December 2010

Exposure Draft

Snapshot: Hedge Accounting

This snapshot is a brief introduction to the exposure draft *Hedge Accounting*. It provides an overview of the main proposals developed by the International Accounting Standards Board (IASB).

Project objectives:	To improve the ability of investors to understand risk management activities and to assess the amounts, timing and uncertainty of future cash flows. The proposals will replace the rule-based hedge accounting requirements in IAS 39 *Financial Instruments: Recognition and Measurement* and more closely align the accounting with risk management activities.
Hedge accounting proposals:	The exposure draft (ED) contains proposals on the accounting for hedging activities. When finalised, the new hedge accounting requirements will be added to IFRS 9 *Financial Instruments*. In addition to the general hedge accounting proposals in the ED, the IASB is discussing portfolio hedge accounting.
Next steps:	During the comment period the IASB will undertake further outreach to seek views on these proposals. Upon completion of those consultations the IASB will redeliberate these proposals to finalise them in the first half of 2011.
Project to replace IAS 39:	Hedge accounting represents the third phase of the project to replace IAS 39. The first phase dealing with classification and measurement for financial instruments has been completed while the second phase dealing with impairment is ongoing.
Comment deadline:	9 March 2011.

The snapshot has been prepared by staff and is not an official technical document of the IASB.

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An overview of hedge accounting

What is the objective of hedge accounting?

The objective of hedge accounting is to represent in the financial statements the effect of an entity's risk management activities that use financial instruments to manage exposures arising from particular risks that could affect profit or loss (P&L).

The existing hedge accounting requirements are contained in IAS 39.

Why use hedge accounting?

An entity uses hedging to manage risks, for example, foreign exchange risk, interest rate risk or the price of a commodity. It may choose to apply hedge accounting to show the effect of managing those risks in the financial statements.

Why change the hedge accounting requirements?

The existing hedge accounting requirements in IAS 39 were developed when hedging activities were relatively new and not as widely understood as they are today.

However, hedging risks and components of items has become common business practice and investors have said they want to be able to understand the risks an entity faces, what management is doing to manage those risks, and how effective those risk management strategies are.

Many investors believe that the current IAS 39 hedge accounting requirements are not adequate for these purposes. As a result, investors often use non-audited (pro-forma) information to understand risk management. Investors, and others, also believe that the present requirements are arbitrary and too rule-based, and they argue for a closer alignment with risk management.

Reflecting risk management appropriately

Many believe that IAS 39 does not allow entities to adequately reflect their risk management practices. For example, there are instances where hedge accounting cannot be applied to groups of items, whereas for risk management purposes items are often hedged on a group basis. Also, IAS 39 does not allow components of non-financial items to be hedged but entities usually hedge components of such items.

Complexity and confusion in cash flow hedges

Some believe that the distinction in IAS 39 between cash flow hedges and fair value hedges adds complexity and is confusing.

Insufficient disclosures

Others believe that the disclosure requirements do not provide sufficient information in the financial statements about an entity's risk management activities.

What are we proposing?

The ED proposes requirements that will enable companies to reflect their risk management activities better in the financial statements. This will help investors to understand the effect of hedging activities upon the financial statements and future cash flows.

The Board is seeking views on the general hedging model first, while continuing to discuss portfolio (macro) hedge accounting.

Building on the proposals in the discussion paper

The ED builds on proposals contained in the IASB's discussion paper *Reducing Complexity in Reporting Financial Instruments* published in March 2008. In developing the ED the IASB considered input from:

- the comment letters received on the discussion paper
- extensive consultation with interested parties, including auditors, regulators, investors and preparers across different jurisdictions and industries.

Closer alignment with risk management

The proposed model will more closely align hedge accounting with risk management activities undertaken by companies when hedging their financial and non-financial risk exposures.

The ED proposes that entities will often use information produced internally for the purpose of risk management as the basis for hedge accounting.

Enhanced presentation and disclosure

The ED proposes comprehensive disclosures focusing on the risks that entities are managing, how they are managing those risks and the outcomes of that risk management activity, including the effect on the financial statements. This is to help investors to understand better the extent and effect of companies' hedging activities and to assist them in forecasting future cash flows.

In addition the ED proposes changing the mechanics of fair value hedge accounting so that the remeasurement of the hedged item is presented separately. It is also proposed that information about fair value hedges (like cash flow hedges) is reflected in other comprehensive income (OCI). This will improve transparency for investors by including all information about hedging in OCI.

A new model for hedge accounting

As an overall objective, the ED proposes a model for hedge accounting that aims to align accounting with risk management activities.

The proposed model combines a management view that aims to use information produced internally for risk management purposes and an accounting view that seeks to address risk management issue of the timing of recognition of gains and losses.

This will provide investors with more useful information and will allow entities to use risk management information as a basis for hedge accounting.

