Hedge accounting (general questions)

1. **What is hedge accounting?**

   - Hedge accounting is a mechanism that allows entities to reflect the results of some risk management activities in the financial statements. This is achieved by changing the timing of the recognition of gains and losses to enable the link between a hedged risk and the instrument providing the hedge to be reflected.

   - For example, an entity may have financial instruments that give rise to some exposure to risks, such as foreign exchange risk, interest rate risk or the price of a commodity. The entity may choose to manage those risks by purchasing another financial instrument (such as a derivative) to offset the risk exposure. Hedge accounting allows the link between these items to be shown.

   - An example would be a company that is exposed to changes in the price of oil and is concerned that its costs will increase if the price of oil increases. To protect against the risk of an increase in oil prices, the company buys a derivative, in this case call options linked to the price of oil. Then, if the price of oil increases the company will benefit from that price increase. Therefore, rises in the future price of oil will be offset by changes in the value of the derivative, allowing the entity to mitigate the risk exposure.

   - Since the derivative and the exposure are related to each other, hedge accounting is a financial reporting tool that is used to show the relationship between those instruments and the offsetting effect they have on each other.

2. **Where are we in the hedge accounting phase?**

   - The Board has now completed its deliberations on the general model for hedge accounting and has published an exposure draft on the general model.

   - This exposure draft forms part of the third phase of the project to replace IAS 39 *Financial Instruments: Recognition and Measurement*. When confirmed the new requirements will be incorporated into IFRS 9 *Financial Instruments*, replacing the general hedge accounting requirements in IAS 39.

   - The objective of this exposure draft is to help the users of financial statements to understand risk management activities and to assess the amounts, timing and uncertainty of future cash flows.

   - Phase one of the project comprised the classification and measurement requirements for financial instruments, which are now included in IFRS 9. Phase two deals with the amortised cost and impairment of financial assets.

- The Board is still discussing portfolio hedge accounting, and expects to decide on the next steps in due course. Until that stage is concluded, the requirements in IAS 39 will continue to apply.
- The Board encourages all interested parties to respond to the exposure draft on the general model because their responses will inform the deliberations on the portfolio hedge accounting model. However, the Board is not limited by the decisions it has made on the general hedge accounting model and may well make changes to it if necessary to accommodate portfolio hedge accounting.
- The Board aims to issue the hedge accounting standard in H1 2011.

3. How comprehensive is the IASB's hedge accounting review?

- The IASB project on hedge accounting is comprehensive, encompassing hedging of financial and non-financial items and portfolio hedge accounting.
- This project responds to the overwhelming view received by the Board that the current hedging model is not consistent with risk management. The Board conducted extensive outreach activities and used the information received in developing the general model.
- With the general model, the Board aims to strengthen the link between accounting and risk management, making it possible for some of the hedging strategies most commonly used, which are not eligible for hedge accounting at present, to qualify under the proposals.

4. What are the major changes proposed in the exposure draft?

- The proposed model would amount to a major overhaul of the existing hedge accounting requirements. It seeks to help management to communicate the entity's risk management activities and their effectiveness. The proposal also seeks to align accounting treatment with the economics of risk management.
- The greatest changes are:
    i. Eligibility of hedged items – the proposal permits designation of components of non-financial instruments.
    ii. Eligibility of hedging instruments – the proposal addresses concerns about the treatment of options designated as hedging instruments.
    iii. Groups and net positions (except macro hedging) – the proposal will expand hedge accounting for particular groups and net positions.
    iv. Effectiveness testing – the proposal replaces the 80-125 per cent effectiveness threshold with a qualitative requirement based on the assessment of hedges undertaken for risk management purposes.

v. Discontinuation (ie under which circumstances hedge accounting must be stopped)

vi. Fair value hedge accounting – the mechanics will change so that users can better understand the carrying amount of items that have been hedged and information about the hedges will be contained in other comprehensive income as for cash flow hedges.

vii. Disclosures – the proposal requires entities to present a clear view of their hedging activities so that users can understand the implications for future cash flows.

5. Will users be able to understand the impact of companies' hedging activities and how effective they are?

- The exposure draft proposes a new set of disclosures specifically designed for hedge accounting. The disclosures aim to provide users with a better insight of the company's hedging activities and the impact on the financial statements of the risks being hedged. This will also help users predict future cash flows.

