
Project	Financial Instruments: Replacement of IAS 39
Topic	Hedge Accounting – accounting for fair value hedges

Introduction

Background

1. At its September 2009 meeting, the Board tentatively decided to simplify today's hedge accounting requirements by replacing the mechanics used for fair value hedge accounting with an approach that is similar to cash flow hedge accounting.
2. Since September 2009 the staff, along with some Board Members, has been actively engaged in outreach activities with preparers, auditors and users. We reached out to:
 - (a) preparers and auditors to seek feedback on common practice issues; and
 - (b) users to gain an overall understanding of how users view hedging and how an entity's hedging activities affect their analysis and decisions.

To date, we have met with more than 80 interested parties.

3. During the course of these outreach activities, the staff also solicited feedback on the Board's tentative decision to replace the mechanics used for fair value hedge accounting with an approach that is similar to cash flow hedge accounting.

This paper has been prepared by the technical staff of the IFRS Foundation for discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in IASB Update. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

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Purpose

4. The purpose of this paper is to:
 - (a) provide feedback received from the outreach activities to the Board on its tentative approach; and
 - (b) ask the Board for its decision on whether to retain its tentative approach or whether an alternative approach would be more appropriate.

Structure

5. The rest of the paper is structured as follows:
 - (a) summary of the Board's tentative approach;
 - (b) summary of the feedback received from the outreach activities on the Board's tentative approach;
 - (c) alternatives for how to proceed;
 - (d) staff analysis of the alternatives;
 - (e) staff recommendation; and
 - (f) question to the Board.
6. The staff recommends that to address the equity volatility impact of the board's tentative approach, the Board replaces the mechanics used for fair value hedge accounting with the proposed 'separate balance sheet line item' through OCI approach.

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Board's tentative approach

7. The Board's tentative approach¹ largely aligns the mechanics used for cash flow hedge accounting and fair value hedge accounting resulting in a single presentation method for hedge accounting.
8. Under the Board's tentative approach, the carrying amount of the hedged item in a fair value hedge is not adjusted.² Gains and losses on the effective portion of the hedging instrument are recognised in other comprehensive income (OCI). Any hedge ineffectiveness is recognised in profit or loss.

Feedback received

9. The feedback received from our outreach activities is mixed.
10. Those who support the Board's tentative approach provided the following key reasons:
 - (a) the tentative approach eliminates the 'mixed measurement' for the hedged item;
 - (b) aligning fair value hedge accounting with cash flow hedge accounting reduces complexity; and
 - (c) the effects of hedge accounting will be presented in one place³.
11. The most significant reason in support of the tentative approach is that the carrying amount of the hedged item is not adjusted.
12. The tentative approach eliminates the 'mixed measurement' that results from adjusting the carrying amount of the hedged item (eg at amortised cost) with the fair value gain or loss on the hedged item attributable to the hedged risk under

¹ The Board tentatively decided to retain the difference between fair value hedges and cash flow hedges in relation to measuring and recognising hedge ineffectiveness (the 'lower-of' test).

² The Board has not yet revisited the basis adjustment option for a hedge of a forecast transaction that results in the recognition of non-financial items.

³ Under the Board's tentative approach effects for both cash flow and fair value hedges will be presented in OCI.

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IAS 39 today. The fair value changes attributable to the hedged risk typically reflect only part of the overall fair value change of the entire hedged item as they relate to only a risk component (eg benchmark interest rate risk and/or a part of the overall maturity of the hedged item). Hence, the amount of the hedged item under IAS 39 is not a consistent measurement and therefore difficult to explain and understand.

13. Another reason in support of the Board's proposal is that the Board's tentative approach would simplify operational requirements. However, we have received feedback from some preparers who think that the incremental benefit from the Board's tentative approach as compared to today's requirements is minimal.
14. Many users support the Board's tentative approach because the effects of hedge accounting will be presented in one place.
15. However, the concerns of those (including some users) who do not support the Board's tentative approach include:
 - (a) the tentative approach introduces 'artificial' volatility in OCI and equity;
 - (b) the tentative approach makes movements in OCI more difficult to comprehend; and
 - (c) the tentative approach makes it difficult to identify the type of risk management strategy employed by the entity.
16. Users also indicated that some equity ratios may have to be calculated excluding hedge accounting effects if the Board decides to finalise its tentative approach.
17. Another concern is that many users indicated that they already have difficulty in understanding the movements in OCI from entities' hedging activities under

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IAS 39 today. Some believe the Board's tentative approach could make it even harder for users to understand the effect of the entities' hedging activities⁴.

