



To:	AASB Members	Date:	27 January 2011
From:	Natalie Batsakis	Agenda Item:	6.1
Subject:	Hedge Accounting	File:	

Action

Consider the matters that should be raised in the AASB's response to IASB ED/2010/13 *Hedge Accounting*.

Background

1. The IASB issued ED/2010/13 in December 2010 and comments are due by 9 March 2011. The AASB issued ED 208 *Hedge Accounting* incorporating ED/2010/13 for comment by 18 February 2011. No submissions have been received to-date.
2. ED/2010/13 is part of the final step (Phase 3)¹ in the IASB's project to replace IAS 39 *Financial Instruments: Recognition and Measurement* and follows on from the Discussion Paper *Reducing Complexity in Reporting Financial Instruments* that was published in March 2008, on which a number of constituents raised concerns in respect of the complexity of the hedge accounting requirements. As such, the IASB has undertaken a comprehensive review of the existing requirements and proposes significant changes to hedge accounting with the aim of eliminating the complex rules and providing more useful hedge accounting information that reflects the entity's risk management strategy.
3. The proposals are summarised in the table below.

	<i>Description</i>	<i>Proposal</i>	<i>Current IAS 39 requirement</i>
1	Objective of hedge accounting	Provide users with a greater opportunity to understand the relationship between financial reporting and an entity's risk management activities, where entities use financial instruments to manage exposures arising from particular	No documented objective of hedge accounting, though it is fair to say that an aim has been to only allow restricted use of hedge accounting, mainly to offset the consequences of accounting for derivatives at fair value.

¹ We are also expecting an exposure draft on off-setting of financial assets and financial liabilities soon. In addition, the IASB is expected to discuss and possibly issue requirements for open portfolio and macro hedging.

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	<i>Description</i>	<i>Proposal</i>	<i>Current IAS 39 requirement</i>
		risks that could affect profit or loss.	
2	Instruments that qualify for designation as hedging instruments	<p>Non-derivative financial assets and non-derivative financial liabilities are eligible for designation as hedging instruments:</p> <p>(i) against foreign currency risk (e.g. an instrument that is a monetary item denominated in a foreign currency); or</p> <p>(ii) when measured at fair value through profit or loss and designated in their entirety to hedge against the fair value movement of a hedged item (rather than a risk component). Non-derivatives measured at amortised cost or fair value through OCI are not eligible hedging instruments.</p> <p>Derivatives embedded in financial asset hosts are not eligible for designation as hedging instruments.</p> <p>Internal derivatives are not eligible for designation as hedging instruments in the financial statements of the reporting entity (eg intra-group derivatives in the consolidated financial statements)</p> <p>Differences arising from the translation of intra-group monetary items in the consolidated financial statements in accordance with IAS 21 can be eligible as a hedged item but not as a hedging instrument.</p>	<p>Non-derivative financial assets and non-derivative financial liabilities (e.g. monetary items denominated in a foreign currency) are eligible for designation as hedging instruments only when hedging foreign currency risk.</p> <p>Embedded derivatives that are separated from their financial asset hosts are eligible for designation as hedging instruments.</p> <p>Consistent with IAS 39 requirements.</p> <p>Consistent with IAS 39 requirements.</p>
3	Derivatives that qualify for designation as hedged items	An aggregated exposure that is a combination of an exposure and a derivative may be designated as a hedged item.	Derivatives can only be designated as hedging instruments (and not as hedged items), except purchased options (paragraph

