Project	**Financial Instruments (Replacement of IAS 39)—Hedge accounting**
Topic	**Hedge accounting for equity investments at fair value through other comprehensive income**

Introduction

Background and purpose

1. In December 2010, the Board published the exposure draft *Hedge Accounting* (ED). The three-month comment period ended 9 March 2011. During the public consultation period the IASB engaged in extensive outreach activities on its proposals set out in the ED. In March 2011, the Board discussed a high level summary of the comment letters received and a summary of the outreach activities.

2. One of the prominent issues that was raised during the public consultation period is that hedge accounting should not be limited to managing exposures arising from particular risks that could affect *profit or loss*. Although almost all respondents to the comment letters and participants from outreach activities are supportive of the ED's objective, a large majority of respondents and participants are of the view that hedge accounting should also be available for equity investments at fair value through other comprehensive income (FVTOCI). Some respondents are also of the view that hedge accounting should *generally* be available for exposures that affect *comprehensive income.*

3. The purpose of this paper is to ask the Board whether:

   (a) equity investments at FVTOCI should be eligible for hedge accounting; and

This paper has been prepared by the technical staff of the IFRS Foundation for discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in IASB *Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

(b) whether hedge accounting should *generally* be available to exposures that affect comprehensive income (ie profit or loss *or* OCI).

4. This paper addresses those issues together because they are interrelated:

(a) Allowing hedge accounting for equity investments at FVTOCI would require expanding the objective of hedge accounting so as to also include items that affect only OCI but not also profit or loss.

(b) If the objective of hedge accounting is expanded to that effect then the question arises whether that should only be for the benefit of *equity investments* at FVTOCI or rather apply to all items that might only affect OCI but not also profit or loss.

Structure

5. The structure of the paper is as follows:

(a) overview of the ED's proposals;

(b) summary of the feedback from comment letters and outreach activities;

(c) equity investments at FVTOCI:

(i) alternatives for how the Board could proceed;

(ii) staff analysis;

(iii) staff recommendation; and

(iv) question to the Board;

(d) eligibility of hedge accounting for exposures that affect comprehensive income:

(i) alternatives for how the Board could proceed;

(ii) staff analysis and recommendation; and

(iii) question to the Board.

Overview of the Board's proposal in the ED

6. The ED proposes that the objective of hedge accounting is to represent in the financial statements the effect of an entity's risk management activities that use financial instruments to manage exposures arising from particular risks that could affect profit or loss. Hence, the ED's proposed objective limits the eligibility to exposures that affect profit or loss. This is reflected in the 'definition-like' description of the types of hedging relationships in the ED. For a fair value hedge and a cash flow hedge the description refers to exposures that could affect *profit or loss*.[1]

7. The Board in its deliberations concluded that hedge accounting for equity investments at FVTOCI cannot be facilitated within the general hedge accounting mechanics because profit or loss is not affected by any fair value changes from any particular risks inherent in such equity investments.

8. The Board was also concerned about the accounting for hedge ineffectiveness in such a hedging relationship. When changes in the value of the equity investment at FVTOCI attributable to the hedged risks are bigger than the changes in the fair value of the hedging instrument, leaving hedge ineffectiveness in OCI would be consistent with the Board's decision in IFRS 9 *Financial Instruments* for equity investments at FVTOCI, but contradict the hedge accounting principle that hedge ineffectiveness should be presented in profit or loss. On the other hand, if the hedge ineffectiveness were presented in profit or loss it would be consistent with the hedge accounting principles but contradict the prohibition of reclassifying from OCI to profit or loss gains or losses on investments in equity instruments at FVTOCI.

9. In addition, the Board also noted that applying hedge accounting to equity investments at FVTOCI would be:

[1] See ED.21(a)-(b).

(a) layering an exception on top of another exception—presenting changes in fair value of the equity instrument in OCI is already an exception to the normal classification in IFRS 9.

(b) adding complexity for mitigating an accounting mismatch that results from an accounting *choice* in IFRS 9—entities have the *choice* of whether they want to present the changes in fair value of an investment in an equity instrument in OCI or not. If they do not make this election hedge accounting would be available.[2]

10. Hence, the ED proposes that hedge accounting shall not be applied to investments in equity instruments classified as at FVTOCI.

