**IASB Meeting** | Agenda reference **8B**

Staff Paper | Date **Week beginning 19 July 2010**

Project **Financial Instruments: Replacement of IAS 39**

Topic **Hedge Accounting – linked presentation for fair value hedges**

## Introduction and purpose of this paper

1. This paper will be discussed only if the Board decides to follow alternative 2 or 3 in Agenda Paper 8A. This is because:

   (a) alternatives 2 and 3 result in the recognition of related assets and liabilities (for both the hedging instrument and the hedged risk) in the balance sheet; whereas

   (b) alternative 1, as a result of applying the cash flow hedge accounting mechanics, does not result in the recognition of assets and liabilities in the balance sheet *in relation to the hedged item* (ie only the hedging instrument is recognised as an asset or a liability). For example, a hedged firm commitment is not recognised as an asset or a liability.

2. The purpose of this paper is to determine if the Board wants to pursue linked presentation for fair value hedge accounting. If the Board decides to pursue linked presentation, the staff will present to the Board at a future meeting a separate paper to discuss *how* linked presentation should be done.

3. Agenda Paper 8C contains illustrative examples of the implications of each of the alternative approaches discussed in Agenda Paper 8A, together with illustrations of how linked presentation could apply. Agenda Paper 8D presents an alternative view to the recommendations in this paper.

***What is linked presentation?***

4. Linked presentation is a way of presenting information to show how particular assets and liabilities are related. Linked presentation is not the same as offsetting. This is because linked presentation displays the 'gross' amount of related items on the face of the balance sheet.

5. This paper looks at linked presentation for the balance sheet only. Below is an illustration of linked presentation:

| **Statement of financial position at 31 December 201X** | | |
|---|---|---|
| | | 201X |
| Hedged item | 100 | |
| Hedging instrument | (90) | |
| | | 10 |

6. This paper is structured as follows:

   (a) feedback received during outreach;

   (b) background;

   (c) staff analysis; and

   (d) staff recommendation.

## Feedback received during outreach

7. Linked presentation was raised during the staff's outreach activities on the hedge accounting project. This issue was specifically raised by Korean ship-building companies.

8. The issue, in summary, is that the Korean ship-builders enter into long-term sales contracts that are normally denominated in US dollars. These companies then enter into a corresponding forward exchange contract to hedge the foreign

currency risk against the Korean Won. The recognised firm commitment and currency forward contracts vary significantly in value because of the long-term nature of the contracts, their size and fluctuations in the foreign exchange rate. There are concerns given that this results in:

(a) large recognised assets and liabilities;

(b) significant balance sheet volatility; and

(c) volatility in key financial ratios

even though the entity has hedged its exposure of foreign currency risk.

9. The Korean ship-building industry is particularly concerned about the magnitude of the liabilities being recognised. This is because these entities appear more risky because of the large liabilities when compared to other international shipbuilders. The Korean shipbuilders believe that the balance sheet should reflect the fact that they have hedged this risk and that linked presentation is one way of doing this.

10. Other concerns include that the balance sheet does not provide sufficient information to users to allow them to assess an entity's future cash flows. Specifically, the concern is that the balance sheet is not necessarily reflecting the hedging activities the entity undertakes. This is because the hedged item and hedging instrument cannot be presented together on the face of the balance sheet to indicate the relationship and the 'net' exposure of the entity after hedging.

11. The staff received a suggested approach to presentation from the Korean shipbuilding industry. The proposed presentation makes use of linked presentation to convey information regarding the hedging activities, their effectiveness and the entity's future cash flows (refer to Agenda Paper 8C for examples illustrating the effects of linked presentation).

12. The supporters of linked presentation argue that it has the following advantages:

(a) it puts the magnitude of the assets and liabilities into perspective by showing in the balance sheet that they are related;

(b) it reduces volatility in assets and liabilities and key ratios such as the debt to equity ratio have greater stability;

(c) it better reflects the economic substance of hedging;

(d) the hedging instrument reflects the entity's reduction of the uncertainty in the future cash flows from the hedged item;

(e) it eliminates the 'non-recurring' fair value changes on derivatives from the balance sheet (based on the net amount); and

(f) it provides useful information on the effectiveness of the hedge relationship (in other words, the larger the difference between the hedged item and the hedging instrument, the less effective the hedge relationship is; this would be an indicator of the speculative nature of the hedge relationship).