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	<i>Description</i>	<i>Proposal</i>	<i>Current IAS 39 requirement</i>
			AG94 of IAS 39).
4	Designation of hedged items	<p>Changes in the cash flows or fair value of an item attributable to a specific risk or risks (i.e. a risk component), that are or are not contractually specified, are eligible for designation as hedged items as long as they are separately identifiable and reliably measurable (ie regardless of whether it is part of a financial or non-financial item).</p> <p>An entity may designate changes in the cash flows or fair value of a hedged item above or below a specified price or other variable (ie a 'one-sided' risk). For example, an entity might hedge an exposure to interest rates above 5% using an interest rate cap.</p> <p>Percentage components of nominal amounts may be designated as hedged items if they are identifiable (ie they are some quantifiable nominal part of the total cash flows of the instrument) and the effectiveness of the hedging relationship can be measured. For example, 50 per cent of the nominal value of a loan, includes all the characteristics of that loan.</p>	<p>Risk components can be designated as hedged items based on the following:</p> <p>(a) for financial items – an entity can designate any risk component as the hedged item if that risk component is separately identifiable and reliably measurable;</p> <p>(b) for non-financial items – an entity can only designate foreign currency risk as a hedged item.</p> <p>Consistent with IAS 39 requirements.</p> <p>Consistent with IAS 39 requirements.</p>
5	Designation of a layer component of the nominal amount	<p>A layer component of the nominal amount of an item can be designated as a hedged item. For example, the first 100 barrels of the oil purchases for a specific month (ie a layer of the total oil purchase volume). Such a designation accommodates the fact that there is some uncertainty surrounding the hedged item regarding the amount or timing and does not affect the hedging relationship to the extent that the hedged volume occurs compared to a</p>	<p>Consistent with IAS 39 requirements.</p>

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	<i>Description</i>	<i>Proposal</i>	<i>Current IAS 39 requirement</i>
		<p>percentage of the nominal amount. However, a layer component of a contract that includes a prepayment option is not eligible as a hedged item in a fair value hedge if the option's fair value is affected by changes in the hedged risk.</p> <p>An entity may designate the LIBOR component of an interest-bearing asset or liability provided that the instrument has a zero or positive spread over LIBOR. When an entity has an interest-bearing debt instrument with an interest rate below LIBOR (or linked to a reference rate that is demonstrably below LIBOR), it would not be able to designate a hedging relationship based on a LIBOR risk component that assumes LIBOR cash flows that would exceed the actual cash flows on that debt instrument. However, for an asset or liability with a negative spread to LIBOR, an entity could still achieve hedge accounting by designating all of the cash flows of the hedged item for LIBOR interest rate risk (which is different from designating a LIBOR component that assumes cash flows exceeding those of the hedged item).</p>	<p>Consistent with IAS 39 requirements.</p>
6	<p>Hedge effectiveness requirement to qualify for hedge accounting</p>	<p>Along with two other criteria, the hedging relationship will qualify for hedge accounting if it meets the hedge effectiveness requirements. A hedging relationship meets the hedge effectiveness requirements if it:</p> <ul style="list-style-type: none"> (a) meets the objective of the hedge effectiveness assessment; and (b) is expected to achieve other than accidental offsetting. There should be no avoidable exposure not explained by the hedge ratio chosen. <p>Paragraphs B27-B39 set out detailed guidance on the:</p> <ul style="list-style-type: none"> (1) meaning of hedge effectiveness; (2) objective and extent of offset required for an effective hedge; 	<p>A hedge must be highly effective (ie if the offset is within the range of 80%-125%) both prospectively and retrospectively. Retrospective testing is required to be undertaken using a quantitative test. However, IAS 39 does not prescribe any particular method to be used.</p>

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	<i>Description</i>	<i>Proposal</i>	<i>Current IAS 39 requirement</i>
		(3) frequency of assessment; (4) methods that can be used to assess effectiveness.	
7	Rebalancing of a hedging relationship	An entity should rebalance the hedging relationship when the hedge continues to meet the original documented risk management objective, but no longer meets the objective of the hedge effectiveness assessment (see (c) above). Rebalancing realigns the hedging relationship with the objective of the hedge effectiveness assessment – and therefore the adjustments do not change the entity’s original risk management objective for entering the hedging relationship. An entity may also rebalance the hedge relationship voluntarily.	IAS 39 treats adjustments to a hedging relationship that were not envisaged or documented at the inception of the hedge as a discontinuation of the existing hedging relationship and the creation of a new relationship.
8	Discontinuing hedge accounting	The hedging relationship is discontinued prospectively when the hedging relationship ceases to meet the qualifying criteria or when it no longer reflects the risk management objective (that is part of the qualifying criteria). There is no free choice to voluntarily discontinue hedge accounting where the hedging relationship continues to meet the risk management objective (that is part of the qualifying criteria to initially allow the hedge).	IAS 39 requires an entity to discontinue hedge accounting when the hedging relationship ceases to meet the qualifying criteria. However, an entity may voluntarily discontinue hedge accounting for any reason, by revoking the designation.
9	Accounting for fair value hedges – gain or loss on remeasuring the hedging instrument	Gain or loss in OCI.	Gain or loss recognised in profit or loss.
10	Accounting for fair value hedges – gain or loss on the hedged item	Gain or loss to be recognised as an asset or a liability that is presented in a separate line item in the statement of financial position and in OCI as a separate line item to the gain or loss on the hedging instrument.	Gain or loss results in an adjustment to the carrying amount of the hedged item and is recognised in profit or loss.
11	Presenting ineffectiveness for fair	The ineffective portion of the gain or loss is transferred from OCI to profit	The ineffective portion is recognised in profit or loss as a