Feedback from comment letters and outreach activities

Summary

11. Many respondents and participants are of the view that hedge accounting should be available for equity investments at FVTOCI so that hedge accounting can be more closely aligned with risk management activities. Many felt that by limiting the eligibility to risks that affect profit or loss, the ED is inconsistent with the proposed objective of aligning accounting more closely with risk management.

12. Many respondents and participants commented that risk management practice manages risk exposures in the same way for those equity investments at FVTOCI and those at fair value through profit or loss (FVTPL). Many respondents and participants commented that a common risk management strategy is for entities to hedge the foreign exchange (FX) risk exposure of equity investments at FVTOCI, eg a foreign currency denominated liability is

[2] Although this still can result in mismatches as discussed later in the paper.

used to hedge the FX risk of a ‘strategic’ equity investment denominated in the same foreign currency.

13. Other respondents and participants also commented that entities may also manage the equity price risk from these equity investments at FVTOCI the same way as other equity investments at FVTPL and felt that the prohibition discourages risk protection against equity risk.

14. Some respondents noted that even if these assets were ‘strategic’ in nature and they did not intend to sell the assets, in order to protect their equity balances they do hedge these assets particularly against FX risk but also downside price risk. This comment was common from financial institutions whose regulatory capital would be affected if these exposures were unhedged.

15. Some respondents further commented that although entities could choose to account for the equity investments at FVTPL under IFRS 9, the accounting would still give rise to accounting mismatches if entities hedge the equity investment for part of the holding period or if they hedge them for only some risks.

16. Hence many respondents and participants think that economic hedges for either FX risk or price risk for equity investments at FVTOCI should be accommodated in the final requirements.

17. Some respondents noted that the ED permits a forecast dividend from such equity investments to be an eligible hedged item and concluded that that it is illogical to prohibit hedge accounting to apply to the fair value of the equity investment since the fair value is the sum of the discounted forecast dividends.

18. We have also received suggestions from respondents and participants on the accounting for hedge ineffectiveness for items that affect OCI. They suggest that hedge ineffectiveness could be accounted in the following ways:

    (a) all ineffectiveness could be presented in OCI—since both profit or loss and OCI are elements of one overall performance statement; or

(b) if fair value changes of the hedging instrument are more (less) than the hedged item, hedge ineffectiveness could be presented in profit or loss (OCI); or

(c) *all* ineffectiveness could be presented in profit or loss.

19. Some respondents further suggest there are also other economic hedging relationships (other than hedging equity investments at FVTOCI) for which the fair value changes of the hedged item affect OCI, eg hedging actuarial gains and losses arising from interest rate risk and mortality risks for defined benefit plans. They argue that such hedging strategies should also be accommodated under the Board's final requirements by extending the eligibility of hedge accounting more generally to risks that affect comprehensive income (ie profit or loss *or* OCI).

Equity investments at FVTOCI

Alternatives for how the Board could proceed

20. The staff think that the Board has at least the following alternatives:

(a) **alternative 1**—prohibit the application of hedge accounting to equity investments at FVTOCI;

(b) **alternative 2**—allow the application of hedge accounting to equity investments at FVTOCI. The alternatives for accounting for hedge ineffectiveness from qualifying hedging relationships are:

(i) **alternative 2a**: present all ineffectiveness in OCI;

(ii) **alternative 2b**: if fair value changes of the hedging instrument are more (less) than equity investment at FVTOCI, hedge ineffectiveness is presented in profit or loss (OCI); and

(iii) **alternative 2c**: present all ineffectiveness in profit or loss.

Staff analysis and recommendation

Alternative 1—finalise proposal in the ED

21. The reasons for this alternative have been outlined in paragraphs 6 to 10 above.

22. Some respondents noted that the ED permits a forecast dividend from such equity investments to be an eligible hedged item and concluded that hedge accounting should also be available for the fair value of the equity investment given that the fair value of an equity investment is considered as an estimation of the present value of the future dividend cash flows. The staff note that forecast dividends are eligible hedged items because dividends that are a return on investment[3] are recognised in *profit or loss* and hence a forecast dividend would meet the definition of a cash flow hedge and the objective as defined in the ED.