Risk management objective

Seeks to link risk management and financial reporting (top down)

Accounting objective

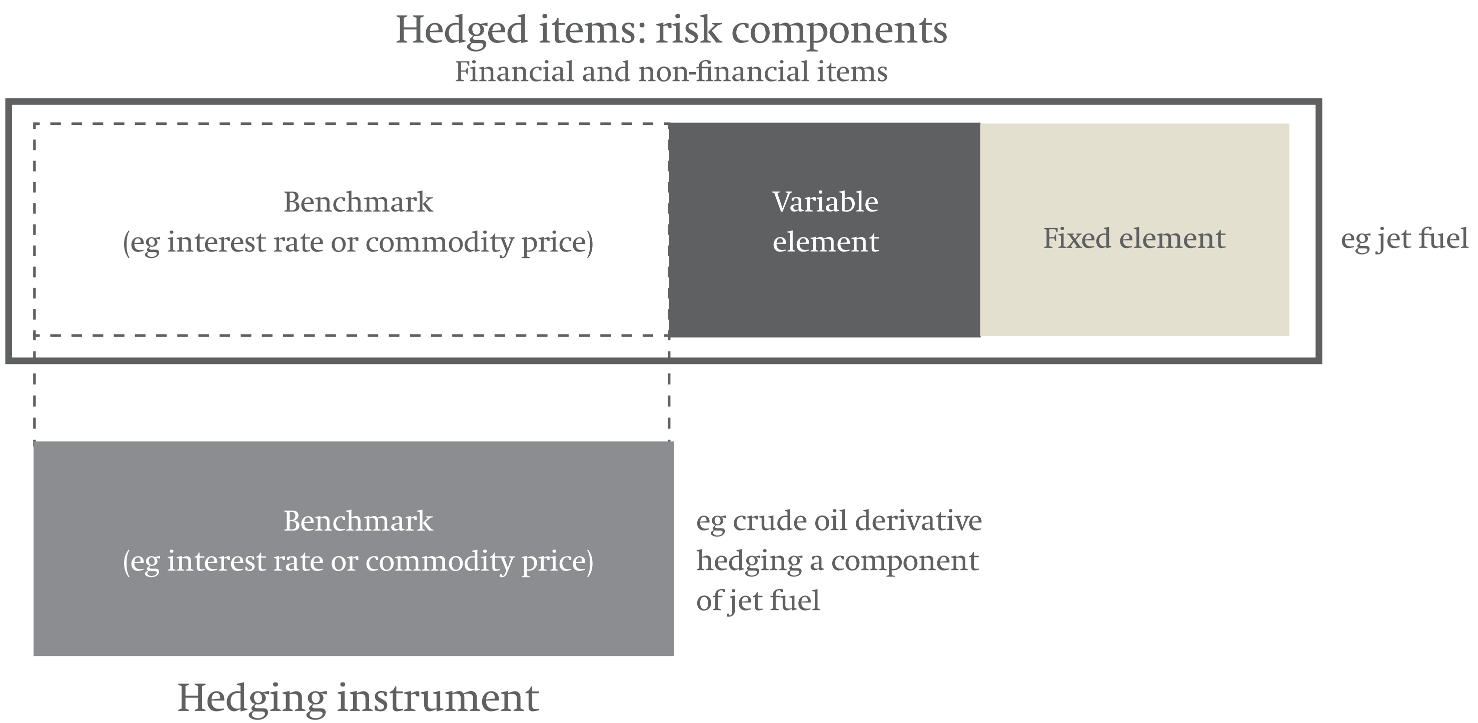
Seeks to manage timing of recognition of gains or losses (bottom up)

Better alignment to risk management activities

IAS 39 allows components (parts) of *financial items* to be hedged, but not components of non-financial items[1].

An example of a risk component in a financial item is the LIBOR risk component of a bond. However, risk managers often hedge a risk component for *non-financial items* as well, for instance, the oil price component of the jet fuel price exposure. This is an important issue for many companies.

The ED proposes to eliminate this distinction. As a principle-based approach, the proposed requirements would look only at whether a risk component can be identified and measured, as opposed to determining what can be hedged by *type* of item. This would enable entities to apply hedge accounting that reflects their risk management activities.

