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Project	<b>Accounting for Hedging Activities</b>
Topic	<b>Summary of Constituent Feedback and Discussion of Risk Management, Financial Reporting and the Interaction Between the Two in Relation to the Reporting of Hedging Activities</b>

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## Purpose of this paper

1. At the December 16, 2009 joint International Accounting Standards Board (IASB) and Financial Accounting Standards Board (FASB) education session, the staff will present to the Boards a summary of:
  - (a) outreach activities conducted by the IASB staff in the past 2-3 months and by the FASB staff when the FASB was working on its hedging project,
  - (b) comments received on the Discussion Paper, *Reducing Complexity in Reporting Financial Instruments* (March 2008), and
  - (c) comments received on the FASB Exposure Draft, *Accounting for Hedging Activities* (June 2008).
2. This paper will also discuss risk management, financial reporting and the interaction between the two in relation to the reporting<sup>1</sup> of hedging activities.

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<sup>1</sup> “Reporting of” hedging activities is used instead of “accounting for” hedging activities to reflect that the informational needs of users could be satisfied through disclosures of hedging activities in addition to recognition and measurement in the financial statements.

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This paper has been prepared by the technical staff of the FASB and the IASCF for discussion at a public meeting of the FASB or 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 FASB or the IASB.

Comments made in relation to the application of U.S. GAAP or IFRSs do not purport to be acceptable or unacceptable application of U.S. GAAP or IFRSs.

The tentative decisions made by the FASB or the IASB at public meetings are reported in FASB *Action Alert* or in IASB *Update*. Official pronouncements of the FASB or the IASB are published only after each board has completed its full due process, including appropriate public consultation and formal voting procedures.

## Summary of Outreach Activities and Comment Letters on the Discussion Paper and the FASB's Exposure Draft

3. Many of the outreach discussions related to specific requirements of the existing hedge accounting model. However, one recurring theme is the lack of an overarching principle to today's requirements. This concern was also raised in comment letters to the discussion paper *Reducing Complexity in Reporting Financial Instruments*. Many have indicated that a principle-based approach to hedge accounting should be considered by the Boards. In addition, it is clear that many users of financial statements do not understand, or find useful, the current approach to hedge accounting.

## Summary of IASB Outreach Activities

4. To date, the staff has organised and attended over 30 outreach meetings involving users, preparers and others. The main issues raised by the various stakeholder groups are summarised below.

### *Users*

5. Feedback received from users of financial statements show that their primary interest is to be able to clearly understand an entity's risks as well as the risk management strategies being employed to manage such risks. Users we have talked to favour a 'top-down' approach that shows the linkage between an entity's exposures, risk management activities and the derivatives (or other hedging instruments) used to manage the different types of risks.
6. The context in which a derivative (or other hedging instrument) is used is important to users. Users think it is important to distinguish by the purpose of the derivative transaction between *trading* derivatives (purpose is for realisation of fair value changes) and *hedging* derivatives and other instruments (purpose is to hold for risk management).
7. In addition, users are interested in the 'effectiveness' of hedging activities. Users of financial statements have repeatedly emphasised that they need to be

able to identify situations in which hedging activities are not wholly effective, and to understand why. That is, to be useful the reflection of economic hedging activities within the financial statements must include recognising all ineffectiveness in profit or loss.

**Preparers**

8. Many preparers believe the inability to achieve hedge accounting for economic hedges is a result of today's rule-based requirements on:
  - (a) hedging relationships eligible for hedge accounting, eg restrictions regarding components of non-financial hedged items, net positions and derivatives as hedged items; and
  - (b) effectiveness testing for qualification purposes; in particular the 80-125% effectiveness range, which is prone to erratic distortions (eg small changes in absolute amounts that result in high *percentage* values of ineffectiveness).
9. Many preparers note that common economic hedging practices cannot be (or can only partially be) reflected in financial statements under existing hedge accounting requirements. A common example cited by almost all entities outside of the financial industry relates to the hedging of non-financial items (eg jet fuel hedging in the airline industry or contractually specified price links in fuel purchase contracts in the energy industry). Issues relating to restrictions on the hedge accounting for components (particularly for non-financial items) were also raised in responses to the IASB's exposure draft *Exposures Qualifying for Hedge Accounting* (September 2007).
10. Entities that adopt more sophisticated risk management strategies (eg option based hedging strategies, hedging of net positions, roll-over strategies etc.) also note that such approaches often cannot qualify for hedge accounting, and so their financial statements do not provide useful information to their investors.
11. For this reason, many have urged the IASB to adopt a principle-based approach to hedge accounting.

