

# Technical Line

FASB – proposed guidance

## Hedge accounting: Is convergence possible?

### In this issue:

Overview .....	1
Hedged items .....	2
Hedging instruments .....	7
Qualifying criteria for hedge accounting.....	11
Maintaining the hedging relationship.....	12
Frequency and nature of effectiveness tests .....	17
Discontinuation of hedging relationships.....	18
Measuring ineffectiveness .....	19
Hedges of a group of items .....	19
Presentation and disclosure .....	22

### What you need to know

- ▶ The FASB and the IASB have proposed amending their hedging models, but there are key differences that would not promote convergence.
- ▶ The FASB solicited comments on the IASB model as part of its deliberations on its own model and may include some of IASB's concepts in the final FASB model.
- ▶ The FASB proposal provides easier access to the hedge accounting model, plus a few specific changes that have received a mixed reaction.
- ▶ The IASB proposal is more ambitious and includes several novel concepts that the IASB believes line up with companies' risk management activities.

### Overview

Among the proposals issued by the Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) to amend financial instruments accounting, the hedge accounting sections were the most favorably received.<sup>1</sup> Both Boards heard support from constituents for attempting to make hedge accounting easier to accomplish with changes that constituents found substantial and helpful.

But even though the FASB and the IASB started with very similar intentions, they did not end up with the same proposed solutions. Just as the FASB processed its largely favorable comment letters in the fall of 2010, the IASB exposed its alternative model in December. In February 2011, the FASB asked its constituents for their views on the IASB's proposals.<sup>2</sup>

Although both Boards had the same objectives in developing an improved hedging model, the proposals are significantly different.

In its redeliberations, the FASB will likely examine some of the differences between its proposal and the IASB's, perhaps considering which of the IASB's ideas should be incorporated to US GAAP. Less likely but still possible, the FASB could drop its proposed model and adopt the IASB's as a starting point, dropping those aspects that would not work in the US. In our comment letter we urged both Boards to jointly deliberate the hedge accounting model.

One challenge to convergence will be scale. The IASB hedging model is much more ambitious than the FASB's. For the most part, the FASB preserved the basic structure of the US GAAP hedging model, including what constitutes an eligible hedge strategy, how hedge ineffectiveness is measured and how the effects of hedge accounting are presented in the balance sheet and income statement. The FASB's goal was to make it easier for companies to qualify for hedge accounting and reduce the chance of losing qualification for hedge accounting.

In this sense, the FASB was responding to requests from constituents who wanted relief from second-guessing and the differing interpretations of the FASB's strict hedge qualification rules and what truly constitutes a "highly effective" hedge relationship. The proposed new FASB standard of "reasonably effective," combined with the qualitative approaches to assessing hedge effectiveness and the removal of the mandatory quarterly reassessments, is designed to provide that relief.

In contrast, the IASB took on large-scale issues, such as allowing a non-financial risk component to be separately hedged, permitting a non-derivative financial instrument measured at fair value through profit and loss (FVTPL) to be a hedging instrument and permitting a net risk position to constitute an eligible hedged item.

Furthermore, the IASB model introduces the concept of "rebalancing a hedge," requiring rebalancing when a hedge relationship loses effectiveness but the risk management objective is still the same. The IASB proposes to view the post-rebalanced hedge as a continuation of the original hedge relationship, which is not in the current or proposed FASB model. Instead, the FASB views a rebalanced hedge relationship as a new relationship that must have a fresh start to hedge documentation and hedge effectiveness assessment.

The remainder of this publication walks through the highlights of both the IASB's and the FASB's hedging models, noting similarities and differences. Because the IASB's model is more ambitious and introduces new concepts, it raises a number of questions. In this document, we express our views on how some of those questions should be addressed.

This document is organized in the order of the major topical categories covered by the IASB Exposure Draft.

## Hedged items

In addition to items currently hedgeable under US GAAP, the IASB's proposal would permit the following items to be eligible for hedge accounting:

- ▶ An aggregated exposure comprising a derivative and a non-derivative
- ▶ Risk components of non-financial items

- ▶ Portions or layer components of items within fair value hedges (discussed on page 21)

## Derivatives as hedged items

### *IASB – Proposed*

The IASB's proposal provides that "an aggregated exposure that is a combination of an exposure and a derivative may be designated as a hedged item." This provision would not allow derivatives to be measured at amortized cost. Rather, it would permit derivatives to be included as a hedged item and included in the assessment of effectiveness and measurement of ineffectiveness.

#### **Illustration 1 – An aggregated exposure**

Entity A (EUR functional currency) may wish to lock in the USD price of its coal purchases for the following year. Entity A's coal purchase for the following year is highly probable and priced in USD. Entity A transacts a coal forward in USD fixing the USD coal price, and designates it as a cash flow hedge of coal price risk. Three months later, Entity A wishes to hedge the FX exposure on the fixed USD coal price using a USD/EUR currency forward. The IASB's proposal would permit Entity A to designate the currency forward as a hedge of the combination of the forecasted purchase of coal in USD and the USD-denominated coal forward. This hedge relationship synthetically achieves a fixed coal price denominated in EUR.

### *FASB – Current and proposed*

Neither current nor proposed US GAAP permits derivatives to be designated as a hedged item. However, US GAAP currently addresses these types of multiple risk hedges by permitting two derivatives to be designated in combination as "the hedging instrument" in a given relationship. In the coal example above, US GAAP permits the coal forward and the USD/EUR currency forward to be designated in combination as the hedging instrument that addresses the cash flow risk associated with the probable purchase of USD-denominated coal with Euros. But because the coal forward was entered into first, US GAAP would require the hedger to re-designate the coal forward into a new hedge relationship that includes the new currency forward, and the hedger would have to address the sometimes problematic issue of the now off-market coal forward no longer having a fair value of zero.

## **How we see it**

Because the IASB's approach to the coal example would simply designate the currency forward anew without needing to change the designation of the original coal forward, the IASB model reflects the way a risk manager would dynamically address an additional risk it wants to hedge. Including an already existing derivative as part of an aggregated hedged item would provide more flexibility in aligning hedging strategies with risk management objectives.

If the FASB were to consider the overall concept of rebalancing a hedge without re-designating a hedge (discussed later in this publication), incorporating this aspect of the IASB proposal would not be difficult.

## Component of a non-financial item

### *IASB – Proposed*

The IASB's proposal would permit a component of a non-financial item to be designated as a hedged item if the component is "separately identifiable and reliably measurable." To be identifiable, the risk component may be contractually specified or implicit in the determination of fair value or the cash flows of the item to which the component belongs. To be reliably measurable, an active market for the component would likely be required unless the entity could otherwise reliably derive a price.

Examples where contractual components of non-financial items may exist would include the following:

- ▶ Gas supply contracts often include a price escalation clause based on the price of gas oil or fuel oil in addition to other components.
- ▶ Electricity is sometimes sold based on a formula tied to the cost structure of a power plant. The contractually agreed prices may include for example, elements of coal prices and the cost of emission rights.
- ▶ Many industries index the price of metals, agricultural produce, oil or chemical products to benchmark commodity prices in their purchase or sales contracts.

All hedges of risk components will not result in a hedge that has no ineffectiveness. If there is basis risk between the risk component and the hedging instrument, there likely would be some ineffectiveness. For example, if the pricing formula for the hedged item is based on the monthly average price for copper and the hedging instrument is priced based on the month-end closing copper price, there will be some ineffectiveness.