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	<i>Description</i>	<i>Proposal</i>	<i>Current IAS 39 requirement</i>
	value hedges	or loss.	separate line item.
12	Accounting for the time value of options for cash flow and fair value hedges	<p>The time value of the option will be accounted for depending on the type of hedged item that the option is used to hedge – either:</p> <ul style="list-style-type: none"> (a) a transaction related hedged item (e.g. the forecast purchase of a commodity) – whereby the cumulative change in fair value of the option’s time value is accumulated in OCI; or (b) a time period related hedged item (eg, hedging existing commodity inventory against commodity price declines) – whereby the fair value of the time value of the option will be allocated over the relevant period on a rational basis – that is, accumulating the cumulative change in fair value of the option’s time value in OCI and amortising the original time value paid by transferring an amount to profit or loss each period. 	IAS 39 allows an entity to designate an option as a hedging instrument in its entirety, or to designate only the intrinsic value of an option as a hedging instrument, in which case, the undesignated time value of the option is treated as held for trading and measured at fair value through profit or loss.
13	Accounting for cash flow hedges – basis adjustment	The choice to reclassify associated gains or losses from OCI to profit or loss, or to use those gains or losses to adjust the carrying amount of the asset or liability is removed. Entities would now be required to adjust the asset or liability.	<p>IAS 39 permits an accounting policy choice:</p> <ul style="list-style-type: none"> (a) to reclassify the associated gains or losses that were recognised in OCI to profit or loss in the same period or periods during which the asset acquired or liability assumed affects profit or loss; or (b) to remove the associated gains or losses that were recognised in OCI and include them in the initial cost or other carrying amount of the asset or liability.

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	<i>Description</i>	<i>Proposal</i>	<i>Current IAS 39 requirement</i>
14	Accounting for cash flow hedges – ‘lower of’ test	Retain the IAS 39 requirements.	<p>At a high level, the ‘lower of’ test requires that:</p> <ul style="list-style-type: none"> (a) the separate component of equity associated with the hedged item is adjusted to the lesser of the following (in absolute amounts): <ul style="list-style-type: none"> (i) the cumulative gain or loss on the hedging instrument from inception of the hedge; and (ii) the cumulative change in fair value (present value) of the expected future cash flows on the hedged item from inception of the hedge; (b) any remaining gain or loss on the hedging instrument or designated component of it (i.e. not an effective hedge) is recognised in profit or loss.
15	Hedges of a net investment in a foreign operation	These types of hedges were not considered by the IASB in the third phase of its project to replace IAS 39. Therefore, no change to IAS 39 requirements.	<p>Hedges of a net investment in a foreign operation (including hedges of monetary items that are accounted for as part of the net investment), are required to be accounted for similarly to cash flow hedges:</p> <ul style="list-style-type: none"> (a) the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge is recognised in OCI; and (b) the ineffective portion is recognised in profit or loss. <p>The gain or loss on the hedging instrument relating to the effective portion of the hedge that has been recognised in OCI is reclassified from equity to profit or loss as a reclassification adjustment in accordance with IAS 21 on the</p>

