Project: **Financial Instruments (Replacement of IAS 39)—Hedge accounting**

Topic: **Groups and net positions—net presentation in a separate line item in the income statement.**

Introduction

Background

1. This paper addresses the feedback received on the proposals in the exposure draft *Hedge Accounting* (ED) regarding groups and net positions.
2. This paper focuses on the issue of presentation of gains and losses on the hedging instrument in the income statement[1] within the context of hedging a group of items with offsetting risks that affect different line items in the income statement (eg a net position hedge). Question 12 in the invitation to comment relates to this issue.
3. The paper contains **one** question to the Board.
4. This paper does not address questions related to macro hedge accounting. These will be discussed as part of a separate work stream on macro hedge accounting.

Summary of the feedback received from comment letters and outreach

5. The feedback from comment letters and the outreach showed very strong support for the proposals that would require the gains or losses on the hedging instrument to be presented in a separate line item for a hedging relationship that

[1] In this paper the term *income statement* is used as a reference to a statement of profit or loss or the profit or loss section of a statement of profit or loss and other comprehensive income (ie the terminology used in the recent amendments to IAS 1 *Presentation of Financial Statements*).

includes a group of items with offsetting risks that affect different line items in the income statement (eg a net position hedge).

6. The vast majority of the respondents and participants in the outreach either agreed or conditionally agreed with the proposals. In their view this presentation avoids artificially grossing-up gains or losses on the hedging instrument.

7. Some participants who agreed with the proposals expressed the view that, despite being useful, this presentation only makes sense if supplemented by an appropriate level of disclosures in the notes. These respondents did not provide any suggestions as to which type of disclosures should be required but raised the issue as a general remark.

8. Some of the respondents who agreed also asked the Board to provide more guidance on whether a single separate line item in the *statement of financial position* is required or permitted for each individual hedge of offsetting risk positions[2] within the context of a fair value hedge.

9. Some respondents conditionally agreed with the proposals. These respondents, despite agreeing with the proposals, provided different alternative views. These are described below:

   (a) Very few have concerns with the presentation in a separate line item in the income statement; the ones who did are of the view that this will produce a different accounting outcome from the one achieved for a gross position and therefore gains and losses should be grossed-up if the hedging relationship meets the qualifying criteria.

   (b) Some asked the Board to eliminate the presentation in a separate line item in the statement of financial position for fair value hedges.

10. Some respondents disagreed with the proposals. They did so for different reasons:

[2] The Board addressed the fair value hedge mechanics as part of its redeliberations and tentatively decided to retain the fair value hedge mechanics in IAS 39 *Financial Instruments: Recognition and Measurement*. Refer to agenda paper 3 presented at the 27 April 2011 IASB meeting and Appendix A.

(a) Some disagreed because the net presentation in the income statement does not represent an adjustment to the line item affected by the underlying hedged item and hence will create volatility within those income statement line items. These respondents are in favour of grossing-up the gains or losses and hence of gross presentation at the hedged rate or price.

(b) A few participants argued that the impact upon profit or loss should be presented in the notes rather than in a separate line item on the face of the income statement, and that a choice of gross or net presentation should be available provided that there are sufficient disclosures.

(c) Some participants also disagreed because of the suggested presentation of fair value hedges. In the view of these participants, two alternatives might be considered. For some, the IAS 39 mechanics should be maintained while for others a single line item in the statement of financial position should be enough and additional disclosures would be provided in the notes.

Staff analysis and alternatives

The issues

11. The feedback from the comment letters and outreach activities showed very strong support for the presentation of the gains or losses on the hedging instrument in a separate line item for hedges of a group of items with offsetting risks affecting different line items of the income statement. Only a small minority of the respondents and participants in the outreach disagreed or suggested further additions or modifications to the original proposals.

12. As a result the staff are of the view that the following issues should be discussed:

(a) Gross presentation versus net presentation in the income statement.

(b) Interaction with the restriction for net position cash flow hedges.

