Financial Accounting Standards Board

International Accounting Standards Board

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Education Session Handout for papers 8 and 8A:

Accounting for Hedging Activities
&
Reducing Complexity in Reporting Financial Instruments

PURPOSE OF MEETING

1. The staff would like to present to the Boards a summary-level analysis of the comment letters received for the following:

   a. International Accounting Standards Board (IASB) Discussion Paper, *Reducing Complexity in Reporting Financial Instruments*.

   b. Financial Accounting Standards Board (FASB) Exposure Draft, *Accounting for Hedging Activities: an amendment of FASB Statement No. 133*.

PLAN FOR REDELIBERATIONS

2. At a future Board meeting, the staff plans to discuss with the Boards different alternatives for addressing, on a joint basis, the project to reduce the complexity of accounting for financial instruments and the FASB's existing project to simplify and improve accounting for hedging activities. At this education session, the staff would like to gain an appreciation for the current views held by the Boards regarding the scope and direction of a potential joint project.

A: REDUCING COMPLEXITY IN REPORTING FINANCIAL INSTRUMENTS

3. In March 2008, the Boards published for comment the Discussion Paper, *Reducing Complexity in Reporting Financial Instruments*, to gather information to assist the IASB and FASB in deciding how to proceed in developing new standards of reporting for financial instruments. The staff has not completed its detailed analysis of all the comment letters, and expects a more detailed analysis to be presented to the Boards at a later date, likely incorporated into the agenda request. The following summary highlights comments that the staff has observed based on the analysis performed to date. The summary analysis focuses primarily on user, preparer, and auditor comments. As of October 1, 2008, the Boards have received 157 comment letters in response to the Discussion Paper.

4. The respondents made the following observations regarding the need for a significant change to the current requirements for reporting financial instruments.

5. Users: Users stated that there is a need for a significant change to the current requirements for reporting financial instruments, as the current mixed-attribute model is not only confusing for users but creates structuring opportunities for preparers to achieve particular accounting effects.

6. Preparers/Auditors: The majority of these constituents believe there is a need for a significant change to the current requirements for reporting financial instruments. Those constituents stated that the current requirements are too complex, do not fit their business models, and should be more principles-based. Some constituents, however, do not agree that a significant change in current reporting requirements is needed. Some of these constituents support a simplified mixed-attribute model, while others argued that financial instruments themselves are inherently complex and that oversimplification would not be a fair representation of the complexity of those instruments.

7. The following is a condensed summary of responses to the following four approaches suggested by the Discussion Paper.

    a. <u>Long-term Solution</u>: Report all financial instruments at fair value

b. Intermediate Approach 1: Reduce the number of categories of financial instruments

c. Intermediate Approach 2: Create a fair value measurement principle with some optional exceptions to fair value

d. Intermediate Approach 3: Simplify hedge accounting by:

(1) Eliminating hedge accounting, or

(2) Maintaining and simplifying existing hedge accounting.

Long-term Solution: Report All Financial Instruments at Fair Value

8. Users: Users generally support the long-term solution of requiring fair value for all financial instruments.

9. Preparers/Auditors: The majority of preparers and auditors do not support a long-term solution requiring fair value for all financial instruments. These constituents stated that fair value measurement is not appropriate for financial instruments not held for trading purposes or not managed on a fair-value basis. They also stated that it is difficult to value financial instruments that are not actively traded. In addition, they believe that moving to a full fair-value method would add artificial volatility to earnings.

Intermediate Approaches 1 and 2

10. Users: Some users would support the elimination of the Held-To-Maturity (HTM) category and/or support a requirement for all financial instruments to be measured at fair value with certain exceptions, presuming those exceptions would limit the ability of management intent to determine the measurement basis.

11. Preparers/Auditors: Many preparers and auditors do not support the intermediate approaches to address complexity issues. Others support some of the intermediate approaches as a way to simplify current reporting complexity, especially for hedge accounting.

12. Some preparers and auditors agree that reducing measurement categories for financial

instruments and eliminating restrictions on the existing measurement categories for financial instruments (Approach 1) would reduce complexity. However, how that should be achieved differed among those constituents. Some of those constituents suggested the Held-To-Maturity (HTM) category should be eliminated. Assets previously categorized under HTM should be moved either to Loans and Receivables or Available-For-Sale (AFS), while others suggested a "Trading" versus "Nontrading" concept.

13. The majority of preparers and auditors do not support replacing existing measurement requirements with a fair value measurement principle with optional exceptions (Approach 2). They believe Approach 2 would add more complexity without apparent benefits.

Intermediate Approach 3

14. Users: Many users expressed support for the Boards working together on a project to simplify the accounting for hedging activities, provided that the simplification would reduce the complexity related to financial statement interpretation. Most users also support the elimination of the ability to hedge individual risks as proposed in the FASB Exposure Draft on simplifying hedge accounting. Those users stated that the changes proposed in the FASB Exposure Draft would more comprehensively reflect risk exposures.

15. Some users expressed a strong preference for an interim approach that would eliminate hedging altogether. Some of these users do not favor the use of the Boards' resources on changes to hedge accounting if that would result in sacrificing the timely resolution of more critical issues in other projects. These users do not believe that modifications to the current hedge accounting model would provide any benefit for users. Other users expressed concern that changes that would simplify the ability to qualify for hedge accounting might further entrench hedge accounting and make the longer term goal of full fair value for financial instruments more difficult to achieve.

