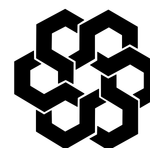

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International Accounting Standards Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: **18 April 2007, London**

Project: **Financial Instruments: Due Process Document (DPD)**

Subject: **Developing examples of the next interim step (Agenda paper 10A)**

BACKGROUND

1. Paper 10 suggests taking a fair value measurement principle-based approach to developing examples of the next interim step with the aim of reducing complexity compared to existing requirements.

2. Two examples of the next interim step for inclusion in the DPD are suggested in Paper 10. These examples include certain exceptions to the fair value measurement principle.

3. The two examples are similar in terms of measurement requirements. The key difference is the extent of exception to the fair value measurement principle.

4. Therefore, the consequences of the two examples are similar. Hence, this paper only discusses the complexity arising in Example 1.

5. Under Example 1, an exception is given to the fair value measurement principle; financial instruments with certain cash flow characteristics that are *not* traded in active markets can be designated to be measured at amortised cost.

PURPOSE OF THIS PAPER

6. This paper discusses the complexity arising from the exception to the fair value measurement in Example 1.

7. This paper also discusses other possible exceptions to the fair value measurement principle, such as cash flow hedge accounting for forecast transactions.

8. This paper focuses on hedge accounting[1]. This paper does *not* exhaustively identify or discuss all issues that might arise in Example 1, specifically in respect of hedge accounting (for example, portfolio hedge accounting).

9. Particularly, this paper:

   - discusses whether fair value hedge accounting should be included as part of Example 1 or a less complex alternative should be considered (see Section 1);

   - considers how existing cash flow hedge accounting can be simplified (see Section 2). This paper assumes that cash flow hedge accounting will not be eliminated as part of a next interim step.

10. This paper makes references to the requirements of IAS 39, where necessary. Similar reference to US GAAP could also be made.

11. This paper raises many questions. This paper does *not* attempt to answer many of those questions.

12. Nor will the DPD attempt to provide answers to all of the issues given the tight deadline for issuance of the DPD. Instead, the DPD will include some of the questions raised and will seek views from respondents on those questions.

13. This paper does *not* ask for the Boards' preliminary views on the issues discussed. This paper seeks the Boards' comments as to whether the questions raised in this paper are in the right direction.

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[1] The Boards have been told by many constituents on many occasions that hedge accounting requirements are one of the most complicated areas in current accounting for financial instruments.

14. Finally, appendix one provides an overview of the possible requirements of Example 1. **Board members may find it useful to refer to this summary when they read through this paper.**

TWO KEY SOURCES OF DEMAND FOR HEDGE ACCOUNTING

15. Paper 7A discussed by the IASB in January 2007 set out two reasons why there is demand for hedge accounting. The two reasons are to:

    (a) Address recognition and measurement anomalies; and

    (b) Reflect the intended effects of managing risks associated with the cash flows of forecast transactions.

SECTION 1 - FAIR VALUE HEDGE ACCOUNTING

16. Current fair value hedge accounting model addresses the following two types of exposures:

    (a) Exposures to changes in the fair value of a recognised item in the scope of the financial instruments standard; and

    (b) Exposures to changes in the fair value of an asset or liability (and unrecognised firm commitments) outside the scope of the financial instruments standard.

Will there still be demand for fair value hedge accounting?

Background

17. When both the hedged item and hedging instrument are measured at fair value, there is no need for fair value hedge accounting because there is *no* measurement anomaly.

18. However, even if all financial instruments were measured at fair value, accounting anomalies still arise from items outside the scope of the financial instruments standard.

Accounting anomalies in Example 1

19. The accounting anomalies arising in Example 1 are as follows:

Exposures	Possible accounting mismatches
(a) Exposures to changes in the fair value of a recognised item *in* the scope of the financial instruments standard	Example 1 gives one exception to the fair value model. That exception would allow an entity to designate certain financial instruments to be measured at amortised cost. Therefore, the use of such an exception may *create* an accounting mismatch.
(b) Exposures to changes in the fair value of an asset or liability (and unrecognised firm commitments) *outside* the scope of the financial instruments standard	Possible recognition and measurement anomalies arise because: • Firm commitments outside the scope of the financial instruments standard are generally not recognised. The committed transactions are recognised when they occur. However, gains or losses on hedging instruments in the scope of the financial instruments standard are recognised in profit or loss immediately. • Assets and liabilities outside the financial instruments standard may not be measured in the same way as financial instruments being used as hedging instruments.