13. Supporters of the linked presentation approach acknowledge that this approach results in an asset (or liability) being recognised on the wrong side of the balance sheet. However, they believe that context can be provided in the notes to the financial statements.

## Background

### *Linked presentation vs offsetting*

14. IFRSs address offsetting in the following standards:

(a) In accordance with IAS 32 *Financial Instruments: Presentation*, financial assets and financial liabilities shall generally not be offset. However, the net amount is presented in the statement of financial position when, and only when, an entity:

(i) currently has a legally enforceable right to set off the recognised amounts; and

(ii) intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.

(b) IAS 1 *Presentation of Financial Statements* also states that an entity shall not offset assets and liabilities or income and expenses, unless required or permitted by an IFRS.

15. Linked presentation is different from offsetting in two respects:

    (a) it provides the gross amounts of the assets and liabilities being linked on the face of the balance sheet (which offsetting does not provide).

    (b) linked presentation provides information about the relationship between specific assets or liabilities. Offsetting portrays the fact that an entity has the right to offset amounts and the intent to do so and that it is, in effect, a single asset (or liability).

***Past decisions by the Board on other projects with regard to linked presentation***

16. The Board discussed linked presentation in other projects in the past. Below is a summary of the nature of the discussion and the decisions made by the Board.

17. *Employee benefits*. The Board discussed linked presentation as part of its amendments to plan assets when it revised the definition in 2000. The Board considered the possibility of adopting a 'linked presentation' that UK Financial Reporting Standard FRS 5 *Reporting the Substance of Transactions*, requires for non-recourse finance. Under FRS 5, the face of the balance sheet presents both the gross amount of the asset and, as a direct deduction, the related non-recourse debt.

18. The Board decided not to adopt this approach because of the possible confusion it could create given this form of presentation was not used in other IASs.

19. *Derecognition*. During its deliberations the Board considered whether linked presentation should be applied for financial assets that are transferred but not derecognised and associated liabilities that have been recognised.

20. The Board tentatively decided that linked presentation could be used in disclosures in the notes of the financial statements to provide information about the relationship between the transferred financial asset not derecognised and the

associated liabilities. The Board decided to use linked presentation *solely in the notes* because of practical difficulties regarding the measurement of the related asset and the liabilities and the doubtful usefulness of the resulting net number on the face of the balance sheet.

21. *Leases*. The IASB and FASB jointly discussed the presentation of the lessor's leased assets in accordance with the performance obligation approach to lessor accounting. Under this model the lessor would recognise an asset representing its right to receive rental payments and a liability representing its performance obligation under that lease (see Agenda Paper 9G of the March 2010 joint meeting).

22. The boards tentatively decided that the lessor would present the leased asset, the lease receivable, and the performance obligation separately in the statement of financial position totalling to a net lease asset or a net lease liability. The Board decided on linked presentation mainly because the difference (net) between the leased asset, the lease receivable and the obligation to perform results in a combined lease asset or liability. However, it is important to note that the leased asset, the lease receivable and the obligation to perform, all relate to the same contract. In other words, one legal agreement is disaggregated into several different units of account for financial reporting purposes.

23. The primary purpose of linked presentation is to portray some sort of relationship (or link) between specific assets and liabilities. However, there is no clear principle behind linked presentation, ie under what circumstances or for what sort of relationship it is appropriate for certain assets and liabilities to be linked and how they should be linked (ie whether it should be presented on the face of the balance sheet or disclosed in the notes). Each project discussed linked presentation with different objectives in mind. Therefore, the Board will have to discuss linked presentation separately in the context of hedge accounting as the decisions it has reached on other projects are not helpful as analogies to determine whether or not linked presentation should be applied (given the absence of a clear principle).

