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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting: **February 2009, London**

Project: **Annual Improvements IAS 39 Financial Instruments: Recognition and Measurement**

Subject: **Cash flow hedge accounting (Agenda paper 4B)**

SUMMARY OVERVIEW

1. Included in the exposure draft of proposed *Improvements to IFRSs* issued in August 2008 was a proposed amendment on the treatment of cash flow hedging within IAS 39 *Financial Instruments: Recognition and Measurement*. This agenda paper:

   a. summarizes the comments received,

   b. proposes clarifications to the proposed amendment, and

c. requests the Board to confirm whether they agree with the staff recommendations.

2. The staff recommendation is to approve the amendment as proposed in the exposure draft with no changes.

BACKGROUND

3. 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. 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.

4. 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).

5. Paragraph 100 of IAS 39 sets out the requirements for cash flow hedges other than those covered by paragraph 97 and 98 (for example, sale of an asset or liability). For such hedges, paragraph 100 requires amounts that were recognised in other comprehensive income to 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.

6. Paragraph 98 and 99 of IAS 39 cover hedges of forecast transactions that subsequently result in the recognition of a non-financial asset or liability. Additionally, Paragraph 101 sets out the accounting required if hedge accounting is discontinued. The paragraphs 98, 99 and 101 are not relevant for this paper.

STAFF ANALYSIS

7. A total of 60 comment letters were received on the comprehensive exposure draft (which encompassed 12 proposed amendments). Only eight respondents included specific comments on this proposed amendment. These comments have been included within Appendix B for your reference. Several other respondents replied noting agreement with this specific proposed amendment.

8. The staff noted a few comment letters believe the current (unamended) wording already provides sufficiently clear guidance and that amending paragraphs 97 and 100 of IAS 39 was not necessary. The staff believes the current (unamended) wording may create confusion and continues to believe the proposed amendment is appropriate to clarify the Board's intent that the gains or losses on the hedging instrument should be reclassified from equity to profit or loss as a reclassification adjustment in the period that the hedged forecast cash flows affect profit and loss.

9. Additionally, a few comment letters stated that a separate project (or separate exposure draft) specific to financial instruments be created to address multiple issues related to financial instruments. The staff reminds the Board of the other financial instrument projects currently in process; however, the staff believes this proposed amendment is properly included within the annual improvements project and the proposed amendment is appropriate.

10. One respondent commented that paragraph 97 and 100 could be combined. The staff does not agree with this comment as paragraph 100 covers cash flow hedges not covered by paragraph 97 and therefore guidance is still needed to cover these transactions.

11. Therefore, the staff recommends that the amendment proposed in the exposure draft be approved with no changes.

QUESTIONS FOR THE BOARD

12. Does the Board agree with the staff recommendation? If not, how would the Board like to proceed?

Appendix A – Draft Wording

Proposed amendments to IAS 39 *Financial Instruments: Recognition and Measurement*

Paragraphs 97 and 100 are amended (new text is underlined and deleted text is struck through) and paragraph 103H is added.

Hedging

Hedge accounting

Cash flow hedges

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 <u>hedged forecast cash flows</u> ~~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 into profit or loss <u>as a reclassification adjustment</u> the amount that is not expected to be recovered.**

100 **For cash flow hedges other than those covered by paragraphs 97 and 98, amounts that had been recognised 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 <u>cash flows</u> ~~transaction~~ affects profit or loss (for example, when a forecast sale occurs).**

Effective date and transition

103H *Improvements to IFRSs* issued in [date] amended paragraphs 97 and 100. An entity shall apply those amendments prospectively for annual periods beginning on or after 1 January 2010. Earlier application is permitted. If an entity applies the amendments for an earlier period it shall disclose that fact.

Proposed amendment to guidance on implementing IAS 39 *Financial Instruments: Recognition and Measurement*

The answer to Question F.6.2 is amended (new text is underlined and deleted text is struck through).

F.6.2 Hedge accounting considerations when interest rate risk is managed on a net basis

Issue (j) – For cash flow hedges, if a derivative is used to manage a net exposure to interest rate risk and the derivative is designated as a cash flow hedge of forecast interest cash flows or portions of them on a gross basis, does the occurrence of the hedged forecast transaction give rise to an asset or liability that will result in a portion of the hedging gains and losses that were recognised in other comprehensive income remaining in equity?

