



To:	AASB members	Date:	10 October 2011
From:	Sue Lightfoot and Huy Pham	Agenda Item:	10.3
Subject:	Update on Hedge Accounting	File:	

Action

1. To provide AASB members with an update of the IASB's tentative decisions resulting from redeliberations of some of the proposals in ED/2010/13 *Hedge Accounting*.

Background

2. The IASB issued Exposure Draft ED/2010/13 *Hedge Accounting* requesting feedback by 9 March 2011. IASB staff have been providing IASB members with agenda papers covering various issues since the IASB's April 2011 meeting. AASB staff are keeping a running catalogue of tentative decisions (provided in the Appendix to this Memorandum), and therefore issues that have been verbally summarised at past meetings are consolidated in this update.
3. In summarising each of the issues discussed by the IASB, staff have provided a summary of constituent feedback received by the IASB, IASB staff recommendations (from IASB Staff agenda papers), a summary of comments made by the AASB in its submission to ED/2010/13 and points made by IASB members during the meeting.
4. As with previous meetings, AASB staff will provide an update on the outcomes of any further IASB deliberations held subsequent to Board paper mail-out, but prior to the AASB October 2011 meeting.
5. Items 21 and 22 in the Appendix have been added and item 20 has been updated since this Memorandum was last presented as agenda item 9.1 of the 7-8 September 2011 AASB meeting.
6. The IASB completed its redeliberations on the Exposure Draft at its 19-22 September 2011 meeting. It was decided that re-exposure would not be necessary. The Board asked staff to draft the final requirements, application guidance and Basis for Conclusions. The draft is to be made available on the IASB website for 90 days. This will allow the IASB to conduct additional outreach and constituents to comment on the final requirements although formal comments will not be requested. As at the date of this Memorandum, the draft of the final requirements is not yet available.

7. The IASB continued its deliberations on macro hedge accounting, discussing the differences between current hedge accounting requirements and risk management. No decisions have been made. AASB staff will provide an update on the deliberations in the December AASB meeting.



April IASB meeting – 13-16 April 2011

1. Designation of equity investments at fair value through other comprehensive income (FVTOCI) as hedged items (IASB Agenda Item 8)

ED Proposals	Hedge accounting shall not be applied to investments in equity instruments at FVTOCI.
Constituent feedback and IASB staff recommendations	<p>Constituents raised concerns that limiting the eligibility of hedged risks to those only affecting profit or loss is inconsistent with the objective to align hedge accounting with risk management activities. Many noted price risk and foreign currency risk on equity investments at FVTOCI are managed in the same way as risks on instruments measured at fair value through profit or loss (FVTPL).</p> <p>Additionally, some constituents suggested that, for equity investments at FVTOCI, hedge ineffectiveness could be presented in OCI – since both profit or loss and OCI are elements of one overall performance statement.</p> <p>Based on feedback, IASB staff recommended allowing equity investments at FVTOCI to be designated as eligible hedged items, with all ineffectiveness being presented in OCI, and noted the following:</p> <p><i>Advantages</i></p> <ul style="list-style-type: none"> • Allows entities to better reflect their risk management activities hence is more consistent with the overall objective of hedge accounting; • Allows entities to better reflect the nature of the equity investment that is in line with their business model (when not hedging the entire holding period). • Presenting ineffectiveness in OCI is consistent with the IASB’s move towards one single performance statement <p><i>Disadvantages</i></p> <ul style="list-style-type: none"> • Makes the option to classify equity investments at FVTOCI more attractive (and hence increases its use); • Changes the current hedge accounting principle that hedge ineffectiveness should be presented in profit or loss.
AASB feedback	The AASB expressed concern that disallowing equity investments at FVTOCI as eligible hedged items was inconsistent with the proposed objective to align hedge accounting with an entity’s risk management objective. Additionally, it felt that the IASB is taking a view on the nature of items presented in profit or loss, rather than in OCI, without identifying an underlying principle/rationale. If the IASB were to develop a clear basis for presenting items in equity versus OCI versus profit or loss, fair value hedging could be markedly simplified by presenting ineffectiveness in OCI without recycling.

IASB redeliberation and tentative decisions	<p>Initially some members noted that if users were being true to the intended use of the FVTOCI classification (investments held for strategic purposes as outlined in paragraph BC5.25(c) of IFRS 9 Financial Instruments), there should not be a need to hedge those types of equity investments. If the staff recommendation were to go ahead, those members wanted to redeliberate the definition of non-trading equity investments and the types of investments that are able to be measured at FVTOCI at a future meeting to try to narrow the classification scope exception.</p> <p>Another significant concern was expressed with the recommendation to recognise ineffectiveness in OCI because it would hide a legitimate failing where users of the financial statements would not see it. Therefore, even though recognising ineffectiveness for equity investments at FVTOCI in profit or loss would undo the “recycling” requirement in IFRS 9, it would be clearer for users. Additionally, some members felt the recognition of dividends in profit or loss and ineffectiveness in OCI to be an inconsistent outcome.</p> <p>Those IASB members that supported the staff recommendation gave the following reasons:</p> <ul style="list-style-type: none"> - Focussing on profit or loss is out-dated – should be looking at the one overall performance statement (profit or loss or OCI) - The IASB should be neutral and true to the principles it created – aligning accounting with risk management activities; - They did not consider the disadvantage that it ‘makes the option to classify at FVTOCI more attractive’ to be legitimate. <p>The IASB tentatively decided to allow equity instruments at FVTOCI to be designated as eligible hedged items, with any ineffectiveness presented in OCI. This would not be extended to other items measured through OCI.</p> <p>The votes were 8 in favour and 7 against.</p>
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2. Hedging risk components in sub-LIBOR instruments (IASB Agenda Item 9)

ED Proposals	Does not allow the designation of a risk component whose cash flows are bigger than the total cash flows of the hedged item.
Constituent feedback and IASB staff recommendations	<p>While constituents were supportive of the restrictions in the ED, clarification was sought for the following circumstances:</p> <ul style="list-style-type: none"> - whether there is a full LIBOR component of an interest bearing financial asset or financial liability if the interest rate of the instrument is lower than LIBOR? If so, should that LIBOR-component be eligible for designation as a hedged item? - would the existence of a floor of the interest-bearing financial asset or financial liability affect whether it is possible to designate a hedged item on a full LIBOR risk components basis? <p>IASB staff recommended retaining the current restriction in the ED and not allowing the designation of a full LIBOR component on a sub-LIBOR instrument. The pros and cons of this recommendation were outlined as follows:</p> <p><i>Pros</i></p> <ul style="list-style-type: none"> - This alternative avoids counterintuitive outcomes such as ‘negative interest’, deferral of hedge ineffectiveness, and ultimately (in

	<p>substance) ‘synthetic accounting’ for the combined position of the variable rate asset and the LIBOR interest rate swap;</p> <ul style="list-style-type: none"> - It highlights the fact that the margin becomes variable within a particular range and therefore captures hedge ineffectiveness that should be recognised in profit or loss. <p><i>Cons</i></p> <ul style="list-style-type: none"> - The designation of hedging relationships involving sub-LIBOR instruments may involve increased complexity because entities would not have a ‘fully matched’ hedging relationship.
AASB feedback	No specific comment.
IASB redeliberation and tentative decisions	<p>The IASB members noted the proposal in the ED (which is consistent with IAS 39 requirements) is to ensure that the portion being designated as a hedged item is not larger than the whole asset or liability because it generates counterintuitive results. It was also noted that the existence of a floor does affect the designation of a full LIBOR component.</p> <p>The IASB tentatively decided to retain its proposal in ED/2010/13 that a portion of the hedged item cannot be greater than the total cash flows of the hedged item. The IASB also noted that it would be helpful to clarify in paragraphs B25 and B26 of the Application Guidance, that for an asset or liability with a negative spread an entity could still designate all of the cash flows of the entire financial asset or financial liability as the hedged item with regard to a benchmark interest rate. Thus hedging the change in the fair value or cash flows of that entire liability that is attributable to changes in LIBOR. Hedge ineffectiveness will arise, but hedge accounting is not prohibited.</p> <p>The votes were 15 in favour and 0 against.</p>