Although not explicitly stated in the proposal, we believe the IASB would restrict the designation of components of non-financial items to components with cash flows less than or equal to the total cash flows of the non-financial item. This restriction would be consistent with the current IAS 39<sup>3</sup> restriction for hedging financial items commonly referred to as the "sub-LIBOR issue," in which LIBOR cannot be identified as a component of fundings that are issued at LIBOR minus a fixed spread.

The IASB's proposal provides that an entity's assessment of which risk components are eligible for designation as a hedged item should be made "in the context of the particular market structure." We understand this provision to mean that the component must be a standard part of the pricing structure by market convention. This guideline would require an evaluation of relevant facts and circumstances, and there would be no bright lines to determine eligible risk components of non-financial items.

Although many industries will likely support component hedging, ineffectiveness will exist anytime there are differences in the terms of the hedging instrument and hedged component.

Identifying risk components that are not contractually specified may require both a qualitative and quantitative analysis. An understanding of the drivers that affect pricing is required to demonstrate that a particular component is a driver of the price of the whole item. While it is likely that the component should be a physical ingredient of the whole item, that fact alone is unlikely to be sufficient. In addition, it would need to be demonstrated that there is a relationship between the price of the component and that of the whole item or that it is standard practice to reflect the price of the component in the price of the whole item. As an example, while rubber is a component of the manufacture of rubber tires, it might be difficult to reliably identify and measure the rubber component's effect on the tire price.

#### ***FASB – Current and proposed***

Under current and proposed US GAAP, a non-financial item may be designated as the hedged item only for its foreign currency risk or all its risks in their entirety. There is currently no accommodation to allow hedging of components of non-financial risk.

Being able to qualify for hedge accounting for a component of a non-financial exposure is probably at the top of most corporate hedgers' wish lists.

#### **How we see it**

Hedging components of non-financial items would be valuable to many industries, particularly for those outside of financial services. The advantage of identifying and designating a risk component of a non-financial item is that the hedging instrument would need only to offset the variability of the identified risk component rather than the risks of the entire non-financial item. This would likely enable many more hedge relationships to qualify for hedge accounting and result in less ineffectiveness in earnings. As a result, we believe FASB constituents, particularly commodity hedgers, will ask the Board to consider incorporating this concept in US GAAP.

One reason we understand that the FASB, and the IASB until now, have disallowed hedging of components of non-financial items is that they believed that such hedges would effectively result in a "self-fulfilling prophecy of no hedge ineffectiveness," because the hedged component would always be defined in such a way as to exactly match the hedging instrument. While in some cases that could be a likely result, there is always the potential for hedge ineffectiveness because of unanticipated changes in quantity or in timing that this provision would not eliminate.

When components are not contractually specified, a quantitative analysis would likely be required to support a hedge ratio that supports an assertion that the hedge relationship will produce an unbiased result and minimize expected hedge ineffectiveness. For hedges that last over several periods, the IASB model would require that hedge ratio to be rechallenge and possibly rebalanced.

We believe that this provision could be very helpful and cause more companies to consider using hedge accounting, particularly since the IASB proposal does not require components to be contractually specified. However, we believe that there will be many implementation questions as to which types of components are eligible for designation. Accordingly, we have recommended that the guidance be expanded.

For example, in demonstrating that a component (by virtue either of manufacture or pricing) is a driver of the price of the whole item, additional guidance could be helpful regarding potential factors to consider. These factors could include whether:

- ▶ The component is a physical ingredient of the whole item.
- ▶ An indicative price list exists that includes the component price in a formula.
- ▶ It is common market practice to include the component in pricing.
- ▶ There is statistical evidence indicating consistent price sensitivity to the component.
- ▶ The risk component is actively traded and therefore liquid prices are readily available.

### Time components of risks

#### *IASB – Proposed*

We believe that allowing the designation of a component of non-financial item may also permit the designation of a time component of a risk. For example, an entity may designate a three-month forward FX risk as a component of a four-month forward FX risk in the same currency. As such, the majority of ineffectiveness from a change in timing of a hedged item could be eliminated in a cash flow hedge as long as the hedged item was expected to occur sometime after three months.

#### *FASB – Current and proposed*

The designation of a “time component” of a risk is not permitted in current or proposed US GAAP.

### **How we see it**

The IASB model would potentially de-link the timing of the cash flow from the derivative from being required to match the timing of the hedged cash flow, if the “component” of the hedged risk were considered a time sub-component. Although entities typically want to match the cash flows of the derivative with the cash flows of the hedged item, there are instances where such a strategy could be useful. For example, assume an entity expects to pay FX expenses in 4 months but also expects to receive an equal amount of the same currency under a separate transaction in 3 months. In this scenario, a 3 month forward FX may suffice as a hedging instrument, since the exposure in the fourth month is expected to be naturally hedged by the currency to be received in the third month and held to pay expenses in the fourth month.

### Credit risk

#### *IASB – Proposed*

Many financial institutions use credit derivatives (such as credit default swaps or CDSs) to manage the credit risk resulting from their lending activities. As the spread between the risk free interest rate and the market interest rate of a financial asset incorporates risk in addition to credit risk, such as liquidity risk, the IASB considers

it difficult to isolate and measure the changes in fair value attributable only to the change in credit risk. Therefore, credit risk would not be an eligible risk component under the IASB's proposal.

However, the IASB requested feedback on four approaches that would allow entities to effectively hedge credit risk by electing the fair value option (FVO) for the hedged item thereby reducing the accounting mismatch.

#### ***FASB – Current and proposed***

Under current and proposed US GAAP, credit risk may be hedged separately from the other risks inherent in the hedged item. However, the types of credit derivatives available in the marketplace are not typically highly effective. Therefore, such hedges are not commonly used in practice. Conceivably, the loosening of the FASB standard from "highly effective" to "reasonably effective" could expand the use of credit derivatives to hedge specific credit risk components of financial items.

### **How we see it**

Many banks and financial institutions have long wanted to achieve hedge accounting for credit risk using credit derivatives. However, while modifying the FVO will reduce the accounting mismatch between credit derivatives and credit exposure of a hedged item, it also would create additional complexity.

The Boards have not offered a solution to the difficulty of hedging credit risk, although the FASB's "reasonably effective" language may be one critical step forward. That said, credit derivatives that are not specifically customized to the credit risk of a particular financial instrument would still require an entity to envision and fair value a perfect hypothetical derivative that is very customized, in order to measure hedge ineffectiveness.

## **Hedging instruments**

The IASB proposed model would permit entities to designate a wider range of instruments as hedging instruments. However, written options and internal derivatives would continue to be prohibited as hedging instruments. For purchased options, the model proposes to change the accounting for the time value portion, which would significantly reduce volatility in earnings when compared to the current IASB hedging model.

The FASB is also proposing a significant change that would require the amortization of the time value of purchased options on a "rational basis," if measuring effectiveness based on total changes in the option's cash flows (as opposed to based only on the option's intrinsic value).

The proposed changes for the time value of options are slightly different under both standards (see further discussion below).