(c) Presentation of the gain or loss on the hedged items in a separate line item in the statement of financial position in a fair value hedge.

(d) Interaction between disclosures and the presentation in a separate line item.

13. The staff note that there is some interaction between the decision as to whether gross or net presentation is appropriate and the issue addressed in agenda paper 13 (ie the restriction on the reporting period for cash flow hedges of a net position). Hence, this paper provides further analysis of that interaction in the section 'Interaction with the restriction for net position cash flow hedges' after the analysis of gross versus net presentation.

Gross versus net presentation

14. The ED proposed net presentation in a separate line item in the income statement on the basis of the following arguments[3]:

(a) It avoids the recognition of gross (partially offsetting) gains and losses that do not exist. These would have arisen as a result of grossing up the line items in the income statement that are affected by the items within the net position. This is inconsistent with the general accounting principles.

(b) It avoids the distortion of separate income statement line items affected by gross items from the net position that are designated in the hedging relationship.

(c) Separate presentation informs users of the financial statements that an entity has a risk management strategy of hedging exposures on a net basis.

15. This has been proposed despite:

(a) the fact that net positions can be complex; for example, for combinations across business segments or with items that affect various types of income and expenses;

[3] Refer to agenda paper 9B presented at the May 2010 IASB meeting and paragraphs ED.BC174 to BC177.

(b) this will require additional disaggregation of information on the face of the income statement; and

(c) the fact that hedges of net positions would be presented differently from hedges of gross positions. By contrast, in a hedge of a gross position the hedging instrument gains/losses would be reclassified to the income statement line item that is affected by the hedged item without the use of a separate line item.

16. A minority of the respondents asked the Board to consider gross instead of net presentation.

17. The staff consider that these requests are based on the view that is often taken by entities that all the items within the net position have been hedged and hence they should all be presented at the hedged rate (or price). In addition, like other outcomes that are solely based on hedge accounting designations, entities appear to consider the distinction between gross and net presentation artificial and accounting driven.

18. This argument appears to have some merit at first glance. However, in order to achieve gross presentation there are several concessions that would need to be made:

(a) In order to achieve gross presentation for the affected line items in the income statement, transactions that do not exist would need to be taken into consideration and hence artificial gains or losses would have to be recognised in the income statement.

(b) If there is hedge ineffectiveness, this would have to be allocated to each item within the net position. This allocation could not simply be done on a pro-rata basis but rather would have to take into account the contribution of each item within the net position for the amount of hedge ineffectiveness.

(c) Applying gross position hedges will not provide useful information as it will distort the way the financial statements report the phenomenon of hedging on a net basis. This is different from hedging on a gross basis because hedging on a net basis involves a lower volume of the hedging instrument.

(d) Allowing a choice between gross and net presentation will also impair comparability.

Interaction with the restriction for net position cash flow hedges

19. As stated in paragraph 13, the decision as to whether gross or net presentation for the gains or losses on the hedging instrument in profit or loss should be considered also depends upon the decision regarding the restriction on the reporting period for net position cash flow hedges. This interaction is an *additional consideration* to those that result from the analysis in the previous section.

20. If the Board does *not* agree with the staff recommendation in section A of Agenda Paper 13 and decides to only address the issue arising from the restriction in the ED if the timing of the forecast transactions changes the staff consider that the requirements for discontinuing cash flow hedge accounting should *not* involve deferring gains and losses on forecast transactions (for the reason set out in Paper 13[4]). This implies that gross presentation in the income statement should *not* apply (otherwise retaining the restriction on deferrals of gains and losses on forecast transactions would not be consistent). Hence, in that case the staff consider that the Board should require net presentation.

21. If the Board *agrees* with the staff recommendation in section A of agenda paper 13, a deferral of gains or losses on forecast transactions that settle in earlier periods to later periods is necessary. This is because eliminating the restriction in the ED and allowing cash flow hedges of a net position to affect profit or loss in more than one reporting period means acknowledging the dual role that forecast transactions play within the net position (hedged item and hedging instrument in a natural hedge). This means that the change in value of the forecast transactions within the net position that affects profit or loss in the earlier stage is needed to offset the transactions that will occur at a later stage.

