Project	**Financial Instruments: Replacement of IAS 39**
Topic	**Hedge accounting - linked presentation, alternative view**

1. I disagree with the project team's recommendation on the question of linked presentation. Rather than attempting to incorporate my views in their paper, they asked me to prepare a short paper outlining my reasons for disagreeing.

2. In my view, allowing a linked presentation of firm-commitment hedges would improve the presentation of the assets and liabilities that result from these hedges. It follows that I do not agree with the proposal to apply cash-flow hedge accounting to these hedges. This paper thus mixes two arguments about firm commitment hedge accounting – (1) that we should change IAS 39 to allow linked presentation and (2) that cash-flow mechanics are not an appropriate answer. I apologise in advance for the mixture.

3. As the project team paper observes, linked presentation is a question of *presentation.* It does not involve questions of recognition and measurement. It is not the same as offsetting, which recognises the offset (that may never occur) of an asset against a liability, and reports a single amount in the statement of financial position. It is not the same as a measurement that incorporates inflows and outflows in a single measurement. It is a technique that gives exactly the same information as an "unlinked" presentation, but shows an asset and a liability that are significantly related in proximity with one another.

4. The distinction is important because many previous Board discussions have confused the point. Some Board members have, mistakenly in my view, characterized linked presentation as "offsetting under a different name." Many of the arguments in those discussions are germane to offsetting, and might be persuasive in that setting. But this isn't a discussion of offsetting.

Linked Presentation – Alternative View

Why Firm Commitment Hedging?

5. One might make an argument that linked presentation would be an improvement for all fair value hedges. I am not making that argument. Instead, I see the presentation as a solution to the particular circumstances that arise in hedges of firm commitments.

6. The original IAS 39 required firm commitments to be accounted for as cash flow hedges. Paragraph 140 of the original standard said:

> A hedge of a firm commitment in an enterprise's own reporting currency is not a hedge of a cash flow exposure but rather of an exposure to a change in fair value. Nonetheless, such a hedge is accounted for as a cash flow hedge under this Standard, rather than as a fair value hedge, to avoid recognising as an asset or a liability a commitment that otherwise would not be recognised as an asset or a liability under current accounting practice.

7. The Board reversed this position in the 2003 amendments to IAS 39. As I recall, Harry Schmidt was especially passionate in his view that fair-value hedge accounting should be permitted.

8. The accounting for hedges of a firm commitment is a strange animal. It is like a cash-flow hedge, because the item being hedged is not reported on the balance sheet. It is like a fair-value hedge, because the exposure could be described as variability in the fair value of an existing asset (the firm commitment), albeit an asset that is not recognized. Fair value hedge accounting represents the part of the cost of the firm commitment that has been recognised as a result of other transactions or events. In this case, the event in question is the change in the value of a derivative. The Board explained the analysis on this point in paragraph BC 152 of IAS 39.

9. Firm-commitment hedge accounting is not especially troubling until three things happen together:

   (a) An entity hedges all or most of the currency risk in firm commitments;

   (b) The commitments are very large and very long (like building a ship), and

   (c) The entity's presentation currency has moved by a significant amount relative to the hedged currency.

10. This is the confluence that confronted the Korean Shipbuilders, who first raised this issue with the IASB. It would be a mistake, though, to regard this as a narrow industry and country-specific issue. I did some research into currency movements as background for the potential post-2011 currency project. The table below shows 2008 percentage changes relative to the US dollar for six currencies.

Brazilian Real	-32.80%
Canadian Dollar	-24.52%
Indian Rupee	-26.08%
South African Rand	-38.08%
South Korean Won	-35.16%
United Kingdom Pound	-37.95%

11. An entity reporting in any of those currencies could have encountered the same problem raised by the Korean Shipbuilders and the KASB. The particular problem faced by the Korean Shipbuilders is perhaps the perfect storm. They agree that the fair value hedge accounting prescribed in IAS 39 appropriately shows the effect of the hedging on profit and loss. The resulting balance sheet, however, is dominated by the fair values of the hedging instrument and hedged firm commitment. The Shipbuilders argue that this distorts other balance sheet relationships.

12. They find the alternative even worse, and I agree. Presenting the change in fair value of the hedging instrument in other comprehensive income would leave most of these companies with a shareholders' deficit – a net debit in the equity section of the balance sheet. I find it hard to justify that result as either a simplification or an improvement in financial reporting.

Why Linked Presentation?

13. Neither IAS 39 nor cash-flow hedge mechanics provide a complete answer for firm-commitment hedges. Both achieve their accounting objective in the

measurement of profit and loss, but at the expense of the balance sheet. When recognition and measurement fail, we turn to presentation and disclosure.

14. In this case, we have two items that meet the *Framework* definitions of asset and liability. They are distinct, in that they will be realised in different ways and involve different counterparties. At the same time, they are related in that the gains and losses from the accounting for one are recognised as the cost of the other. Linked presentation would portray that relationship in the balance sheet, while preserving the separate character of the asset and liability.

15. The project staff observe that linked presentation changes two key metrics – total assets and total liabilities. They also observe that the asset and liability share only one risk, usually currency. The remaining risks, including the counterparty’s ability to perform on the derivative and the entity’s ability to deliver or receive the committed item are separate. They question whether linked presentation might create a mistaken impression that these other risks counterbalance each other.

16. I agree that those are concerns that the Board should consider. They go to what I consider the heart of the question on linked presentation. How do we portray an asset and a liability that are closely related to one another, but not so closely as to justify collapsing them into a single item? That is certainly a question for broader discussion some day, but we have a problem right now. The project team recommends against linked presentation, and I respect their analysis. I recommend in favour because I think it would help users to understand the relationship between hedged and hedging item.