16. Preparers/Auditors: The majority of preparers and auditors stated that hedge accounting should not be eliminated and partial hedges should be permitted because they believe

such accounting better reflects the reporting entities' risk management strategies. However, many of those constituents would support replacing fair value hedge accounting with a model that permits recognition outside of earnings gains and losses on hedging instruments (similar to cash flow hedge accounting).

B: ACCOUNTING FOR HEDGING ACTIVITIES

17. In June 2008, the FASB published for comment the Exposure Draft, *Accounting for Hedging Activities: an amendment of FASB Statement No. 133*. As of October 1, 2008, the Board received 127 comment letters in response to the Exposure Draft. The staff would like to present the Boards with a condensed summary of the main issues raised by respondents, segregated by responses from users and preparers/auditors, to the Exposure Draft. The topics covered are as follows

    a. Joint Project

    b. Qualitative Effectiveness Assessment

    c. Reasonably Effective Threshold

    d. Elimination of Bifurcation-By-Risk

    e. Hedging of an Entity's Own Debt.

Joint Project

18. Users/Preparers/Auditors: A majority of respondents recommended that any project that would significantly change the application of hedge accounting should be undertaken on a joint basis between the FASB and IASB.

19. A number of respondents expressed concern that if the FASB issues the proposed amendments without IASB involvement, preparers would be required to implement the proposed changes and, upon international accounting convergence, implement a different hedge accounting model under IFRS. Preparers may face a third hedge accounting change if the IASB pursues Intermediate Approach 3 as described in the IASB Discussion Paper.

Qualitative Effectiveness Assessment

20. Users: Users disagreed with the move away from a quantitative analysis of hedge effectiveness. While users acknowledged the benefits of allowing qualitative assessments, including reduced compliance costs for preparers and a possible reduction in restatements, they believe that the proposal would increase the overall complexity and reduce the transparency of financial reporting.

21. Preparers/Auditors: Preparers and auditors generally expressed support for the elimination of quantitative effectiveness assessments, noting that the proposed change would simplify and reduce the costs of hedge accounting. However, the cost savings would be limited for those entities which already have developed the models and infrastructure necessary to perform quantitative effectiveness assessments.

22. Many preparers and auditors requested additional clarification from the Board regarding situations in which a qualitative assessment would not be sufficient to demonstrate that a hedging relationship is reasonably effective.

Reasonably Effective Threshold

23. Users: Users objected to the proposed reduction in effectiveness threshold, noting the following concerns: the term *reasonably effective* is not clearly defined; a lower threshold may permit greater deferral of derivative gains and losses from earnings under cash flow hedging; a reduced threshold may increase preparer opposition in the future towards a movement to full fair value; and if the purpose of the reduced threshold is to reduce the occurrence of ‘in and out’ hedging, that concern can be dealt with by moving towards full fair value rather than reducing the threshold.

24. Preparers/Auditors: The majority of preparers and auditors expressed support for the proposed change in effectiveness threshold. Some respondents believe the reduced threshold would increase the number of hedging relationships that qualify for hedge accounting, improving the comparability of financial statements, and encourage the use of risk management strategies. Other respondents anticipate that the reduced threshold would simplify the application of hedge accounting and provide operational benefits to preparers.

25. Some respondents believe the reasonably effective threshold is a positive move towards principle-based standards. However, the majority of preparers and auditors requested additional guidance and clarification from the Board on how to determine whether a hedging relationship is reasonably effective.

Elimination of Bifurcation-by-Risk (With 2 Exceptions)

26. Users: Users support the elimination of bifurcation-by-risk. Users believe this change would allow the financial statements to more comprehensively reflect entities' risk exposures and would reduce the opportunity for inconsistencies in the accounting for hedging a financial asset or liability and the accounting for hedging a non-financial asset or liability.

27. Preparers/Auditors: The majority of preparers and auditors disagree with the elimination of bifurcation-by-risk. These respondents expressed concern that preparers may no longer qualify for hedge accounting for common hedging strategies, or preparers may not apply hedge accounting, even if they would qualify, because they do not wish to report the resulting increased earnings volatility in their financial statements. A number of respondents believe the proposed change is inconsistent with preparers' risk management strategies because preparers generally use derivatives to manage discrete risks. In addition, many respondents expressed concern about including changes in an entity's own credit risk in evaluating and recording hedging ineffectiveness.

Hedging of an Entity's Own Debt

28. Users: Users disagreed with allowing an exception from the elimination of bifurcation-by-risk for the hedge of an entity's own issued debt, if hedged at inception. Users believe that the exception would allow an entity to underreport other risk exposures, such as counterparty risk, that would otherwise be reported under the elimination of bifurcation-by-risk.

29. Preparers: Many preparers believe that the exception related to interest rate risk of an entity's own debt should be expanded to include situations in which the debt is hedged prior to, or subsequent to, inception of the debt. Preparers noted the following concerns: consideration of the credit spread may preclude hedges of only the interest rate risk

from qualifying for hedge accounting, or may create such volatility that preparers would be discouraged from applying hedge accounting even if the hedging relationships would qualify; valuing an entity's own credit risk may be difficult and may rely on unobservable inputs; and the limitation of the interest rate risk exception to debt hedged at inception would result in different accounting for similar transactions, depending solely on the timing of the designation of the hedge.