## Summary of FASB Outreach Activities

12. The FASB staff conducted outreach during the time period in which the FASB was working on the hedging project. The following is a summary of that outreach.

### *Users*

13. Users indicated that hedge accounting should be permitted for fair value hedging relationships in situations when a mixed measurement attribute exists between the hedged item and the hedging instrument. In those situations they generally stated that (a) the balance sheet should reflect the fair value of both the hedging instrument and the hedged item, and (b) gains and losses on derivatives and hedged items should be presented in the income statement in a manner that distinguishes between the gains and losses associated with operations from other changes in fair value.
14. For cash flow hedging relationships in which the variability in interest cash flows on an existing variable-rate debt or on a forecasted issuance of fixed-rate debt is being hedged, most users indicated that the effective portion of the changes in value of the derivative should be deferred in OCI and reclassified to earnings in the time period in which interest income/expense impacts earnings. The ineffective portion of the change in value should be reported in earnings immediately. Those users want to see the interest income/expense section of the income statement reflect the effective interest rate resulting from the combination of the debt instrument and derivative instrument.
15. For hedging variability in cash flows associated with forecasted purchases and sales of nonfinancial items, some users indicated that cash flow hedge accounting should not be permitted. Those users believe that recording the derivatives in earnings immediately reflects economic reality and leads to greater comparability. Some of those users also believe that entities that enter into derivatives “to hedge variability in cash flows associated with forecasted purchases and sales” are actually speculating on price changes and not hedging.

16. Users that stated that cash flow hedge accounting should be permitted indicated that the purpose of cash flow hedge accounting makes sense. However, they stated that the accounting doesn't provide much useful information and that more disclosures are needed around the purpose of the hedge and the financial statement impact of the hedge.

***Preparers and Auditors***

17. Preparers and auditors generally stated that the current hedge accounting model is too complex, rules driven, and doesn't leave room for judgement. Many of the comments related to:
  - (a) Documentation requirements - Constituents have indicated that some of the documentation requirements are too strict and create challenges that prevent entities from applying hedge accounting. For example, the method used for assessing hedge effectiveness and measuring ineffectiveness must be documented with sufficient specificity so that a third party could perform the measurement based on the documentation. Constituents are concerned that shortcomings in the specificity of some of the documentation for a hedging relationship that was otherwise properly identified lead to the denial of hedge accounting. That, in turn, results in reporting financial information that is not consistent with the economics of the transaction.
  - (b) Designation, dedesignation, and redesignation – In many instances, entities struggle with when dedesignation and redesignation are required. The lack of clarity and exactness in the guidance causes problems with assessing effectiveness and measuring ineffectiveness as well as policy formation and documentation. Another example demonstrating confusion about dedesignation and redesignation events exists when a proportion of a derivative instrument needs to be dedesignated.
  - (c) Identification of hedged item or hedged transaction - Entities struggle with what degree of aggregation is permitted when grouping similar assets or liabilities or transactions.

- (d) Assessing effectiveness - Entities struggle with many aspects of assessing effectiveness. For example, entities struggle with when it would be appropriate to (1) use a qualitative assessment versus a quantitative assessment, (2) assess based on the critical terms of the hedging instrument and hedged item (or transaction) and whether and to what extent all sources of ineffectiveness must be identified and considered, and (3) exclude the time value of money from the assessment.

Entities also noted that there is difficulty in incorporating certain aspects or features of hedging instruments and hedged items into the assessment of effectiveness. For example, there is inconsistency in how changes in discount rates or credit are incorporated into the assessment process in situations in which an individual risk, such as interest rate risk, is designated as the hedged risk. Auditors indicated that many entities fail to grasp the concept behind hedge accounting in Statement 133 that, for example, designating a fixed-to-floating swap as a hedge against a fixed-rate instrument hedges changes in economic fair value rather than simply creating a third instrument. As a result, diversity exists on how the credit aspect of the discount rate should be incorporated into the assessment of effectiveness. How to incorporate cash settlements and the passage of time in the assessment also are treated inconsistently.

