

Investor Perspectives

Stephen Cooper: Reforming hedge accounting



As part of our project to improve accounting for financial instruments, we, the International Accounting Standards Board (IASB), recently issued an exposure draft (ED) on proposals to replace the hedge accounting requirements in IAS 39 *Financial Instruments: Recognition and Measurement*. Hedge accounting is a complex and controversial topic in financial reporting and has long been an area of difficulty both for companies seeking to inform investors about what they are doing and for standard-setters in trying to regulate it appropriately.

Essentially, hedge accounting concerns the reporting of derivative instruments that companies hold to hedge various exposures to risk that affect their business. The general accounting treatment of a derivative instrument is that it should be measured at fair value with changes being reported as gains and losses in the income statement. This was the approach in IAS 39 and has been carried forward to IFRS 9 *Financial Instruments*. While some commentators have suggested a cost basis for derivatives, most consider that cost measurement would be completely inappropriate, because the cost is often zero and changes in value can be significant.

The main problem, though, is that most derivatives are held in order to hedge more than one risk. If such an exposure arises from an asset and liability that are recognised in the balance sheet, and it is measured at fair value with changes in value reported in the income statement, then there is no problem if that exposure is hedged against fair value changes. Gains and losses on both the hedged exposure and the hedging instrument are reported together and the hedging activity is correctly reported. This simple

state of affairs might arise where, for example, an entity uses a forward contract to hedge an investment in an equity instrument, because both instruments are reported at fair value through profit and loss. However, matters are not so simple for many other hedges, which present a greater accounting challenge.

Gains and losses on a hedged risk exposure may not be reported in profit or loss for two main reasons. Firstly, the asset or liability may be measured at cost or amortised cost and secondly, there may be no asset or liability at all, because the risk exposure relates to, for example, a transaction that has not yet actually happened. In these circumstances some modification to the accounting for the derivative or to the hedged item is necessary to faithfully represent the activity. This is where hedge accounting is needed.

Hedging and hedge accounting has been an area of business activity and financial reporting where investors often struggle to understand what is going on. This has not been helped by the restrictions in IAS 39 which, arguably, limit the practical ability of companies to faithfully report their risk management activity. Some companies, because of these restrictions, choose not to apply hedge accounting at all and, instead, provide supplementary non-GAAP disclosures reflecting their own version of hedge accounting. Others use IAS 39 hedge accounting for some risks, but present similar supplementary non-GAAP information. The resulting lack of comparability, together with the use of sometimes confusing unaudited supplementary disclosures, creates problems for investors. Hedge accounting that is applied in accordance with IAS 39 can be confusing, because of the different methods available (cash flow and fair value hedges) and the lack of clear disclosure requirements. In addition, many companies feel that the accounting creates artificial restrictions on how they may hedge, which has negatively affected the way in which the business was managed. It is for all these reasons that the IASB has proposed significant changes to the hedge accounting model.

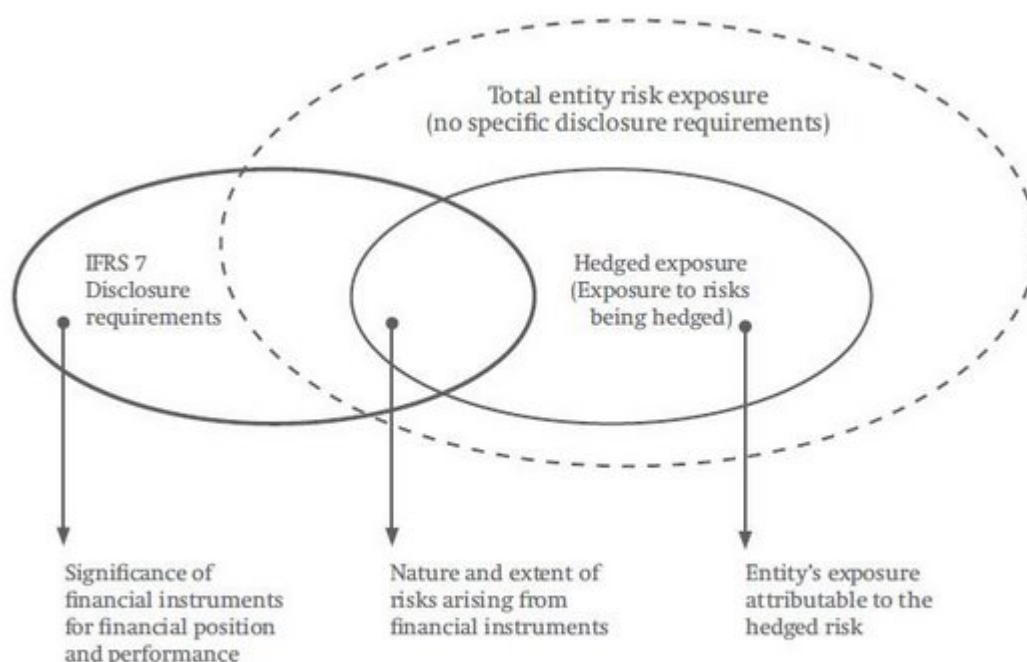
The main proposal in the hedge accounting exposure draft is to adopt a principle-based approach that will align hedge accounting more closely with risk management activities undertaken by companies when hedging their financial and non-financial risk exposures. The proposals also include enhanced presentation and new disclosure requirements. Investors should find the application of the new hedge accounting model more logical, and they should also find that its effects are more transparent and easier to understand.