Alternatives to address accounting anomalies in Example 1

20. The table below summarises possible alternatives to address these accounting anomalies[2].

<table>
<tr><th>Exposures</th><th>Possible alternatives</th></tr>
<tr><td>Exposures to changes in the fair value of a recognised item in the scope of the financial instruments standard

The ‘recognised item’ concerned in this section is a financial instrument that is designated to be measured at amortised cost in Example 1.</td><td>(1) Exposures to all changes in the fair value of an item

It can be argued that there is no need for fair value hedge accounting in respect of exposures to all changes in the fair value of a recognised item in the scope of the financial instruments standard; if an entity wishes the offsetting gains or losses on two instruments to be recognised in profit or loss in the same accounting periods, it could simply choose not to use the exception of designating a financial instrument to be measured at amortised cost.

This suggests that Example 1 should not allow fair value hedge accounting to be used to hedge exposures to all changes in the fair value of an item.

(2) Exposures to changes in the fair value of a portion of an item

Some might still demand fair value hedge accounting to hedge against a portion of the financial instrument. That is, some might still demand fair value hedge accounting in order to achieve an offset between the fair value change of a portion of a financial instrument (that in its entirety has been designated to be measured at amortised cost) and the fair value change of another financial instrument.

Three possible alternatives:

• Not permit any fair value hedge accounting

• Permit fair value hedge accounting for a portion of a financial instrument measured at amortised cost; or

• Not permit fair value hedge accounting, but allow a fair value option to be applied to a portion of a financial instrument measured at amortised cost.</td></tr>
</table>

[2] There may also be display and disclosure mechanisms that might reduce demand for hedge accounting. However, this would not eliminate the accounting anomalies discussed.

Exposures	Possible alternatives
Exposures to changes in the fair value of an asset or liability (and unrecognised firm commitments) *outside* the scope of the financial instruments standard	Two possible alternatives: • Permit fair value hedge accounting; or • Not permit fair value hedge accounting, but allow a fair value option to be applied to items (and possibly, portions of items) outside the scope of the financial instruments standard[3].

21. As illustrated in the table above, an alternative to fair value hedge accounting is to allow an entity to apply a fair value option to:

- certain portions of a financial instrument that has been designated to be measured at amortised cost (in other words, effectively allow a *portion* of an item to be designated to be measured at cost); and

- certain items that are outside the scope of the financial instruments standard (and possibly portions of these items) – effectively (1) extend the scope of the financial instruments standard and (2) treat such items as if they were financial instruments.

22. **So, the issue is whether Example 1 should contain a fair value hedge accounting model. A less complex alternative approach to address the accounting anomalies discussed above is to use a fair value option.**

23. The following section discusses the advantages of a fair value option over fair value hedge accounting.

[3] The FASB in phase 2 of its Fair Value Option project will consider whether the fair value option might be extended to items that are not financial instruments and are not otherwise included in Statement No. 159 *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115.*

Advantages of using a fair value option in Example 1

Reason 1 – Reduce complexity

24. Fair value hedge accounting requires many complex rules. A fair value option need not be complex.

25. In addition, fair value hedge accounting is not very transparent in the financial statements. Fair value hedge accounting results in adjustments to the carrying value of hedged items. The effect of fair value hedges in profit or loss is not always clear to users of financial statements.

26. Eliminating one hedge accounting model would also be responsive to comments received from some constituents. Such constituents argue that there should only be one hedge accounting model to reduce complexity.

Reason 2 – Addressing accounting anomalies

27. The fair value option would achieve the same objective as a fair value hedge accounting model – that is, to result in offsetting gains or losses on two items to be recognised in profit or loss in the same accounting period.

Reason 3 – Encouraging greater use of fair value measurement

28. Without fair value hedge accounting, some entities may be less willing to designate financial instruments to be measured at amortised cost than would otherwise be the case. For example, a bank with fixed rate loans may use a derivative instrument to hedge the benchmark interest rate risk only. With no hedge accounting, there may be less incentive to designate the loans at amortised cost and suffer volatility in profit or loss arising from the hedging instrument. (This is also a relevant consideration for the later discussion on ‘portions’ in a fair value option).

Reason 4 – Allowing more flexibility to reduce complexity in cash flow hedge accounting

29. Eliminating fair value hedge accounting would possibly allow greater freedom to address the complexity associated with cash flow hedge accounting (see later comments regarding the requirement for effectiveness bands for cash flow hedges).

Summary

30. In the staff's view, the fair value option offers the best opportunity to reduce complexity and to improve financial reporting, yet at the same time address some of the accounting anomalies that exist.

Possible issues associated with a fair value option in Example 1

31. Certain issues in respect of the suggested fair value option have to be addressed, including:

    i) Whether the fair value option designation should be permitted only at intial recognition (when the exposure first occurs for an unrecognized firm commitment), or at some later date.

    ii) Whether an entity should be permitted to designate a portion of an item at fair value through profit or loss.

    iii) Whether an entity should be permitted to de-designate an item or a portion of an item (that is, stop measuring it at fair value).

