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International
Accounting Standards
Board

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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:	**24 January 2007, London**
Project:	**Financial Instruments – Due Process Document (DPD)**
Subject:	**Hedge accounting (Agenda Paper 7A)**

BACKGROUND

1. This paper discusses hedge accounting and is based on the Boards' preliminary view that all items in the scope of the DPD should be measured at fair value with changes in the fair value reported in profit or loss. Hedge accounting will also be considered in the DPD discussion (planned for Q2 2007) of possible intermediate steps towards requiring all financial instruments being measured at fair value that the Boards could take.

PURPOSE OF THIS PAPER

2. Hedge accounting is an exception to normal recognition, measurement and display accounting principles.

3. This paper seeks any preliminary views of the Boards as to which situations, if any, justify a departure from normal accounting principles.

4. If the Boards believe that a departure from the normal accounting principles is justified in certain situations, the staff will address any further issues in a subsequent paper.

5. This paper does not address possible hedge accounting mechanisms that are different from special hedge accounting permitted by IAS 39 *Financial Instruments: Recognition and Measurement* and Statement No. 133 *Accounting for Derivative Instruments and Hedging Activities* (for example, the deferral of gains and losses on cash flow hedging instruments as assets or liabilities) – with the exception of paragraphs 47-48.

6. In addition, this paper does not address hedges of the foreign currency exposure of a net investment in a foreign operation. This issue was not re-deliberated in IAS 39 or Statement 133 and it is not the intention of the staff to address such hedges in the DPD.

DEMAND FOR HEDGE ACCOUNTING

7. As previously noted, hedge accounting changes the normal accounting for one or more components of a hedge relationship. This results in offsetting gains and losses arising from the hedged item and hedging instrument being recognized in earnings in the same accounting period.

8. Demand for such special accounting arises in order to:

   (a) Address recognition and measurement anomalies; and

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

Accounting anomalies

9. Accounting anomalies arise because of differences in the way hedged items and hedging instruments are recognized and measured.

10. Recognition anomalies arise because hedging instruments are recognized in the financial statements while some hedged items (such as many firm commitments) are not.

11. Measurement anomalies arise because some assets and liabilities are measured differently than other assets and liabilities. For example, currently some financial instruments are measured at fair value while other financial instruments are measured on a cost basis.

12. Hedge accounting is based on relationships between different assets and liabilities that are identified by the reporting entity and (in part) seeks to compensate for such accounting anomalies between the hedged item and hedging instrument.

Risks associated with the cash flows of forecast transactions

13. Demand for hedge accounting also arises when no recognition and measurement anomalies exist.

14. Many want exceptions to normal accounting principles for instruments used to offset changes in the cash flows associated with forecast transactions. Such an exception allows the recognition of gains or losses on the hedging instrument in profit or loss in the period or periods in which the forecasted transaction will affect profit or loss.

15. Such forecasted transactions do not meet our recognition criteria as an asset or liability – and can only be identified by management's assertions about transactions expected to occur in the future.

DIFFERENT TYPES OF POSSIBLE HEDGED ITEMS

16. This paper discusses the following different types of hedged items:

    (a) Exposures to changes in the fair value of a recognized item in the scope of the DPD;

(b) Exposures to changes in the expected future cash flows of a recognized item in the scope of the DPD;

(c) Exposures to changes in the expected cash flows of a forecast transaction to buy/sell an item that, when recognized, will be within the scope of the DPD;

(d) Exposures to changes in the fair value of assets or liabilities (including firm commitments) outside the scope of the DPD; and

(e) Exposures to changes in the expected cash flows of a forecast transaction to buy/sell an item that, when recognized, will be outside the scope of the DPD.

Exposures to changes in the fair value of a recognized item in the scope of the DPD

17. The Boards' preliminary view is that all items in the scope of the DPD should be measured at fair value with changes in the fair value recognized in profit or loss.

18. This means that no accounting anomalies will arise when both the hedged item and hedging instrument are in the scope of the DPD. Both items will be accounted for at fair value with offsetting gains and losses recognized immediately in profit or loss.

19. Of course, there will still be demand for an exception to the normal accounting principles in some situations – for example, when changes in the fair value of the hedged item do not fully offset changes in the fair value of the hedging instrument in a partial hedge.

