IASB Meeting | Agenda reference **16B**

Staff Paper | Date **Week beginning 13 September 2010**

Project **Financial Instruments: Replacement of IAS 39**

Topic **Hedge accounting – presentation: hedge of foreign currency risk of firm commitments**

Introduction

Purpose

1. This paper analyses:

   (a) the choice in IAS 39 *Financial Instruments: Recognition and Measurement* (IAS 39) today for hedges of foreign currency (FX) risk of a firm commitment; and

   (b) other alternatives for the Board.

2. This paper does not ask the Board for any decisions.

3. Because of the interaction of the issues addressed in papers 16A and 16B all questions in relation to this series of papers are included in one paper (agenda paper 16C).

4. Hence, the Board will be asked for a decision in agenda paper 16C whether to retain the requirement in IAS 39.87, or whether an alternative approach would be more appropriate.

Structure

5. The rest of the paper is structured as follows:

   (a) overview of the issue;

   (b) staff analysis of the issue;

(c) alternatives for how to proceed;

(d) staff analysis of the alternatives; and

(e) staff recommendation.

The issue

6. Paragraph 87 of IAS 39 states:

> A hedge of the foreign currency risk of a firm commitment may be accounted for as a fair value hedge or as a cash flow hedge.

7. The staff notes that the choice in IAS 39.98 as discussed in agenda paper 16A is an accounting policy choice and therefore once elected, entities are required to apply it consistently to all hedges[1]. In contrast, entities can make the election in IAS 39.87 on a *hedge-by-hedge* basis.

Staff analysis of the issue

8. This section of the paper provides an analysis of the accounting option in paragraph 87 of IAS 39. It is divided into the following subsections:

(a) the effects of FX risk of firm commitments;

(b) interaction with forecast transactions that result in the recognition of non-financial items;

(c) comparability; and

(d) feedback from outreach activities.

[1] IAS 39.99.

Effects of foreign currency risk on the hedged item

9. The Board noted in the Basis for Conclusions of IAS 39 that a hedge of the FX risk of a firm commitment affects both the cash flows and the fair value of the hedge item[2].

10. For example, an entity enters into a binding contract to purchase coffee in US dollar (USD). FX movements between USD and the entity's functional currency affect both the fair value and cash flows of the purchase contract. Therefore, when the entity takes out a foreign exchange future to hedge its exposure to movements between USD and its functional currency it can be viewed as either a fair value hedge or a cash flow hedge.

11. The staff notes that only FX risk gives rise to both cash flow and fair value risk. If the entity's functional currency is USD in the example above, the entity has no exposure to FX risk. By entering into a binding contract to purchase coffee at a fixed price in USD it is exposed to the fair value changes of the coffee price. However it is no longer exposed to variability to cash flows as the price (hence the cash flows) has been fixed in the entity's functional currency.

Interaction with forecast transactions that subsequently result in the recognition of non-financial items

12. Because IAS 39.87 allows hedges of FX risk of firm commitments to be accounted for as cash flow hedges, when an FX cash flow hedge of a forecast transaction becomes a firm commitment, entities need not re-designate the hedge as a fair value hedge[3]. Entities may continue to account for the hedge as a cash flow hedge when the forecast transaction becomes a firm commitment.

13. If the choice to account for hedges of FX risk of a firm commitment as either a cash flow hedge or a fair value hedge is eliminated, depending on the decision that the Board makes in relation to basis adjustments (agenda paper 16A), it

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[2] IAS 39.BC154.
[3] IAS 39.BC154.

could result in a split of the hedging gain or loss from one single hedging instrument (with one part remaining in OCI and one part being included in the cost of the non-financial item).

14. Also, if the accounting choice for hedges of FX risk of a firm commitment remains, and basis adjustments are eliminated, the non-financial item would be recognised at different carrying amounts depending on whether an entity chooses to apply cash flow hedge or fair value hedge accounting.

15. The implications of the interaction between the alternatives for basis adjustments and FX hedges of firm commitments are discussed further in agenda paper 16C.