3. Eligibility of cash instruments as hedging instruments (IASB Agenda Item 10)

ED Proposals	Only cash instruments at FVTPL can hedge risks other than foreign currency risk.
Constituent feedback and IASB staff recommendations	<p>The ED proposals have extended eligibility of hedging instruments to include all non-derivative financial instruments measured at FVTPL. Some constituents requested that the IASB further extend the eligibility to cash instruments at amortised cost to be designated as hedging instruments against risks other than foreign exchange risk. IASB staff noted that this would allow entities which used cash instruments at amortised cost for hedging to better represent their risk management activities but require a change to the measurement basis of the instrument and this would result in additional issues and complexity.</p> <p>An additional issue for consideration was cash instruments and the fair value option (FVO) – and whether cash instruments designated at FVTPL under the FVO should be eligible as hedging instruments. The main issue that staff considered was that the FVO eliminates an accounting mismatch – so if applying hedge accounting undermined the original rationale for that initial designation, then it would not be appropriate to allow those instruments to be designated in a hedging relationship (for example – cash flow hedge where gains or losses on the hedge instrument are recognised in OCI). However, due to the nature of the option – being a once-off irrevocable election on day 1 –</p>

	the mismatch may not exist at a later date. Therefore, the entity should be able to designate that instrument as an eligible hedging instrument. The only exception should be that financial liabilities designated at FVTPL where part of the fair value change is recognised in OCI cannot be designated as eligible hedging instruments.
AASB feedback	The AASB supported that proposal that a non-derivative financial asset and a non-derivative financial liability measured at FVTPL should be eligible hedging instruments.
IASB redeliberation and tentative decisions	<p>IASB members noted that this issue mainly arises in jurisdictions that do not have access to a derivatives market and therefore, use cash instruments in their hedging strategies. However, during IASB outreach, IASB staff determined that most of the cash instruments were at fair value and therefore, it would not be necessary to further consider the eligibility of cash instruments at amortised cost as hedging instruments – IASB members agreed.</p> <p>The IASB tentatively decided to retain its proposals in the ED that only cash instruments at FVTPL can hedge risks other than foreign currency risk. Additionally, IASB members agreed with the staff analysis and recommendation regarding the interaction between cash instruments and the FVO. Since the mismatch may not exist at a later date, but the instrument would still classified and measured at FVTPL, it would not be appropriate to prohibit designation of the financial instrument as a hedging instrument in a hedging relationship. However, the IASB will clarify that financial liabilities designated at FVTPL, where part of the change in fair value is recognised in OCI, will not be eligible for designation as hedging instruments.</p> <p>The votes were 15 in favour and 0 against.</p>

4. Treatment of forward points (difference between spot rate and forward rate) in foreign currency derivatives (IASB Agenda Item 11)

ED Proposals	Entities can designate the spot element of a forward contract and leave the change in the forward points undesignated - therefore the gain or loss from the changes in the forward points is presented in profit or loss (like a trading gain or loss).
Constituent feedback and IASB staff recommendations	<p>Constituents raised the use of funding swaps in managing FX risk. This issue arises where financial institutions have more funding in their local currency than they can invest in financial assets in domestic currency and so they go offshore to do so. They enter into FX derivatives to hedge against FX risk and lock in a net interest margin. The transaction is normally undertaken by:</p> <ol style="list-style-type: none"> (1) Swapping local funds into foreign currency at the spot rate; (2) Investing in FX denominated financial assets; (3) Entering into FX derivatives to convert foreign funds back to local currency at a forward rate. <p>The forward points (difference between the forward and spot rates) cannot be designated in a hedging relationship. Constituents view the forward points as part of interest revenue in the context of the funding swap and would therefore like to see the proposals for the treatment of the time value of options extended to the treatment of forward points.</p>

AASB feedback	The AASB noted that it was not appropriate to treat the time value of an option as a cost of hedging in isolation of other instruments – there are other types of instruments that have a time value component – for example, forward foreign exchange contracts. The recognition and measurement requirements for a time value component should be applied consistently across all types of instruments.
IASB redeliberation and tentative decisions	No decisions were made in respect of this agenda item. IASB members will consider possible alternatives for the treatment of forward points at a future meeting. [See item 13 for latest tentative decision]

Additional IASB meeting – 27 April 2011

5. Accounting for the time value of options – ‘zero-cost collars’ (IASB Agenda Item 2)

ED Proposals	The treatment for the time value of options would not apply to zero-cost collars because they have no net time value at inception.
Constituent feedback and IASB staff recommendations	Feedback received is that the treatment for the time value of options should be extended to zero-cost collars – to avoid structuring opportunities to achieve the desired accounting outcome. In addition, constituents noted that whilst the time value of the collar is zero at its expiry, it fluctuates during the life of the hedge. Therefore, the time value of zero-cost collars should be aligned with the treatment for the time value of options. IASB staff agreed with comment letter feedback and recommended aligning the treatment for time value of options and zero-cost collars.
AASB feedback	The treatment proposed in respect of the time value associated with zero-cost collars was not appropriate because it may encourage entities to undertake particular types of transactions – that is, replace zero-cost collars by collars with a nominal cost so that the proposed accounting treatment for options can be applied.
IASB redeliberation and tentative decisions	The IASB supported the arguments put forward by staff and tentatively decided to align the treatment of the time value of options and zero cost collars. IASB staff will ask the IASB to consider at a future meeting whether the treatment of the time value of options proposed in ED/2010/13 is appropriate. The votes were 11 in favour, 0 against and 1 abstained.

6. Accounting for fair value hedges (IASB Agenda Item 3)

ED Proposals	<i>The use of OCI</i> – the ED proposes that the gain or loss on the hedged item and hedging instrument be separately presented in OCI and that any ineffectiveness be recognised in profit or loss. <i>Statement of financial position presentation</i> – the ED proposed that the gain or loss on the hedged item be presented as a separate line item
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	<p>in the statement of financial position.</p> <p><i>Linked presentation</i> – the ED does not allow linked presentation for fair value hedges.</p>
<p>Constituent feedback and IASB staff recommendations</p>	<p><i>The use of OCI</i></p> <p>Most respondents supported the proposal in the ED. However, a number of constituents believe that the gain or loss on the hedging instrument and hedged item should be presented in profit or loss (consistent with the requirements in IAS 39). This was supported by other constituents who commented that the use of OCI should be limited until the IASB completes its financial statement presentation project. However, those constituents supported disclosure of the gain or loss on the hedging instrument and the hedged item in the notes in order to understand the extent of offset between the hedging instrument and the hedged item.</p> <p>In addition, presenting gains/losses on the hedging instrument and hedged item in OCI and then taking any ineffectiveness to profit or loss was akin to the ‘two-step’ approach proposed in the IASB’s Exposure Draft ED/2009/4 <i>Fair Value Option for Financial Liabilities</i>, which the IASB decided to abandon in finalising the requirements in respect of presenting changes in fair value due to credit risk in OCI.</p> <p>Despite the concerns raised, IASB staff recommend that the proposals in the ED should be retained as they provide information about the extent of offset between the hedged item and hedging instrument which is useful information to users. Further, IASB staff do not consider the proposals to be more complex than IAS 39 requirements – an entity would just need to map the gain or loss on the hedging instrument and hedged item to OCI instead of profit or loss.</p> <p><i>Statement of financial position presentation</i></p> <p>The majority of constituents supported the separate presentation of the hedged item and the gain or loss on the hedged item from the fair value hedge as it will increase transparency. However, there are concerns that the additional line items will clutter the statement of financial position. Additionally, the gain or loss on the hedged item does not of itself represent an asset or a liability.</p> <p>Despite the concerns raised, IASB staff recommended that the IASB retain the proposals in the ED as it provides the most useful and transparent information, and the impact of the additional line item on the statement of financial position would be limited.</p> <p><i>Linked presentation</i></p> <p>Most constituents supported the proposals in the ED not to allow linked presentation for fair value hedges because it may confuse users and limit comparability of entities’ financial statements. In addition, a number of constituents felt that linked presentation should not be considered as part of the project on hedge accounting, and that if the IASB wishes to pursue such presentation, it should be included as part of either the financial statement presentation project or the conceptual framework project, or be a totally separate project. However, some constituents believe that linked presentation reflect “...the ‘real’ economic effects of hedges of foreign currency risk of firm commitments”.</p> <p>Based on the majority of feedback received and the fact that there is not a clear principle for linked presentation, IASB staff recommended that the Board retain the proposals in the ED in respect of linked presentation.</p>