18. Some also think that the alignment of one single hedge accounting method makes it difficult to identify the type of risk management strategy employed by the entity (ie it would be more difficult to differentiate whether it is a fair value hedge or a cash flow hedge). The staff thinks that this concern can be also addressed through improved disclosure and presentation requirements. During the outreach many users also said that the differentiation into existing versus non-existing (ie forecast) hedged items is a more relevant differentiation than fair value versus cash flow hedge.⁵
19. Some banks who apply fair value hedge accounting today and non-financial entities (corporates) who take out long term foreign exchange contracts to hedge the foreign exchange risk of large firm commitments (eg shipbuilders and aircraft manufacturers) do not support the Board's tentative approach. They argue that the Board's tentative approach introduces 'artificial' volatility in OCI and equity compared to the requirements under IAS 39 today⁶. These constituents consider the Board's tentative approach causes 'artificial' volatility in OCI and equity as in their view the tentative approach does not reflect the underlying economics. The hedged risk (eg foreign currency risk) would be mitigated and therefore should not cause OCI and equity volatility.
20. The key concern for those preparers and users who disagree with the Board's tentative approach is the potential impact of scenarios where equity turns negative and the significant long term impact on ratios such as debt/equity,

⁴ The staff however notes that such a concern has arisen largely because of the lack of transparent information currently in the financial statements on hedge accounting and the use of derivatives under today's requirements. The staff believes that this issue can be addressed to a large extent when the Board discusses presentation and disclosure requirements to accompany any final proposed model (eg by requiring a breakdown of the cash flow hedge reserve by existing versus forecast hedged items).

⁵ A difference between these two perspectives is for example a cash flow hedge of a variable interest rate asset or liability where the hedged cash flows are an existing contractual right or obligation (just as the principal related to these assets or liabilities).

⁶ Under IAS 39 today, the effective portion of the hedge is offset in profit or loss by taking both the gains and losses attributable to the hedged risk and the hedging instrument to profit or loss.

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which would in turn have an impact on common debt covenants. They also note possible significant consequences in terms of solvency relating to prudential requirements. Covenants may require renegotiation and prudential filters may need to apply to address the equity movements as a result of the Board's tentative approach.

Alternatives

21. The rest of the paper sets out the alternatives for how the Board could proceed following the feedback received from the outreach activities.
22. The staff thinks the Board has at least the following alternatives:
 - (a) **Alternative 1:** retain the Board's tentative approach;
 - (b) **Alternative 2:** propose the 'separate balance sheet item' approach; or
 - (c) **Alternative 3:** revert back to the fair value hedge mechanics under IAS 39 today.
23. Agenda Paper 8C sets out examples to illustrate these 3 possible alternatives.

Staff analysis

Alternative 1: retain the Board's tentative approach

24. The Board discussed the advantages and disadvantages of its tentative approach in September 2009 (Appendix B)
25. If the Board decides to retain its tentative decision, the staff recommends the Board addresses (to the extent possible) some of the key concerns raised when it discusses presentation and disclosures requirements to accompany any new proposed hedge accounting model.

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26. However, the staff notes that presentation and disclosures will not eliminate the OCI and equity volatility impact that some consider ‘artificial’⁷ - a key concern raised during our outreach activities. Example 1 in paragraph 6 and example 8 in paragraph 15 of Paper 8C illustrate the scenarios where the Board’s tentative approach could result in negative OCI and equity.

Alternative 2: ‘separate balance sheet line item’ approach

27. Under alternative 2, the gain or loss on the hedged item attributable to the hedged risk is presented as a separate line item in the balance sheet within assets (liabilities) for those reporting periods for which the hedged item is an asset (liability).
28. The carrying amount of the hedged item remains unadjusted.
29. Example 2 in paragraph 7 and example 9 in paragraph 16 of Paper 8C illustrate the balance sheet presentation under alternative 2.
30. The following table summaries the advantages and disadvantages under alternative 2:

Advantages	Disadvantages
<ul style="list-style-type: none"> • Carrying amount of the hedged item remains unadjusted • Avoids OCI and equity volatility that some consider ‘artificial’ 	<ul style="list-style-type: none"> • Recognises amounts as assets or liabilities that might not be assets and liabilities in their own right (but rather relate to the measurement of another asset or liability) • More complex than the Board’s tentative approach - results in two different hedge accounting mechanics