## **Cash instruments**

### ***IASB – Proposed***

The IASB proposal would expand the population of permissible hedging instruments to include certain non-derivative financial instruments. Under the proposal, entities would be able to use cash instruments that are measured at fair value through

profit or loss as hedging instruments of different types of risks. For example, an entity wishing to hedge interest rate exposure from a commitment to make a loan would no longer be required to enter into a derivative, but could instead hedge that exposure by “short selling” a bond. In such a fair value hedge, the changes in fair value of the short position would be recorded in other comprehensive income (OCI) until the hedged risk affects profit or loss.

The IASB’s proposal would require the cash instrument (1) to be designated in its entirety (or a pro-rata portion) for hedges other than hedges of foreign currency risk and (2) to be a contract with a party external to the reporting entity. Therefore, in the example, the changes in the credit spread of the bond would result in ineffectiveness.

### ***FASB – Current and proposed***

Currently, under US GAAP, cash instruments may be used to hedge only foreign exchange exposures (in a net investment hedge) or an unrecognized firm commitment (in a fair value hedge). The FASB proposal retains this requirement.

### **How we see it**

Entities that use cash instruments as part of their risk management activities would benefit from the IASB proposal. There has not been a wide desire in the US to use cash instruments for hedging purposes. The requirement to designate the entire cash instrument (or a pro-rata portion) in the hedging relationship may further deter this because the ineffectiveness may be significant.

### **Options**

#### ***IASB – Proposed***

The IASB proposal would continue to prohibit designating individual written options as hedging instruments, even when combined with others such that the combination is not a net written option. Conversely, derivative instruments such as collars have the characteristics of a combination of written and purchased options yet they are permitted as hedging instruments as long as the entire instrument is not a net written option. If a collar is constructed through a designation of separate instruments, one of which is a written option, only the purchased option can be designated as an eligible hedging instrument. The written option would be ineligible.

In addition, the IASB proposes to account for the time value of an option in a hedge accounting relationship by making a distinction between two types of hedged items:

- ▶ Transaction related (e.g., the forecast purchase of a commodity)
- ▶ Time period related (e.g., the interest payments on a debt instrument)

This approach reflects the risk management function of options rather than their time value being treated as trading derivatives. Consequently, option premiums (time value of options) can be deferred in OCI and would be either capitalized as part of the cost of the hedged item or expensed over the period for which the entity is insured.

The proposal also requires aligning the option’s time value to that of the hedged item by comparing the time value with a hypothetical option that perfectly matches the hedged item (e.g., with the same notional amount, life and underlying), to determine the amount of the time value to be recorded initially in OCI.

<b>Illustration 2 - Accounting for time value of options</b>		
	<b>Transaction related</b>	<b>Time period related</b>
<b>Cumulative FV change of option's time value</b>	<ul style="list-style-type: none"> <li>▶ Recognized in OCI based on the 'lower of' the cumulative FV change of:               <ul style="list-style-type: none"> <li>▶ The actual time value (the initial time value of the purchased option)</li> <li>▶ The aligned time value (the time value that would have been paid for an option that perfectly matched the hedged item)</li> </ul> </li> <li>▶ If the actual time value is greater than the aligned time value, difference goes to P&amp;L</li> </ul>	
<b>Recycle/transfer out to P&amp;L</b>	<ul style="list-style-type: none"> <li>▶ Recycle when the hedged item affects P&amp;L</li> <li>▶ Capitalize into carrying value as basis adjustment (for non-financial hedged item)</li> <li>▶ Recognized in P&amp;L immediately if hedged item is no longer expected to occur</li> </ul>	Amortization of OCI into P&L as an expense over the period of protection on a "rational basis"
<b>Discontinuation of hedge</b>	Follow general requirements above	Unamortized OCI amount will be recognized in P&L immediately

The IASB's proposed accounting for the time value of options would apply to both fair value and cash flow hedge relationships.

***FASB – Current and proposed***

US GAAP has always permitted use of written options in the scenarios described above when the combination of the hedging instruments is not a net written option and the other qualifying criteria are met. It also permits time value decay for certain qualifying cash flow hedge relationships to be deferred in OCI and subsequently released into earnings when the hedged cash flow affects earnings (well known as the "DIG G20" method of accounting for time value of purchased options). The proposed model would change the reclassification timing and require expensing the time value component over the life of the hedging relationship from OCI to net income each period on a "rational basis."

Many constituents expressed concerns over the model's proposal to amortize the cost of an option on a "rational basis" because it would eliminate the current symmetry between the accounting for the use of an option and a forward contract in a cash flow hedge. The FASB proposal would force certain portions of the option's "cost" to be recognized before the hedged item affects earnings, while allowing the "cost" of hedging with a forward (i.e., the time value element that distinguishes between the spot and forward rates) to be included as part of hedge effectiveness and recognized at the same time as the hedged item affects earnings.

Many others also found it counterintuitive that the amortization on a "rational basis" could result in recycling an amount from OCI (to profit or loss) that is larger than the amount accumulated in OCI related to the change in the option's time value for some periods. Consider the following example:

**Illustration 3 – Time value of option used in time period related hedge**

Company A purchases a call option, as a hedging instrument, at a premium of \$24. The option is out of the money and therefore the premium represents only time value. No ineffectiveness is also assumed. Straight-line amortization is used, and it is presumed that the option never moves into the money and thus never has intrinsic value.

Period	Option's FV (time-value only) at end of period
0	24
1	20
2	6
3	0

Journal entries:

**Period 0**

Dr. Derivative asset	\$24	
Cr. Cash		\$24

Purchase of a call option – hedging instrument

**Period 1**

Dr. OCI	\$4	
Cr. Derivative asset		\$4

To record the change in fair value of the option's time value in OCI

Dr. Expense	\$8	
Cr. OCI		\$8

To record the amortization of the option's original time value on a straight-line basis over the three-year term of the hedging relationship (\$24 premium / 3 years = \$8)

**Period 2**

Dr. OCI	\$14	
Cr. Derivative asset		\$14

To record the change in fair value of the option's time value in OCI

Dr. Expense	\$8	
Cr. OCI		\$8

To record the amortization of the option's original time value on a straight-line basis over the three-year term of the hedging relationship

**Period 3**

Dr. OCI	\$6	
Cr. Derivative asset		\$6

To record the change in fair value of the option's time value in OCI

Dr. Expense	\$8	
Cr. OCI		\$8

To record the amortization of the option's original time value on a straight-line basis over the three-year term of the hedging relationship

## How we see it

Under IFRS, the overall effect of the change in accounting for the time value of purchased options would be to reduce the earnings volatility that results from the current requirements. The US GAAP proposal would represent a major change for entities that extensively use purchased options and currently do not record the “cost” of options in net income until the hedged item affects earnings.

The IASB proposal would more closely converge the accounting for time value of options for transaction-related hedged items to US GAAP. However, the FASB has proposed to replace this concept with the one described above. The proposed FASB model is similar to part of the new IASB model (for time period related hedges).

By supporting amortizing the premium paid for a purchased option on a “rational” basis over the life of the option, both Boards have implicitly adopted the “insurance premium” view to align the accounting with the risk management strategy. However, not all organizations think of purchased options as “insurance.” Some organizations believe that the cost of a purchased option is a hedging cost that should be expensed when the hedged item affects earnings. One possible compromise in a converged standard would be to allow the accounting for time value of purchased options to reflect an organization’s pre-documented accounting policy – based on its risk management philosophy.

