30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
E-mail: iasb@iasb.org Website: www.iasb.org

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: **15 April 2008, London**

Project: ***IAS 39 Financial Instruments: Recognition and Measurement*, Exposures Qualifying for Hedge Accounting (ED)**

Subject: **Exposures Qualifying for Hedge Accounting (Agenda paper 3)**

Introduction

1. The comment letter period for the Exposure Draft (ED) on Exposures Qualifying for Hedge Accounting ended on 11 January 2008. The staff presented an overview of comments received at the March 2008 Board meeting. The comment letter analysis did not include any staff views or recommendations as to how the Board should proceed.

2. Respondents generally supported the objective (as set out in the ED) to clarify the Board's original intentions regarding what can be designated as a hedged risk and when an entity may designate a portion of the cash flows of a financial instrument as a hedged item.

3. Overall, the responses demonstrated that there was little diversity in practice regarding the designation of risks and portions of cash flows for hedged financial items. Two notable exceptions were:

a) designation of a purchased option in its entirety as the hedging instrument of a hedged item that contains no optionality in such a way that no ineffectiveness arises (paragraph AG99E of the ED[1]).

b) designation of inflation risk in particular situations.

4. The diversity in practice appeared to be much greater for the situation described in paragraph 3(a) than paragraph 3(b).

5. Other main issues highlighted in the comment letter analysis included:

a) opposition to the rules-based approach adopted in the ED (respondents preferred a principle-based approach).

b) concerns that the proposed amendments may have implications for the designation of non-financial items (some respondents supported extending the scope of the proposed amendments to include non-financial hedged items).

c) interaction with the EU-carve out of IAS 39.

d) opposition to retrospective application of the proposed amendments.

Purpose of this paper

6. This paper presents:

a) possible ways forward, and arguments for and against each of these approaches,

b) the staff's recommendation.

Possible ways forward

7. The staff has identified the following approaches:

Approach A- wait for the responses to the Discussion Paper *Reducing Complexity in Reporting Financial Instruments* (DP) before deciding what, if anything, to do on hedge accounting.

[1] Paragraph AG99E states that:

> In designating as a hedged item a portion of a financial instrument, an entity cannot specify as the hedged item a cash flow that does not exist in the financial instrument as a whole. For example, in designating a one-sided risk (such as the decrease in the fair value of a financial asset) as a hedged portion, an entity cannot include any cash flows that are imputed or inferred in the designated hedged portion (for example, inferring the cash flows arising from the time value of a hypothetical written option in a non-derivative financial asset).

Approach B- move forward with a short-term amendment using the rules-based approach of the ED. There are several ways to do this as described in paragraph 14.

Approach C- move forward with a short-term amendment but develop a principle-based approach to address financial (and possibly non-financial) hedged items.

Issues to consider

8. A number of factors that might be relevant in determining the best way forward. These include:
    a) consistency with the Board's aim for the proposed amendments. The Board's aim was to provide a limited scope amendment to *clarify* its original intentions regarding what can be designated as a hedged risk and when an entity may designate a portion of the cash flows of a *financial* instrument as a hedged item.
    b) timing of final amendments. Respondents have identified current diversity in practice in some areas of hedge accounting. The longer the Board takes to issue an amendment, the longer that diversity in practice will continue.
    c) potential for overlap with the DP. The Board recently published a DP on financial instruments that advocates a principle-based standard for financial instruments and also discusses how hedge accounting might be improved and simplified.
    d) relationship with other hedge accounting issues. The Board has or will shortly discuss a number of other hedge accounting issues (for example, paragraph 97 and paragraph 100 of IAS 39 that sets out the period during which gains/losses on cash flow hedging instruments should be reclassified to profit or loss).
    e) relationship with other IAS 39 issues. The Board has or will shortly discuss a number of other issues on IAS 39 that are not related to hedge accounting (for example, paragraph 2(g) of IAS 39 that provides a scope exception for particular financial instruments).
    f) resources available. Some approaches will require more Board and staff time and resources than other approaches.