## Staff analysis

### *Linked presentation and risk*

24. Consider the following example: an entity has an asset (hedged item) exposed to a foreign currency risk and a financial liability (hedging instrument) exposed to the same foreign currency risk. If an entity applies linked presentation for the hedged risk (ie foreign currency risk), the entity would present the gross value of the asset and financial liability in the balance sheet subtracted from each other. However, this net number is not a 'closed position' regarding *all* the risks of the related asset and liability but only regarding a portion of the risk (ie the hedged risk component of foreign currency risk). In this example, the entity is exposed to the credit risk of the counterparty to the asset. In other words, the entity still carries the risk of the counterparty to the asset defaulting. Considering the magnitude of the numbers, this credit exposure is significant.

25. Moreover, the degree of offset of the changes of the asset and the related liability might differ for other reasons than solely credit risk. For example, if the currency risk does not relate to the same currency but a currency that usually moves in tandem (eg so called 'pegged currencies') the relationship of movements between the two currencies might change over time. The net amount of the asset and the liability would not reflect that risk. Hence, a net amount does not allow users to identify the total amount of assets and liabilities that are open to different exposures.

26. One could argue that linked presentation does not result in a loss of information. This is because the gross amounts are still presented on the face of the balance sheet and users will still be able to assess the exposure to, for example, credit risk in the example above.

27. However, the staff thinks that while linked presentation provides some information about a special relationship between an asset and a liability it does *not* differentiate by the risk components covered by that relationship. This is because linked presentation would result in one net amount for the related asset

and liability that are ‘linked’ and thus determines the totals for assets and liabilities on the face of the balance sheet even though the relationship affects eg only one risk component.

### *Financial ratios and analysis*

28. The balance sheet is inherently limited in that it only captures the recognised assets and liabilities. It does not provide information regarding the relationship that exists between specific assets and liabilities.

29. In the example presented to us by the Korean ship-building companies, some argue that the entity’s ‘real’ exposure is the net difference between the hedged item and the hedging instrument. They argue that entering into forward contracts *reduces* foreign currency risk but the entity’s financial position appears more risky than if it had not hedged its exchange rate exposure.

30. People that agree with this argument believe that the ‘net’ amount in the balance sheet (even though the gross amounts are displayed on the face of the balance sheet) would be the correct number to use for financial analysis. In other words, when ratios are calculated it will be done based on the difference between the hedged item and the hedging instrument (ie the net amount) rather than on the gross amount of each of these items separately. The examples in agenda paper 8C illustrate how the debt to equity ratio differs depending on whether linked presentation is applied.

31. However, not everyone shares this view. Many believe that the separate gross asset or liability (or gross leverage position) should not be ignored in financial analysis even if they are hedged. In essence, the outcome of linked presentation could eg in case of a firm commitment hedged for foreign currency risk be considered close to ‘synthetic accounting’.

32. For example, if an entity hedges a position, the movements in the asset should largely offset the movement in the liability. However, this assumes that the counterparties to both the hedging transaction and the hedged item do not

default. Therefore, because of credit risk, many believe that the amounts should not be excluded when comparing total debt to equity.

33. Irrespective of the information provided on the face of the balance sheet, users have different views on financial ratios and the items that should or should not be included in their analyses.

34. Therefore, the staff thinks that it is *not* appropriate for linked presentation to be used because of the possible effects on ratio analyses. Rather, disclosures about hedging activities should be done in such a way that allows users to assess the relevance of the information for their analyses. This approach reflects that different types of assets and liabilities, and any interrelation between them, can have a different effect in terms of leverage but that some form of leverage exists. Rather than the Board determining in general and for all users how relevant each type of leverage is, that would be left to each user to decide according to their own purposes and views.

## Staff recommendation

35. The staff recommends the Board not allow linked presentation for fair value hedges on the face of the balance sheet for the reasons set out in paragraphs 14 to34. The staff recommends that the Board consider disclosures about the relationship (or link) between the hedged item and the hedging instrument as part of its discussion of disclosures for hedge accounting.

36. Some staff have expressed an alternative view to this recommendation. The alternative view is presented in agenda paper 8D.

| Question |
| --- |
| Does the Board agree with the staff recommendation in paragraph35?<br><br>If not, why not and what would the Board propose instead? |