



Project	Hedge Accounting
Topic	Overview of issues

Background

1. Phase 3 of the project to replace IAS 39 *Financial Instruments: Recognition and Measurement* is hedge accounting.
2. The Board has been asked on many occasions (including, most recently, in the extensive outreach the staff has undertaken) to address particular hedge accounting issues. The issues raised can easily be categorised into a number of common areas.
3. In addition, the Board has consistently been asked (for example, in the responses to the IASB discussion paper *Reducing Complexity in Reporting Financial Instruments*) to develop a hedge accounting model with clear, explicit principles.
4. One last observation. It has become very clear during our outreach that constituents would like the Board to fully consider the hedge accounting issues, and take the time that it requires, rather than simply ‘patch’ existing requirements. As the staff has noted before, it is this phase of the project to replace IAS 39 that has attracted the interest of the broadest range of IFRS constituents.

This paper has been prepared by the technical staff of the IASCF for discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

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Purpose of this paper

5. This paper responds to the request of some Board members to set out the *major* issues that we expect the Board to consider, and how those issues fit into the context of the overall hedge accounting model.
6. This paper considers the general hedge accounting model only. The Board has previously decided that issues should be addressed in the general hedging model first, and then the implications of decisions taken should be considered in the context of portfolio hedges. Portfolio hedge accounting is complex and applied by relatively few entities (notwithstanding that many entities manage and hedge risks on a portfolio level). The staff believes the approach adopted by the Board is the most efficient approach. However, the staff plans to ask the Board to start discussing portfolio hedge accounting before the deliberations on the general model are finished.
7. This paper is for information only and does not ask for any decisions.

Overall approach

8. The approach that the staff has been following can be characterised as:
 - (a) using the existing architecture of the hedging model in IAS 39;
 - (b) but, within that architecture, addressing specific areas that have been identified as being problematic since IAS 39 was issued and became effective.
9. The staff believes this approach is the most efficient, and responds to the requests noted in paragraph 2 of this paper (to address particular hedge accounting issues).
10. In terms of the requests noted in paragraph 3 (that the Board develop a hedge accounting model with clear, explicit principles), the staff has the following observations:

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- (a) Constituents believe that such an approach can reduce the complexity of understanding and applying the accounting requirements.
 - (b) The hedge accounting model in IAS 39 already has some underlying principles. It is just that they are often implied rather than explicitly stated. In fact, the staff in previous board papers articulated the underlying hedge accounting principles. Appendix 1 includes an extract from a board paper discussed by the Board in December, 2006.
 - (c) The staff believes that those principles to a large degree are very relevant to the hedge accounting model the board is developing in this project, and we intend to consider them as we develop the model.
 - (d) However, because some of these principles are not explicit, and the many detailed rules that are in IAS 39 often seem to contradict or obscure some of these principles, the hedging model in IAS 39 is almost universally perceived as being rules-based with often arbitrary outcomes.
11. Given all of this, the staff's approach to respond to requests that the Board develop a hedge accounting model with clear, explicit principles and address existing hedge accounting issues is to rewrite the hedge accounting requirements.
12. The staff believes that simply amending the words in IAS 39 to 'patch' particular issues will be difficult and time-consuming, and is unlikely to be responsive to the request from constituents.
- 13.** In rewriting the requirements, the staff will attempt to articulate clear and explicit principles (similar to the approach in Appendix 1).
14. However, the staff is realistic. Hedge accounting inevitably will have some rules because the Board will not always feel comfortable with the accounting outcomes in all situations. However, the Board should clearly indicate when such rules exist, and especially when they contradict the stated principles.

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15. So that is the overall approach. The following section details the main issues that the staff will ask the Board to address.

Main issues to be addressed

16. This table shows the components of the hedge accounting model, and summarises the main issues to be addressed. The table also notes the issues that the Board has already discussed (although not necessarily finalised).

