



Memorandum

To:	Members of the FRSB and AASB	Date:	5 March 2010
From:	Sarah Bate	Agenda Item:	B3C.1
Subject:	Financial Instruments: Hedge Accounting	File:	--

Action

Note memo from Sarah Bate

Purpose

1. The purpose of this memo is to update the FRSB and AASB on the progress of the IASB and FASB to simplify and improve the accounting for financial instruments. The FRSB has requested that FRSB staff update the Board at every FRSB meeting as to the recent discussions of the IASB and FASB and for any tentative or final decisions undertaken. This memo is a continuation of that updating process. This is the third phase of the IAS 39 *Financial Instruments: Recognition and Measurement* rewrite project: addressing hedging.

Background

2. At the January 19 2010 joint meeting, the Boards decided that due to the FASB's aim to publish a comprehensive exposure draft on financial instruments in March 2010 and the IASB's plan to publish an exposure draft on the remaining main phases of the project to replace IAS 39, *Financial Instruments: Recognition and Measurement*, in the first quarter of 2010, the Boards would first jointly consider hedge accounting issues relating to financial hedged items. Therefore, the IASB and FASB focused on bifurcation-by-risk approaches for financial hedged items only at the February 17th meeting.
3. At the February 2, 2010 meeting, the IASB tentatively decided to permit bifurcation-by-risk for financial items. At the same meeting, the FASB decided to explore bifurcation-by-risk for financial items and requested the staff to develop possible approaches for consideration at a future meeting. This was discussed at the February 17th meeting.
4. The FASB has decided to require that all financial instruments be recognised on the balance sheet at fair value with the change in fair value recognised in net income ("FV-NI" category) unless the financial instrument qualifies for recognising certain changes in fair value in other comprehensive income ("FV-OCI" category). If an entity's business strategy is to hold debt instruments with principal amounts for collection or payment(s) of contractual cash flows rather than to sell or settle the financial instruments with a third party, those instruments qualify for FV-OCI. The amount of the change in fair value that is permitted to be recognised in OCI equals the entire change in

fair value, excluding current period interest accruals (including amortisation/accretion of premium/discount upon acquisition), minus the amount allocated to credit losses. In addition, realised gains or losses from sales or settlements would be recognised in net income. The FASB also tentatively decided to allow certain types of an entity's own debt that qualify for FV-OCI to be measured at amortised cost.

5. FRSB and AASB staff have included the staff papers 9B and 9C written for IASB and FASB members should FRSB and AASB members require further detail. These are included at B3C.2 and B3C.3.

Detail

FRSB staff note that the IASB and FASB are currently unable to reach an agreement on the principles underlying hedge accounting, but are progressing with the application. At present it is unclear how separate decisions take to date will combine to form a cohesive Exposure Draft.

17 February 2010 Joint IASB and FASB Meeting

Hedged items: Approach for determining what risk components are eligible for designation (IASB Paper 9C)

6. The Boards discussed, primarily in the IASB context, possible conditions for bifurcation-by-risk. The discussion was a follow-up to the 2 February 2010 discussion in which some IASB members expressed their concerns that the broad approach to risk components designation might lead to what would be a free choice in componentisation of items and could lead to a situation where designation of a component would automatically result in a hedge accounting relationship being 100% effective.
7. The staff paper provided an analysis of the current requirements of IAS 39 with the emphasis on the criteria for eligibility of risk components to be designated as hedged items being separately identifiable and reliably measurable.
8. Based on the application of the IAS 39 criteria to a set of risk components that may or may not be explicitly specified in the contract, the staff concluded that IAS 39 criteria does not lead to a free choice of how to split an item into components and does not automatically lead to 100% effectiveness of hedging relationship. Nonetheless, the staff concluded that the current requirements of IAS 39 are problematic, as they are rule-based and internally inconsistent.
9. Following this discussion the Board agreed to explore a new criterion for the purpose of determining eligible hedged components. The staff will present such analysis at a future Board meeting.
10. In the ensuing discussion about possible criteria, one Board member expressed concerns whether, in case of non-contractually specified risk components, the risk component would be separately identifiable within the entire hedged item. He argued that the application of IAS 39 in some of these cases does not result from the fact that the

risk component was separately identifiable, but rather from the fact that IAS 39 allows the component to be a hedged item. He expressed his concerns about interdependence of risk components in many of the cases.