Comparability

16. This section discusses the following comparability issues related to IAS 39.87:

    (a) hedges of firm commitments other than hedges of FX risk;

    (b) US GAAP;

    (c) financial statement presentation; and

    (d) ‘lower of’ test for cash flow hedges.

Hedges of firm commitments other than hedges of FX risk

17. The staff notes that the choice of fair value and cash flow hedge is not available for other hedges of firm commitments. However, as discussed in paragraphs 9 to 11, hedges of firm commitments for risks other than FX risk are only hedges for fair value risk, and therefore are accounted for as fair value hedges only. Hence, the choice between cash flow hedge and fair value hedge accounting for FX risk reflects the unique dual character of that risk and therefore a difference in circumstances.

US GAAP

18. Hedges of FX of firm commitments may also be accounted for as fair value hedges or as cash flow hedges under US GAAP[4]. Hence, paragraph 87 of IAS 39 is comparable with US GAAP.

Financial statement presentation

19. The staff notes that fair value hedges and cash flow hedges are presented differently as follows:

    (a) for fair value hedges the gains or losses on the hedged item attributable to the hedged risk are presented as a separate line item in the balance sheet[5]; and

    (b) for cash flow hedges the gains or losses on the hedging instrument are deferred and recognised in OCI.

20. Because the alternative in IAS 39.87 is elected on a hedge-by-hedge basis, it could result in an entity recognising the hedging gain or loss on some FX hedges of firm commitments in a separate line item on the balance sheet, and others being deferred and recognised in OCI.

'Lower of' test for cash flow hedges

21. For cash flow hedges, the *lower of* the cumulative fair value change of the hedged item and the cumulative fair value change of the hedging instrument is recognised in profit or loss as hedge ineffectiveness[6] (ie the 'lower of' test applies for cash flow hedges).

22. For fair value hedges, ineffectiveness arises when fair value changes of the hedging instrument exceed those of the hedged item or when the fair value

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[4] ASC 815-20-55-137 to 138.
[5] The Board made the tentative decision in the July 2010 meeting (agenda paper 8A) that for fair value hedges the gain or loss on the hedged item attributable to the hedged risk is presented as a separate line item in the balance sheet.
[6] IAS 39.96(a)

changes of the hedging instrument are less than those of the hedged item (ie the 'lower of' test does not apply for fair value hedges).

23. Therefore, depending on whether an entity chooses to account for the FX hedge of firm commitment as a cash flow hedge or a fair value hedge, the amount of ineffectiveness recognised in profit or loss could be different.

24. The rationale for the 'lower of' test is to avoid recognition of gains on transactions that do not exist (highly probable forecast transactions). For fair value hedges, the hedge item exists. For firm commitments while it may not be recognised under IFRSs as an asset or liability, the transaction already exists whereas a forecast transaction does not yet exist but will (probably) only occur in the future. Hence, this rationale seems to suggest that the 'lower of' test should not be applied to hedges of FX risk of firm commitments (as the transactions already exist).

Feedback from outreach activities

25. The staff has received limited feedback to date on this issue. However, some constituents suggested that if the Board decides to eliminate the choice, they recommended hedges of FX risk of firm commitment be accounted for as cash flow hedges.

26. However, the staff also notes that in the outreach activities, some banks and non-financial entities (corporates) have voiced their concerns for the hedging gain or loss for firm commitments being deferred in OCI. Constituents who take out long term FX contracts to hedge FX risk of large firm commitments may have the potential scenarios of where equity turns negative (as discussed in agenda paper 8A of the July 2010 meeting) when the mechanics of cash flow hedge accounting is applied to hedges of FX risk of firm commitments.

Alternatives

27. This section of the paper sets out alternatives for how the Board could proceed. The staff think the Board has at least the following alternatives to accounting for hedges of FX risk of firm commitments:

    (a) **alternative A:** continue to permit choice;

    (b) **alternative B:** require cash flow hedge accounting only; and

    (c) **alternative C:** require fair value hedge accounting only.