9. Appendix B provides a comparative table of the proposed approaches against these considerations.

10. Also, the FASB shortly will be issuing an exposure draft of amendments to FASB Statement of Financial Accounting Standards No. 133 *Accounting for Derivatives Instruments and Hedging Activities* (SFAS 133) with the objective of:
    a) resolving practice issues that have arisen with SFAS 133.
    b) simplifying accounting for hedging activities.
    c) improving the financial reporting of hedging activities to make the accounting model and associated disclosures easier to understand for users of financial statements.
    d) addressing differences in the accounting for derivative instruments and hedged items or transactions.

11. Appendix A provides an overview of FASB project on hedge accounting (extracted from the DP *Reducing Complexity in Reporting Financial Instruments*).

12. The staff believes that the FASB approach can be considered a subset of Approach A. The FASB project addresses only hedge accounting issues while the DP addresses all issues relating to reporting financial instruments

Approach A (wait for the responses to the DP before deciding what, if anything, to do on hedge accounting)

13. Arguments for Approach A include:
    a) this approach is more likely to result in a comprehensive and well-thought out approach that fully addresses *all* issues relating to hedge accounting for both financial and non-financial hedged items.
    b) some issues that respondents raised (for example, extending the scope of the ED to address non-financial hedged items) are beyond the limited scope of the objectives set out in the ED and would require more fundamental changes to hedge accounting. The DP addresses some of these fundamental hedge accounting issues.
    c) the Board is less likely to have to change decisions made in a short-term amendment; anything the Board does in a short-term project may require

changing as a result of any decisions made following re-deliberations of the DP.

14. Arguments against Approach A include:
    a) there is diversity in practice. The Board acknowledged in the ED that additional guidance is required. Diversity in practice will continue if the Board does not address these issues in a short-term project.
    b) the timing of changes, if any, to hedge accounting following re-deliberations of the DP are uncertain. The DP is part of a long-term project on reporting financial instruments.
    c) the IFRIC may have to continue to address issues in this area on a case-by-case basis. This will take up the IFRIC's resources.

Approach B (move forward with a short-term amendment using the rules-based approach of the ED)

15. There are a number of possible variations of Approach B. These include:

    Approach BI- move forward with a limited amendment to IAS 39 that addresses only those areas in which there is diversity in practice (as identified in responses to the ED).

    Approach BII- move forward with an amendment based on scope of the ED (hedged financial items).

    Approach BIII- move forward with an amendment based on the ED but extend the scope to include non-financial hedged items.

Approach BI (move forward with a limited amendment to IAS 39 that addresses only those areas in which there is diversity in practice (as identified in responses to the ED))

16. Arguments for Approach BI include:
    a) this approach would clarify the application of principles currently in IAS 39 in particular situations. This Approach would continue to rely on the principles that are already set out and which, in most situations, appear to be applied appropriately.

b) this approach would be relatively simple and quick to implement as it would involve few changes to IAS 39. It would not require re-exposure or significant re-deliberation.

c) this approach would limit the unintentional effects of any amendments on existing practice as it less restrictive than the ED.

d) this approach will require the least amount of Board and staff time and resources.

17. Arguments against Approach BI include:

a) this approach may not adequately clarify the Board's original intentions regarding portions that are eligible as hedged items, and may be less effective in reducing diversity in practice *in the future*. Consequently, there may be additional requests for guidance in the future. (However, the staff notes that Approach BII could be subsequently implemented should further significant diversity in practice arise in this area in the future.)

b) this approach will not address some of the issues identified in the comment letter analysis (for example, designation of non-financial hedged items).

c) additional guidance could add complexity.