<p>AASB feedback</p>	<p><i>The use of OCI</i></p> <p>The AASB repeated its overriding concern with expanding the use of OCI prior to the completion of the IASB’s project on financial statement presentation and would prefer it finish that project to ensure there is consistency with the items being presented in OCI.</p> <p><i>Statement of financial position presentation</i></p> <p>Whilst the AASB considered that users would find it useful to present the gain or loss on the hedged item separately, it expressed concern that the gain or loss adjustment would not meet the definition of an asset or a liability.</p> <p><i>Linked presentation</i></p> <p>No specific comment.</p>
<p>IASB redeliberation and tentative decisions</p>	<p><i>The use of OCI</i></p> <p>IASB members acknowledged the intention to present the effects of an entity’s risk management activities in one place. However, some members were concerned with the increasing ‘unjustified’ use of OCI in various IASB projects. Therefore, the IASB tentatively decided to disagree with the staff recommendation and retain the fair value hedge accounting mechanics currently in IAS 39 – that is, presenting gains/losses from the hedging instrument and hedged in profit or loss (rather than in OCI). Additionally, the IASB tentatively decided to enhance disclosures about the impact of an entity’s hedge accounting activities by requiring the effect of all fair value hedges and cash flow hedges to be disclosed in one comprehensive note.</p> <p>The votes were 11 in favour, 0 against and 1 abstained.</p> <p><i>Statement of financial position presentation</i></p> <p>The Board disagreed with the staff recommendation and tentatively decided to retain the requirements currently in IAS 39 – that is, recognise the gain or loss on the hedged item as part of the item in the statement of financial position, rather than have it as a separate line item. However, the IASB will require disclosure of the fair value adjustment to the hedged item in the notes.</p> <p>The votes were 13 in favour and 0 against.</p> <p><i>Linked presentation</i></p> <p>The Board discussed the feedback received and tentatively decided to retain the proposals in the ED, subject to doing further outreach.</p> <p>The votes were 12 in favour and 1 against.</p> <p>Update 28 July 2011 meeting: After additional outreach activities, the Board confirmed its decision to not allow linked presentation for fair value hedges. The votes were 10 in favour and 0 against.</p>

7. Nominal components (IASB Agenda Item 5)

ED Proposals	<p>A layer component of the nominal amount of an item would be eligible for designation as a hedged item.</p> <p>There is no distinction needed between anticipated and existing transactions when designating a layer component of a nominal amount.</p> <p>A layer component of a contract that includes a prepayment option would not be 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>
Constituent feedback and IASB staff recommendations	<p>Constituents generally supported the proposals but some constituents wanted to allow the designation of a layer component when it includes a prepayment option in some circumstances. Staff analysed the issue and recommended retaining the proposals in the ED of not allowing a layer component with a prepayment option to be included as a hedged item.</p>
AASB feedback	<p>The AASB supported the ED proposals.</p>
IASB redeliberation and tentative decisions	<p>All IASB members present agreed with the first two ED proposals and tentatively decided to retain the proposals.</p> <p>The Board members tentatively decided to allow the designation of a layer component of a nominal amount with a prepayment option in the following two circumstances:</p> <ul style="list-style-type: none"> • for partially prepayable items a layer-based designation of the hedged item should be allowed for those amounts that are not prepayable at the time of designation (12 in favour and 1 against); and • for a designation of a layer as the hedged item if it includes the effect of a related prepayment option when determining the change in fair value of the hedged item (11 in favour and 2 against).

Additional IASB meeting – 11-12 May 2011

8. Clarification of ‘other than accidental offsetting’ and the meaning of the ‘unbiased requirement’ (IASB Agenda Item 1)

ED Proposals	<p>Eliminate the bright line 80%-125% test associated with the qualifying criteria for a hedging relationship and replace the prospective and retrospective hedging requirements with new prospective hedging requirements:</p> <p>(a) must meet the objective of the hedge effectiveness assessment (it ensures that the hedging relationship will produce an ‘unbiased result’ and ‘minimise hedge ineffectiveness’); and</p> <p>(b) must be expected to achieve ‘other than accidental offsetting’.</p>
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<p>Constituent feedback and IASB staff recommendations</p>	<p>Constituents expressed overwhelming support for the proposal to eliminate the 80-125% rule and the proposal of a more qualitative approach. However, constituents asked for guidance around the intention/meaning of the umbrella terms used in the proposals. As an example, constituents expressed uncertainty about whether ‘unbiased result’ meant having to find the perfect instrument that would give 100% offset between hedged item and hedging instrument.</p> <p>IASB staff recommended that umbrella terms be avoided and requirements in the finalised standard should clearly articulate what is meant. As such, they came up with recommended wording for the IASB’s consideration.</p> <p><i>“Other than accidental offsetting’</i></p> <p>(a) the notion of an economic relationship between the hedged item and the hedging instrument during the life of the hedging relationship, which gives rise to offset; and</p> <p>(b) the effect of credit risk on the level of offset between gains and losses on the hedging instrument and the hedged item that may reduce or modify the extent of offset.” <i>(IASB meeting 11-12 May 2011, IASB Staff paper, Agenda paper 1A, paragraph 30)</i></p> <p>[Part (a) above must be able to be demonstrated – for example if the entity has a 1:1 LIBOR swap with the same underlying, then it is easy to demonstrate an economic relationship, but the further the entity moves away from the same underlying and gets into benchmarks/substitutes, the more there is a need to run tests to demonstrate a relationship between the hedging instrument and the hedged item.]</p> <p><i>‘Unbiased’ – the meaning aims to address two issues</i></p> <p>(a) “Deliberate mismatch between hedged quantity and designated quantity (the IASB wanted to ensure that entities would not deliberately create a difference between the quantity actually hedged and the quantity designated as the hedged item in order to achieve a particular accounting outcome.</p> <p>(b) Inappropriate hedge ratio (the IASB wanted to ensure that an entity would not inappropriately designate a hedging relationship such that it would give rise to systematic hedge ineffectiveness that could be avoided by a more appropriate designation.” <i>(IASB meeting 11-12 May 2011, IASB Staff paper, Agenda paper 1B, paragraph 42)</i></p>
<p>AASB feedback</p>	<p>The AASB agreed that there should be hedge effectiveness requirements as part of the qualifying criteria and supported the removal of the ‘bright-line’ effectiveness testing rules under IAS 39. However, the AASB raised concerns with the proposed undefined terms that were introduced and noted that the wording seemed overly complex, which would result in confusion and inconsistent application – for example, ‘unbiased’ and ‘accidental offset’. The AASB suggested that the wording of the requirements be simplified if it is to be retained.</p>
<p>IASB redeliberation and tentative decisions</p>	<p>All IASB members agreed with the intended meaning of the terms ‘other than accidental offset’ and ‘unbiased’ as articulated in the papers.</p>