## Qualifying criteria for hedge accounting

The concepts expressed in both Boards’ proposals are intended to lower the “highly effective” threshold that is currently the foundation for qualifying hedges under both ASC 815 and IAS 39, thereby granting companies more flexibility to enter into hedging relationships.

### *IASB – Proposed*

Under the IASB ED, a hedge relationship must produce an unbiased result, minimize ineffectiveness and achieve other than accidental offsetting. For a hedging relationship to be considered unbiased, the ratio of the hedging instrument to the hedged item should not result in an intentional mismatch. This does not imply that the hedging relationship would be expected to be perfectly effective at all times but it should minimize expected ineffectiveness.

Further, entities would need to support that offsetting expected to be achieved from the hedging relationship is “other than accidental.” This may be done by qualitatively or quantitatively assessing the economic relationship between the hedging instrument and the hedged item through studies of historical correlations, price, volatility and liquidity behaviors during different economic cycles and other forward-looking expectations that support management’s views. Similar to the FASB’s proposal, a key underlying objective of this model is to align hedge accounting more closely with a company’s risk management strategies.

### *FASB – Current and proposed*

The FASB’s proposal would replace the current requirement that a qualifying hedging relationship be “highly effective” with a requirement that it will be “reasonably effective.” ASC 815 acknowledges that circumstances may exist in which the initial

Both proposed models would allow more hedges to qualify for hedge accounting than under current practice, but the IASB’s model may require substantial effort to continuously support such qualification.

assessment of hedge effectiveness may be accomplished easily without quantitative analysis, and the proposed change reinforces and broadens this concept. Specifically, to designate a qualifying hedging relationship, companies would need to document the risk management objective expected to be achieved by the hedging relationship and how the hedging instrument is expected to manage the risks inherent in the hedged item or forecasted transaction. They must also establish that:

- ▶ An economic relationship exists between the hedging instrument and the hedged item or hedged forecasted transaction.
- ▶ Changes in fair value of the derivative are expected to be “reasonably effective” in offsetting changes in the hedged item’s fair value or the variability in the hedged cash flows.

### How we see it

Early commenters expressed concerns that the IASB’s ED is stricter than the FASB’s proposed model, as it seems to indicate that an unnecessary degree of precision may be required to qualify for hedge accounting. The FASB’s proposal does not focus on the requirement that a hedge design eliminate all bias. Instead, there is an implicit recognition that some bias in the design is acceptable as long as the hedge remains reasonably effective and hedge ineffectiveness is recognized in the financial statements.

We understand from the IASB staff that the ED was not intended to require a stricter framework. Therefore, since the objectives of both Boards are the same, we believe the IASB should consider incorporating some of the language of the FASB model. In our comment letter to the IASB, we suggested that the objective of the hedge effectiveness assessment should be to ensure that the accounting hedge relationship is expected to be reasonably effective in offsetting the entity’s exposure to the designated risk over the hedged term (i.e. the life of the hedge relationship). This includes an expectation that both:

- ▶ The changes in the value of the hedging instrument will not systematically exceed or be less than the change in value of the hedged item.
- ▶ An economic relationship exists between the hedging instrument and the hedged item.

However, this does not mean that the hedging relationship has to be expected to be perfectly effective to qualify for hedge accounting.

The IASB concept of rebalancing would likely reduce the instances requiring de-designation, but it is not clear when rebalancing would be inappropriate and de-designation would be required.

## Maintaining the hedging relationship

### *IASB – Proposed*

The IASB proposal would introduce the concept of “rebalancing” a hedge relationship. An entity would need to consider rebalancing when bias exists or it expects that ineffectiveness will not be minimized by the current hedge designation. In such cases, an entity would need to determine whether the original risk management objective remains unchanged and the qualifying criteria are still met. If so, the entity would be required to rebalance the hedging relationship to minimize any expected ineffectiveness. If there is a change in the risk management strategy, the entity would have to terminate the relationship.

Rebalancing is treated as a continuation of the originally documented relationship, rather than a de-designation and re-designation of a new relationship. Upon rebalancing, ineffectiveness is determined and recognized in earnings before any adjustment. The prospective effectiveness assessment is then performed considering the effect of rebalancing, but without the need to restart the hedge relationship.

In other words, the hedger can use the same derivative going forward as part of the new hypothetical derivative (plus any new additional derivatives used for rebalancing purposes) for the effectiveness assessment and ineffectiveness measurement rather than having to reset the hypothetical derivatives terms so that its opening fair value is zero. This definition of the appropriate hypothetical derivative avoids additional new ineffectiveness from defining a new hypothetical derivative that differs from the actual derivative(s) in use post-rebalancing.

The proposed guidance on rebalancing deals almost exclusively with situations in which the volume of the existing hedged item or hedging derivative changes. It is unclear whether rebalancing is appropriate in situations involving a change in the expected timing of a hedged item or a change in the tenor of the interest rate index underlying forecasted cash flows, but we see no reason why the guidance shouldn't apply to these situations. Consider the following example:

#### Illustration 4 – Rebalancing

On 1 January 2010, it is highly probable that on 1 July 2010 Company A will issue \$100,000,000 of five year, one-month LIBOR-based debt, with monthly coupons payable at the end of each month. To hedge the variability in cash flows related to the forecast debt issuance, Company A enters into an at-market LIBOR-based forward starting interest rate swap and designates it as a cash flow hedge. There is no initial indication of ineffectiveness at inception because the terms of the hedging instrument and the hedged item match exactly.

But on 1 July 2010, Company A issues three-month LIBOR-based debt instead, with quarterly coupons, having made the decision the day before, at the end of the 30 June reporting period. As a result, unexpected ineffectiveness now exists and the company decides to transact an at-market one-month vs. three-month basis swap to eliminate that source of ineffectiveness. Company A performs hedge effectiveness assessment on a quarterly basis.

The terms of the forward starting swap and the basis swap are as follows:

Terms	Forward starting swap	Basis swap
Trade date	1 January 2010	1 July 2010
Notional	\$100,000,000	\$100,000,000
Effective date	1 July 2010	1 July 2010
Payments	Receive: one-month LIBOR Pay: 3.30%	Receive: three-month LIBOR + 9.92 bps Pay: one-month LIBOR
Payment frequency	Monthly	Quarterly/Monthly
Maturity	1 July 2015	1 July 2015

#### Illustration 4 – Rebalancing (continued)

The following table reflects the terms of the hypothetical derivatives<sup>4</sup> at each of the following dates:

	Hypo #1	Hypo #2 <sup>5</sup>	Hypo #3 (Hypo #1 + Basis swap)
As of dates	31 March 2010	30 June 2010	1 July 2010
Trade date	Same as actual	Same as actual	Same as actual
Notional			
Effective date			
Payments	Receive: 3.30% Pay: one-month LIBOR	Receive : 3.37% Pay: three-month LIBOR	Receive: 3.30% Pay : one-month LIBOR Receive: one-month LIBOR Pay: three-month LIBOR + 9.92 bps
Settlement frequency	Same as actual	Quarterly	Quarterly/Monthly
Maturity		Same as actual	Same as actual

The fair values of the actual and hypothetical derivatives at the following reporting dates are as follows:

Dates	Fair value of actual derivatives	Fair value of hypothetical derivatives	Cumulative change of actual derivatives	Cumulative change of hypothetical derivatives	Lesser of the two cumulative changes
<b>31 March 2010</b>	(\$ 2,285,089)	\$ 2,285,089	\$ 2,285,089	\$ 2,285,089	\$ 2,285,089
<b>30 June 2010</b>	(\$ 6,746,776)	\$ 6,608,578	(\$ 6,746,776)	\$ 6,608,578	\$ 6,608,578
<b>30 September 2010</b>	(\$ 10,075,211) <sup>6</sup>	\$ 10,075,211	\$ 10,075,211	\$ 10,075,211	\$ 10,075,211

The following discussion illustrates how rebalancing might be applied to this cash flow hedge relationship<sup>7</sup>:

##### On 1 January 2010

No entry is required because the fair value of the forward starting swap is zero at inception.

