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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:	**13 December 2007, London**
Project:	**IAS 39 Financial Instruments: Recognition and Measurement**
Subject:	**Cash flow hedge accounting issues (Agenda Paper 3D)**

BACKGROUND

1. At the October 2007 meeting, the Board discussed a staff paper summarising discussions held between an IASB team and a number of banks about the application of portfolio cash flow hedge accounting.

2. The staff reported that the banks successfully apply portfolio cash flow hedge accounting but identified the following issues that may require clarification or reconsideration.
   a. What is meant by a "hypothetical derivative" for testing effectiveness
   b. Ability to improve documentation/effectiveness methodology for existing hedge relationships
   c. The period in which gains or losses on hedging instruments should be reclassified from equity to profit or loss as a reclassification adjustment
   d. Designation of a sub-benchmark interest rate

3. At that meeting, the Board asked the staff to conduct further analysis and make recommendations to the Board.

PURPOSE OF PAPER

4. The paper examines issue (c) in paragraph 2. The staff expect to present papers on the other issues at subsequent meetings.

STAFF ANALYSIS

5. In summary, the issue relates to when gains or losses on hedging instruments should be reclassified from equity to profit or loss for cash flow hedges.

6. The guidance regarding reclassification of gains or losses from equity to profit or loss on cash flow hedging relationships is set out in paragraphs 97, 98, 100 and 101 of IAS 39.

7. If a hedged forecasted transaction subsequently results in the recognition of a financial asset or a financial liability, paragraph 97 of IAS 39 requires the associated gains or losses on hedging instruments to be reclassified from equity to profit or loss as a reclassification adjustment in the same period or periods during which the asset acquired or liability assumed affects profit or loss (such as when the interest income or interest expense is recognised).

8. Paragraph 98 of IAS 39 covers hedges of forecast transactions that subsequently result in the recognition of a non-financial asset or liability (not relevant for this paper).

9. Paragraph 100 of IAS 39 covers cash flow hedges other than those covered by paragraph 97 and 98 (for example, sale of an asset or liability). Paragraph 100 states that for such hedges, amounts that had been recognised in other comprehensive income shall be reclassified from equity to profit or loss as a reclassification adjustment in the same period or periods during which the hedged forecast transaction affects profit or loss.

10. Paragraph 101 sets out the accounting required if hedge accounting is discontinued.

11. There appears to be some confusion regarding the period during which reclassification adjustments should be made if the hedged forecasted transaction results in recognition of a financial instrument.

12. The example below illustrates the issue:

Example

An entity applies IG F6.3 in IAS 39. On 1 January 200x the entity designates forecast cash flows for variability arising from changes in interest rates. Those forecast cash flows arise from repricing of existing financial instruments and are scheduled to occur at 1 April 200x. The period of exposure to interest rate changes being hedged is from 1 January 200x to 31 March 200x, and the effects of interest rate changes on the cash flows are hedged for a period of 3 months from 1 April 200x.

The forecast cash flows are deemed to be highly probable of occurring and all the other relevant hedge accounting criteria are met.

The financial instrument that results from the hedged forecast cash flows is a 5 year interest bearing instrument.

13. Paragraph 97 requires that the gains or losses on the hedging instrument should be reclassified from equity to profit or loss as a reclassification adjustment in the same period or periods during which the asset acquired or liability assumed affects profit or loss. The financial instrument that was recognised is a 5 year instrument that will affect profit or loss for 5 years. The wording in paragraph 97 suggests that the gains or losses should be reclassified over 5 years, despite the fact that the cash flows designated as the hedged item were actually only being hedged for the effects of interest rate changes over a 3 month period.

14. The staff believes that this interpretation does not reflect the underlying rationale in hedge accounting; that is, the gains/losses on the hedging instrument should offset the losses/gains on the hedged item, and that offset should be reflected in profit or loss by way of the reclassification adjustments.

15. The staff believes that, in the example set out above, the gains or losses should be reclassified over a period of 3 months starting from 1 April 200x, and not over a period of 5 years starting on 1 April 200x.

16. The staff therefore recommends that paragraph 97 of IAS 39 should be amended, as set out in appendix 1. The staff also believes that paragraph 100

of IAS 39 should be amended to be consistent with paragraph 97 and to avoid similar confusion.

QUESTIONS FOR THE BOARD

17. Does the Board agree with the staff analysis in paragraph 13 regarding the period during which gains/losses on hedging instruments should be reclassified from equity to profit or loss as a reclassification adjustment?

18. If so, does the Board agree that paragraph 97 and paragraph 100 of IAS 39 should be amended?

19. The issue meets the criteria for inclusion in the annual improvements process (i.e. a minor and non-urgent issue). Does the Board agree that this issue should be included as part of the Annual Improvements process? If not, how would the Board like to proceed?

Appendix 1

Proposed Amendment to Paragraph 97 and Paragraph 100 of IAS 39

97 If a hedge of a forecast transaction subsequently results in the recognition of a financial asset or a financial liability, the associated gains or losses that were recognised in other comprehensive income in accordance with paragraph 95 shall be reclassified from equity to profit or loss as a reclassification adjustment (see IAS 1 (as revised in 2007)) in the same period or periods during which the hedged forecast cash flows ~~asset acquired or liability assumed~~ affects profit or loss (such as in the periods that interest income or interest expense is recognised. However, if an entity expects that all or a portion of a loss recognised in other comprehensive income will not be recovered in one or more future periods, it shall reclassify from equity to profit or loss as a reclassification adjustment the amount that is not expected to be recovered.

…

100 For cash flow hedges other than those covered by paragraph 97 and 98, amounts that had been recognized in other comprehensive income shall be reclassified from equity to profit or loss as a reclassification adjustment (see IAS 1 (revised 2007)) in the same period or periods during which the hedged forecast cash flows ~~transaction~~ affects profit or loss (for example, when a forecast sale occurs).

Appendix 2

DRAFT BASIS FOR CONCLUSION

1. If a hedged forecasted transaction subsequently results in the recognition of a financial asset or a financial liability, paragraph 97 of IAS 39 requires the associated gains or losses on hedging instruments to be reclassified from equity to profit or loss as a reclassification adjustment in the same period or periods during which the asset acquired or liability assumed affects profit or loss (such as in the periods that interest income or interest expense is recognised).

2. The Board was informed that there was uncertainty as to how paragraph 97 should be applied in situations that the designated cash flow exposure being hedged differed from the financial instrument arising from the forecast cash flows.

3. The Board decided to amend paragraph 97 of IAS 39 to clarify that the gains or losses on the hedged instrument should be reclassified from equity to profit or loss in the period that the forecasted cash flows affect profit or loss. The Board also decided that paragraph 100 of IAS 39 should be amended to be consistent with paragraph 97 and to avoid similar confusion.