	<p>In respect of ‘accidental offsetting’, some members thought the words should focus on ‘offset’ whereby an economic relationship can be demonstrated when the hedging instrument and hedged item will move in contemporaneously in opposite directions.</p> <p>In addition, some members thought the wording for part (b) of the concept of ‘accidental offsetting’ as articulated by staff may be wrongly interpreted to mean that you can never hedge credit risk – however, this paragraph has nothing to do with credit risk as a hedged item or if the hedged item is affected by credit risk – members did not want this confusion to arise.</p> <p>In respect of the meaning of ‘unbiased’, IASB members agreed the intention is that an entity should not be purposely designating a hedging relationship with ineffectiveness or purposely over- or under-hedging. The intention is that an entity avoids the designation of an inappropriate ratio and appropriately recognises any ineffectiveness that arises.</p> <p>The IASB tentatively decided that the words around the hedge effectiveness requirements need to be articulated more clearly, but that the wording provided in the agenda papers did not give the high qualification that the IASB intended. IASB staff have been instructed to provide revised wording for members to consider at a future meeting.</p> <p>The voting was 12 in favour and 0 against.</p>
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Additional IASB meeting – 31May-2 June 2011

9. Accounting for the time value of options (IASB Agenda Item 7B)

ED Proposals	<p>When an entity designates the intrinsic value of an option as the hedging instrument, the change in fair value of the time value of the option is accumulated in OCI and accounted for depending on the type of hedged item:</p> <p>(a) Transaction related – reclassified based on the general requirements (e.g. purchase of PPE – accumulated change in fair value is recorded in OCI and a basis adjustment is made to the non-financial asset).</p> <p>(b) Time-period related – amortised on a rational basis over the term of the hedging relationship (e.g. future sale of inventory – accumulated change in fair value is recorded in OCI and reclassified to profit or loss on a rational basis over the term of the hedging relationship).</p>
Constituent feedback and IASB staff recommendations	<p>The feedback was generally supportive of the proposed treatment. However, some constituents expressed concerns that the treatment was complicated and there was confusion about the difference between a transaction related hedged item and a time-period related hedged item.</p> <p>Based on the feedback, IASB staff recommended that the proposed treatment for the time value of an option be retained and to provide additional guidance to assist preparers in applying the requirements.</p>
AASB feedback	<p>The AASB noted that all hedging instruments could be seen as providing ‘insurance’ and therefore, the time value of options should not be isolated and treated differently. Forward foreign exchange contracts also have a time value component, and other</p>

	instruments have an implied cost – such costs should be treated in the same manner.
IASB redeliberation and tentative decisions	<p>Whilst one Board member raised concerns about including the time value of an option as a hedging expense, all other Board members supported the staff recommendation that treating the time value as a cost of insurance requires the distinction between transaction related and time-period related hedged item, otherwise it would be inconsistent with the treatment of such costs in other IFRSs. In addition, based on a previous IASB tentative decision, the treatment of time value will also be applied to zero-cost collars.</p> <p>The voting was 13 in favour and 1 against.</p> <p>In coming to this conclusion, the Board also considered whether there should be a choice to treat the time value either as proposed or in accordance with current IAS 39 requirements – i.e. a trading gain or loss recognised in profit or loss. However, the Board tentatively decided not to allow such a choice, because the treatment in IAS 39 is inconsistent with the ‘insurance premium’ view and would impair comparability of financial statements.</p>

10. Designating combinations of options as the hedging instrument (IASB Agenda Item 7C)

ED Proposals	Consistent with current IAS 39 requirements, the ED prohibited the designation of a written option in combination with a purchased option as a hedging instrument where there are two or more separate contracts. However, if it is a single instrument (e.g. a collar) and not a net written option, it can be designated as a hedging instrument.
Constituent feedback and IASB staff recommendations	<p>Whilst there was support for the retention of IAS 39 requirements, some constituents requested that written options not be excluded from being eligible hedging instruments if combined with other designated hedging instruments and the combination does not result in a net written option – that is, the economic substance is the same as a collar. Those constituents noted that:</p> <ul style="list-style-type: none"> - Individual contracts are widely available on trading exchanges; and - Often it is more cost effective to purchase two instruments rather than a collar. <p>Based on the feedback received, IASB staff recommended that the proposals be amended to allow the designation of a written option with a purchased option as a hedging instrument, whether it arises from one or several contracts, unless the combination results in a net written option.</p>
AASB feedback	No specific comment.
IASB redeliberation and tentative decisions	<p>Whilst one Board member disagreed with the IASB staff recommendation on the basis that written options do not reduce risk and therefore should not qualify as eligible hedging instruments, the majority of Board members supported the recommendation as long as such a combination would not result in a net written option.</p> <p>The voting was 13 in favour and 1 against.</p>

11. Rebalancing – adjustments to the hedge ratio (IASB Agenda Item 8)

ED Proposals	The notion of rebalancing was introduced in the ED to complement the hedge effectiveness assessment requirements and thereby allow changes to the hedge ratio without having to discontinue the hedge.
Constituent feedback and IASB staff recommendations	<p>The feedback was generally supportive as the proposals addressed concerns about the existing IAS 39 requirements that do not allow changes to hedge relationships that were not envisaged at the inception of the hedge.</p> <p>However, there were a number of requests for clarification:</p> <ul style="list-style-type: none"> - When rebalancing was required as opposed to permitted; - The frequency of rebalancing – and noted that it would be onerous if it were to be on an ongoing basis; - Whether rebalancing should only be done for risk management purposes – such that the accounting does not trigger changes to, or drive, the risk management objective. <p>Based on the feedback, and the IASB’s previous tentative decision on hedge effectiveness assessment, IASB staff proposed that the hedging relationship be rebalanced for hedge accounting purposes when the entity adjusts the hedge ratio for risk management purposes. This would mean that rebalancing is no longer a response to changes in circumstances that affect the hedge ratio, therefore eliminating the need to proactively rebalance.</p> <p>IASB staff note that there may be instances where the hedge ratio is different for hedge accounting and risk management purposes:</p> <ul style="list-style-type: none"> (i) If the change for risk management purposes results in a ratio that would create ineffectiveness; or (ii) If the hedge ratio is retained for risk management purposes, but in new circumstances that ratio would result in ineffectiveness.
AASB feedback	The AASB noted that some may perceive the proposals to be onerous, but on balance supported the proposals in respect of rebalancing. However, the AASB noted that there were areas within the proposals that could be clarified – for example, the difference between rebalancing and an overhaul event; whether a delay in the timing of a hedged item would constitute a rebalancing event and whether old terminology (such as ‘de-designation’) was still relevant.
IASB redeliberation and tentative decisions	All IASB members supported the IASB staff recommendation with 14 votes in favour.