6. How is a model that focuses on risk management different from the existing hedge accounting requirements?

- The hedge accounting requirements in IAS 39 were developed in an economic climate when hedging activities were relatively new and not as widely understood. The Board was concerned about management using hedge accounting with an earnings management view. To address this concern, the hedge accounting requirements in IAS 39 are rule-based and restrictive.

- Hedging various risks and components of items has become common business practice and users have said that they want to be able to understand the risks an entity faces, what management is doing to manage the risks, and how effective risk management strategies are. The proposal is drafted with the objective of helping management communicate this information to users.

7. Why has it taken so long to produce an exposure draft on hedge accounting?

- Early comments on hedge accounting urged the Board to address hedge accounting comprehensively. This required extensive outreach activities and more time for the Board to understand the issues raised. The Board's primary objective is to address the issues appropriately and provide a clear and substantiated rationale for the decisions taken.

- During outreach activities, respondents said that it was more important for the IASB to take the time necessary to 'get it right', than to meet pressing deadlines.

- The IASB plans to complete the requirements for general hedge accounting in H1 2011.

8. Why does such a complex and comprehensive exposure draft have a short comment period?

- The Board remains committed to completing the general model for hedge accounting in H1 2011.
- Even before the exposure draft is published, constituents will have a clear understanding of what it will contain. To support those wishing to respond, Board members and staff will continue their extensive outreach activities and provide additional materials, such as illustrative examples, podcasts, webcasts and PowerPoint presentations. See the project page for further details.

9. What will be the effective date for the new requirements?

- For consistency with IFRS 9, the Board is proposing that the requirements should be effective for periods beginning on or after 1 January 2013 with earlier application permitted.
- The Board is proposing prospective application with no requirement to restate the comparative information.
- The Board will consider comments on the effective date and transition requirements proposed in the exposure draft in addition to the comments received on the consultative document *Request for Views on Effective Dates and Transition Methods* when finalising these proposals.

10. If an entity wants to adopt the new requirements, does it have to change the way it accounts for financial assets and financial liabilities under IFRS 9?

- The proposals on hedge accounting will not change the classification and measurement criteria for financial assets and financial liabilities in IFRS 9.
- The exposure draft proposes that if an entity wants to adopt hedge accounting it will also need to adopt the classification and measurement rules that are already contained in IFRS 9.

11. Will the changes to hedge accounting include a solution to the existing EU carve-out?

- The Board decided to look first at hedging of financial instruments, secondly at hedging of non-financial items and then at portfolio hedge accounting.
- In view of the extreme complexities surrounding portfolio hedge accounting, it makes sense to leave portfolio hedge accounting until last so as to build on the concepts developed in the earlier phases. Although the

exposure draft does not address portfolio hedge accounting, the Board has already starting discussing aspects of it.

- The Board would like to reach a position where the EU carve-out can be removed, but it is too early to say what the outcome will be. However, the IASB has been undertaking outreach activities on this issue with interested parties.

12. Why doesn't the exposure draft include proposed requirements for macro portfolio hedging?

- The Board has already made numerous important decisions about the general hedge accounting model that would amount to a substantial change in hedge accounting, and it would like to receive constituents' views on those decisions. The general model may have a significant impact on the portfolio hedge accounting model. The Board therefore decided to expose the general model for hedge accounting so that it can take into consideration the comments received on the general model when developing the portfolio hedge accounting model.
- The Board understands that many are keen to address the issues arising from portfolio hedge accounting. However, it believes that it needs to obtain comments on the general model for consideration as part of the portfolio hedge accounting model.
- The Board is not ruling out the possibility of adjusting the general model as a result of its deliberations on the portfolio model.

13. Will the IASB achieve convergence with US GAAP on hedge accounting?

- The projects on hedge accounting being undertaken by the IASB and the US Financial Accounting Standards Board (FASB) have different objectives and scope.
- In May 2010 the FASB published a draft Accounting Standards Update (ASU) as part of its comprehensive project to revise the accounting for financial instruments. This ASU was focused solely on financial instruments and proposed *some* changes to hedge accounting. No specific changes were proposed for hedge accounting of non-financial exposures.
- The FASB ASU proposes some changes to the hedge accounting requirements in US GAAP, whereas the IASB is undertaking a comprehensive review of its hedge accounting model.
- The FASB is considering the comments received on its proposed model and has not started redeliberating hedge accounting.
- It is still unclear whether the FASB will solicit feedback on the IASB's proposed model.