(i) When the fair value designation should be permitted

32. Current fair value hedge accounting models include an 'on-off' switch. That is, an entity may start hedge accounting, discontinue hedge accounting and re-designate hedge accounting any time during which an exposure exists (provided that hedge accounting criteria are met). This reflects the fact that the hedging instrument and hedged item may not have the same terms, or an entity may terminate the hedging instrument before the hedged item.

33. Designation under a fair value option could be made either at initial recognition (when the exposure first occurs for an unrecognized firm commitment), or at some later date.

34. Obviously, there will be demand for the ability to designate an item at a later date.

35. However, if an entity is allowed to use the fair value designation option at some later date, then the Boards inevitably have to consider:

    - How the designated item is measured at the time the fair value option is used (could be fair value, or something other than cost or fair value); and

    - If the item is measured at an amount that is different to its carrying amount at the time when the fair value designation option is made, how the difference, if any, should be accounted for and presented.

(ii) Whether the fair value option can be applied to 'portions' of an item

36. Introducing the notion of a 'portion' into a fair value option would increase complexity. Guidance would be required on what eligible portions can be designated at fair value through profit or loss.

37. Allowing a portion of an item (regardless of whether it is a financial instrument or non-financial instrument) would also result in inconsistent accounting treatments with a single item – that is, the designated portion is measured at fair value through profit or loss but the undesignated portions may not be recognised or may be measured at something other than fair value. Such an accounting treatment could actually result in the carrying cost of a financial instrument being adjusted away from its fair value[4]. Moreover, such an accounting treatment is not consistent with the principle that the fair value measurement should be applied to a financial instrument in its entirety.

38. Furthermore, given that one item normally has one fair value measure and that different portions are interdependent, guidance would be required on how to measure the designated portion.

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[4] Hence perpetuating one of the sources of complexity in the fair value hedge accounting model used today.

39. Also, some entities may be less willing to designate financial instruments to be measured at amortised cost if no portions (or only very restricted types of portions) for financial instruments were permitted. For example, a bank with fixed rate loans may use a derivative instrument to hedge the benchmark interest rate risk only. If no portions were permitted in a fair value option, then there may be less incentive to designate the loans at amortised cost and suffer volatility in profit or loss arising from the hedging instrument.

What are the possible eligible portions (if the fair value option is allowed to be applied to a portion of an item)?

40. The following section only discusses (a) a percentage of the entire item; and (b) the portion attributable to the foreign currency exposure of the item.

(a) A percentage of the entire item

41. A percentage of the entire item could be designated as a designated portion – it should not be difficult to determine the fair value of a percentage of the entire item.

(b) Foreign currency exposure of the item

When a hedged item is a financial instrument (which is designated to be measured at amortised cost)

42. There might *not* be any demand for designating the foreign currency exposure of an item within the scope of the financial instruments standard as at fair value through profit or loss. Current literature requires the foreign currency exposure to be measured at each balance sheet date. Any changes are required to be recognised in profit or loss immediately.

When a hedged item is a non-financial instrument

43. Many entities currently hedge the foreign currency risk of non-financial firm commitments. In the context of the fair value option, some might demand for a foreign currency component of an item to be designated as at fair value through profit or loss.

44. Current accounting requirements allow a portion that is attributable to the foreign currency risk of a non-financial instrument to be designated as a hedged item.

45. For example, IAS 39 paragraph 82 requires that, if the hedged item is a *non-financial asset or non-financial liability*, it should be designated as a hedged item for (a) foreign currency risks, or (b) in its entirety, because of the difficulty of isolating and measuring the appropriate portion of the cash flows or fair value changes attributable to specific risks other foreign currency risks.

46. The foreign currency portion is considered to be able to be separated from other portions of the item and changes in the fair value of the foreign currency portion are considered to be able to be measured reliably.

47. However, instead of complicating the fair value option by introducing ‘portions’, a preferable route may be to account for a hedge of the foreign currency risk of a firm commitment as *a cash flow hedge*. Such an accounting treatment is not different from the current IFRS requirements: IAS 39 allows an entity to account for a hedge of the foreign currency risk of a firm commitment as either a fair value hedge or a cash flow hedge (see IAS 39 paragraph 87).

(iii) Whether de-designation should be permitted

48. This is the ‘off’ part of the ‘on-off’ switch. There will be demand for such an ‘off’ switch.

49. However, such an ‘off’ switch would add complexity and is inconsistent with the fair value measurement principle for items in the scope of the financial instruments standard.

50. In addition, once an entity identifies a risk and designates that risk as at fair value through profit or loss, it should continue to report that risk at fair value through

profit or loss in order to achieve 'faithful' and 'consistent' reporting. The risk is still there even if the entity de-designates the fair value option.