12. (No) voluntary discontinuation – clarification (IASB Agenda Item 9)

ED Proposals	An entity must discontinue hedge accounting prospectively when the hedge relationship ceases to meet the qualifying criteria; and that if the entity still meets the qualifying criteria (and the risk management objective has not changed), then the entity is prohibited from voluntarily discontinuing hedge accounting.
Constituent feedback and IASB staff recommendations	<p>The feedback was mixed. Those that supported the proposed requirements considered it an improvement to financial reporting as it holds entities accountable for their decisions by preventing the creation of hedging activities to achieve particular outcomes at particular points in time.</p> <p>Those that disagreed with the proposals did so on the basis that if hedge accounting is voluntary, then discontinuing hedge accounting should also be voluntary. IASB staff noted that there are other instances in IFRS 9 of irrevocable options, such as the fair value option and the FVTOCI presentation exception for equity investments not held for trading purposes. Therefore, that would not be a sound conceptual basis to allow voluntary discontinuation.</p> <p>Others that disagreed with the proposals suggested that discontinuation can be achieved in a number of ways – by closing-out the hedging instrument or entering another opposite instrument, but not designating it in another hedge relationship, to offset the fair value changes of the designated hedging instrument in profit or loss.</p> <p>Additionally, some constituents raised the need to clarify the difference between risk management strategy and risk management objective, and at what level within an organisation risk management policies/procedures should be considered.</p> <p>Based on the feedback, IASB staff recommended to retain the proposed requirements in the ED, but that additional guidance should be added to clarify how risk management strategy differs from risk management objective.</p>
AASB feedback	The AASB agreed that hedge accounting should be discontinued prospectively when the relationship ceases to meet the qualifying criteria. However, the AASB raised concerns that disallowing an entity to voluntarily discontinue hedge accounting is inconsistent with the objective of hedge accounting. If the entity terminates and pays out the hedging instrument or takes out a new instrument to offset the gains/losses of the designated hedging instrument, then the accounting should reflect this.
IASB redeliberation and tentative decisions	<p>Some Board members agreed with the view that since hedge accounting is an option in accounting standards, then discontinuing hedge accounting should also be voluntary. In addition, some members noted the range of options available to entities to close out the hedging instrument or offset changes in the fair value of the designated instrument in profit or loss, suggesting therefore, that the proposals are not operational and will cause confusion.</p> <p>The Board also discussed the difference between risk management objective and risk management strategy and agreed with the IASB staff view that risk management strategy is how an entity manages risk at the highest level of the organisation (broad policies). Whereas, risk management objective is at the level of the hedging relationship, i.e. how the particular hedging</p>

	<p>instrument designated is used to hedge a particular exposure – therefore there may be different risk management objectives required to achieve the entity’s strategy. In addition, risk management objective is likely to be subject to changes on a more frequent basis in order to continue to achieve an entity’s risk management strategy.</p> <p>Whilst one Board member was strongly opposed to not allowing voluntary discontinuation, others supported the proposals in the ED (and therefore the IASB staff recommendation to retain those proposals) as discontinuing hedge accounting when the original risk management objective remains unchanged would be inconsistent with the objective of hedge accounting as proposed in the ED.</p> <p>The Board tentatively decided:</p> <ul style="list-style-type: none"> ▪ to add guidance showing how the risk management objective and the risk management strategy relate to each other using examples contrasting these two notions; and ▪ to confirm the proposals in the ED and hence prohibit voluntary discontinuation of hedge accounting when the risk management objective (not risk management strategy) remains the same and all the other qualifying criteria are still met. <p>The voting was 13 in favour and 1 against.</p>
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IASB meeting – 20-22 July 2011

13. Accounting for forward points (IASB Agenda Item 12)

NB: This topic was previously discussed at the IASB 13-16 April 2011 meeting but no decisions were made (see item 4).

ED Proposals	Entities may only designate the spot element of a forward contract in a hedging relationship (same as existing standard).
Constituent feedback and IASB staff recommendations	<p>Constituents suggested the proposed treatment for the time value of options (see item 9 in this paper) should be extended to forward points (difference between the spot and forward rate of a forward contract). It was noted that both the time value of options and the forward points of a forward contract are costs of hedging and should be accounted for consistently. Financial institutions in Asia also commented they often enter into ‘funding swap’ transactions that lock in a profit at the outset, the economic substance of which is not reflected by hedge accounting under the ED proposals.</p> <p>Staff noted that the same accounting outcome as the time value of options could be achieved for transaction related hedge items by designating the forward contract in its entirety using the forward rate method when measuring the value of the hedged item. However, for time-period related hedged items the same accounting outcome cannot be achieved. It was assessed that allowing the recognition and amortisation of forward points on a rational basis in a hedging relationship that spans across reporting periods, profit and loss would be less volatile and better reflect the economic substance and risk management of the transactions. For these reasons staff recommended that forward points that exist at inception of the hedging relationship should be recognised in profit or loss over time on a rational basis and subsequent fair value changes should be accumulated in OCI.</p>

AASB feedback	The AASB noted that it was not appropriate to treat the time value of an option as a cost of hedging in isolation of other instruments – there are other types of instruments that have a time value component – for example, forward foreign exchange contracts. The recognition and measurement requirements for a time value component should be consistent across all types of instruments.
IASB redeliberation and tentative decisions	<p>Board members were in agreement with the staff view and supported the recognition of forward points in the hedging relationship to provide a better representation of the economic substance of funding swap transactions and the measurement of net interest margin. One member was opposed to the treatment because forward points, unlike the time value of options, can be an income item as well as a cost. Members also discussed whether the treatment of forward points should be made mandatory or a choice be given. Views were mixed with some believing that imposing the requirement for all would add too much complexity and given that hedge accounting is optional, then recognising the forward points should also be an option. Others argued that once hedge accounting is adopted it should be applied consistently. This was not an issue in the paper however and no decision was made.</p> <p>The voting was 14 in favour and 1 against allowing the recognition and amortisation of forward points in a hedging relationship.</p>

14. Group and net positions – Net position cash flow hedges (IASB Agenda Item 13)

ED Proposals	Restriction on hedge accounting being applied to a net position consisting of forecast transactions that will affect profit or loss in different reporting periods.
Constituent feedback and IASB staff recommendations	<p>Constituent responses were mixed with some supporting the proposal and others requesting the restriction be lifted as it adds complexity and does not allow for hedge accounting to be applied to some economic hedging relationships. Some constituents want the restriction changed to ‘annual reporting period’ to not disadvantage entities which report on a more frequent basis. Others have requested guidance on treatments of amounts deferred in OCI for a cash flow hedge of a net position where the forecast transactions are no longer expected to occur within the same period.</p> <p>IASB staff made the following recommendations to Board members:</p> <p>Restriction on hedge accounting for cash flow hedges – staff considered varying degrees of restriction from retaining the proposal in the ED to lifting the restriction completely. The trade-offs were preventing earnings management as opposed to allowing for the designation of more cash flow hedges and better alignment of hedge accounting to risk management. Staff proposed removing the restriction only when the reporting period in which the transaction is expected to affect profit and loss, the nature and the volume of each forecasted transaction are specified at the inception of the hedge. Staff noted that this would involve significant tracking of the hedge.</p> <p>The next two issues are only relevant if the restriction in the ED proposal is retained.</p> <p>Restriction on reporting period to be changed to annual reporting period – staff acknowledged that the reporting period restriction would result in different economic consequences for entities with differing frequency of reporting where one entity is able to apply hedge accounting and the other is not. However, the restriction was deemed necessary in order to prevent the deferment of income in accumulated OCI from forecasted transactions which have occurred.</p> <p>Treatment of deferred OCI when forecasted transactions are no longer expected to occur in the same reporting period – It was noted that, when the forecasted transactions are no longer expected to occur in the same period, the transaction would no longer be eligible for hedge accounting. Staff discussed immediately recycling any amounts in the cash flow hedge reserve to profit and loss but</p>

