



Project	Financial Instruments: Replacement of IAS 39
Topic	Hedge Accounting

Purpose of this paper

1. The Board decided to address the replacement of IAS 39 *Financial Instruments: Recognition and Measurement* in three main phases:
 - (a) Phase 1 – Classification and Measurement.
 - (b) Phase 2 – Impairment (methodology).
 - (c) Phase 3 – Hedge Accounting.
2. This paper sets out an overview of possible approaches for phase 3 – hedge accounting. In its June 2009 technical plan the Board indicated that it expects to publish an exposure draft (ED) on hedge accounting in December 2009.
3. **The purpose of this paper is to ask the Board which possible approach or approaches it wishes to further develop. Making such a decision is critical given the expected ED publication date in December 2009.**
4. The staff recommends that the Board focus on one approach. This paper provides a staff recommendation on one possible approach that the Board might consider for further development.
5. This paper sets out:
 - (a) the purpose of hedge accounting.
 - (b) the possible objectives of phase 3 - hedge accounting.
 - (c) an overview and analysis of possible approaches to address today's hedge accounting issues.
 - (d) a staff recommendation and questions to the Board.
 - (e) specific types of hedges.
 - (f) other issues.

6. Since approval of IAS 39 in December 2003 the Board has amended and improved current hedge accounting requirements several times. Appendix C provides a summary of the Board's work on hedge accounting and highlights some of the key issues the Board is still to resolve.

Purpose of hedge accounting

7. Hedge accounting is an exception to the normal recognition, measurement and presentation principles in IAS 39. The demand for hedge accounting arises to address recognition and measurement anomalies. Mismatches arise because of the differences in the way hedged items and hedging instruments are recognised or measured (eg the hedging instrument is measured at fair value while the hedged item is carried at amortised cost).
8. It is important to note that hedging differs from hedge accounting. Hedging refers to the risk management activities of an entity – the management of particular types of risk exposures. Hedge accounting is a means to reflect some of those activities in financial statements.
9. Under IAS 39 hedge accounting is optional. An entity that (economically) hedges is not required to apply hedge accounting. However, as hedge accounting is considered an exception to normal accounting recognition and measurement principles, restrictions are in place to ensure disciplined application¹. Such restrictions and rules are a principal source of today's complexity. Most hedge accounting requirements are set out in detailed application and implementation guidance and an IFRIC Interpretation. In practice, non-authoritative literature (including IFRIC agenda decisions) is also used to provide further guidance.

¹ IAS 39.BC145 and BC172H

Possible objectives of phase 3 - hedge accounting

10. As a starting point, the Board can consider the project objective established at the March 2009 joint IASB and FASB meeting.

“[T]he boards decided that the objective of the project is to replace their respective financial instruments standards with a common standard that will significantly improve the decision-usefulness for users of financial statements. The boards believe that improving the decision-usefulness will also lead to simpler accounting requirements. The boards decided that, although the project objective is comprehensive, the project should be addressed expeditiously.”²

11. Hence, the staff thinks that any approach developed for hedge accounting must:
- (a) significantly improve the decision-usefulness for users – in the case of hedge accounting this includes providing users with information that reflects the risk management activities of an entity and the effectiveness of such risk management activities.
 - (b) simplify existing accounting requirements.
 - (c) be comprehensive – address all aspects of hedge accounting ie not a piecemeal approach.
 - (d) be developed expeditiously – the Board is committed to replacing IAS 39 in its entirety in 2010 and has committed to publishing an ED on hedge accounting in December 2009. The staff notes that some approaches will require more Board and staff time and resources than others.

Possible approaches to address today’s hedge accounting issues

12. The staff thinks there are two broad approaches to address hedge accounting issues. These are:

² March 2009 IASB Update.

- (a) **Approach A** – eliminate hedge accounting in its entirety.
 - (b) **Approach B** – simplify today’s requirements; this could include developing a principle-based approach to hedge accounting or retaining a rules-based exception but simplify and improve specific aspects.
13. Broad approach B could be executed in different ways. This paper discusses the possible variants (summarised in Appendix G).
14. The staff notes that simply retaining the existing requirements would be inconsistent with the objectives of this project phase set out in the previous section. Thus, that alternative is not further addressed in this paper.

Approach A – Eliminate hedge accounting in its entirety

15. One possible approach to address hedge accounting issues is to eliminate hedge accounting altogether. This approach was considered (and proposed) by the Joint Working Group of standard setters (JWG) and was also addressed in the discussion paper *Reducing Complexity in Reporting Financial Instruments* (DP) published in March 2008.
16. Appendix A sets out the arguments for and against this approach. A small number of respondents to the DP supported eliminating hedge accounting in its entirety. However, most respondents to the DP did not support elimination of hedge accounting. Respondents presented arguments similar to those set out in Appendix A.
17. One variant to approach A is approach A1 – to eliminate all hedge accounting requirements but mandate specific disclosures that reflect an entity’s hedging activities.
18. The staff notes that the arguments for and against approach A remain relevant under approach A1. However, the staff notes further issues relating to approach A1. These issues are also outlined in Appendix A.
19. The staff thinks that approach A and variants of approach A are not consistent with the Board’s objective for the project – to significantly improve the decision-usefulness for users. Without hedge accounting, information relating to

an entity's risk management activities would no longer be available in the primary financial statements, especially if more than one measurement method is used to measure financial instruments (but also in the case of hedging of unrecognised forecast transactions). The staff notes that many users find information relating to an entity's risk management activities useful.