[4] See paragraph 103 of agenda paper 13.

22. The staff note that the deferral of gains or losses on forecast transactions to later periods can be achieved by two alternative presentations for income statement line items:

    (a) In a separate line item in the income statement *without* adjusting the line item affected by the forecast transaction. This is a deferral that would preserve the default measurement for the respective income statement line item (instead of using the hedged rate or price). (Refer to Appendix A of *agenda paper 13* for an illustration).

    (b) As part of the income statement line item affected by the forecast transaction. This is a deferral that would change the default measurement of the income statement line item and instead measure it at the hedged rate or price. Hence, it would not involve a separate line item for presenting the hedging gain or loss. This is illustrated in Appendix B using the same example set out in Appendix A of agenda paper 13 but modified for the effect of this presentation alternative.

23. Some respondents advocated adjusting each income statement line item because they believe that as the result of hedging the net position all items in that position are hedged and hence the respective line items in the income statement should be measured at the hedged rate.

24. However, the staff note that presenting gains or losses on the hedging instrument in a separate line item better reflects the rationale of the proposals in the ED.[5] In particular, it would avoid taking into consideration transactions that do not exist and hence presenting artificial gains or losses to achieve gross presentation. It would also show that an entity is hedging on a net basis and would clearly present the impact of those net position hedges on the face of the income statement.

[5] See also paragraph 18.

Presentation of the gain or loss on the hedged item in a separate line item in the statement of financial position in a fair value hedge

25. The Board has already discussed this issue as part of its redeliberations. As a result the Board decided to retain the fair value hedge accounting mechanics in IAS 39. The Board's tentative decision is reproduced in Appendix A.

Interaction between presentation in a separate line item and disclosure

26. A few participants advocated that a choice of gross or net presentation should be available provided that there are sufficient disclosures.

27. The staff note that the presentation of the gains and losses in a separate line item in the income statement has been designed to deal with the issue of grossing-up the gains or losses on the hedging instrument (refer to the section above on gross versus net presentation). The staff consider that disclosure of the effect that gross presentation has on the income statement does not justify a change in the measurement of line items in the income statement.[6] Instead, the decision on what the appropriate measurement of income statement line items is (and hence whether gross or net presentation is appropriate) should be made in contemplation of the considerations set out in the section 'Gross versus net presentation' (considering the interaction with the decision on the restriction for net position cash flow hedges).

Staff recommendation and question to the Board

28. For the reasons set out in the staff analysis,[7] the staff recommend presenting the reclassification of gains or losses on hedging instruments in a separate line item in the income statement *without* adjusting the line items affected by the forecast transactions (ie *net presentation*). This would confirm the proposal in the ED regarding presentation in the income statement. In addition, if the Board *agrees* with staff recommendation in section A of agenda paper 13 the staff recommend a similar presentation, ie that the separate line item also includes the deferral of

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[6] The staff note that IAS 1 *Presentation of Financial Statements* says that inappropriate accounting policies cannot be rectified by providing notes (IAS 1.18).
[7] See paragraphs 18, 24 and 27.

gains or losses on forecast transactions to later periods and the effect of their later reclassification.

Question: groups and net positions—presentation of hedging gains and losses
Does the Board agree with the staff recommendation on presentation in paragraph 28? If the Board does not agree with the staff recommendation, what would the Board prefer instead, and why?

Appendix A

Accounting for fair value hedges

1. The Board discussed the mechanics of presenting fair value hedges. The discussion addressed three aspects:

a) Presentation in the statement of comprehensive income.
b) Presentation in the statement of financial position.
c) Linked presentation.