11. Another IASB member reinforced this view, by expressing his doubt whether this proposed approach would be operational. He also expressed his view that hedge accounting as such is an exception to the classification and measurement principles of financial instruments. Therefore, in his view, it would be difficult to formulate a broad principle underpinning hedge accounting, and some rules would be necessary. The staff responded that it was not their intention to formulate the principle behind hedge accounting but rather a principle-based approach for designation of risk components that in their view should be possible.
12. Another Board member supported the broad direction the staff had taken. He asked the staff whether, based on the preliminary analysis, the new criteria for designation of risk components would be broader or narrower in comparison with current requirements of IAS 39. The staff responded that the answer would depend on the usefulness of the information provided to the users of financial statements.

Bifurcation-by-risk approaches (IASB Paper 9B)

13. The discussion continued by focusing on the FASB approach, being the current, bifurcation-by-risk for financial instruments within the overall FASB model for financial instruments.
14. The current FASB approach provides guidance on the accounting for subsequent changes in fair value of a derivative instrument designated and qualifying as part of a hedging relationship and the hedged item. For fair value hedges, the gain or loss on a derivative instrument designated and qualifying as a fair value hedging instrument as well as the offsetting loss or gain on the hedged item attributable to the hedged risk is recognised in net income. Under this approach, if an entity designates a financial asset or financial liability (that is measured at amortised cost or at fair value with changes in fair value recognised in OCI) as the hedged item in a fair value hedge, it would be allowed to recognise in net income only the hedged item's offsetting gains and losses for the risk hedged. For cash flow hedges, the effective portion of the gain or loss on a derivative instrument designated and qualifying as a cash flow hedging instrument is recognised in OCI and reclassified into net income as and when the hedged forecasted transaction affects net income. The remaining gain or loss on the derivative instrument (the ineffective portion), if any, is recognised in net income.
15. The FASB staff recommended the application of the current bifurcation-by-risk model in the ASC Topic 815 (current US GAAP) if the FASB retains the tentative classification and measurement model for financial instruments. Further, the staff recommended that if the FASB increases the amortised cost category to allow more financial instruments to be measured at amortised cost, the FASB should utilise bifurcation-by-risk guidance similar to that proposed in FASB ED *Accounting for Hedging Activities*, issued in June 2008, to determine if the relationship qualified for hedge accounting.

16. The FASB agreed with this staff recommendation. The FASB also agreed that the reasonable effective threshold for hedge effectiveness (also proposed in June 2008 FASB ED) should be carried forward into the new guidance, thereby allowing more hedging relationships to qualify for hedge accounting. The FASB members noted that given the FASB tentative model, the current US GAAP model is the least onerous. However, they noted that any drift to the amortised cost category beyond own debt would mean that a more fundamental change was required. The Boards discussed both models and concluded that it is very difficult to further specify the hedge accounting models until the classification and measurement guidance is finalised (the division between the fair value and amortised cost). The differences between both models are based mainly on the fact that the FASB and IASB classification and measurement models are different, thus leading to different requirements for hedge accounting.
17. The FASB briefly discussed any need for fair value hedge accounting in the context of financial instruments held for the contractual cash flows. The Board members noted that it is more a synthetic accounting rather than a hedge accounting, and its purpose is in many cases to lock-in a cash flow in case of mismatch of fixed-rate financial assets financed by variable-rate financial liabilities (such as in the context of a financial institution).
18. The Boards concluded that the FASB hedge accounting model would portray all the risk in the financial statements whereas the IASB model consistently with the amortised cost notion would not portray all the risks in the financial statements. One IASB member noted that a paradoxical implication of the FASB model in the IASB context would be that financial instruments measured at amortised cost subject to hedge accounting rules would also portray effects of non-hedged risks in the profit and loss (fair value) whereas reporting entities not applying hedge accounting rules would not.
19. The FASB disagreed as they believed that their model provided a consistent measurement attribute and any inefficiency in the profit or loss portrayed the actual financial risks and their management by the reporting entity.
20. The IASB members noted that the IASB had previously decided to apply the cash flow hedge mechanics also to fair value hedges that would provide a consistent measurement attribute.