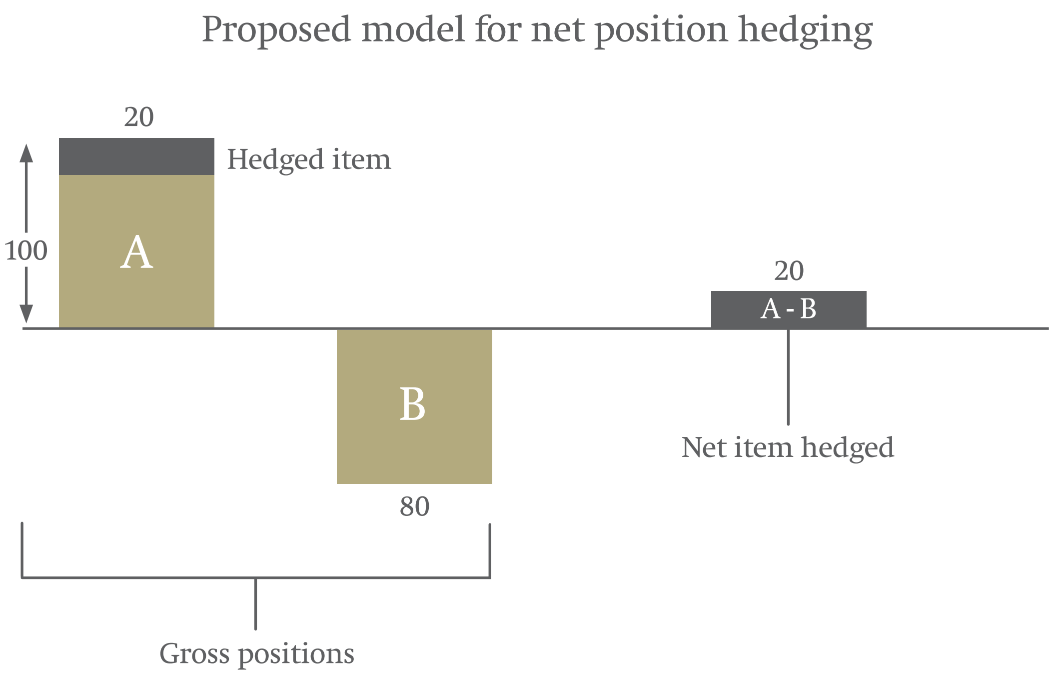


1 Except foreign currency risk.

A new approach to net positions

IAS 39 does not allow net positions to be hedged. However, companies often hedge net positions; for example, they may hedge a net foreign exchange position of 20 that is made up of an asset of 100 and a liability of 80. This creates an inconsistency between hedge accounting and risk management activity.

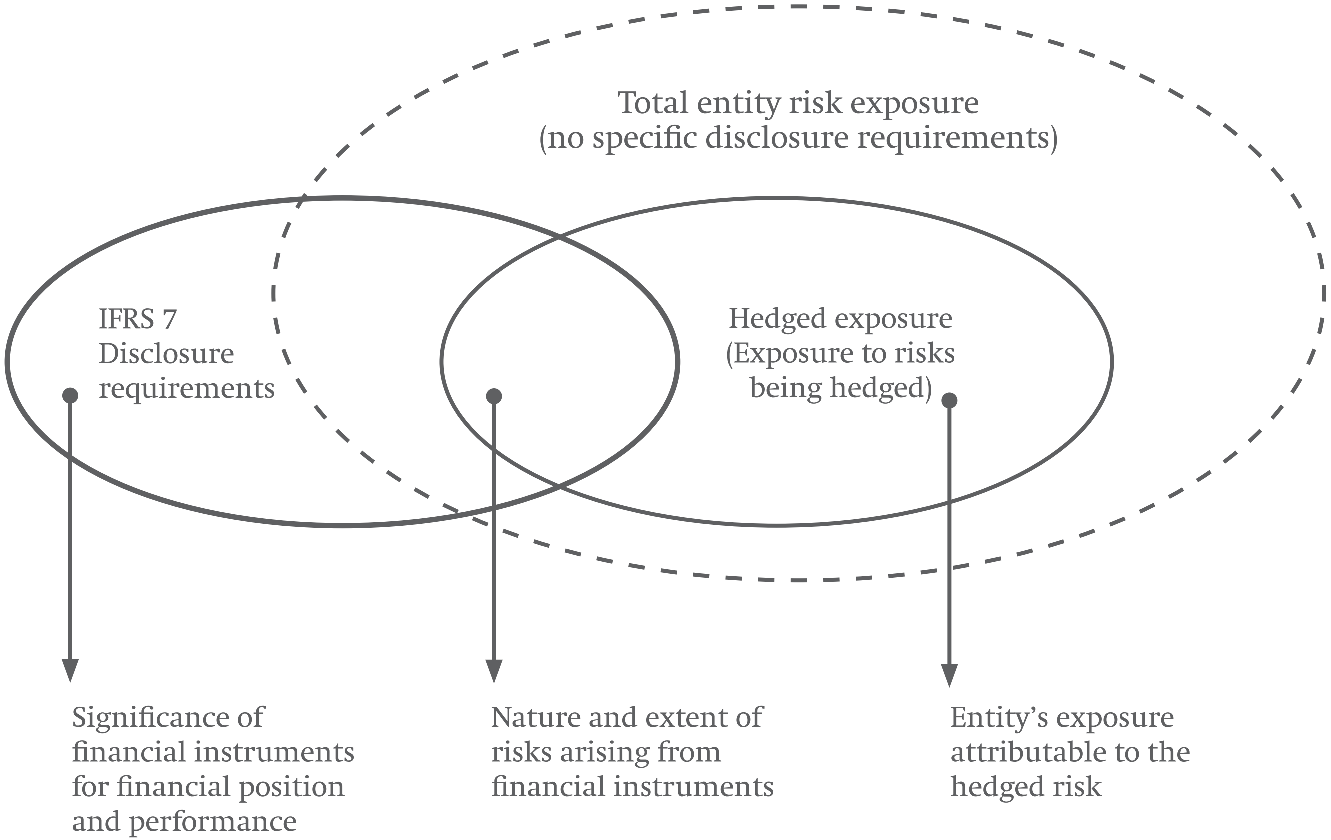
The ED proposes extending the use of hedge accounting to net positions and, thereby, improving the link to risk management.



