Project: **Financial Instruments (Replacement of IAS 39) – Hedge Accounting**

Topic: **Hedge accounting for groups of hedged items including net positions**

Introduction

Background and purpose of this paper

1. Over the past four months the Board has discussed various aspects of hedge accounting for groups of hedged items (including net positions).

2. The purpose of this paper is to summarise the tentative decisions that the Board has made to date and describe the overall combined effect of these decisions. The objective of this is to ask the Board where it would like to draw the line with respect to which types of groups of hedged items, if any, should be eligible for hedge accounting under the general hedge accounting model.

3. This paper also considers some of the Board's concerns with the staff proposals presented so far.

4. As a reminder this paper considers only the *general* hedge accounting model (referred to as 'the proposed model') applicable to groups of hedged items (including net positions) that are:

   (a) managed on a group basis for risk management purposes;

   (b) closed groups of items;

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(c) financial or non-financial[1] ;

(d) either existing (eg firm commitment) or anticipated (eg forecast transaction);

(e) hedged as either a cash flow hedge or a fair value hedge; and

(f) without prepayment options (or the prepayment option has a fair value strike price such that its value does not change for changes in the hedged risk).

5. The structure of the remainder of this paper is as follows:

   (a) Summary of model for groups of hedged items excluding net positions.

   (b) Summary of model for groups of hedged items that are net positions.

   (c) Summary of the Board's concerns with staff proposals for the model to date.

   (d) Summary of alternatives for the Board.

Groups of hedged items excluding net positions (gross groups)

Eligibility criteria for groups of items[2]

6. For groups of hedged items to be eligible for hedge accounting an entity must demonstrate that it manages the items on a group basis for risk management purposes.

7. In addition to this, the other qualification criteria that will be applicable to individual hedged items must be satisfied. That is, the same criteria will apply to both one-to-one hedges and group hedges (for example, eligibility of the

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[1] It should be noted that although the examples discussed by the Board to date have focussed mainly on hedges of non-financial items, the issues are in effect the same for both financial and non-financial items, with the exception of prepayable financial items which will be dealt with separately as described in the cover paper 14. Hence the proposed model in this paper would apply to both non-financial and financial items.

[2] See agenda paper 9 from the May 2010 IASB meeting.

hedged items and hedging instruments; hedge effectiveness requirements for assessment; documentation; etc).

8. No *additional* restrictions will apply for 'gross groups' of hedged items.

Layers of hedged items[3]

9. When a group of items is hedged for less than its entirety, the designated hedged amount may be identified and designated as only a layer of entire group (eg a bottom layer) if this is consistent with the entity's risk management objective.

10. Additionally, for a layer of a group of items to be eligible as the hedged amount the following conditions must be met:

    (a) The hedged layer must be clearly identifiable and reliably measurable[4].

    (b) The items in the overall group from which the hedged layer is defined must be exposed to the same hedged risk. In other words, it should not matter which items from the overall group end up in the hedged layer because the measure of changes in fair value (for the hedged risk) for each currency unit of the layer is the same.

    (c) For a fair value hedge, an entity must be able to demonstrate that it can identify and track the overall group of items from which the hedged layer is defined. This includes tracking of any hedge adjustments posted to the statement of financial position as part of fair value hedge mechanics.

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[3] See agenda paper 5 from IASB meeting on 24 August 2010.

[4] Note that this requirement is consistent with the criterion we have today in IAS 39 for a risk component of a hedged item to be eligible for hedge accounting. The Board is in the process of debating the eligibility criteria for risk components under the new hedge accounting model. Hence, depending on the outcome of those discussions, the criteria for risk components may change. If so, the staff will use the criteria that result from those discussions also for layer components to maintain consistency between layer components and risk components.

Combinations of gross groups (groups of groups)

11. It should be noted that under the model described above in paragraphs 7 to 10 it would be possible to *combine* eligible gross groups of hedged items and hedge them together as a larger group. This could result in groups that:

    (a) have combinations of more than one layer; and/or

    (b) are net positions (see next section from paragraph 13)

12. For example, if the following two sub-groups were managed together for risk management purposes (eg as part of a rollover strategy that uses 6-month rolling FX forwards), a combination of both sub-groups would be eligible for hedge accounting as a single group (ie a group with two different defined layers from two different sub-groups of items[5]) (assume USD is a foreign currency).