Summary of possible features of Example 1

51. The staff considers that Example 1 should contain no fair value hedge accounting, but should include a fair value option for non-financial items. The table below summarises the possible features of Example 1:

Possible features of Example 1
1) No fair value hedge accounting.
2) Instead, a fair value option should be allowed to be applied to an item *outside* the scope of the financial instruments standard.
3) Fair value option should be applied on initial recognition.
4) Fair value option should be applied to the entire item (or a percentage of the entire item).
5) A hedge of the foreign currency risk of non-financial firm commitments should be accounted for as a cash flow hedge.
6) De-designation should not be allowed.

52. **Question to the Boards:**

    (a) Do the Boards have any comments and observations regarding these possible features of Example 1?

SECTION 2 - CASH FLOW HEDGE ACCOUNTING

53. Current cash flow hedge accounting allows effective gains or losses on hedging instruments to be deferred in equity and recycled to profit or loss when the underlying exposure affects profit or loss. Ineffectiveness is recognised in profit or loss immediately.

54. Current cash flow hedge accounting addresses the following exposures:

    (a) Exposures to changes in the expected future cash flows of a recognised item in the financial instruments standard (for example, exposures to changes in future interest payments of an existing floating rate liability);

    (b) Exposures to changes in the expected cash flows of a forecast transaction to buy, sell or issue an item that, when recognised, will be within the scope of the financial instruments standard (for example, the forecast issuance of a financial liability); and

    (c) Exposures to change in the expected cash flows of a forecast transaction to buy or sell an item that, when recognised, will be outside the scope of the financial instruments standard (for example, the forecast sale of oil).

Will there still be demand for cash flow hedge accounting in Example 1?

Exposures to changes in the expected future cash flows of a recognised item in the financial instruments standard

55. There will still be demand for cash flow hedge accounting for these types of exposures in Example 1.

56. As with the previous discussion on fair value hedges involving two financial instruments, this is because Example 1 contains an exception whereby certain financial instruments can be designated to be measured at amortised cost (whereas hedging instruments might not be eligible to be designated to be measured at amortised cost).

57. Therefore profit or loss will include mixed measurement gains or losses, including (i) fair value gains or losses on hedging instruments (that are not eligible for

designation to be measured at cost); and (ii) historic interest income or expense determined using the effective interest method.

58. However, unlike fair value hedge accounting, there is no obvious alternative to cash flow hedge accounting (such as a fair value option). The need for hedge accounting arising from the exception in Example 1 can however be met by cash flow hedge accounting.

Exposures to changes in the expected cash flows of a forecast transaction to buy or sell (or issue) an item

59. For a forecast transaction of a financial instrument that, on recognition, will be measured at fair value, the fair value measurement principle dictates that *no* cash flow hedge accounting should be permitted.

60. However, significant demand for cash flow hedge accounting will exist for exposures to changes in the expected cash flows of a forecast transaction to buy or sell:

    - an item that, when recognised, will be within the scope of the financial instruments standard and be allowed to be designated to be remeasured at amortised cost.

    - an item that, when recognised, will be outside the scope of the financial instruments standard.

61. The IASB's preliminary view is that cash flow hedge accounting is not justified to be used for exposures in relation to forecast transactions (regardless of whether the underlying item is accounted for using the fair value model).

In summary…

62. Because entities wish to reflect the intended effects of managing risks associated with the cash flows of forecast transactions in their financial statements, significant demand for cash flow hedge accounting is still there.

63. Therefore, any next interim step is unlikely to eliminate cash flow hedge accounting.

64. Consequently, the following section considers how existing cash flow hedge accounting (for all of the types of exposures mentioned previously) could be simplified when compared to today's requirements.

65. This following section does *not* discuss whether there is a feasible alternative mechanism to cash flow hedge accounting that fundamentally differs from the approach used today. There may be, and this is an area the staff intends to explore at a later stage.

How to simplify existing cash flow hedge accounting?

Key principles

66. Because cash flow hedge accounting is primarily based on management intent (see the discussion above), there must be some hurdles (for example, prospective designation and documentation etc.) to avoid abuse.

67. One of these hurdles is the requirement for a certain level of effectiveness between a hedged item and hedging instrument before an entity can qualify for hedge accounting.

68. Hedge accounting is actually an 'offset' model (rather than an 'economic risk reduction' model). That is, hedge accounting considers the offset in profit or loss over time between the gains (losses) on one item and the losses (gains) on another item.

69. The level of offset must be able to be measured reliably. Any changes in the fair value of the hedging instrument that do not offset the hedged item must be

recognised in profit or loss immediately (that is, the recognition of actual ineffectiveness).

70. So two key and related issues arise:

- What 'hurdles' are required to avoid abuse of an accounting exception; and
- Specifically, whether a certain amount of offset between the hedging instrument and hedged item should be required to qualify for hedge accounting.