Staff analysis

Alternative A: permit choice to apply cash flow hedge or fair value hedge accounting

28. Alternative A is to retain the requirement in IAS 39.87 and continue to permit the choice. The following table summaries the advantages and disadvantages of alternative A:

Advantages	**Disadvantages**
• Reflects the economics of hedging FX risk (dual character of the risk) • Entities do not have to change their systems today • In line with US GAAP • Allows entities to continue to account for an FX cash flow hedge of a forecast transaction as a cash flows hedge when the forecast transaction becomes a firm commitment	• Could result in hedging gains or losses of some hedges of FX of firm commitments presented on the balance sheet and some in OCI • Could result in a different amount of ineffectiveness recognised due to the ‘lower of’ test for cash flow hedges

Alternative B: require cash flow hedge accounting only

29. Alternative B is to require hedges of FX risk of a firm commitment to be accounted for as a cash flow hedge only. The following table summaries the advantages and disadvantages of alternative B:

Advantages	**Disadvantages**
• Entities can continue to account for FX cash flow hedges of forecast transactions as cash flows hedges when the forecast transaction becomes a firm commitment • Hedging gains or losses of all FX risk hedges of firm commitments are presented in one place (OCI)	• Not in line with US GAAP • May result in OCI and equity volatility that some consider 'artificial'[7] • 'Lower of' test would apply to transactions that already exist

Alternative C: require fair value hedge accounting only

30. Alternative C is to require hedges of FX risk of a firm commitment to be accounted for as a fair value hedge only. The following table summaries the advantages and disadvantages of alternative C:

Advantages	**Disadvantages**
• Hedging gains or losses of all FX risk hedges of firm commitments are presented as a separate line item on the balance sheet	• Not in line with US GAAP • FX cash flow hedges of forecast transactions need to be re-designated as fair value hedges when the forecast transaction becomes a firm commitment

[7] As discussed in agenda paper 8A of the July 2010 Board meeting.

Staff recommendation

31. The staff notes that in its July 2010 meeting, the Board has tentatively decided that for fair value hedges, the gain or loss on the hedged item attributable to the hedged risk is presented as a separate line item in the balance sheet. This is to address the potential OCI and equity volatility that arises as a result of applying cash flow hedge accounting mechanics to fair value hedges. Hence, the staff does not recommend the Board to adopt alternative B as the Board will re-create the OCI and equity volatility concerns that it addressed by its tentative decision in July 2010.

32. Under alternative C, entities are required to re-designate a hedging relationship as a fair value hedge when the FX cash flow hedge of a forecast transaction becomes a firm commitment. Alternative C creates operational complexity eg on re-designation, the entity would be required to change its measurement for ineffectiveness from a 'lower of' test to a symmetrical test. The staff notes that one of the objective of this phase of the project to replace IAS 39 is to reduce complexity.

33. The staff notes that, as discussed in paragraphs 9 to 11, hedges of FX risk of firm commitments affect both the cash flow and fair value of the hedge item. Hence, the staff questions whether the effort of re-designating the firm commitment as a fair value hedge is conceptually warranted for hedges of FX risk.

34. Furthermore, if basis adjustment is prohibited for a hedge of a forecast transaction that subsequently result in the recognition of a non-financial item, requiring fair value hedge accounting (alternative C) result in a split recognition of hedging gains or losses in OCI and the cost of the hedged item.

35. Permitting the hedge to be accounted for either as a cash flow hedge or fair value hedge (ie alternative A) reflects the underlying economics of the hedging transaction. It also allows operational simplicity in that entities can continue to apply cash flow hedge accounting when the forecast transaction becomes a firm commitment.

36. The staff notes that alternative A could result in some hedging gains or losses presented on the balance sheet (for those hedges that are accounted for as fair value hedges) and some in OCI (for those FX hedges of firm commitments that are accounted for as cash flow hedges). This concern may be addressed by requiring entities to provide more transparency in the note disclosures.

37. On balance, the staff recommends alternative A. That is, to permit a hedge of the FX risk of a firm commitment to be treated as either a fair value hedge or a cash flow hedge (ie to retain the requirement in IAS 39.87).

38. As explained in paragraphs 3 and 4, the question to the Board is included in paper 16C.