Approach BII (move forward with an amendment based on scope of the ED (hedged financial items))

18. Arguments for Approach BII include:

a) this approach is in line with the aim set out in the ED to clarify the Board's original intentions.

b) this approach would eliminate diversity in practice *now and in the future* by clearly specifying eligible financial hedged items (risks and portions).

c) as stated in the ED, clearly defining eligible risks and portions may make the application of hedge accounting simpler.

d) this approach would be relatively simple to implement, requiring some drafting changes to the ED.

19. Arguments against Approach BII include:

a) the Board will need to re-deliberate a number of issues identified by respondents in their comments. These issues include:
    i. the list of risks in paragraph 80Y of the ED
    ii. the list of portions in paragraph 80Z of the ED
    iii. potential knock-on effects to existing requirements (for example, effects on non-financial hedged items)
b) re-deliberation of these issues will take some time. Diversity in practice will continue during re-deliberation.
c) this approach will not address some of the issues identified in the comment letter analysis (for example, non-financial hedged items).
d) as noted by some respondents, the effects of this approach are likely to be short-term. The Board may be required to re-visit the lists of risks and portions as markets, products and hedging strategies develop.
e) this approach is rule-based as noted by many respondents and is contrary to the principle-based approach advocated by these respondents and in the DP.
f) this approach will require more Board and staff resources and time than Approach BI.

Approach BIII (move forward with an amendment based on the ED but extend the scope to include non-financial hedged items)

20. Arguments for Approach BIII include:
   a) this approach takes into consideration respondents' requests to extend the scope of the proposed amendments to non-financial hedged items.
   b) this approach would clarify requirements for hedging non-financial items which some believe are unclear.
   c) this approach would eliminate diversity in practice now and in the future by clearly specifying eligible hedged items (risks and portions).
   d) as stated in the ED, clearly defining eligible risks and portions may make the application of hedge accounting simpler.

21. Arguments against Approach BIII include:
   a) re-exposure may be necessary. Diversity in practice will continue during re-deliberation and re-exposure.

b) this approach is inconsistent with the Board’s aim to provide a limited scope amendment to clarify only eligible hedged financial items.

c) this approach is contrary to a principle-based approach as noted by many respondents and as advocated in the DP.

d) by expanding the scope of the proposed amendments, this approach could result in significant changes and unintended consequences to existing practice. Based on the comment letter analysis, there is little diversity in practice with respect to non-financial hedged items with the exception of possible effects of paragraph AG99E of the ED.

e) as noted by some respondents, the effects of this approach are likely to be short-term. The Board may be required to re-visit the lists of risks and portions as markets, products and hedging strategies develop.

f) the DP discusses how to improve and simplify hedge accounting. As this approach extends the scope of any short-term amendments, there could be significant overlap between this amendment and any possible long-term project on IAS 39.

g) this approach will require more Board and staff resources and time than Approaches BI or BII.

Approach C (move forward with a short-term amendment but develop a principle-based approach to address financial (and possibly non-financial) hedged items)

22. Arguments for Approach C include:

a) this approach is consistent with IASB’s objective of setting principle-based standards as advocated in the DP.

b) this approach is responsive to respondents’ requests to adopt a principle-based approach.

c) if a principle was extended to non-financial items, this approach would be responsive to respondents’ requests to extend the scope of the amendments to eliminate arbitrary treatment between hedged financial and non-financial items.

d) this approach may result in a durable set of requirements that are unlikely to require further amendments at a later date.