Questions to the Boards

20. **Do you want to state a preliminary view about whether there is any justification for an exception to normal accounting principles for exposures to changes in the fair value of a recognized item in the scope of the DPD? If so, what is that view and justification for that view?**

21. **If you believe you could answer those questions with some additional information, what additional information do you need?**

Exposures to changes in the expected future cash flows of a recognized item in the scope of the DPD

22. An entity may be exposed to variability in the expected future cash flows arising from a recognized item in the scope of the DPD. For example, an entity that holds a floating interest rate asset is exposed to variability of the expected future cash receipts as a result of changes in interest rates. Similarly, an entity that holds non-functional currency assets is exposed to variability of future cash flows as a result of changes in exchange rates.

23. An entity may hedge the risk of changes in the cash flows by using another financial instrument to remove the cash flow risk for a certain period of time. For example, an entity may enter into a receive-fixed /pay-variable interest rate swap to hedge its exposure to changes in the cash flows of a floating rate asset. By entering into the interest rate swap, the entity subjects itself to fair value risk.

24. Based on the preliminary views of the Boards, both financial instruments in the preceding paragraphs will be measured at fair value with changes in the fair value recognized in profit or loss.

25. If gains and losses on a hedging instrument (such as an interest rate swap) were recognized as interest income or expense when the hedged cash flows are recognized in profit or loss, then this would result in reporting interest income or expense on a cost basis. Changes in the fair value of the hedging instrument would be used to adjust the future cash flows received on the hedged item to a level that was fixed at the time the hedging relationship was established. That is, interest income or expense reflects the same amounts that it would have reflected if a fixed rate asset had been accounted for on an amortized cost basis.

26. To illustrate – take an asset that pays a return that resets periodically based on changes in interest rates. The entity enters into a receive-fixed/pay-variable

interest rate swap whose terms exactly match the terms of the asset. Assume that the interest rate for a comparable fixed rate asset was 5% when the transactions were entered into. If the entity is permitted to recognize the gains or losses on the swap in profit or loss when the future hedged cash flows are also recognized in profit or loss, then interest income of 5% will be reported in every future accounting period. This will be despite the fact that market interest rates in all of those future periods will, in all likelihood, be something other than 5%.

Questions to the Boards

27. **Do you want to state a preliminary view about whether there is any justification for an exception to normal accounting principles for exposures to expected future changes in the cash flows of a recognized item in the scope of the DPD? If so, what is that view and justification for that view?**

28. **If you believe you could answer those questions with some additional information, what additional information do you need?**

Exposures to changes in the expected cash flows of a forecast transaction to buy/sell an item that, when recognized, will be within the scope of the DPD

29. An entity may be exposed to variability in the expected future cash flows arising from a forecast transaction to buy/sell an item that, when recognized, will be within the scope of the DPD. An entity may hedge the cash flow risk by entering into a financial instrument with offsetting cash flows.

30. An example is the forecast purchase of a fixed rate debt instrument. The forecast transaction does not qualify for recognition as an asset or liability under our conceptual frameworks because the entity has no present rights or obligations.

31. However, the hedging instrument does meet our recognition criteria and would be measured at fair value with changes in the fair value recognized in profit or loss when they arise.

32. There are no accounting anomalies that justify an exception to normal accounting principles (unless one believes that forecasted transactions should be recognized as assets and liabilities).

33. Based on the preliminary views of the Boards, if that debt instrument is recognized it will be measured at fair value with changes in the fair value recognized in profit or loss when they arise. There is therefore no future earnings effect against which any gains or losses on the hedging instrument could be offset – assuming that gains and losses on the hedging instrument were permitted to be deferred. (In other words, if gains and losses on the hedging instrument were deferred, then interest income or expense would effectively be reported as if a synthetic asset or liability had been created and reported on an amortized cost basis).

34. Reporting the gains and losses on the hedging instrument in profit or loss as they arise faithfully represents the entity's present rights and obligations. In the previous example, the recognition of the gains and losses on the hedging instrument reflects the fact that the entity is subject to interest rate risk from the time it entered into the hedging instrument.

Questions to the Boards

35. **Do you want to state a preliminary view about whether there is any justification for an exception to normal accounting principles for exposures to changes in the expected cash flows of a forecast transaction to buy/sell an item that, when recognized, will be within the scope of the DPD? If so, what is that view and justification for that view?**

36. **If you believe you could answer those questions with some additional information, what additional information do you need?**

Exposures to changes in the fair value of assets or liabilities (including firm commitments) outside the scope of the DPD

37. An entity may be exposed to fair value changes in an asset or liability (or an unrecognized firm commitment) that is outside the scope of the DPD. The entity may seek to hedge such risk by entering into a hedging instrument that is in the scope of the DPD.