⁷ See paragraphs 44-45 **Error! Reference source not found.**

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31. One key advantage of alternative 2 is that it would eliminate the mixed measurement for the hedged item. Hence, it would achieve the main objective of the Board's tentative approach, ie the carrying amount of the hedged item remains unadjusted (see example 9 in paragraph 16 of Paper 8C).
32. Another advantage of alternative 2 is that it addresses a key concern from our outreach activities on the Board's tentative approach by avoiding OCI and equity volatility that some consider 'artificial'. Under alternative 2, the cumulative fair value movement from the effective portion of the fair value hedge is recognised as a separate balance sheet line item. Hence, alternative 2 avoids the 'artificial' volatility created in OCI and the potential impact of negative equity, alleviating the concern regarding the perception issue related to volatile and negative equity, the impact in terms of solvency and related prudential issues. However, balance sheet ratio volatility⁸ would still exist under alternative 2 just like under IAS 39 today.
33. One disadvantage of alternative 2 is that it recognises in many cases assets and liabilities that are not (separate) assets or liabilities on their own but rather reflect measurement aspects (partial fair value changes) of other assets or liabilities. In BC 152 of IAS 39, the Board acknowledged that for all fair value hedges, applying hedge accounting has the effect that amounts are recognised as assets or liabilities that would otherwise not be recognised.
34. However, the 'separate balance sheet line item' approach exists under IAS 39 today for a portfolio hedge of interest rate risk. Instead of directly adjusting the carrying amount of the hedged item, paragraph 89A of IAS 39 allows alternatively to present the gain or loss attributable to the hedged item either:
 - (a) in a single separate line item within assets, for those repricing time periods for which the hedged item is an asset; or

⁸ However, ratios such as debt-to-equity and total assets-to-total liabilities or equity would still be volatile under alternative 2 (see also the cover note, agenda Paper 8C paragraphs 5-7).

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- (b) in a single separate line item within liabilities, for those repricing time periods for which the hedged item is a liability.

35. A second disadvantage of alternative 2 is that it results in two different hedge accounting mechanics. However, as presented in paragraph 13 of the paper, the feedback from the outreach activities indicates that aligning the fair value hedge accounting mechanics with the cash flow mechanics only provides minimal relief from an operational perspective as for preparers it is merely an account mapping issue.

Two methods under alternative 2

36. Under alternative 2 the staff thinks that the Board has the following two methods in recognising the gains and losses regarding a fair value hedge:

- (a) alternative 2a: recognise both the fair value change of the derivative and that related to the hedged risk through profit or loss like IAS 39 today; or
- (b) alternative 2b: recognise both the fair value change of the derivative and that related to the hedged risk through other comprehensive income and only transfer any ineffectiveness (ie any difference) to profit or loss.⁹

37. Example 4 in paragraph 9 of Paper 8C sets out the statement of comprehensive income presentation under alternative 2a. The disadvantages for alternative 2a are:

- (a) the effects of risk management activities will not be presented in one place (whereas under the Board's tentative approach and alternative 2b the effects for both cash flow and fair value hedges will be presented in OCI); and

⁹ Please refer to Example 5 of agenda paper 8C for an illustration of this approach.

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- (b) the extent of the offsetting of the effective portion of the fair value hedge is not apparent from the face of the statement of comprehensive income.
38. The staff thinks that the disadvantages of alternative 2a can be addressed if any proposed disclosure in the notes to the financial statements would require entities to separately disclose (similar to IFRS 7 today) the gains or losses on the hedging instrument and on the hedged item attributable to the hedged risk¹⁰.
 39. The staff thinks that alternative 2b would address the disadvantages of alternative 2a as outlined in paragraph 37 above. Example 5 in paragraph 10 of Paper 8C sets the presentation in the statement of comprehensive income under alternative 2b.
 40. Under alternative 2b the effects of both cash flow and fair value hedges will be presented in one place on the face of the statement of comprehensive income ie in OCI. This was a key rationale for the Board’s tentative approach in response to outreach feedback.
 41. Also, under alternative 2b gains or losses on the hedging instrument and the hedged item attributable to the hedged risk are presented as separate line items in OCI and the amounts and extent of hedge effectiveness (ie the offsetting amounts) are apparent from the face of the statement of comprehensive income. However, alternative 2b is a change from current practice.

Alternative 3: retain the fair value hedge mechanics under IAS 39 today

42. The following table summaries the advantages and disadvantages of alternative 3:

Advantages	Disadvantages
<ul style="list-style-type: none"> • Avoids OCI and equity 	<ul style="list-style-type: none"> • Results in a mixed

¹⁰ IFRS 7.24(a).