23. The following table summarises the advantages and disadvantages of alternative 1:

Advantages	**Disadvantages**
• Does not introduce additional complexity into IFRS 9 • Helps ensure FVTOCI is only used when an entity is not focused on price performance consistent with the Board's original aim of limiting this to strategic investments	• May not align with risk management practices and hence may be inconsistent with the overall objective of hedge accounting (refer to paragraphs 11 and 12) • Cannot elect the FVTOCI option after inception; if the hedge is only for a limited period, retaining the initial

[33] IFRS 9.B5.12 restricts dividends recognised in profit or loss for equity investments at FVTOCI to those that are a return *on* investment. Dividends that are a return *of* investment are not recognised in profit or loss.

Advantages	Disadvantages
	classification of the equity investment at FVTPL would not be representative of the business model

Alternative 2a

24. Alternative 2a is to allow the application of hedge accounting to equity investments at FVTOCI and present the hedge ineffectiveness from such hedging relationship in OCI—provided that the hedging relationship meets the qualifying criteria.

25. Respondents and participants who suggest this approach argue that presenting ineffectiveness in OCI may be just as appropriate as recognising ineffectiveness in profit or loss since profit or loss and OCI are presented in one overall performance statement. Hence, ineffectiveness would be presented in the performance statement and is consistent with the Board's move towards the concept of one single performance statement.

26. The following table summarises the advantages and disadvantages of alternative 2a:

Advantages	Disadvantages
• Allows entities to better reflect their risk management activities hence is more consistent with the overall objective of hedge accounting • Less complex than alternative 2b • Allows entities to better reflect	• 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

Advantages	Disadvantages
the nature of the equity investment that is in line with their business model (when not hedging the entire holding period)	

Alternative 2b

27. Alternative 2b is to allow the application of hedge accounting to equity investments at FVTOCI. In relation to hedge ineffectiveness, if fair value changes of the hedging instrument are more (less) than the hedged item, hedge ineffectiveness could be presented in profit or loss (OCI).

28. Respondents and participants who suggest this approach argue that this approach may avoid contradicting principles of the FVTOCI category (or the presentation of gains and losses on derivatives). However, as Appendix A illustrates, the *cumulative* ineffectiveness presented in profit or loss or OCI over the total period of the hedging relationship may still contradict the principle of recognising changes in the fair value of equity investments at FVTOCI in OCI (without recycling to profit or loss).

29. The following table summarises the advantages and disadvantages of alternative 2b:

Advantages	Disadvantages
• 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	• Makes the option to classify equity investments at FVTOCI more attractive (and hence increases its use) • More complex than alternatives 2a and 2c

Advantages	Disadvantages
the nature of the equity investment that is in line with their business model (when not hedging the entire holding period)	• Changes the current hedge accounting principle—hedge ineffectiveness as a result of 'under hedging' in a fair value hedge would not be presented in profit or loss • Presentation in profit or loss and OCI over the hedge period may not be consistent with the FVTOCI category

Alternative 2c

30. Some respondents and participants suggest allowing the application of hedge accounting to equity investments at FVTOCI and presenting all ineffectiveness in profit or loss.

31. The staff note that this alternative will result in recycling to profit or loss the fair value changes of the equity investment to the extent that the fair value change of the equity investment is greater than that of the hedging instrument. Arguably this would be inconsistent with the Board's recent decisions on recycling where recycling has generally been prohibited prior to a broader consideration of the role of OCI and recycling.

32. The following table summarises the advantages and disadvantages of alternative 2c:

Advantages	Disadvantages
• Allows entities to better reflect their risk management activities hence is more	• Makes the option to classify equity investments at FVTOCI more attractive (and hence

Advantages	Disadvantages
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) • Less complex than alternative 2b	increases its use) • Inconsistent with the FVTOCI classification—would allow recycling to profit or loss of fair value changes of the equity investment at FVTOCI (ie would create an exception)

Staff recommendation

33. In its deliberations and redeliberations of the classification and measurement phase of IFRS 9, the Board considered that only *strategic* equity investments should qualify for the FVTOCI presentation. A key feature of holding such equity investments is that the equity price and/or expected dividend flows are not (or not the only) factor behind a sell or hold decision. The staff note that entities that hold these *strategic equity investments* may still wish to manage their exposure to FX risk (eg by borrowing in the same currency as the equity investment). Entities may still need to enter into hedging activities in order to protect their equity balances.