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	<i>Description</i>	<i>Proposal</i>	<i>Current IAS 39 requirement</i>
			disposal or partial disposal of the foreign operation.
16	Hedges of a group of items – eligibility of a group of items as the hedged item	<p>Groups of items will be eligible as hedged items only if:</p> <p>(a) it consists of items (including components of items) that individually are eligible hedged items;</p> <p>(b) the items in the group are managed together on a group basis for risk management purposes; and</p> <p>(c) for the purpose of cash flow hedge accounting only, any offsetting cash flows in the group of hedged items exposed to the hedged risk affect profit or loss in their entirety in the same reporting period (including interim periods).</p>	<p>IAS 39 restricts the application of hedge accounting for groups of items. The assets and liabilities being aggregated in the group must be similar and the individual assets or individual liabilities in the group must share the risk exposure that is designated as being hedged.</p> <p>Furthermore, it is expected that the change in fair value attributable to the hedged risk for each individual item in the group is approximately proportional to the overall change in fair value attributable to the hedged risk of the group of items.</p>
17	Accounting for a contract for a non-financial item that can be settled net in cash as a derivative	Apply derivative accounting to contracts that would otherwise meet the ‘own use’ scope exception if that is in accordance with the entity’s fair value-based risk management strategy. If the entity’s business model changes and the contract is no longer managed on a fair value basis then the contract would be subject to the ‘own use’ scope exception.	IAS 39 has an ‘own use’ scope exception that excludes contracts that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity’s expected purchase, sale or usage requirements – (mostly applies to commodity contracts).
18	Accounting for credit risk using credit derivatives	The IASB decided not to provide an alternative approach for hedge accounting when credit derivatives are used to hedge credit risk because it is considered to be operationally difficult to isolate and measure the change in fair value that is attributable solely to credit risk ² . Therefore, an entity will not be allowed to elect fair value accounting for part of the nominal amount of hedged credit exposures in loans or loan commitments.	IAS 39 does not have any specific requirements for the use of credit derivatives in hedging credit risk.

² Which might be contrasted with the accounting for own credit risk on an entity’s liability that is subject to the fair value option. The value of that credit risk must be separated from other fair value movements and taken directly to OCI.

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4. AASB staff have considered the above proposals in order to identify issues that could be used in the AASB and Asian Oceanian Standard Setters Group (AOSSG) submissions to the IASB, as well as seeking feedback with members of the AASB's Financial Instruments Project Advisory Panel and members of the AOSSG Financial Instruments Working Group. They, and certain Board members, have also participated in 5 reach-out meetings with constituents organised for IASB representatives and held on 24 and 25 January in Sydney. Further meetings are to take place in Perth and Melbourne in coming days. The issues identified by AASB staff and attending Board members are set out in the Appendix to this Memorandum.

Next steps

5. Following this meeting, the plan is to finalise an AASB submission out-of-session. Staff will continue to liaise with members from the Financial Instruments Project Advisory Panel and consider responses from Australian constituents in developing responses to the specific questions in ED/2010/13 for consideration and approval by the Chairman and a small sub-committee of AASB members.
6. AASB staff will also be leading the AOSSG Financial Instruments Working Group, as well as working with the AOSSG Islamic Finance Working Group and other AOSSG members to finalise AOSSG responses to the IASB on ED/2010/13 during the remainder of February.

Attachments

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| Agenda paper 6.2 | AASB ED 208 <i>Hedge Accounting</i> |
| Agenda paper 6.3 | PowerPoint presentation summarising the proposals and examples of the issues identified at the IASB outreach meetings (to be tabled at the meeting) |



Preliminary issues for consideration

<p>1 <i>Hedging objective – link to risk management activities</i></p>	<p>The proposals articulate that the objective of hedge accounting is:</p> <p>“...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> <p>In his Alternative View, John T Smith raised concerns about linking hedge accounting to an entity’s risk management strategy, suggested that such an objective will result in hedge accounting becoming the norm, rather than an exception to normal recognition and measurement requirements. The term ‘risk management’ is not defined and “...provides little rigour because policies can be written in any manner to permit an entity to move in and out of hedge accounting freely....”</p> <p>However, an opposing argument is that linking the qualifying criteria to an entity’s risk management activities will provide greater transparency. More of the ‘economic hedges’ that previously did not qualify for hedge accounting will be disclosed in the financial statements in a way that better reflects the underlying substance of the transaction – some would say it ‘more accurately’ reflects the reason for, and the way in which, the transaction was undertaken. In addition, if an entity does move in and out of hedging relationships part of its risk management strategy, then these transactions should be reflected in the financial statements to provide users with a proper understanding of the activities of the entity.</p> <p><u>Staff comments:</u></p> <ul style="list-style-type: none">- Is the AASB happy to endorse an expansion of hedge accounting based more on risk management strategy and without much guidance on the meaning of an entity’s risk management strategy.- Rather than linking the hedge accounting objective to the entity’s risk management strategy, which is undefined and is a result of management intention, perhaps the IASB could consider incorporating the concept of an entity’s ‘business model’, which is already used in IFRS 9 <i>Financial Instruments</i> to assist in determining the classification and measurement of financial assets.³ Changes to the business model for assessing risk would be expected to be rare and not dependent on management’s risk policy at any particular time.
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³ Paragraph BC4.20 of the Basis for Conclusions to IFRS 9 notes the view of the majority of IASB members that “...an entity’s business model does not relate to a choice (ie it is not a voluntary designation) but rather it is a matter of fact that can be observed by the way an entity is managed and information is provided to its management.”