Component of hedge accounting model	Main issues to address
Overall approach	Establish an objective and develop principles
Hedged items - eligibility	-Identification of risk components (including non-financial items) -Derivatives as hedged items -Groups of items, net positions
Hedging instruments - eligibility	-Purchased options -Cash instruments
Effectiveness - qualification	Prospective/retrospective, qualitative/ quantitative, any thresholds
Effectiveness - measurement	How shall it be determined (guidance)
Dedesignation/ discontinuation	Mandatory or optional, any other restrictions
Presentation/ disclosures	Address based on user outreach, including linked presentation
FVHA Mechanics	Adjustment of hedged item
Knock-on effects of other project phases	Implications of non-bifurcation of hybrid financial assets, impairment approach, fair value through OCI without recycling
Legend:	Already discussed by the Board

17. Some of these issues are complex and require significant analysis. For example:

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- (a) *Eligibility of hedged items* – how eligible hedged items should be identified. Whatever approach is used should ideally be applied consistently to financial and non-financial hedged items.
 - (b) *Groups of items and net positions* – entities often hedge for risk management purposes gross positions that may include items that include similar or dissimilar features. Other entities (notably financial institutions) hedge for risk management purposes net positions. Permitting hedge accounting for situations other than a single hedging instrument to single hedged item in order to reflect how an entity manages risk raises significant hedge identification and effectiveness measurement issues.
18. Other items are less complex, but still very important to how the hedge accounting approach works. Of course, just because the issues are not complex does not mean that the Board will always find it easy to take a decision. For example:
- (a) *Effectiveness qualification* – one of the biggest issues surrounding hedge accounting relates to effectiveness qualification. The existing effectiveness qualification requirements are seen as onerous, restrictive and based on arbitrary bright-lines.
 - (b) *Dedesignation and discontinuation* – under IAS 39, the application of hedge accounting is an option. Hedge accounting is also viewed as an exception to normal recognition and measurement requirements. This option to apply an exception can be discontinued at any time. Such optionality could impair comparability.
 - (c) *Fair value hedge accounting mechanics* – under IAS 39 different accounting mechanics apply to cash flow hedge and fair value hedges. These differences result in added complexity.
 - (d) *Knock-on effects of other project phases* – recent changes proposed within other phases of the project to replace IAS 39 ie (i) classification and measurement and (ii) amortised cost and impairment have resulted

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in consequential issues that must be addressed in finalising any hedge accounting model.

19. Finally, but very importantly, is the issue of presentation and disclosure. During the staff's outreach, many users highlighted the need to improve information presented in the financial statements about an entity's risk management activities. The fair value hedge accounting mechanics that the Board decides to propose may help address some of the presentation issues. It is clear, however, that the Board needs to undertake a significant overhaul of the existing hedge accounting disclosure package. However, a lot of that work cannot be completed until the basic components of the hedge accounting model are in place.
20. One last comment. The danger of addressing each component in isolation could result in new set of arbitrary requirements which is no better than IAS 39 today.
21. The staff has, with limited success to date, encouraged the Board to think about an objective for hedge accounting. Or put another way, a clear description of what the Board is trying to achieve in financial reporting in terms of hedge accounting.
22. The staff continues to believe that such an articulation is important, and we plan to return to this discussion as the project continues.
23. For the benefit of Board members, Appendix 2 to this paper provides more detail on some of the main issues to be addressed.

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Appendix 1

Extract from November, 2006 Board paper

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14. *Principle 1* - derivative contracts create rights and obligations that meet the definitions of assets and liabilities and, as a result, should be recognized.
15. *Principle 2* - fair value is the only relevant measurement basis for derivatives because, for example, it is the only measurement basis that can communicate to the users of financial statements the nature of the rights and obligations inherent in derivatives (such as the level of risk arising from the leveraged nature of a derivative).
16. *Principle 3* – items that do not meet the definition of assets and liabilities (such as deferred gains and losses) should not be recognised as if they were assets and liabilities¹.
17. *Principle 4* – hedge accounting is a departure from normal accounting treatment that would otherwise be applied to the items in the hedge accounting relationship.
18. *Principle 5* – because hedge accounting is a departure from normal accounting treatment, hedge accounting principles are required to provide discipline over the use of hedge accounting. Such principles prevent a free choice over when to recognize gains and losses.
19. *Principle 6* – the criteria to be met to qualify for hedge accounting include that:
 - (a) there must be exposure to changes in the fair value of a recognized asset or liability or an unrecognized firm commitment, or exposure to variability in cash flows that is attributable to a particular risk