23. Arguments against Approach C include:
    a) the IFRIC and staff have previously spent time in attempting to refine the principle behind portions, but the IFRIC was unable to agree on how the principle should be refined.
    b) the Board had previously decided on the rules-based approach adopted by the ED with reasons set out in paragraph BC13 of the ED. These reasons included:
        i. the situations in which an entity can designate a portion of the cash flows of a financial instrument are clearly defined in the proposed approach, making application of the hedge accounting requirements of IAS 39 simpler.
        ii. it places effective restrictions on when an entity can designate as a hedged item a portion of the cash flows of a financial instrument. This ensures that the situations in which ineffectiveness exists but is not recognised are minimised.
        iii. limiting the situations in which an entity can designate as a hedged item a portion of the cash flows of a financial instrument to those situations that are commonly used in practice minimises the impact of the proposed amendments on practice.
        iv. amendments of this type are relatively simple to implement, requiring only minor changes to IAS 39.
    c) significant Board and staff time will be required to develop a new or refined principle. Moreover, re-exposure will probably be required. Diversity in practice will continue in the meantime.
    d) this approach could result in future requests for more application guidance, to the extent that any principle developed differs from the principle set out in IAS 39.
    e) the DP discusses how to improve and simplify hedge accounting. As this approach could possibly extend the scope of hedge accounting (by addressing non-financial items), there could be significant overlap between this short-term amendment and any possible long-term project on IAS 39.

Staff recommendation

24. The staff recommends Approach BI. Specifically, the staff recommends that IAS 39 be amended to address:

a) the designation of a purchased option in its entirety as a hedging instrument of an item that contains no optionality in such a way that no ineffectiveness results (paragraph AG99E of the ED).
b) the hedging of inflation risk in particular situations.

25. The staff further recommends that principles underlying portions for hedge accounting be re-emphasised in the basis of conclusions (BC) of the amendments. In particular, that:
    a) if a portion of the cash flows of a financial asset or liability is designated as the hedged item, that designated portion must be less than the total cash flows of the asset or liability.[2]
    b) a portion of cash flows or fair value may be a hedged item provided that effectiveness can be measured. The portion should be identifiable and separately measurable.[3]

26. The staff recommends Approach BI for the following reasons:
    a) it is consistent with the Board's aim for the proposed amendments as set out in the ED. The Board's aim for the proposed amendments was to *clarify* its original intentions regarding eligible risks and portions for hedged financial items. The approach clarifies application of the existing principles in particular situations (by for example, adding to the application guidance).
    b) it is an effective way of eliminating diversity in practice. The recommended approach is an effective way to eliminate diversity in practice in the areas highlighted by respondents to the ED. Moreover, the effects on existing practice are limited as the recommended Approach will only affect the areas in which diversity in practice exists.
    c) it does not overlap with the DP. Such limited amendments will not overlap with work on the long-term project as discussed in the DP.
    d) it is efficient and timely. The recommended approach does not require re-exposure or significant re-deliberation. It is relatively simple and quick to implement and requires the least amount of Board and staff time and resources.

[2] IAS 39.AG99C
[3] IAS 39.81

27. If the Board agrees with the staff recommendation, the staff intends to return to the Board with separate papers to re-examine:

    a) the designation of a purchased option in its entirety as a hedging instrument of an item that contains no optionality in such a way that no ineffectiveness results (paragraph AG99E of the ED).
    b) the hedging of inflation risk in particular situations.
    c) retrospective application of the proposed amendments.

Question 1: Does the Board agree with the staff recommendation? If not, which approach described in this paper does the Board prefer, and why? If the Board does not prefer any of the approaches described in this paper, what does the Board wish to do, and why?

Appendix A

Overview of FASB project on hedge accounting (extracted from the DP)

1. In May 2007 the FASB took onto its agenda a project to simplify accounting for hedging activities. The objective of the project is to amend SFAS 133, so as to achieve the following:
   i. resolve practical issues that have arisen under SFAS 133.
   ii. simplify accounting for hedging activities.
   iii. improve the financial reporting of hedging activities to make the accounting model and the associated disclosures easier to understand for financial statement users.
   iv. address differences in the accounting for derivative instruments and hedged items or transactions.

2. The hedge accounting approach would establish a fair value methodology to hedge accounting. The approach would eliminate many elements that exist under the current hedge accounting model, including bifurcation by risk, the 'shortcut' method, critical terms match, and the requirement to assess effectiveness quantitatively in order to qualify for hedge accounting.

