:

⁶For example, an approach similar to that contained in paragraph 21(f) of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, might be one method for restricting which factors (or components) could be fair valued and might be one method for calculating the overall effect on the fair value of the financial asset or financial liability. Paragraph 21 discusses eligible hedged items in a fair value hedge. Paragraph 21(f) sets out eligible risks that may be hedged for hedged items that are financial assets, financial liabilities, recognized loan servicing rights, or nonfinancial firm commitments with financial components. Paragraph 21(f) also states that in calculating the change in the hedged item's fair value attributable to (for example) changes in the benchmark interest rate, the estimated cash flows used in calculating fair value must be based on **all contractual cash flows** of the entire hedged item.

- a. The difficulties in measuring the change in value of the component because of ordering issues and joint effects
- b. The amounts recognised in the balance sheet that would be neither fair value nor cost
- c. The fair value adjustment for a component that may move the carrying amount of an instrument away from its fair value.

66. The FASB also discussed in paragraph A9 of the Exposure Draft on the fair value option whether entities should be permitted to elect (outside of hedge accounting provided in Statement 133) to recognise in earnings the change in an asset's or a liability's fair value attributable to only certain selected risks. The FASB Board rejected recognising only fair value changes that are attributable to only selected risks because it was inconsistent with expanding use of the fair value measurement attribute and international convergence. Moreover, the resulting measurement would not represent the fair value of the financial asset or financial liability as a whole.

67. However, the staff would like to highlight that these discussions did not occur in the context of eliminating or significantly reducing special accounting for fair value hedges.