¹ So for special cash flow hedge accounting, qualifying gains and losses on the hedging instrument are reported as a component of equity until the offsetting gain or loss is recognized in profit or loss.

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associated with a recognized asset or liability or a highly probable forecast transaction, that could affect profit or loss,²

- (b) a hedging relationship must be designated and documented at the inception of the hedge as well as the entity's risk management objective and strategy for undertaking the hedge, and
 - (c) the effectiveness of a hedging relationship must be reliably measurable and is expected to be, and actually was, highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk, consistent with the originally documented risk management strategy for that particular hedging relationship.
20. *Principle 7* – if a hedging relationship is not effective, the ineffectiveness is recognised immediately in profit or loss.

² Including identified portions for certain exposures.

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Appendix 2

Hedged items – eligibility

1. Today many common hedging strategies do not qualify for hedge accounting because of the rules surrounding what items can be designated as hedged items.
2. Specific issues related to the eligibility of hedged items are:
 - (a) risk components – under IAS 39 only the foreign currency risk component of a non-financial item is an eligible hedged component.³ In contrast, for financial items many other risk components (generally any risk component that is separately identifiable and reliably measurable) might be eligible hedged items. This arbitrary distinction between financial and non-financial items has been a long-standing issue and is a particular concern for corporates.
 - (b) derivatives as hedged items – the rule-based eligibility criteria under IAS 39 do not accommodate more sophisticated hedging strategies such as those where the hedged exposure is a combination of a derivative and a non-derivative. Such situations arise when two exposures are managed using different strategies eg when the commodity price risk (in USD) and the foreign currency risk (USD to the entity's functional currency) of coffee are managed using a layering approach for FX risk.
 - (c) groups of items – IAS 39 restricts the designation of items as a group by requiring that for each item in the group the fair value change attributable to the hedged risk must be approximately proportional to the overall fair value change for the group as a whole regarding the hedged risk. However, some hedging strategies rely on groups of items

³ Otherwise the entire non-financial item must be designated as the hedged item.

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because of the effect of items having fair value changes in opposite direction that are offsetting on a group level.

- (d) net positions – risk management is often managing net positions rather than the underlying gross exposure separately. While IAS 39 allows designating part of a gross positions as hedged items such that the hedged amount coincides with the amount of the net position this does not achieve entirely the same effect and also creates accounting complexity.

Hedging instruments – eligibility

- 3. Like for hedged items, there are rules surrounding what items can be designated as hedging instruments.
- 4. Three specific issues relating to the eligibility of hedging instruments that the Board needs to consider are:
 - (a) purchased options – IAS 39 permits the designation of purchased options as hedging instruments⁴. An option contains both intrinsic value and time value. Under IAS 39, the time value (premium) of an option is treated as a separate held-for-trading instrument (or alternatively as ineffectiveness) and recognised in profit or loss in the period it arises. Many disagree with this treatment stating that that the time value is interim volatility while the option premium has inevitably decayed to zero when the hedge matures. Furthermore, current and proposed US GAAP differs in the treatment of such options.
 - (b) cash instruments – IAS 39 restricts the designation of non-derivative assets and liabilities only allowing a hedge of a foreign currency risk. Some think that the ability to designate cash instruments as hedging instruments should be extended.