Approach B – Simplify today's hedge accounting requirements

20. The staff has identified the following approaches to simplify today's hedge accounting requirements:
 - (a) **Approach B1** – develop a principle-based approach to hedge accounting.
 - (b) **Approach B2** – replace fair value hedge accounting with another method that addresses measurement anomalies.
 - (c) **Approach B3** – maintain but simplify existing hedge accounting requirements.
21. The staff notes that there are further variants of some of these approaches. These further variants are set out under the respective approaches.
22. The staff thinks approach B is broadly in line with the objectives of the project to improve the decision-usefulness for users and simplify existing accounting requirements. Retaining hedge accounting ensures that information on an entity's risk management activities and the effectiveness of such activities remains in an entity's primary financial statements. Retaining hedge accounting also helps alleviate some of the recognition and measurement mismatches that will arise from a mixed measurement classification model, if that is the outcome of the Board's redeliberations on the classification and measurement phase.
23. However, the variants of approach B would meet the objectives in varying degrees. For example, some approaches might improve decision-usefulness to a greater extent than others, some approaches represent a more comprehensive simplification than others and some require more Board and staff time and resources than others.

Approach B1 – Develop a principle-based approach to hedge accounting

24. Hedge accounting is considered an exception to normal recognition and measurement principles. IAS 39 does not establish a principle to hedge accounting. IAS 39.88 sets out several conditions necessary for a hedging relationship to qualify for hedge accounting. These conditions are generally considered today’s ‘principles’ to hedge accounting.
25. One possible approach to simplifying hedge accounting is to develop a clear principle to hedge accounting.
26. Many respondents to the DP urged the Board to adopt a principle-based approach to hedge accounting. These respondents believe that a principle-based approach is:
 - (a) conceptually preferable and consistent with the IASB’s objective to develop principle-based standards.
 - (b) more robust and responsive to developments in markets, products and hedging strategies and reduces structuring opportunities.
 - (c) consistent with the Board’s desire to simplify hedge accounting.
 - (d) helpful in preventing arbitrary distinctions between different hedging strategies.
27. As a starting point the Board could consider the objective of general purpose financial reporting as set out in the Framework:

“[T]o provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions.”³

This includes information about the *timing, amount and uncertainty of cash flows*. The staff thinks that any principle or approach that the Board develops to hedge accounting should be consistent with this objective.

³ Framework, paragraph 12

28. However, the staff also notes that in the case of hedge accounting there is a conflict between the objectives of:
- (a) providing information that is useful to users; and
 - (b) adhering to general recognition and measurement principles.
29. In addition, the staff has identified some follow-on issues that the Board would need to address in developing a principle to hedge accounting. These are:
- (a) **optionality of hedge accounting** – Under current requirements hedge accounting is considered an exception and hence is optional. Developing a principle to hedge accounting raises the issue whether the Board should require all entities that hedge economically to apply hedge accounting (hence eliminating the optionality). However, are there any circumstances where an entity should be provided an option of whether or not to apply hedge accounting even when the principle is met?
 - (b) **possible exceptions to the principle** – Are there any circumstances where the principle developed does not render useful information and hence an exception is needed? The staff is aware that options and exceptions generally result in added complexity.
 - (c) **scope** – A decision on a general principle to hedge accounting should be applicable to all forms of hedge accounting (including portfolio hedge accounting).
30. The Board might further consider the need for additional requirements to ensure any exceptions are applied consistently.

Approach B2 – Replace fair value hedge accounting

31. Fair value hedge accounting is designed to eliminate or reduce measurement anomalies caused by recognising and measuring hedging instruments (mainly

derivatives)⁴ at fair value and measuring or recognising hedged items in a different way. The need for fair value hedge accounting would be reduced if more financial instruments were measured at fair value through profit or loss.

32. Hence, it is possible to replace fair value hedge accounting by adopting a less complex alternative (ie accounting as at fair value through profit or loss) to eliminate or reduce measurement anomalies.
33. Unlike fair value hedge accounting, cash flow hedge accounting is designed to reflect the management of cash flow risk associated with forecast transactions and other future cash flow exposures arising from transactions that are highly probable to occur by allowing recognition of gains and losses in profit or loss in a period other than the period in which they occur. However, neither the staff nor respondents to the DP have identified an obvious alternative to replace cash flow hedge accounting.
34. The DP considered three possible ways to replace existing fair value hedge accounting. These were:
 - (a) **Approach B2(i)** – substitute a fair value option for instruments that would otherwise be hedged items.
 - (b) **Approach B2(ii)** – permit recognition outside profit or loss of gains and losses on financial instruments designated as hedging instruments (an approach similar to cash flow hedge accounting).
 - (c) **Approach B2(iii)** – measure all financial instruments at fair value and permit recognition outside profit or loss of gains and losses on hedged items.
35. Another possible approach could be **Approach B2(iv)** – to require the entire fair value change of a hedged item to be recognised during a fair value hedge accounting relationship, and to require the fair value changes relating to the designated risk or portion to be recognised in profit or loss, with any other fair

⁴ IAS 39.72 permits non-derivative financial assets and liabilities to be designated as hedging instruments only for a hedge of foreign currency risk.

value changes recognised in other comprehensive income (OCI). This approach was not considered in the DP.