<p>2</p>	<p><i>Hedging objective – link to the impact on profit or loss</i></p>	<p>The ED expresses that the objective of hedge accounting is to “...manage exposures arising from particular risks that could affect profit or loss.” It is not clear why the IASB has targeted ‘profit or loss’ in the objective – that is, wouldn’t an entity be interested in managing risks that could affect the comprehensive income statement?</p> <p>This affects a number of decisions made by the IASB:</p> <ol style="list-style-type: none"> (1) Instruments measured at fair value through other comprehensive income cannot be designated as hedged items. This appears consistent with the hedging objective of managing exposures that could affect profit or loss. However, there is nothing in IAS 39 that currently prevents entities from hedging investments in equity instruments that are not held for trading (previously classified as available-for-sale assets) whose movements in fair value are recognised in other comprehensive income (OCI), and it is likely that there are entities that may wish to hedge those types of investments. (2) The ED proposes that for fair value hedges, gains or losses from the hedged item and hedging instrument will be recorded in OCI and any ineffectiveness will be transferred to profit or loss. The AASB submission to the IASB’s ED/2010/4 raised the concern that recycling from OCI to profit or loss undermines the notion that items of revenue are ‘income’ and items of expense are ‘expenses’, regardless of where they are presented in the comprehensive income statement. <p><u>Staff comments:</u></p> <ul style="list-style-type: none"> - The IASB should clearly articulate and justify its focus on risks that affect profit or loss rather than the comprehensive income statement to ensure there is a conceptual basis for determining the types of assets that can be designated as hedged items - It would be preferable for the IASB to finish its project on what is presented in equity versus OCI versus profit or loss, so that it is understood, at a conceptual level, what it means to present items in the different areas of the financial statements, and where necessary, can justify recycling to profit or loss.
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3	<p><i>Discontinuing hedge accounting</i></p>	<p>The proposals in the ED prevent an entity from voluntarily discontinuing hedge accounting. Therefore an entity would be prevented from terminating and paying out the hedging instrument or taking out a new instrument to offset the gains/losses on the designated hedging instrument where its risk management strategy was unchanged.</p> <p>This seems like an unnecessary bright line rule to perhaps mitigate the concerns raised by Mr Smith in his alternative view that linking hedge accounting to risk management activities will allow entities to freely move into and out of hedge accounting (thereby making hedge accounting the norm rather than an exception to recognition and measurement principles).</p> <p>Paragraph 91(c) of IAS 39 currently allows an entity to revoke its designation of the hedge accounting relationship and prospectively discontinue hedge accounting. A number of entities utilise this election – for example mining companies, where FX and commodity pricing fluctuations can result in significant losses if the hedge is not discontinued. It can be a question of survival. In addition, discontinuation of a hedge may not be due to any change in an entity’s risk management strategy, but rather solvency regulatory requirements.</p> <p><u>Staff comments:</u></p> <ul style="list-style-type: none"> - If the entity’s risk management strategy is to enter and exit hedging relationships to mitigate risk exposures, then not allowing entities to voluntarily discontinue hedge accounting is inconsistent with the IASB’s stated objective of hedge accounting. - Staff raised this issue with IASB staff during the Sydney outreach meetings, and they noted that the IASB’s main concern in making this decision was to prevent entities from discontinuing hedge accounting for no reason. The wording in the ED is confusing – the IASB should try to more clearly articulate this intention, rather than using words that are confusing constituents.
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4	<i>Hedging credit risk</i>	<p>The Basis for Conclusions to the ED discusses the use of credit derivatives to manage credit risk. Paragraph BC220 notes that “...using credit derivatives generally do not achieve hedge accounting because it is operationally difficult (if not impossible) to isolate and measure the credit risk of a financial item as a component that meets the eligibility criteria for hedged items. The spread between the risk-free rate and the market interest rate incorporates credit risk, liquidity risk, funding risk and any other unidentified risk component and margin elements. Although it is possible to determine that the spread includes credit risk, it is operationally difficult to isolate and measure the change in fair value that is attributable solely to credit risk.”</p> <p>This discussion forms part of the basis for IASB’s decision not to provide requirements or guidance for hedging credit risk. In the recent past, the IASB acknowledged the difficulty in deducing the impact of credit risk, and noted that the methodology prescribed in IFRS 7 <i>Financial Instruments: Disclosures</i> does not deduce an exact measure of the impact of credit risk – it is only a proxy. However, if these issues did not raise sufficient concern amongst the majority of IASB board members regarding the presentation of fair value changes due to own credit risk in OCI for financial liabilities designated at fair value through profit or loss, then it seems ironic that these arguments are used in the Basis for Conclusions to this ED to support the IASB’s decision to not provide appropriate guidance for hedging credit risk.