⁴ Written options could qualify in some situations, see IAS 39.AG94

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- (c) similarly to the discussion of components for hedged items the question arises whether there should be separate, different requirements for components of hedging instruments.

Effectiveness qualification requirements

- 5. One of the biggest issues in relation to the IAS 39 hedge accounting model is effectiveness qualification. The requirement to perform both qualitative and quantitative prospective and retrospective tests is criticised by many as overly-onerous.
- 6. Moreover the effectiveness threshold of 80-125% is considered an arbitrary bright line that is prone to erratic distortions (eg small changes in absolute amounts that result in high *percentage* values of ineffectiveness).
- 7. The consequences of failing the effectiveness qualifications are severe. An entity must discontinue hedge accounting in the period it fails effectiveness qualifications. Many consider these requirements overly-restrictive. Many hedging relationships that are highly effective over their entire life might fall out of the arbitrary 80-125% threshold in some interim periods. However, on the whole such a hedging relationship is nonetheless often highly effective.
- 8. In addition, IAS 39 provides little guidance on how to quantify effectiveness (eg the use of hypothetical derivatives). Some have asked for clarifications on how some of these methods should be applied. Some have also raised issues relating to the current 'highly probable' threshold for forecast transactions.
- 9. The proposed FASB hedge accounting model addresses this overall issue.

Designation and discontinuation

- 10. There are relatively few issues relating to designation and discontinuation. Although some have noted that the current documentation requirements are onerous. Some have also raised concerns relating to the unwinding of cash flow hedge reserves for designated interest rate hedges.

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11. In finalising any hedge accounting model the Board develops, the Board must also consider whether hedge accounting should remain an option. Under IAS 39 it is not mandatory for an entity that hedges economically to apply hedge accounting. This also relates to the issue of voluntary dedesignation. Under today's requirements, even if an entity opts to apply hedge accounting, it can voluntarily dedesignate some of its hedges. If hedge accounting were mandatory, the Board would need to consider whether to continue to allow voluntary dedesignation (in all or some cases).
12. The proposed FASB hedge accounting model addresses this issue, in part.

Presentation and disclosure

13. During the staff's user outreach, many users have highlighted the lack of good quality information on hedge accounting available in the financial statements. Many users find it difficult to understand information provided under the current IFRS 7 *Financial Instruments: Disclosures* requirements. It is also difficult for users to comprehend the 'big picture' as existing disclosures are often accounting driven and do not show the link between an entity's exposures, how the exposures are managed (including instruments used) and the effectiveness of the strategies. As part of the staff's work on presentation the staff will consider linked presentation in the balance sheet of the hedging instrument and hedged item.

Fair value hedge accounting mechanics

14. Under IAS 39 different accounting mechanics apply to fair value and cash flow hedges. For a fair value hedge, the carrying amount of the hedged item is adjusted for the effective portion of the hedge.
15. Two main issues relating to this approach are:
 - (a) different mechanics used for fair value and cash flow hedges increase complexity.

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- (b) adjusting the hedged item for the effective portion of the hedge, results in the measurement of the hedged item being neither amortised cost nor fair value (this third measurement attribute is confusing for many).

Knock-on effects of other project phases

16. There are aspects of other phases of the project to replace IAS 39 that affect hedge accounting:
- (a) Classification and measurement: embedded derivatives are no longer separated from hybrid financial assets. Thus, separated embedded derivative features that are available for designation as hedging instruments under IAS 39 disappear under IFRS 9 *Financial Instruments*. This raises the question of the eligibility of non-derivative financial instruments as hedging instruments (and any designation of components of those) as hedging instruments.
 - (b) The proposed impairment model for the amortised cost category uses expected cash flows without an incurred loss threshold. This raises the question how it interacts with a requirement that hedged cash flows must be highly probable of occurring.
 - (c) The presentation alternative for fair value changes of investments in equity instruments (other than those held for trading) raises the question whether such items can be designated as hedged items. This question arises because the gains and losses recognised in OCI are not recycled to profit or loss.