Approach B2(i) – substitute a fair value option for instruments that would otherwise be hedged items

36. Under approach B2(i) fair value hedge accounting would only be permitted for assets and liabilities that are not permitted to be measured at fair value using a fair value option. Hence, fair value hedge accounting might be limited but still permitted for particular financial instruments and many non-financial instruments. An entity can use a fair value option, if available, to address (other) accounting mismatches.
37. Appendix B sets out arguments for and against approach B2(i). The staff notes that the Board could consider addressing issues relating to the approach by:
 - (a) allowing application of the fair value option on any date after initial recognition and allowing dedesignation after election of the option.
 - (b) allowing the fair value option to be applied to specific risks and portions.
 - (c) extending the fair value option to non-financial items.
38. However, the staff notes that providing more flexibility to the existing fair value option could result in other issues, eg applying the fair value option to a portion of an instrument might result in an amount recognised in the statement of financial position that is neither fair value nor cost. Moreover, this simplification could result in a hedge accounting method that is very similar to existing fair value hedge accounting.
39. The staff notes that today's restrictions on the use of the fair value option are aimed at removing the ability of an entity to *cherry-pick* the recognition of gains or losses. Hence, introducing flexibility in applying the fair value option (without restrictions) might not improve comparability or result in more relevant and understandable information for users. In addition, the Board is yet to resolve issues relating to own credit risk in fair valuing liabilities.

40. There was limited support for approach B2(i) by respondents to the DP. Respondents raised issues relating to the restrictive nature of the fair value option. Respondents that supported approach B2(i) suggested allowing for a more flexible fair value option.

Approach B2(ii) – permit recognition outside profit or loss of gains and losses on financial instruments designated as hedging instruments (an approach similar to cash flow hedge accounting)

41. Unlike fair value hedge accounting, cash flow hedge accounting generally does not result in adjusting the carrying amount of the hedged item (with exception to a hedge of a forecast transaction that results in the recognition of non-financial items)⁵. Gains and losses on the hedging instrument are initially recognised in OCI and subsequently recycled into profit or loss when the hedged cash flows affect profit or loss. Approach B2(ii) applies a similar mechanism to fair value hedge accounting. Gains and losses on the effective portion of the hedge are recognised in OCI and measurement of the hedged item is not affected. Any ineffectiveness is recognised in profit or loss.
42. Appendix B sets out arguments for and against approach B2(ii). The staff notes that approach B2(ii) interacts with the Board's work on the financial statement presentation project in that this approach results in more items recognised in OCI. Hence, this approach partly relies on the Board's decisions on the use of OCI, recycling and disaggregation of items in OCI.
43. Of the three methods set out in the DP to replace fair value hedge accounting, most respondents preferred approach B2(ii).

⁵ IAS 39.98(b) permits an entity to either reclassify associated gains or losses that were recognised in OCI to profit or loss as a reclassification adjustment or *to remove associated gains or losses recognised in OCI and include them in the initial cost or carrying amount of the non-financial item* (often referred to as a 'basis adjustment'). In this situation, recycling of the gains and losses from OCI results before there is a profit or loss effect. Moreover, as a result of the basis adjustment, the measurement of the hedged item is affected.

Approach B2(iii) – permit recognition outside profit or loss of gains and losses on hedged items

44. Under approach B2(iii) for financial instruments other than those that are measured at fair value through profit or loss an entity would be permitted to recognise all unrealised gains and losses or unrealised gains and losses attributable to specified risks in either profit or loss or OCI subject to one exception. The exception is that unrealised gains and losses on interest bearing financial liabilities attributable to own credit risk must be recognised in OCI.
45. An entity could also elect to report a specified percentage of gains and losses on those financial instruments in profit or loss and the remainder in OCI. This election would be made on an instrument by instrument basis on initial recognition. The election would be revocable.
46. Paragraphs 2.49-2.54 of the DP further discuss this approach. In summary, approach B2(iii) results in more (all) financial instruments at fair value. This approach permits a discretionary split in hedging gains and losses between profit or loss and OCI and requires recycling of hedging gains and losses recognised in OCI to profit or loss when an entity changes its hedge accounting decisions. However, unlike fair value hedge accounting, this approach would not require effectiveness testing.
47. Appendix B sets out arguments for and against approach B2(iii). Overall, respondents to the DP did not support approach B2(iii). Many provided arguments similar to those in Appendix B.

Approach B2(iv) – require the entire fair value change of a hedged item to be recognised during a fair value hedge accounting relationship, and require the fair value changes relating to the designated risk or portion to be recognised in profit or loss, with any other fair value changes recognised in OCI.

48. Under this approach the entire fair value change of a hedged item would be recognised *during the hedging accounting relationship*. However the fair value changes recognised would be split between profit or loss and OCI. Fair value changes relating to the designated risk would be recognised in profit or loss and other fair value changes would be recognised in OCI.

49. This approach uses mechanics broadly similar to that of approach B2(iii) but it would apply only when the hedged item is designated in a fair value hedge relationship (whereas the approach B2(iii) discussed in the DP requires all financial instruments to be measured at fair value – even if they are not designated as hedged items – and only provides a presentation choice for fair value changes). Appendix B further sets out other issues relevant to approach B2(iv).

Approach B3 – Maintain but simplify existing hedge accounting requirements

50. Under approach B3 the current hedge accounting model in IAS 39 would be retained but individual aspects of the model would be considered for simplification.
51. The staff thinks that approach B2 (ie to replace fair value hedge accounting) can be combined with different aspects of approach B3. For example, the replacement of fair value hedge accounting with a mechanism similar to cash flow hedge accounting (approach B2(ii)) can be further improved by considering simplification of existing cash flow hedge accounting requirements.
52. The DP identified several aspects of both fair value and cash flow hedge accounting and proposed possible simplifications. These include some of the following:
- (a) partial hedges ('portions')
 - (i) prohibit hedge accounting for portions.
 - (ii) develop a principle for identifying portions eligible for hedge accounting.
 - (b) designation and documentation – allow management to set a general policy for effectiveness testing that would include a fallback position if the initially documented method turns out to be in error.
 - (c) dedesignation and redesignation – require irrevocable designation, ie the hedging relationship can only be discontinued when the hedging instrument is sold, terminated or exercised.

