

Welcome to IASB Update

This IASB Update is a staff summary of the tentative decisions reached by the Board at a public meeting. As a project progresses, the Board can, and sometimes does, modify its earlier tentative decisions. Tentative decisions do not change existing requirements until those decisions are incorporated in a new or amended standard.

The International Accounting Standards Board met in London on **27 October 2010**, the topic discussed was:

Hedge Accounting

At this meeting, the Board discussed:

- hedging using intragroup monetary items;
- risk components that are not contractually specified;
- accounting for the time value of options
- eligibility of non-derivative financial instruments as hedging instruments; and
- proposed transition requirements and effective date.

Hedging using intragroup monetary items

The Board discussed whether in consolidated financial statements intragroup monetary items transacted between two group entities with different functional currencies should be eligible *hedging instruments* when hedging foreign exchange risk (FX risk). In accordance with IAS 39 *Financial Instruments: Recognition and Measurement*, a difference arising from their translation in the consolidated financial statements can be an eligible hedged item but is not an eligible hedging instrument.

The Board tentatively decided that the issue could be addressed comprehensively only in conjunction with a project to amend IAS 21 *The Effects of Changes in Foreign Exchange Rates*, which would require broadening the scope of the hedge accounting project. The Board also noted that this is not a widespread issue in practice. Hence, the Board tentatively decided not to allow intragroup monetary items to be eligible hedging instruments but instead to retain the requirements in IAS 39.

Risk components that are not contractually specified

The Board continued its previous discussions of the eligibility of risk components for designation in

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Future Board meetings

The IASB meets at least once a month for up to five days.

The next Board meetings in 2010 are:

10-12 November (joint with FASB)
15 - 19 November
(Norwalk, US)

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hedging relationships. The previous tentative decisions were:

- to permit the designation of risk components as eligible hedged items;
- that 'one-sided risks' (ie hedging exposures only against changes to one side of a specified level) would be eligible for designation as hedged items;
- that a *contractually-specified* risk component should be an eligible hedged item (irrespective of whether it is the component of a financial or a non-financial item); and
- to retain the restrictions regarding the designation of risk components when the designated component would exceed the total cash flows of the hedged item (paragraphs AG99C and AG99D of IAS 39—the 'sub-LIBOR' issue).

At this meeting the Board discussed whether risk components that are not contractually specified should be eligible for designation as hedged items. The Board discussed examples involving commodity markets and noted that a principle-based, single approach to determining the eligibility of risk components would have to be criteria-based in order address the many different circumstances in which entities hedge.

The Board tentatively decided to align the criteria for determining risk components for financial and non-financial hedged items (ie that the risk component is separately identifiable and reliably measurable). The Board also tentatively decided to add guidance an entity needs to evaluate the facts and circumstances with regard to the particular market structure to which the risk relates and in which the hedging activity takes place.

Accounting for the time value of options

The Board noted that for hedges involving option-type derivatives IAS 39 gives entities the choice to:

- designate the option-type derivative as a hedging instrument in its entirety; or
- separate the time value of the option and designate as the hedging instrument only (the change in) its intrinsic value.

The Board also noted that, because of the interaction with the hedge effectiveness assessment, the time value of an option is almost always separated.

The Board noted that the standard setting debate about the accounting for the time value of options historically has been focussed on hedge ineffectiveness. However, the Board noted that the accounting for time value of options in hedge accounting could be considered from a different perspective, and viewed as the hedging entity paying a premium for risk cover (an 'insurance' premium view).

The Board tentatively decided to propose accounting for the time value of options similarly to how insurance premiums are treated (from the perspective of the holder of the instrument). The approach the Board tentatively decided to propose is as follows:

- A distinction would be made between two types of hedged items:
 1. *transaction related* (eg the forecast purchase of a commodity); and
 2. *time period related* (eg hedging existing commodity inventory regarding commodity price changes).
- For *transaction related* hedged items the cumulative change in fair value of the option's time value would be accumulated in other comprehensive income (OCI) and be recycled under the general requirements.
- For time period related hedged items the cumulative change in fair value of the option's time value would be accumulated in OCI with that part of the original time value paid to the option writer or seller that relates to the current period being transferred from accumulated OCI to profit or loss. The amount transferred (ie the amortisation pattern) would be determined on a rational basis.
- In order to avoid accounting under this approach for more time value of an option than was actually



paid, if the actual time value is lower than the aligned time value (being the time value that would have been paid for an option that perfectly matches the hedged item) the amount recognised in accumulated OCI would be determined by reference to the lower of the cumulative fair value change of:

1. the actual time value; and
 2. the aligned time value.
- The balances accumulated in OCI would be subject to the following impairment test:
 1. for *transaction related* hedged items the impairment test for the cash flow hedge reserve would be applied; and
 2. for *time period related* hedged items the part of the option's time value that has not been amortised would be immediately recognised in profit or loss when the hedging relationship is discontinued.
 - For the reconciliation of the accumulated OCI balance an entity would have to provide disclosures that differentiate by transaction related hedged items and time period related hedged items.

Eligibility of non-derivative financial instruments ('cash instruments') as hedging instruments

The Board continued its discussion of 5 October of the eligibility of cash instruments as hedging instruments.

The Board tentatively decided to extend the eligibility as hedging instruments to non-derivative financial instruments classified as at fair value through profit or loss. The Board noted that this would align more closely with the classification model of IFRS 9 *Financial Instruments* and make the new hedge accounting model more future proof as hedging strategies developed.

Transition

The Board noted that hedge accounting requires designation of hedge accounting relationships on a prospective basis. That means that retrospective application of any final requirements is not relevant, and some form of prospective application is necessary.

The Board tentatively decided to propose the following transition approach:

- Application of the new hedge accounting requirements should be prospective.
- Comparative figures would not be restated.
- For entities that already apply IFRSs the previous hedge accounting relationships under IAS 39 that qualify under the proposed model would be regarded as continuing hedges and therefore would not involve a discontinuation and restart. Conversely, previous hedge accounting relationships that do not qualify under the proposed model would be subject to the requirements regarding discontinuation of hedge accounting.
- There would be no changes to the transition requirements in IFRS 1 *First-time Adoption of International Financial Reporting Standards*.
- The proposed effective date should be for annual periods beginning on or after 1 January 2013 with earlier application permitted. (However, at the time of redeliberations the staff would provide the Board with the input received from the consultation document on effective dates).

The Board also tentatively decided that, consistent with earlier decisions regarding transition to IFRS 9 *Financial Instruments*, entities will only be able to apply the new hedge accounting model if they adopt all other IFRS 9 requirements that were finalised earlier, and early adoption of previously finalised IFRS 9 requirements will not necessitate early adoption of any final hedge accounting requirements.

Next steps

This was the last meeting of the hedge accounting project before moving towards an exposure draft for the general hedge accounting model. The Board will continue its deliberations of a macro-hedge ('portfolio') accounting model, including consideration of the feedback received on the exposure draft on the general hedge accounting model.

The Board asked the staff to proceed with drafting and balloting the exposure draft. The Board tentatively agreed on a 90 day comment period for the exposure draft. In reaching that tentative decision, the Board acknowledged that the issues addressed in the exposure draft are complex, but also noted the extensive outreach activities by the staff and board members during the project to ensure that constituents have been able to follow the project.

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