Components of existing cash flow hedge accounting

71. Existing cash flow hedge accounting consists of the following key components:

    (a) Designation and documentation of a hedging relationship;

    (b) Hedging instruments;

    (c) Hedged items; and

    (d) Effectiveness testing –qualification tests and actual effectiveness measurement.

(a) Designation and documentation of a hedging relationship

72. Cash flow hedge accounting is established by *management intent* only. That is, gains or losses on a financial instrument are deferred because management states that a financial instrument is entered into to hedge a risk to which the entity is not yet exposed.

73. Given that management intent plays such a key role, designation and documentation of the relationship between hedging instruments and hedged items is a vital hurdle. Existing designation and documentation requirements require an entity to identify the hedged risk, hedged item and hedging instrument of a hedging relationship.

74. Such requirements also require entities to document how hedge effectiveness will be assessed and measured – to ensure entities apply a consistent method over the life of the hedging relationship.

Staff's preliminary comments

75. The staff considers that there is *little* room for significant simplification in this area.

76. **Question to the Boards:**

(a) Do the Boards have any comments and observations as to how existing cash flow hedge accounting can be simplified in the above respect?

(b) Hedging instruments

77. Current requirements restrict eligible hedging instruments to derivatives, with an exception that cash instruments are permitted to hedge foreign currency risks (only certain types of foreign currency risks under US GAAP).

78. An interim step could either:

- relax these restrictions and permit any financial instrument to be eligible for designation as a hedging instrument; or
- restrict eligible hedging instruments as exists today or further.

79. Any restriction regarding what can be designated as a hedging instrument would involve complexity – for example, defining a 'derivative'.

80. Permitting any financial instrument to be a hedging instrument is more appealing.

81. Many of the reasons advanced as to why cash instruments are not permitted to be designated as a hedging instrument relate to fair value hedge accounting (for example, see IAS 39 paragraphs BC144 – BC145). However, this section focuses on cash flow hedge accounting.

82. Furthermore, the staff does *not* consider that permitting any financial instrument to be designated as a hedging instrument in a cash flow hedge would have any significant implications for the following reasons:

- Certain cash hedging instruments might be designated to be measured at amortised cost (provided that the hedging instrument has the relevant cash flow characteristics). In those instances, there are no accounting mismatches.

- Cash instruments are commonly used to be designated as hedging instruments to hedge foreign currency exposures. However, existing requirements already allow that. Therefore, there would be no change to the existing requirements.

83. Furthermore, other types of cash instruments (such as a floating rate asset measured at fair value are used to hedge future changes in interest streams of a floating rate liability) would typically have little fair value volatility. Interest income received from the asset would match interest expenses paid for the liability (although this might raise presentation issues as to how the two items are reported in profit or loss).

Staff's preliminary comments

84. The staff considers that Example 1 could permit *any* financial instrument to be designated as a hedging instrument in a cash flow hedge.

85. **Question to the Boards:**

    (a) Do the Boards have any comments and observations as to how existing cash flow hedge accounting can be simplified in the above respect?

(c) Hedged items

86. Existing requirements require that a forecast transaction must be highly probable to qualify for cash flow hedge accounting. Such a requirement is an essential hurdle and hence should *not* be changed.

87. Another important issue in respect of hedged items is whether a portion (and if so, what portions) can be designated as a hedged item. This is relevant, regardless of whether or not the hedged items are within the scope of the financial instruments standard.

When a hedged item is a non-financial instrument

88. If a hedged item is a *non-financial instrument* (apart from situations in which the entire item is designated as a hedged item), current accounting restricts the eligible hedged risk to be foreign currency risk only.

89. As noted previously, the reason for this includes the difficulty in certain situations to isolate other components of a non-financial instrument and to measure fair value gains or losses of those components reliably.

90. Consequently, the Boards may wish to carry forward such a requirement to the next interim step.

91. Also, as discussed previously, the next interim step could require a hedge of the foreign currency risk of a firm commitment to be accounted for as a cash flow hedge. This would avoid introducing the notion of 'portions' into a fair value option for recognised non-financial items and unrecognised firm commitments.

92. In addition, Example 1 could allow a percentage of the entire non-financial instrument to be designated as a hedged item.

<u>When a hedged item is a financial instrument</u>

93. Under IAS 39, a portion of a financial instrument can be designated as a hedged item provided that it is identifiable and its changes in fair value can be measured reliably.

94. The IASB has been told that the 'portion' notion creates significant complexity and requires lots of guidance as to what eligible portions are[5].

95. Possible alternatives to simplify existing requirements might include to:

- Not allow any portion of a financial instrument to be designated as a hedged item at all. This alternative would dramatically simplify existing hedge accounting requirements. However, this alternative is unlikely to be popular. This might also result in fewer eligible hedge accounting relationships and greater reported ineffectiveness being reported in profit or loss.