    (a) Sub-group 1 – a bottom layer of USD400k of a group of 10 firm purchase commitments due to settle in 6 months' time.

    (b) Sub-group 2 – a bottom layer of USD100k of a group of 7 firm purchase commitments due to settle in 18 months' time.

Net positions

13. As described in a paragraph 11, a combination of two 'gross groups' could give rise to a group that is a net position. For example a combination of the following two groups could be hedged together as one, for FX risk (assume USD is a foreign currency):

    (a) Sub-group 1: a bottom layer of USD400k of a group of 10 firm <u>purchase</u> commitments due to settle in 6 months' time.

    (b) Sub-group 2: a bottom layer of USD200k of an overall group of 8 firm <u>sale</u> commitments due to settle in 12 months' time.

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[5] Note that in this simple combination of two layers, the benefit of combining layers is limited. However, in practice there could be a number of sub-groups, eg one for every month for 24 months. Also note that the different layers could be hedged for different risks (eg one layer hedged for FX risk and another layer hedged for interest rate risk).

14. The group described in paragraph 13 is considered a net position because it is a combination of sales and purchase commitments. As described in agenda paper 9 discussed at the May 2010 Board meeting, it is common for entities to manage risks on a net basis.

Presentation

15. Presentation of net position hedges depends on whether the hedge is a fair value hedge or a cash flow hedge. See paragraphs 17 and 20.

Fair value hedges

16. In a qualifying fair value hedge, changes in fair value of both the hedged item and the hedging instrument, for changes in the hedged risk, are recognised in other comprehensive income (OCI) with any difference, which is hedge ineffectiveness, being transferred to profit or loss[6]. In other words the treatment of gains and losses for both the hedged item and the hedging instrument (for the hedged risk) is the same. As a result, no additional change to the hedge accounting mechanics is required to accommodate net position fair value hedges – the required offset and hedge ineffectiveness are appropriately recorded in OCI and profit or loss, respectively.

17. Furthermore the *presentation* of fair value hedges of gross positions and net positions would be the same. In both cases the hedging instrument gains/losses are shown in one of two lines in OCI (depending on whether they are gains or losses) and are not shown as part of the hedged item gain/loss.

Cash flow hedges

18. In a cash flow hedge, changes in fair value of the hedging instrument are deferred in OCI to be later recycled when the hedged item affects profit or loss. In order for a cash flow hedge of a net position of anticipated transactions to be

[6] Where the hedging instrument is a derivative, this is part of the full fair value change of the derivative.

recorded appropriately a change to the normal cash flow hedge mechanics is required.

19. For net position cash flow hedges, the (effective amount of the) cumulative value change (from inception of the hedge) of anticipated transactions (when they arise and affect profit or loss) must be deferred in OCI (ie treat it as a hedging instrument) to be reclassified later when the last hedged item affects profit or loss[7].

20. Regarding presentation, if the hedged items in a net position cash flow hedge affect different lines in the income statement, gains/ losses from 'hedging instruments'[8] (both ineffective amounts recognised immediately in profit or loss and effective amounts reclassified from OCI to profit or loss) will be shown in a separate line (eg if sales and cost of sales are hedged for FX risk on a net basis with a single FX forward then the gain/loss on the FX forward (ie hedging instrument) is shown in a separate line after the sales and cost of sales line items).

Identification of the hedged item[9]

21. For a net position hedge to qualify for hedge accounting gross amounts must be identified and designated in the hedge relationship. For example, for a hedge of a net position of CU20, consisting of CU100 assets and CU80 liabilities, the hedge relationship must designate an amount of assets and an amount of liabilities. It would not be sufficient to designate only a net position of CU20 without reference to an amount of assets and liabilities. This is because without reference to an amount of assets and liabilities it is not possible to appropriately apply the mechanics of cash flow and fair value hedge accounting (which require the hedged items to be known and measured).

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[7] See agenda paper 6A from July 2010 IASB meeting.
[8] This can include anticipated transactions that behave as hedging instruments in the reporting period when they affect profit or loss (see agenda paper 6A from July 2010 IASB meeting).
[9] See agenda paper 6C from the July 2010 IASB meeting.

22. It should be noted that the amounts of the assets and liabilities could be defined as layers of those assets and liabilities if the eligibility criteria are met. However, for the same reasons as described above it would not be possible to define the hedged item only as a bottom layer of a net position, say a bottom layer of CU15 of the CU20 net position.