	recommended that it would be more appropriate to use the existing principles for discontinuing hedge accounting. Gains and losses from the hedging instrument that have been accumulated in the cash flow hedge reserve are deferred if the forecast transactions are still highly probable or expected to occur. There is also a condition that restricts entities that have a history of revising the timing of forecast transactions from designated such hedges.
AASB feedback	The AASB is concerned with the requirement for a net position to be designated as a hedge item only if the offsetting cash flows in the group of items associated with the hedged risk affect profit or loss in their entirety in the same reporting period. This restriction might conflict with an entity's risk management strategy, especially for those that report on a quarterly or half-yearly basis. The AASB is supportive of departing from the principle if it is not possible to reconcile the financial reporting construct with the risk management approach. The IASB should justify the decision to deviate from the objective of aligning hedge accounting with risk management.
IASB redeliberation and tentative decisions	Board members were concerned with lifting the restriction as it would allow deferring gains and losses in OCI of transactions which have already occurred at reporting period and open up earnings management possibilities. Staff noted that in order for the hedge to be eligible, the items within the net position must be specified in such a way that the pattern of how they will affect the income statement is set out as part of the initial hedge designation, which will eliminate the opportunity to manage earnings. The staff recommendation was changed to only allow hedges of foreign currency risk for net positions as these would be the most relevant transactions and would limit the possibility of managing earnings. The voting was 9 in favour and 6 against allowing hedge accounting for foreign exchange risk of net positions with forecast transactions that will occur in different reporting periods.

15. Group and net positions – Net presentation in a separate line item in the income statement (IASB Agenda Item 14)

ED Proposals	Reclassification of gains and losses on hedging instruments designated in net position hedges should be presented in a separate line item in the income statement without adjusting the line items affected by the forecast transactions (i.e. net presentation).
Constituent feedback and IASB staff recommendations	The vast majority of constituents agreed with the proposals while some argued the gains and losses should be presented on a gross basis or a choice be given between the two. Staff assessed that net presentation is more appropriate as it avoids the recognition of gains and losses that do not exist from the grossing up of affected line items and informs users that the entity is hedging on a net basis. The recommendation was to retain the ED proposal and also present deferred gains and losses from forecast transactions on a net basis if the staff recommendation in agenda paper 13 (item 14 in this paper) is adopted.
AASB feedback	The AASB supports the separate presentation of hedging instrument gains or losses from those line items affected by hedged items in profit or loss as this presentation avoids artificially grossing up gains or losses on the hedging instrument.
IASB redeliberation and tentative decisions	All board members agreed with the staff recommendation to present the hedging gains and losses in a separate line item in the income statement. Voting was 15 in favour and 0 against.

16. Hedged items – aggregated exposures (IASB Agenda Item 15)

<p>ED Proposals</p>	<p>An entity is able designate a combination of 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) as a hedged item.</p>
<p>Constituent feedback and IASB staff recommendations</p>	<p>Feedback was overwhelmingly supportive of the ED proposal because it aligns hedge accounting with risk management. Commentators noted the proposal removes arbitrary restrictions and is principle-based. Entities would be able to designate hedging relationships where there is an existing hedge in place. While it is possible to jointly designate multiple derivatives as the hedging instrument under IAS 39, the proposal provides more scope for entities to apply the requirements to suit circumstances involving multiple derivatives at different times. Entities would no longer have to discontinue the hedging relationship and designate a new one when hedge accounting is applied to an existing hedging relationship involving an exposure and derivative. Many constituents commented that the examples provided in the ED are relevant to practice.</p> <p>The main suggestions constituents had were for further examples and guidance to be provided, clarification regarding ‘synthetic accounting’ and to clarify whether hedge accounting needed to be applied for the combination of the exposure and the derivative that constitutes the aggregated exposure.</p> <p>One of the specific situations that staff analysed was the use of basis swaps when hedging aggregated exposures. It was noted that what is generally described by the term ‘basis swap’, an exchange of one variable payment for another (e.g. a swap of 1 month LIBOR for 3 month LIBOR payments), does not qualify for hedge accounting. Staff concluded that no specific requirements had to be added for aggregated exposures and the general requirements for basis swaps could continue to be applied.</p> <p>Staff considered the main issues and other specific situations involving aggregated exposures and recommended IASB members:</p> <ul style="list-style-type: none"> – Confirm the proposal in the ED; (The voting was 12 in favour and 3 against) – Provide examples and guidance including illustrative examples; (The voting was 14 in favour and 1 against) – Add a specific statement that derivatives that form part of an aggregated exposure are always recognised as separate assets or liabilities and measured at fair value, and, state in the basis for conclusions that accounting for aggregated exposures is a part of hedge accounting and hence different from ‘synthetic accounting’, which is not allowed; (All 15 members voted in favour) – Not impose any specific restrictions on an aggregated exposure being in a hedging relationship or all its items being at fair value through profit and loss if otherwise a hedging relationship between the two items would be a fair value hedge; and (The voting was 10 in favour and 5 against) – Add clarification for the following two aspects: <ul style="list-style-type: none"> • Expand the description of aggregated exposure to note that the notion of an aggregated exposure includes a highly probably forecast transaction of an aggregated exposure if that aggregated exposure once executed is eligible as a hedged item; and • Add application guidance on the general hedging requirements in the context of aggregated exposures, i.e. the way a derivative is designated as a hedged item as part of an aggregated exposure must be consistent with any designation of that derivative as the hedging instrument at the level of the aggregated exposure and designated in its entirety or as a

	percentage of its nominal amount. (The voting was 14 in favour and 1 against)
AASB feedback	<p>The AASB supports the proposal to expand the exposures eligible for designation as a hedged item. However, the AASB believes that guidance is needed in this area. The proposals have raised a number of concerns. For example:</p> <ul style="list-style-type: none"> – Is it necessary for the first hedge to meet the hedge accounting criteria, or only the combined hedge? – Not all of these types of hedges will be transacted at inception – therefore, if the first hedge is transacted and subsequently the entity decides to enter a second hedge, would this be a change in risk management strategy such that the first hedge should be discontinued.
IASB redeliberation and tentative decisions	<p>Board members generally agreed with the staff recommendations but were concerned about the earnings management possibilities. One member pointed out that it was possible to defer the recognition of any gains or losses of a derivative in profit or loss by combining it with another exposure to create an aggregated exposure. Staff noted that a requirement to create an aggregated exposure is that the derivative and exposure must be managed as one exposure for risk. Other members requested that more clarification and emphasis be placed on the concept of ‘managed as one exposure’. The votes are presented above.</p>

Additional IASB meeting – 28 July 2011

NB: Five Board members were absent for this meeting.

17. Disclosures (IASB Agenda Item 1)

ED Proposals	<p>The ED proposed a series of disclosure requirements related to the risk exposures an entity decides to hedge and for which hedge accounting is applied:</p> <ul style="list-style-type: none"> – an entity’s risk management strategy and how it is applied to manage risk; – how the entity’s hedging activities may affect the amount, timing and uncertainty of its future cash flows; and – the effect that hedge accounting has had on the entity’s financial statements.
Constituent feedback and IASB staff recommendations	<p>Constituents were generally supportive of the disclosure proposals [except topic (c) below] but have raised some concerns, which staff have analysed and brought to the Board for consideration. The topics discussed were:</p> <ul style="list-style-type: none"> (a) scope of the hedge accounting disclosures; (b) description of the risk management strategy (paragraph 44 in the ED); (c) timing, amount and uncertainty of future cash flows (paragraph 45-48 in the ED); and (d) effects of hedge accounting on the financial statements (paragraph 49-52 in the ED). <p>The staff analysis and recommendations are as follows:</p> <ul style="list-style-type: none"> (a) Confirm the proposed scope in the ED – to disclose information for only those risks that entity manages as part of its risk management strategy and for which hedge accounting is applied. (b) Confirm the proposed disclosure requirements related to an entity’s risk management strategy in the ED with added clarity and guidance examples. Staff think that additional principle based guidance is needed to avoid entities taking a checklist approach and