- Only allow certain types of portions to be designated as hedged items – for example, a percentage of the entire financial instrument item and the portion attributable to the foreign currency exposure. However, guidance is required

[5] The IASB, at its meeting in December 2006, decided to amend IAS 39 to clarify what risks and portions are eligible to be designated as hedged risks and hedged items respectively, *when a hedged item is a financial instrument.*

in respect of what portions can be designated as hedged items. This approach might not dramatically simplify hedge accounting.

Staff's preliminary comments

96. The staff considers that the 'highly probable' hurdle must be retained.

97. The staff considers that Example 1 should permit a portion attributable to the foreign currency risk to be designated as a hedged item. In addition, the staff considers that Example 1 should permit certain other portions to be designated as hedged items (for example, a percentage of the entire item).

98. **Question to the Boards:**

(a) Do the Boards have any comments and observations as to how existing cash flow hedge accounting can be simplified in the above respect?

(d) Effectiveness testing

99. Before exploring how to simplify existing cash flow hedge accounting in this respect, it is important to understand existing requirements first.

Highly effective qualification tests

Existing requirements

100. Current effectiveness testing is a two-step approach. First, an entity has to consider whether a hedge is 'highly effective' in order to qualify for hedge accounting. Then, the entity has to determine the amount of gains or losses on the hedging instrument to be deferred in equity.

101. To determine whether a hedge is highly effective, existing standards require the entity to pass the following two tests (see AG 105 of IAS 39):

    - *Prospective hedge effectiveness test* – At inception of the hedge and in subsequent periods, the hedge is expected to be highly effective in achieving offsetting between gains or losses on the hedged item and hedging instruments; and

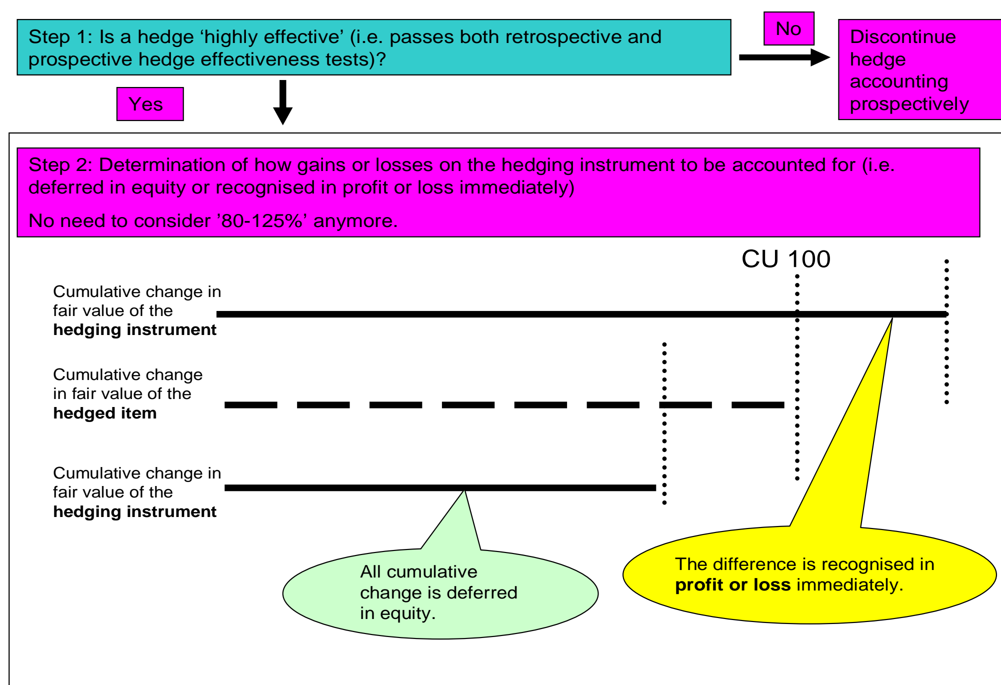
    - *Retrospective hedge effectiveness test* – The actual offsetting results of the hedge are within a range of 80-125%.

102. If a hedge is *no longer* highly effective (i.e. fails prospective *and/or* retrospective hedge effectiveness tests), an entity has to discontinue hedge accounting prospectively.

103. If a hedge is considered as highly effective (i.e. passes *both* retrospective and prospective hedge effectiveness tests), the entity then determines the amount of gains or losses on hedging instruments to be deferred in equity.

104. If the hedge is considered as highly effective, the entire gains or losses on the hedging instrument can be deferred in equity, provided that the cumulative change in fair value of the hedging instrument does not exceed the cumulative change in fair value of the hedged item (see IAS 39 paragraph 96 and F.5.3 of the Guidance on Implementing IAS 39). Any excess of the cumulative change in fair value of the hedging instrument over the cumulative change in fair value of the hedged item is required to be recognised in profit or loss immediately.

