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Project	<b>Financial Instruments (Replacement of IAS 39) – Hedge Accounting</b>
Topic	<b>Hedge accounting for investments in equity instruments at fair value through OCI</b>

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## Purpose of this paper

1. This paper asks the Board to consider any possible effects on hedge accounting of its decision in IFRS 9 *Financial Instruments* to allow entities the option of presenting the changes in fair value of an equity investment (not held for trading) in other comprehensive income (OCI).
2. This paper only addresses hedge accounting of the investments in equity instruments classified as at fair value through OCI. It does *not* address any hedge accounting for dividend payments from such investments.
3. This paper is structured as follows:
  - (a) background;
  - (b) staff analysis; and
  - (c) staff recommendation and question to the Board.
4. On balance, the staff recommend that the Board should *not* allow hedge accounting for investments in equity instruments designated as at fair value through OCI.

## Background

5. When the IASC issued IAS 39 *Financial Instruments: Recognition and Measurement* the notion of OCI was not part of what was then International

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This paper has been prepared by the technical staff of the IFRS Foundation 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.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination.

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Accounting Standards. However, the Board subsequently introduced OCI and in recent decisions has increased its use.

6. One example of where the Board has recently decided to use OCI is in IFRS 9, for equity investments not held for trading. In accordance with IFRS 9, entities have the option to make an irrevocable election (at initial recognition) to present in OCI subsequent changes in the fair value of an investment in an equity instrument not held for trading. Any gains or losses on these investments recognised in OCI are *not* later reclassified from equity to profit or loss. In other words, the gains and losses are recognised in the statement of comprehensive income only once – in OCI. However, dividends from these investments are recognised in profit or loss.
7. IAS 39 requires that the exposure hedged by a fair value hedge or a cash flow hedge could affect *profit or loss*. Hence, if an exposure affects OCI (rather than profit or loss) an entity can not achieve hedge accounting because any related hedge would not meet the definition of a hedging relationship:<sup>1</sup>

Hedging relationships are of three types:

- (a) *fair value hedge*: a hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or an identified portion of such an asset, liability or firm commitment, that is attributable to a particular risk and could affect **profit or loss**.
- (b) *cash flow hedge*: a hedge of the exposure to variability in cash flows that (i) is attributable to a particular risk associated with a recognised asset or liability (such as all or some future interest payments on variable rate debt) or a highly probable forecast transaction and (ii) could affect **profit or loss**.
- (c) *hedge of a net investment in a foreign operation* as defined in IAS 21<sup>2</sup>.

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<sup>1</sup> IAS 39 defines hedging relationships in paragraph 86.

<sup>2</sup> These hedges are accounted for similarly to cash flow hedges. This type of hedge is not applicable for the types of hedged items analysed in this paper.

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8. Consequently, as part of developing a hedge accounting model for IFRS 9, the Board needs to address whether hedge accounting should be allowed for investments in equity instruments at fair value through OCI (or not). In other words, should IFRS 9 facilitate the application of hedge accounting when the exposure affects OCI rather than profit or loss?

***The rationale for the OCI presentation alternative for equity investments not for trading***

9. When the Board deliberated the classification and measurement requirements for financial instruments in the IAS 39 replacement project, it established the principle that all equity investments should be measured at fair value with changes in fair value presented in profit or loss. However, in finalising IFRS 9 the Board determined that for some equity investments the changes in fair value could be presented in OCI. As paragraph BC 84 of the Basis for Conclusions of IFRS 9 explains, this is because users of financial statements often differentiate between fair value changes arising from equity investments held for purposes other than generating investment returns and equity investments held for trading.
10. When the Board considered *which* equity investments should be eligible for presenting their changes in fair value through OCI, it looked at '*strategic*' equity investments<sup>3</sup>.
11. What meaning of *strategic* equity investments did the Board consider? The Board discussed investments that are strategic in nature and are not purchased solely for, or managed on the basis of, the financial benefits inherent in the equity instrument itself. In some situations, such investments are purchased and subsequently managed because of an enabling role that holding such investments may allow. For example, by holding such an investment, access to specific markets may be facilitated or eased, hence generating economic benefit to the entity. A further feature that distinguishes such holdings from other

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<sup>3</sup> Agenda paper 3A of the June 2009 IASB meeting.