##### On 31 March 2010

Company A performs an effectiveness assessment and concludes that the hedge continues to meet all qualifying criteria. There has not been any change in the anticipated debt issuance with respect to timing, amounts, tenor of the interest rate index, etc. The terms of the hypothetical derivative (hypo #1) continue to match the actual forward starting swap exactly. No ineffectiveness is recorded.

Other comprehensive income	\$ 2,285,089
Derivative liability	\$ 2,285,089
To account for the change in the fair value of the forward starting swap <sup>8</sup>	

#### Illustration 4 – Rebalancing (continued)

##### On 1 July 2010

Company A meets the criteria for required rebalancing and executes a one month vs. three-month basis swap to eliminate the unexpected source of ineffectiveness arising from the issuance of three-month LIBOR-based debt.

Under the IASB proposal, upon rebalancing, Company A would be required to calculate ineffectiveness as of the rebalancing date based on the terms of the hedging instrument and the hedged item before the rebalancing (30 June 2010). For purposes of this exercise, Company A must re-create a hypothetical derivative with a fair value of zero that reflects the terms of the forecasted debt being three-month LIBOR-based from the inception of the hedge relationship. In other words, the hypothetical derivative used in this calculation is re-defined by going back to the forward curve that existed on the date Company A entered into the actual derivative (1 January 2010) and envisioning the floating leg as based on three month LIBOR-based cash flows (see terms of hypo #2 above).

Other comprehensive income	\$ 4,323,489	
Income/expense (ineffectiveness)	138,198	
Derivative liability		\$ 4,461,687

To record the change in the fair value of the forward starting swap. As the cumulative change in fair value of the actual derivative of (\$6,746,776) is more than the cumulative change in the value of the hypo #2 of \$6,608,578, there is \$138,198 of “over-effectiveness” of the hedge. Pursuant to the proposal, Company A would be required to recognize the “over-effectiveness” amount in earnings.

In addition, Company A must perform a prospective effectiveness assessment by considering the effect of rebalancing. For purposes of this exercise, the company would use the same hypothetical derivative as the original one, plus the basis swap (the effect of rebalancing), without having to re-start a new hypothetical derivative with a fair value of zero (i.e. hypo #2) to assess the hedge effectiveness. In this case, the hypothetical derivative exactly matches the actual hedging instruments in use after the rebalancing (see terms of hypo #3 above), which addresses the new source of variability. Company A concludes the hedge relationship continues to meet all the qualifying criteria and has no other source of ineffectiveness.

There is no entry required for the basis swap because its fair value is zero at inception.

##### On 30 September 2010

Company A performs the quarterly hedge effectiveness assessment and concludes the hedge relationship continues to meet all the qualifying criteria. This is also the first quarter Company A measures ineffectiveness of the hedge after rebalancing.

Consistent with the effectiveness assessment, the measurement of the changes in value of the hedged item will be based on the adjusted terms – that is, the terms of hypo #3. For the hedging instrument, the fair value change from the date of rebalancing is also measured by reference to the adjusted terms. Because the terms of the actual and hypothetical are the same, no ineffectiveness is recorded. (Previously recorded ineffectiveness is reversed from the application of the principle of having OCI always reflect the lesser of the cumulative change of the hypothetical derivative or the cumulative change of the actual derivative.)

**Illustration 4 – Rebalancing (continued)**

Other comprehensive income	\$ 3,466,633	
Derivative liability		\$ 3,328,435
Income/expense		138,198
To account for the change in the fair value of the forward starting swap and the basis swap.		

The above hedge strategy would allow companies to improve the effectiveness of a hedge without terminating the original derivative. The IASB proposal is unclear as to whether the change illustrated above (i.e., basis change in cash flows) requires a rebalancing, provides a voluntary opportunity for rebalancing or constitutes a fundamental change in risk management strategy that necessitates hedge termination. We do not interpret this as a fundamental change in risk management strategy, which is why we have illustrated a rebalancing. Our comment letter to the FASB points out that the concept of rebalancing needs to be clarified for scenarios such as this and others.

***FASB – Current and proposed***

A change in a hedge relationship often results in the need to de-designate a relationship and re-designate a new one. Upon re-designation, the hedging instrument will likely have a non-zero fair value, whereas the hedged item would be reset with a fair value of zero. The requirement of de-designation and re-designation is onerous and creates volatility in profit or loss as the non-zero fair value of the hedging instrument introduces a source of ineffectiveness in the new relationship. In extreme cases, this could cause hedge accounting for the new relationship to fail. The FASB proposed model retains this requirement and does not contain the “rebalancing” notion to deal with changes to hedge relationships.

In the example above, under the FASB current and proposed model, the original hedge relationship would be terminated on 1 July 2010, if the company decided to address the new source of variability with a basis swap and wanted to include it in a new hedge relationship. (Another possibility is that the company could decide to accept the ineffectiveness presented by the new source of variability and test to see if the existing derivative would still qualify for hedge accounting (under the “highly effective” standard of current US GAAP or the “reasonably effective” standard of proposed US GAAP).

If the company seeks to include the new basis swap in the formal hedge designation, it must de-designate the original hedge relationship and designate a new relationship that includes the original derivative plus the basis swap. The new hypothetical derivative after de-designation and re-designation would reflect a three-month LIBOR based interest rate swap that is at market with a fair value of zero on the re-designation date.

There is a slight mismatch between the new hypothetical derivative and the two actual derivatives. While the basis swap is at-market on 1 July 2010, the original forward starting swap is not, causing that hedging instrument to be off market. Because the actual hedging instrument does not match the at-market hypothetical derivative, a new source of ineffectiveness is introduced to the hedge relationship as a result of the difference under the FASB current and proposed models.

Under both the FASB's current and proposed models, the journal entries through second quarter (and including 1 July 2010) would be the same. However, the journal entry at 30 September 2010 would reflect the change in the FASB-defined hypothetical derivative from zero to \$3,311,149.

On 30 September 2010

Other comprehensive income	\$ 3,311,149	
Income/expense (ineffectiveness)	17,286	
Derivative liability		\$ 3,328,435

To account for the change in the fair value of the forward starting swap and the basis swap.

### How we see it

Rebalancing would help eliminate difficulties we now have in practice for hedging instruments with non-zero fair values, particularly for cash flow hedge relationships. However, the IASB proposal is not clear about how companies should apply rebalancing and what other sources of ineffectiveness other than those related to volume may be subject to rebalancing. There are many common situations where other-than-volume-related ineffectiveness will be present in a relationship (e.g., location differences, quality differences or timing differences). How rebalancing is applied in these situations will be important for many hedgers. Given the many ways in which the model can be read to apply to a scenario like the one in our illustration, further clarification is necessary.