- (d) effectiveness testing and recognition of ineffectiveness:
 - (i) eliminate some or all effectiveness qualification requirements.
 - (ii) eliminate all effectiveness tests and simply require actual ineffectiveness to be recognised in profit or loss immediately.
 - (iii) eliminate either all effectiveness tests or only retrospective effectiveness test (but require a prospective qualitative effectiveness test) when an item in its entirety is designated as a hedged item.
 - (e) recycling of deferred gains and losses for cash flow hedges – require that an entity state at inception when a hedged transaction is expected to affect profit or loss and to recycle gains and losses at that time (whether or not the forecast transaction occurs and affects profit or loss as planned). However, the staff notes this simplification can only be applied to simple hedges and would not work in many other scenarios.
 - (f) options and exceptions – eliminate options and exceptions, eg the ‘basis adjustment’ option permitted in IAS 39.98(b) and the option of fair value or cash flow hedge accounting for a hedge of a foreign currency risk of a firm commitment.
53. Overall, respondents to the DP supported simplifying existing hedge accounting requirements. In particular respondents suggested simplification of documentation requirements and effectiveness testing (particularly elimination of effectiveness testing and the arbitrary 80%-125% effectiveness threshold but instead continue to require actual ineffectiveness to be recognised in profit or loss immediately). Respondents also supported enhanced disclosures.
54. However, most respondents did not support elimination of portions. Many respondents believe that hedge accounting for portions is necessary to faithfully represent an entity’s actual hedging activities. In addition, several respondents requested extending hedge accounting to portions of non-financial items, net positions and exposure to sub-LIBOR interest rate.

55. The staff notes that there are arguments for and against ways to simplifying individual aspects of hedge accounting. The staff intends to bring papers that further analyse these individual aspects if the Board were to consider simplifying some or all of these aspects. Appendix B sets out some broad arguments for and against approach B3.
56. In addition, the staff has identified two further alternatives to simplifying existing hedge accounting requirements. These include:
- (a) Approach B3(i) – adopt an approach similar to that of IFRS for SMEs.
 - (b) Approach B3(ii) – adopt an approach similar to that proposed by the US Financial Accounting Standards Board (FASB) in its past ED on hedging.
57. Both these approaches maintain the existing fair value and cash flow hedge accounting models but simplify some of the individual aspects set out above. Appendix D summarises the IFRS for SMEs approach and provides arguments for and against the approach. Similarly, Appendix E summarises and provides an analysis of the FASB approach.
58. The analyses on these further alternatives highlight some of the issues that might arise in simplifying existing aspects of hedge accounting. The analysis on the FASB approach also incorporates the views of respondents to the FASB's exposure draft on hedge accounting published in June 2008.

Staff recommendation

59. **The staff recommends approach B2(ii) (replace fair value hedge accounting by permitting recognition outside profit or loss of gains and losses on financial instruments designated as hedging instruments, an approach similar to cash flow hedge accounting).**
60. In addition, the staff thinks that additional simplifications to the existing cash flow hedge accounting model should be considered in conjunction with the recommended approach ie approach B2(ii) should be combined with aspects of approach B3.

61. The staff thinks that the Board should also consider approach B1 (to develop a principle for hedge accounting).
62. However, the staff notes that the general purpose of hedge accounting is clear. Consistent with the project objective to provide decision-useful information, the purpose of hedge accounting is to reflect an entity's risk management activities and effectiveness of such activities in the financial statements. The staff recommends emphasising this within the revised standard.
63. The staff agrees with the arguments for approach B2(ii) set out in Appendix B. In addition, the staff thinks the recommended approach is meets the objectives of phase 3 that include:
 - (a) significant improvement of decision-usefulness for users – under this approach all hedging activities (including hedges of fair value risk) will be reflected in OCI resulting in greater transparency and comparability. Moreover, the measurement attribute of the hedged item would generally not be affected.
 - (b) simplification of existing requirements – although fair value and cash flow hedge accounting are designed to address different exposures, the same mechanism can be used to reflect how an entity manages these exposures in the financial statements. Eliminating one of the two different methods (fair value hedge accounting or cash flow hedge accounting) will reduce complexity. This approach aligns fair value hedge accounting and cash flow hedge accounting resulting in a single method to hedge accounting.
 - (c) a comprehensive review – this approach considers both simplification of the approach to hedge accounting by replacing fair value hedge accounting and further considers simplification of individual aspects of cash flow hedge accounting mechanics.
 - (d) an expeditious approach – as this approach relies on the existing mechanics of cash flow hedge accounting this approach can be developed within the expected project timeline.

64. Moreover, among possible approaches to replace fair value hedge accounting set out in the DP, most respondents preferred approach B2(ii). The staff also perceives possible reduction in systems and operating costs under this approach. However, the staff notes that as with any change in requirements there is a one off cost on adoption.

Question 1 – Approach to address hedge accounting

The staff recommends that the Board simplify today's hedge accounting requirements by replacing fair value hedge accounting with an approach that is similar to cash flow hedge accounting (approach B2(ii)), and to consider additional simplifications to the existing cash flow hedge accounting model (approach B3) to further reduce complexity.

