Project	**Accounting for Financial Instruments – Hedge Accounting**
Topic	**The objective of hedge accounting – objective #3**

Background

1. At the 21 January 2010 meeting, the IASB discussed two possible descriptions of an objective for hedge accounting:

   (a) **Objective 1** – the objective of hedge accounting should be to provide a link between an entity's risk management and its financial reporting. Hedge accounting can convey the context of hedging instruments, which allows insights into their purpose and effect.

   (b) **Objective 2** – the objective of hedge accounting should be to (a) mitigate the recognition and measurement anomalies between the accounting for derivatives (or other hedging instruments) and the accounting for hedged items and (b) manage the timing of the recognition of gains or losses on derivative hedging instruments used to mitigate cash flow risk.

2. The IASB did not support either objective. Concerns expressed about each possible objective are summarised below:

   (a) Objective 1

      (i) the objective is too broad

      (ii) the objective takes into account *any* risk management activity including insurance activities for non-financial exposures eg theft

(iii) the reference to risk management is unclear ie what is the definition of risk management (risk reduction, risk mitigation, risk transformation, or something else)?

(b) Objective 2

(i) the objective is too narrow

(ii) the objective focuses on the mechanics of hedge accounting rather than the objective of hedge accounting ie how it is done instead of why it is done

(iii) the term mitigate is associated with risk reduction. Risk reduction notions are not operational

(iv) it is unclear how this objective would apply in the context of risk components as eligible hedged items

Staff Analysis

3. The staff would like to remind the Board that the purpose of setting an objective of hedge accounting is to establish a common starting point for Board discussions. It sets out the broad direction the Board would like to take on this project.

4. The staff thinks that in developing an objective, the Board should ensure that the objective:

(a) will help answer upcoming questions relating to eligibility of hedged items and hedging instruments and effectiveness testing

(b) is sufficiently broad to address a range of exposures (relating to both financial and non-financial items as well as groups of items including portfolios)

(c) is responsive to feedback received from constituents over a long period of time to develop a hedge accounting model that has an objective and clear principles

(d) is not confused with the issue of what subsequent restraints should be applied to hedge accounting

(e) can be supported by further principles (and sub-principles) and conditions that address individual issues such as eligibility of hedged items and effectiveness requirements

5. The staff thinks it is important to reemphasise that an objective in itself is not a principle or a requirement. As a top-down approach the staff intends to first identify an objective, then develop principles (conditions) to achieve that objective, then develop any appropriate exceptions (if needed).

6. The staff believes such an approach ensures a comprehensive, coherent and consistent hedge accounting model.

Proposed objective to accounting #3

7. The purpose of this session is not to ask the Board to hold a drafting session. If the Board believes that none of the proposed objectives are appropriate, the staff recommends that the Board stop trying to articulate an objective for the moment, and instead start to address individual pieces of the hedge accounting model. The Board should revisit an objective at a later stage in the project.

8. However, based on IASB members' comments at the IASB January meeting, the staff has developed the following objective. In order to illustrate the link between the objective and the application of the objective the staff has then also outlined some possible principles that are needed to achieve this objective in the context of risk components (see Paper 4C/33) and ineffectiveness.

The objective of hedge accounting is to reflect the relationship between an entity's risk management activities and the related hedged exposures by:

- **i. changing the timing of recognising gains or losses on hedging instruments, or the recognition or measurement of hedged items, and**
- **ii. the presentation and disclosures in relation to these items.**

For the purpose of this objective, risk management activities are those activities that use financial instruments (or other contracts that are accounted for as financial instruments) as hedging instruments.

9. To achieve the objective of hedge accounting some *possible* principles relating to specific areas include:

   (a) eligible hedged items/hedging instruments (ie when are items eligible for hedge accounting)

      (i) the hedged exposure could affect profit or loss

      (ii) there must be an economic relationship between the hedged item or items and the hedging instrument or instruments

      (iii) hedged components must be separately identifiable and measurable for purpose of determining hedge effectiveness

   (b) effectiveness (ie when changes in recognition, measurement and timing of items eligible for hedge accounting are permitted and how the changes are accounted for)

      (i) hedge effectiveness and ineffectiveness is based on a notion of offset and can be reliably measured

      (ii) all ineffectiveness is recognised in profit or loss in the period it occurs

10. The staff will further develop such principles (and refine sub-principles) that focus on the mechanical aspects of hedge accounting in subsequent papers on individual topic areas. The purpose of principles is to ensure that the overarching objective of hedge accounting can be achieved within the context of financial reporting.

Question 1 – The objective of hedge accounting

Which of the three proposed objectives of hedge accounting do the Boards believe is appropriate?

If none of the proposed objectives are appropriate, do the Boards prefer to not articulate an objective at this point in the project but revisit it later in the project?