</p> <p><u>Staff comments:</u></p> <ul style="list-style-type: none"> - Although the IASB seems to think that hedging against credit risk is unlikely to meet hedging requirements because the value of the credit derivative cannot be expected to move in the same way as the value of receivables and it is not possible to measure the credit risk element of the receivable, financial institutions are of a different view. - The IASB should be consistent in its views on measuring credit risk. If they are satisfied that the fair value change of a financial liability that is due to a change in the entity’s credit risk can be measured sufficiently reliably to be presented in OCI, then it should not be impossible for financial institutions to achieve hedge accounting for credit risk. More generally the IASB needs to be able to reliably identify the impact of credit risk as it is becoming an increasingly significant issue in the application of IFRSs – and not just financial instruments accounting.
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5	<i>Accounting for the time value of money for options</i>	<p>The IASB proposes to treat the time value of money, paid for via an option premium, as either a transaction cost incurred in making a purchase (for example, plant and equipment) or insurance against price/interest rate/FX fluctuations on inventory held. The premium is then either basis adjusted or amortised to the income statement over a rationale period, respectively, so as to avoid the current volatility of that time value being taken to the income statement over the life of the option.</p> <p><u>Staff comments:</u></p> <ul style="list-style-type: none">- There are a number of concerns with the proposed treatment<ul style="list-style-type: none">(i) is it reasonable to depend even more on a cost accumulation model;(ii) this treatment somewhat goes against defining historical cost and fair value as being the same at origination;(iii) the fair value of the time value of an option will not incorporate the cost of an option – therefore, the cost will not be included when the non-financial asset is basis adjusted;(iv) there are other instances where the IASB does not capitalise such costs (for example, IFRS 3) – it seems strange to have the measurement of a derivative exacerbate the accounting for transaction costs; and(v) is the premium in an option truly a premium for risk protection? We need to determine whether it is calculated by reference to that risk or as an interest rate differential.
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6	<p><i>Aggregated exposures as a hedged item</i></p>	<p>The proposals expand what is an eligible hedged item to allow the designation of aggregated exposures – that is, taking out a hedge on an already existing hedging relationship. For example, an entity has foreign currency borrowings and uses a cross currency swap to convert fixed foreign currency to variable domestic currency in a fair value hedge. If the entity has expectations about increases in interest rates, it will wish to fix the interest rate for a short period of time by taking out an interest rate swap to receive variable interest and pay fixed rates (i.e. a cash flow hedge).</p> <p>Under existing IAS 39 requirements, this second leg of the transaction could not be designated as a hedging relationship.</p> <p><u>Staff comments:</u></p> <ul style="list-style-type: none"> - The IASB gave the above example in the outreach meetings held in Sydney. There was some confusion at those meetings whether an aggregate exposure could be designated as a hedged item if it was the opposite way around. AASB staff subsequently discussed that concern with IASB staff who did not believe it was an issue. Paragraph B9 in the Application Guidance notes that “...an entity assesses whether the aggregated exposure combines an exposure with a derivative so that it creates a different aggregated exposure that is managed as one exposure for a particular risk (or risks).” Even if the entity entered into a cash flow hedge first (to swap floating rates to fixed) and the second leg was a fair value hedge, the aggregated exposure would still be eligible as a hedged item, because the aggregated exposure would be to fixed interest rates – which is different to the exposure in the original loan. - Staff believe that there will be some operational concerns with this proposal. Participants at the outreach meetings were concerned with how this would work on transition (given the diversity in current practice regarding these types of hedges) and how effectiveness would be determined if the second leg of the transaction was not taken out on day 1.
7	<p><i>Presentation of fair value adjustments in the balance sheet</i></p>	<p>The ED proposes to present separate line items in the balance sheet for fair value adjustments to the hedged item rather than directly adjusting the carrying amount.</p> <p>There are concerns that this presentation is not appropriate as the adjustment for the fair value gain or loss on the hedged item will not be an element – that is, it will not meet the definition of an asset or a liability. However, this presentation could be analogised to the way in which assets and accumulated depreciation are presented gross, with the presentation of the resulting net balance.</p> <p><u>Staff comments:</u></p> <ul style="list-style-type: none"> - the feedback from the user group was that this separate presentation would be useful to users as it is currently difficult to decipher what the carrying amount of the asset is (its amortised cost) and the portion that reflects adjustments made for hedging purposes.