We hope the FASB will discuss rebalancing and open up the ability of hedgers to more easily make mid-course corrections that can eliminate ineffectiveness from hedging relationships without having to terminate already existing, highly effective derivatives.

## Frequency and nature of effectiveness tests

### *IASB – Proposed*

The IASB's ED would require entities to perform an ongoing assessment as to whether the hedging relationship continues to remain effective at each reporting date or upon a significant change in circumstances affecting the hedge effectiveness requirements, whichever comes first. However, such assessment would be performed only on a prospective basis.

### *FASB – Current and proposed*

The IASB's ED is similar to the FASB's ASC 815, except that ASC 815 also requires a retrospective, backward looking assessment at each reporting date as a way of determining if hedge accounting was still achieved for the reporting period just ended. In the FASB proposal, however, the requirement that this assessment be performed every reporting period would be removed and required (qualitatively or quantitatively if necessary) only when circumstances suggest that the relationship would no longer be reasonably effective.

## How we see it

The IASB's and FASB's models, in essence, both aim to instill a framework that requires ongoing monitoring and assessing of hedge effectiveness (either qualitatively or quantitatively), based on the specific facts and circumstances. However, while the IASB would explicitly require that assessment to be performed only on a prospective basis, the FASB's proposal requires reassessment of the hedge when circumstances dictate.

However, the proposals differ on the requirement for retrospective assessment. In this sense, the FASB's proposal is most similar to IAS 39 and ASC 815. We believe this retrospective assessment requirement should be included in any converged model.

## Discontinuation of hedging relationships

### *IASB – Proposed*

The IASB's ED permits discontinuation of hedge accounting only when (1) the risk management objectives are no longer met or (2) the hedging instrument expires, is sold, terminated or exercised.

### *FASB – Current and proposed*

Similarly, and representing yet another change, the FASB's proposal would prohibit companies from de-designating an otherwise "reasonably effective" ongoing hedge. Rather, a company would be required to "cash out" of that derivative (or otherwise neutralize its ongoing changes in fair value) if it no longer wishes to pursue hedge accounting, which may be accomplished by paying or receiving cash to exit the derivative or by entering into a perfectly offsetting derivative.

## How we see it

Both proposals would rule out voluntary terminations of hedge accounting aside from effectively terminating the hedging instrument itself. However, the IASB proposal would permit, and even require, an early hedge termination if the risk management objective changes, a seemingly low hurdle that turns the similarity into a difference.

Constituents are generally unhappy with the proposal to remove the option to voluntarily discontinue hedge accounting for a number of reasons, including the fact that entering into a hedging relationship is voluntary. Even under the new proposals, if an entity wanted to discontinue a hedge relationship, it could attempt to close out the derivative and transact a new one. Since the same goal is ultimately achieved, albeit with increased transaction costs, the prohibition would seem to be one of form rather than substance.

The Boards seem to be concerned about potential abuse by users of swap instruments, whereby long-term and typically higher fixed rates are swapped for short-term and typically lower initial floating rates (or vice versa when the hedged cash flows represent income), and then terminated before the swap tends to flip from an asset to a liability. We believe this proposed prohibition is unnecessarily broad and that as long as there is no ability to de-designate a hedge retrospectively, the potential for abuse appears to be small and fraught with uncertainty for those who might attempt it.

## Measuring ineffectiveness

### IASB – Proposed

The measurement of ineffectiveness related to fair value hedges would remain largely unchanged under the IASB’s ED, from an income statement perspective. However, in relation to the balance sheet, remeasurement gains or losses of the hedging instrument would be recorded in other comprehensive income, as a separate line item, and the ineffective portion would then be transferred to profit or loss.

As for cash flow hedges, the IASB’s ED retains the existing “lower of” test where ineffectiveness is not recognized when the cumulative change in fair value of the hedging instrument is less than the cumulative change in fair value of the hedged item (commonly referred to as under-hedges).

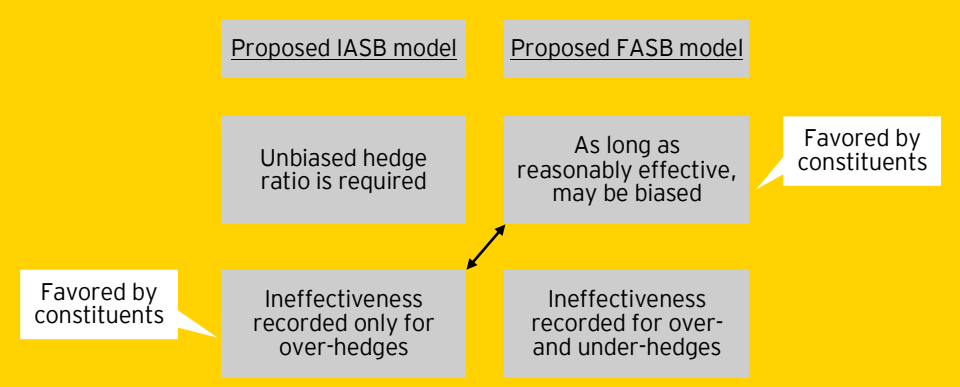
### FASB – Current and proposed

In contrast, the FASB’s proposal would introduce more significant changes to both fair value and cash flow hedges. First, the shortcut and critical terms match methods that currently exist in ASC 815 would be eliminated. Second, and more notable, is that any ineffectiveness for cash flow hedges would be recognized in profit or loss, whether the hedging derivative results in an “overhedge” (same as current model) or an “underhedge” (new in the proposed model).

The proposal would reconfirm concepts from the original discussion on DIG Issue G7 that the credit risk adjustment for a hedged item in a cash flow hedge mirrors that of the actual derivative as long as the hedged cash flows are probable of occurring.

### How we see it

As shown in the illustration below, each Board’s proposed model has features that hedgers like and dislike. Therefore, to achieve convergence, a model that embraces the FASB’s “reasonably effective” concept and the “lower of” test for cash flow hedges could be a possible solution.



The FASB proposal would require recognition of ineffectiveness from underhedges of cash flow hedges. The IASB proposal would not.

## Hedges of a group of items

The hedge accounting rules in US GAAP and IFRS were primarily designed, from a single instrument point of view where a single hedging instrument (e.g. interest rate swap) hedges a single item (e.g. a loan).

IFRS and US GAAP allow multiple items to be hedged as a group. However, the restrictions are so narrow that groups that are eligible are generally those that would also qualify for hedge accounting on an individual basis, particularly in the US GAAP model.

In an effort to address the issues raised by these restrictions, the IASB proposal would provide new criteria for multiple items to be hedged together as a group. These new criteria would address three different situations:

- ▶ Groups of gross positions (with no offsetting risk positions within the group)
- ▶ Groups of gross positions where only a bottom layer is hedged
- ▶ Groups of net positions (where the variation in the hedged items themselves offset part of the risk that is managed on a group basis)

We consider each of these in detail in the discussion that follows.

### **Hedges of groups of gross positions**

#### ***IASB – Proposed***

The IASB's proposal provides that a group of gross positions may be an eligible hedged item if both:

- ▶ The group consists of items (including components of items) that are individually eligible as a hedged item (i.e., the qualification criteria must be satisfied by each individual item within the group).
- ▶ The items in the group are managed together on a group basis for risk management purposes.