3 March 2010 IASB only Meeting

Eligible hedged items: derivatives as hedged items (IASB Paper 1A)

21. The IASB discussed whether derivatives should be eligible as hedged items. The staff argued that many entities are economically required to enter into transactions that result in commodity price risk, interest rate risk, and foreign exchange risk, and they manage these risks independently of each other.
22. Most IASB members agreed with the idea that hedge accounting should reflect the management of the risk of the underlying (including a derivative) as modified by another derivative, if that is an entity's strategy used for managing different risks. Nonetheless, many IASB members were concerned that the proposed wording was too general and could allow general designation of derivatives as hedged items. Those Board members noted that

although such designation would have no net effect on profit or loss, because all derivatives should be measured at fair value through profit or loss, it might decrease clarity and increase opportunity for structuring.

23. The staff responded that even now there are some exceptions to the general prohibition of designating derivatives as hedged items (a purchased option is eligible to be designated as a hedged item if it is hedged by a written option). Moreover, some special types of derivatives might not qualify for measurement at fair value through profit or loss – for example, some embedded derivatives that are not separated from the host contract that is measured at amortised cost or contracts that are measured at fair value in their entirety as they did not fulfil the own-use exemptions.
24. Some Board members suggested that the wording should be tightened to reflect the concerns expressed above. Finally, the Board agreed with the general principles presented but agreed to define the eligibility more narrowly and to provide more examples.

Eligible hedged items: components of nominal amounts (IASB Paper 1B)

25. The IASB briefly discussed and agreed with the designation of components of nominal amounts as hedged items. Those requirements would reflect the current IAS 39 requirements.
26. Some Board members were concerned with clarity and suggested:
- clarification of the terms 'portion' and 'proportion', and
 - inclusion of examples of nominal amounts in terms of monetary and physical metrics.
27. Some Board members discussed a broader issue related to proportions and their eligibility in connection with timing of the forecast transactions. The staff clarified that those issues would be addressed at a later stage as part of the effectiveness criterion debate.

Eligible hedged items: one-sided risk components (IASB Paper 1C)

28. The IASB agreed to carry forward the IAS 39 requirements that permit the designation of one-sided risk components as hedged items.
29. One Board member asked the staff whether they considered changing the prohibition to use written options as hedging instruments. The staff replied that this discussion should not imply any such change and should be limited to eligible hedged items. Moreover, they noted that they would discuss option strategies at a future meeting.

Question for the FRSB and AASB

30. Does the FRSB and the AASB wish to comment on the approach the IASB and FASB are taking towards Phase 3, Hedge Accounting?

Next steps

31. Staff will continue to provide the FRSB and AASB with selected IASB/FASB agenda papers and relevant summaries for consideration as the IASB and FASB progress towards an updated IAS 39.

Attachments

- B3C.2 Note IASB / FASB Joint meeting paper 9C (February 2010)
Hedged items: Approach for determining what risk components are eligible for designation
- B3C.3 Note IASB / FASB Joint meeting paper 9B (February 2010)
Bifurcation-by-risk approaches
- B3C.4 Note IASB meeting paper 1A (March 2010)
Eligible hedged items: derivatives as hedged items
- B3C.5 Note IASB meeting paper 1B (March 2010)
Eligible hedged items: components of nominal amounts
- B3C.6 Note IASB meeting paper 1C (March 2010)
Eligible hedge items: one-sided risk components