38. Measuring financial instruments (and other items) that are in the scope of the DPD at fair value would not reduce the demand for hedge accounting for the hedging relationship addressed in this section. Accounting anomalies still arise. Possible recognition and measurement inconsistencies include:

    - *Recognition accounting anomalies* - Firm commitments outside the scope of the DPD generally are not recognized, and the committed transactions are recognized as they occur. However, the gains or losses on hedging instruments in the scope of the DPD are recognized in profit or loss when they arise; and

    - *Measurement accounting anomalies* – the assets or liabilities are not measured at fair value. However, hedging instruments in the scope of the DPD are measured at fair value with changes in the fair value recognized in profit or loss when they arise.

The scope of the DPD

39. Fair value hedge accounting does not affect the accounting for a hedging instrument; it only affects the hedged item. Any exception to normal accounting principles for hedges of assets or liabilities outside the scope of the DPD will therefore not affect the accounting for the hedging instrument. In accordance with the preliminary views of the Boards, the hedging instruments will be measured at fair value with changes in the fair value recognized in profit or loss in the period in which they arise.

40. Special accounting for exposures to changes in the fair value of an asset or liability outside the scope of the DPD would, however, result in recognizing and measuring the hedged item (or part of, or specific risks associated with, the hedged item) as if it were a financial instrument.

41. If the Boards believe that there is justification for an exception to the normal accounting principles for the hedged item, then this might suggest that the scope of the DPD should be reconsidered to include the recognition and measurement of certain non-financial items.

42. The Boards could express a preliminary view that the DPD should not address any departure from normal accounting principles relating to hedged items outside the scope of the DPD. Such a decision would not preclude some form of special accounting for hedged items outside the scope of the DPD; such special accounting would simply not form part of the DPD.

Other considerations relating to exposures to changes in the fair values of an asset or liability (including firm commitments) outside the scope of the DPD

43. Some believe that, without special accounting to 'correct' accounting anomalies, financial statements will not faithfully represent the relationship between a hedging instrument and hedged item and the way that an entity manages risks. (Arguably disclosures of the effect of hedging relationships in the notes to the financial statements would also serve the same purpose).

44. Of course, if the Boards permit such an exception, then only those items or risks of items outside the scope of the DPD that an entity does manage will arguably be faithfully represented.

45. In most hedging relationships there are two separate contracts with separate parties involved. The hedging relationship is merely established by management's intention. Whether management intention alone is sufficient justification to link the two separate contracts and to allow an exception to normal accounting principles is questionable.

46. Furthermore, any exception to normal accounting principles would inevitably result in the need for complex accounting guidance/rules, particularly regarding (a) what risks qualify for being designated as hedged risks; (b) what the eligible hedging instruments are; and (c) how to assess and measure hedge effectiveness.

Possible accounting mechanisms

47. If the Boards believe that an exception to normal accounting principles is justified for the hedging relationship addressed in this section, the Boards may also need to discuss the accounting mechanisms to be used.

48. Possible accounting mechanisms include:

- *Mark-to-fair value hedge accounting* – an approach requiring all changes in the fair value of the hedged item to be recognized in profit or loss when they arise;

- *Fair value hedge accounting* – an approach that is similar to the current accounting for fair value hedges. Unlike the mark-to-fair value hedge accounting, this mechanism allows for partial hedges;

- *A fair value option for non-financial items* – an approach whereby an entity could designate all of (or part of or specific risks associated with) an item outside the scope of the DPD to be measured at fair value;

- *Bifurcation of the financial component(s) from a firm commitment* – an approach requiring financial component(s) of a firm commitment, such as foreign currency, to be measured at fair value with changes in the fair value recognized in profit or loss when they arise; and

- *Deferral of the gains or losses on the hedging instruments in equity (or other comprehensive income under US GAAP)* - an approach similar to the accounting treatment currently applicable to cash flow hedges. Under such an approach a designated hedging instrument would be considered to be hedging the variability of expected future cash flows of the anticipated future transaction that is expected to arise when the designated hedged item is realized (although see later comments).