105. The diagram below summarises the above requirements:



106. The prospective and retrospective effectiveness tests are mechanisms to restrict the number of relationships that are eligible to be accounted for as cash flow hedges (that is, 'hurdles'); only 'highly effective' hedges are allowed to be accounted for as cash flow hedges. They are the 'price of admission' to cash flow hedge accounting.

107. The staff understand that the effectiveness requirements (and required bands within which effectiveness must fall) originated in FASB Statement No. 80 *Accounting for Futures Contracts* – which was originally an all or nothing approach. That is, if the effectiveness was within the band then hedge accounting was permitted and no ineffectiveness was recognised. If effectiveness was outside the bands, then no hedge accounting was permitted.

108. However, some constituents cite the 'highly effective' qualification tests (particularly, the retrospective hedge effectiveness test) as the area that creates the most problematic and complex hedge accounting issues.

Possible simplifications in Example 1

109. Possible simplifications in Example 1 might include:

Possible simplifications	Staff's preliminary comments
1) Simply require actual ineffectiveness to be recognised in profit or loss immediately. No more 'highly effective' qualification tests.	As previously discussed, hedge accounting is an offset model. As long as there is some offset between the hedged item and hedging instrument, should there arguably be no requirement that hedge effectiveness should fall within a certain range. Removing the 'highly effective qualification' tests (particularly the retrospective hedge effectiveness test) would significantly reduce complexity[6]. However, there is a trade-off; more hedging relationships would qualify for cash flow hedge accounting if the 'highly effective qualification' tests were removed. This could result in more gains or losses on hedging instruments being deferred in equity. However, to reduce gains or losses on hedging instruments to be deferred in equity, the next interim step could prohibit portions of an item to be designated as hedged items (or only allow very limited specified portions to be designated as hedged items). Such a treatment might reduce the amount of gains or losses on hedging instruments being deferred in equity because the gains or losses of the hedging instruments and hedged items are unlikely to completely offset.

[6] The hedged item in a cash flow hedge differs significantly from that in a fair value hedge. In a fair value hedge, the hedged item actually exists, and can and has to be identified. However, the identification of the actual hedged exposure is much more problematic for a forecast transaction. IAS 39 already recognizes this fact – for example, by permitting an entity to take a layer approach to a hedged item for calculating effectiveness in the portfolio cash flow hedging model in IG F6.3 versus the prohibition against such an approach in the IAS 39 fair value portfolio hedging model.

Possible simplifications	Staff's preliminary comments
2) Some hurdles should still be retained so that only 'highly effective' hedges qualify for cash flow hedge accounting. Retain the prospective hedge effectiveness test but remove the retrospective hedge effectiveness test. Actual ineffectiveness to be recognised in profit or loss immediately.	This simplification would remove the 80-125% rule. However, management would still be required to assert that the hedging relationship is still highly effective prospectively.

Measurement of actual effectiveness and recognition of ineffectiveness

110. As mentioned above, hedge accounting concerns that there should be offset between gains or losses on the hedged item and losses or gains on the hedging instrument. To the extent that fair value change of the hedging instrument does not offset the change of the hedged item, the difference should be recognised in profit or loss immediately.

111. However, measuring actual effectiveness against a forecast transaction is difficult and sometimes highly problematic. An alternative to requiring effectiveness to be measured in each period might be to simply require an entity on original designation to state when the hedged item will affect profit or loss. That would then determine the timing of when gains or losses on the hedging instrument deferred in equity should be recycled to profit or loss. Such an approach may raise other issues however.

112. **Question to the Boards:**

(a) Do the Boards have any comments and observations as to how cash flow hedge accounting can be simplified in the above respect?

(e) Other simplifications

113. If a hedge of a forecast transaction subsequently results in the recognition of a non-financial asset or non-financial liability, IAS 39 allows an entity to choose how to account for the cumulative gains or losses on the hedging instruments. IAS 39 allows the entity to include the cumulative gains or losses on the hedging instruments in the initial cost of the asset or liability ('basis adjustment'). Such an adjustment (1) reduces the transparency associated with cash flow hedge accounting, and (2) is an accounting option and hence reduces comparability. The 'basis adjustment' should not be allowed in the next interim step.