#### ***FASB – Current and proposed***

Current and proposed US GAAP allow hedges of a group of liabilities, assets, firm commitments or forecasted transactions (or a specific portion thereof) if the individual items that make up the group share the same risk exposure designated in the hedge. For a fair value hedge, the change in fair value attributable to the hedged risk of each individual item must be expected to respond in a generally proportionate manner to the overall change in fair value of the group. This requirement is often summarized by saying that every individual item must pass a "homogeneity screen."

### **How we see it**

The requirements to hedge groups of gross positions under the IASB's proposal are less restrictive than current or proposed US GAAP, particularly for fair value hedges. In addition, the IASB's proposed requirements would further align an entity's risk management strategies with its hedging activities.

One issue that would have to be resolved by the FASB if it considers this provision is how to account for an item that was fair value hedged once it is no longer part of the hedged group. The Board would have to resolve how the adjustment to the carrying value would be attributed to a particular hedged item for eventual income statement recognition.

## Hedges of layers of groups of gross positions

### *IASB – Proposed*

The IASB's proposal would permit a layer component of a nominal amount to be designated as the hedged item in a fair value hedge. A "layer" is expressed in an amount of currency (e.g., "bottom \$50 million of our \$100 million debt") as opposed to a "proportion" that is expressed as a percentage (e.g., 50% of our \$100 million debt). To designate a layer component, all of the following conditions must be met:

- ▶ The layer component must be specified from a defined nominal amount (e.g. the last \$80 million of a \$100 million firm commitment or the top layer of \$20 million of a \$100 million fixed rate bond).
- ▶ The layer component must be tracked to determine *when* the layer component must be recognized in profit or loss.
- ▶ The contract cannot include a prepayment option whose fair value is affected by changes in the hedged risk. Therefore, the bottom layer of a fixed-rate loan with a prepayment option at par is not an eligible layer component.

This guidance would also extend to layers of an overall group of items (e.g. a bottom layer), based on similar conditions as follows:

- ▶ The items in the overall group are separately identifiable and reliably measurable.
- ▶ The items must be exposed to the same hedged risk.
- ▶ The entity must be able to identify and track the overall group of items from which the hedged layer is defined.
- ▶ The items in the group do not contain prepayment options other than those whose fair value is not affected by the hedged risk for fair value hedges.

The ability to designate a layer component would be particularly useful for fair value hedges of existing transactions subject to non-performance risk.

For example, assume an entity has 10 non-prepayable fixed-rate bond assets of \$10 million principal each. It wishes to hedge \$40 million for interest rate risk. If consistent with its risk management objective, the entity may designate a bottom layer of \$40m from the 10 bonds (a defined group). Therefore, up to \$60 million of bonds could be sold without affecting the hedge relationship, because the hedged \$40 million will remain. Alternatively, the top \$60 million of bonds could be designated within a fair value hedge under the IASB's proposal, if their disposal was expected and the risk management strategy was to protect the fair value of the portion to be sold first.

### *FASB – Current and proposed*

Current and proposed US GAAP does not specifically contemplate the designation of a layer component in a fair value hedge, but under some interpretations it may be non-objectionable if clearly designated at the inception of the hedge.

## **How we see it**

The proposal does not affect cash flow hedges, where "the last XX units" to be transacted in a given period will not be allowed to be hedged. Accordingly, we see no theoretical objection in US GAAP to what the IASB model proposes.

## Hedges of net positions

### *IASB – Proposed*

The IASB's proposal would allow a group of net positions to be an eligible hedged item in a fair value hedge based on the same criteria mentioned above for groups of gross positions:

- ▶ The items in the group must be individually eligible hedged items (i.e., the qualification criteria must be satisfied by each individual item within the group).
- ▶ The items in the group must be managed together on a group basis for risk management purposes.

For the purpose of cash flow hedge accounting, the IASB's proposal specifies an additional criterion, which would require any offsetting cash flows in the group to affect profit or loss in the same reporting period (including interim reporting periods).

For example, if an entity anticipates both the purchase of a fixed asset for FC200 million and FC100 million of sales in six months, a net hedge would be precluded as the FC100 million of sales will affect profit or loss in six months, whereas the fixed asset will affect profit or loss over a period of years through depreciation. Therefore, even though the hedged cash flows might occur on the same day, hedge accounting of the net amount is not permitted because recognition in profit or loss is over different reporting periods.

### *FASB – Current and proposed*

Current and proposed US GAAP do not permit the designation of a net position.

## **How we see it**

Under US GAAP, hedgers have attempted to achieve the hedging results of a net position designation by designating a percentage of the gross exposure forming the net position. For example, if an entity forecasts a forecast foreign currency sale of FC100 million and a purchase of FC80 million in month 1, hedge accounting could be applied by designating FC20 million of a forward exchange contract as hedging FC20 million of the first FC100 million in forecast sales.

The net margin would be affected in the same way as if a net exposure were allowed to be designated.

The ability to hedge a net position would likely make hedges of net exposures easier than under current practice, however. We believe it may be most advantageous in industries with certain commodity exposures such as energy refiners that are exposed to crude oil purchase prices and refined product sales prices.

## **Presentation and disclosure**

### Presentation – Net position hedges

#### *IASB – Proposed*

For a fair value hedge of net positions, the IASB proposal would require that all of the items in the overall net position must be recognized on the balance sheet on a gross basis (next to each line item that includes the related asset or liability<sup>9</sup>).

Changes in the fair value of both the hedged item (attributable to changes in the hedged risk), and the hedging instrument would be recognized in OCI with any ineffectiveness recognized in profit or loss immediately. Also, if the groups of items with offsetting hedged risk positions affect different line items in profit or loss, the hedging gains or losses would be presented in a separate line in the income statement, as illustrated in the following example:

**Illustration 5 – Presentation of net position hedges**

Consider a net position of a \$100 fixed-rate loan asset and a \$80 fixed-rate debt liability hedged on a group basis for risk management purposes with a \$20 receive fixed swap. Since the two offsetting items affect two different line items in the income statement (interest income and interest expense), the gains or losses recognized in profit or loss on the swap would be presented in a separate line. Assuming the effect of the hedge is a gain of \$7, and under IAS 39, the hedge was designated as a proportion of the \$100 fixed-rate loan asset, the proposed and current presentation under IFRS would look as follows:

Income statement	Proposed IFRS	IAS 39
Interest income (fixed rate of the loan)	\$ 40	\$ 47
Interest expense (fixed rate of the debt)	(30)	(30)
Hedging (gain/loss)	<u>7</u>	<u>-</u>
<b>Net interest income/(expense)</b>	<b>\$ <u>17</u></b>	<b>\$ <u>17</u></b>

Similarly, for a cash flow hedge of net positions, any hedging instrument gains or losses recognized in profit or loss shall be presented in a separate line, if the items in the net position affect different line items in the income statement. Therefore, when forecasted sales and purchases are an eligible hedged net position (e.g., because they affect profit or loss in the same period), their corresponding line items in the profit or loss (“sales” and “cost of goods sold”) would still be recorded at spot rate and not reflect the effect of the hedge (which is to be shown on a separate line). This may not be the desired outcome for many entities, as volatility would still occur in gross line items in the income statement.