	<p>disclosing only minimum information.</p> <p>(c) Due to concerns expressed by constituents, staff recommended that disclosure exemptions be provided in situations which would result in commercially sensitive information being disclosed or hedge accounting is used as a surrogate for dynamic hedging. Instead of the proposals in the ED entities would have to disclose for commercially sensitive information:</p> <ul style="list-style-type: none"> – the principal, stated, face or other similar amount (referred to as the notional amount) of the hedging instrument; – a profile of the timing of the principle, stated, face or similar amount. <p>For situations where an entity applies hedge accounting as a surrogate for dynamic hedging, an entity would disclose:</p> <ul style="list-style-type: none"> – why the entity uses hedge accounting as a surrogate for dynamic hedging; and – what the ultimate risk management strategy is (for the dynamic hedge) and how it meets the objective using hedge accounting and designating the particular hedging relationships. <p>(d) Confirm the tabular disclosures in the ED with additional information on the changes in fair value of the hedged item and hedging instrument used to calculate hedge ineffectiveness and to not introduce a disclosure requirement specifically for distinguishing between financial instruments that have been designated as hedging instruments and those that have not. Staff also proposed not to prescribe a specific level of aggregation or disaggregation but instead consider the level of aggregation or disaggregation of the disclosures in IFRS 7 and IFRS 13 for hedge accounting disclosures.</p>
AASB feedback	<p>The AASB supports the proposed disclosure requirements, especially in respect of an entity’s risk management strategy. However, there are concerns that those entities choosing to apply hedge accounting would be required to comply with extensive disclosure requirements, while those entities that elect not to apply hedge accounting do not (as the requirements will only apply to entities that apply hedge accounting). Presumably the disclosures are intended to lead to clearer and more transparent reporting about an entity’s risk management strategy and hedging activities, yet many entities would not be making those disclosures.</p>
IASB redeliberation and tentative decisions	<p>(a) Board members agreed that the scope is limited to disclosure of information on risk exposures being hedged and for which hedge accounting is applied. Requiring disclosures for all risk exposures would create inconsistencies with entities that do not apply hedge accounting at all. (The voting was 9 in favour and 1 against)</p> <p>(b) Board members agreed with the principle based approach and additional guidance recommended by staff. (The voting was 9 in favour and 1 against)</p> <p>(c) Board members recognised that the requirements could result in commercially sensitive information being disclosed and agreed with the staff recommendation about disclosing additional information on the average price or rate of the hedging instrument. While the Board discussed what disclosures would be useful when a dynamic hedging process is applied, no decision was made and the topic will be further discussed in the next meeting. (The voting was 10 in favour and 0 against)</p> <p>(d) The Board tentatively agreed with the staff recommendations. (The voting was 10 in favour and 0 against except for not distinguishing between financial instruments that have been designated as hedging instruments and those that have not which was 7 in favour and 3 against)</p>

18. Hedged items – risk components (IASB Agenda Item 3)

ED Proposals	An entity is able to designate as a hedged item the changes in the cash flows or fair value of an item attributable to a specific risk (both financial and non-financial) provided that the risk component is separately identifiable and reliably measurable.
Constituent feedback and IASB staff recommendations	<p>Constituents were overwhelmingly supportive of the proposals as crucial to aligning hedge accounting with risk management. It was noted that hedging of a risk component as opposed to the whole item is the norm. The main requests were for additional guidance and clarification, especially on non-contractual components of non-financial items.</p> <p>Staff made the following proposals to the Board:</p> <ul style="list-style-type: none"> (a) confirm the use of risk components as eligible hedge items; (b) set a criteria-based approach for determining eligible hedged items (separately identifiable and reliably measurable); (c) use the same criteria for financial and non-financial items; (d) provide guidance by using examples to illustrate how the criteria should be applied; and (e) address the restriction in the ED that prohibits non-contractually specified inflation risk components of financial items as a hedged item.
AASB feedback	The AASB agrees with the proposal to expand on the requirements in IAS 39 to allow an entity to designate changes in the cash flows or fair value of either a financial or non-financial item attributable to a specific risk or risks (ie a risk component), provided that the risk component is separately identifiable and reliably measurable.
IASB redeliberation and tentative decisions	<ul style="list-style-type: none"> (a) Board members agreed with the need for entities to apply hedge accounting to risk components. (The voting was 9 in favour and 1 against) (b) The Board agreed with the criteria-based approach and confirmed that ‘separately identifiable’ and ‘reliably measurable’ are suitable. (The voting was 9 in favour and 1 against) (c) The Board agreed the same criteria-based approach should be applied for financial and non-financial items as there was no basis for differentiating between the two types. (The voting was 9 in favour and 1 against) (d) Board members discussed the need to provide examples as guidance. While it was agreed that examples are the best way of explaining the criteria, members were concerned that constituents would interpret the application in the examples as requirements. The Board voted 8 in favour and 2 against providing examples. (e) Board members discussed inflation risk and agreed that the prohibition on designating inflation risk components needed to be removed as there existed situations where it can be separately identifiable and reliably measurable. Members voted (9 in favour and 1 against) to remove the restriction in the ED but add a ‘caution’ and ‘rebuttable presumption’ regarding its use. It was also agreed to provide an example where an inflation risk component is eligible for designation as a hedged item and one where it is not. (The voting was 6 in favour and 4 against)

19. Contracts to buy or sell non-financial items that can be settled net in cash (IASB Agenda Item 4)

ED Proposals	The ED proposes that derivative accounting apply to contracts to buy or sell a non-financial item that can be settled net in cash that was
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	entered into and continues 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 (ie 'own use' contracts) if it is in accordance with the entity's fair value-based risk management strategy and the entity manages the net risk position to nil or close to nil.
Constituent feedback and IASB staff recommendations	<p>There was general support for the proposed change as it would facilitate a better presentation of the overall economic effects of such transactions albeit for a limited number of entities. However, some responded with significant concerns that the proposal would create accounting mismatches for other entities with items managed within a fair value based risk management strategy that are not measured at fair value. Staff provided the following alternatives to address the issue:</p> <ol style="list-style-type: none"> 1. retain the proposal in the ED (forced to recognise 'own use' contracts as derivatives if the conditions are met); 2. extend the FVO in IFRS 9 to these 'own use' contracts (irrevocable election only in situations which it eliminates or significantly reduces an accounting mismatch); 3. provide an elective 'own use scope' exception (irrevocable free choice election without restriction); 4. retain the requirements in IAS 39 and reconsider the issue more comprehensively at a later date (no derivative accounting applied to 'own use' contracts). <p>Staff recommended the Board adopt alternative 3 as it would allow for more faithful representation of the financial position and performance of entities and avoid creating unintended accounting mismatches.</p>
AASB feedback	For the reasons outlined in paragraph BC209-BC218 of the Basis for Conclusions, the AASB agrees that an entity should be able to account for contracts that can be settled net in cash 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 at fair value if that is in accordance with the entity's risk management strategy.
IASB redeliberation and tentative decisions	The Board considered the issues raised by staff and acknowledged the accounting mismatch that would be faced by some entities due to the proposals in the ED. While some Board members were hesitant to provide another accounting policy choice, members agreed with the staff recommendation to extend the FVO to 'own use' contracts. (The voting was 7 in favour and 3 against)

20. Hedges of credit risk using credit derivatives (IASB Agenda Item 5)

ED Proposals	The ED discussed applying hedge accounting to the hedging of credit risks and asked for comments on the issue but did not propose any changes. The ED presented three alternatives to hedge accounting involving electing use of fair value through profit or loss in order to avoid an accounting mismatch with the economic consequences of the credit derivatives.
Constituent feedback and IASB staff recommendations	Constituents commented that it was a significant issue with financial institutions frequently using credit derivatives (eg credit default swaps (CDS)) to manage exposures to credit risk from loans and loan commitments. However, hedge accounting is not currently being applied to these transactions because it is operationally difficult to isolate and measure the credit risk component. Staff analysed several alternative methods including using the same guidance in IFRS 7 and IFRS 9 for measurement of an entity's own credit risk but concluded that all methods could only at best provide an approximation of the credit risk component. The staff recommendation was to adopt alternative 3 in the ED that would permit entities to elect measure loans and loan commitments being hedged by credit derivatives at fair value through profit and loss at initial recognition or subsequently.