Does the Board agree with the staff recommendation? If not, why and what other approach or approaches would the Board like to develop and why?

65. Appendix F sets out the staff's tentative project plan should the Board agree with the staff recommendation.

Specific types of hedges

66. This section addresses two specific types of hedges with a narrower scope than the broader categories of fair value and cash flow hedges.

Portfolio hedge accounting

67. Today's hedge accounting requirements apply to both micro hedge accounting, ie hedging individual assets and liabilities and portions of individual assets and liabilities⁶, and macro/portfolio hedge accounting, ie hedging a portfolio of assets and/or liabilities. The requirements and mechanism of portfolio hedge accounting differ from general micro hedge accounting.

⁶ IAS 39.83 permits the grouping of similar assets and liabilities as hedged items under some conditions.

68. The staff notes that in considering portfolio hedge accounting several issues become more pertinent (some of these issues also relate to micro hedge accounting), for example:
- (a) **unit of account** for reporting for financial instruments – what unit of account should be used for reporting financial instruments ie the level at which the unit of account is determined (individual items or groups of items)?
 - (b) **hedges of net positions** – can a net position which itself is not an asset or liability be hedged?
69. The Board has previously considered some of these issues (see Appendix C).
70. As a result of the differences between portfolio hedge accounting and general hedge accounting and the related additional complexities associated with portfolio hedge accounting, some (including the DP) considered eliminating portfolio hedge accounting, ie to only allow the application of hedge accounting to individual assets and liabilities.
71. The staff has not fully assessed the implications of eliminating *only* portfolio hedge accounting. Portfolio hedge accounting and general hedge accounting are somewhat related eg a decision on fair value hedge accounting might affect fair value hedge accounting for a portfolio hedge of interest rate risk.
72. The staff recommends that the Board separately consider portfolio hedge accounting outside the scope of phase 3. The staff notes that portfolio hedge accounting is significantly different from general hedge accounting and hence should be separately considered. Moreover, the Board has historically considered portfolio hedge accounting as a separate issue.
73. If the Board agrees with the staff recommendation, the staff will provide further analysis on possible approaches to addressing portfolio hedge accounting in a future meeting.

Question 2 – Portfolio hedge accounting

The staff recommends that the Board separately consider portfolio hedge accounting.

Does the Board agree with the staff recommendation?

Hedges of a Net Investment in a Foreign Operation

74. This paper does not separately address hedge accounting of the foreign currency risk arising from a net investment in a foreign operation. The International Financial Reporting Interpretation Committee (IFRIC) issued IFRIC Interpretation 16 *Hedges of a Net Investment in a Foreign Operation* to provide further guidance on that type of hedge accounting. The mechanism of hedge accounting of a net investment in a foreign operation is similar to that of cash flow hedge accounting. The staff's recommended approach does not change such hedges.

Question 3 – Net investment hedge accounting

The staff recommends that the Board not address hedge accounting for net investments in a foreign operation.

Does the Board agree with the staff recommendation?

Other issues

75. The staff notes that in addressing hedge accounting issues the Board might also consider the following factors. These issues are flagged below without a detailed staff analysis. There are no staff recommendations or questions to the Board regarding these issues.

Hedge accounting for non-financial items

76. IAS 39.82 only permits that non-financial instruments be hedged in their entirety or for foreign currency risks. In responses to the exposure draft *Exposures Qualifying for Hedge Accounting* and the DP many respondents urged the Board to consider extending hedge accounting to portions of non-financial items.

Designating portions that exceed the total hedged cash flows

77. IAS 39.AG99C prohibits designating as hedged items portions of cash flows that would exceed the total cash flows. For example, an entity cannot designate cash

flows based on LIBOR if the contractual interest is below LIBOR (eg specified as LIBOR *less* x basis points). This issue will likely have to be revisited when discussing eligible hedged risks. There is also interaction with any decisions on hedge effectiveness testing.

Disclosures

78. Many respondents to the DP and the FASB's exposure draft suggested improving disclosures related to hedge accounting. Existing requirements in *IFRS 7 Financial Instruments: Disclosures* require disclosures relating to hedged risks but not risks that an entity has decided not to hedge.⁷ The staff notes that the amount of disclosures required might vary depending on the approach the Board decides to adopt. Moreover, the staff notes that SFAS 161 *Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133* requires specific hedge accounting disclosures. The staff thinks the Board should consider these in developing disclosures.

Convergence with US GAAP

79. The FASB will address hedge accounting along with measurement, classification and impairment. The FASB's decisions in these other areas will influence its approach on hedge accounting. The FASB's project plan indicates it will discuss hedge accounting in November 2009. The staff notes that the boards remain committed to a joint approach to address the reporting of financial instruments.

Systems changes and transition

80. Depending on the approach the Board develops significant systems changes might be needed. This raises the issues of effective date and transition. The staff notes the Board has not permitted retrospective application of hedge

⁷ IFRS 7 includes disclosure requirements regarding financial risks in general but they do not include their connection with hedging.

accounting amendments in the past. The staff would expect that the Board continue to take that position in any proposals made.