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Advantages	Disadvantages
<p>volatility that some consider ‘artificial’</p>	<p>measurement for the hedged item (carrying amount of the hedged item is neither at fair value nor [amortised] cost)</p> <ul style="list-style-type: none"> • Recognise assets and liabilities that would otherwise not be recognised • More complex than the Board’s tentative approach - results in two different hedge accounting mechanics • Effects of risk management activities will not be presented in one place¹¹

Staff recommendation

43. The staff first dismisses alternative 3 for the disadvantages outlined in paragraph 42 above and because of the discussions that underpinned the Board’s original tentative decision, which in the staff’s view remain valid.
44. In the staff’s view the volatility in the performance statement and in equity arising from the tentative approach is no more or less arbitrary than the effect that financial reporting requirements generally have on the recognition and measurement of assets and liabilities. The staff notes that equity under IFRSs is a residual amount that results from what is recognised as assets and liabilities in the balance sheet and how these items are measured. Hence, the carrying amount of equity under IFRSs (ie ‘book equity’) is generally *not* equal to the equity value of the entity (eg measured as the aggregate market value of the shares of the entity or the value the sum that could be raised by disposing of

¹¹ Under the Board’s tentative approach effects for both cash flow and fair value hedges will be presented in OCI.

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either the net assets on a piecemeal basis or the entity as a whole on a going concern basis¹²).

45. Therefore, any financial reporting measure of equity is to a significant degree driven by recognition requirements (limitations) regarding assets and liabilities as well as the different measurement attributes that apply to the various different assets and liabilities. In that respect book equity is an arbitrary amount that incorporates all these limitations and differences. Consequently, it is highly debatable what differences between book equity and the entity's equity value are 'artificial' – arguably all of them are and to single out as 'artificial' the effect of fair value hedge accounting is arbitrary in itself.
46. Hence, the volatility is no more artificial than many other omissions of assets, liabilities as well as amounts of assets or liabilities that are not part of IFRSs measurements. Consequently, the view that objects to the volatility may also be considered the result of an inappropriate use of book equity.
47. However, the staff acknowledges that financial reporting sometimes – no matter how warranted or not – has an impact merely based on perception and that many economic consequences are tied to financial reporting even though those consequences are not necessarily aligned with the objective of financial reporting (eg linking debt covenants directly to IFRS information).
48. The staff notes that alternative 2 would allow the Board to achieve its main objective that resulted in the tentative approach while alleviating the concerns about 'artificial' OCI and equity volatility. The trade-off is the recognition of amounts as separate assets and liabilities that often are rather related to measurement aspects of other assets or liabilities.
49. On balance, the staff recommends alternative 2 as that choice addresses the main concerns raised by different parts of our constituency. Within alternative 2, for the reasons set out in paragraphs 37 to 41 above, the staff recommends

¹² Paragraph 67 of the *Framework for the Preparation and Presentation of Financial Statements*.

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alternative 2b, ie to replace the current mechanics of fair value hedge accounting with the proposed ‘separate balance sheet item’ through OCI approach. Alternative 2b provides more transparency than alternative 2a resulting in the entire effect of all hedge accounting being presented in one place.

Question 1– Alternative approach to fair value hedge accounting

Does the Board agree with the staff recommendation to replace the current tentative fair value hedge accounting approach with the ‘separate balance sheet line item’ through OCI approach (ie alternative 2b)?

If not, why and what other approaches would the Board like the staff to further develop and why?

Appendix B

A1. Appendix B is an excerpt from appendix A of agenda paper 15 of the Board's September 2009 meeting. It presents the arguments for and against the Board's tentative approach.

Approach B2(ii) – permit recognition outside profit or loss of gains and losses on financial instruments designated as hedging instruments (an approach similar to cash flow hedge accounting)

Arguments for Approach B2(ii)	Arguments against Approach B2(ii)
<p>(a) the carrying amount of the hedged item would not be affected (with exception to the basis adjustment option for a hedge of a forecast transaction that results in the recognition of non-financial items).</p> <p>(b) this approach aligns cash flow hedge accounting and fair value hedge accounting resulting in a single method to hedge accounting.</p> <p>this approach results in more transparent information with all effects of risk management activities presented in OCI.</p>	<p>(a) this approach introduces artificial volatility in OCI.</p> <p>(b) deferral of gains and losses and recycling is required.</p> <p>(c) there is a need to track adjustments in equity to ensure that recycling occurs at the right time.</p> <p>(d) depending on the approach adopted, many restrictions that apply to cash flow hedge accounting today continue to be needed to ensure discipline.</p>