Board member concerns with the proposed model

23. The following paragraphs summarise some concerns (and staff's responses to those concerns) that board members have expressed with the proposed model. For other pros and cons of the proposed model please refer to the relevant previous staff papers referenced above.

Similar items with similar risk characteristics

24. **Concern:** Not including the criteria that exist today in IAS 39 *Financial Instruments: Recognition and Measurement*, and permitting dissimilar items with potentially dissimilar risk characteristics to be hedged together, could give rise to 'artificial' hedge relationships.

25. **Staff response:** The model we have today in IAS 39 often results in artificial hedge relationships that are not consistent with the risk management objective. The proposals in this paper would better allow reporting entities to create hedge relationships that are consistent with their risk management objectives. In the proposed model, hedge relationships must be consistent with risk management objectives to qualify for hedge accounting. To reinforce this principle, examples could be included in the proposed model. Furthermore, it should be noted that hedge relationships must pass the necessary effectiveness assessment requirements to qualify, thus restricting further 'artificial' hedge relationships. For example, based on the Board's tentative decision on effectiveness assessment, hedge relationships that are expected to achieve only accidental offset would be 'screened out' and precluded from hedge accounting.

Net positions

26. **Concern:** Allowing hedge accounting for net positions could provide reporting entities with the opportunity to circumvent the hedge accounting requirement that a hedge relationship must contain both a hedging instrument and a hedged item. For example, an entity could achieve hedge accounting for two *hedged items* provided it ensured some amount (however insignificant) of a net position remained which it hedged with an eligible *hedging instrument.*

27. **Staff response:** Such structuring would not be in line with the principle of permitting hedge accounting for net positions only when it is consistent with the risk management objective. Hence it would not be permitted. The proposed model could make this clear by presenting examples, re-enforcing the principle of when hedge accounting is permitted.

Cash flow hedge mechanics for net position hedges

28. **Concern:** When the staff presented paper 6A at the IASB meeting in July 2010, some board members expressed the following concerns:

    (a) Anticipated transactions should not be treated as hedging instruments as their change in value from inception of the hedge is not a gain or loss arising from a contractual arrangement and hence should not be treated as a gain or loss in profit or loss or OCI.

    (b) Once the hedged transactions have occurred they may affect profit or loss in different periods (eg if sales and stock purchases (not linked) are hedged on a net basis for FX risk they may affect profit or loss in different reporting periods). In this case, the deferral in OCI of value changes (positive or negative) of the sale, to be reclassified later when the stock purchase is recorded as cost of sales, is in effect the same as grossing up hedging instrument gains/losses (ie treating a single hedging instrument as if it was two partially offsetting instruments) in order to achieve the hedged rate in profit or loss.

(c) The mechanics required for net positions in a cash flow hedge are too complex.

29. **Staff response:** Although the cumulative value change of the hedged anticipated transactions are not fair value gains/losses arising from contractual arrangements, for risk management purposes, entities regard these as economic gains/losses. However, if these reasons *against* permitting cash flow hedges of net positions outweigh the reasons *for* permitting cash flow hedges of net positions[10], then criteria restricting in some circumstances net position cash flow hedges from qualifying should be included in the proposed model.[11]

Presentation of cash flow hedging instrument gains/losses for net positions

30. **Concern:** For net position cash flow hedges, the hedging instrument gains/losses are shown in a separate income statement line. Some board members were concerned that this could result in too many additional lines in the statement of comprehensive income.

31. Staff response: The number of risks hedged on a net basis in practice is limited and the likelihood that a reporting entity hedges more than two of these concurrently is further limited. Alternatives to showing the hedging instrument gains/losses in a separate line for each net position hedge are:

(a) show hedging instrument[12] gains/losses with the hedged items they are hedging and show hedge ineffectiveness in a separate line; or

(b) require all net position hedging instrument gains/losses to be shown in one line (although this could result in less useful information); or

(c) do not permit hedge accounting for net position hedges because of this issue.

[10] Presented in paper 6A from July 2010 IASB meeting.

[11] See Appendix B for an extract from agenda paper 6A from July 2010 of the benefits and consequences of cash flow hedging net positions.

[12] Including anticipated transactions behaving as hedging instruments.

Alternatives for the Board

32. The staff believes that the Board has the following alternatives to choose from. Note that, as no concerns were raised with the concept of defining a component of a hedge as a layer[13], all of these alternatives assume that the proposed model will permit this.