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equity investments is that the equity price and/or expected dividend flows are not (or not the only) factor behind a sell or hold decision.

12. However, in order to limit the option to present changes in fair value in OCI to *strategic equity investments*, that term would have to be defined. After several unsuccessful attempts to define the term *strategic equity investments*, the Board decided to only limit the option to present changes in fair value in OCI to equity investments not held for trading. In part, this is because the term *held for trading* is already defined in IFRSs.
13. IAS 39 defines a financial asset or a financial liability as *held for trading* if:<sup>4</sup>
  - (i) it is acquired or incurred principally for the purpose of selling or repurchasing it in the near term;
  - (ii) on initial recognition, it is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or
  - (iii) it is a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).
14. To put some discipline into the application of this option, the Board decided:
  - (a) the option must be selected at initial recognition of the investment and is irrevocable; and
  - (b) not to allow recycling of gains or losses to profit or loss. This is because allowing recycling would create something similar to the available-for-sale category in IAS 39 and would create the requirement to assess the equity investment for impairment, which had created application problems. It would also have required a different impairment test specifically for this type of instrument, which conflicted with the Board's objective to reduce complexity in reporting financial instruments.

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<sup>4</sup> Paragraph 9 of IAS 39.

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**Staff analysis**

15. If the Board wants to facilitate hedge accounting for investments in equity instruments designated as at fair value through OCI, it could amend the definitions of fair value hedges and cash flow hedges (see paragraph 7). In other words, the reference would have to be to changes in fair value or cash flows of the hedged item attributable to the hedged risk that could affect either profit or loss *or* OCI. However, such an approach gives rise to some mechanical issues that would need to be resolved.
16. For example, how do we match the changes in the fair value of the hedging instrument with the changes in the hedged item attributable to the hedged risk and account for the related hedge ineffectiveness?

***Hedge ineffectiveness***

17. At the July 2010 IASB meeting, the Board decided that for fair value hedges the fair value changes of the hedging instrument and the hedged item attributable to the hedged risk are taken to OCI, and any ineffectiveness (ie any difference) is transferred immediately to profit or loss. Therefore, if the hedge is 100% effective, the change in the fair value of the hedging instrument will match completely the change in the fair value of the hedged item attributable to the hedged risk.
18. However, if the hedge is not 100% effective, it poses a problem. IFRS 9 does not allow any recycling of gains or losses to profit or loss for investments in equity instruments designated as at fair value through OCI.

*Changes in the value of the hedged item are bigger than the changes in the fair value of the hedging instrument*

19. For example, if the changes in the value of the hedged item attributable to the hedged risk are bigger than the changes in the fair value of the hedging instrument, should the ineffectiveness be kept in OCI?

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20. If so, it would contradict one of the key principles of hedge accounting – that hedge ineffectiveness be recognised in profit or loss.
21. Conversely, if the hedge ineffectiveness in the situation set out above were recognised in profit or loss it would contradict the prohibition of recycling to profit or loss gains and losses on instruments accounted for as at fair value through OCI.

*Changes in the fair value of the hedging instrument are bigger than the changes in the value of the hedged item*

22. When the changes in the fair value of the hedging instrument are bigger than the changes in value of the hedged item attributable to the hedged risk), the ineffectiveness could be recorded in profit or loss. That would be consistent with the key hedge accounting principle to recognise hedge ineffectiveness in profit or loss. However, the question remains what to do when the situation changes to that discussed in the preceding section.

*A 'split' approach*

23. Alternatively, a 'split' approach could be used that differentiates the situation discussed in the preceding paragraphs. However, such a 'split' approach would then raise additional questions.
24. For example, how to account for ineffectiveness when part of the ineffectiveness relating to the situation in paragraph 22 arises from the reversal of hedge ineffectiveness in relation to the situation in paragraph 19 (if) that was recognised in OCI in a previous period.

*Conclusion*

25. Hedge accounting for equity investments at fair value through OCI cannot be facilitated within the general hedge accounting mechanics for fair value or cash flow hedges. Instead, different mechanics specifically for this type of hedged item would have to be developed.

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26. This raises the question whether this additional complexity is warranted. Some relevant considerations include:
- (a) Presenting changes in fair value of the equity instrument through OCI is already an exception to the default treatment of equity instruments in IFRS 9. Applying hedge accounting would be layering an exception on top of another exception.
  - (b) Presenting changes in the fair value of the equity instrument through OCI is an option. This means that entities have the *choice* of whether they want to present the changes in fair value of an investment in an equity instrument through OCI or not. Applying hedge accounting would be adding complexity for mitigating an accounting mismatch that results from an accounting *choice* in IFRS 9.