Appendix A

Approach A – Eliminate hedge accounting altogether

Arguments for Approach A	Arguments against Approach A
<p>(a) hedge accounting is not principle-based and is an exception to normal recognition, measurement and presentation principles.</p> <p>(b) some users believe that today’s hedge accounting requirements do not always reflect the economic consequences of hedging activities. These users believe that disclosure of hedging activities better address their information needs.</p> <p>(c) eliminating requirements on hedge accounting would significantly reduce complexity and opportunities for error and restatement.</p> <p>(d) the fair value option is available in many circumstances to address measurement mismatches.</p>	<p>(a) hedge accounting addresses recognition and measurement anomalies and is needed under a mixed-attribute measurement model.</p> <p>(b) hedge accounting reflects an entity’s risk management strategies and such information is useful to users.</p> <p>(c) eliminating hedge accounting results in profit or loss volatility that does not reflect the economic consequences of hedging activities.</p> <p>(d) rather than reducing complexity eliminating hedge accounting would disguise or negate what is economic reality (which often is complex).</p>

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Approach A1 – Eliminate all hedge accounting requirements but mandate specific disclosures

Arguments for Approach A1	Arguments against Approach A1
See above	See above
<p>Other issues relating to approach A1 include:</p> <ul style="list-style-type: none"><li data-bbox="226 641 1843 771">(a) information about an entity’s hedging activities would be available to users in the notes to financial statements. Nonetheless, the effects of hedging activities would be reflected in the entity’s performance statements as if the hedging instruments were held for trading.<li data-bbox="226 808 1881 893">(b) <i>Framework</i> paragraph 82 states that failure to recognise elements of financial statements cannot be rectified by disclosures⁸. Hence, one key consideration is whether hedge accounting is a recognition and measurement issue.<li data-bbox="226 930 1843 1060">(c) the main challenge to approach A1 is developing sufficient qualitative and quantitative disclosures relating to hedging activities. Requiring specific quantitative disclosures might require entities to engage in a process that is not significantly less complex than hedge accounting.	

⁸ Also see IAS 1. 18.

Appendix B

Approach B2(i) – Substitute a fair value option for instruments that would otherwise be hedged items

Arguments for Approach B2(i)	Arguments against Approach B2(i)
<p>(a) a fair value option is already available under today's requirements (subject to some restrictions).</p> <p>(b) a fair value option need not be complex and the results are easier to understand.</p>	<p>(a) the existing fair value option is available only on initial recognition, unlike fair value hedge accounting it cannot be started and stopped at any point.</p> <p>(b) the existing fair value option must be applied to the entire financial asset or liability, hence the hedging of specific risks and 'portions' is not possible. Moreover, since the entire fair value change of the hedged item (including the unhedged portion) is recognised in profit or loss, such hedges might appear ineffective even though they are effective on the basis of the risk management objective. This can result in misleading information. Additional disclosures might be required to for clarification.</p> <p>(c) the existing fair value option is only available for</p>

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	financial instruments, hence the hedging of non-financial items is not possible.
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Approach B2(ii) – permit recognition outside profit or loss of gains and losses on financial instruments designated as hedging instruments (an approach similar to cash flow hedge accounting)

Arguments for Approach B2(ii)	Arguments against Approach B2(ii)
<p>(a) the carrying amount of the hedged item would not be affected (with exception to the basis adjustment option for a hedge of a forecast transaction that results in the recognition of non-financial items).</p> <p>(b) this approach aligns cash flow hedge accounting and fair value hedge accounting resulting in a single method to hedge accounting.</p> <p>(c) this approach results in more transparent information with all effects of risk management activities presented in OCI.</p>	<p>(a) this approach introduces artificial volatility in OCI.</p> <p>(b) deferral of gains and losses and recycling is required.</p> <p>(c) there is a need to track adjustments in equity to ensure that recycling occurs at the right time.</p> <p>(d) depending on the approach adopted, many restrictions that apply to cash flow hedge accounting today continue to be needed to ensure discipline.</p>

Approach B2(iii) – permit recognition outside profit or loss of gains and losses on hedged items

Arguments for Approach B2(iii)	Arguments against Approach B2(iii)
<p>(a) this approach does not require effectiveness testing.</p> <p>(b) hedged items would generally be measured at fair value instead of being adjusted for some fair value changes but not others. This would address some of the challenges with isolating particular elements of a fair value change.</p>	<p>(a) this approach includes few restrictions on where to recognise gains and losses (if restrictions were added there would be little reduction in complexity).</p> <p>(b) recognising part of gains and losses in OCI and part in profit or loss and being able to change that choice creates complexity.</p> <p>(c) recycling of gains and losses from OCI to profit or loss is needed when an entity changes its hedging choices.</p> <p>(d) this approach results in a fundamental change to the existing hedge accounting model and might require significant systems changes.</p> <p>(e) this approach relates to fair value as a primary basis for measuring all financial instruments.</p>

IASB Staff paper

Approach B2(iv) – require the entire fair value change of a hedged item to be recognised during the hedging relationship, fair value changes recognised would be split between profit or loss and OCI

Arguments for Approach B2(iv)	Arguments against Approach B2(iv)
Similar to some of the points made above	Similar to some of the points made above
<p>Other issues relevant to approach B2(iv) include:</p> <ul style="list-style-type: none"> (a) this approach does not require that all financial instruments are measured at fair value. Only those designated as a hedged item in a fair value hedge during the hedging relationship are at fair value. (b) this approach is more restrictive than approach B2(iii) as the presentation split between profit and loss and OCI is not discretionary. Only fair value changes relating to the designated hedged risk is recognised in profit or loss. (c) this approach might be perceived to be contradictory to the basis that amortised cost in some circumstances provides more useful information proposed in the classification and measurement phase as it requires all hedged items in a fair value hedge to be measured at fair value. (d) increased use of OCI. (e) the issue of own credit risk in fair valuing liabilities remains relevant under this approach, subject to the Board’s decision. 	