A comprehensive set of disclosures

Hedge accounting today focuses on an entity's *hedging instruments*. The ED proposes a comprehensive set of new disclosures that focus on the *risks being hedged*, how those risks are being managed and the effect of hedging those risks upon the primary financial statements.

This is in response to the feedback we have received from investors who want to be able to have a better understanding of the performance of the entity's risk management activities and the effect of risk management on an entity's future cash flows.



Other issues

Premium paid for options

Hedge accounting in IAS 39 treats part of the value of a purchased option (the part that reflects time value)[1] as if it was a derivative held for trading purposes. This creates volatility in P&L. However, when hedging, risk managers view the time value premium paid as a cost of hedging rather than a speculative trading position.

The ED proposes that the time value premium should be treated as a cost of hedging, which will be presented in OCI. Therefore, this will decrease inappropriate volatility in P&L and be more consistent with risk management practices.

Adjusting hedging relationships

IAS 39 sets a high hurdle before hedge accounting is available. It also sets a high hurdle for hedge accounting to continue. These hurdles result from a strict quantitative test, and the accounting consequences of failing this test are drastic. This is widely criticised as being arbitrary and for causing hedge accounting not to be available or to stop when a hedge is a good one economically.

The ED proposes to base qualification for hedge accounting on how entities design hedges for risk management purposes. The ED also proposes that hedging relationships can be adjusted without necessarily stopping and potentially restarting hedge accounting.

This enables hedge accounting to better reflect risk management activity, which often requires adjustments to hedges to accommodate changes in market conditions.

1 The time value of a purchased option reflects the cost of obtaining a one-sided protection that protects an entity against the downside risk while giving participation on the upside. The time value of the option reflects in substance the probability that the entity will make use of its right to the downside protection.

IFRSs and US GAAP

The IASB and the US Financial Accounting Standards Board (FASB) have a joint project to improve accounting for financial instruments and a shared objective of improving comparability internationally on the accounting for financial instruments. The boards' efforts to develop a common and improved financial instruments standard have been complicated by different project timetables established to respond to their various stakeholders.

The FASB published a draft Accounting Standards Update (ASU) as part of its comprehensive project to revise accounting for financial instruments. The draft ASU proposed changes to classification and measurement, impairment accounting and hedging. It was focused solely on financial instruments, and proposed some limited changes to hedge accounting. The IASB's project on hedge accounting is a comprehensive re-examination of hedge accounting, covering hedging of both financial and non-financial exposures. Hence, the hedging projects have a different scope.

The FASB is considering the feedback received from its constituents on its proposed ASU and will decide shortly on the next steps for its financial instruments project and whether it will directly ask for views on the IASB ED.

What happens now?

During the comment period Board members and staff will undertake outreach activities to discuss the proposals with a wide range of interested parties.

These outreach activities will include:

- discussions with investors, preparers of financial statements, audit firms, regulators, national standard-setters and other interested parties.
- workshops
- webcasts, podcasts and presentations.

How can I comment on the proposals?

The ED includes questions on the proposals. Respondents may choose to answer all or only selected questions and are welcome to comment on any other matter that they think the IASB should consider in finalising the proposals. Comment letters will be posted on the IASB's website.

The IASB will carefully consider all responses and will discuss them in public meetings. The IASB plans to issue the new standard in mid-2011.

The deadline for comments is 9 March 2011.

Stay informed

The IASB will announce on its website the dates of any meetings at which it discusses the feedback on the ED.

To stay up to date about the project, you can also subscribe to email alerts on the IAS 39 replacement project page.

To view the ED, submit your comments or subscribe to email alerts on this project, visit www.ifrs.org.

The IASB will publish a feedback statement as an accompanying document to the standard to show how the Board responded to views received during the consultation process.

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