Presentation in the statement of comprehensive income

2. In the ED, the Board proposed that the gain or loss on the hedging instrument and the hedged item should be recognised in other comprehensive income (OCI) with the ineffective portion of the gain or loss transferred to profit or loss. Although most respondents were supportive of providing this type of information, many disagreed with the proposed location (ie the face of the statement of comprehensive income). The main concerns were the unclear conceptual basis for using OCI and the additional number of line items on the face of the statement of comprehensive income.

3. The Board discussed this feedback and tentatively decided to retain the requirement in IAS 39 Financial Instruments: Recognition and Measurement, which means gains and losses from hedging instruments and hedged items for the hedged risk of a fair value hedge, are recognised in profit or loss. However, in order to provide more transparency about hedging activities, the Board also tentatively decided to require in the notes to the financial statements disclosure in one single note of the effects of fair value hedges and cash flow hedges on profit or loss and OCI, respectively. That disclosure includes the gross gain or loss from the hedged item and the hedging instrument as well hedge ineffectiveness.

Appendix B—Cash flow hedge mechanics for a net position whose forecast transactions affect profit or loss in different periods (Extract of agenda paper 19A presented at the IASB meeting on 19 October 2010) adapted for presenting the income statement line items using the *hedged rate*[8]

Profit or loss and OCI				
	30/6/X0	**31/12/X0**	**30/6/X1**	**31/12/X1**
Profit **or loss**	Dr/(Cr)	Dr/(Cr)	Dr/(Cr)	Dr/(Cr)
Forecast sale**	-	-	-	- 150,000
Forecast expense*	-	100,000	-	-
Net hedge gain/loss		-		-
Net	-	100,000	-	- 150,000
OCI				
Cash flow hedge reserve	- 10,000	- 65,000	18,750	56,250

* This amount includes the forecast transaction measured at the spot rate (50,000) adjusted for the 50,000 hedge loss.
** This amount includes the forecast sale measured at the spot rate (120,000) adjusted for the 30,000 hedge gain

Double entry

30/6/X0				
Dr		Forward 1(B/S)	10,000	
	Cr	Cash flow hedge reserve (OCI)		10,000
		To recognise Forward 1 at FV on balance sheet, recognise effective gain/loss in OCI and ineffective gain/loss in P/L.		

31/12/X0				
Dr		Forward 1(B/S)	15,000	
Dr		Forecast expense (P/L)*	100,000	
Dr		Net hedge gain/loss (P/L)	-	
	Cr	Cash (B/S)		50,000
	Cr	Cash flow hedge reserve (OCI)		65,000

[8] Note: This example only shows the main changes that arise from measuring the income statement line items that include the hedged items at the hedged rate (instead of using a separate line item). It does not replicate the example to its full extent.

		To recognise Forward 1 at FV on balance sheet, recognise $200,000 expense in P/L, and defer effective (1) gain on Forward 1 (Cr 15,000) and (2) favourable value change on expense (Cr 50,000) in OCI (net = Cr 65,000).		

* The forecast expense includes the hedge gain or loss related to the change in value of the first forecast transaction.

31/12/X1				
Dr		Cash flow hedge reserve (OCI)	26,250	
	Cr	Forward 1(B/S)		8,750
	Cr	Forward 2 (B/S)		17,500
		To recognise Forward 1 and Forward 2 at FV on balance sheet, recognise effective gain/loss in OCI and ineffective gain/loss in P/L.		
Dr		Cash (B/S)	120,000	
	Cr	Forecast sale (P/L)		120,000
		To recognise $300,000 sale		
Dr		Cash flow hedge reserve (OCI)	30,000	
	Cr	Forecast Sale (P/L)**		30,000
		To reclassify remaining gains/losses from OCI.		
Dr		Forward 2 (BS)	30,000	
	Cr	Forward 1 (BS)		10,000
	Cr	Cash		20,000
		To recognise cash settlement of Forward 1 and Forward 2		

** The forecast sale is adjusted for the gains or losses remaining in accumulated OCI.