AASB feedback	<p>The AASB is concerned with the proposal in respect of credit risk and the justification that “...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...”.</p> <p>The IASB should be consistent in its decisions regarding credit risk – if it is satisfied that the fair value change of a financial liability due to a change in the entity’s credit risk can be measured sufficiently reliably to be presented in OCI, then it is not clear why financial institutions should not be able to achieve hedge accounting for credit risk.</p> <p>More generally, the AASB believes the IASB should specifically consider how to account for the impact of credit risk as it is becoming an increasingly significant issue in the application of IFRSs.</p>
IASB redeliberation and tentative decisions	<p>The Board noted that accounting for CDS transactions used to hedge credit risk is an urgent issue that needs to be addressed. However, views were mixed on which method should be used and whether it should be a part of the hedge accounting project. The Board members and staff concluded that the issue needed to be explored further including an approach reflecting the insurance-like nature of credit derivatives that are used to manage credit exposures. (The voting was 10 in favour and 0 against)</p>
Update from 19-22 September 2011 IASB meeting (agenda item 16)	<p>The Board members decided that an insurance-like approach for accounting for credit derivatives would not be suitable as it would involve not measuring the credit derivatives at fair value. While members were generally unsatisfied with the solutions available, it was decided that the elective FVTPL method was the least unattractive. It was recognised that this issue needed an urgent solution and that the elective FVTPL method, while not perfect, would be a vast improvement over the current accounting for CDSs.</p> <p>The elective FVTPL method would permit:</p> <ul style="list-style-type: none"> (a) electing FVTPL at initial recognition or subsequently for credit exposures (if subsequently, the difference between the then carrying amount and fair value is recognised immediately in profit or loss), (b) making that election for a component of nominal amounts (instead of the entire nominal amount), and (c) discontinuation of FVTPL accounting. <p>In order to qualify to use elective FVTPL, the credit exposure must match the CDS and additional disclosures are required.</p> <p>The voting was 11 in favour and 4 against.</p>

IASB meeting – 19-22 September 2011

21. Disclosures – dynamic hedging strategies (IASB Agenda Item 14)

ED Proposals	<p>This issue relates to disclosure requirements on the amount, timing and uncertainty of future cash flows (paragraph 45-48 in the ED), which were amended at the July 2011 IASB meeting (item 17 in this paper). The Board tentatively agreed to change the focus of the disclosures to the hedging instruments instead of the exposures because of concerns over commercially sensitive information. Dynamic hedging strategies were not discussed in the ED.</p>
Constituent feedback and IASB staff	<p>Feedback from constituents identified that some entities employ a ‘dynamic’ hedging process, which involves frequently discontinuing and restarting hedging relationships for constantly evolving exposures.</p>

recommendations	<p>The IASB staff view is that in such situations it would not be useful to provide disclosures about the hedging relationships at balance date when they are constantly changing throughout the period. Therefore, staff recommended that hedging instruments that are a part of dynamic hedging processes should be exempt from disclosure requirements about their terms and conditions. Instead, entities shall expand the description of their risk management strategy by providing:</p> <ul style="list-style-type: none"> (a) information about what the ultimate risk management strategy is for the dynamic hedging process; (b) a description of how it meets that objective by using hedge accounting and designating the particular hedging relationships; and (c) an indication of how frequently the hedging relationships are discontinued and restarted as part of the dynamic process. <p>Further, entities would have to disclose if the volumes of the hedging relationships at balance date are not representative of the normal volumes throughout the period.</p>
AASB feedback	No specific comment
IASB redeliberation and tentative decisions	<p>Board members agreed with the staff view that the disclosures about the hedging instruments would not be useful when dynamic hedging strategies are applied. Some members were concerned about the exact nature of the additional replacement disclosure requirements. Staff indicated that the general wording was to encourage entities to provide useful information instead of boiler plate disclosures. The voting was 13 in favour and 2 against providing the exemption and replacement disclosure requirements. The voting was 12 in favour and 3 against requiring disclosure that the volumes of the hedging relationships are not representative of the normal volumes.</p>

22. Transition (IASB Agenda Item 15)

ED Proposals	<p>The ED proposed that the new requirements be applied prospectively with an effective date of 1 January 2013 (amended to 1 January 2015 for IFRS 9) and that the new model could only be applied if all the existing IFRS 9 requirements are adopted. It was mentioned that one-off transitional provisions would be allowed.</p>
Constituent feedback and IASB staff recommendations	<p>Constituents were strongly in favour of prospective application as it would reduce complexity and mitigate the risk of hindsight in designating hedging relationships retrospectively. It is noted that this is consistent with the transition requirements in IAS 39 for hedge accounting. Some requested that limited retrospective application be allowed in situations where eligibility criteria for hedge accounting have been extended, ie for risk components, aggregated exposures, groups and net positions, and the time value of options and forwards points.</p> <p>Staff considered the feedback and considered that it would not be possible to allow retrospective application where it involves the designation of hedging relationships for past transactions because of the hindsight and earnings management risks. However in situations where the hedging relationships are already in place, retrospective application should be allowed so that the hedges are revalued under the new requirements (for options and forwards). This would increase comparability and usefulness with limited hindsight risk. For options, retrospective application would be mandatory as accounting for the time value of options is mandatory under the new model.</p>

	<p>Retrospective application would be optional for forwards as recognition of the forward points in the hedging relationship is also optional. However entities must choose whether to apply the new treatment to forwards on an all-or-nothing basis retrospectively. This contrasts with the hedge-by-hedge decision available prospectively.</p> <p>Staff also suggested that two practical accommodations be made for prospective application of continuing hedging relationships. Entities would be able to consider the moment that IAS 39 ceases to apply and the moment when the new model is applied as the exact same point in time. This would allow entities to discontinue hedges under IAS 39 and designate new hedges under the new model without a time lag affecting values. The hedge ratio used under IAS 39 would be the starting point for rebalancing hedging relationships to ensure that they qualify under the new requirements.</p>
AASB feedback	<p>It is not clear what the IASB's means by 'prospective' in the proposals. In addition, the AASB believes that providing a once-off retrospective adjustment on transition to the new requirements may be warranted, especially in instances where there are long-dated existing hedging relationships and applying the requirements prospectively would require the entity to keep two sets of hedging books and report different results for the same type of hedging relationship.</p>
IASB redeliberation and tentative decisions	<p>Board members agreed with the staff view on all matters. The voting was 15 in favour and 0 against prospective application (with the exceptions mentioned) and aligning the mandatory effective date with the other phases of IFRS 9 to 1 January 2015. The voting was 14 in favour and 1 against allowing retrospective application for options and 13 in favour and 2 against for the treatment of forwards as per the staff recommendations. Members all voted in favour of the practical accommodations.</p>

Attachments

The IASB agenda papers are available on the IASB website. However, please contact Huy Pham (hpham@asb.gov.au) if you would like to receive copies of any of those agenda papers.