IASB Staff paper

Approach B3 – Maintain but simplify existing hedge accounting requirements

Arguments for Approach B3	Arguments against Approach B3
<p>(a) this approach limits effects on existing practice as it retains the current hedge accounting models.</p> <p>(b) several common practice issues can be addressed through proposed simplifications.</p>	<p>(a) this approach in itself (ie without being combined with other approaches) does not fundamentally reconsider the need for and form of existing hedge accounting requirements.</p> <p>(b) this is a piecemeal approach to simplifying hedge accounting.</p>

Appendix C

Summary of the Board's work on hedge accounting and some of the key issues

Amendments and Interpretations

C1. The following are some of the main hedge accounting issues the Board has addressed since approval of IAS 39 in December 2003:

(a) Amendments to IAS 39:

(i) Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk (March 2004) – the amendment permits fair value hedge accounting to be used more readily for a portfolio hedge of interest rate risk.

(ii) Cash Flow Hedge Accounting of Forecast Intragroup Transactions (April 2005) – the amendment permits the foreign currency risk of a forecast intragroup transaction to be the hedged item in a cash flow hedge in consolidated financial statements.

(iii) Eligible Hedged Items (July 2008) – the amendment clarified how the principles that determine whether a hedged risk or portion of cash flows is eligible for designation should be applied in particular situations.

(iv) Annual improvements.

(b) Interpretations:

(i) IFRIC 16 *Hedges of a Net Investment in a Foreign Operation* (July 2008) – the interpretation provided guidance on where within a group hedging instruments that are hedges of net investments in a foreign operation can be held to qualify for hedge accounting.

Portfolio hedge accounting

C2. The remaining EU carve-out of some hedge accounting requirements reflects criticism by some European banks that IAS 39 would force them into disproportionate and costly changes both to their asset/liability management and

to their accounting systems and would produce unwanted volatility. Between 2006 and 2007 the IASB considered some of the issues relating to portfolio hedge accounting.

C3. Key issues raised by these banks include:

- (a) application of portfolio *cash flow hedge accounting* to interest rate exposures (IAS 39 provides guidance on fair value hedge accounting for a portfolio hedge of interest rate risk).
- (b) hedging of net interest margin (IAS 39 does not permit hedging of a net position).
- (c) hedging of core demand deposits (IAS 39 precludes non-interest bearing demand deposits from being designated as a hedged item in cash flow hedging of interest rate risk on a portfolio of items).

C4. In addition, other issues raised by these banks include:

- (a) extension of cash flow hedge accounting exceptions – allowing a currency swap derivative for designation as part of a hedged item.
- (b) externalisation of hedging instruments – allowing for an internal contract to be designated as a hedging instrument.

C5. In October 2007 the Board tentatively decided to consider addressing the following issues:

- (a) what is meant by a hypothetical derivative for purposes of testing effectiveness.
- (b) improvement of documentation/effectiveness methodology applied to existing hedge relationships.
- (c) designation of sub-benchmark interest rate items as hedged items.

Appendix D

IFRS for SMEs approach

D1. The following are some of the aspects that are simplified under the SME approach:

- (a) eligible hedged risks and items are limited to (IFRS for SMEs 12.17):
 - (i) interest rate risk of debt measured at amortised cost.
 - (ii) foreign exchange or interest rate risk in a firm commitment or a highly probable forecast transaction.
 - (iii) price risk of a commodity that an entity holds or a firm commitment or highly probable forecast transaction to purchase or sell a commodity.
 - (iv) foreign exchange risk in a net investment in a foreign operation.
 - (v) hedge accounting for non-financial items is permitted.
- (b) eligible hedging instruments:
 - (i) hedge accounting cannot be achieved using debt instruments (cash instruments).
 - (ii) hedge accounting is not permitted with an option-based hedging strategy.
- (c) partial hedges ('portions') - hedging of portions is prohibited.
- (d) effectiveness testing and recognition of ineffectiveness:
 - (i) requires prospective effectiveness testing but not retrospective testing (the highly effective threshold is retained).
 - (ii) requires periodic recognition and measurement of hedge ineffectiveness but under less strict conditions, eg ineffectiveness is recognised and measured at the end of the financial reporting period and hedge accounting is discontinued prospectively starting from that point for hedges that no longer meet conditions for hedge

accounting (IAS 39 requires discontinuation prospectively starting at the date conditions are not met).

- D2. In summary, this approach limits eligible hedged risks and hedged items and hedging instruments but relaxes existing requirements on effectiveness testing.
- D3. Arguments for approach B3(i) include:
- (a) reduction of complexity with the reduction of possible hedge accounting relationships.
 - (b) simplification of effectiveness testing requirements.
- D4. Argument against approach B3(i) include:
- (a) This approach focuses on SMEs whose hedge accounting needs differ from larger entities with more complex hedging strategies, hence simplifications for SMEs might not be appropriate for larger entities and financial institutions.
 - (b) The elimination of alternatives in themselves are not always a reduction of complexity but can be tantamount to ignoring or denying complexity, which undermines the usefulness of information.
- D5. Moreover, the staff notes that IFRS for SMEs provide an option for SMEs to elect IAS 39 in full. The Board's rationale for this decision was that all options in full IFRSs should be available to SMEs. At the same time the Board recognised that most SMEs would prefer the simpler option to full IFRSs (IFRS for SMEs BC90).