Questions to the Boards

49. **Do you want to state a preliminary view about whether the DPD should address the possible departure from normal accounting principles (special hedge accounting) for exposures to changes in the fair value of an asset or liability (including a firm commitment) that is outside the scope of the DPD?**

50. **If you believe that the DPD should address this issue, what would you say about it? Do you want to state a preliminary view about whether special hedge accounting should be provided for hedges of exposures to changes in the fair value of assets, liabilities, and firm commitments that are outside the scope of the DPD? If so, what is that view and justification for that view?**

51. **If the Boards believe that (i) the DPD should address this issue, and (ii) a departure from normal accounting principles is justified, do the Boards wish to include in the DPD any discussion of the possible accounting mechanisms (including possible preliminary views)?**

52. **If you believe you could answer those questions with some additional information, what additional information do you need?**

Exposures to changes in the expected cash flows of a forecast transaction to buy/sell an item that, when recognized, will be outside the scope of the DPD

53. An entity may be exposed to changes in the expected cash flows of a forecast transaction to buy or sell an item that, if and when recognized, will be outside the scope of the DPD. The entity may seek to hedge such risk by entering into a hedging instrument that is in the scope of the DPD.

54. The demand for this type of hedge accounting does not arise as a result of accounting anomalies. Forecast transactions do not qualify for recognition as assets or liabilities under our conceptual frameworks. There is therefore no recognition or measurement accounting anomalies.

55. Of course, in accordance with the preliminary views of the Boards, the hedging instruments would be measured at fair value with changes recognized in profit or loss when they arise. However, cash flow hedge accounting requires deferral of gains and losses on the hedging instrument, which conflicts with that preliminary view. Therefore, unlike fair value hedges of assets or liabilities outside the scope of the DPD, special hedge accounting for cash flow hedges *would* affect the accounting of an instrument in the scope of the DPD[1].

Arguments for an exception to the normal accounting principles

56. Many entities' risk management activities relate to changes in the expected cash flows of forecast transactions. Entities use financial instruments to hedge these exposures and "synthetically" fix the price of the future transaction. Those supporting an exception to normal accounting principles argue that hedge accounting reflects management's intention to mitigate risks. It is argued that recognizing the gain or loss on the hedging instrument in earnings in the period or periods in which the forecasted transaction affects earnings more faithfully represents the way an entity manages its business.

57. In addition, some argue that the deferral of a loss on a hedging instrument in anticipation of a future transaction is no different than incurring costs to acquire an asset such as directly attributable transportation costs. Costs incurred to acquire assets are capitalised as assets. However, there is a difference; costs incurred can be capitalised as assets if it is probable that future economic benefits will flow to entities but losses on hedging instruments do not give rise to any future economic

[1] This assumes that the Boards do not wish to recognize items that do not meet the definitions of assets or liabilities (such as forecast transactions).

benefits. Also unlike direct purchase costs, gains or losses on hedging instruments are not a necessary part of acquiring an asset in a future transaction.

Arguments against an exception to the normal accounting principles

58. The result of deferring recognition in earnings of only selected gains and losses on hedging instruments results in a mixed attribute profit or loss, as far as items in the scope of the DPD are concerned. Gains or losses arising from financial instruments not held for hedging purposes would be recognized in profit or loss immediately while gains or losses on certain hedging financial instruments would be deferred.

59. Creating an exception to the normal accounting principles for items in the scope of the DPD because of a possible transaction that may or may not occur seems to conflict with one of the objectives of financial statements – to faithfully represent the present rights and obligations of an entity.

60. Hedge relationships between forecast transactions and hedging instruments are established by management assertions about future intentions only. Forecast transactions may never occur. Creating an exception to the normal accounting principles because of management assertions has no conceptual justification.

61. Moreover, since an exception to normal accounting principles would be established only by management intention, there would inevitably have to be restrictions regarding the circumstances in which departure from normal principles is justified. It is often difficult in practice to distinguish hedging from speculation. Any restrictions would inevitably result in rules and complexity.

62. Any deferral of gains and losses on items in the scope of the DPD also arguably results in the forecast transaction, when it is recognized as an asset or liability, not being faithfully represented. For example, deferring gains and losses on a hedging instrument and including such gains and losses in the initial recorded amount of an asset would result in the asset being measured as if it met the recognition

criteria when the hedging instrument was entered into, rather than when the asset was acquired.

63. Finally, most acknowledge that the ways in which an entity seeks to manage risks provides users with decision useful information. However, such information could be included in the notes to the financial statements rather then developing complex hedge accounting rules and reducing comparability between different entities because of the ‘optional’ nature of hedge accounting.

Questions to the Boards

64. **Do you want to state a preliminary view about whether there is any justification for an exception to normal accounting principles for a forecast transaction to buy/sell an item that, when recognized, will be outside the scope of the DPD? If so, what is that view and justification for that view?**

65. **If you believe you could answer those questions with some additional information, what additional information do you need?**