34. However, in finalising IFRS 9, the Board did not define *strategic equity investment*, and only limited the FVTOCI presentation option to equity investments that are not *held for trading*. Although the Board arguably still had an objective of targeting strategic equity investments by prohibiting recycling for these investments, respondents and participants have argued that entities may

still hedge and protect themselves from the equity price changes without contradicting the requirement *as finalised* by IFRS 9.

35. Some have argued that if the entity decides to hedge the equity investment it does not have to choose the FVTOCI option. In finalising IFRS 9, the Board decided that the option must be selected at initial recognition and is irrevocable (to limit the use of this option and hence avoid the trouble that would arise from reclassifications). The staff note that respondents and participants have argued that even if the FVTOCI option is not elected, an accounting mismatch would still arise if the entity economically hedges for only part of holding period of the equity investment or only hedges some risks. The staff note that because entities want to avoid accounting mismatches, the irrevocable election at inception limits the ability for entities to designate the equity investment at FVTOCI after the end of the hedge. If the entity does not designate the equity investment at FVTOCI at inception the default classification of FVTPL applies. The entity cannot reclassify that equity investment to FVTOCI after the end of the hedge term—even if the equity investment meets all the qualifying criteria for the FVTOCI option and better reflects the entity's business model.

36. The staff note that allowing equity investments at FVTOCI to be eligible for hedge accounting would make the option to classify equity investment at FVTOCI more attractive and hence increase its use. Furthermore, it would require the Board to reconsider the objective of hedge accounting.

37. However, the staff also note that it would provide a better reflection of entities' risk management practices. For the reasons outlined in paragraphs 33 and 35 above the staff recommend that the Board should consider allowing the application of hedge accounting to equity investments at FVTOCI.

38. If the Board allows the application of hedge accounting to equity investments at FVTOCI, there are three alternatives on how to account for hedge ineffectiveness for those hedging relationships that qualify and meet the effectiveness testing requirements (see paragraph 24 to 32). The staff note that alternatives 2a and 2c are less complex than alternative 2b.

39. As appendix A illustrates, the *cumulative* ineffectiveness presented in profit or loss or OCI over the total period of the hedging relationship may still contradict the principle of recognising changes in the fair value of equity investments at FVTOCI in OCI (without recycling to profit or loss). The staff is also of the view that the ineffectiveness can be more easily understood if it is presented in one place. Hence the staff does not recommend alternative 2b.

40. Alternative 2c introduces recycling of fair value changes of the equity investment to profit or loss. Hence, it is inconsistent with the finalised requirement of the FVTOCI presentation option under IFRS 9. Alternative 2c introduces an exception to the FVTOCI category, ie an exception on an exception. In the staff's view this is not in line with the aim to reduce complexity in accounting for financial instruments.

41. Alternative 2a requires broadening the approach of hedge accounting to further align risk management practice with hedge accounting. The staff does not consider that this would contradict the principles in IFRS 9 and hence it would not introduce an exception. Alternative 2a is also consistent with the Board's move towards the concept of a single performance statement.

42. On balance, the staff recommend alternative 2a. This assumes that the Board agrees that equity investments at FVTOCI are eligible hedged items. If the hedging relationship qualifies for hedge accounting, any hedge ineffectiveness is presented in OCI.

Question 1— equity investments at FVTOCI
Does the Board agree with the staff recommendation to adopt alternative 2a as outlined in paragraph 42? If the Board does not agree, which alternative does the Board prefer and why?

Applying hedge accounting to exposures that affect comprehensive income

43. This section is only applicable if the Board decides to adopt alternatives 2a, 2b or 2c.

44. Many respondents have suggested that the objective of hedge accounting should include risks that affect comprehensive income.

Alternatives for how the Board could proceed

45. The staff think that the Board has at least the following alternatives:

    (a) **alternative A**—*only* equity investments at FVTOCI would be eligible for hedge accounting; and

    (b) **alternative B**—*any* exposures that would effect OCI (where recycling is prohibited) are eligible for hedge accounting.