Appendix E

FASB proposed approach

- E1. In May 2007 the FASB took onto its agenda a project to simplify hedge accounting. Some of the main features of the FASB approach include simplifications in the following areas:
- (a) eligible hedged risks and items
 - (i) no bifurcation of risk (ie no hedging of portions) with two exceptions:
 - (a) foreign exchange rate risk; and
 - (b) interest rate risk in a hedge of an entity's own issued debt.
 - (b) dedesignation and redesignation - dedesignation is prohibited.
 - (c) effective testing and recognition of ineffectiveness:
 - (i) qualitative instead of quantitative effectiveness assessment (except in some situations when a quantitative analysis is more effective in demonstrating the hedging relationship) with a 'reasonably effective' threshold.
 - (ii) no ongoing effectiveness testing unless circumstances suggest that the hedge is no longer reasonably effective.
 - (iii) elimination of short-cut method and critical terms matching.
 - (d) portfolio hedge accounting - portfolio hedge accounting is generally not permitted under current US GAAP requirements.
- E2. The FASB published an exposure draft of the proposed Statement, *Accounting for Hedging Activities: an amendment of FASB Statement No. 133* in June 2008. The FASB considered responses to this exposure draft in October 2008 and tentatively decided to redeliberate hedge accounting as part of its comprehensive

project on financial instruments (Agenda paper 8A of joint IASB FASB October 2008 meeting).

- E3. The following analysis of the FASB approach incorporates views expressed by respondents to its exposure draft.
- E4. Arguments for approach B3(ii) include:
- (a) elimination (with some exceptions) of quantitative effectiveness assessments simplifies and reduces costs of hedge accounting and avoids restatements.
 - (b) lower effectiveness threshold would increase the use of hedge accounting and encourage the use of risk management strategies increasing comparability between entities that currently apply hedge accounting and ones that do not apply.
 - (c) the ‘reasonably effective’ threshold is principle-based.
 - (d) elimination of portions more comprehensively reflect risk exposures and reduces the opportunities for inconsistencies as the unhedged risk profile also affects overall performance.
 - (e) continuous reassessment results in termination of hedging relationships in times of stability even when the economic hedging relationship is strong (prohibition of dedesignation prevents this).
- E5. Arguments against approach B3(ii) include:
- (a) elimination of portions is inconsistent with an entity’s risk management strategy as many entities use derivatives to manage specific risks.
 - (b) changes in own credit risk is included in assessing hedge effectiveness when hedging interest rate risk on own issued debt.
 - (c) many of the current hedging strategies of interest rates might no longer qualify (under the two exceptions). Restrictions on eligible hedged risks and items might reduce the use of hedging accounting.

- (d) a move away from quantitative effectiveness assessments increases overall complexity and reduces transparency. The usefulness of only qualitative effectiveness testing is also questionable.
 - (e) the ‘reasonably effective’ threshold is not clearly defined. There are concerns relating to possible diversity in practice and the operationality of the threshold. Moreover, a lower threshold might permit greater deferral on cash flow hedges.
 - (f) without ongoing effectiveness testing there would be ability to hide derivative losses particularly for cash flow hedges. In addition, disallowing voluntary dedesignation reduces the number of discontinued hedges (including ones that are ineffective).
 - (g) disallowing voluntary dedesignation results in significant costs for an entity to transact an offsetting derivative and enter into a new derivative arrangement.
- E6. Some respondents to the FASB exposure draft supported additional disclosures instead of the ED proposals. Particularly, disclosure of both hedged and unhedged risks. Moreover, respondents generally supported elimination of the short-cut method and critical terms matching.

Appendix F

Staff's proposed project plan

September	
September main meeting	Decision on broad approach
29 September extra meeting	<ul style="list-style-type: none"> • Clarification of the purpose of hedge accounting
October	
October main meeting	<ul style="list-style-type: none"> • Eligible hedged risks and items (non-financial instruments and portions) • Overview of cash flow hedge accounting model (including issues to resolve in replacing fair value hedge accounting with an approach similar to cash flow hedge accounting) • Other simplifications to the hedge accounting model (documentation, effectiveness testing)
November	
3 November extra meeting	<ul style="list-style-type: none"> • Issues carried over from October
November main meeting	<ul style="list-style-type: none"> • Presentation and disclosures • Interaction with other phases of IAS 39 replacement project or other cross cutting issues • Transition and effective date
December	
1 December extra meeting	<ul style="list-style-type: none"> • Sweep issues (if any)
December main meeting	Drafting and balloting

The staff will also conduct outreach activities between September and November.

Appendix G

Possible approaches

Approach A – Eliminate hedge accounting altogether	Approach B – Simplify today’s requirements on hedge accounting
A1 – Eliminate hedge accounting but mandate disclosures on hedging activities	B1 – Adopt a principle-based approach to hedge accounting
	B2 – Replace fair value hedge accounting <ul style="list-style-type: none"> • B2(i) – substitute a fair value option for instruments that would otherwise be hedged items • B2(ii) – permit recognition outside profit or loss of gains and losses on financial instruments designated as hedging instruments (an approach similar to cash flow hedge accounting) • B2(iii) – permit recognition outside profit or loss of gains and losses on hedged items • B2 (iv) – require the entire fair value change of a hedged item to be recognised during the hedging relationship, fair value changes recognised would be split between profit or loss and OCI
	B3 – Maintain but simplify existing hedge accounting requirements <ul style="list-style-type: none"> • B3(i) – adopt an approach similar to IFRS for SMEs • B3(ii) – adopt an approach similar to that proposed by the FASB