No. In the hedging relationship described in Issue (c) above, the hedged item is a group of forecast transactions consisting of interest cash flows in specified future periods. The hedged forecast transactions do not result in the recognition of assets or liabilities and the effect of interest rate changes that are designated as being hedged is recognised in profit or loss in the period in which the forecast transactions occur. Although this is not relevant for the types of hedges described here, if instead the derivative is designated as a hedge of a forecast purchase of a financial asset or issue of a financial liability, the associated gains or losses that were recognised in other comprehensive income are reclassified from equity to profit or loss in the same period or periods during which the ~~asset acquired or liability incurred~~ <u>hedged forecast cash flows</u> affect~~s~~ profit or loss (such as in the periods that interest expenses are recognised). However, if an entity expects at any time that all or a portion of a net loss recognised in other comprehensive income will not be recovered in one or more future periods, it shall reclassify immediately from equity to profit or loss the amount that is not expected to be recovered.

Appendix B – Comments Received

CL 5	On the other hand, we consider that it is not necessary to amend para 97 and 100 of IAS 39 as described in the ED. The hedged forecast cash flows mentioned in BC12, occurring from 1 April 20X0 to 30 June 20X0 would not result in the recognition of a five-year interest-bearing instrument. They would only make the entity to recognise profit or loss while they incur, or to recognise a prepaid interest or unearned interest which would affect profit or loss from 1 April to 30 June. Therefore, the deferred gains or losses on the hedging instrument would be reclassified from equity to profit or loss over a period of three months beginning on 1 April 20X0 rather than over a period of five years beginning on 1 April 20X0. That means the original paragraph 97 and 100 of IAS 39 are more precise and can be applied correctly. So it does not need to be amended.
CL 22	[The respondent] agrees with proposed amendments – however, given other various amendments to IAS 39 and the complex issues involved, we believe it may have been more appropriate to expose these amendment in an IAS 39 specific ED.
CL 24	We agree with the proposed clarification that the gains and losses on hedging instruments should be reclassified from equity to profit or loss as a reclassification adjustment in the period or periods that the hedged forecast cash flows affect profit or loss. In addition, we agree with the proposed effective date of 1 January 2010 and a prospective application of the amendment. As IAS 39.97 and .100 after having been amended require the same accounting for gain and losses that had been recognised in other comprehensive income, we think two separate paragraphs are no longer necessary and IAS 39.97 and .100 could therefore be combined into one paragraph.
CL 26	We support the proposed amendments as they will eliminate an uncertainty in respect of the timing of the gains or losses on the hedging instrument reclassification from equity to profit or loss when the designated cash flow exposure being hedged differs from the financial instrument arising from the hedged forecast cash flows.
CL 37	Yes, we agree. We believe that recognition of gains and losses recognised in other comprehensive income in a cash flow hedge when the hedged cash flow affects profit or loss is consistent with the inherent logic of the cash flow hedge accounting model in IAS 39.
CL 44	As far as IAS 39 is concerned, we believe it is not appropriate at this time to formulate specific comments, given that in the perdurance of the financial turmoil several arguments are currently under discussion. We are of the opinion, irrespective from the above, that the IAS 39 should be fully reviewed and significantly amended with the aim of: - simplifying the requirements; - converge to US GAAPs; - convert the standard to a pure “principle based” one.
CL 53	39. We agree with [CL 60] and the proposed amendment to paragraphs 97 and

	100 of IAS 39 to clarify that the gains or losses on the hedging instrument should be reclassified from equity to profit or loss in the period that the hedged forecast cash flows affect profit or loss. We agree with [CL 60]'s draft response that the wording of paragraph 97 needs to be improved. 40. We think the proposed wording of "the hedged item" would work. We are not aware of any examples of contracts for which there could be difficulties arising with interpreting paragraph 97 if it was amended this way.
CL 60	57 If a hedged forecast transaction 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 (ie recycling) in the same period or periods during which the asset acquired or liability assumed affects profit or loss. 58 It has been noted that this wording might be problematical in situations when, for example, an entity applies hedge accounting to hedges of cash flows associated with a time period that is shorter than the time to maturity of the instrument. In such circumstances, paragraph 97 can be interpreted to suggest that the gains and losses on the hedging instrument should be reclassified to profit or loss over the time until maturity of the instrument rather than a shorter time period when hedged cash flows affect profit or loss. This is not the intention of IAS 39. 59 The IASB therefore proposes to amend paragraphs 97 and 100 of IAS 39 to clarify that the gains or losses on the hedging instrument should be reclassified from equity to profit or loss in the period that the hedged forecast cash flows affect profit or loss. 60 [The respondent] agrees with the proposed amendment.