Here are some of our key proposals:

- Presentation of all hedges in Other Comprehensive Income (OCI): IAS 39 requirements permit only cash flow hedges to be reflected in OCI. We now propose that all gains and losses from hedges, including fair value hedges, should be initially reported in OCI. The extent to which a hedge is ineffective will now be more transparent because there will be a separate transfer from OCI to profit and loss in respect of ineffectiveness.
- Separate presentation of the effects of fair value hedges: in IAS 39, a hedge of a component of the fair value change resulted in the remeasurement of the hedged item to a value that was neither cost nor fair value. The proposals will require such hedged value changes to be reported separately in the balance sheet with the hedged item itself remaining at amortised cost.
- Hedges of risk components of non-financial items: IAS 39 severely restricts the ability to hedge part of a risk exposure. This is a common problem for non-financial companies where the available hedging instrument often does not exactly match the hedged item. This can be the case, for example, for an airline that is hedging its exposure to changes in the future cost of jet fuel. Because jet fuel derivatives are not particularly liquid, a strategy of hedging the crude oil component of jet fuel is often adopted. In effect, this hedges only part of the overall cost. The proposals explicitly permit this, provided that the component can be separately identified.
- Aggregated exposures of derivatives and non-derivatives: IAS 39 does not allow derivatives to be part of the hedged item. This causes problems for many common risk management approaches that hedge different risks using different strategies. For example, an entity first hedges commodity price risk by converting it into a fixed amount in US dollars. In a second step, the entity includes that US dollar amount in its foreign currency hedging strategy. IAS 39 does not allow an entity to choose that fixed US dollar amount as a hedged item for foreign currency hedging because it results from a commodity derivative. We propose that entities should be able to look at both the commodity purchase and the commodity derivative and hedge the resulting US dollar exposure.
- Removing the artificial qualification criteria: at present, a hedge needs to be demonstrated to be highly effective (both expected and observed). A limit as a percentage range was imposed such that price changes for the hedging instrument needed to be within

a 80-125 per cent band of those for the hedged item. We propose to remove this artificial bright line and, instead, specify that hedges should be determined in an unbiased manner that minimises ineffectiveness and that is in accordance with the risk management policy. Any ineffectiveness that then arises will continue to be reported in profit or loss.

- Changes to the treatment of option premiums: one of the current 'rules' that has frustrated investors is the artificial volatility that can arise where an option strategy is used to effectively provide insurance against an adverse price change, such as a change in the purchase price of a raw material. In IAS 39 the intrinsic value of the option is treated as the hedging instrument, with changes in the time value of the option being reported each period in profit or loss. However, in practice, changes in the time value are often irrelevant because the option runs to maturity and so the time value is lost. In effect it is a cost of the hedge. We propose to align the accounting more closely with the underlying economic reality thus avoiding these artificial gains and losses.
- Enhanced disclosures: we propose a comprehensive set of new disclosures that focus on the risks being hedged and on how the use of hedge accounting affects the financial statements. These proposed disclosures have been developed after extensive discussions with a range of investors and analysts. If you would like to read more or to see examples of how the disclosures will work then [click here](#). The diagram below illustrates how we have developed the disclosure package.



We have some proposed some further changes to those outlined above, all of which have the objective of making hedge accounting more usable and transparent. If you would like to learn more please go the hedge accounting pages on the IASB website where you will find the full exposure draft, webcasts, podcasts and other supporting material.

We would particularly like to hear from investors regarding hedge accounting. Comments on the ED would be greatly appreciated by 9 March 2011. Additionally, we would welcome any thoughts you may have regarding difficulties that you have in understanding hedging activities and the related hedge accounting. We will do our best to ensure that these problems are addressed as part of the final standard.

Stephen Cooper is a Board member of the IASB. The views expressed in this article are those of the author as an individual and do not necessarily reflect the views of the International Accounting Standards Board (Board) or the IFRS Foundation (Foundation). The Board and the Foundation encourage members and staff to express their individual views. This article has not undergone the Foundation's due process. The Board takes official positions only after extensive review, in accordance with the Foundation's due process.