Staff analysis and recommendation

46. We learnt from comment letters and outreach activities that entities also engage in economic hedges of defined benefit obligations. Similar to equity investments at FVTOCI, there are changes in actuarial gains or losses of defined benefit obligation are presented in OCI and not recycled to profit or loss. Entities with defined benefit pension plans hedge interest rate risk, foreign currency and mortality risk using long dated interest rate, foreign currency or longevity swaps.

47. The staff is of the view that alternative B would facilitate better alignment with risk management practice and is more consistent with principle-based accounting. Alternative B would also ‘future proof’ the new hedge accounting model regarding the use of OCI in the future.

48. Alternative B would involve amending the description of a cash flow hedge and a fair value hedge to exposures that could affect *profit or loss* or *other comprehensive income*. Whereas alternative A would involve introducing an

exception to the hedge accounting objective, and the description of a fair value hedge.

49. Hence, the staff recommend that the Board adopt alternative B, ie extend the objective of hedge accounting to exposures from particular risks that affect comprehensive income (ie profit or loss or other comprehensive income (where recycling is prohibited)).

Question 2—applying hedge accounting to exposures that could affect comprehensive income
Does the Board agree with the staff recommendation to adopt alternative B? If the Board does not agree, what does the Board prefer instead and why?

Appendix A

A1. Appendix A illustrates the mechanics of alternative 2b. Under alternative 2b, if fair value (FV) changes of the hedging instrument are more (less) than the hedged item, hedge ineffectiveness is presented in profit or loss (OCI).

A2. This example illustrates that the *cumulative* ineffectiveness presented in profit or loss or OCI over the total period of the hedging relationship may still contradict the principle of recognising changes in the fair value of equity investments at FVTOCI in OCI (without recycling to profit or loss).

	t0	t1	t2	t3	Total FV change
Equity investment at FVTOCI	150	130	180	110	
Change in FV		-20	50	-70	-40
Hedging instrument	-	30	-20	20	
Change in FV		30	-50	40	20

	t0	t1	t2	t3
Balance sheet				
Asset				
Equity investment at FVTOCI	150	130	180	110
Derivative	-	30	-	20
Liability				
Derivative	-	-	(20)	-
Equity				
Issued capital	(150)	(150)	(150)	(150)
Retained earnings		(10)	(10)	(10)
AOCI		-	-	30
( ) = credit				

Statement of Comprehensive Income		t1	t2	t3	Total
Profit or (loss)					
Hedge ineffectiveness		10	-	-	10
Other comprehensive income					
FV changes of equity investment at FVTOCI		-20	50	-70	-40
FV change of hedging instrument-derivative		30	-50	40	20
Transfer to profit or loss		-10	-	-	-10
		-	-	-30	-30

A3. In t1, there is an ‘over hedge’ of 10 (FV change of hedging instrument is 30 and equity investment at FVTOCI is -20), hence a gain of 10 is recognised in profit or loss.

A4. In t2 the *period* FV change of the equity investment is 50 and that of the hedging instrument is -50. No ineffectiveness is recognised. However, the *cumulative* change of the equity investment at FVTOCI is 30 and that of the hedging instrument is -20. According to the mechanics under alternative 2b, 10 ineffectiveness should be recognised in OCI since the gain on the equity investment is larger than the loss on the hedging instrument (from the perspective of the total hedge period from inception to t2). However, hedge ineffectiveness was presented in profit or loss because the ineffectiveness from the FV changes from t1 were recognised in profit or loss when it arose.

A5. In t3 the *period* FV change of the equity investment is -70 and that of the hedging instrument is 40. A loss of -30 is recognised in OCI as ineffectiveness. The *cumulative* FV change of the equity investment at FVTOCI is -40 and that of the hedging instrument is 20. According to the mechanics under alternative 2b, -20 ineffectiveness should be recognised in OCI (from the perspective of the total hedge period). However, due to the accounting in previous periods, hedge ineffectiveness is presented in other comprehensive income as -30 and a gain of 10 was previously recognised in profit or loss (from the perspective of the total hedge period).