8	Hedge effectiveness assessment	<p>Paragraph 19(c) states that in order for a hedging relationship to qualify for hedge accounting, the hedging relationship must “...meet the hedge effectiveness requirements (see paragraphs B27-B39)...”, which are that the hedging relationship:</p> <ul style="list-style-type: none"> (i) meets the objective of the hedge effectiveness assessment; and (ii) is expected to achieve other than accidental offsetting. <p>Three new phrases are introduced in the above paragraph – (1) ‘hedge effectiveness requirements’, (2) ‘hedge effectiveness assessment’ and (3) ‘accidental offsetting’. In respect of (1), the hedge effectiveness requirements are clearly explained in sub-paragraphs 19(c)(i) and (ii).</p> <p>However, in respect of phrases (2) and (3), these phrases are not discussed further in the proposed amendments to the body of IFRS 9. The only indication of where to find an explanation of what is meant by ‘hedge effectiveness assessment’ and ‘accidental offsetting’ is the reference to paragraphs B27-B39 in the Application Guidance (Appendix B).</p> <p>The first mention of ‘hedge effectiveness assessment’ is not until paragraph B29, stating that its objective:</p> <p style="padding-left: 40px;">“...is to ensure that the hedging relationship will produce an unbiased result and minimise expected hedge ineffectiveness. Therefore, a hedging relationship shall not reflect a deliberate mismatch between the weightings of the hedged item and the hedging instrument that would create ineffectiveness.</p> <p>The discussion on ‘accidental offsetting’ is located in paragraph B31, which notes that when a relationship between the changes in the value of the hedged item and the hedging instrument breaks down (i.e. due to a deterioration in the credit standing of the issuer of the derivative), then it would not be expected that the hedging relationship could achieve other than accidental offsetting – and as such, would fail to meet the hedge effectiveness requirements.</p> <p>When considering the objective of the ‘hedge effectiveness assessment’, and the discussion on ‘accidental offsetting’, it seems that sub-paragraph (ii) repeats the intention of of sub-paragraph (i) – if a hedging relationship is expected to ‘achieve other than accidental offsetting’ (i.e. there is a) then one would expect that the hedging relationship is one which will produce an ‘unbiased result and minimise expected hedge effectiveness’.</p> <p><u>Staff comments:</u></p> <ul style="list-style-type: none"> - It would be clearer if the objective of the hedge effectiveness assessment was included as part of the qualifying criteria in paragraph 19(c). The paragraph could be amended to simply say: <ul style="list-style-type: none"> “A hedging relationship must produce an unbiased result and minimises expected hedge ineffectiveness.” <p>This eliminates the 3 phrases which are undefined and confusing. The Application Guidance should retain the detailed discussion regarding how an entity minimises hedge ineffectiveness and obtains other than accidental offsetting.</p>
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9	<i>Rebalancing</i>	<p>Rebalancing is required when the hedging relationship ceases to meet the objective of the hedge effectiveness assessment (that is, after effectiveness is assessed) or if it is expected to do so – in both instances, this is done, after hedge effectiveness is assessed. Therefore, hedge effectiveness will be assessed for the following period based on the rebalanced hedge relationship. This is not clear in the proposals and raised questions at the IASB’s outreach meetings in Sydney.</p> <p>In addition, it is not clear:</p> <ul style="list-style-type: none"> (a) if the IASB is totally replacing its old terminology (de-designation and re-designation) with new terms (rebalancing, continuation and discontinuation) because there are a number of instances when the term de-designation is used in the Application Guidance; (b) whether a delay in the time of the hedged item would be a rebalancing event (for example, if the entity is hedging sales of its inventory for a particular date, but its manufacturing process breaks down and results in delays on production); (c) what the difference is between rebalancing and overhaul (paragraph BC110 of the Basis for Conclusions). <p><u>Staff comments:</u></p> <ul style="list-style-type: none"> - the IASB should clarify these issues around the newly introduced concept of rebalancing and ensure that the terms are appropriately defined/explained in the finalised standard.
10	<i>Component hedging</i>	<p>Paragraph 18 of the ED allows a component to be hedged when the risk component is separately identifiable and reliably measurable. From discussions at the IASB outreach meetings in Sydney it became clear that it is actually the impact of the risk component on the pricing of the hedged item that needs to be reliably measurable. Paragraph B13 states that it is “...the changes in the cash flows or fair value of the item attributable to changes in that risk component...” that must be reliably measurable, not just the risk component by itself. Therefore, if an entity cannot determine the impact of the risk component on the hedged item, it will not be eligible for designation as a hedged item.</p> <p><u>Staff comments:</u></p> <ul style="list-style-type: none"> - It is not clear in the proposed amendments to the body of IFRS 9 that the impact of the risk component on the value of the hedged item must be reliably measurable – therefore, it would be better if the wording in B13 was included in paragraph 18.