***Dividends from investments in equity instruments at fair value through OCI***

27. Another complexity to be considered is the interaction with the accounting for dividends from investments in equity instruments at fair value through OCI.
28. In accordance with IFRS 9, dividends from equity investments designated as at fair value through OCI are recorded in profit or loss. Therefore, if the fair value of an equity instrument is considered as an estimation of the present value of its future dividend cash flows, a hedge of the exposure to changes in the investment's fair value could affect profit or loss even though the changes in fair value for the equity instrument are presented in OCI (if elected). Hence, the definition of a cash flow hedge<sup>5</sup> might appear to be met.
29. However, paragraph B5.12 in IFRS 9 states that dividends on such investments are recognised in profit or loss in accordance with IAS 18 *Revenue* unless the dividend clearly represents a recovery of part of the cost of the investment. If the dividend represents a recovery of part of the cost of the investment, the

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<sup>5</sup> See paragraph 7.

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dividend would be recorded in OCI. In this case, the definition of a fair value hedge or a cash flow hedge is not met because profit or loss is not affected. On the other hand, if the dividend is a return *on* the investment, an entity would still need to be able to ensure that any hedged fair value changes of the investment are those that at least potentially could give rise to dividends that would be recognised in profit or loss (rather than OCI).

*Conclusion*

30. If the Board reaches the conclusion that hedge accounting could be permitted, mechanical issues similar to that addressed in paragraphs 17 to 24.
31. On the other hand, if the Board does *not* want to accommodate hedge accounting for equity instruments designated as at fair value through OCI, the Board should consider whether it wants to remain silent on the matter or explicitly prohibit equity instruments designated as at fair value through OCI from being eligible for hedge accounting. Remaining silent will for example mean that the Board leaves the question of whether the fact that dividends affect profit or loss qualifies the equity instrument to be eligible as a hedged item (as explained above) open to interpretation.

**General implication**

32. The staff have set out some points below to help the Board consider the implications of allowing hedge accounting to apply (or not to apply) to investments in equity instruments at fair value through OCI.

*Pros and cons of allowing hedge accounting for investments in equity instruments designated as at fair value through OCI*

33. **Pro:** An entity will be able to match the gain or loss on a hedge that it entered into to manage (for example) the foreign exchange translation risk with the gain or loss attributable to the hedged risk associated with the equity investment.
34. **Con:** It introduces complexity around the mechanics of accounting for the ineffectiveness related to the hedge (see paragraphs 17 to 20). This means that



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we introduce complexity in IFRS 9 for something that is merely an option and that is already an exception to the accounting treatment in IFRS 9.

*Pros and cons of not allowing hedge accounting for investments in equity instruments designated as at fair value through OCI*

35. **Pro:** It does not introduce complexity into IFRS 9. In addition, for those that think that the option available in IFRS 9 should be limited to a narrow subset, this will avoid making the option to present changes in fair value through OCI more attractive (and hence increase its use). This is because an entity will have to consider very carefully whether it wants to designate the investment in an equity instrument as at fair value through OCI, because it will not be able to apply hedge accounting to those equity instruments.
36. **Con:** For those that do not think that the option available in IFRS 9 should be limited to a narrow subset of investments in equity instruments, this will limit the usefulness of the option to present changes in the fair value of the equity instrument through OCI for entities that hedge risks associated with these instruments. This would mean that an entity will not be able to apply hedge accounting for a hedge that it entered into to manage the (for example) foreign exchange translation risk for such equity instruments.

**Staff recommendation and question to the Board**

37. The staff recommend that the Board prohibit the application of hedge accounting to investments in equity instruments designated as at fair value through OCI. This is because:
- (a) It would otherwise introduce significant complexity into IFRS 9 for something that is already an option for entities and that is already an exception to the accounting for equity instruments in accordance with IFRS 9.

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- (b) It clarifies whether the fact that dividends affect profit or loss means that the equity instrument could be eligible as a hedged item (as explained above).

**Question**

Does the Board agree with the staff recommendation in paragraph 37?

If not, why not, and what would the Board propose and why?