3. The items and transactions currently eligible for special hedge accounting would continue to be eligible under this approach. However, hedges of individual risks in a hedged item or transaction would generally not be permitted. Except in the situations discussed in paragraph A4, the hedged risk must be the risk of all changes in fair value of the hedged item or all changes in the hedged cash flows.

4. There are two exceptions to the requirement that the hedged risk must be the risk of all changes in fair value in the hedged item—hedges of foreign currency risk and for hedges of interest rate risk in an entity's own debt. Entities would be permitted to designate just foreign currency risk as the hedged risk in any hedged item subject to foreign currency risk. Entities would also be permitted to designate interest rate risk as the hedged risk in its own fixed or variable rate debt, but that exception would apply only at initial recognition of the debt.

5. Formal, contemporaneous documentation of the hedging instrument, and hedged item or forecast transaction would be required along with a qualitative evaluation of the nature of the risk that the entity is attempting to hedge. The qualitative evaluation would demonstrate that (a) an economic relationship exists between the hedging instrument and hedged item or forecast transaction, and (b) the derivative should be expected to reasonably offset changes in fair value or the variability in the hedged cash flows attributable to all risks. In some situations, a quantitative analysis may be more effective in demonstrating the relationship between the derivative instrument and the hedged risk.

6. After inception, an entity would need to reassess effectiveness if circumstances indicate that the hedging relationship is no longer reasonably effective. These circumstances would depend on the nature of the hedged item or transaction and hedging instrument. The ability to discontinue hedge accounting by simply removing the designation of the hedging relationship would not be permitted.

7. In December 2007 the FASB directed the staff to begin drafting an exposure draft for vote by the FASB.

Appendix B (Summary of proposed approaches)

	Approach A	Approach BI	Approach BII	Approach BIII	Approach C
Considerations (paragraph 8)	*wait for the responses to the Discussion Paper Reducing Complexity in Reporting Financial Instruments (DP) before deciding what, if anything, to do on hedge accounting.*	*move forward with a limited amendment to IAS 39 that addresses only those areas in which there is diversity in practice (as identified in responses to the ED)*	*move forward with an amendment based on scope of the ED (hedged financial items)*	*move forward with an amendment based on the ED but extend the scope to include non-financial hedged items*	*move forward with a short-term amendment but develop a principle-based approach to address financial (and possibly non-financial) hedged items*
a) The Board's aim to provide a limited scope amendment for clarification of its original intentions	▪ Differs from the Board's aim	▪ Consistent with the Board's aim	▪ Consistent with the Board's aim	▪ Differs from the Board's aim	▪ Differs from the Board's aim
b) Timing of the final amendments	▪ Indeterminate	▪ Immediately addresses diversity in practice in the short-term	▪ Diversity in practice will continue during re-deliberation	▪ Diversity in practice will continue during re-deliberation and re-exposure	▪ Indeterminate
c) Potential for overlap with the DP	▪ Does *not* overlap	▪ Does *not* overlap	▪ Does *not* overlap	▪ Overlaps	▪ Overlaps
d) Relationship with other hedge accounting issues	▪ Deals with all issues related to reporting financial instruments	▪ Does *not* deal with other hedge accounting issues	▪ Does *not* deal with other hedge accounting issues	▪ Deals with issues of financial and non-financial hedged items	▪ Deals with all hedge accounting issues
e) Relationship with other IAS 39 issues	▪ Deals with all issues related to reporting financial instruments	▪ Does *not* deal with other IAS 39 issues	▪ Does *not* deal with other IAS 39 issues	▪ Does *not* deal with other IAS 39 issues	▪ Does *not* deal with other IAS 39 issues
f) Use of Board and staff time and resources	▪ The IFRIC will be required to address issues on a case by case basis	▪ Requires some re-deliberation but does *not* require re-exposure	▪ Requires re-deliberation of some issues but does *not* require re-exposure	▪ Requires significant re-deliberation and re-exposure	▪ Requires significant re-deliberation and re-exposure