***Summary of Comment Letters on the Discussion Paper and the FASB's Exposure Draft***

18. Appendix A provides the comment letter summary for the Discussion Paper and Appendix B provides the comment letter summary for the FASB's Exposure Draft.

**Discussion of Risk Management, Financial Reporting and the Interaction Between the Two in Relation to the Reporting of Hedging Activities**

19. The staff believes that it is important for the Boards to understand and/or establish (a) the objective(s) for hedge accounting (why it is needed), and (b) the

goals to be achieved with a hedging model in order for the reporting of hedging activities to better reflect the economics of those activities.

20. The following discusses risk management, financial reporting and the interaction between the two in order to get Board members thinking about those areas and their impact on (a) and (b) above.

### ***Risk management***

21. Entities face economic risks in carrying out their business and operations. This includes exposures to interest rate risk, credit risk, foreign currency risk, commodity price risk, equity price risk and other business risks. Consequently, some entities develop risk management frameworks, policies and strategies to transform or reduce risk exposures in order to manage them.
22. Derivatives and some non-derivative instruments are effective tools to manage or transform some of these risks. In developing hedging strategies, management identifies risks the entity is exposed to and determines what are the most effective tools to either partly or fully transform or reduce the risk exposures that are identified by the entity as being necessary to manage.
23. As indicated in the outreach section above, it is important for users to understand an entity's risks as well as the risk management strategies being employed to manage or transform such risks.

### ***Financial reporting***

24. Today economic hedging activities are only partly reflected in financial statements<sup>2</sup>. This is due to restrictions imposed by existing recognition and measurement requirements<sup>3</sup>.

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<sup>2</sup> Like the business activities and their value more generally.

<sup>3</sup> Timing requirements relate to recognition and measurement requirements. Timing mismatches arise because gains and losses are recognised in the period determined by the recognition and measurement requirements. For example, a forecast transaction does not occur in the current period. However, the gains and losses on a derivative instrument entered into to hedge exposures arising from the forecast transaction are recognised as they arise.

*Recognition requirements*

25. Recognition restrictions result from the recognition criteria set out in IFRSs and US GAAP. Some items meet existing recognition criteria and are recognised in the statement of financial position while others do not meet the criteria and hence are not recognised. For example, all derivatives in the scope of the financial instruments standards are required to be recognised. Some of these derivatives can be hedging instruments. If the hedged item is not recognised in the financial statements due to the recognition restrictions (eg a forecasted transaction or a firm commitment that is an executory contract) only part of the economic hedging relationship (ie the derivative) is reflected in the financial statements.
26. This issue can be alleviated by recognising all hedged exposures as well. In some cases we already do this. For example, IAS 39 and Derivatives and Hedging Topic 815 in US GAAP codification permit the recognition of fair value changes of firm commitments that are designated as hedged items<sup>4</sup>. Under normal circumstances, firm commitments do not meet the recognition criteria and are not recognised in the statement of financial position.
27. In other cases we do not. In the case of hedging a forecast transaction, the designated hedged transaction is a highly probable anticipated transaction. Under normal circumstances, a forecast transaction does not meet the recognition criteria as it does not yet exist. Yet IAS 39 and Topic 815 currently permit deferral of fair value changes arising from the derivative hedging instrument into OCI until the forecast transaction occurs.

*Measurement requirements*

28. Even if all risk exposures and hedging instruments were recognised, measurement mismatches result from items in the financial statements being required (or permitted) to be measured in different ways. For example, the hedging instrument could be required to be measured at fair value through profit

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<sup>4</sup> See IAS 39.87.

or loss while the hedged item could be required to be carried at amortised cost or another cost-based measurement (eg lower of cost and net realisable value for inventories).