Consider an entity with a USD functional currency forecasts that sales of €80 and purchases of €54 to occur in six months. For risk management purposes, the entity hedges the foreign currency exposures related to the net position of €26 with a forward contract at a rate of 0.75. The spot rate on settlement is 0.70, resulting a loss on the forward of \$2. The proposed and current presentation under IFRS would look as follows:

Income statement	Proposed IFRS	IAS 39
Sales (recorded at spot rate)	\$ 114	\$ 112
Cost of sales (recorded at spot rate)	(77)	(77)
Hedging gain/(los)	<u>(2)</u>	<u>-</u>
Gross profit (reflected at hedged rate)	\$ 35	\$ 35

The basis for this presentation is to preserve each gross line item in its “natural” state since the hedger did not designate its hedge as of either of the two gross exposures.

### **Presentation – Fair value hedge accounting**

#### ***IASB – Proposed***

The IASB proposal would change the method of accounting for fair value hedges so that it is more in line with that for cash flow hedging. Changes in the fair value of both the hedging instrument and the hedged item would be recognized in OCI and any difference (ineffectiveness) would be recognized in profit or loss immediately. The IASB proposal on fair value hedge mechanics is aimed at reflecting the effect of the hedging activity in one place in the primary financial statements.

The proposal would also result in changes in presentation to the face of the balance sheet in that the cumulative gain or loss on the hedged item attributable to the hedged risk will be presented as a separate line item in the balance sheet, rather than being included as an adjustment to the carrying amount of the hedged item as currently required under IFRS. (In an IASB meeting on 27 April 2011, the Board began to reconsider this presentation and, therefore, it may not survive to the final standard.)

<b>Illustration 6 – Fair value hedge journal entries</b>			
<b>Scenario 1 – FV of hedged item &gt; FV of hedging instrument</b>		<b>Scenario 2 – FV of hedging instrument &gt; FV of hedged item</b>	
FV change of hedged item	100	FV change of hedged item	80
FV change of hedging instrument	(80)	FV change of hedging instrument	(100)
<b>Accounting for the hedged item</b>		<b>Accounting for the hedged item</b>	
DR Cumulative FVH adjustment (BS)	100	Dr Cumulative FVH reserve (BS)	80
CR OCI	(80)	Cr OCI	(80)
CR Hedge ineffectiveness (P&L)	(20)		
<b>Accounting for the hedging instrument</b>		<b>Accounting for the hedging instrument</b>	
Dr OCI	80	Dr OCI	80
Cr Hedging instrument (BS)	(80)	Dr Hedge ineffectiveness (P&L)	20
		Cr Hedging instrument (BS)	(100)
▶ No net effect on OCI Ineffectiveness of (20) taken to P&L		▶ No net effect on OCI Ineffectiveness of 20 taken to P&L	

### ***FASB – Current and proposed***

The accounting for fair value hedges would remain unchanged from current US GAAP under the FASB proposal and would continue to require a basis adjustment to the hedged item for changes in fair value attributable to the hedged risk. Changes in the fair value of both the hedging instrument and the hedged item would be recognized in profit or loss immediately.

### **Disclosures**

The IASB's proposed disclosure requirements are extensive but generally consistent with the objective that hedge accounting is aligned with an entity's risk management activities. In addition to the requirements in IFRS 7,<sup>10</sup> the proposal would require an entity to disclose the following:

- ▶ 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
- ▶ The overall effect that hedge accounting has had on the entity's financial statements

The disclosure requirements under US GAAP would remain substantially the same, other than the additional disclosures required regarding fair value adjustments in a fair value hedge relationship and benchmark interest risk hedges of an entity's own issued debt or other liabilities.

### **How we see it**

The IASB proposal's disclosure requirements are considerably more expansive than under current US GAAP, which would still be primarily defined by the disclosures that were issued in with the issuance of FASB Statement 161. Respondents to the IASB exposure draft expressed concerns that some of the information required to be disclosed is not appropriate for the financial statements. Many believed the proposal needs to better articulate the linkage between an entity's risk management object and its hedge accounting. This might be achieved by requiring entities to explain their risk management strategy, the extent to which it is aligned (or, the extent to which it is different) to hedge accounting and the related consequences.

Although some view the two current hedge accounting models as more converged than the two proposed models, we support both Boards' efforts to make hedge accounting more accessible.

## What's next

- ▶ The IASB has already moved forward in its redeliberations, having received comments from its constituents in early March. The FASB, which postponed deliberations on the hedging model while it focused its efforts this fall and winter on classification and measurement and impairment, has just begun to consider comments on the IASB model that were due on April 25.
- ▶ While we recommended joint deliberation ensue on the hedging model, there are no assurances that that will occur. The more ambitious agenda of the IASB has left certain areas of their model in need of further clarity, according to many respondents. Because the FASB is likely to hear the same requests for clarity regarding the otherwise well-received IASB model, there may be an opportunity for joint dialogue.

## Endnotes:

- <sup>1</sup> IASB Exposure Draft 2010-13, *Hedge Accounting* and FASB Proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedge Accounting*
- <sup>2</sup> FASB Discussion Paper, *Selected Issues about Hedge Accounting*
- <sup>3</sup> International Accounting Standard 39, *Financial Instruments: Recognition and Measurement*
- <sup>4</sup> The terms of hypothetical derivatives mirror those of the cash flows from the forecast debt, thus, representing the hedged item. Accordingly, the pay/receive legs are mirror opposite of the actual derivatives.
- <sup>5</sup> Represents terms that at 1 January 2010, would have resulted in an inception fair value of zero and a pay leg equivalent to three-month LIBOR
- <sup>6</sup> The hedging instrument for periods beginning 1 July 2010 and afterward is a combination of the actual forward starting swap and the basis swap. Therefore, the fair value represents the total fair value of the two derivatives.
- <sup>7</sup> Journal entries related to recording interest payments of the debt, swap settlements, and reclassification of hedge effectiveness from OCI to profit or loss as hedge cash flows affect earnings are not illustrated here.
- <sup>8</sup> The 30 June quarterly effectiveness assessment and ineffectiveness measurement will be the same procedures as those in the quarter ended 31 March 2010. However, an additional ineffectiveness measurement calculation will be performed as of 30 June 2010, when the debt is issued.
- <sup>9</sup> If the net position pertains to off-balance sheet exposures such as firm commitments, then the amount is presented in a separate line (as is current practice), although there is no asset or liability pertaining to the hedging gain or loss.
- <sup>10</sup> International Financial Reporting Standard 7, *Financial Instruments: Disclosures*

Ernst & Young

Assurance | Tax | Transactions | Advisory

© 2011 Ernst & Young LLP.

All Rights Reserved.

SCORE No. BB2125

### About Ernst & Young

Ernst & Young is a global leader in assurance, tax, transaction and advisory services. Worldwide, our 141,000 people are united by our shared values and an unwavering commitment to quality. We make a difference by helping our people, our clients and our wider communities achieve their potential.

Ernst & Young refers to the global organization of member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit [www.ey.com](http://www.ey.com).

Ernst & Young LLP is a client-serving member firm of Ernst & Young Global Limited operating in the US.

This publication has been carefully prepared but it necessarily contains information in summary form and is therefore intended for general guidance only; it is not intended to be a substitute for detailed research or the exercise of professional judgment. The information presented in this publication should not be construed as legal, tax, accounting, or any other professional advice or service. Ernst & Young LLP can accept no responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this publication. You should consult with Ernst & Young LLP or other professional advisors familiar with your particular factual situation for advice concerning specific audit, tax or other matters before making any decision.