Memorandum

11	<i>Hedging the operating result from foreign operations</i>	<p>The IASB did not address hedges of a net investment in a foreign operation. IAS 21 requires the operating results from foreign subsidiaries to be recorded at average historical rates but entities would prefer to be able to hedge the foreign currency risk associated with these investments. The IASB did not want to consider this issue as it did not want to contradict its belief that the reporting entity is the consolidated entity and therefore, there was no interest in considering intra-group hedges.</p> <p><u>Staff comments:</u></p> <ul style="list-style-type: none"> - A number of constituents at the IASB outreach meetings in Sydney raised this concern, stating that the FX risk is a legitimate risk management issue, for which hedge accounting cannot be applied. This outcome is inconsistent with the IASB’s hedge accounting objective that links to an entity’s risk management activities.
12	<i>Risk management strategy disclosures</i>	<p>The requirements proposed for disclosure of an entity’s risk management strategy will only apply to entities that apply hedge accounting. There are concerns that those that choose to apply hedge accounting are still required to comply with fairly onerous disclosure requirements, as opposed to those entities that elect not to apply hedge accounting. This is hardly an incentive for clearer and more transparent reporting, particularly as it will nearly always result in the disclosure of commercially sensitive information which their peers may choose not to disclose.</p> <p><u>Staff comments:</u></p> <ul style="list-style-type: none"> - Paragraphs 44 and 45 of the proposals require disclosures about the entity’s risk management strategy, the risks that an entity is exposed to, how an entity manages those risks, including whether an entity hedges risky items in their entirety or hedges a risk component, and the effect of the hedging strategy. - These types of disclosures provide useful information, even more so for entities that do not apply hedge accounting, as it will give the user of the financial statements an understanding of the risks of the entity and how the entity is managing those risks. Therefore, it would be appropriate for these disclosures to be included in IFRS 7 and not just form part of the hedging section in IFRS 9.
13	<i>Transitional provisions</i>	<p>The transitional provisions propose that the hedging requirements will be applied prospectively. Some constituents at the IASB’s outreach meetings in Sydney raised concerns that existing hedging relationships will be treated differently depending on how the entity designated the hedge. For example, hedging using options – the impact of transitioning to the new requirements will differ for those entities that designated the option as a hedging instrument and those that did not. Those that designated the option as a hedging instrument will be able to recompute the time value and allocate it to OCI, and therefore get the benefit of capitalising the remaining time value. Those that did not designate their option as a hedging instrument will not get this benefit.</p> <p><u>Staff comments:</u></p> <ul style="list-style-type: none"> - We acknowledge that the time and effort to require everyone to reconsider their designated hedging relationships retrospectively would be considerable. However, given that the same hedging relationships would be treated differently depending on the entity’s choice under existing IAS 39 requirements, perhaps the IASB could consider providing an option for a once-off reallocation of derivatives.