Summary of possible cash flow hedge accounting features of Example 1

114. The table below is a summary of possible cash flow hedge accounting features of Example 1.

Possible features of Example 1
1) Cash flow hedge accounting is not permitted for forecast transactions to buy/sell or issue a financial instrument that, when recognised, will be measured at fair value at profit or loss.
2) Cash flow hedge accounting is permitted for other exposures (see the discussion above).
3) Designation and documentation - prospective designation and documentation of hedging relationship should still be required.
4) Hedging Instrument - any financial instrument should be eligible to be designated as a hedging instrument.
5) Hedged item - any forecast transaction must be 'highly probable'.
6) Hedged item – certain 'portions' should be permitted (e.g. a percentage, the foreign currency component).
7) Actual ineffectiveness - actual measurement of hedge effectiveness required. Any ineffectiveness recognised in profit or loss immediately.
8) No 'highly effective' qualification tests (i.e. no prospective and retrospective hedge effectiveness tests).
9) No basis adjustments to hedged items should be permitted.

SECTION 3 - OBSERVATIONS ON OTHER COMPONENTS OF EXAMPLE 1

115. The implications on the following components of Example 1 are considered below:

    (a) Embedded derivatives;

    (b) Impairment and uncollectability of financial assets; and

    (c) Derecognition of financial instruments

(a) Embedded derivatives

116. Example 1 does not allow financial instruments that contain one or more embedded derivatives to be designated to be measured at amortised cost. Therefore, there is no need for provisions for the identification and separation of derivatives embedded in hybrid contracts within the scope of the financial instruments standard.

117. However, these provisions might still be required for hybrid contracts that include hosts that are *outside* the scope of the standard. Indeed, this is a scope issue of the financial instruments standard.

118. However, the Boards have been told that the identification and separation of derivatives embedded in hybrid contracts is complex and costly.

119. One possible method to reduce complexity in this area is the use of a fair value option, whereby an entity is permitted to measure the whole contract at fair value through profit or loss if it contains certain ‘derivative-like’ features.

120. Another possible alternative is to require any contract that contains certain ‘derivative-like’ features to be measured at fair value (in effect, to be accounted as if it were a financial instrument).

(b) Impairment and uncollectibility of financial assets

121. Impairment provisions will be required in Example 1 for financial assets that are measured at cost or amortised cost (including loans and receivables with certain cash flow characteristics and equity investments that are not traded in active markets).

122. This paper does not address how this area might be changed.

(c) Derecognition of financial instruments

123. Any exception to the fair value measurement principle will result in more complex derecognition requirements.

124. There is a separate project on derecognition. Therefore this issue will not be addressed in the DPD.

(d) Determination of 'amortised cost' and effective interest method

125. Current accounting requires financial instruments that are measured at amortised cost to be determined using the effective interest method. Example 1 would also require such guidance.

126. This paper does not address how this area might be changed.

127. **Question to the Boards:**

(a) Do the Boards have any comments and observations as to how the above-mentioned components can be simplified in the next interim step?

APPENDIX ONE – SUMMARY OF POSSIBLE FEATURES OF EXAMPLE 1

Component	Outline Requirements	Any comments
Scope	Cover all financial instruments, subject to certain exceptions. Include certain non-financial instruments (as if they were financial instruments).	o Treatment of contracts that are not financial instruments but that contain 'derivative-like' features?
Measurement	The fair value measurement is a default category. Exception – financial instruments with certain cash flow characteristics that are *not* traded in an active market may be designated on initial recognition to be measured at amortised cost. Such a designation is irrevocable.	o Other exceptions?
Fair value hedge accounting	No fair value hedges. Instead, suggest fair value option for items outside the scope of financial instruments standard. Fair value option applies to the entire item (or a percentage of the entire item). A hedge of the foreign currency risk of non-financial firm commitments should be accounted for as cash flow hedge accounting.	Questions associated with the fair value option: o Ability to designate at any date? o Ability to de-designate?
Cash flow hedge accounting	Not permitted for forecast transactions to buy/sell or issue a financial instrument that, when recognised, will be measured at fair value at profit or loss Still need designation and documentation of hedging relationship. Any financial instrument should be eligible to be designated as a hedging instrument. Hedged item – certain 'portions' permitted (e.g. a percentage, the foreign currency component). Where hedged item is a forecast transaction, the transaction must be 'highly probable'. Actual hedge ineffectiveness should be recognised in profit or loss immediately. Measurement of actual effectiveness is still required.	Should there be any restriction as to what can be designated as hedging instruments? Should a portion of an item be allowed to be designated as a hedged item? If yes, what are they?
Cash flow hedge accounting (cont'd)	No 'highly effective' qualification tests (i.e. no	Should 'highly effective

	prospective or retrospective hedge effectiveness tests). No basis adjustments to hedged items permitted. Requirements in respect of when hedge accounting should be discontinued are the same as exists today. Re-designation of hedge accounting is still allowed (same as the requirements that exist today).	qualification' tests be required (given that actual ineffectiveness will be recognised in profit or loss immediately)?
Impairment of financial assets	Required for assets that are designated to be measured at amortised cost.	
Determination of amortised cost and effective interest method	Required for assets that are designated to be measured at amortised cost.	