    (a) Alternative 1: carry over from IAS 39, <u>all</u> of the existing restrictive criteria that apply to groups of hedged items (see appendix A); or

    (b) Alternative 2: carry over from IAS 39, <u>some</u> of the existing restrictive criteria that appy to groups of hedged items (see paragraph 33); or

    (c) Alternative 3: do not carry over from IAS 39 any of the existing restrictive criteria that apply to groups of hedged items and instead incorporate the criteria and principles summarised above in this paper (paragraphs 6 and 21).

33. Under Alternative 2 one or more of the following restrictive requirements could be included in the proposed model:

    (a) Items in the group must be similar;

    (b) Items in the group must have similar risk characteristics;

    (c) Items in the group must share the risk exposure being hedged;

    (d) The change in fair value (for the hedged risk) for each individual item in the group must be approximately proportional to the group as a whole;

    (e) A net position cannot be an eligible hedged item in a cash flow hedge:

        (i) in some circumstances (eg in situations where non-existing items behave as hedging instruments); or

        (ii) in all cases

[13] See papers 2 and 5 from 3 and 24 August 2010 IASB meetings respectively.

(f) A net position cannot be an eligible hedged item in a fair value hedge.

34. From the above, Alternative 3 would be consistent with the staff recommendations in the individual papers presented on this topic to date. However, the staff acknowledges the concerns raised with the proposed mechanics of cash flow hedging for net positions in paragraph 28. Therefore if the Board feels that these concerns outweigh the benefits of such a model[14] the staff recommends Alternative 2 with restriction in paragraph 33(e)(i).

Question to the Board
Which of the alternatives does the Board wish to proceed with? If none of the alternatives presented, what does the Board propose instead and why?

[14] See agenda paper 6A from the July 2010 IASB meeting and extracts in Appendix B.

Appendix A

Below are relevant extracts from IAS 39.

IAS 39.78 A hedged item can be a recognised asset or liability, an unrecognised firm commitment, a highly probable forecast transaction or a net investment in a foreign operation. The hedged item can be (a) a single asset, liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation, (b) a group of assets, liabilities, firm commitments, highly probable forecast transactions or net investments in foreign operations with similar risk characteristics or (c) in a portfolio hedge of interest rate risk only, a portion of the portfolio of financial assets or financial liabilities that share the risk being hedged.

IAS 39.83 Similar assets or similar liabilities shall be aggregated and hedged as a group only if the individual assets or individual liabilities in the group share the risk exposure that is designated as being hedged. Furthermore, the change in fair value attributable to the hedged risk for each individual item in the group shall be expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group of items.

IAS 39.84 Because an entity assesses hedge effectiveness by comparing the change in the fair value or cash flow of a hedging instrument (or group of similar hedging instruments) and a hedged item (or group of similar hedged items), comparing a hedging instrument with an overall net position (eg the net of all fixed rate assets and fixed rate liabilities with similar maturities), rather than with a specific hedged item, does not qualify for hedge accounting.

Appendix B

Below are extracts from agenda paper 6A from the July 2010 Board meeting that discussed net positions of forecast transactions.

29. The benefits of applying hedge accounting for net positions [of forecast transactions] might include:

    (a) avoiding distortion of financial reporting caused by designating gross hedged positions in hedge relationships when the economic basis for the hedge is to hedge a net position.

    (b) providing useful information to users of financial statements about how an entity manages risks arising from assets, liabilities, firm commitments and forecast transactions that are managed together on a net basis.

    (c) informing users of financial statements, through separate presentation, that the entity has a risk management strategy of hedging net exposures.

30. However, some of the consequences of permitting hedge accounting for net positions of forecast transactions are:

    (d) Increased use of equity to defer gains and losses from *recognised* hedged items (ie acting as hedging instruments) to be later reclassified to match the timing of recognition of gains/losses on other hedged items.

    (e) Increased complexity of applying hedge accounting due to

        (i) the <u>dual role</u> of hedged items in the net position (ie sometimes acting as hedged item and sometimes acting as hedging instrument).

        (ii) potential changes in timing and amount of anticipated transactions (because by their nature the transactions are not certain to occur).

    (f) The dual role of hedged items acting as hedging instruments results in circumstances where anticipated transactions are treated as hedging instruments.