29. Moreover, measurement mismatches arise in the situation where an entity manages risks by transforming exposures, eg by converting fixed cash flows into variable cash flows or vice versa to manage fair value and cash flow volatility, respectively. For example, the conversion of interest payments on fixed rate assets into variable rate payments by using an interest rate swap reduces the fair value interest rate risk associated with fixed rate assets. The swap (hedging instrument) is recognised and measured at fair value while the hedged exposure, ie the prospective volatility in cash flows, is not recognised until the interest receipt and payment occurs.
30. The staff notes that the measurement mismatch can be alleviated (although not eliminated) if all items in the financial statements are measured in the same way. However, the IASB has decided to retain a mixed measurement model in phase 1 of the replacement of IAS 39 project and the FASB has decided in its project to permit certain changes in fair value to be recorded outside of net income. Moreover, most non-financial items such as inventory and property plant and equipment are measured using cost-based measurements.

***Hedge accounting in the context of financial reporting***

31. The objective of financial statements is set out in paragraph 12 of the IASB *Framework*. Concepts Statement 1 of the FASB's concepts statements sets out a similar notion.

[T]o provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions.

32. This includes information about the *timing, amount and uncertainty* of cash flows.
33. As mentioned, economic hedging affects an entity's financial position and performance. It does so by creating cash flows (eg by entering into a derivative)

that offset other cash flows thereby changing the *timing, amount and uncertainty* of the future cash flows of the entity.

34. For example, hedging prepayment risk reduces uncertainty in the timing of cash flows and hedging cash flow interest rate risk reduces uncertainty in the amount of cash flows paid or received.
35. The purpose of financial reporting is to provide this type of information to users of financial statements. To the extent that hedging activities are not reflected within the financial statements, the reported information denies the fact that:
  - (a) entities manage risks;
  - (b) entities enter into economic hedges using derivatives (or other financial or non-financial instruments) to manage risks; and
  - (c) economic hedging affects the financial position and performance of an entity by creating cash flows that offset other cash flows thereby changing the *timing, amount and uncertainty* of cash flows arising from the hedged exposure. This effect is not reflected when only part of the hedging relationship is reported in the financial statements. For example, if the derivative is recognised at fair value through profit or loss the financial statements imply a higher exposure to the hedged risk than there is because the offsetting effect of the hedged exposure is omitted.
36. As mentioned earlier in this paper, users' primary interest is to understand an entity's risks as well as the risk management strategies being employed to manage such risks. The linkage between an entity's exposures, risk management activities and the derivatives used to manage the different types of risks is important. In particular, the context in which a derivative is used (ie its purpose) is important information to users.
37. Hedge accounting is often perceived to be an exception to normal recognition and measurement principles because its purpose is to address the restrictions that

prevent the reflection of economic risk management activities in the financial statements<sup>5</sup>. For example, existing hedge accounting provisions allow for:

- (a) recognition of items that would otherwise not be recognised, eg hedging of firm commitments.
- (b) measurement of items on a measurement basis that differs from its original basis, eg adjusting the measurement of a hedged item in a fair value hedge.
- (c) deferral of fair value changes that would otherwise have been recognised in the current reporting period eg hedging of a highly probable forecast transaction.

38. Complexity relating to hedge accounting does not arise from the fact that it is a departure from normal recognition and measurement principles but rather from the nature of general recognition and measurement requirements and the rules-based design of the current hedge accounting model. This inevitably results in a set of rules that are arbitrary at times. Under today's requirements, in some situations some recognition and measurement principles can be overridden to ensure risk management activities are reflected (by applying hedge accounting) but in other situations recognition and measurement principles cannot be overridden even if overriding the principles better reflects an entity's risk management activities.

39. The staff believes that much complexity can be eliminated by establishing a consistent objective to hedge accounting. A sound objective helps determine *when* and *how* recognition and measurement principles can be overridden (ie *when and how* hedge accounting should be applied). If that objective is robust, a new hedge accounting model can be integrated in the existing recognition and measurement model as an override of existing recognition and measurement requirements when that results in more useful information.

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<sup>5</sup> IAS 39 itself describes it as an exception.

40. At a future meeting the staff plans to bring to the Boards for discussion alternatives for what should be (a) the objective(s) for hedge accounting (why it is needed), and (b) the goals to be achieved with a hedging model in order for the reporting of hedging activities to better reflect the economics of those activities.